STAFF PAPER

Week commencing 27 February 2012

FASB | IASB Meeting

Project	**Insurance Contracts**
Paper topic	Premium Allocation Approach – FASB staff recommendations on Eligibility

CONTACT(S)	Lauren Alexander	lalexander@fasb.org	+1 203 956 5282
	Andrea Silva	alsilva@fasb.org	+1 203 956 3445
	Jennifer Weiner	jmweiner@fasb.org	+1 203 956 5305

What is the paper about?

1. This paper should be read in conjunction with agenda paper 3E/79E *Premium allocation approach: amendments to the January staff recommendations on Eligibility and Mechanics*. This purpose of this paper is to:

   (a) Summarize the FASB staff's proposals regarding eligibility for the premium allocation approach, including the use of the updated eligibility criteria in agenda paper 3E/79E and a practical expedient, and

   (a) Discuss whether the premium allocation approach should be permitted or required.

2. Agenda paper 3H/71H sets out the IASB staff's proposals on eligibility for the premium allocation approach. The main differences between the FASB staff proposals and the IASB staff proposals are as follows:

   (a) The FASB believe eligibility for the premium allocation approach should be determined by eligibility criteria described in agenda paper 3E/79E. The IASB staff recommend that eligibility for the premium allocation approach should be determined by an overall principle, supported by the eligibility criteria in agenda paper 3E/79E as application guidance.

(b) The FASB staff recommend that the premium allocation approach should be required for contracts that qualify for premium allocation approach. The IASB staff recommend that the premium allocation should be permitted for contracts that qualify for premium allocation approach.

Staff Analysis

Inclusion of a practical expedient

3. The FASB staff recommend that the principles-based eligibility criteria described in agenda paper 3E/79E should determine eligibility for the premium allocation approach. In addition, the staff recommend that application guidance should be included to clarify and provide more information regarding circumstances when the criteria are met.
4. The Board asked the staff to explore whether there should be a practical expedient to determine that the proposed eligibility criteria are met. The staff note that when insurance contracts have a coverage period of one year or less:

   (a) There are unlikely to be significant changes in expectations about future cash flows before the claim is incurred;

   (b) There is no uncertainty about the coverage period;

   (c) Judgment regarding the period of time to allocate the premiums is not likely to be significant.

5. In addition, the staff note:

   (a) The effect of the time value of money before a claim is incurred is likely to be less significant;

   (b) Acquisition costs are likely to be less substantial and if there is any difference in their treatment between the two approaches (building block versus premium allocation), the effect of that difference will disappear over a short period.

6. Consequently, the FASB staff believe that insurance contracts with a coverage period of one year or less are likely to fail at least one of the criteria and hence qualify for the premium allocation approach. Therefore the FASB staff recommend, in addition to the eligibility criteria described in agenda paper 3E/79E, that:

> A contract should fall within the scope of the premium allocation approach without further evaluation if the coverage period is one year or less.

Staff recommendation

7. The staff recommend the following eligibility criteria for the premium allocation approach:[1]

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

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

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

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

         (b) the length of the coverage period.

[1] The staff also recommend that application guidance should be included according to agenda paper 3E/79E.

(b) A contract should fall within the scope of the premium allocation approach without further evaluation if the coverage period is one year or less.

Question 1 – Practical expedient
Do the Boards agree that a contract should fall within the scope of the premium allocation approach without further evaluation if the coverage period is one year or less?

Permit or require

8. The Board also needs to determine whether to:

    (a) Require the premium allocation approach to be applied to contracts that are eligible; or

    (b) Permit the use of the premium allocation approach.

Background

9. Paragraph 54 of the IASB's Exposure Draft requires the premium allocation approach to be applied to contracts that meet the eligibility criteria. BC147 of the Basis for Conclusions of the IASB's Exposure Draft states:

    > *The Board considered whether the modified approach should be permitted but not required. Proponents of that view argue that the modified approach is intended to provide a practical short cut that combines the strengths of the approach now proposed for insurance contracts in general with the virtues of existing approaches for these contracts; for these contracts, they believe that the incremental benefits of switching fully to the new model are not sufficient to justify the costs. Those proponents argue that requiring insurers to use that short cut rather than merely permitting them to do so is inconsistent with the rationale for the short cut. However, to ensure comparability between the*

financial statements of different insurers, the Board proposes to require insurers to apply the modified measurement approach to all short-duration contracts that meet the specified conditions.

10. The FASB Board did not conclude on whether the premium allocation approach should be permitted or required in its Discussion Paper.
11. The boards discussed the premium allocation approach at the Joint Board Meetings held on 27 April 2011, 21 July 2011, and 20 October 2011. Tentative decisions made at those meetings are included in the comparison table below.

Feedback received

12. Some respondents, especially preparers that write both life and nonlife business, would like the premium allocation approach to be permitted rather than required. These respondents indicated that mandatory application of the premium allocation approach would cause composite insurers to apply two different models to similar products. Furthermore, some state that permitting an option to apply the premium allocation approach would be more consistent with the view that the premium allocation approach is a simplification of the building block approach, rather than an alternative model.
13. Others responded that for comparability the premium allocation approach should be required for all contracts that meet the eligibility criteria.
14. Many users expressed a preference to require the premium allocation approach. They prefer consistency in the model applied between insurers who issue similar types of contracts and have similar business models, as they compare these entities' financial statements. Also, in response to the suggestion that differences in the measurement models could be reconciled in the footnotes, they expressed concern that useful information may be obscured by that approach, because they rely on information from press releases for analysis, which includes the amounts from the face of the financial statements, not the footnotes.

Comparison of measurement models

15. The staff considered the tentative decisions regarding both measurement models to determine whether the premium allocation approach should be permitted or required.
16. Some changes made to the premium allocation approach during re-deliberations align it more closely with the revenue recognition model and therefore distinguish it from the building block approach. The staff evaluated these and other changes made during re-deliberations to assess the differences between the measurement models. The staff believe that the extent of the differences will dictate whether to permit or require the premium allocation approach. Said differently, the decision about whether to permit or require should depend on whether the results from the two measurement models are different and whether the differences between the results of the two models can be reconciled in disclosures and effectively communicated to users.
17. The table below summarizes the differences between the building block approach and the premium allocation approach, and the staff assessment of the significance of each difference for contracts that would be eligible for the premium allocation approach using the criteria recommended by the staff.

Issue	Building Block Approach	Premium Allocation Approach	Significance of Differences
Measurement of liability			
Liability for remaining coverage	Explicit, unbiased, and probability-weighted estimate of the future cash outflows, less future cash inflows, that will arise as the insurer fulfils the insurance contract. Cash outflows include direct and incremental acquisition costs as tentatively decided by the respective boards (limited to successful contracts under the FASB approach) FASB: Plus a single margin which is measured as the difference between the amount that the insurer expects to collect from premiums and the amount that the insurer expects to pay out for claims, benefits, and expenses. The single margin is amortized as the insurer is released from risk evidenced by a reduction in the variability of expected cash flows. IASB:	Equal to the premium written at initial recognition. Reduced over the coverage period on the basis of time or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. Not remeasured each reporting period unless facts and circumstances trigger the onerous contract test. Not yet decided whether the liability should be discounted and interest should be accreted. Not yet decided whether the liability should be reduced for acquisition costs or if acquisition costs will be recorded as a separate asset.	Liability for remaining coverage measured using the premium allocation approach is gross of future expected cash inflows whereas the liability for insurance contracts measured using the building block approach is net of future expected cash inflows. Although the liability for remaining coverage is not remeasured each reporting period under the premium allocation approach it is unlikely there would be a significant change in the expected net cash flows in the period before a claim is incurred if it was remeasured. If interest is accreted on the liability for remaining coverage under the premium allocation approach, this will create a difference with the building block approach if the boards decide that there would be no accretion of interest in the premiums due presented in the building block approach. The significance of this difference depends on the circumstances. The boards do not propose that the insurer should split the insurance contract liability into a liability for remaining coverage and a liability for incurred

Issue	Building Block Approach	Premium Allocation Approach	Significance of Differences
	Plus an explicit risk adjustment that may reflect diversification benefits and is remeasured each reporting period. Plus a residual margin which is measured as the difference between the amount that the insurer expects to collect from premiums and the sum of the amount that the insurer expects to pay out for claims, benefits, and expenses and the risk adjustment and is allocated over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.		claims in the building block approach. However, the boards could require insurers to disclose the amounts of claims incurred for contracts measured using the building block approach.
Liability for incurred claims		*FASB* Equal to expected present value of unbiased estimate of probability-weighted expected cash flows, without a single margin. As a practical expedient insurers are not required to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event.	*FASB* The liability for incurred claims under the premium allocation approach does not include a single margin. If the contract was measured using the building block approach, the single margin would be released on the basis of reduced uncertainty in the timing of the specified event or as information about expected cash flows becomes more known throughout the life cycle of the contract. This may be difficult to reconcile.
		IASB Equal to expected present value of fulfilment cash flows plus an explicit risk adjustment that may reflect diversification benefits. The residual margin is not applicable because it is recognized in earnings over the coverage period in the same manner as the liability for remaining coverage. As a practical expedient insurers are not	*IASB* There are no significant differences.

Issue	Building Block Approach	Premium Allocation Approach	Significance of Differences
		required to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event.	
Presentation			
Presentation – Statement of Comprehensive Income	Premiums, claims, benefits, and the gross underwriting margin should be presented in the statement of comprehensive income. The boards have indicated a tentative leaning toward presentation of premiums due. The boards have not yet decided whether this amount would reflect the accretion of interest. Acquisition costs are included in the measurement of the insurance contract liability and reduce the amount of residual/single margin. The Boards have yet to decide how acquisition costs would be presented in profit or loss.	Premiums, claims, benefits, and the gross underwriting margin should be presented in the statement of comprehensive income.[2] The boards have indicated a tentative leaning toward presentation of premiums earned. This amount represents revenue earned by the insurer over the coverage period and is allocated on the basis of time or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. The boards have not yet decided whether to discount and accrete interest on the liability for remaining claims. Acquisition costs are amortized over the coverage period on the basis of time, but on the	Under the premium allocation approach, premium is earned as the insurer satisfies its performance obligations. However, premiums due is not reflective of the exposure and risk the insurer has for each reporting period. While premiums earned and premiums due clearly do not represent the same thing, there may be little difference in the premiums presented in the statement of comprehensive income if: • Premiums are earned in the same pattern as they are due; or • The insurer is in a steady state, writing a similar volume of business each year. Depending on the boards decisions on Agenda Paper 3G/79G and any future decisions on accretion of interest in the building block approach, there may be differences as a result of interest accretion.

[2] Note: The boards will decide later whether these items should be presented separately for contracts measured using the building block approach and the premium allocation approach.

Issue	Building Block Approach	Premium Allocation Approach	Significance of Differences
		basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time, and will be shown in the statement of comprehensive income (as discussed in Agenda Paper 2B/78B for the January 2012 meeting).	The boards could require insurers to disclose the amount of premium due during the reporting period for contracts measured using the premium allocation approach, however, the staff do not believe this is meaningful. There may be differences in the presentation of acquisition costs depending on decisions yet to be taken.
Presentation – Statement of Financial Position	The liability includes the expected present value of the cash outflows, net of the conditional right to premiums. Any unconditional right to premiums should be separately presented in the statement of financial position. The expected future cash flows, the risk adjustment (IASB), the residual margin (IASB), the single margin (FASB), and the effect of discounting should be separately presented in the statement of financial position or in the notes. An insurer should disclose a reconciliation of the opening balance and closing balance of insurance contract liabilities,	The receivable for premiums written but not yet collected should be equal to and presented separately from the liability for remaining coverage. The liability for incurred claims should be presented separately from both of these items (for the IASB, this includes a risk adjustment). An insurer should disclose a reconciliation of the opening balance and closing balance of insurance contract liabilities, insurance contract assets, and risk adjustments (IASB). The Boards have not yet decided if acquisition costs should be presented as a separate asset.	These differences are not significant, as differences between gross presentation and net presentation could be reconciled in the rollforward of opening balances and closing balances in the disclosures.

Issue	Building Block Approach	Premium Allocation Approach	Significance of Differences
	insurance contract assets, risk adjustments (IASB), residual margins (IASB), and single margins (FASB).		

Permit the Premium Allocation Approach

18. If any significant differences between the premium allocation approach and the building block approach can be reconciled in disclosures, concerns about comparability may not be warranted. If so, some believe it would not be appropriate to prevent insurers from applying the building block approach in full. Some entities have the capabilities to perform the full building block approach – in most cases because the insurer writes both life and nonlife insurance contracts. These entities have various reasons for wanting to apply the building block approach, including for consistency within their entity. Requiring composite insurers to apply two approaches could be more complicated than applying a single (building block) approach for all contracts, thereby defeating the objective of the premium allocation approach.
19. As mentioned above, the staff considered whether the decision to permit or require the premium allocation approach should depend on whether the results are similar from each measurement model. As the table above indicates, many of the differences between the premium allocation approach and the building block approach could be reconciled in the footnotes to the financial statements. As a result, with appropriate disclosures of an entity's policies, users of the financial statements can determine the approximate differences for the significant items and access the information they need to understand the financial position and performance of an entity. It may therefore be argued that entities should be given the option of applying the building block approach or the premium allocation approach.

Require the Premium Allocation Approach

20. As mentioned, the main argument to require the premium allocation approach is that the results from the premium allocation approach are different from those in the building block approach.

21. Based on the analysis above, the staff note one significant difference that could not be reconciled by disclosures or other means. The FASB's tentative decision not to include a single margin in the measurement of the liability for incurred claims under the premium allocation approach results in a difference that would be difficult to reconcile to the measurement of the insurance liability under the building block approach.
22. Based on the staff recommendations regarding discounting and interest accretion for the measurement under the premium allocation approach in agenda paper 3G/79G, the results may not be equivalent to the results obtained by applying the building block approach. Requiring the premium allocation approach for contracts that meet the eligibility criteria would thus enhance comparability.
23. Some argue that contracts that meet the criteria of the premium allocation approach as analyzed in agenda paper 3E/79E are fundamentally different from those that do not. Those that support this view believe that the premium allocation approach should be required for those contracts.
24. As noted above, many of the differences between the building block approach and the premium allocation approach outlined in the table above can be reconciled through disclosures or other means. However, there is an argument that disclosures are not a substitute for presentation on the face of the financial statements. Many users have indicated that the face financial statements should be consistent across entities for the same types of business. The key performance indicators for long duration life contracts are different than those for shorter duration non-life contracts. To permit insurers to measure and present insurance related balances and activities differently will compromise users' ability to perform analysis and comparisons.

Staff recommendation

25. The staff recommend requiring the premium allocation approach for insurance contracts that meet the eligibility criteria. As mentioned previously, the difference between the measurement of the liability under the premium allocation approach

and the building block approach according to the FASB's tentative decisions to date cannot be reconciled. In addition, there are other differences in the measurement of the liability, albeit potentially minor ones and the determination of the activity recognized in the statement of comprehensive income. Therefore, requiring the premium allocation approach would improve comparability across insurers that issue similar types of contracts.

Question 2 – Permit or require
Do the Boards agree that an insurer should be required to apply the premium allocation approach for contracts that meet the eligibility requirements?