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Project	**Insurance contracts**		
Paper topic	Premium allocation approach – discount rate follow-up		

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What is this paper about?

1. This paper discusses discounting and interest accretion under the premium allocation approach. In particular, this paper addresses:
   (a) whether to use the discount rate[1] at the inception date of the contract or a current rate when discounting and accreting the liability for remaining coverage[2];
   (b) how the boards' tentative decision to present changes in the insurance liability arising from changes in discount rates in other comprehensive income (OCI) would apply to contracts accounted for under the premium allocation approach. In particular, this paper considers the discount rate that should be used, and subsequently locked-in, when presenting interest expense in profit or loss for:
      (i) the liability for incurred claims; and

[1] The rest of the paper uses the term 'discount rate' to mean the appropriate discount rate related to the timing of the cash flows determined from the yield curve at that date.

[2] The rest of the paper uses the term 'inception date' to mean the date the coverage period begins and the insurance liability is recognised.

(ii) the liability recognised when a contract is onerous during the coverage period.

2. This paper considers:

(a) whether the measurement of the liability for remaining coverage shall be accreted and discounted using the discount rate at the inception of the contract or a current rate (paragraphs 4-15);

(b) whether the claims and interest expense for the liability for incurred claims should be presented, using the rate at the inception of the contract or the rate on the date the claim is incurred[3]. Subsequently that rate is locked-in for presentation in profit or loss (paragraphs 16-27); and

(c) for the onerous liability, the presentation of the losses and the interest expense presented in profit or loss (paragraphs 28-37).

Staff recommendation

3. The staff recommends for the premium allocation approach:

(a) that when the liability for remaining coverage is accreted or discounted, the rate that shall be required for its measurement is the discount rate at the inception of the contract;

(b) that when the liability for incurred claims is discounted, that the claims and interest expense is presented using:

(i) the discount rate at the inception of the contract, and that rate is subsequently locked-in; or

(ii) the discount rate at the date the claim is incurred, and that rate is subsequently locked-in;

[3] The rest of the paper uses the term 'date the claim is incurred' to mean when the claim is recorded as incurred (ie actual or incurred, but not reported).

(c) If the boards decide that the claims and interest expense for the liability for incurred claims shall be presented using the rate at the date the claim is incurred (paragraph (b)(ii) above), that the same rate is used for the presentation of the onerous losses, claims and interest expense in the statement of comprehensive income by:

(i) using the rate when the onerous liability is recognised to recognise the liability for incurred claims; or

(ii) resetting the rate for the onerous liability when the claim is incurred.

Liability for remaining coverage

4. This section discusses:

(a) background information on the boards' tentative decisions, relevant proposals in the Exposure Draft *Insurance contracts* (ED) and Discussion Paper *Preliminary Views on Insurance Contracts* (DP) and feedback received (paragraphs 5-11); and

(b) whether to use the discount rate at the inception date of the contract or a current rate when discounting and accreting the liability for remaining coverage (paragraphs 12-15).

Background

5. The premium allocation approach provides a simplified way of measuring the insurer's obligation to pay for future insured events covered by existing contracts ('the liability for remaining coverage'). The liability for remaining coverage is measured initially at the present value of the premiums received and receivable under the contract, less acquisition costs. Subsequently, that liability is reduced according to the expected timing of incurred claims and benefits.

6. The boards have previously decided that the liability for remaining coverage should reflect the time value of money. Consequently, discounting and interest

accretion are required for the liability for remaining coverage for contracts that have a significant financing component, as defined under the revenue recognition proposals[4]. However, as a practical expedient, insurers need not apply discounting or interest accretion in measuring the liability for remaining coverage, if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's corresponding obligation to provide insurance coverage will be one year or less. The majority of contracts eligible for the premium allocation approach are likely to qualify for the practical expedient.

7. Consequently, when there is a significant financing component present (or the entity chooses not to apply the practical expedient), in measuring the liability for remaining coverage:

   (a) interest shall be accreted on the carrying amount of the liability for remaining coverage; and

   (b) any expected future premiums shall be discounted.

8. This section discusses whether the liability for remaining coverage should be discounted or accreted using the current rate or the rate at the inception of the contract.

Proposals in the ED/DP and feedback received

9. The IASB ED proposed that a current, updated discount rate be used to accrete or discount the liability for remaining coverage.

10. The FASB had not determined whether interest should be accreted on the carrying amount of the liability for remaining coverage.

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[4] 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; and
c. the interest rate in the contract and prevailing interest rates in the relevant market.

11. Respondents to the ED/DP did not specifically comment on whether a current, updated rate should be used to accrete or discount when measuring the liability for remaining coverage.

Discount rate when accreting and discounting: current or at inception of contract

12. The following are arguments for accreting or discounting at the rate at the inception of the contract:

    (a) Most, if not all, of the contracts eligible for the premium allocation approach would be a fixed-price contract at inception (the premiums will only change if there is a change in coverage). A fixed-price contract effectively 'locks in' a contract price and payment terms:

        (i) For the insurer, discounting or accreting at the rate at inception is a better reflection of the underlying pricing assumptions.[5] The insurer may price the different payment alternatives based on the time value assumptions at inception. Depicting interest expense using the rate at inception in these cases is a better reflection of the 'implicit' interest that has been considered in pricing the payment alternatives. In addition, accreting at the rate at inception will result in similar amounts recognised as premiums in profit or loss regardless of whether the premiums are paid in-advance or over time. Appendix A provides a simplified example illustrating this.

        (ii) For the policyholder, accreting and discounting at the inception rate reflect the implicit economic choices that the policyholder makes when choosing to pay over time or in-advance. At inception, the policyholder considers the time value of money at that point in time.

[5] For some contracts accounted for the under the PAA, the staff understand from insurers that pricing assumptions are not highly dependent on time value of money considerations. Instead, differences in pricing whether a policyholder pays upfront or over time may reflect a nominal processing fee for the insurer processing additional premium payments. For other contracts, the pricing difference for paying over time may be up to 10 percent of the premium.

(b) It is consistent with the revenue recognition proposals, which require that when a contract has a significant financing component, interest is accreted at the interest rate at the inception of the contract. In the revenue recognition proposals, the boards clarified that an entity should not update the discount rate for a change in circumstances because they decided that an entity should reflect in the measurement of the transaction price only the discount rate that is implicit in the contract at inception. Some of the simplifications in the premium allocation approach are consistent with the proposals in the revenue recognition project.

(c) It is also consistent with US GAAP guidance regarding discounting receivables arising from transactions with customers in the normal course of business. ASC Topic 835-30, *Imputation of Interest*, in the *FASB Accounting Standards Codification*®, states that a "a note exchanged for property, goods, or service," which could be likened to the liability for remaining coverage (because it represents the liability for the service of providing insurance coverage and the related premium has already been received), includes "an interest factor to compensate the supplier over the life of the note for the use of funds that would have been received in a cash transaction at the time of the exchange." The interest factor here is also intended to be implicit in the contract at contract inception. This is similar to the guidance in IAS 18 *Revenue* paragraph 11 when the payment terms effectively constitute a financing transaction.

(d) It is consistent with the 'locked-in' nature of the liability for remaining coverage because the other assumptions used to measure the liability for remaining coverage are based on those used at inception of the contract under this approach (unless there is an onerous contract).

(e) Contracts that qualify for the use of the premium allocation approach will have a relatively short coverage period and a minority of those will have to discount or accrete because of a significant financing component. Therefore, the costs involved in updating the rate and accreting, or discounting, for the relatively short time frame may not outweigh the benefits.

(f) For the IASB only, it is consistent with the IASB's decision to accrete interest on the residual margin using the rate at inception.

13. The argument for accreting and discounting at a current rate is that it is consistent with the overall building block approach, which is a current measure of the insurance contract.

14. If the boards decided to accrete or discount the liability for remaining coverage at a current rate, then the boards will need to decide how to present interest expense. At the May 2012 meeting, the boards tentatively decided to require insurers to present changes in the insurance liability arising from changes in the discount rate in OCI. For the building block approach, interest expense is presented in profit or loss based on the interest rate at inception of the contract. The staff believes that those decisions would also apply to contracts accounted for under the premium allocation approach. Arguably presenting the effects of changes in discount rate in OCI is complex. The complexity introduced by having to present the effects of changes in discount rates in OCI is inconsistent with the boards' intention that the premium allocation approach be a simplified model. If the boards decide to accrete and discount the liability of remaining coverage at a current rate, staff will consider the presentation of interest expense at a later stage.

15. Consequently, the staff recommends that the carrying amount of the liability for remaining coverage should be accreted and discounted at the rate at the inception of the contract for the reasons discussed in paragraph 12.

Question 1: Discounting and accreting the liability for remaining coverage
Do the boards agree that when the liability for remaining coverage is accreted or discounted, the rate that shall be required for its measurement is the discount rate at the inception of the contract?

Liability for incurred claims

Background

16. The insurer's obligation to pay claims for insured events that have already occurred ('the liability for incurred claims') is measured in a manner consistent with the building block approach, which includes discounting using a current rate that reflects the characteristics of the liability. The boards tentatively decided that insurers are required to discount the liability for incurred claims when the effects of discounting would be material.

17. A practical expedient permits insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event. Long-tail contracts accounted for under the premium allocation approach will not qualify for the practical expedient not to discount the liability for incurred claims. Examples of long-tail contracts that may not qualify for the practical expedient are workers' compensation, disability, product liability, etc. In addition, some insurers may elect not to apply the practical expedient not to discount the liability for incurred claims when it is available.

18. As discussed in paragraph 14, the boards' decision to present the effects of changes in discount rate in other comprehensive income applies to contracts under the premium allocation approach. In particular, if the liability for incurred claims is discounted:

    (a) interest expense presented in profit or loss would be based on a locked-in rate (the locked-in rate refers to the initial or base discount rate for comparison with the current discount rate); and

    (b) the effect of changes in discount rate on the measurement of the liability for incurred claims would be presented in OCI.

19. This paper addresses a follow-on question—the appropriate locked-in discount rate to present the claims and interest expense on the liability for incurred claims. This is discussed in paragraphs 21-27. There are two alternatives for the rate for the presentation of claims and interest expense:

    (a) the discount rate at the inception of the contract; or

    (b) the discount rate at the date the claim is incurred.

    Subsequently, that rate is locked-in. This question does not arise under the building block approach because the date of the inception of the contract is the date the insurance liability is recognised.

20. Under both alternatives, the liability in the balance sheet is measured using a current discount rate and hence, is reported at the same amount.

At inception of the contract

21. Under this alternative, the liability for incurred claims is presented in the statement of comprehensive income as follows:

    (a) When the claim is recorded as incurred the amount recognised as a claims expense in profit or loss is the estimated claims (with associated cash flows) discounted using the discount rate *at the inception of the contract*.

    (b) The interest expense in profit or loss is presented using the discount rate *at the inception of the contract.* Subsequently, that rate is locked-in for the presentation of interest expense.

    (c) The effects of changes in discount rate between the locked-in rate (discount rate *at the inception of the contract*) and current discount rate are presented in OCI.

        (i) When the claim is recorded as incurred, the difference between the estimated claims discounted using the rate at inception and the rate at the date the claim is incurred is recognised in other comprehensive income; and

(ii) Subsequently, the impact from the changes in the discount rate between the current rate and the initial rate is recognised in other comprehensive income.

The date the liability is incurred

22. Under this alternative, the liability for incurred claims is presented in the statement of comprehensive income as follows:

(a) When the claim is recorded as incurred, the amount recognised as a claims expense in profit or loss is the estimated claims (with associated cash flows) discounted using the discount rate on that date *(ie the date the claims are incurred).*

(b) The interest expense in profit or loss is presented using the discount rate at *the date the claims are incurred.* Subsequently, that rate is locked-in for the presentation of the interest expense.

(c) The effect of changes in discount rate between the locked-in rate (the discount rate at *the date the claims are incurred*) and current discount rate is presented in OCI.

(i) When the date the claim is incurred, no adjustment is recorded in OCI; and

(ii) Subsequently, the impact from the changes in the discount rate between the current rate and the rate at *the date the claims are incurred* is recognised in OCI.

Comparison of both alternatives

23. Both alternatives result in the same:

(a) amounts recognised on the balance sheet for the liability; and

(b) the amount recognised as total comprehensive income in a period.

24. On the date the claim is incurred, the alternatives may result in different amounts reported as claims expense, and subsequently, different amounts are also

recognised as interest expense. Consequently, this results in differing impacts upon net profit or loss. The following is a simple example to illustrate the alternatives.

Example 1: Illustrating the alternatives for the liability for incurred claims

Premiums for one year coverage = CU 12,000 and are earned rateably over the year (ie CU 3,000 per quarter)

Expected losses are CU 9,600 or CU 2,400 per quarter (ie an expected loss ratio of 80%). Assume claims are paid one-year after they are incurred

Discount rate at the inception of the contract is 4%.

First quarter

At the end of the first quarter the insurer has reduced the liability for remaining coverage by CU 3,000 and recognized that as earned premium.

Assume the liability for incurred claims is discounted and at the date the liability for incurred claims is recognised the discount rate is 5%. Using *the rate at the date the liability for incurred claims is recognised* the insurer would recognize an expense for the liability for incurred claims of CU 2,286 (CU 2,400 discounted at 5%) and establish the liability at the same amount. The profit recognised would be CU 714 (CU 3000 – CU 2286 = CU 714).

Using *the rate at inception of the contract* of 4%, an expense for the liability for incurred claims would be recognised of CU 2,308 (CU 2,400 discounted at 4%), and the profit recognised would be CU 692 (CU 3000 – CU 2308 = CU 692). However, the liability on the statement of financial position would be recorded at CU 2,286 (CU 2,400 discounted at 5%) and therefore a difference of CU 22 (CU 2,286 – CU 2,308) would be recorded to OCI.

Second quarter

At the end of the second quarter the insurer again has reduced the liability for remaining coverage by CU 3,000 and recognized this as earned premium. However, assume that the current discount rate at that date has changed to 3%. Using *the rate at the date the liability for incurred claims is recognised* (i.e. 3%), the insurer would recognise an expense for the liability for incurred claims of CU 2,330 (CU 2,400 discounted at 3%) (and profit of CU 670).

Using *the rate at the inception of the contract* of 4%, an expense for the liability for incurred claims would be recognised of CU 2,308 (and the profit recognised would be CU 692). However the liability on the statement of financial position would be recorded at CU 2,330 and therefore a difference of CU 22 (2,330-2,308) would be recorded to OCI.

25. Arguments for the presentation of claims and interest expense for the liability for incurred claims to be locked in at the rate at the inception:

(a) Presenting the claims and interest expense locked-in at the discount rate when the claim is incurred will result in many more ‘locked-in’ discount rates for the same portfolio of contracts. For example, assume the same amount of nominal claims are incurred in different periods (ie the same loss ratio), each period will report a different claims incurred expense in earnings because of the different discount rates used, which some think does not aid comparability.

(i) Some argue this may not be useful to users because the loss ratios would be distorted by the rate changing each quarter through the contract (and by extension a block of contracts) thus making it difficult to understand the profitability of a portfolio of contracts. In addition, this makes it more difficult for preparers to explain and users to understand the impact of interest rates on the profitability (eg loss ratios) of the portfolio. Using the rate at inception of the contract should allow preparers to better isolate and explain the initial impact of interest rates and subsequently interest rate movements.

(ii) It would also be more complex to disaggregate the impact of discounting from underwriting than it would be if one rate (the rate at inception) for the portfolio of contracts were used. Some users have indicated that they would like to understand the impact of discounting independently from the impact of underwriting results, and that they would like to unwind the impact of discounting to apply their own discount rate assumptions.

(iii) Presenting the interest expense locked-in at the discount rate at the inception of the contract will result in consistency for the amounts reported as claims expense and interest expense in the statement of comprehensive income for an entire portfolio when assumptions regarding the underwriting results have not changed. Under this approach, users may not need to determine whether the change in the claims expense recorded is due to a change in underwriting assumptions or a change in discount rates.

(b) Some think that using the discount rate at inception of the contracts is more consistent with the portfolio notion because one rate would apply to a group of contracts.[6] Insurers record an expense and the liability for incurred claims for the portfolio each period based on loss ratios determined using historical data, which is updated for current assumptions. Therefore, using the rates at the date the claim is incurred is more analogous to discounting on an individual claim basis – not even on a contract basis. Adding to the complexity will be that when claims are paid, insurers will need to know how to match that with when the liability for incurred claims was recorded, which may fall within different quarters for the same claim. This may require insurers to track at a lower level (eg by contract, by claim and potentially by each additional reserve strengthening for a claim) than current practice, which may initially be at the portfolio level for incurred but not reported claims which then gets allocated to the actual claims. Using the rate at the inception of the contract more readily aligns with the current concept of reserving by accident year. It also allows an annual contract to be one interest rate "block" instead of at a minimum four as would be required if the rate was updated each quarter.

(c) Some think it is less complex to use the same rate to present the interest expense for the liability for remaining coverage and the liability for

[6] An alternative would be to record claims expense using the rate the date the claim is incurred, and true-up the rate at year end to reflect one rate for the portfolio. However, the staff did not pursue this alternative because the true-up process, ie adjusting the rates to reflect one rate for the portfolio, may be confusing for users.

incurred claims (assuming the insurer discounts or accretes the liability of remaining coverage).

(i) Under this approach, insurers would need to track rates at the inception of the contract, and also the current rate to calculate the liability for incurred claims on the statement of financial position. This would result in two rates.

(ii) For the liability for incurred claims, if the rate when the claim is incurred is used, the insurers would need to track multiple base rates, each of which would need to be compared to the current rate used to record the liability for incurred claims on the statement of financial position. As discussed in (b), this could possibly present substantial systems changes and tracking issues.

(d) Presenting interest expense in profit or loss using the rate at inception of the contract is consistent with the presentation under the building block approach of interest expense, and hence, with the amounts in net profit or loss.

26. Arguments for the presentation of claims and interest expense for the liability for incurred claims using the rate on the date when the claim is incurred, and subsequently locked-in, are as follows:

(a) It results in more useful information than the rate at inception of the contract. If the rate at inception of the contract is used, a catch-up adjustment must be recognised in OCI to reflect the effect of changes in discount rates between inception and when the claim is incurred. This catch up adjustment may be difficult to explain because it is inconsistent with what else is reported for the liability for incurred claims at that date—no gains or losses are separately recognised in the statement of comprehensive income for any changes in assumptions between the date at inception of the contract and the date the claim is incurred.

(b) Some think using the rate at the date the claim is incurred reports a more useful claims expense because the claims expense is determined using a discount rate that reflects the market conditions at that time.

(c) Presenting the interest expense in profit or loss using the rate at inception of the contract may increase complexity by requiring insurers to track discount rates applicable at inception of the contract. For some, this may be the only reason to track the rate at inception. Many non-life insurers, for which the premium allocation approach will be most applicable, maintain data on an accident year basis (as opposed to an underwriting year basis)[7]. Maintaining data on an accident year basis means that many insurers do not track the rate at the inception of the contract. In addition, discounting and accretion of the liability for remaining coverage would only apply to contracts that have a significant financing component, which are expected to be a minority.

(d) Some staff believe that this alternative is consistent with the boards' rationale for providing the premium allocation approach because it is a simplified model that results in approximately the same results as the building block approach but at a lower cost (ie one model view) or because it may better reflect the economics of the contracts that are eligible to apply the premium allocation approach at a lower cost (ie the two model view).

27. FASB staff recommend that insurers should be required to present the claims and interest expense for the liability for incurred claims locked in at the rate at the inception for the reasons listed in paragraph 25. IASB staff recommend that insurers should be required to present the claims and interest expense for the liability for incurred claims at the rate at the date the claim is incurred because of the reasons listed in paragraph 26.

[7] Accident year is based on the 12-month period in which losses occur. In contrast, underwriting year is based on the year in which the contract was written regardless of when the premiums and losses were actually reported or paid. Differences arise when the insurance contract is not January 1 – December 31. On the basis of the boards' tentative decisions, an expense is recorded for the liability for incurred claims in the statement of comprehensive income on an accident year basis.

Question 2: Presentation of claims and interest expense for liability for incurred claims
When the liability for incurred claims is discounted, which of the following rates should be used to present the claims and interest expense? That rate is subsequently locked-in. (a) The rate at the inception of the contract; or (b) The rate on the date the claim is incurred?

Onerous contracts

28. If the boards tentatively decide that the current rate on the date the claim is incurred should be used to present the claims and interest expense (Recommendation 2(b)), then the boards need to consider the rate to be used to present losses arising on recognition of an onerous liability and the interest expense, in the profit or loss for the onerous liability. The staff note that the recognition of onerous liabilities, for contracts accounted for under the premium allocation approach is likely to be infrequent.

29. The boards have tentatively decided that an additional liability is recognised when a contract is determined to be onerous. The onerous liability is measured on a basis consistent with the measurement of the liability for claims incurred. This is because recognising an onerous contract liability accelerates the recognition of the liability for incurred claims. If the onerous contract liability was measured on a basis inconsistent with the liability for incurred claims, a gain or loss might arise when the onerous liability is derecognised and the liability for incurred claims is recognised. This gain or loss may be difficult to understand.

30. Consequently, the staff believes that the rate used to present interest expense on onerous contracts recognised under the PAA, and subsequently locked-in, should be the same rate as that used for the liability for incurred claims. This would avoid gains and losses in profit or loss due to changes in the discount rate between the recognition of the onerous liability and the liability for incurred claims. In

addition, it avoids different locked-in rates for the presentation of the interest expense between when the onerous contract liability is recognised and the subsequent liability for incurred claims recognised.

31. If the boards decide that the interest expense for the liability for incurred claims should be the rate at the inception of the contract (Recommendation 2(a)), the interest expense for the onerous liability shall be presented using the rate at inception. That rate is subsequently locked-in for presentation in profit or loss.

32. If the boards decide that the interest expense for the liability for incurred claims should be the rate on the date the claim is incurred (Recommendation 2(b)), paragraphs 33-37 discuss two alternative ways of achieving this. Both alternatives result in the same amounts reported on the balance sheet for the onerous liability and the liability for incurred claims.

Alternative 1: Use the rate when the onerous liability is recognised to recognise the liability for incurred claims

33. IASB staff recommends that both the interest expense for the onerous liability and the liability for incurred claims be presented using the rate at the date the onerous liability is recognised. That rate is subsequently locked-in for the presentation of interest expense. This is consistent with the view that the onerous liability accelerates the recognition of the liability for incurred claims. Consequently, once an onerous liability has been recognised, the discount rate on the date of the recognition of the onerous liability will be used to present the interest expense for the onerous liability and the subsequent incurred claims recognised in profit or loss.

34. Under this alternative, the onerous liability and the liability for incurred claims is presented in the statement of comprehensive income as follows:

    (a) When the onerous liability is recorded, the amount recognised as a claims expense in profit or loss is the estimated claims in excess of the premiums discounted using the discount rate on that date *(ie the date the onerous liability is recognised).*

(b) Subsequently, when the claim is recorded as incurred, the amount recognised as a claims expense in profit or loss is the estimated claims discounted using the discount rate on *the date the onerous liability is recognised*.

(c) The interest expense for both the onerous liability and subsequent incurred claims is presented using the discount rate at *the date the onerous liability is recognised.* Subsequently, that rate is locked-in for the presentation of the interest expense.

(d) The effect of changes in discount rate between the locked-in rate (the discount rate at *the date the onerous liability is recognised*) and current discount rate is presented in OCI.

   (i) On the date the onerous liability is recognised, no adjustment is recorded in OCI;

   (ii) On the date the claim is incurred, the difference between the estimated claims discounted using the rate at *the date the onerous liability is recognised* and the rate at *the date the claim is incurred* is presented in OCI; and

   (iii) Subsequently, the impact from the changes in the discount rate between the current rate and the rate at *the date the onerous liability is recognised* is presented in OCI.

Alternative 2: Reset the rate for the onerous liability when the claim is incurred

35. If the boards decide that the interest expense for the liability for incurred claims is presented using the rate at the date the claims are incurred, the FASB staff recommends that when an onerous contract is initially recognised it is recorded at the rate on that date. Subsequently, when the claims to which the onerous contract liability relates are incurred, the incurred claims and the onerous liability expense are reported using the same rate—the rate on the date the claims is incurred—in profit and loss.

36. Under this alternative, the onerous liability and the liability for incurred claims is presented in the statement of comprehensive income as follows:

    (a) When the onerous liability is recorded, the amount recognised as a claims expense in profit or loss is the estimated claims in excess of the premiums discounted using the discount rate on that date *(ie the date the onerous liability is recognised)*. Interest expense on the onerous contract liability would be presented at that rate until the claim to which it relates is recorded as incurred.

    (b) Subsequently, when the claim is recorded as incurred, the amount recognised as a claims expense in profit or loss is the estimated claims discounted using the discount rate on *the date the claims are incurred*. The previous amount recognized for the onerous contract liability would be updated to apply this rate (the rate on the date the claim is incurred) with the difference being recorded in the statement of comprehensive income.

    (c) The interest expense is presented using the discount rate at *the date the claims are incurred* for the liability for claims incurred. For the onerous liability related to the claims incurred, the interest expense is reported using the rate on *the date the claims are incurred.* Subsequently, that rate is locked-in for the presentation of the interest expense.

    (d) The effect of changes in discount rate between the locked-in rate (the discount rate at *the date the onerous liability is recognised*) and current discount rate is presented in OCI as follows:

        (i) On the date the onerous liability is recognised, no adjustment is recorded in OCI;

        (ii) Prior to the recognition of the claims, the impact from the changes in the discount rate between the current rate and the rate at *the date the onerous liability is recognised* is presented in OCI for the onerous liability;

(iii) On the date the claim is incurred, previously recorded adjustments in OCI are reversed to profit or loss; and

(iv) Subsequently, the impact from the changes in the discount rate between the current rate and the rate at *the date the claims are incurred* is recognised in OCI.

37. The benefit of this alternative is that the claims expense reported in profit and loss is discounted using the rate on the date the claims are incurred. The arguments for presenting the claims expense using the rate on the date the claims are incurred are discussed in paragraphs 26.

Question 3: Presentation of the interest expense for the liability for incurred claims and the onerous liability
This question only applies if the boards decide that the claims and interest expense for the liability for incurred claims shall be presented using the rate at the date the claim is incurred (Recommendation 2(b)). Which alternative do the board prefer so that the same rate is used for the presentation of the onerous liability and liability for incurred claims in profit or loss? (a) Alternative 1: Use the rate when the onerous liability is recognised to recognise the liability for incurred claims (paragraphs 33-34); or (b) Alternative 2: Reset the rate for the onerous liability when the claim is incurred (paragraphs 35-37)?

Appendix A: Comparing accreting the liability for remaining coverage using the rate at inception or the current rate

A1. The following example illustrates the differences between using a current rate or the interest rate at the inception of the contract when accreting the carrying amount of the liability for remaining coverage. It illustrates the theoretical reasons for accreting using the rate at inception, namely that it results in the premiums recognised in profit or loss being similar irrespective of when the premiums are collected when a financing component has been included. To do this, the example uses the assumption that all the claims are expected to be incurred in the last quarter and hence, all of the earned premiums are recognised in the last quarter. In reality, this is unlikely to occur because claims are likely to be incurred on a different basis (for example, rateably) except for specific types of contracts such as those that cover hurricanes.

A2. To illustrate only the effects of accretion at different rates, the following simplified assumptions are used:

(a) An insurance contract is written with an 18-month coverage period.

(b) A claim is expected to be incurred in the last quarter of the coverage period. Consequently, premiums will be recognised in full in that last quarter of the coverage periods in line with expected claims.

(c) There are no acquisition costs.

(d) There are no changes in assumptions, except changes in discount rates.

(e) For discount rates, flat yield curves are assumed as follows.

Quarterly discount rates applicable at the end of the period		Year 1				Year 2	
	At inception	Q1	Q2	Q3	Q4	Q1	Q2
Discount rate for the insurance liability	1.63%	1.65%	1.68%	1.70%	1.75%	1.78%	1.80%

A3. The insurer prices the contract with two payment alternatives as follows:

(a) Premiums paid at inception at CU5000.

(b) Premiums paid at the beginning of every quarter of CU867 and totalling CU5204.

The amount for the premiums paid at inception is the present value of the premiums paid each quarter discounted at the discount rate at inception of the contract, 1.63%.

A4. The following table compares the premium recognised in the profit or loss statement when the premiums are paid at inception or the premiums are paid every quarter:

(a) accreted at the current rate; and

(b) accreted at the interest rate at the inception of the contract.

A5. Accretion at the interest rate at the inception of the contract results in the same amount of premium recognised in profit and loss regardless of whether the premiums are paid in-advance or over-time. In addition, the amount of total interest expense is the same when the rate at inception of the contract is used, regardless of whether the premium is received upfront or over-time.

	Premiums paid in advance		Premiums paid each quarter	
	Accreted at the current rate	Accreted at the locked-in rate @1.63%	Accreted at current rate	Accreted at the locked-in rate @1.63%
Total premiums recognised in profit or loss in Year 2, Q2	5531	5508	5526	5508

A6. The difference between accreting at the inception rate or current rate is the amount of interest expense recognised. Because interest rates are rising during the coverage period in the example, the total interest expense recognised when accreting at the current rate is larger than accreting at the inception rate.

Workings to support the accretion of the liability for remaining coverage

A7. The following are the workings to support the example that discusses the effects of accreting the liability of remaining coverage at the rate at inception or the current rate. The workings illustrate how the premium recognised in paragraph A4~~A5~~ is calculated when the total premium is received in advance, using the rate at inception and the current rate. The calculations for accretion are similar for when the premiums are received each quarter and are therefore not shown. Please note that amounts in the examples may not sum because of rounding.

A8. If the liability for remaining coverage is accreted using the rate at inception, the following is how the amount of premium recognised is calculated.

	At inception	Year 1				Year 2		
		Q1	Q2	Q3	Q4	Q1	Q2	Total
Interest expense (calculated using the interest rate at inception)		5000*1.63%= 81	5081*1.63%= 83	5164*1.63%= 84	5248*1.63%= 85	5333*1.63%= 87	5420*1.63%= 88	508
Accumulated balance of the liability for remaining coverage	5000	5081^	5164	5248	5333	5420	5508*	

^The accumulated balance of the liability for remaining coverage grows by the interest expense in each quarter.

* The accumulated balance at the end of the second quarter, Year 2 is recognised in profit or loss as premiums (ie CU5508).

A9. If the liability for remaining coverage is accreted using the current rate, the following is how the amount of premium recognised is calculated.

		Year 1				Year 2		
	At inception	Q1	Q2	Q3	Q4	Q1	Q2	Total
Interest expense (calculated using the interest rate prevailing at the beginning of the quarter)		5000*1.63%= 81	5081*1.65%= 84	5165*1.68%= 87	5252*1.70%= 89	5341*1.75% 93	5434*1.78%= 97	531
Accumulated balance of the liability of remaining coverage	5000	5081^	5165	5252	5341	5434	5531*	

^The accumulated balance of the liability for remaining coverage grows by the interest expense in each quarter.

*The accumulated balance at the end of the second quarter, Year 2 is recognised in profit or loss as premiums (ie CU5531).