IASB
Insurance Contracts Project

Field Testing Questionnaire: Unearned premium model
Date of issue : November 2009
Name of participant :

Field Testing – Round 1

In Round 1 of the targeted field test we ask you to submit information on specific topics prior to the publication of an exposure draft (ED) in 2010. The questions we would like you to answer are detailed below. Please ensure that you provide the name of your organisation in the box above.

This questionnaire has been made available on the IASB's public website. We shall treat any information that you provide to us in the strictest confidence.

The questionnaire is supported by background information, including the most recent decisions made by the IASB and FASB boards.

Unearned premium model

Return date: 15 December

Introduction

The Discussion Paper (DP) *Preliminary Views on Insurance Contracts* discussed the possibility of using an unearned premium as a reasonable approximation to an explicit measurement of the pre-claims liability using the three building blocks.

The unearned premium approach would measure the liability initially at the premium. Subsequently, the insurer would measure the pre-claims liability at the unearned portion of that premium.

Supporters of this approach claim that is has the following advantages:

- For short-duration contracts, the unearned premium model is less costly and easier to apply than a 3 building block approach.
- Users are accustomed to using information about earned premiums and incurred claims to derive ratios, such as claims ratios and combined ratios.
- Consistency with the customer consideration approach in the boards' Revenue Recognition project.
- Existing accounting models use an unearned premium approach.

The DP discussed whether insurers should be **permitted or required** to measure short-duration, non-life insurance pre-claims liabilities using an unearned premium approach.

[Paragraphs 111-112]

Questions for Participants

Question 1
Do you currently use an unearned premium approach? If so, for which types of contracts?

Question 2
If you currently use an unearned premium model, what is the driver for releasing the earned premium to the income statement:

- Passage of time
- Release from risk
- Other (please specify)

The IASB[1] has tentatively decided that:

- an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts; and

- to require, rather than permit, the use of an unearned premium approach for those liabilities.

Question 3
What are the practical implications of **requiring** (mandatory) as opposed to **permitting** (optional) measurement of short-duration non-life insurance pre-claims liabilities using an unearned premium approach?

If permitted, are there any specific types of circumstances for which it should always be used or never be used?

Question 4

How important, from your perspective, is a consistent accounting treatment for **all** insurance contracts (within insurers' financial statements)?

To determine which contracts should be accounted for under an unearned premium approach, staff identified factors that may indicate when the additional costs of applying a prospective explicit building block approach may exceed its benefits. In other words, from a cost-benefit perspective an unearned premium approach is less onerous to apply and does not generate

[1] The FASB has yet to discuss the use of an unearned premium approach. The staff will send field test participants an update, and any necessary follow-up requests, when the FASB concludes tentatively on these issues.

significantly lower benefits. These factors could be defined broadly along the lines of pre-claims liabilities of short-duration contracts, such as:

- duration of the coverage period, for example 12 months or less
- the insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows
- no embedded options or guarantees.

Question 5
In your view, are the factors above appropriate for identifying the liabilities that should be accounted for under an unearned premium approach?

Have you identified any other factors that could be considered?

In their project on Revenue Recognition for contracts with customers, the boards decided tentatively that an entity should recognise revenue as the entity performs under the contract. In other words, the pattern of revenue is driven by the entity's performance under the contract. Staff expect that in the forthcoming exposure draft on insurance contracts the same principle will be applied to a unearned premium approach.

Question 6
To appropriately reflect the principle that revenue should be recognised when the insurer performs under the contract, what driver do you think should be used for releasing the earned premium to the income statement? (Please describe).

Does this driver differ from the driver you use for unearned premium under your existing accounting model (as per question 2)? If it differs, is the information provided under the proposed model more or less decision-useful? Please explain why or why not.

The liability adequacy test

Because the unearned premium may not be sufficient to cover the obligation, a liability adequacy test is required for the unearned premium approach.

Question 7
If you apply an unearned premium approach:

(a) what is your policy for testing that the premium is adequate to cover the obligation? Will a liability adequacy test always be applied? What is the basis for such a test? Is the test carried out on a group-wide, company-wide, portfolio or contract basis?

(b) How often does the application of that test result in the recognition of an additional loss? Please give an indication of the materiality of such losses compared to the premium for those contracts for which a loss is recognised.

If the boards adopt the unearned premium approach for some types of insurance contract, they will need to define the trigger (and measurement basis) for the liability adequacy test. The two obvious candidates are:

(a) the onerous contract test included in the DP on Revenue Recognition

(b) the prospective measurement approach selected for all other insurance liabilities.

The boards' preliminary view in the Revenue Recognition DP is in favour of a cost test (as opposed to a current price trigger that includes a margin as well as expected cost) whereby a contract is deemed onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of the performance obligation. In this instance, the performance obligation is re-measured to the entity's expected cost of satisfying the performance obligation and the entity would recognise a contract loss. The DP also states that although measurement of a performance obligation should include a margin, often it is not practical to do so due to the complexity of determining what margin should be included in the re-measurement particularly when observable prices do not exist.

Selecting (a) would ensure consistency with Revenue Recognition in that the same trigger would be used. Selecting (b) raises questions as to how to treat risk margins; should they be included in the onerous contract test?

Question 8
Should an onerous contract test be based on:

(a) the test included in the DP on Revenue Recognition
(b) the prospective measurement approach to be used for all (other) insurance liabilities
(c) some other basis (please specify).

Please state your reasons.

If you selected (b), should the test include the risk margin? Why / why not?

Time value of money

In their project on Revenue Recognition, the boards have decided tentatively that an entity's net contract position should reflect the time value of money whenever the effect would be material. Applying this principle to an unearned premium approach for Insurance Contracts would mean that the insurer should accrue interest on its unearned premium liability (the net contract position for pre-claims liabilities) if that effect would be material.

Question 9
Did you identify any practical issues with applying time value of money to the unearned premium approach (by accruing interest on the unearned premium liability)?

Do you have any other comments on this issue?

Please submit your results to Jane Jordan (jjordan@iasb.org) by 15 December.

Background Information

Where are the boards?

IASB

The IASB discussed this topic at their July meeting. At this meeting the Board decided tentatively:

- that an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts; and

- to require, rather than permit, the use of an unearned premium approach for those liabilities.

FASB

The FASB will discuss at a future meeting whether and how to apply an unearned premium approach for insurance contracts.

Other sources of information

Agenda papers

- Agenda paper 11B Unearned premium model (July 2009 meeting)

Other projects

The Revenue Recognition Discussion Paper (DP) *Preliminary Views on Revenue Recognition in Contracts with Customers* (December 2008). Chapter 5 (paragraphs 5.58-5.90).