

Staff Paper

Project	Insurance contracts
Topic	Simplified measurement

Purpose of this paper

1. The IASB discussed a premium allocation model as a simplified version of the basic measurement model for insurance contracts in July 2009. The FASB discussed this approach in its June 2010 meeting. Both boards came to similar conclusions, with a few issues that need further consideration:
 - (a) The criteria for applying the simplified measurement.
 - (b) The treatment of acquisition costs.
 - (c) The discount rate for accreting interest.
2. In this paper the staff asks the boards to decide on those issues.

Criteria for applying the simplified measurement

3. The boards decided tentatively to require the premium allocation model for pre-claims liabilities of short-duration insurance contracts. [The main building block model applies to the liability for incurred claims.] This requirement puts some pressure on the line between those types of contracts (short-duration contracts) and other insurance contracts.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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4. The boards considered the following factors for determining when the premium allocation model has to be applied, but highlighted that those factors may need further refinement:
 - (a) the duration of the coverage period is approximately 12 months or less
 - (b) the insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows
 - (c) the contract does not have embedded options or guarantees.
5. The next paragraphs examine those factors further.

Duration of the coverage period

6. The staff proposed to use an indicator of “approximately 12 months” to describe a contract with a short coverage period. Short duration can be seen as a period within which an insurer is unlikely to become aware of events that could cause significant changes in the expected cash flows. If significant changes do occur in such a short period, they are likely to be adverse changes and the proposed approach includes a liability adequacy test that should capture them. The premium allocation method could therefore provide a measure that is obtainable with less cost and effort. A coverage period of approximately 12 months or less seems to be a reasonable period to support that assumption in the majority of cases.
7. The staff believes it is not necessary to create a precise cut-off point at 12 months exactly, because this criterion is intended to capture cases when the premium allocation approach is likely to be a reasonable proxy for use of the full building block approach.

Likelihood of unexpected events that could significantly decrease the expected cash outflows

8. The criterion that the insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out

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flows is clearly linked to the previous criterion of the short duration of a contract. The longer the coverage period of a contract lasts, the higher is generally the likelihood of unexpected positive or negative events. However, some contract types might be prone to unexpected events that have a significant (positive) impact on the performance of the contract.

9. If contracts give rise to significantly lower cash outflows than previously expected, they may be measured more transparently and in a more meaningful way using the main measurement model that depicts the high variability and uncertainty of the cash flows in a way that reports promptly the effect of changes in circumstances.
10. The staff thinks that, in general, short duration contracts are not prone to unexpected events that have a significant positive impact on the performance of the contract. It may be too burdensome to apply this second factor and, essentially, this factor may already be included in the requirement of “short duration”.

Embedded options or guarantees

11. Embedded options and guarantees can have a great impact on the cash flows of an insurance contract. The premium allocation model may not be appropriate for contracts containing embedded options and guarantees because it does not depict that variability in a way that reports changes in circumstances immediately.
12. Insurance contracts may contain many options and guarantees. However, not every option or guarantee will have a significant impact on the (variability of) cash flows. Therefore, the factors for application of the simplified measurement should refer to significant embedded options and guarantees.

Staff recommendation

13. The staff recommends to present the factors as explained above as a set of defined criteria that must all be met to apply the premium allocation model. The staff thinks that providing indicators that the insurer may consider in deciding whether to apply the premium allocation model seems to be insufficient in the light of the

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boards' tentative decision to require (rather than permit) the application of the premium allocation model. The staff proposes to mention the second criterion (the insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows) only as an explanation supporting the first factor (short duration), because it cannot add significantly to the analyses whether the premium allocation model has to be applied.

Question 1 – criteria for application

Do the boards agree that the required application of the premium allocation model should be restricted to the pre-claims liability of short-duration contracts, which incorporate both the following features:

- a) the coverage period is approximately 12 months or less and
- b) do not contain significant embedded options or guarantees?

Comparison with the basic measurement model

14. The main measurement model measures an insurance contract at the present value of the fulfilment cash flows and a residual margin. The measurement is based on three components that are remeasured at every reporting date: expected (probability-weighted) cash flows, a risk adjustment and the time value of money, and a fourth component, the residual margin, that eliminates any gain at inception of the contract.
15. The premium allocation model, in contrast, can be analysed as the sum of the following **implicit** building blocks:
 - (a) cash flows as implied by the premiums, locked-in at inception;
 - (b) time value of money as implied by the premiums received, locked in at inception;
 - (c) a margin as implied by the premiums, also locked-in at inception.
16. As the insurer fulfils its obligation to provide insurance coverage continuously over the coverage period, the insurer is released from risk and the related part of

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the premium is regarded as earned and recognised as revenue. The unallocated part of the premium is recognised as a liability. The premium allocation model measures an insurance liability at the part of the premium allocated to the remaining coverage period.

Treatment of acquisition costs

17. The main measurement model treats incremental acquisition costs as cash flows arising from the contract. Therefore, incremental acquisition costs impact the measurement of the insurance contract.
18. The premium allocation model recognises cash flows only implicitly and as locked-in at inception. That brings up the question how to treat acquisition costs in a manner that is as consistent as possible with the main measurement model (ie ensures that the simplified model remains the best possible reflection of the main model).
19. The staff found three possible ways how to treat acquisition costs in the premium allocation model:
 - (a) To expense all acquisition costs at inception, and recognise no revenue at that point (paragraph 20).
 - (b) To calibrate the initial measurement to the premium less incremental acquisition costs and to recognise an amount equal to the incremental acquisition costs as revenue (paragraph 21).
 - (c) To defer incremental acquisition costs incurred and present the deferred acquisition costs either as a separate asset or as a deduction from the part of the premium allocated to the remaining coverage period (paragraph 22 to 23).
20. Expensing all acquisition costs at inception is inconsistent with the main measurement model. The outcome of the two models would, depending on the significance of the acquisition costs, differ significantly.

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21. Recognising revenue equal to the incremental acquisition costs is also inconsistent with the basic measurement model and would accelerate revenue by recognising acquisition costs, which some would find counter-intuitive.
22. Deferring incremental acquisition costs would produce an outcome that would be closest to the outcome of the main measurement model. The presentation of those deferred incremental acquisition costs could be as a separate asset or as a deferred item presented together with the insurance liability. The recognition of a separate asset is in the staff's view not consistent with the boards' logic applied within the main model to include incremental acquisition costs as cash flows in the measurement of the contract. It seems to be more consistent to present the incremental acquisition costs as a deduction from the part of the premium allocated to the remaining coverage period.
23. The deferred incremental acquisition costs would be recognised as an expense over time in a pattern consistent with the pattern in which the premium is recognised as revenue (passage of time, or the timing of expected benefits and claims incurred if that reflects better the insurance coverage).

Staff recommendation and question for the boards

Question 2 – treatment of acquisition costs

Do the boards agree with the staff recommendation to:

- a) defer incurred incremental acquisition costs associated with insurance contracts that are measured and presented using the premium allocation model?
- b) present those incremental acquisition costs as a deferred item as a deduction from the unallocated premium liability?

Discount rate: locked-in or updated

24. The main measurement model explicitly considers time value of money and uses a discount rate that is updated at each reporting date.

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25. The premium allocation model implicitly considers the time value of money at inception of the contract. Subsequently, an insurer should accrete interest on the contract position (expected present value of remaining premiums less unallocated premium obligation) unless that effect would be immaterial. This is also consistent with the model proposed in the boards' Exposure Draft *Revenue from Contracts with Customers*.
26. The question remains as to which discount rate should be used for accreting interest. Internally consistent with the locked-in nature of the premium allocation model is using the discount rate as established at inception of the contract (the 'locked-in discount rate'). However, using a current rate would be consistent with the main measurement model and the overall approach to determine a current measure for insurance contracts. A current rate may also be easier to apply because the insurer does not have to track all the implicit discount rates at inception. Further, the use of a current rate may help avoiding accounting mismatches if the insurer invests the premium received in assets measured at fair value.

Staff recommendation and question for the boards

Question 3 – discount rate: locked-in or current

Do the boards agree with the staff recommendation to use a current rate for the accretion of interest to an unallocated premium liability?