STAFF PAPER

Week commencing 27 February 2012

FASB | IASB Meeting

Project	**Insurance contracts**		
Paper topic	Premium allocation approach – IASB staff recommendations on Eligibility		
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What is the paper about

1. This paper should be read with agenda paper 3E/79E *Premium allocation approach: amendments to the January staff recommendations on Eligibility and Mechanics*. During January 2012, the IASB instructed the IASB staff to prepare a short supplement to agenda paper 2A *Premium allocation approach: Eligibility Criteria* (reposted as agenda paper 3F/79F for this meeting) outlining a proposal for eligibility criteria that would:
   (a) State a principle that the premium allocation approach could be used when the results would be similar to those produced by using the building block approach.
   (b) Permit contracts that have a coverage period of approximately twelve months or less to be eligible for the premium allocation approach.
   (c) Provide application guidance on when the premium allocation approach and the building block approach would produce similar results based on the criteria being developed by the staff in agenda paper 2A.
2. This paper responds to the IASB's request.

3. In addition, this paper discusses whether the premium allocation approach should be permitted or required.

4. Agenda paper 3E/79E discusses proposed changes to the wording of the:

   (a) proposed eligibility criteria in AP 3F/79F *Premium allocation approach: Eligibility Criteria* (these wording changes have been incorporated into the recommendations in this paper);

   (b) staff recommendations in AP 3G/79G – *Premium allocation approach: Mechanics.*

5. Agenda paper 3I/79I *Premium allocation approach: FASB staff recommendations on eligibility* sets out the FASB staff's proposals on eligibility for the PAA approach. The main differences between the FASB staff proposals and the IASB staff's proposals are as follows:

   (a) 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. The FASB staff propose that eligibility for the premium allocation approach should be determined by the eligibility criteria in agenda paper 3E/79E.

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

IASB staff recommendation

6. The IASB staff recommend the following:

   (a) Contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach.

(b) A contract should be deemed to meet the condition in (a) without further work if the coverage period is one year or less.

(c) The boards should provide application guidance that contracts would not produce measurements that are a reasonable approximation to those that would be produced by the building block approach if, at the contract inception date, either of the following conditions are 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 performance obligations in each reporting period. This may be the case if, for example, significant uncertainty exists about:

1. The premium that would reflect the exposure and risk the insurer has for each reporting period; or
2. the length of the coverage period.

(d) An insurer should be permitted but not required to apply the premium allocation approach to contracts that are eligible for that approach.

Eligibility for the premium allocation approach

7. At the education session in January 2012, a majority of IASB Board members stated that:

(a) eligibility for the premium allocation approach should be determined by an overall principle.

(b) in order to reduce the costs and complexity associated with applying the principle, a practical expedient should be introduced;

(c) application guidance should be produced to help insurers apply the overall principle.

8. The following sections discuss each of these three elements in turn.

The principle

9. At the January 2012 meeting, all of the IASB Board members stated that they believe that a single accounting model (the building block approach) should be applied to all insurance contracts. However, in some situations the costs of applying the full building block approach may outweigh the benefits. Consequently, they support developing a simplified accounting approach (the premium allocation approach).

10. This view was discussed in agenda paper 8B/71B *Premium allocation approach – a simplification of the building block approach* at the July 2011 Board meeting. Agenda paper 8C/71C *Premium allocation approach – A two model solution* from the July 2011 meeting discusses the alternative view that the building block approach and the premium allocation approach are separate accounting models that can potentially produce fundamentally different results.

11. Because most IASB members believe that the premium allocation should be a simplified application of the building block approach, most IASB members believe that the premium allocation approach should only be used in situations where it provides a reasonable approximation to the building block approach.

12. The eligibility criteria developed for the January 2012 meeting attempted to identify situations where the premium allocation approach and the building block approach produce similar results. However, the IASB staff believe that stating an overall principle will help users determine when the premium allocation approach can be used.

13. Consequently, the IASB staff recommend that the boards state the principle that contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation of those that would be produced by the building block approach.

The practical expedient

14. The IASB staff note that stating the eligibility criteria purely in principles terms would raise practical difficulties. Insurers might need to estimate what the measurement of their liabilities would be using the building blocks approach to prove that they would unlikely to be materially different under the premium allocation approach. This undermines the simplifications that the premium allocation approach is designed to achieve.

15. This problem could be avoided if the boards introduced a practical expedient that would allow insurers to assume, without further work, that some types of contract would produce measurements under the premium allocation approach that are a reasonable approximation to those that would be produced under the building block approach.

16. The IASB staff note that the premium allocation approach produces a reasonable approximation to the building block approach for most short duration contracts. This is because when the duration of a contract is short:

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

    (b) There are unlikely to be significant changes in expectations about future cash flows and the risks associated with those cash flows;

    (c) There is unlikely to be significant uncertainty about the coverage period;

    (d) 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.

17. Consequently, the IASB staff recommend that a contract should be deemed to produce measurements that are a reasonable approximation of those that would be produced by the building block approach if the coverage period is one year or less.

18. The IASB staff note that the exposure draft required insurers to apply the premium allocation approach if the coverage period is *approximately* one year or less. The IASB staff believe that the word *approximately* is unnecessary in the proposed practical expedient. If a contract has a coverage period of over one year, an insurer could still apply the premium allocation approach if the insurer can demonstrate it produces measurements that are a reasonable approximation to the building block approach.

19. In addition, the exposure draft precluded insurers from applying the premium allocation approach if a contract contains embedded options or other derivatives that significantly affect the variability of cash flows. The staff believe that this additional criterion is unnecessary in a practical expedient that is limited to contracts with a coverage period of one year or less. (As explained in agenda paper 3E/79E *Premium allocation approach: Amendments to the January staff recommendations on Eligibility and Mechanics*, when the practical expedient does not apply, a contract would not typically be eligible for the premium allocation approach if the embedded options or guarantees significantly affect the variability of cash flows.)

Application guidance

20. In AP 2A/78A *Premium allocation approach: Eligibility criteria* for the January meeting (reposted as AP3F/79F for this meeting), the staff recommended two criteria to determine when insurers should apply the building block approach rather than the premium allocation approach. Those criteria are discussed in agenda paper 3E/79E, which also proposes some amendments to the criteria considered in January.

21. At the January IASB education session, IASB members expressed concern that these criteria would, in the absence of a principle, be difficult to apply. However, they noted that the criteria could be used as application guidance to help insurers identify situations in which the premium allocation approach would not produce measurements that are a reasonable approximation to those that would be produced by the building block approach.

22. The IASB staff agrees that these criteria, amended as proposed in agenda paper 3E/79E, could be used as application guidance.

IASB staff recommendation

23. The IASB staff believe that the combination of a principle, a practical expedient and the proposed application guidance will produce substantially the same results as the use of the (amended) eligibility criteria proposed in January. That is, in general, the same contracts will qualify for the premium allocation approach. However, the IASB staff believe that providing a principle would be helpful to constituents in their interpretation of the eligibility criteria.

Question for the boards

The IASB staff recommend that:

(a) Contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach.

(b) A contract should be deemed to meet the condition in (a) without further work if the coverage period is one year or less.

(c) the boards should provide application guidance that contracts would not produce measurements that are a reasonable approximation to those that would be produced by the building block approach if, at the contract inception date, either of the following conditions are 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 performance obligations in each reporting period. This may be the case if, for example, significant uncertainty exists about

1) when the insurer will satisfy its performance obligations; or

2) the length of the coverage period.

Do the boards agree?

Permit or require

24. The boards need to decide whether to :

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

(b) permit the use of the building block approach.

25. 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.

26. Some respondents to the exposure draft, especially preparers that write both life and nonlife business (composite insurers), 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.

27. Others responded that for comparability the premium allocation approach should be required for all contracts that meet the eligibility criteria. In particular, some users expressed a preference to require the premium allocation approach so that there would be consistency in the model applied for same types of contracts.

28. The staff note that concerns about comparability are reduced if the premium allocation approach can only be applied in situations where it would produce measurements that are a reasonable approximation to those produced by the building block approach. Consequently, the IASB staff recommend that insurers should be permitted but not required to apply the premium allocation approach to contracts that meet the eligibility requirements.

Question 2: Permit or require?
Do the boards agree that an insurer should be permitted but not required to apply the premium allocation approach to contracts that meet the eligibility requirements?