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Insurance Accounting Alert

Boards make decisions on the premium allocation approach

What you should know

- The Boards have agreed on conditions for determining whether the PAA or the BAA should be applied to contracts that are eligible. But they remain divided on what PAA represents.
- The Boards decided on several aspects of the PAA, including the measurement of an onerous contract.
- The Boards agreed to use guidance from the ED *Revenue from Contracts with Customers* as the basis to determine whether non-insurance goods and services included in an insurance contract should be presented and measured separately.
- The IASB tentatively decided to keep financial instruments with discretionary participation features within the scope of the standard, but will seek to limit this to such contracts that are issued by insurers only. The FASB tentatively decided that financial instruments with discretionary participation features should not be included within the scope of the insurance contracts standard, unless the contract meets the definition of insurance.

Overview

During February, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, collectively, the Boards) each held meetings to re-deliberate tentative decisions in the IASB's Exposure Draft, *Insurance Contracts* (ED) and in the FASB's Discussion Paper *Preliminary Views on Insurance Contracts* (DP). The following topics were discussed:

- Eligibility for and certain mechanics of the premium allocation approach
- Measurement of liabilities for infrequent, high-severity events
- Onerous contracts
- Treatment of non-insurance goods and services

The IASB and FASB separately discussed whether financial instruments with discretionary participation features (i.e., contracts where the amount or timing of profit sharing is at the discretion of the issuer) should be within the scope of the insurance standard, or to treat those instruments under the financial instruments standard.

Premium allocation approach – eligibility criteria

At their January education sessions, the Boards held an extensive educational debate on proposals prepared by both staffs on eligibility for the PAA. It emerged from this debate that many IASB members preferred to see the PAA as an approximation for the BBA, while the FASB members tended to see it as a separate model that best reflects the characteristics of the contracts to which it is applied. The staff was asked to prepare revised eligibility criteria derived from the Boards' input from the educational sessions - in a way that those criteria would not necessarily depend on whether one sees the PAA as an approximation for the BBA or, instead, as a separate model next to the BBA.

In February, the IASB tentatively decided that contracts should be eligible for the PAA if the approach would produce measurements that are a reasonable approximation to those produced by the building block approach. As a practical expedient, contracts should be deemed to satisfy that principle without further consideration if the coverage period is one year or less. For other contracts, the IASB agreed that contracts would not produce measurements that are a reasonable approximation to those produced by the BBA. Therefore, the contracts would not be eligible for PAA if, at the contract inception date:

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 for 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 that the insurer has for each reporting period

   Or

   2. The length of the coverage period

As the PAA would reflect an approximation of the BBA, the IASB concluded that an insurer should be permitted, but not required, to apply the PAA to contracts that are eligible for the approach. The IASB noted that it would review whether it will need to update these criteria after its future discussions on the BBA.

The FASB also adopted the conditions in (i) and (ii) above, but as part of an approach that treats the PAA as a separate model: insurers are required to apply the BBA rather than the PAA if, at the contract inception date, either of the conditions in (i) or (ii) are met. The FASB selected the same practical expedient (i.e., coverage period is one year or less) as the IASB. As the FASB sees the PAA as a separate model, it decided that the PAA should be required for contracts that qualify for that approach.

How we see it

For the most part, the staff succeeded in developing a common set of conditions that clarifies when to apply either the PAA or the BBA. This indicates that the Boards have similar ideas on the types of contracts that should fall under the PAA.

However, the different viewpoints on the nature of the PAA remain. As noted by one Board member during the meeting, this disparity may stem from the Board's differing views on measurement, and on margins, in particular. Whether the Boards will be able to reconcile their differences and come to a consistent overall eligibility approach to PAA may depend on the Boards converging on measurement.

Based on the eligibility guidance determined by each of the Boards during this meeting, we expect the types of contract that are measured using the PAA to be fairly consistent between those applying IFRS and those applying US GAAP. However, the Boards' divergence on the use of "require" versus "permit" may have a significant impact on whether the PAA or the BBA is applied. For example, some life insurance contracts may meet the eligibility criteria for the PAA.

The future US GAAP on insurance contracts would then require application of the PAA for those contracts, while the future IFRS would allow application of the BBA to be consistent with the treatment of all other life products. Therefore, we expect that companies applying IFRS will start looking at their contracts and begin the process of deciding where they may elect BBA when the PAA criteria are met.

Premium allocation approach – mechanics

As a follow-up to their January meeting, the Boards discussed the use of time value of money and the treatment of acquisition costs under the PAA.

The Boards tentatively decided that discounting and interest accretion to reflect the time value of money should be required to measure the liability for the remaining coverage in contracts that have a significant financing component. The characteristics of what constitutes a significant financing component will be consistent with the exposure draft *Revenue from Contracts with Customers*. The Boards noted that time value of money is a fundamental aspect of insurance contracts. Hence, it would be difficult to explain that time value of money would not be considered within the insurance model.

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 of time 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. While making this decision, the Boards noted, that the practical expedient also present within the revenue recognition proposals, and the proposed wording for insurance could be used to resolve uncertainty that exists around the practical expedient in the revenue recognition exposure draft.

On measurement of acquisition costs, the Boards tentatively decided:

- The measurement of acquisition costs should include directly attributable costs (for the FASB limited to successful acquisition efforts only)

- Insurers should be permitted to recognise all acquisition costs as an expense if the contract coverage period is one year or less

The Boards also agreed to explore a presentation approach in which acquisition costs would be netted against the single/residual margin under the BBA, and netted against the liability for remaining coverage under the PAA.

How we see it

Netting the acquisition costs against the liability for remaining coverage as a presentation method is not new, as it is used under the PAA method in the IASB's ED. However, exploring such a presentation for the BBA means investigating a new concept and a change to the ED in which acquisition costs are treated as one of the cash flows. If acquisition costs are thought of as a separate item, then the Boards would have to consider whether the acquisition costs should follow the amortisation pattern of the residual margin or whether a separate amortisation pattern would be needed.

Measurement of liabilities for infrequent, high-severity events

The Boards received comments from insurers that sought clarification on when and how to measure a potential future insured event that is impending at the end of the reporting period. This concern was raised particularly in the context of infrequent, high-severity events such as a hurricane or other catastrophes. For example, a storm is building up before the reporting date, but does (or does not) make landfall after the reporting date. The Boards tentatively confirmed that insurers should measure the insurance contract liabilities taking into account estimates of expected cash flows at the reporting date, both when measuring the BBA and the onerous contract liability for the PAA.

The Boards agreed to provide application guidance to clarify whether an insured event, that was impending at the end of the reporting period and eventually occurs or not after that date, constitutes evidence of a condition that existed at the end of the reporting period. Consequently, such an event would be a non-adjusting event, to which IAS 10 Events after the Reporting Period applies, and a non-recognised event to which ASC Topic 855-10-25 applies.

How we see it

The Boards concluded that estimates should be made solely based on conditions present at reporting date. This will lead to volatility between reporting periods because the expected severity of pending wind related storms often change daily. This raises the question whether the outcome is a fair reflection of the actual circumstances around infrequent, high-severity events, or an artificial result from the model.

During the meeting, the Board members made it clear what their answer to this question would be: they commented this would reflect real economic volatility that comes with estimating future cash flows at a particular point in time. In any case, disclosure will be paramount in explaining the effects of such events.

Onerous contracts

At the December 2011 meeting, the Boards tentatively decided on the definition of onerous contracts and when insurers should perform onerous contract tests. They also discussed the basis for measuring onerous contracts and requested the staff to make further considerations in light of their tentative decision to introduce a practical expedient that would permit insurers not to discount claims incurred, and are expected to be paid within 12 months of the insured event. At the February meetings, the Boards continued their discussions on onerous contracts in the following areas.

When to re-measure an onerous contract liability

The Boards unanimously agreed with the staff recommendation that onerous contract liabilities should be updated at the end of each reporting period.

Should the risk adjustment be considered when identifying and measuring onerous contracts (IASB only)

A majority of the IASB members were in favour of considering the risk adjustment when identifying onerous contracts, and the measurement of the onerous contract liability should include a risk adjustment. This decision was supported by the staff analysis, although including the risk adjustment in identifying onerous contracts would make the onerous test more difficult. However, this difficulty would be alleviated by a previous decision that insurers perform onerous contract test calculation only when facts and circumstances indicate that the contract may be onerous.

Application of the practical expedient to identification and measurement of onerous contracts

During the session on the PAA (see above), the Boards confirmed their intention to provide a practical expedient for contracts accounted under the premium allocation approach. The practical expedient would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event.

A number of Board members felt that, if an insurer applies this practical expedient and, hence, elects not to discount the liability for incurred claims, then there is a potential inconsistency between the approach for measuring onerous contracts and one for measuring incurred claims liability. The Boards followed that logic and tentatively decided that, if an insurer elects not to discount the liability for incurred claims expected to be paid within 12 months, the insurer should use an undiscounted basis for both identifying whether contracts are onerous and measuring the liability for onerous contracts.

How we see it

The Boards made significant progress in determining the onerous contract test. However, one critical aspect of the test that still needs to be addressed is the aggregation level. In the exposure draft *Revenue from Contracts with Customers*, the Boards require the onerous test be performed at the level of an individual performance obligation (which would be more granular than an individual contract if more than one performance obligation were to be identified within the contract).

For the proposed insurance model, the level of aggregation is principally at the portfolio level since pooling of homogeneous risks through grouping of individual contracts is a fundamental aspect of insurance. Therefore, we expect that the Boards will get comments that question if the aggregation level for the onerous contract test from their proposed revenue recognition model is appropriate for insurance contracts.

Treatment of non-insurance goods and services

At prior meetings, the Boards had tentatively decided that goods and services should be unbundled from insurance contracts in accordance with the guidance for identifying separate performance obligations in the revenue recognition project, and that unbundled goods and services should be accounted for in accordance with whatever guidance is relevant, based on the characteristics of the unbundled component. The staff noted that this discussion does not address asset management services, which will be considered separately at a future meeting.

At this meeting, the Boards considered how to incorporate the criteria for identifying separate performance obligations from the exposure draft *Revenue from Contracts with Customers* into the insurance contracts project, so they can be used to unbundle goods and services components from insurance contracts. Under this approach, an insurer should identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the exposure draft *Revenue from Contracts with Customers*. If such a performance obligation to provide goods or services would be considered distinct, an insurer shall apply the applicable IFRS or US GAAP guidance in accounting for that performance obligation.

The Boards asked the staff to evaluate whether some of the revenue recognition guidance would actually be relevant to insurance. Several Board members also noted that a follow-up is needed to address how to allocate premiums and costs, considering the measurement bases under the insurance contracts model and the revenue recognition model is different.

How we see it

The fact that asset management services will be considered separately may indicate that the staff sees this as a more prominent issue than other goods and services because it is present in many long-term life contracts and may potentially be more integrated with the insurance component.

Allocation of premiums and costs between the insurance and other components of a contract may come with challenges; in the past, the staff already made the observation that this ultimately requires an approach that involves some arbitrariness.

Financial instruments with discretionary participation features

Separately, the Boards discussed whether financial instruments with discretionary participation features (DPF) should be included in the scope of the insurance contract standard. The IASB also discussed how the term DPF should be defined.

The IASB staff recommendation was to include financial instruments with DPF within the scope of the insurance contracts standard, as opposed to including them within the scope of the financial instrument standards. The IASB staff provided arguments for and against applying the insurance contracts model to all financial instruments with DPF, and argued that the benefits of applying the insurance contracts model to all financial instruments with DPF outweighed those for application to insurance contracts only.

The majority of the IASB supported the staff recommendation to include financial instruments within the insurance contracts standard, but to limit the application to the insurance industry. Regarding the definition of DPF, the Board agreed it should take into account the different ways of limiting contracts to those written within the insurance industry. The staff was instructed to draft another paper to address the definition issues noted.

In a separate meeting on 7 March 2012, the FASB staff recommended to exclude financial instruments with DPF from the scope of the insurance contracts standard. The FASB agreed with their staff and tentatively decided not to scope in financial instrument contracts with DPFs into the insurance contracts standards, regardless of whether those contracts were issued by an insurer.

How we see it

The choice for the IASB is a difficult one. On one hand, these contracts are not insurance contracts. On the other hand, they share many features with life insurance contracts containing DPF. Two important questions remain. First, will the IASB be able to find an appropriate principle to limit this scoping to financial instruments with DPF issued by insurance companies only. Second, will this be an interim solution that gives the IASB time to modify its financial instruments guidance, or will it prove to be a more permanent solution. Meanwhile, the FASB will have to focus on the measurement of financial instruments with DPF within the constraints of its Financial Instruments Project.

The IASB has tried not to make this an industry specific standard, but a standard on insurance contracts. However, the IASB has put itself in a position where the insurance standard will be an industry specific standard in at least one aspect. With each of the Boards taking fundamentally different routes on financial instruments on DPF, we expect that this issue will be re-debated at least one more time before the Boards will publish their documents. However, it is impossible to predict the outcome of this debate.

Next steps

The IASB plans to issue a revised exposure draft or a review draft of the final standard in the second half of 2012. It will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period.

The Boards will have their next discussion on insurance at the March Board meetings, when they will address the definition of a portfolio of insurance contracts and separation of investment components from insurance contracts.

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