FA Module 23: IFRS 17 premium allocation approach – IFRS practice problems

(The attached PDF file has better formatting.)

Premium allocation approach

IFRS 17 paragraphs 55–56, 59, 100 and B126 explain the premium allocation approach:

The liability for remaining coverage at initial recognition (the insurance contract liability) depends on whether acquisition cash flows are charged to expense when they occur or are amortized over the contract period:

- ! if they are charged to expense when they occur, the insurance contract liability = the premium received
- ! if they are amortized over the contract period, the insurance contract liability = premium received minus the acquisition cash flows

At later valuation dates, the liability for remaining coverage at the end of the year =

the insurance contract liability at the beginning of the year
+ the premiums received during the year
– the acquisition cash flows during the year (if the insurer amortizes them)
+ the acquisition cash flows amortized during the year
+ the insurance finance expense for the year
– the insurance revenue for coverage provided during the year
+ minus any investment component paid (or transferred to the liability for incurred claims)

The insurance finance expense for the premium allocation approach is like that for the general measurement approach, except that

- ! it is required only if the contracts have a significant financing component
  - " if the time between the premium due date and the provision of coverage is a year or less, the financing component is not significant.
- ! it uses the discount rate determined at initial recognition, not the current discount rate.

The insurance revenue is the allocation of the premium proportional to the passage of time. Acquisition cash flows, if they are amortized, are also proportional to the passage of time.

Investment components are they same as for the general measurement approach, though they are rare in contracts measured with the premium allocation approach.

Insurance revenue is the expected premium receipts (adjusted for the time value of money if the insurer elects to do so) allocated based on the passage of time; but if the expected pattern of release of risk differs from the passage of time, then based on the timing of insurance service expenses.

Exercise 23.1: premium allocation approach

On 1 July 20X1, and insurer issues ten-month insurance contracts that expire on 30 April 20X2.

The insurer's fiscal year ends each December 31, and the insurer prepares interim financial statements ending each June 30.

- The premium for the group of contracts is 1,220, received right after initial recognition.
- The directly attributable acquisition cash flows are 20, paid right after initial recognition.
- Claims are incurred and risk is released evenly over the contract period.
- The insurer expects no contracts to lapse and the group not to be onerous.

The insurer makes the following elections:

- To use the premium allocation approach, since the contract period is one year or less.
- *Not* to adjust the liability for remaining coverage for the time value of money, since the lag from premium collection to the provision of insurance service is one year or less.
- *Not* to adjust the liability for incurred claims for the time value of money, since the lag from occurrence to payment of claims is one year or less.
- To charge directly attributable acquisition cash flows to expense when they are incurred.

A. What is the insurance revenue in 20X1 and in 20X2?
B. What is the liability for remaining coverage at 12/31/20X1 and at 6/30/20X2?
C. What are the insurance service expenses for the period 1 July 20X1 to 31 December 20X1?
D. What are the insurance service expenses for the period 1 January 20X2 – 30 June 20X2?

Part A: The contract period is ten months, from 1 July 20X1 to 31 April 20X2, of which six months are in 20X1 and four months are in 20X2. The gross premium is 1,220, so the insurance revenue is

- 1 July 20X1 – 31 December 20X1: 1,220 × 6 / 10 = 732
- 1 January 20X2 – 30 June 20X2: 1,220 × 4 / 10 = 488

The contracts expire on 31 April 20X2, so the insurance revenue for 1 July 20X2 – 31 December 20X2 is 0.

Question: Is the insurance revenue allocated as the time elapsed in the period or the expected claims in the period?

Answer: For most short term insurance contracts that use the premium allocation approach, claims occur evenly over the contract period. Only if the insurance contract provides different levels of reimbursement over the contract period does one allocate insurance revenue by expected claims.

Part B: The liability for remaining coverage at any valuation date is the liability for remaining coverage at the previous valuation date + the cash inflows (premium received) – the insurance revenue for the period.

- 31 December 20X1: 0 + 1,220 – 732 = 488
- 30 June 20X2: 488 + 0 – 488 = 0

Question: Is IFRS 17 the same as GAAP (SFAS 60) for this liability?

Answer: The IFRS 17 premium allocation approach allows the insurers to choose whether to charge directly attributable acquisition cash flows to expense when they occur or to subtract them from the gross premium to give a net premium. In this exercise, the insurer elects to charge directly attributable acquisition cash flows to expense when they occur. Right after the premium is received and the directly attributable acquisition cash flows are paid, the liability for remaining coverage in this exercise is 0 + 1,220 – 0 = 1,220. The net GAAP liability is the unearned premium reserve of 1,220 – the deferred policy acquisition cost asset of 20 = 1,200.

- GAAP matches the directly attributable acquisition cash flows to the premium income.
- IFRS 17 gives the insurer the option to charge the directly attributable acquisition cash flows to expense when they are incurred (if it uses the premium allocation approach).

Part C: The insurance service expense is the change in the estimate of the present value of future cash flows (the claims) + the change in the risk adjustment for non-financial risk + the cash outflows (claims paid). The insurance service expenses for 1 July 20X1 to 31 December 20X1 = the estimated incurred claims of 600 + the risk adjustment for non-financial risk of 36 = 636. The insurer elected not to adjust the liability for incurred claims for the time value of money, so we use the incurred claims, not their present value.

Part D: The insurance service expenses for 1 January 20X2 to 30 June 20X2 = the estimated incurred claims of 400 + the risk adjustment for non-financial risk of 24 = 424:

- the liability for incurred claims = 600 at 12/31/20X1 and 1,000 at 6/30/20X2, for a change of 400.
- the risk adjustment for non-financial risk = 36 at 12/31/20X1 and 60 at 6/30/20X2, for a change of 24.

Part E: At December 31, 20X2, all claims are settled, so the liability for incurred claims is zero and the risk adjustment for non-financial risk is zero.

The insurance service expenses for 1 July 20X2 to 31 December 20X2 =

	the change in the liability for incurred claims = 0 – 1,000 = –1,000
+	the change in the risk adjustment for non-financial risk = 0 – 60 = –60
+	the cash outflows = 1,070
=	-1,000 + -60 + 1,070 = 10.

The insurance service expense in this exercise has a ratio of 60% to 40% for 20X1 and 20X2, just like the insurance revenue. The exercise assumes that claims occur evenly over the contract period.

In this exercise, the liability for incurred claims equals the insurance service expenses, since actual claims equal expected claims.