Case Study 4 – PAA approach

The premium allocation approach is a simplified form of measuring insurance contracts in comparison with the general model. Use of the premium allocation approach is optional for each group of insurance contracts that meets the eligibility criteria at the inception of the group:

- The entity reasonably expects that this will be a reasonable approximation of the General Model, or

- The coverage period of each contract in the group is one year or less.

Where, at the inception of the group, an entity expects significant variances in the fulfilment cash flows (FCF) during the period before a claim is incurred, such contracts are not eligible to apply to the PAA. According to the PAA, the obligation for remaining coverage is initially recognized as the premiums paid at initial recognition, if any, less any cash flows from insurance purchase. The carrying amount of the liability is then equal to the carrying amount at the beginning of the reporting period plus the premiums received during that time, less any cash flows generated by the purchase of insurance, plus the cash flows from the amortization of those cash flows, less the amount recognized as insurance revenue for coverage provided during that time, and less any investment component that was paid to the liability or transferred to it in connection with incurred claims.

Differences between the premium allocation approach and the general model include:

Simplified measurement of the liability for remaining coverage for groups of insurance contracts that are not onerous. The overall liability measurement of the premium allocation approach and the general model would be the same for groups of contracts that are onerous.

- An option not to account for the effects of financial risk and time value of money when calculating the liability for claims that have already been incurred when the anticipated payment or receipt of those payments is projected to occur within a year of the claim's inception.
- If the coverage duration of each contract in the group is no longer than a year, there is an option to recognize any insurance acquisition cash flows as expenses when they are incurred (instead of adjusting the obligation for remaining coverage).

- An entity need only assess whether a group of insurance contracts is onerous if facts and circumstances indicate that the group is onerous (the general model effectively requires an assessment of whether a group of contracts is onerous at each reporting date after the initial recognition of a group).

<table>
<tr><th colspan="3">Liability for remaining coverage at initial recognition</th></tr>
<tr><td rowspan="3">Premium received less acquisition costs</td><td></td><td>Contractual service margin</td></tr>
<tr><td></td><td>Risk adjustment</td></tr>
<tr><td></td><td>Expected cash flows (adjusted for time value of money)</td></tr>
<tr><td>Premium allocation approach</td><td></td><td>General model</td></tr>
</table>

The accounting model for the premium allocation approach is broadly like the accounting model used under IFRS 4 by most non-life or short-duration insurers, sometimes referred to as "an earned premium approach". There are some differences, for example:

- Presentation in the balance sheet Premium allocation approach:

  -No separate asset is recognized for deferred acquisition costs. Instead, deferred acquisition costs are subsumed into the insurance liability for remaining coverage.

  -No separate presentation of a premium receivable asset in the balance sheet under IFRS 17 (implicitly included in the insurance liability for remaining coverage)

- Measurement of the liability for remaining coverage includes an explicit risk adjustment for non-financial risk when a group of contracts is onerous.

- Measurement of the liability for incurred claims includes an explicit risk adjustment for non-financial risk and is subject to discounting (an entity need not discount the liability for incurred claims if settlement is expected within a year).

Practical expedients available under the Premium allocation approach

The liability for remaining coverage must be discounted if any of the group's insurance contracts have a sizable financing component, but it is not necessary to do so if the entity anticipates that the time between providing each component of the coverage and the related premium due date will not exceed a year at the time of initial recognition.

In applying PAA, an entity may choose to recognize any insurance acquisition cash flows as an expense when it incurs those costs, provided that the coverage period at initial recognition is no more than a year.

The General Model's measurement of the group's obligation for incurred claims is exempt from the simplifications brought on by the PAA. However, if the balance is anticipated to be paid or received one year or sooner after the date the claims are incurred, then those cash flows do not need to be discounted.

A Case Study

The case:

- An insurance company issues a property insurance contract on 1 July 20X1 Premium allocation approach.

- The coverage period is 1 year i.e. 1 July 20×1 – 30 June 20×2 Premium allocation approach

- The premium is CU 1,200 per annum Premium allocation approach.

- Insurance acquisition costs are paid at the beginning of the insurance and amount to CU 180 Premium allocation approach.

- Insurance services are covered evenly over the coverage period (yes indeed the property insurance is the same throughout the year)

- No claims are incurred (quite normal for property insurance covers) Premium allocation approach.

- Under IFRS 17 the contract is accounted for as a group of insurance contracts Premium

PREMIUM PAID UPFRONT

IFRS 4	01/07/x1	30/09/x1	31/12/x1	31/03/x2	30/06/x2
Insurance premium receivable	0	0	0	0	0
Unearned premium reserve (UPR)	-1,200	-900	-600	-300	0
Deferred acquisition cost (DAC)	180	135	90	45	0
Sum of insurance line items in the statement of financial position	-1,020	-765	-510	-255	0
Revenue (change in UPR)		300	300	300	300
Amortization DAR		-45	-45	-45	-45

Insurance contract asset(liability) and revenue/amortization DAR

IFRS 17	01/07/x1	30/09/x1	31/12/x1	31/03/x2	30/06/x2
Opening balance	0	-1,020	-765	-510	-255
Premium received on initial recognition	-1,200				
Insurance acquisition cost	180				
Premiums received in the period		0	0	0	0
Amortization of insurance acquisition cost		-45	-45	-45	-45
Insurance revenue		300	300	300	300
Closing balance	-1,020	-765	-510	-255	0

PREMIUM PAID AT THE END

IFRS 4	01/07/x1	30/09/x1	31/12/x1	31/03/x2	30/06/x2
Insurance premium receivable	1,200	1,200	1,200	1,200	0
Unearned premium reserve (UPR)	-1,200	-900	-600	-300	0
Deferred acquisition cost (DAC)	180	135	90	45	0
Sum of insurance line items in the statement of financial position	180	435	690	945	0
Revenue (change in UPR)		300	300	300	300
Amortization DAR		-45	-45	-45	-45

Insurance contract asset(liability) and revenue/amortization DAR

IFRS 17	01/07/x1	30/09/x1	31/12/x1	31/03/x2	30/06/x2
Opening balance	0	180	435	690	945
Premium received on initial recognition					
Insurance acquisition cost	180				
Premiums received in the period		0	0	0	-1,200
Amortization of insurance acquisition cost		-45	-45	-45	-45
Insurance revenue		300	300	300	300
Closing balance	180	435	690	945	0

PREMIUM PAID MONTHLY

IFRS 4	**01/07/x1**	**30/09/x1**	**31/12/x1**	**31/03/x2**	**30/06/x2**
Insurance premium receivable	1,200	900	600	300	0
Unearned premium reserve (UPR)	-1,200	-900	-600	-300	0
Deferred acquisition cost (DAC)	180	135	90	45	0
Sum of insurance line items in the statement of financial position	180	135	90	45	0
Revenue (change in UPR)		300	300	300	300
Amortization DAR		-45	-45	-45	-45

Insurance contract asset(liability) and revenue/amortization DAR

IFRS 17	**01/07/x1**	**30/09/x1**	**31/12/x1**	**31/03/x2**	**30/06/x2**
Opening balance	0	180	135	90	45
Premium received on initial recognition	0				
Insurance acquisition cost	180				
Premiums received in the period		-300	-300	-300	-300
Amortization of insurance acquisition cost		-45	-45	-45	-45
Insurance revenue		300	300	300	300
Closing balance	180	135	90	45	0

Infigos's team can support these qualitative analyses and can rely on its experience with the implementation of IFRS 9.