December 9, 2019

Financial Reporting Center –
Credit Losses

Working Draft:

Allowance for Credit Losses Implementation Issue

(with a focus on Insurance Entities)

Issue #44: Considerations Related to ASC Topic 326: Financial Instruments - Credit Losses, for Premiums Receivable

Wording to be Included in the Audit and Accounting Guides: Allowance for Credit Losses, Life and Health Insurance Entities, and Property and Liability Insurance Entities

Background

1. In some cases, an insurance entity records, as of the effective date of a contract, written premiums (income statement) and a receivable from the policyholder to reflect the entire amount of premium due under the contract for the period of coverage. At the same time, the insurance entity records an unearned premium reserve (a liability) for the portion of the written premium that has not yet been earned, along with an income statement charge for the change in the unearned premium reserve. As such, at the effective date of the contract, the insurer generally presents a premium receivable and an equivalent unearned premium reserve liability, as well as an equal amount of written premium and change in unearned premium (for a net earned premium of zero). As noted in FASB ASC 944-605-25-1, “Premiums from short-duration contracts shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided.”

2. Premiums are generally billed to the policyholder in advance of the coverage being provided by the insurance entity, which may occur annually, semi-annually, quarterly, or monthly. If the policyholder does not pay the premium, the insurer can generally unconditionally cancel the policy and is under no obligation to further perform. Generally, a policyholder is given a 30-60 day grace period to pay the premium before the coverage is cancelled. Once a policy is canceled, the remaining unearned premium liability for that policy is written off along with the remaining premium receivable balance, with limited income statement impact, other than the exposure to unpaid earned premium before the cancelation date.

Scope

3. In accordance with FASB ASC 326-20-15-2a, FinREC believes that premium receivables (i.e., uncollected premiums) should be evaluated for credit losses under the guidance in FASB ASC 326.

Determination of Expected Credit Losses

Initial Measurement

4. FASB ASC 326-20-30-1 states,

   > The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

5. In accordance with FASB ASC 326-20-30-1, after deducting the allowance for credit losses the balance sheet should "present the net amount expected to be collected on the financial asset."

6. The unearned premium reserve related to unpaid premiums, represents the portion of the premium receivable balance for which future performance (i.e., coverage) is required, which may be conditional based on the policyholder paying premiums. The portion of the premium receivable balance for earned premiums, relates to premiums earned by satisfying the performance obligation of providing insurance coverage.

7. FinREC believes that when measuring expected credit losses relating to premium receivables, an insurer should consider contractual provisions that, upon default or delinquency of the policyholder, allow an insurer to cease coverage for the remaining period after a legal grace period, if applicable. These cancellation of coverage provisions reduce credit losses associated with the underlying premium receivable (in essence, the write-off of any premium receivable upon cancellation of coverage does not represent a credit loss that needs to be captured in the current expected loss calculation). Additionally, while not prevalent in the United States (U.S.), in certain non U.S. jurisdictions, local laws may require coverage to be provided for the remaining term despite a delinquency or default by the policyholder. In these situations, FinREC believes an insurer should consider credit losses on the entire premium receivable without consideration of the unearned premium.

Similar Risk Characteristics (Level of Aggregation)

8. FASB ASC 326-20-30-2 states:

   > An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

9. In accordance with FASB ASC 326-20-30-2, policyholders that owe premiums should be evaluated for similar risk characteristics to determine if the expected credit loss on premium receivables should be measured on an individual basis or by grouping the receivables.

Assessment of Collectability of Cash Flows

10. Paragraphs 7-9 of FASB ASC 326-20-30 provide guidance on the development of reasonable and supportable forecasts.

11. As required by FASB ASC 326-20-30-7, an insurance entity should consider all available, reasonable, and supportable information to assess the collectability of cash flows to develop an estimate of the allowance for credit losses of premiums receivables that includes the contractual period that the insurer is exposed to credit risk.

Methods for Estimating Expected Credit Losses

12. Paragraphs 3-6 of FASB ASC 326-20-30 provide guidance and also explains that various methods may be used in determining the allowance for credit losses.

13. FASB ASC 326-20-55-7 states:

> Because of the subjective nature of the estimate, this Subtopic does not require specific approaches when developing the estimate of expected credit losses. Rather, an entity should use judgment to develop estimation techniques that are applied consistently over time and should faithfully estimate the collectability of the financial assets by applying the principles in this Subtopic. An entity should utilize estimation techniques that are practical and relevant to the circumstance. The method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity.

14. In accordance with FASB ASC 326-20-30, an insurance entity should select an appropriate method to be used to estimate the allowance for credit losses based on reasonable and supportable information that is available to the entity.

Comments should be received by February 10, 2020, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to attention: Kim Kushmerick, 1345 Avenue of the Americas, New York, N.Y., 10105.