



# Applying IFRS 17

**A closer look at the new  
Insurance Contracts  
Standard**

June 2021



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## What you need to know

- ▶ The IASB issued IFRS 17, a comprehensive new accounting standard for insurance contracts in May 2017 which was subsequently amended in June 2020.
- ▶ IFRS 17 will become effective for annual reporting periods beginning on or after 1 January 2023, with early application permitted.
- ▶ The IFRS 17 model combines a current balance sheet measurement of insurance contracts with recognition of profit over the period that services are provided.
- ▶ The general model in the standard requires insurance contract liabilities to be measured using discounted probability-weighted current estimates of future cash flows, an adjustment for non-financial risk, and a contractual service margin representing the profit expected from fulfilling the contracts.
- ▶ Effects of changes in the estimates of future cash flows (and the risk adjustment for non-financial risk) relating to future services are recognised over the period services are provided rather than immediately in profit or loss.
- ▶ The standard includes specific adaptations for the measurement and presentation of insurance contracts with direct participation features and for reinsurance contracts held.
- ▶ The standard contains a simplified model, the premium allocation approach, which can be used for contracts with coverage periods of one year or less, or when doing so approximates the general model.
- ▶ Entities have an option to present the effect of changes in discount rates either in profit or loss, or in other comprehensive income, in order to present this in way that fits best with the accounting for assets that back the insurance liabilities.

# Introduction

The International Accounting Standards Board (IASB) issued IFRS17 *Insurance Contracts* (IFRS 17 or the standard) in May 2017. In June 2020, IFRS 17 was amended by *Amendments to IFRS 17* (the June 2020 amendments). Following these amendments, IFRS 17 is effective for annual periods beginning on or after 1 January 2023, with earlier application permitted, provided the entity also applies IFRS 9 *Financial Instruments* (IFRS 9) at the same time.

IFRS 17 supersedes IFRS 4 *Insurance Contracts*, an interim standard that allowed entities to use a wide variety of accounting practices for insurance contracts, reflecting national accounting requirements and variations of those requirements. The IASB had always intended to replace IFRS 4; the differences in accounting treatment across jurisdictions and practices have made it difficult for investors and analysts to understand and compare insurers' results. Most stakeholders agreed on the need for a common global insurance accounting standard even though opinions varied as to what it should contain. Long-term and complex insurance risks are difficult to reflect in the measurement of insurance contracts. In addition, insurance contracts are subject to several measurement challenges. Some previous accounting practices under IFRS 4 did not adequately reflect the true underlying financial position or the financial performances of these insurance contracts.<sup>1</sup>

More than 20 years in development, IFRS 17 represents a complete overhaul of accounting for insurance contracts. The new standard will increase the transparency of insurers' financial positions and performance and is intended to make their financial statements more comparable with both other insurers and other industries.

The new standard applies a current value approach to measuring insurance contracts and recognises profit as insurers provide services to policyholders. The profit or loss earned from underwriting activities are reported separately from financing activities. Detailed note disclosures explain how items like new business issued, experience in the year, cash receipts and payments, and changes in assumptions affected the performance and the carrying amount of insurance contracts.

IFRS 17 is a complex standard. It covers accounting for a wide range of contracts that insurers issue globally. The degree of change compared to existing practice will vary based on existing accounting policies and the types of business insurers write. However, the change will be significant for nearly all insurers. Therefore, the IASB has allowed more than three years after issue date for the standard to become effective.

The changes in financial reporting that come with IFRS 17 will affect both preparers of financial statements and users. Users of financial statements will receive more and different information about an entity's insurance contracts in the IFRS financial statements than in the past, which may change the way they assess and compare insurers. Preparers will need to help analysts and other users of their financial statements to interpret the new information and understand how it relates to what they receive currently. Analysts may wish to evaluate an insurer's performance on the new basis (albeit estimated), even for comparative periods, before the standard is effective.

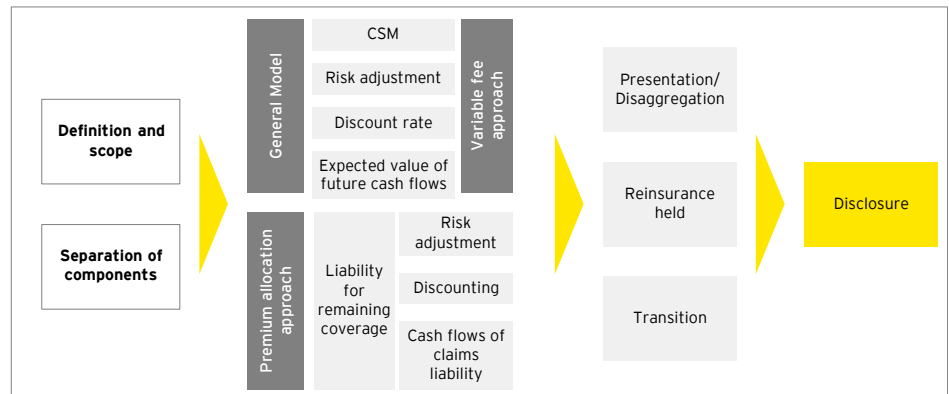
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<sup>1</sup> IFRS 17.BC1, BC4.

# 1. Overview of IFRS 17

IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features that an entity issues.

The following diagram visually presents the key features of the standard:



IFRS 17 is the first comprehensive international accounting standard for insurance contracts.

IFRS 17 reflects the Board's view that an insurance contract combines features of both a financial instrument and a service contract. In addition, many insurance contracts generate cash flows with substantial variability over a long period. To provide useful information about these features, the Board developed an approach that:<sup>2</sup>

- ▶ Combines current measurement of the future cash flows with the recognition of profit over the period services are provided under the contract
- ▶ Presents insurance service results (including presentation of insurance revenue) separately from insurance finance income or expenses
- ▶ Requires an entity to make an accounting policy choice whether to recognise all insurance finance income or expense for the reporting period in profit or loss on a portfolio basis or to recognise some of that income or expense in other comprehensive income.

The measurement required by IFRS 17 results in:<sup>3</sup>

- ▶ The liability for a group of insurance contracts relating to performance obligations for remaining service being measured broadly consistent with IFRS 15 - *Revenue from Contracts with Customers* (IFRS 15) - except that:
  - ▶ The measurement is updated for changes in financial assumptions (to varying degrees depending on the type of insurance contract)
  - ▶ The liability often includes an investment component typically not in contracts within the scope of IFRS 15

<sup>2</sup> IFRS 17.IN5 (May 2017).

<sup>3</sup> IFRS 17.IN7 (May 2017).

- ▶ The liability for a group of insurance contracts relating to incurred claims being measured is broadly consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, (IAS 37) except that the liability often includes an investment component that is typically not in contracts within the scope of IAS 37.

An entity may apply a simplified measurement approach (the premium allocation approach) to some insurance contracts. This simplified measurement approach allows an entity to measure the amount relating to remaining service by allocating the premium over the coverage period.<sup>4</sup>

IFRS 17 was effective originally for annual accounting periods beginning on or after 1 January 2021. However, as a result of the June 2020 amendments, IFRS 17 is effective for accounting periods beginning on or after 1 January 2023. Early application is permitted for entities that apply IFRS 9 *Financial Instruments* on or before the date of initial application.

IFRS 17's transition provisions require a full retrospective application of the standard unless it is impracticable, in which case, entities should apply either a modified retrospective approach or a fair value approach (see 17.2. below).

Following the issuance of IFRS 17, the IASB created a Transition Resource Group (TRG). The members of the TRG include financial statement preparers and auditors with both practical and direct knowledge of implementing IFRS 17. The TRG members work in different countries and regions. The TRG's purpose is to:

- ▶ Provide a public forum for stakeholders to follow the discussion of questions raised on implementation
- ▶ Inform the IASB in order to help it determine what, if any, action will be needed to address those questions. Possible actions include providing supporting materials such as webinars, case studies and/or referral to the Board or Interpretations Committee

Up to the date of this publication, the TRG met three times in 2018 and once in 2019. As of the date of the last TRG meeting, in April 2019, a total of 127 issues had been submitted by constituents of which the TRG discussed 22 in detail. The rest are questions that:

- ▶ Have been answered by IASB staff applying only the words in IFRS 17
- ▶ Do not meet the submission criteria

Or

- ▶ Were considered through a process other than a TRG discussion (e.g., annual improvements or outreach)

At the time of writing, there are no further TRG meetings scheduled although the TRG submission process remains open for stakeholders to submit questions that they believe meet the TRG submission criteria. While TRG members' views are non-authoritative, entities should consider them as they implement the new standard.

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<sup>4</sup> IFRS 17.IN8 (May 2017).

During the period to May 2019, as a result of the TRG discussions and issues identified by constituents, the IASB discussed and agreed several amendments to IFRS 17. In June 2019, the IASB issued an Exposure Draft - ED/2019/4 *Amendments to IFRS 17* (the ED) containing the proposed amendments. The IASB discussed comments on the ED in the period to May 2020 and then issued the June 2020 amendments to IFRS 17. The June 2020 amendments have been incorporated throughout the applicable sections of this publication.

The views expressed in this publication may evolve as implementation continues and additional issues are identified. Conclusions in seemingly similar situations may differ from those reached in the illustrations contained in this publication due to differences in the underlying facts and circumstances.

## 2. The objective, definitions and scope of IFRS 17

### 2.1. The objective of IFRS 17

The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents the recognition, measurement, presentation and disclosure principles for insurance contracts within its scope. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.<sup>5</sup>

### 2.2. Definitions

The definitions that are relevant to the application of IFRS 17 and included within Appendix A of the standard are likewise included in Appendix A of this publication. A list of these terms is produced below, in alphabetical order. Those items marked with an asterisk (\*) were impacted by the amendments to IFRS 17 issued in June 2020.

- ▶ Contractual service margin\*
- ▶ Coverage period\*
- ▶ Experience adjustment
- ▶ Financial risk
- ▶ Fulfillment cash flows
- ▶ Group of insurance contracts\*
- ▶ Insurance acquisition cash flows\*
- ▶ Insurance contract
- ▶ Insurance contract services (newly added in 2020)\*
- ▶ Insurance contract with direct participation features
- ▶ Insurance contract without direct participation features
- ▶ Insurance risk
- ▶ Insured event
- ▶ Investment component\*
- ▶ Investment contract with discretionary participation features
- ▶ Liability for incurred claims\*
- ▶ Liability for remaining coverage\*
- ▶ Policyholder
- ▶ Portfolio of insurance contracts
- ▶ Reinsurance contract

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<sup>5</sup> IFRS 17.1.

- ▶ Risk adjustment for non-financial risk
- ▶ Underlying items

## How we see it

- ▶ IFRS 17 does not mention a “*de minimis*” limit on the number of insurance contracts that an entity must issue to ensure that its investment contracts with discretionary participation features are within the scope of IFRS 17.
- ▶ The IASB’s decision to, in line with IFRS 4, retain investment contracts with discretionary participation features within the scope of the insurance contracts standard means that entities account for these contracts under IFRS 17. However, the measurement model under IFRS 17, in many cases, will represent a major change from existing accounting practices applied to investment contracts with discretionary participation features under IFRS 4.

## 2.3. Scope

An entity should apply IFRS 17 to:<sup>6</sup>

- ▶ Insurance contracts, including reinsurance contracts, that it issues
- ▶ Reinsurance contracts it holds

And

- ▶ Investment contracts with discretionary participation features that it issues, provided the entity also issues insurance contracts

IFRS 17 specifies that all references to insurance contracts throughout the standard also apply to:<sup>7</sup>

- ▶ Reinsurance contracts held, except:
  - ▶ For references to insurance contracts issued
  - ▶ The specific requirements for reinsurance contracts held discussed at 11 below
- ▶ Investment contracts with a discretionary participation feature as set out above except for the reference to insurance contracts as described at 12.4 below.

In addition, all references to insurance contracts also apply to insurance contracts acquired by an entity in a transfer of insurance contracts or a business combination other than reinsurance contracts held.<sup>8</sup>

It can be seen from this that IFRS 17 applies to all insurance contracts (as defined in IFRS 17) throughout the duration of those contracts, regardless of the type of entity issuing the contracts.<sup>9</sup> Consistent with other IFRSs it is

<sup>6</sup> IFRS 17.3.

<sup>7</sup> IFRS 17.4.

<sup>8</sup> IFRS 17.5.

<sup>9</sup> IFRS 17.BC64.

Entities will continue to account for investment contracts with discretionary participation features under the insurance standard.

a transaction-based standard. Consequently, non-insurance entities will be within its scope if they issue contracts that meet the definition of an insurance contract.

The Board decided to base its approach on the type of activity rather than on the type of the entity because:<sup>10</sup>

- ▶ A robust definition of an insurer that could be applied consistently from country to country would be difficult to create
- ▶ Entities that might meet the definition frequently have major activities in other areas as well as in insurance, and would need to determine how and to what extent these non-insurance activities would be accounted for in a manner similar to insurance activities or in a manner similar to how other entities account for their non-insurance activities
- ▶ If an entity that issues insurance contracts accounted for a transaction in one way and an entity that does not issue insurance contracts accounted for the same transaction in a different way, comparability across entities would be reduced.

Conversely, contracts that fail to meet the definition of an insurance contract are within the scope of IFRS 9 if they meet the definition of a financial instrument (unless they contain discretionary participation features and the entity also issues insurance contracts). This will be the case even if such contracts are regulated as insurance contracts under local legislation. Such contracts are commonly referred to as 'investment contracts'. If an investment contract contains an insignificant amount of insurance risk, that insignificant insurance risk is not within the scope of IFRS 17 since the contract is an investment contract and not an insurance contract.

The assessment of whether a contract is an insurance contract will include an assessment of whether the contract contains significant insurance risk (discussed at 3.5 below). In addition, even if the contract contains significant insurance risk, an entity needs to assess whether the contract also contains embedded derivatives (discussed at 5.1 below), distinct investment components (discussed at 5.2 below), or a promise to provide distinct goods or services other than insurance contract services (discussed at 5.3 below) that need to be separated and accounted for under other standards.

Contracts within the scope of IFRS 17 are excluded from the scope of the following IFRSs (except for specific exceptions which are discussed separately elsewhere in this chapter):

- ▶ IFRS 7 - *Financial Instruments: Disclosures*
- ▶ IFRS 9 - *Financial Instruments*
- ▶ IFRS 15 - *Revenue from Contracts with Customers*
- ▶ IAS 32 - *Financial Instruments: Presentation*
- ▶ IAS 36 - *Impairment of Assets*
- ▶ IAS 37 - *Provisions, Contingent Liabilities and Contingent Assets*

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<sup>10</sup> IFRS 17.BC63.



▶ IAS 38 - *Intangible Assets*

Any assets for insurance acquisition cash flows (see 7.3 below) are also excluded from the scope of IAS 38.

Contracts within the scope of IFRS 17 are excluded from the measurement provisions of IFRS 5 - *Non-current Assets Held for Sale and Discontinued Operations*.

Contracts within the scope of IFRS 17 are not excluded from the scope of IFRS 13 - *Fair Value Measurement* (IFRS 13) which means that any reference to fair value in IFRS 17 should be fair value as defined and measured under IFRS 13. However, IFRS 17 does not generally require that insurance liabilities are measured at fair value except on transition in certain circumstances and, in those circumstances, IFRS 13's measurement requirements are modified to exclude the demand deposit floor (see 17.5 below).

### **2.3.1. Transactions not within the scope of IFRS 17**

IFRS 17 excludes the following transactions that may meet the definition of insurance contracts:<sup>11</sup>

- ▶ Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see 2.3.1.A below).
- ▶ Employers' assets and liabilities that arise from employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (these are accounted for under IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payment* and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).
- ▶ Contractual rights or contractual obligations contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, variable and other contingent lease payments and similar items (these are accounted for under IFRS 15, IFRS 16 *Leases* - and IAS 38).
- ▶ Residual value guarantees provided by the manufacturer, dealer or retailer and lessees' residual value guarantees embedded in a lease (they are accounted for under IFRS 15 and IFRS 16). However, stand-alone residual value guarantees that transfer insurance risk are not addressed by other IFRSs and are within the scope of IFRS 17.<sup>12</sup>
- ▶ Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts (see 2.3.1.B below).
- ▶ Contingent consideration payable or receivable in a business combination. Contingent consideration in a business combination is required to be recognised at fair value at the acquisition date with subsequent remeasurements of non-equity consideration included in profit or loss.<sup>13</sup>
- ▶ Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held (see 2.3.1.C below)

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<sup>11</sup> IFRS 17.7.

<sup>12</sup> IFRS 17.BC87(d).

<sup>13</sup> IFRS 3.58.

- ▶ Credit card contracts (or similar contracts) that provide insurance coverage (see 2.3.1.D below).

The main scope exclusions are discussed below.

### **2.3.1.A. Product warranties**

Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer are outside the scope of IFRS 17.<sup>14</sup> Such warranties might provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications (called 'assurance-type warranties'), or they might provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications (called 'service-type warranties').<sup>15</sup> Paragraphs B28 to B33 of IFRS 15 set out the accounting treatment for these two types of warranties.

Without this exception, many product warranties would have been covered by IFRS 17 as they would normally meet the definition of an insurance contract. The Basis for Conclusions observes that the IASB has excluded them from the scope of IFRS 17 because if the standard were to apply, entities would generally apply the premium allocation approach to such contracts, which would result in accounting similar to that which would result from applying IFRS 15. Further, in the Board's view, accounting for such contracts in the same way as other contracts with customers would provide comparable information for the users of financial statements for the entities that issue such contracts. Hence, the Board concluded that changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.<sup>16</sup>

Conversely, a product warranty is within the scope of IFRS 17 if it is not issued by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer. See 5.3. below.

Other types of warranty are not specifically excluded from the scope of IFRS 17.

### **How we see it**

- ▶ A product warranty is within the scope of IFRS 17 if it is not issued by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer. Other types of warranties are not specifically excluded from the scope of IFRS 17. A warranty issued by a vendor to the purchaser of a business (e.g., for contingent liabilities related to tax computations of the acquired entity) is an example of a transaction that may fall within the scope of this standard.
- ▶ IFRS 17 excludes residual value guarantees provided by a manufacturer, dealer or retailer, which were in the scope of IFRS 4. This change brings residual value guarantees into line with product warranties by enabling manufacturers, dealers and retailers to apply IFRS 15 and IAS 37 and

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<sup>14</sup> IFRS 17.7(a).

<sup>15</sup> IFRS 17.BC89; IFRS 15.B28.

<sup>16</sup> IFRS 17.BC90.

to avoid some of the complexities of the IFRS 17 general model, such as the contractual service margin accounting.

### **2.3.1.B. Financial guarantee contracts**

A financial guarantee contract is defined as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.<sup>17</sup> These contracts transfer credit risk and may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract.<sup>18</sup>

Financial guarantee contracts are excluded from the scope of IFRS 17 unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. If so, the issuer may elect to apply either IFRS 17 or IAS 32, IFRS 7 and IFRS 9 to the financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.<sup>19</sup>

It is observed in the Basis for Conclusions that some credit-related contracts lack the precondition for payment that the holder has suffered a loss. One example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index. The Board concluded that those contracts are derivatives and do not meet the definition of an insurance contract. Therefore, such contracts will continue to be accounted for as derivatives under IFRS 9. The Board noted that these contracts were outside the scope of the policy choice in IFRS 4 carried forward into IFRS 17, so continuing to account for them as derivatives would not create further diversity.<sup>20</sup>

The IASB was concerned that entities other than credit insurers could elect to apply IFRS 4 to financial guarantee contracts and consequently (if their accounting policies permitted) recognise no liability on inception. Consequently, it imposed the restrictions outlined in the previous paragraph.<sup>21</sup> The application guidance contains further information on these restrictions where it is explained that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation as well as in their financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements would typically include a statement that the issuer had used those accounting requirements, i.e. ones normally applied to insurance contracts.<sup>22</sup> Nevertheless, other companies do consider it appropriate to apply IFRS 4 rather than IFRS 9 to these contracts.

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<sup>17</sup> IFRS 9 Appendix A.

<sup>18</sup> IFRS 17.BC91.

<sup>19</sup> IFRS 17.7(e).

<sup>20</sup> IFRS 17.BC94.

<sup>21</sup> IFRS 9.BCZ2.12.

<sup>22</sup> IFRS 9.B2.6.

This accounting policy election is the same as that previously in IFRS 4. The Board decided to carry forward to IFRS 17 the option to account for a financial guarantee contract as if it were an insurance contract, without any substantive changes, because the option has worked in practice and results in consistent accounting for economically similar contracts issued by the same entity. The Board did not view it as a high priority to address the inconsistency that results from accounting for financial guarantee contracts differently depending on the issuer.<sup>23</sup>

IFRS 17 does not elaborate on the phrase 'previously asserted explicitly'. However, the application guidance to IFRS 9 states that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.<sup>24</sup>

Accounting for the revenue associated with financial guarantee contracts issued in connection with the sale of goods is dealt with under IFRS 15.<sup>25</sup>

## How we see it

- ▶ In our view, on transition to IFRS 17, an entity that has previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts may reconsider its previous election regarding accounting for financial guarantee contracts made under IFRS 4 and decide whether it would prefer to account for those contracts under IFRS 17 or IFRS 9. This is because there are no specific transition provisions either within IFRS 17 or IFRS 9 as to whether previous elections made under a different standard, i.e. IFRS 4, should be continued. Hence, IFRS 17 would not prevent an entity from making new elections on application of IFRS 17. However, an entity which had not previously asserted explicitly that it regards such contracts as insurance contracts or which it had not previously used accounting applicable to insurance contracts (i.e. IAS 39 - *Financial Instruments: Recognition and Measurement* or IFRS 9 accounting was applied under IFRS 4) may not reconsider its previous election (either implicitly or explicitly made).
- ▶ It is likely that insurers that have previously issued financial guarantee contracts and accounted for them under an insurance accounting and regulatory framework will meet this requirement. It is unlikely that an entity not subject to an insurance accounting and regulatory framework and existing insurers that had not previously issued financial guarantee contracts would meet this requirement because it would not have previously made the necessary assertions.

<sup>23</sup> IFRS 17.BC93.

<sup>24</sup> IFRS 9.B2.6.

<sup>25</sup> IFRS 9.B2.5(c).

### **2.3.1.C. Direct insurance contracts in which the entity is the policyholder**

Accounting by policyholders of direct insurance contracts (i.e., those that are not reinsurance contracts) is excluded from the scope of IFRS 17. However, holders of reinsurance contracts (cedants) are required to apply IFRS 17.<sup>26</sup>

The IASB originally intended to address accounting by policyholders of direct insurance contracts in IFRS 17. The Basis for Conclusions observes that other IFRSs include requirements that may apply to some aspects of contracts in which the entity is the policyholder. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* sets out the requirements for reimbursements from insurance contracts held that provide cover for expenditure required to settle a provision and IAS 16 *Property, Plant and Equipment* sets out the requirements for some aspects of reimbursement under an insurance contract held that provides coverage for the impairment or loss of property, plant and equipment. Furthermore, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specifies a hierarchy that an entity should use when developing an accounting policy if no IFRS standard applies specifically to an item. Accordingly, the Board did not view work on policyholder accounting as a high priority.<sup>27</sup>

### **2.3.1.D. Credit card contracts (or similar contracts) that provide insurance coverage**

Credit card contracts (or similar contracts that provide credit or payment arrangements) that provide services that meet the definition of an insurance contract are excluded from the scope of IFRS 17 if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. If excluded from IFRS 17, these contracts would be within the scope of IFRS 9 and other applicable standards. However, if, and only if, the insurance component is a contractual term of such a financial instrument (rather than, say, required by local legislation), IFRS 9 requires an entity to separate and apply IFRS 17 to that insurance component.<sup>28</sup>

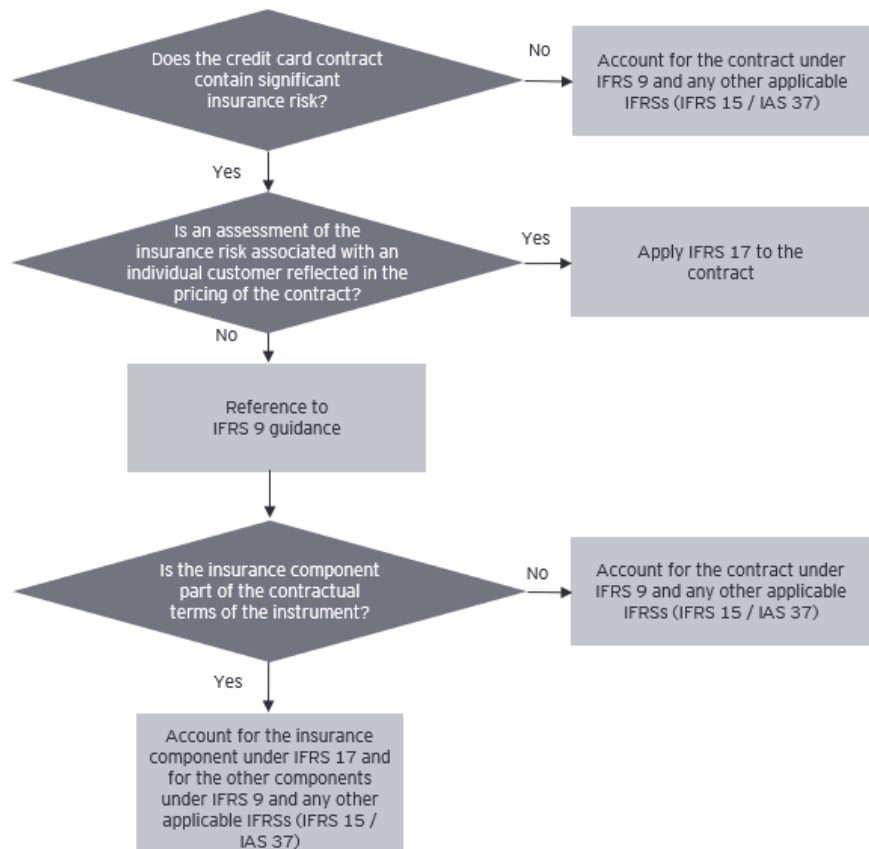
This can be illustrated by the diagram below:

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<sup>26</sup> IFRS 17.7(g).

<sup>27</sup> IFRS 17.BC66.

<sup>28</sup> IFRS 17.7(h), IFRS 9.2.1(e)(iv).



An example of a credit card contract (or similar contract) that provides insurance coverage is one in which the entity:

- ▶ Must refund the customer for some claims against a supplier in respect of a misrepresentation or breach of the purchase agreement (for example, if the goods are defective or if the supplier fails to deliver the goods) if the supplier does not rectify it
- ▶ Is entitled to be indemnified by the supplier for any loss suffered in satisfying its liability with its customer

As a result, the entity and the supplier are jointly and severally liable to the customer, i.e., the customer can choose whether to claim from the entity or from the supplier. In addition, subject to a maximum amount, the customer can claim from the entity or from the supplier an amount in excess of the amount paid using the specific credit card (for example, the entire purchase price, even if only part of the purchase price was paid using the credit card, and any additional costs reasonably incurred as a result of the supplier failure). Normally, the entity does not charge any fee to the customer or charges an annual fee to the customer that does not reflect an assessment of the insurance risk associated with that individual customer.

This scope exclusion was added to IFRS 17 in the June 2020 amendments. The Board noted that IFRS 9 and IFRS 17 both have requirements that address credit risk and insurance risk, which are the prominent features of such contracts. Furthermore, the Board was aware that in applying IFRS 4, which had different criteria for separating components of an insurance contract compared

to IFRS 17, most entities separated the components of such contracts. For example, an entity applying IFRS 4 might account for the credit card component applying IFRS 9, the insurance component applying IFRS 4, and any other service components applying IFRS 15. Acknowledging that entities had already identified methods to separate the components of such contracts, the Board concluded that changing the existing accounting for these contracts would impose costs and disruption to entities that typically do not issue contracts in the scope of IFRS 17, other than some credit card contracts and similar contracts that meet the definition of an insurance contract, for no significant benefit.<sup>29</sup>

In the Board's view, applying IFRS 17 to the insurance coverage components in credit card (or similar) contracts that include insurance coverage as part of the contractual terms will result in the most useful information for users of financial statements. In addition, it will increase comparability between insurance coverage provided as part of the contractual terms of a credit card contract and insurance coverage provided as a separate stand-alone contract. Other IFRS standards, such as IFRS 15 or IAS 37, might apply to other components of the contract, such as service components or insurance components required by law or regulation.<sup>30</sup>

### How we see it

The requirements in IFRS 17 for credit cards or similar arrangements that provide insurance coverage will result in a different accounting treatment depending on the terms and conditions of the arrangement:

- ▶ **Arrangements wholly accounted for under IFRS 17** - notably those where the entity does reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer.
- ▶ **Arrangements wholly accounted for under other standards** - notably those where entity does *not* reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer, and the insurance coverage is not a contractual term of the instrument.
- ▶ **Arrangements that are accounted for under other standards with the insurance component separated under IFRS 9 and accounted for under IFRS 17** - notably those where entity does *not* reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer, and the insurance coverage is a contractual term of the instrument.

### 2.3.2. Fixed-fee service contracts

A fixed-fee service contract is one in which the level of service depends on an uncertain event but the fee does not. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees

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<sup>29</sup> IFRS 17.BC94B.

<sup>30</sup> IFRS 17.BC94C.

to repair specified equipment after a malfunction. Such contracts can meet the definition of an insurance contract because:<sup>31</sup>

- ▶ It is uncertain whether, or when, assistance or a repair will be needed
- ▶ The owner is adversely affected by the occurrence
- ▶ The service provider compensates the owner if assistance or repair is needed.

Although they may meet the definition of insurance contracts, their primary purpose is to provide services for a fixed fee. IFRS 17 permits entities a choice of applying IFRS 15 instead of IFRS 17 to such contracts that it issues if, and only if, they meet specified conditions. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:<sup>32</sup>

- ▶ The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer.
- ▶ The contract compensates the customer by providing services, rather than by making cash payments to the customer.
- ▶ Insurance risk transferred by the contract arises primarily from the customer's use of services, rather than from uncertainty over the cost of those services.

The Board had proposed originally to exclude fixed fee service contracts whose primary purpose is the provision of services from the scope of IFRS 17. However, some stakeholders noted that some entities issue both fixed-fee service contracts and other insurance contracts. For example, some entities issue both roadside assistance contracts and insurance contracts for damage arising from accidents. Therefore, the Board decided to allow entities a choice of whether to apply IFRS 15 or IFRS 17 to fixed-fee service contracts to enable such entities to account for both types of contract in the same way. In the view of the Board, if IFRS 17 is applied to fixed-fee service contracts, entities would generally apply the premium allocation approach (see 9 below) to such contracts which would result in accounting similar to that resulting from applying IFRS 15.<sup>33</sup>

## How we see it

- ▶ The Basis for Conclusions mentions that the choice of whether to apply IFRS 15 or IFRS 17 was introduced to assist entities that issue both roadside assistance contracts and insurance contracts in being able to apply IFRS 17 to all the contracts that it issues. However, it is possible that other types of fixed-fee service contracts are now within the scope of IFRS 17 as the choice between IFRS 15 and IFRS 17 is only available where the specified conditions are met.
- ▶ Whether an individual risk assessment is present or not may require the exercise of judgement. In many cases, service agreements are priced to reflect some form of risk assessment. If an entity charges

<sup>31</sup> IFRS 17.BC95.

<sup>32</sup> IFRS 17.8.

<sup>33</sup> IFRS 17.BC96, BC97.



each policyholder the same fee to service the same asset ('community priced'), then the risk assessment is performed at a portfolio level rather than the individual customer level. However, if the fixed fee for servicing is based on the specific condition of the asset (for example, the age or type of motor vehicle) and/or the policyholder (for example, claims history), this would be indicators of an individual risk assessment that reflects the nature of an insurance contract rather than a service contract.

- ▶ The accounting policy choice between applying IFRS 17 or IFRS 15 applies to fixed-fee service contracts. IFRS 17 does not mention contracts that are priced depending on the level of service. When an entity charges a fee which varies with the level of service provided (e.g., an elevator service contract that levies a fee per breakdown according to the work required), then the contract is unlikely to have significant insurance risk and this would be a service contract within the scope of IFRS 15.

### **2.3.3. *Loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract***

Some contracts meet the definition of an insurance contract, but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). An entity may choose to apply either IFRS 17 or IFRS 9 to such contracts that it issues unless such contracts are excluded from the scope of IFRS 17 (see 2.3.1. above). The entity must make that choice for each portfolio (see 6.1 below) of insurance contracts, and the choice for each portfolio is irrevocable. [IFRS 17.8A].

Examples of such contracts are:

- ▶ Mortgages when the outstanding balance of the mortgage is waived if the borrower dies.
- ▶ Lifetime mortgages (sometimes called equity release mortgages) where the entity's recourse is limited to the mortgaged property. If the property is sold for less than the mortgage balance (when the customer dies or moves into long-term care) then the loss is borne by the entity.
- ▶ Student loan contracts where repayments are income and/or life contingent and may not be made at all if the borrower's income never exceeds the repayment threshold or the borrower dies.
- ▶ A loan provided to a customer to buy a non-financial asset which is repaid via low installments over the period of the loan with a final, higher 'balloon' payment at maturity, but where the customer can choose to return the non-financial asset to the entity instead of making the 'balloon' payment. If the contract compensates the customer only for changes in market prices and not for changes in the condition of the customer's non-financial asset, then it would not provide insurance coverage and meet the definition of a derivative within the scope of IFRS 9.

This accounting policy choice was added to IFRS 17 by the June 2020 amendments. This was a result of stakeholder concerns that such contracts

are typically issued by non-insurers who might be expected to be in a less advanced stage of IFRS 17 implementation and might not have fully assessed the implications of IFRS 17 on their business, and because these contracts do not usually have the legal form of insurance contracts. It is observed in the Basis for Conclusions that applying either IFRS 17 or IFRS 9 would provide useful information about such contracts. Hence, the Board concluded that requiring an entity to apply IFRS 17 to those contracts, when the entity had previously been applying an accounting policy consistent with IFRS 9 or IAS 39 to those contracts (or vice versa), could impose costs and disruption with no significant benefit.<sup>34</sup>

It is further observed in the Basis for Conclusions that the accounting policy choice for each portfolio was made irrevocable in order to mitigate the lack of comparability that might otherwise arise between similar contracts issued by the same entity, and between similar contracts issued by different entities.<sup>35</sup>

### How we see it

- ▶ While the definition of an insurance contract has not changed much from IFRS 4, the consequences of a contract qualifying as an insurance contract have changed. IFRS 4 allowed entities to use their previous accounting policies for items that qualified as insurance contracts. Many non-insurance entities applied guidance from other IFRS standards (e.g., IAS 39 *Financial Instruments: Classification and Measurement*/ IFRS 9 *Financial Instruments* or IFRS 15 *Revenue from Contracts with Customers*). Banks and service companies issuing contracts within the scope of IFRS 4 applied accounting treatments that were like those applied to other non-insurance contracts. Many of these contracts also fall within IFRS 17. Since IFRS 17 has specific recognition, measurement and presentation requirements for financial statements, these entities will not be able to continue with these practices and will have to apply the requirements of IFRS 17 instead. Examples of the contracts issued by non-insurers that may meet the definition of insurance contracts include loans with a waiver upon the death of the borrower and service contracts with a fixed fee. However, some scope exemptions and accounting policy choices may apply (see Section 2.3 below). The effect of applying IFRS 17 to such contracts could be significant for non-insurance entities.

#### 2.3.4. Other accounting standards which affect insurers

IFRS 17 does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers which are within the scope of IFRS 7, IFRS 9 and IAS 32. However:

- ▶ IFRS 9 permits an entity that operates an investment fund that provides investors with benefits determined by units in that fund and recognises liabilities for the amounts to be paid to those investors (e.g. some insurance

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<sup>34</sup> IFRS 17.BC94E.

<sup>35</sup> IFRS 17.BC94F.

contracts with direct participation features and some investment contracts with discretionary participation features) to elect not to derecognise any underlying items held by the funds that include the entity's own financial liabilities. Normally, if an entity issues a financial liability, for example a corporate bond, that is purchased by one of its investment funds, or included within the underlying items behind the insurance contracts that are held on the entity's balance sheet, such a purchase should result in derecognition of the financial liability. This election is irrevocable and made on an instrument-by-instrument basis.<sup>36</sup>

- ▶ IAS 40 - *Investment Property* - permits an entity to separately choose between the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property (e.g. insurance contracts with direct participation features as discussed at 11.3 below).<sup>37</sup> The choice to use either the fair value model or the cost model for all other investment property is a separate election.

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<sup>36</sup> IFRS 9.3.3.5.

<sup>37</sup> IAS 40.32A.

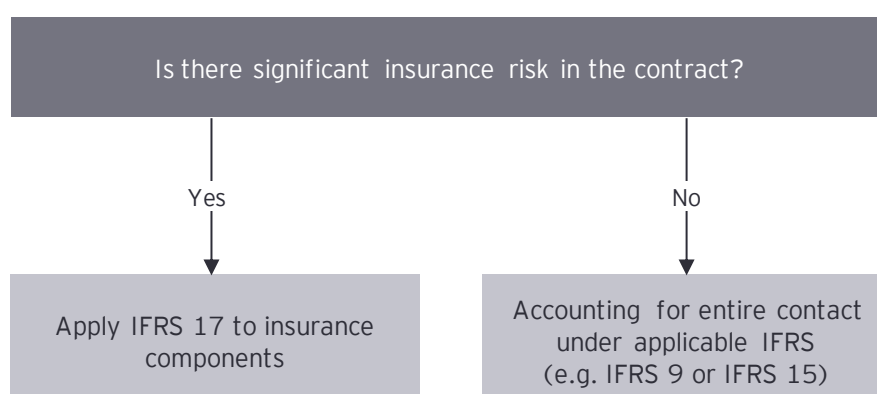
## 3. The definition of an insurance contract

### 3.1. The definition

The definition of an insurance contract in IFRS 17 is:

‘A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder’.<sup>38</sup>

This definition determines which contracts are within the scope of IFRS 17 as opposed to other standards.



The definition of an insurance contract is, in essence, the same as in IFRS 4. Therefore, in many cases, contracts that were insurance contracts under IFRS 4 are expected to be insurance contracts under IFRS 17 although IFRS 17 contains no transitional provisions which ‘grandfather’ conclusions made under IFRS 4 (except for the consequential amendments to IFRS 3 *Business Combinations* - see 14 below).

However, there have been clarifications to the related application guidance explaining the definition to require that:<sup>39</sup>

- ▶ An insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant (see 3.5 below)
- ▶ A contract does not transfer significant insurance risk if there is no scenario with commercial substance in which the insurer can suffer a loss on a present value basis (see 3.5 below)

Both of these clarifications are intended to ensure that the determination of insurance risk is made on a present value basis as it was considered that IFRS 4 was unclear on the matter. Additionally, the definition of significant insurance risk (see 3.5 below) uses the word ‘amounts’ instead of ‘benefits’ in order to

<sup>38</sup> IFRS 17 Appendix A.

<sup>39</sup> IFRS 17.BC67.

capture payments that may not necessarily be payable to policyholders (for example claim handling expenses).

An entity should consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity should disregard terms that have no commercial substance (i.e., no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).<sup>40</sup> The Basis for Conclusions observes that these considerations are consistent with IFRS 15 and apply when an entity classifies a contract and when it assesses the substantive rights and obligations for determining the boundary of a contract.<sup>41</sup>

The definition of an insurance contract is discussed in more detail, as follows:<sup>42</sup>

- ▶ Uncertain future events (see 3.2 below)
- ▶ Payments in kind (see 3.3 below)
- ▶ The distinction between insurance risk and other risks (see 3.4 below)
- ▶ Significant insurance risk (see 3.5 below)
- ▶ Changes in the level of insurance risk (see 3.6 below)
- ▶ Examples of insurance and non-insurance contracts (see 3.7 below)

### Frequently asked questions

***Question 3-1: Would IFRS 17 apply to, among others, service contracts including a form of EBITDA guarantee? [TRG meeting September 2018 - Agenda paper no. 11, Log S33]***

The submission described a specific fact pattern of an entity that provides hotel management services. The service fee that the entity charges is determined as a percentage of gross hotel revenue. The entity also guarantees the hotel owner a specified level of EBITDA. To the extent that the actual hotel EBITDA is below the specified level, the entity is obligated to make payments to the hotel owner. The amount payable under the guarantee may exceed the amount of the service fee receivable. The submission asks whether the guarantee provided by the entity is within the scope of IFRS 17.

The IASB Staff noted a contract should be assessed against the definition of an insurance contract and the scope requirements of IFRS 17. The definition of an insurance contract in IFRS 17 is the same as the definition of an insurance contract in IFRS 4, with clarifications to the related

<sup>40</sup> IFRS 17.2.

<sup>41</sup> IFRS 17.BC69.

<sup>42</sup> IFRS 17.B2.

### Frequently asked questions (cont'd)

guidance in Appendix B of IFRS 4. When assessing whether the contract meets the definition of an insurance contract, an assessment is made as to whether the contract transfers significant insurance risk. When assessing whether an insurance contract is within the scope of IFRS 17, an assessment is made as to whether any of the scope exclusions of IFRS 17 are applicable. IFRS 17 includes a scope exclusion for warranties provided by a manufacturer, dealer or retailer in connection with the sale of its services to a customer and also excludes contractual obligations contingent on the future use of a non-financial item (for example, contingent payments), as stated in paragraph 7 of IFRS 17. (see 2.3.1. above)

The implication from the IASB staff's response is that the EBITDA guarantee is excluded from the scope of IFRS 17 as it is a guarantee given by a retailer in connection with the sale of its services to a customer.

### How we see it

- ▶ While the definition of an insurance contract has not changed much from IFRS 4, the consequences of qualifying as an insurance contract have changed. This is because IFRS 4 allowed entities to use their previous accounting policies for contracts that qualified as insurance contracts. Hence, under IFRS 4, many non-insurance entities, such as banks and service companies, applied guidance from other standards, such as IFRS 9 and IFRS 15, to recognise and measure insurance contracts. This will no longer be possible since IFRS 17 has specific recognition, measurement and presentation requirements for financial statements. As discussed at 2.3.1.D and 2.3.3 above, IFRS 17 has a scope exclusion for certain credit card contracts (or similar contracts) that provide insurance coverage and an accounting policy choice to apply either IFRS 9 or IFRS 17 to loan contracts that transfer significant insurance risk only on settlement of the policyholder's obligation created by the contract.

## 3.2. Uncertain future events

Uncertainty (or risk) is the essence of an insurance contract. Accordingly, IFRS 17 requires at least one of the following to be uncertain at the inception of an insurance contract:<sup>43</sup>

- (a) The probability of an insured event occurring
  - (b) When the insured event will occur
- Or
- (c) How much the entity will need to pay if the insured event occurs

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<sup>43</sup> IFRS 17.B3.

An insured event will be one of the following:

- ▶ The discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract
- ▶ A loss that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term<sup>44</sup>

Or

- ▶ The determination of the ultimate cost of a claim which has already occurred but whose financial effect is uncertain<sup>45</sup>

This last type of insured event above arises from 'retroactive' contracts, i.e., those providing insurance coverage against an adverse development of an event which has occurred prior to the policy inception date. An example is a reinsurance contract that covers a direct policyholder against adverse development of claims already reported by policyholders. In those contracts, the insured event is the determination of the ultimate cost of those claims. The implications of this on measurement is discussed at 11.5.2.A below.

### 3.3. Payments in kind

Some insurance contracts require or permit payments to be made in kind. In such cases, the entity provides goods or services to the policyholder to settle the entity's obligation to compensate the policyholder for insured events. Such contracts are insurance contracts, even though the claims are settled in kind, and are treated the same way as insurance contracts when payment is made directly to the policyholder. For example, some insurers replace a stolen article directly rather than compensating the policyholder for the amount of its loss. Another example is when an entity uses its own hospitals and medical staff to provide medical services covered by the insurance contract.<sup>46</sup>

Although these are insurance contracts, if they meet the conditions for fixed-fee service contracts (see 2.3.2 above) entities can elect to apply either IFRS 15 or IFRS 17.

### 3.4. The distinction between insurance risk and financial risk

The definition of an insurance contract refers to 'insurance risk' which is defined as 'risk, other than financial risk, transferred from the holder of a contract to the issuer'.<sup>47</sup>

A contract that exposes the reporting entity to financial risk without significant insurance risk is not an insurance contract.<sup>48</sup> 'Financial risk' is defined as 'the risk of a possible future change in one or more of a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit

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<sup>44</sup> IFRS 17.B4.

<sup>45</sup> IFRS 17.B5.

<sup>46</sup> IFRS 17.B6.

<sup>47</sup> IFRS 17 Appendix A.

<sup>48</sup> IFRS 17.B7.

rating or credit index or other variable, provided in the case of a non-financial variable that variable is not specific to a party to the contract'.<sup>49</sup>

An example of a non-financial variable that is not specific to a party to the contract is an index of earthquake losses in a particular region or an index of temperatures in a particular city. An example of a non-financial variable that is specific to a party to the contract is the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects changes in the market prices for such assets (i.e., a financial variable) and the condition of a specific non-financial asset held by a party to the contract (i.e., a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in that car's condition, that risk is insurance risk, not financial risk.<sup>50</sup> This is illustrated in Illustration 1 below.

Contracts that expose the issuer to both financial risk and significant insurance risk can be insurance contracts. For example, many life insurance contracts guarantee a minimum rate of return to policyholders, creating financial risk, and at the same time promise death benefits that may significantly exceed the policyholder's account balance, creating insurance risk in the form of mortality risk. Such contracts are insurance contracts.<sup>51</sup>

Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts provided that the payment contingent on the insured event could be significant.<sup>52</sup> This is illustrated in Illustration 2 below.

The definition of an insurance contract requires risk to be transferred from the policyholder to the insurer. This means that the insurer must accept, from the policyholder, a risk to which the policyholder was already exposed. Any new risk created by the contract for the entity or the policyholder is not insurance risk.<sup>53</sup>

#### **Illustration 1 – Residual value insurance**

Entity A issues a contract to Entity B that provides a guarantee of the fair value at a future date of an aircraft (a non-financial asset) held by Entity B. Entity A is not the manufacturer, dealer or retailer of the aircraft and also is not the lessee of the aircraft (residual value guarantees given by a lessee under a lease are within the scope of IFRS 16).

This is an insurance contract (unless changes in the condition of the asset have an insignificant effect on its value). The risk of changes in the fair value of the aircraft is not a financial risk because the fair value reflects not only changes in market prices for similar aircraft but also the condition of the specific asset held.

However, if the contract compensated Entity B only for changes in market prices and not for changes in the condition of Entity B's asset, the contract would be a derivative and within the scope of IFRS 9.

<sup>49</sup> IFRS 17 Appendix A.

<sup>50</sup> IFRS 17.B8.

<sup>51</sup> IFRS 17.B9.

<sup>52</sup> IFRS 17.B10.

<sup>53</sup> IFRS 17.B11.



### Illustration 2 – Contract with life contingent annuity linked to price index

Entity A issues a life-contingent annuity the value of which is linked to a cost of living index.

The contract is an insurance contract because the payment is triggered by an uncertain future event – the survival of the person who receives the annuity. The link to the price index is a derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the resulting transfer of insurance risk is significant, the derivative meets the definition of an insurance contract in which case it should not be separated from the host contract (see 5.1 below).

### How we see it

- ▶ Under the general model, insurance finance income or expenses includes the change in the carrying amount of the group of insurance contracts arising from the effect of financial risk and changes in such risk. The effect of, and changes in, financial risk are treated differently to the effect of, and changes in, non-financial risks (e.g., insurance risk). It, therefore, becomes important to make a distinction between non-financial risk and financial risk. An example was the subject of a submission to the TRG that asked whether changes in fulfilment cash flows as a result of changes in inflation assumptions should be treated as changes in non-financial risk (and adjust the contractual service margin) or changes in financial risk for contracts measured under the general model (see Question 17-3 below). For contracts with direct participation features, a distinction between non-financial risk and financial risk is also necessary but this distinction has different consequences in terms of the measurement model (see section 12 below).

#### 3.4.1. *Insurable interest*

For a contract to be an insurance contract the insured event must have an adverse effect on the policyholder.<sup>54</sup> In other words, there must be an 'insurable interest'.<sup>55</sup>

The IASB considered whether it should eliminate the notion of insurable interest and replace it with the notion that insurance involves assembling risks into a pool in which they can be managed together.<sup>56</sup> However, the IASB decided to retain the notion of insurable interest contained in IFRS 4, because without the reference to 'adverse effect', the definition might have captured any prepaid contract to provide services with uncertain costs. In addition, the notion of insurable interest is needed to avoid including gambling in the definition of insurance. Furthermore, the definition of an insurance contract is a principle-

<sup>54</sup> IFRS 17.B12.

<sup>55</sup> IFRS 17.BC73.

<sup>56</sup> IFRS 17.BC74.

based distinction, particularly between insurance contracts and those used for hedging.<sup>57</sup>

The adverse effect on the policyholder is not limited to an amount equal to the financial impact of the adverse event. So, for example, the definition includes 'new for old' insurance coverage that pays the policyholder an amount that permits the replacement of a used or damaged asset with a new asset. Similarly, the definition does not limit payment under a life insurance contract to the financial loss suffered by a deceased's dependents, nor does it preclude the payment of predetermined amounts to quantify the loss caused by a death or accident.<sup>58</sup>

A contract that requires a payment if a specified uncertain event occurs which does not require an adverse effect on the policyholder as a precondition for payment is not an insurance contract. Such contracts are not insurance contracts even if the holder of the contract uses the contract to mitigate an underlying risk exposure. For example, if the holder of the contract uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the uncertain event actually caused an adverse effect, but it does permit the insurer to deny payment if it is not satisfied that the event caused an adverse effect.<sup>59</sup>

### **Illustration 3 – Reinsurance contract with 'original loss warranty' clause**

Entity A agrees to issue a contract to Entity B to provide reinsurance cover for CU5 m against losses suffered. The insurance losses suffered by Entity B, which are recoverable under the contract, are limited to those arising from events where the industry-wide insured loss exceeds a threshold of CU100 m (sometimes described as an 'original loss warranty'). This means that only losses suffered by Entity B up to CU5 m from events exceeding an industry-wide insured loss of CU100 m can be recovered under the contract.

Assuming insurance risk is significant, this is an insurance contract as Entity B can only recover its own insurance claims arising from those events.

If the contract allowed Entity B to claim up to CU5 m every time there was an event with an industry-wide loss exceeding a threshold of CU100 m, regardless of whether Entity B had suffered insurance claims from that event, then this would not be an insurance contract because there would be no insurable interest in the arrangement.

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<sup>57</sup> IFRS 17.BC75.

<sup>58</sup> IFRS 17.B12.

<sup>59</sup> IFRS 17.B13.

### 3.4.2. *Lapse, persistency and expense risk*

Lapse or persistency risk (the risk that the policyholder will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk. This is because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder.<sup>60</sup>

Similarly, expense risk (the risk of unexpected increases in the administrative costs incurred by the issuer associated with the servicing of a contract, rather than in the costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the policyholder.<sup>61</sup>

Therefore, a contract that exposes an entity to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the entity to significant insurance risk.<sup>62</sup>

### 3.4.3. *Insurance of non-insurance risks*

If the issuer of a contract which does not contain significant insurance risk mitigates the risk of that contract by using a second contract to transfer part of that first contract's risk to another party, this second contract exposes that other party to insurance risk. This is because the policyholder of the second contract (the issuer of the first contract) is subject to an uncertain event that adversely affects it and thus it meets the definition of an insurance contract.<sup>63</sup>

#### **Illustration 4 – Insurance of non-insurance risks**

Entity A agrees to compensate Entity B for losses on a series of contracts issued by Entity B that do not transfer significant insurance risk. These could be investment contracts or, for example, a contract to provide services.

The contract issued by Entity A is an insurance contract if it transfers significant insurance risk from Entity B to Entity A, even if some or all of the underlying individual contracts do not transfer significant insurance risk to Entity B. The contract is a reinsurance contract if any of the underlying contracts issued by Entity B are insurance contracts. Otherwise, the contract is a direct insurance contract.

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<sup>60</sup> IFRS 17.B14.

<sup>61</sup> IFRS 17.B14.

<sup>62</sup> IFRS 17.B15.

<sup>63</sup> IFRS 17.B15.

### 3.5. Significant insurance risk

A contract is an insurance contract only if it transfers 'significant insurance risk'.<sup>64</sup>

Insurance risk is 'significant' if, and only if, an insured event could cause an insurer to pay significant additional amounts in any scenario, excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in scenarios that have commercial substance, this condition may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.<sup>65</sup>

In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts.<sup>66</sup>

The additional amounts described above are determined on a present value basis. If an insurance contract requires payment when an event with uncertain timing occurs and if the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is insurance that provides a fixed death benefit when the policyholder dies, with no expiry date for the cover (often referred to as whole-life insurance for a fixed amount). It is certain that the policyholder will die, but the date of death is uncertain. Payments may be made when an individual policyholder dies earlier than expected. Because those payments are not adjusted for the time value of money, significant insurance risk could exist even if there is no overall loss on the portfolio of contracts. Similarly, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. An entity should use the discount rates required as discussed at 9.3 below to determine the present value of the additional amounts.<sup>67</sup>

IFRS 17 does not prohibit a contract from being an insurance contract if there are restrictions on the timing of payments or receipts. However, the existence of restrictions on the timing of payments may mean that the policy does not transfer significant insurance risk if it results in the lack of a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis.

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<sup>64</sup> IFRS 17.B17.

<sup>65</sup> IFRS 17.B18.

<sup>66</sup> IFRS 17.B19.

<sup>67</sup> IFRS 17.B20.

### 3.5.1. *Quantity of insurance risk*

No quantitative guidance supports the determination of 'significant' in IFRS 17. This was a deliberate decision because the IASB considered that if quantitative guidance was provided, it would create an arbitrary dividing line that would result in different accounting treatments for similar transactions that fall marginally on different sides of that line and would, therefore, create opportunities for accounting arbitrage.<sup>68</sup>

The IASB also rejected defining the significance of insurance risk by reference to the definition of materiality within the Conceptual Framework for Financial Reporting because, in its opinion, a single contract, or even a single book of similar contracts, would rarely generate a loss that would be material to the financial statements as a whole. Consequently, IFRS 17 defines the significance of insurance risk in relation to individual contracts (see 3.5.2 below).<sup>69</sup>

The IASB also rejected the notion of defining the significance of insurance risk by expressing the expected (probability weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This definition would mean that a contract could start as a financial liability and become an insurance contract as time passes or probabilities are reassessed. This idea would have required the constant monitoring of contracts over their life to see whether they continued to transfer insurance risk. The IASB considered that it would be too burdensome to require an entity to continuously monitor whether a contract meets the definition of an insurance contract over its duration. Consequently, as discussed at 3.6 below, an assessment of whether significant insurance risk has been transferred is normally required only at the inception of a contract.<sup>70</sup>

IFRS 4 contained an illustrative example which implied that insured benefits must be greater than 101% of the benefits payable if the insured event did not occur for there to be insurance risk in an insurance contract.<sup>71</sup> However, no equivalent example has been included in IFRS 17.

Some jurisdictions have their own guidance as to what constitutes significant insurance risk. However, other jurisdictions offer no quantitative guidance. Some US GAAP practitioners apply a guideline that a reasonable possibility of a significant loss is a 10% probability of a 10% loss, although this guideline does not appear in US GAAP itself.<sup>72</sup> It is not disputed in the Basis for Conclusions that a 10% chance of a 10% loss results in a transfer of significant insurance risk and, indeed, the words 'extremely unlikely' and 'a small proportion' (see 3.5 above) suggests that the IASB envisages that significant insurance risk could exist at a lower threshold than a 10% probability of a 10% loss.

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<sup>68</sup> IFRS 17.BC78.

<sup>69</sup> IFRS 17.BC79.

<sup>70</sup> IFRS 17.BC80.

<sup>71</sup> IFRS 4.IG2.E1.3.

<sup>72</sup> IFRS 17.BC77.

## How we see it

- ▶ The lack of a quantitative definition of significant insurance risk means that insurers must apply their own judgement as to what constitutes significant insurance risk. Although the IASB did not want to create an 'arbitrary dividing line', the practical impact of this lack of guidance is that insurers have to apply their own criteria to determine what constitutes significant insurance risk and there will probably be diversity in practice as to what these dividing lines are, at least at the margins.
- ▶ There is no specific requirement under IFRS 17 for insurers to disclose any thresholds used in determining whether a contract contains significant insurance risk. However, IFRS 17 requires an entity to disclose the significant judgements made in applying IFRS 17 (see 16.3 below) whilst IAS 1 *Presentation of Financial Statements* requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

### 3.5.2. *The level at which significant insurance risk is assessed*

Significant insurance risk must be assessed by individual contract, rather than by portfolios or groups of contracts or by reference to materiality to the financial statements. Thus, insurance risk may be significant even if there is a minimal probability of significant losses for a portfolio or group of contracts.<sup>73</sup> There is no exception to the requirement for assessment at an individual contract level, unlike IFRS 4 which permitted an insurer to make an assessment based on a small book of contracts if those contracts were relatively homogeneous.

The IASB decided to define significant insurance risk in relation to a single contract rather than at a higher level of aggregation because, although contracts are usually managed on a portfolio basis, the contractual rights and obligations arise from individual contracts. Materiality by reference to the financial statements was considered an inappropriate basis to define significant insurance risk because a single contract, or even a single book of similar contracts, would rarely generate a material loss in relation to the financial statements as a whole.

See section 4 below on when it may be necessary to combine a set or series of contracts as a whole to report the substance.

If an insurance contract is separated into non-insurance components and insurance components (see 5 below) IFRS 17 is applied only to the remaining components of the host insurance contract.<sup>74</sup>

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<sup>73</sup> IFRS 17.B22.

<sup>74</sup> IFRS 17.13.

### **3.5.2.A. Self insurance**

An insurer can accept significant insurance risk from a policyholder only if it issues an insurance contract to an entity separate from itself. Therefore, 'self-insurance', such as a self-insured deductible where the insured cannot claim for losses below the excess limit of an insurance policy, is not insurance because there is no insurance contract with a third party.<sup>75</sup> Accounting for self-insurance and related provisions is covered by IAS 37 which requires that a provision is recognised only if there is a present obligation as a result of a past event, if it is probable that an outflow of resources will occur and a reliable estimate can be determined.<sup>76</sup>

### **3.5.2.B. A mutual insurer**

A mutual insurer accepts risk from each policyholder and pools that risk. Although policyholders bear the pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract and therefore IFRS 17 applies to those contracts.<sup>77</sup> Accounting for insurance contracts issued by mutual entities is discussed at 12.1 below.

### **3.5.2.C. Intragroup insurance contracts**

Where there are insurance contracts between entities in the same group, these would be eliminated in the consolidated financial statements as required by IFRS 10 *Consolidated Financial Statements*. If any intragroup insurance contract is reinsured with a third party that is not part of the group, this third-party reinsurance contract must be accounted for as a direct insurance contract in the consolidated financial statements of a non-insurer because the intragroup contract will be eliminated on consolidation. This residual direct insurance contract (i.e., the policy with the third party) is outside the scope of IFRS 17 from the viewpoint of the consolidated financial statements of a non-insurer because policyholder accounting is excluded from IFRS 17 as discussed at 2.3.1.C above.

### **3.5.3. Significant additional amounts**

The 'significant additional amounts' described at 3.5 above refer to the present value of amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). These additional amounts include claims handling and claims assessment costs, but exclude:<sup>78</sup>

- ▶ The loss of the ability to charge the policyholder for future service. For example, in an investment-linked life contract, the death of the policyholder means that the entity can no longer perform investment management services and collect a fee for doing so. However, the economic loss for the entity does not result from insurance risk. Consequently, the potential loss or future investment management fees are not relevant when assessing how much insurance risk is transferred by a contract

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<sup>75</sup> IFRS 17.B27(c).

<sup>76</sup> IAS 37.14.

<sup>77</sup> IFRS 17.B16.

<sup>78</sup> IFRS 17.B21.

- ▶ The waiver on death of charges that would be made on cancellation or surrender of the contract. Because the contract brought these charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in determining how much insurance risk is transferred by a contract
- ▶ A payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, where the issuer must pay CU1 m if an asset suffers physical damage causing an insignificant economic loss of CU1 to the holder. The holder, in this case, has transferred to the insurer the insignificant insurance risk of losing CU1. At the same time, the contract creates non-insurance risk that the issuer will need to pay an additional CU999,999 if the specified event occurs. Because there is no scenario in which an insured event causes a significant loss to the holder of the contract, the issuer does not accept significant insurance risk from the holder and this contract is not an insurance contract
- ▶ Possible reinsurance recoveries - the insurer must account for these separately

It follows from this that if a contract pays a death benefit exceeding the amount payable on survival (excluding any waiver or surrender charges mentioned above), the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire portfolio of contracts). Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant. In this case, the insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.<sup>79</sup>

### Frequently asked questions

***Question 3-2: Is the risk related to a premium waiver provision a pre-existing risk of the policyholder transferred to the entity by the contract and therefore an insurance risk, or a new risk created by the contract? [TRG meeting September 2018 - Agenda paper no. 07, Log S78]***

The TRG members considered a submission which discussed whether a contract that contains a provision that waives the payment of a premium under certain circumstances is an insurance contract. In such cases, the main insured event in the contract differs from the event triggering a premium waiver. For example, the primary coverage may be a term life contract covering mortality risk and premiums are waived if the policyholder has been disabled for six consecutive months, although the policyholder continues to receive the benefits originally promised under the insurance contract despite the waiver of premiums. The TRG members agreed with the IASB staff analysis and observed that:

- ▶ There is an insurance risk when an entity provides a waiver of premiums if a specified event occurs

<sup>79</sup> IFRS 17.B23.



### Frequently asked questions (cont'd)

- ▶ The waiver of premiums differs from the situations discussed above (i.e., the economic loss of the ability to charge the policyholder for future service and the waiver, on death, of contract surrender or cancellation charges).

This is because the risk of the events giving rise to the waiver exists before the contract is issued. It is not a risk created by the contract and the contract does not increase the potential adverse effects. In addition, the events that trigger a waiver are contractual pre-conditions without which the entity can deny the waiver.

The TRG members observed that the consequences of such a waiver of premiums are:

- ▶ The inclusion of a clause in an investment contract in which premiums are waived by contractual pre-conditions makes the investment contract an insurance contract

The inclusion of such a waiver in a contract that would also be an insurance contract without the waiver, would impact the quantity of benefits provided by the contract and therefore the coverage period, affecting the recognition of the contractual service margin in profit or loss.

***Question 3-3: Should an entity exclude from revenue premiums waived as a result of an insured event or should it account for them as part of insurance service expense (i.e. an incurred claim)? [TRG meeting February 2019 - Agenda paper no. 02, Log S117]***

The IASB staff clarified, and the TRG agreed, that, to the extent that a premium waiver results from an insured event, it is a claim and, therefore, recognised as an insurance service expense.

### How we see it

- ▶ Section 3.5.2.C discusses intragroup insurance contracts. Reporting entities could consider practical approaches to deal with intragroup contracts. In doing so, entities should be aware of the consequences to the financial statement prepared under IFRS, other than the consolidated financial statements, e.g., separate financial statements or individual financial statements of, for example, the subsidiary. For example, a subsidiary may have to perform another measurement of its insurance liabilities for the purpose of its own IFRS financial statements.

## 3.6. Changes in the level of insurance risk

IFRS 17 requires the assessment of whether a contract transfers significant insurance risk to be made only once. The Basis for Conclusions states that this assessment is made 'at inception'.<sup>80</sup> We interpret this phrase to mean that

<sup>80</sup> IFRS 17.BC80.

the assessment is made when the contract is issued rather than the start of the coverage period since a contract can be recognised at an earlier date than the start of the coverage period (see 7 below).

As the assessment of significant insurance risk is made only once, a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished, i.e., discharged, cancelled or expired, unless the contract is derecognised because of a modification (see 13 below).<sup>81</sup> This applies even if circumstances have changed such that insurance contingent rights and obligations have expired. The IASB considered that requiring insurers to set up systems to continually assess whether contracts continue to transfer significant insurance risk imposed a cost that far outweighed the benefit that would be gained from going through the exercise.<sup>82</sup> For a contract acquired in a business combination or transfer, the assessment of whether the contract transfers significant insurance risk is made at the date of acquisition or transfer (see 14 below).

For some contracts, the transfer of insurance risk to the issuer occurs after a period.<sup>83</sup>

#### Frequently asked questions

***Question 3-4: How should the exercise of an option to convert a contract to a different type of contract should be treated? [TRG meeting April 2019 - Agenda paper no. 02, Log S107]***

The submission asked how a contract which transfers insurance risk after a period of time, as discussed in paragraph B24 of IFRS 17, should be classified. The Staff analysis explained that for a contract to meet the definition of an insurance contract, there needs to be a transfer of significant insurance risk. Paragraph B24 of IFRS 17 explains that contracts that transfer insurance risk only after an option is exercised do not meet the definition of insurance contracts at inception. An entity should consider the requirements of other IFRS Standards in order to account for such contracts until they become insurance contracts. A contract which only transfers insurance risk after a period of time is different from an insurance contract that provides an option to add further insurance coverage, discussed in Agenda Paper 3 of the May 2018 TRG meeting.

Some stakeholders suggested to the IASB that a contract should not be accounted for as an insurance contract if the insurance-contingent rights and obligations expire after a very short time. IFRS 17 addresses aspects of this by requiring that scenarios that lack commercial substance are ignored in the assessment of significant insurance risk and stating that there is no significant transfer of insurance risk in some contracts that waive surrender penalties on death (see 3.5.3 above and 11.3.1 below).<sup>84</sup>

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<sup>81</sup> IFRS 17.B25.

<sup>82</sup> IFRS 17.BC80.

<sup>83</sup> IFRS 17.B24.

<sup>84</sup> IFRS 17.BC81.

**Illustration 5 – Deferred annuity with policyholder election (the standard provides the following example in IFRS 17.B24)**

Entity A issues a deferred annuity contract which provides a specified investment return to the policyholder and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rate that Entity A charges other new annuitants at the time the policyholder exercises that option.

This is not an insurance contract at inception because it does not contain significant insurance risk. Entity A remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to it at that time. Such a contract transfers insurance risk to the issuer only after the option is exercised. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract, and before exercise there are no insurance cash flows within the boundary of the contract. Consequently, on inception, the contract is a financial instrument within the scope of IFRS 9.

However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to Entity A (the issuer) because Entity A is exposed to the risk that the annuity rates will be unfavourable when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.

### **3.7. Examples of insurance and non-insurance contracts**

This section contains examples given in IFRS 17 of insurance and non-insurance contracts.

#### **3.7.1. Examples of insurance contracts**

The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:<sup>85</sup>

- ▶ Insurance against theft or damage
- ▶ Insurance against product liability, professional liability, civil liability or legal expenses
- ▶ Life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance)
- ▶ Life-contingent annuities and pensions (contracts that provide compensation for the uncertain future event - the survival of the annuitant or pensioner - to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival)
- ▶ Insurance against disability and medical costs

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<sup>85</sup> IFRS 17.B26.

- ▶ Surety bonds, fidelity bonds, performance bonds and bid bonds (i.e., contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building)
- ▶ Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of IFRS 17. However, as discussed at 2.3.1.A above, product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of IFRS 17 and are instead within the scope of IFRS 15 or IAS 37
- ▶ Title insurance (insurance against the discovery of defects in title to land that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself
- ▶ Travel assistance (compensation in cash or in kind to policyholders for losses suffered in advance of, or during travel)
- ▶ Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or a foreign exchange rate)
- ▶ Insurance swaps and other contracts that require a payment based on changes in climatic, geological and other physical variables that are specific to a party to the contract

These examples are not intended to be an exhaustive list.

The following illustrative examples, based on examples contained previously in IFRS 4, provide further guidance on situations where there is significant insurance risk.

#### **Illustration 6 – Guarantee fund established by contract**

A guarantee fund is established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, e.g., insurance, banking or travel.

The contract that establishes the guarantee fund is an insurance contract.

This example contrasts with Illustration 10 below, where a guarantee fund has been established by law and not by contract.

#### **Illustration 7 – No market value adjustment for maturity benefits**

A contract permits the issuer to deduct a market value adjustment (MVA), a charge which varies depending on a market index, from surrender values or death benefits. The contract does not permit the issuer to deduct an MVA for maturity benefits.

The policyholder obtains an additional survival benefit because no MVA is applied at maturity. That benefit is a pure endowment because the insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then. If the risk transferred by that benefit is significant, the contract is an insurance contract.

### **Illustration 8 – No market value adjustment for death benefits**

A contract permits the issuer to deduct an MVA from surrender values or maturity payments. The contract does not permit the issuer to deduct an MVA for death benefits.

The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that benefit is significant, the contract is an insurance contract.

### **3.7.2. Examples of transactions that are not insurance contracts**

The following are examples of transactions that are not insurance contracts:<sup>86</sup>

- ▶ Investment contracts that have the legal form of an insurance contract but do not transfer significant insurance risk to the issuer. For example, life insurance contracts in which the insurer bears no significant mortality or morbidity risk are not insurance contracts. Investment contracts with discretionary participation features do not meet the definition of an insurance contract. However, they are within the scope of IFRS 17 provided they are issued by an entity that also issues insurance contracts (see 12.4 below)
- ▶ Contracts that have the legal form of insurance, but return all significant risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example, some financial reinsurance contracts or some group contracts. Such contracts are normally financial instruments or service contracts
- ▶ Self-insurance, in other words retaining a risk that could have been covered by insurance. See 3.5.2.A above
- ▶ Contracts (such as gambling contracts) that require a payment if an unspecified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as a death or an accident. See 3.4.1 above
- ▶ Derivatives that expose one party to financial risk but not insurance risk, because the derivatives require that party to make payment based solely on the changes in one or more of a specified interest rate, a financial instrument price, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index or other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract
- ▶ Credit-related guarantees that require payments even if the holder has not incurred a loss on the failure of a debtor to make payments when due

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<sup>86</sup> IFRS 17.B27.

- ▶ Contracts that require a payment that depends on a climatic, geological or any other physical variable not specific to a party to the contract (commonly described as weather derivatives)
- ▶ Contracts that provide for reduced payments of principal, interest or both, that depend on a climatic, geological or any other physical variable that is not specific to a party to the contract (commonly referred to as catastrophe bonds)

An entity should apply other IFRSs, such as IFRS 9 and IFRS 15, to the contracts described above.<sup>87</sup>

The credit-related guarantees and credit insurance contracts referred to above can have various legal forms, such as that of a guarantee, some types of letters of credit, a credit default contract or an insurance contract. As discussed at 2.3.1.B above, those contracts are insurance contracts if they require the issuer to make specified payments to reimburse the holder for a loss that the holder incurs because a specified debtor fails to make payment when due to the policyholder applying the original or modified terms of a debt instrument. However, such insurance contracts are excluded from the scope of IFRS 17 unless the issuer has previously asserted explicitly that it regards the contracts as insurance contracts and has used accounting applicable to insurance contracts.<sup>88</sup>

Credit-related guarantees and credit insurance contracts that require payment, even if the policyholder has not incurred a loss on the failure of the debtor to make payments when due, are outside the scope of IFRS 17 because they do not transfer significant insurance risk. Such contracts include those that require payment:<sup>89</sup>

- ▶ Regardless of whether the counterparty holds the underlying debt instrument

Or

- ▶ On a change in the credit rating or the credit index, rather than on the failure of a specified debtor to make payments when due

The following examples, based on examples contained previously in IFRS 4, illustrate further situations where IFRS 17 is not applicable.

#### **Illustration 9 – Investment contract linked to asset pool**

Entity A issues an investment contract in which payments are contractually linked (with no discretion) to returns on a pool of assets held by the issuer (Entity A).

This contract is within the scope of IFRS 9 because the payments are based on asset returns and there is no transfer of significant insurance risk.

<sup>87</sup> IFRS 17.B28.

<sup>88</sup> IFRS 17.B29.

<sup>89</sup> IFRS 17.B30.

#### **Illustration 10 – Guarantee fund established by law**

Guarantee funds established by law exist in many jurisdictions. Typically, they require insurers to contribute funds into a pool in order to pay policyholder claims in the event of insurer insolvencies. They may be funded by periodic (usually annual) levies or by levies only when an insolvency arises. The basis of the funding requirement varies although typically most are based on an insurer's premium income.

The commitment of participants to contribute to the fund is not established by contract so there is no insurance contract. Obligations to guarantee funds are within the scope of IAS 37.

#### **Illustration 11 – Right to recover future premiums**

Entity A issues an insurance contract which gives it an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money.

Insurance risk is insignificant because all claims can be recovered from future premiums. Consequently, the insurer cannot suffer a significant loss and the contract is a financial instrument within the scope of IFRS 9.

#### **Illustration 12 – Market value adjustment without death or maturity benefits**

A contract permits the issuer to deduct an MVA from surrender payments. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.

The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money. Therefore, the contract is an investment contract because there is no significant insurance risk. This contract combines the two features discussed at 3.7.1 above. When considered separately, these two features transfer insurance risk. However, when combined, they do not transfer insurance risk. Therefore, it is not appropriate to separate this contract into two insurance components. [IFRS 17.9].

If the amount payable on death were not adjusted in full for the time value of money, or were adjusted in some other way, the contract might transfer significant insurance risk.

## 4. Combining insurance contracts

A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In those circumstances, it may be necessary to treat the set or series of contracts as a whole in order to report the substance of such contracts. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations of another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.<sup>90</sup> This requirement is intended to prevent entities entering into contracts that individually transfer significant insurance risk, but collectively do not, and accounting for part(s) of what is effectively a single arrangement as (an) insurance contract(s).

### Frequently asked questions

**Question 3-5: When may it be necessary to treat a set or series of insurance contracts as a whole, applying paragraph 9 of IFRS 17? [TRG meeting May 2018 - Agenda paper no. 01, Log S47]**

The TRG members discussed the analysis of an IASB staff paper and observed that:

- ▶ A contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance. However, there may be circumstances where a set or series of insurance contracts with the same or a related counterparty reflect a single contract in substance;
- ▶ The fact that a set or series of insurance contracts with the same counterparty are entered into at the same time is not, in itself, sufficient to conclude that they achieve, or are designed to achieve, an overall commercial effect. Determining whether it is necessary to treat a set or series of insurance contracts as a single contract involves significant judgement and careful consideration of all relevant facts and circumstances. No single factor is determinative in applying this assessment
- ▶ The following considerations might be relevant in assessing whether a set or series of insurance contracts achieve, or are designed to achieve, an overall commercial effect:
  - ▶ The rights and obligations are different when looked at together compared to individually. For example, if the rights and obligations of one contract negate the rights and obligations of another contract.
  - ▶ The entity is unable to measure one contract without considering the other. This may be the case where there is interdependency between the different risks covered in each contract and the contracts lapse together. When cash flows are interdependent, separating them can be arbitrary.

<sup>90</sup> IFRS 17.9.



### Frequently asked questions (cont'd)

- ▶ The existence of a discount, in itself, does not mean that a set or series of contracts achieve an overall commercial effect.
- ▶ The TRG members also observed that the principles for combining insurance contracts in paragraph 9 of IFRS 17 are consistent with the principles for separating insurance components from a single contract, as discussed at the February 2018 meeting of the TRG (see 5 below).

### Illustration 13 – Combination of insurance contracts

Insurance Company A enters an insurance policy with Insured B. A simultaneously enters a fronting agreement with Captive Insurer C, a related party of Insured B. The purpose of the fronting agreement is to reinsure 100% of the insurance risk from the insurance policy with B. However, A would be legally required to honour the obligations imposed by the insurance policy with B if C failed to indemnify it.

Insurance Company A should consider whether it should combine the insurance policy with Insured B and the reinsurance contract with Captive Insurer C, thereby taking into consideration the factors identified by the TRG (see Question 3-5 above).

## How we see it

- ▶ Parties are considered to be related for the purpose of combining contracts when they meet the definition of related parties in IAS 24 *Related Party Disclosures*.
- ▶ The TRG discussion clarifies that in order for an entity to combine a set or series of insurance contracts, those contracts firstly need to be entered into with the same or a related counterparty. If this requirement is not met, the set or series of insurance contracts cannot be combined under this specific guidance in IFRS 17. If this requirement is met, this fact, in and of itself, is not sufficient to conclude that the set or series of insurance contracts should be combined.
- ▶ Determining whether it is necessary to combine a set or series of insurance contracts into a single contract involves significant judgement and careful consideration of all relevant facts and circumstances. Examples of facts and circumstance to consider for determining whether the contracts were designed to achieve an overall commercial effect are:
  - ▶ Are the two contracts priced as a single risk; or priced in contemplation of the entire transaction?
  - ▶ Does the lapse of one contract changes the rights and obligations of the other contract(s)?
  - ▶ Does measuring the contracts separately result in one/some of the contract(s) being onerous whereas when measured as a whole the contract is profitable?
  - ▶ Do both the direct and ceded policies cover the same underlying insurance risks, and would they be impacted similarly by the underlying insured events?
  - ▶ Are the rights and obligations different when looked at together, compared to when looked at individually, for example through a guarantee or indemnification provided to the insurer?
- ▶ This guidance on the combination of insurance contracts may impact the accounting for fronting arrangements with related parties (see illustration 13 above):
  - ▶ In illustration 13, if the insurance contract is not combined with the reinsurance contract, the two contracts will be accounted for on a gross basis. The liabilities under the insurance policy may consequently not exactly offset the reinsurance asset due to, for example, different measurement models (the insurance contract would be eligible for the premium allocation approach but the reinsurance contract not, or vice versa), contract boundary, coverage period and allowing for the risk of non-performance within the measurement of the reinsurance contract.
  - ▶ In illustration 13, if the insurance contract is combined with the reinsurance contract, the single arrangement will be accounted for on a net basis under IFRS 17. However, if the combined arrangement

does not meet the criteria for significant insurance risk transfer, it would not be within the scope of IFRS 17.

- ▶ In addition to the specific guidance on combining contracts in IFRS 17, it may be necessary to consider whether the reporting entity is acting as an agent or principal in relation to the insurance contract services being provided. Where the entity merely acts as an agent on behalf of the other parties of an arrangement through for example a tripartite arrangement or a series of agreements, it would be necessary to account for the contracts on that basis in order to reflect the economic substance of a set or series of insurance contracts, even if a related party situation is not present. Concluding that an insurance company is acting as an agent is not expected to be common because the entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer, i.e. the entity commonly retains the primary responsibility for fulfilling the insurance contract services to its policyholders. While IFRS 17 does not include specific guidance on how to determine whether an entity is acting as an agent or a principal, IFRS 15 paragraphs B34 to B38 does. Where an entity would act as an agent, the accounting for the contract would be outside of the scope of IFRS 17.

## 5. Separating components from an insurance contract

Insurance contracts may contain one or more components that would be within the scope of another IFRS if they were separate contracts. Such components may be embedded derivatives, an investment component or a component for services other than insurance contract services.

IFRS 17 requires an insurer to identify and separate components in certain circumstances. When separated, those components must be accounted for under the relevant IFRS instead of under IFRS 17.<sup>91</sup> The IASB considers that accounting for such components separately using other applicable IFRSs makes them more comparable to similar contracts that are issued as separate contracts and allows users of financial statements to better compare the risks undertaken by entities in different businesses or industries.<sup>92</sup>

Therefore, an insurer should:

- ▶ Apply IFRS 9 to determine whether there is an embedded derivative to be bifurcated (i.e., be separated) and, if there is, account for that separate derivative (see 5.1 below)
- ▶ Separate from a host insurance contract an investment component if, and only if, that investment component is distinct and apply IFRS 9 to account for the separated component unless it is an investment contract with discretionary participation features (see 5.2 below),<sup>93</sup> and then
- ▶ Separate from the host insurance contract any promise to transfer to a policyholder distinct goods or services other than insurance contract services applying paragraph 7 of IFRS 15 (see 5.3 below)<sup>94</sup>

After separating the components described above (i.e., distinct non-insurance components), an entity should apply IFRS 17 to all remaining components of the host insurance contract.<sup>95</sup> The recognition and measurement criteria of IFRS 17 are discussed at 7 and 8 below.

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<sup>91</sup> IFRS 17.10.

<sup>92</sup> IFRS 17.BC99.

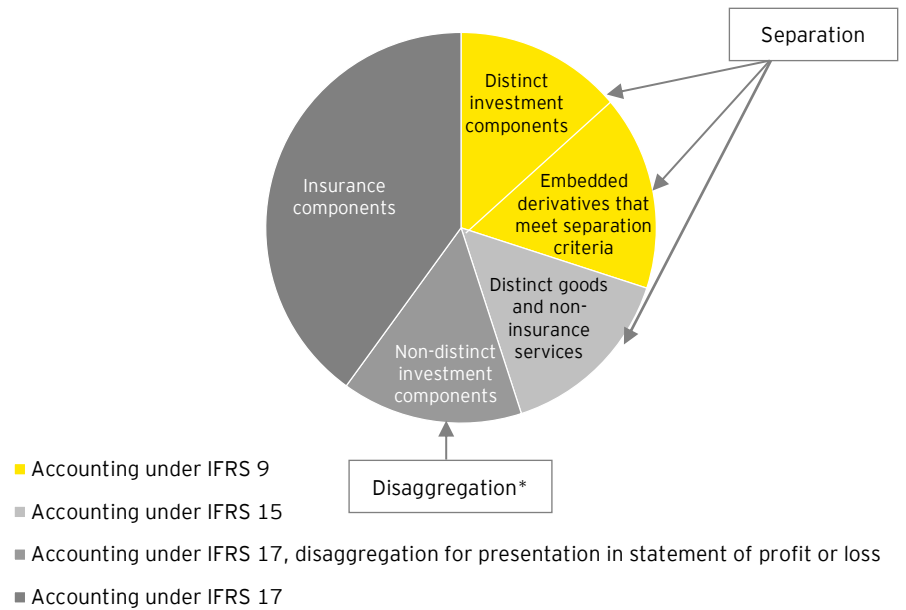
<sup>93</sup> IFRS 17.11

<sup>94</sup> IFRS 17.12

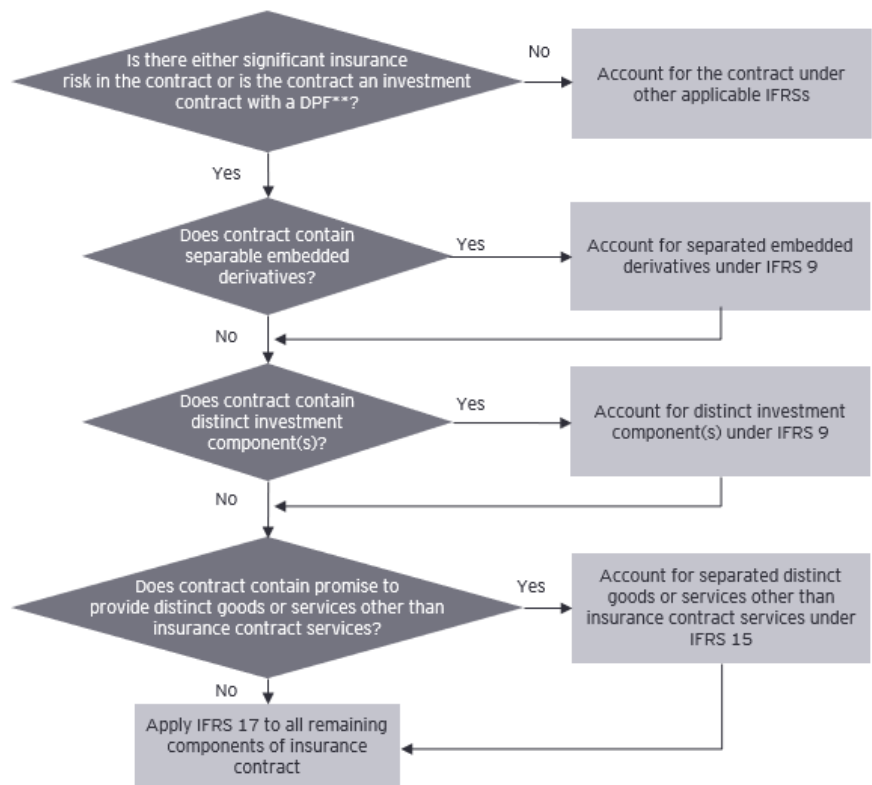
<sup>95</sup> IFRS 17.13

The prohibition of voluntary separation of non-insurance components will have a significant impact on some accounting practices.

The diagram below illustrates the approach to separating non-insurance components:



\* Disaggregation is the exclusion of a non-distinct investment component from insurance revenue and insurance service expenses.



\*\* Investment contracts with Discretionary Participation Features (DPF) are within the scope of IFRS 17 if the entity that issues them also issues insurance contracts. See sections 2.3 and 14.2.

## 5.1. Separating embedded derivatives from an insurance contract

An entity applies IFRS 9 to determine whether to separate an embedded derivative from a host insurance contract. An embedded derivative is a component of a hybrid contract that also includes a non-derivative host, meaning that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified. This is determined according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, price or rate index, credit rating or index, or other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract.<sup>96</sup>

IFRS 9 requires separation of an embedded derivative from its host if, and only if:<sup>97</sup>

- ▶ A separate instrument with the same terms as the embedded feature meets the definition of a derivative within the scope of IFRS 9 (this would not be the case if the embedded derivative is itself an insurance contract within the scope of IFRS 17).
- ▶ The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contract. According to IFRS 9, a derivative embedded in an insurance contract relates closely to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (without considering the host contract)<sup>98</sup>
- ▶ The hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e., a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

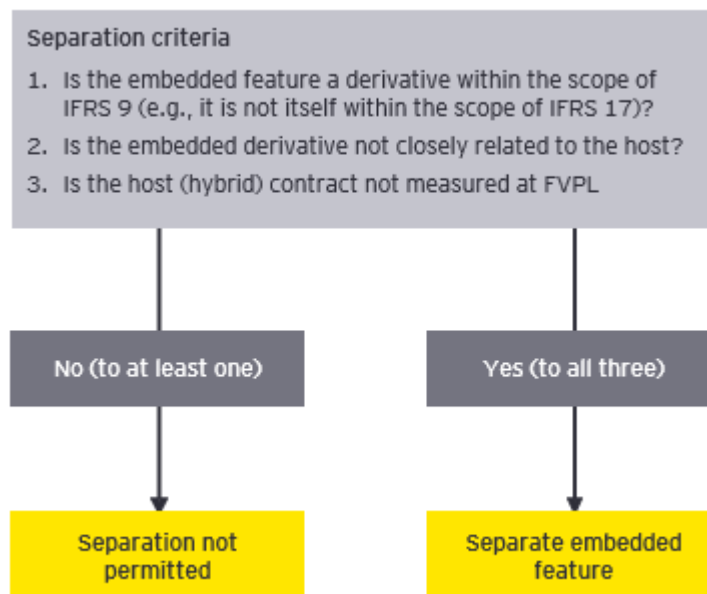
The diagram below illustrates the embedded derivative decision tree:

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<sup>96</sup> IFRS 9.4.3.1.

<sup>97</sup> IFRS 9.4.3.3.

<sup>98</sup> IFRS 9.B4.3.8(h).



The Board believes that accounting separately for some embedded derivatives in insurance contracts:<sup>99</sup>

- ▶ Ensures that contractual rights and obligations that create similar risk exposures are treated alike whether or not they are embedded in a non-derivative host contract
- ▶ Counters the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative host contract

IFRS 4 had previously required IFRS 9 or IAS 39 to be applied to derivatives embedded in a host insurance contract unless the embedded derivative was itself an insurance contract.<sup>100</sup> IFRS 17 no longer includes the statement that such embedded derivative is not within the scope of IFRS 9. However, any derivative that itself is an insurance contract is scoped out by IFRS 9 and, therefore, would not be subject to the embedded derivative separation guidance of IFRS 9 but is accounted for under IFRS 17.<sup>101</sup>

IFRS 17 has also removed the exception in IFRS 4 which allowed an insurer not to separate and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differed from the carrying amount of the host insurance liability.<sup>102</sup> Instead, the requirements of IFRS 9 are used to determine whether an entity needs to separate a surrender option.<sup>103</sup> However, the value of a typical surrender option and the host insurance contract are likely to be interdependent because one component cannot usually be measured without the other. Therefore, these requirements

<sup>99</sup> IFRS 17.BC104.

<sup>100</sup> IFRS 4.7.

<sup>101</sup> IFRS 9.2.1(e)

<sup>102</sup> IFRS 4.8.

<sup>103</sup> IFRS 17.BC105(b).

will very often result in not separating the surrender option from the host insurance contract.

A derivative is a financial instrument within the scope of IFRS 9 with all three of the following characteristics:<sup>104</sup>

- ▶ Its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to the underlying of the contract
- ▶ It requires no initial net investment or an initial net investment that would be smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- ▶ It is settled at a future date

The following are examples of embedded derivatives that may be found in insurance contracts:

- ▶ Benefits, such as death benefits, linked to equity prices or an equity index
- ▶ Options to take life-contingent annuities at guaranteed rates
- ▶ Guarantees of minimum interest rates in determining surrender or maturity values
- ▶ Guarantees of minimum annuity payments where the annuity payments are linked to investment returns or asset prices
- ▶ A put option for the policyholder to surrender a contract. These can be specified in a schedule, based on the fair value of a pool of interest-bearing securities or based on an equity or commodity price index
- ▶ An option to receive a persistency bonus (an enhancement to policyholder benefits for policies that remain in-force for a certain period)
- ▶ An industry loss warranty where the loss trigger is an industry loss as opposed to an entity specific loss
- ▶ A catastrophe trigger where a trigger is defined as a financial variable such as a drop in a designated stock market
- ▶ An inflation index affecting policy deductibles
- ▶ Contracts where the currency of claims settlement differs from the currency of loss
- ▶ Contracts with fixed foreign currency rates

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<sup>104</sup> IFRS 9 Appendix A.



The following example illustrates an embedded derivative in an insurance contract that is not required to be separated and accounted for under IFRS 9.

#### **Illustration 14 – Death or annuity benefit linked to equity prices or index**

A contract has a death benefit linked to equity prices or an equity index “that is payable only on death or when annuity payments begin, and not on surrender or maturity.”

The equity-index feature meets the definition of an insurance contract (unless the life-contingent payments are insignificant) because the policyholder benefits only when the insured event occurs. Therefore, the derivative and the host insurance contract are interdependent. The embedded derivative is not required to be separated and accounted for under IFRS 9, but remains within the scope of IFRS 17.<sup>105</sup>

#### **Illustration 15 – Policyholder option to surrender contract for value based on a market index**

An insurance contract gives the policyholder the option to surrender the contract for a surrender value based on an equity or commodity price or index.

The option is not closely related to the host insurance contract because the surrender value is derived from an index and is not interdependent with the insurance contract. Therefore, the surrender option is required to be accounted for under IFRS 9.<sup>106</sup>

### **How we see it**

- ▶ IFRS 17 did not carry forward the exception to separate, and measure at fair value, a policyholder’s option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate). However, the value of a typical surrender option and the host insurance contract are likely to be interdependent because one component cannot be measured or exist without the other. Therefore, in practice, this change may not result in separation of the surrender option in any case.

<sup>105</sup> IFRS 9.B4.3.8(h).

<sup>106</sup> IFRS 9.B4.3.5(c)-(d).

## 5.2. Separating investment components from an insurance contract

IFRS 4 referred to the notion of a deposit component.<sup>107</sup> IFRS 17 does not refer to a deposit component, but introduces a new concept called an investment component. An investment component is the amount an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs.<sup>108</sup>

IFRS 17 requires distinct investment components to be separated from the host insurance contract and accounted for under IFRS 9. Investment components that are not distinct are accounted for under IFRS 17. However, investment components accounted for under IFRS 17 are excluded from the insurance service result (i.e. they are not accounted for as either insurance revenue or insurance service expenses).<sup>109</sup>

### 5.2.1. The definition of an investment component

The definition of investment components was clarified in June 2020, because the explanation of an investment component contained in the Basis for Conclusions was not entirely captured by the original wording of the definition in the standard.

#### Frequently asked questions

**Question 5-1: How to determine whether an insurance contract includes an investment component. [TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112]**

The submissions ask how to:

- ▶ Determine whether an insurance contract includes an investment component
- ▶ Assess whether an investment component is distinct (see 5.2.2 below)
- ▶ Determine the amount of an investment component (see 5.2.3 below)

In determining whether the contract requires the entity to make a payment in all circumstances, the Staff observed that:

- ▶ IFRS 17 requires an entity to assess at inception whether an investment component is separated from an insurance contract. To make that assessment, the entity determines whether the contract includes an investment component at inception.
- ▶ Different events can trigger a payment to a policyholder under an insurance contract. For example, a payment could be due because the policyholder terminates the contract, an insured event occurs, or the contract reaches its maturity. The insurance contract includes an investment component only if a payment would occur in all circumstances. For example, a non-cancellable contract that requires an entity to pay an amount when the policyholder dies, includes an investment component because the entity is required to pay the amount in all circumstances. The amount to be paid in this case is a claim for a future event that is the death of the policyholder

<sup>107</sup> IFRS 4.10-12, 20D and B28.

<sup>108</sup> IFRS 17 Appendix A.

<sup>109</sup> IFRS 17.85.

## Frequently asked questions (cont'd)

(although the timing is uncertain). However, a non-cancellable contract that requires an entity to pay an amount only if the policyholder survives to a specified age but does not require the entity to pay any amount if the policyholder dies before that, does not include an investment component. The amount to be paid in this case is a claim for an insured event, i.e., the survival of the policyholder.

- ▶ IFRS 17 states that an entity needs to assess the insurance risk excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). Hence, for the purpose of determining whether an insurance contract includes an investment component, the entity needs to assess whether scenarios in which no payments are made have commercial substance. The entity does not consider a scenario for which no payment is made if that scenario has no commercial substance.
- ▶ In some scenarios, the amount of the payment could be zero. However, this does not necessarily mean that no investment component exists. For example, an entity would need to consider whether a scenario in which the amount of payment is zero arises from:
  - ▶ A payment that an entity makes to the policyholder early in the coverage period that might reduce the investment component to zero later in the coverage period.
  - ▶ The policyholder's decision to use a payment due from the entity to settle amounts due to the entity. This might be the case when the policyholder decides to terminate a contract early in the coverage period and uses a surrender amount to pay surrender charges that are equal to or higher than the surrender amount, or when the policyholder has the option to use a surrender amount to buy insurance coverage, such as an annuity. In the staff's view, the fact that the policyholder chooses to use a payment it is due to fund payments to the entity does not mean the entity is not required to make payments in all circumstances. This is because settling amounts due on a net or gross basis should not affect the outcome of the assessment of whether an investment component exists.
  - ▶ A payment amount may be made to a policyholder upon cancellation of a contract that is calibrated to reflect outstanding future periods in which a service is provided. Such a payment may indicate that the policyholder is entitled to a premium refund reflecting its consumption of service over the life of the contract. In this case, the payments may represent a refund of premiums for unused coverage rather than an investment component.

#### **Illustration 16 – Investment component in a life cover contract**

In exchange for a single premium of CU1,000 paid by a 60 year-old policyholder, the life cover contract promises to pay an amount of CU2,000 when the policyholder reaches 80 years old or when the policyholder dies before reaching 80 years old. The policyholder cannot terminate the contract.

The life cover contract includes an investment component because the contract requires the insurer to make a payment to the policyholder in all circumstances, i.e. whether the policyholder reaches 80 years old or dies before reaching 80 years old.

#### **Illustration 17 – Investment component in immediate annuity contract**

In exchange for premiums, the immediate annuity contract with a guarantee payment period promises to make regular payments to the policyholder for the remainder of the policyholder's life, or the estate of the policyholder for a remaining guaranteed period if the policyholder dies before the end of the guaranteed period (for example, if the guaranteed period is three years and the policyholder dies at the end of Year 1, the estate will continue to receive regular payments for two years). This example assumes that the policyholder cannot terminate the contract.

The immediate annuity contract with a guaranteed payment period includes an investment component. The staff observe that the contract requires the entity to make a payment in all circumstances—i.e. regular payments to the policyholder or to the estate of the policyholder for the guaranteed period.

#### **Illustration 18 – Investment component in deferred annuity contract**

The deferred annuity contract promises to pay a surrender amount to the policyholder if the policyholder dies or terminates the contract before reaching 60 years old or, if the policyholder reaches 60 years old, to make regular payments to the policyholder for the remainder of the policyholder's life. In addition, if the policyholder dies before reaching 80 years old, the contract requires the entity to pay an amount at least equal to the amount accumulated to the policyholder through deposits less payments already made. It is assumed that if the policyholder reaches 80 years old, the regular payments received between the ages of 60 years old and 80 years old at least equal the amount accumulated through deposits and the amount accumulated through deposits does not accrue interest after the policyholder reaches 60 years old. The policyholder cannot terminate the contract after reaching 60 years old.

The deferred annuity contract includes an investment component because the contract requires the entity to pay a fixed amount in all circumstances, either a surrender amount if the policyholder dies or terminates the contract before reaching 60 years old or an amount that is equal to the amount accumulated by the policyholder through deposits, if the policyholder dies between the ages of 60 and 80 or reaches 80 years old.

### **Illustration 19 – Pure protection contract**

In exchange for premiums, the pure protection contract promises to pay a fixed amount of CU1,000 to the policyholder on the death of the policyholder, if the policyholder dies within a 5-year coverage period or a variable surrender amount to the policyholder if the policyholder opts to surrender the contract before the end of Year 4. No amount is paid to the policyholder if the policyholder keeps the contract to Year 5 and survives.

The pure protection contract does not contain an investment component because there are circumstances with commercial substance in which no amount is paid.

A contract which does not require a payment to a policyholder if it continues to the end of the coverage period without a claim being made does not contain an investment component. There may be a payment upon surrender but this payment is regardless of whether the insured event occurs. However, because there is no payment on maturity there is a scenario where no payment to the policyholder is made (provided this scenario has commercial substance). Therefore, a pure protection contract does not contain an investment component because there are circumstances with commercial substance in which no amount is paid. The same would apply to a contract where there is no payment upon death before maturity (i.e., a pure endowment contract).

### **5.2.2. Separable investment components**

Many insurance contracts have an implicit or explicit investment component that would, if it were a separable financial instrument, be within the scope of IFRS 9. However, the Board decided that it would be difficult to routinely separate such investment components from insurance contracts.<sup>110</sup>

Accordingly, IFRS 17 requires an entity to separate from a host insurance contract an investment component if, and only if, that investment component is distinct from the host insurance contract.<sup>111</sup> The Board concluded that, in all cases, entities would be able to measure the stand-alone value for a separated investment component by applying IFRS 9.<sup>112</sup>

The words 'if, and only if' mean that voluntary separation of investment components which are not distinct is prohibited. This is a change from IFRS 4, which permitted voluntary unbundling of deposit components if the deposit component could be measured separately. The Board considered whether to permit an entity to separate a non-insurance component when not required to do so by IFRS 17; for example, some investment components with interrelated cash flows, such as policy loans. Such components may have been separated when applying previous accounting practices. However, the Board concluded that it would not be possible to separate in a non-arbitrary way, a component that is not distinct from the insurance contract nor would such a result be desirable. The Board also noted that when separation ignores interdependencies between insurance and non-insurance components, the sum

<sup>110</sup> IFRS 17.BC108.

<sup>111</sup> IFRS 17.11(b).

<sup>112</sup> IFRS 17.BC109.

of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. That would reduce the comparability of the financial statements across entities.<sup>113</sup>

An investment component is distinct if both of the following conditions are met:<sup>114</sup>

- ▶ The investment component and the insurance component are not highly interrelated
- ▶ A contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity should take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately. It is not necessary to undertake an exhaustive search to identify whether an investment component is sold separately. However, the entity should consider all information that is reasonably available.

An investment component and an insurance component are highly interrelated if:<sup>115</sup>

- ▶ The entity is unable to measure one component without considering the other. For example, if the value of one component varies according to the value of the other, an entity should apply IFRS 17 to account for the combined investment and insurance components.
- ▶ The policyholder is unable to benefit from one component unless the other is also present. For example, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity should apply IFRS 17 to account for the combined investment and insurance components.

### Frequently asked questions

**Question 5-2: How to determine whether an insurance contract includes an investment component. [TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112]**

The submissions ask how to:

- ▶ Determine whether an insurance contract includes an investment component (see 5.2.1 above)
- ▶ Assess whether an investment component is distinct
- ▶ Determine the amount of an investment component (see 5.2.3 below)

Assessing whether an investment component is distinct, the Staff considered the two criteria in paragraph B31.

TRG members discussed the analysis on assessing whether an investment component is distinct and observed that an investment component within an insurance contract is not distinct if the investment component and the insurance component are highly interrelated, i.e., when:

<sup>113</sup> IFRS 17.BC114.

<sup>114</sup> IFRS 17.B31.

<sup>115</sup> IFRS 17.B32.

### Frequently asked questions (cont'd)

- ▶ It is not possible to measure one component without considering the other. This could be the case when the contract requires the entity to make payments for which either the amount or the timing depend on the insured event. Paragraph BC10(a) of the Basis for Conclusions on IFRS 17 explains that ignoring interdependencies between components of an insurance contract would have the result that the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. Thus, if the value of one component varies according to the value of the other component the resulting measurement might not be meaningful for one of (or for both) the components.
- ▶ The policyholder cannot benefit from one component if the other is not present. The lapse or maturity of one component causing the lapse or maturity of the other component is sufficient to conclude that the two components are highly interrelated. For example, the lapse of the insurance component causing the lapse of the investment component is sufficient to conclude that the two components are highly interrelated, even if the lapse of the investment component does not cause the lapse of the insurance component. A contractual term preventing the policyholder from cancelling the investment component or the insurance component or both may indicate that the policyholder cannot benefit from one component without the other.

TRG members also observed that the hurdle for separation of investment components from an insurance contract is high.

### Illustration 20 – Investment component in a life cover contract

In exchange for a single premium of CU1,000 paid by a 60 year-old policyholder, the life cover contract promises to pay an amount of CU2,000 when the policyholder reaches 80 years old or when the policyholder dies before reaching 80 years old. The policyholder cannot terminate the contract.

The value of the insurance component varies according to the value of the investment component because the insured event in this example is the timing of death. Although the payment of CU2,000 is certain, it is uncertain when the policyholder will die and, therefore whether the entity will pay the amount of CU2,000 before the policyholder reaches 80 years old and how soon that may be after the inception of the contract. Therefore, the entity cannot measure the insurance component without considering the investment component and, as a result, the investment component is not distinct and the entity cannot separate it from the insurance contract.

The IASB staff further observed that the policyholder cannot benefit from one component when the other component is not present because both components lapse together.

### **Illustration 21 – Investment component in deferred annuity contract**

The deferred annuity contract promises to pay a surrender amount to the policyholder if the policyholder dies or terminates the contract before reaching 60 years old or, if the policyholder reaches 60 years old, to make regular payments to the policyholder for the remainder of the policyholder's life. In addition, if the policyholder dies before reaching 80 years old, the contract requires the entity to pay an amount at least equal to the amount accumulated to the policyholder through deposits less payments already made. It is assumed that if the policyholder reaches 80 years old, the regular payments received between the ages of 60 years old and 80 years old at least equal the amount accumulated through deposits and the amount accumulated through deposits does not accrue interest after the policyholder reaches 60 years old. The policyholder cannot terminate the contract after reaching 60 years old.

In this contract the investment component is: (i) a surrender amount if the policyholder dies or terminates the contract before reaching 60 years old; or (ii) an amount that is equal to the amount accumulated by the policyholder through deposits, if the policyholder reaches 60 years old. The insurance component is possible payments exceeding the amount accumulated by the policyholder through deposits.

If the policyholder dies after reaching 60 years old and before reaching 80 years old, the entity makes a payment reflecting the amount accumulated by the policyholder through deposits. The timing of that payment depends on the death of the policyholder. Therefore, the entity cannot measure the investment contract without considering the insurance component. As a result, the investment component is not distinct and the entity cannot separate it from the insurance contract.

The IASB staff also observed that the death of the policyholder causes the maturity of both the insurance component in the contract and the investment component in the contract.

### **Illustration 22 – Insurance contract with an account balance and a minimum death benefit [Based on example 4 in the Illustrative Examples to IFRS 17, IE43-51]**

An entity issues a whole life insurance contract with an account balance. The contract does not have a fixed term. The entity receives a premium of CU1,000 when the contract is issued. The account balance is increased annually by voluntary amounts paid by the policyholder, increased or decreased by amounts calculated using the returns from specified assets and decreased by fees charged by the entity (e.g. asset management fees).

The contract promises to pay the following:

- ▶ A death benefit of CU5,000 plus the amount of the account balance if the insured person dies during the coverage period
- ▶ The account balance, if the contract is cancelled (i.e., there are no surrender charges).



**Illustration 22 – Insurance contract with an account balance and a minimum death benefit [Based on example 4 in the Illustrative Examples to IFRS 17, IE43-51] (cont'd)**

The entity has a claims processing department to process the claims received and an asset management department to manage investments. An investment product that has equivalent terms to the account balance, but without the insurance coverage, is sold by another financial institution.

The contract contains an investment component because an amount is paid to the policyholder in all circumstances (i.e., either the account balance if the contract is cancelled or the death benefit plus the account balance if the insured person dies during the coverage period).

The existence of an investment product with equivalent terms indicates that the components may be distinct. However, if the right to provide death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance, the insurance and investment components are highly interrelated and are therefore not distinct. Consequently, the account balance would not be separated from the insurance contract and would be accounted for by applying IFRS 17.

Claims processing activities are part of the activities the entity must undertake to fulfil the contract and the entity does not transfer a good or service to the policyholder because the entity performs those activities. Thus, the entity would not separate the claims processing component from the insurance contract.

Asset management activities, similar to claims processing activities, are part of the activities the entity must undertake to fulfil the contract and the entity does not transfer a good or service other than insurance contract services to the policyholder because the entity performs those activities. Thus, the entity would not separate the asset management component from the insurance contract.

## How we see it

- ▶ An account balance in a savings-type insurance contract is a clear example of a repayable contract feature that would typically be an investment component. There are various other repayable amounts that may also meet the definition of an investment component depending on the applicable circumstances, for example guaranteed annuity payments and no-claim bonuses.
- ▶ The requirements in IFRS 17 for separating investment components do not specifically address the issue of contracts artificially separated through the use of side letters, the separate components of which should be considered together. However, IFRS 17 does state that it may be necessary to treat a set or series of contracts as a whole in order to report the substance of such contracts. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations of another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist (see 4 above).

- ▶ Generally, IFRS 4 permitted voluntary separation of non-insurance components in an insurance contract where separation (referred to as “unbundling”) is not required. Some entities used this option to voluntarily separate non-insurance components from their host insurance contracts and account for them under other IFRSs, for example, because their previous accounting policies applied under IFRS 4 required the separation of some of these components. In such cases, entities will have to assess whether separation of the non-insurance components is required under IFRS 17. Any such components not requiring mandatory separation will have to be accounted for together with the host insurance contract under IFRS 17.

### 5.2.3. *Measurement of the non-distinct investment component*

Although an entity applies IFRS 17 to account for both the combined investment and insurance components of an insurance contract if those components are highly interrelated, insurance revenue and insurance service expenses presented in profit or loss must exclude any non-separated investment component.<sup>116</sup>

IFRS 17 does not explain how to determine the amount of non-distinct investment components that an entity is required to exclude from insurance revenue and insurance service expense. This issue was discussed at the April 2019 meeting of the TRG.

#### **Frequently asked questions**

***Question 5-3: How to determine whether an insurance contract includes an investment component. [TRG meeting April 2019 - Agenda paper no. 01, Log S85, S90 and S112]***

The submissions ask how to:

- ▶ Determine whether an insurance contract includes an investment component (see 5.2.1 above)
- ▶ Assess whether an investment component is distinct (see 5.2.2 above)
- ▶ Determine the amount of an investment component.

The Staff observed that there could be circumstances in which the investment component is not explicitly identified by the contractual terms or where the amount of the investment component varies over time. The Staff observed that, in these circumstances, an approach for determining the investment component that is based on a present value basis as at the time of making this determination would be consistent with the requirements of paragraph B21 of IFRS 17, which refers to the present value of significant additional amounts that result in a contract being defined as an insurance contract (see 3.5.3 above). The staff consider that if the amounts that would be payable if no insurance event had occurred are

<sup>116</sup> IFRS 17.85, BC108(b).

### Frequently asked questions (cont'd)

determined on a present value basis, it would be consistent to determine the investment component on a present value basis too.

The TRG members observed that:

- ▶ In some cases, it may be reasonable to determine the amount of the investment component that an entity is required to exclude from insurance revenue and insurance service expenses using the explicit amount identified by contractual terms. For example, the amounts of a non-distinct investment component can be identified as an explicit surrender amount or explicit guaranteed payments.
- ▶ In other cases, it may be appropriate to determine the amount of the investment component that an entity is required to exclude from insurance revenue and insurance service expenses on a present value basis at the time of making the determination. For example, in an uncancellable contract that requires an entity to pay the policyholder an amount when the policyholder dies or reaches the age of 80 (see Illustration 15 and 18 above), using the present value of the payments the contract requires the entity to make at the age of 80 as the amount of the investment component would result in a reasonable outcome because death in the early periods of coverage would reflect a higher insurance claim than in later periods.

The TRG members also observed that if an entity uses an explicit surrender amount for determining the amounts to be excluded from insurance revenue and insurance service expense, it should not be required to determine whether a part of that amount reflects a premium refund. The TRG members noted that both an investment component and a premium refund will be excluded from revenue and expenses recognised from a contract in these circumstances. In addition, there is no requirement to separately disclose any premium refund from the non-distinct investment component.

## How we see it

- ▶ It is observed in the Basis for Conclusions that non-distinct investment components need be identified only at the time revenue and incurred claims are recognised, so as to exclude the investment components so identified.<sup>117</sup> However, since the contractual service margin in the general model is determined by considering both insurance coverage and investment return service, if any (see 9.7.1 below), an entity may also need to determine whether an insurance contract includes a non-distinct investment component before an incurred claim is recognised.
- ▶ Furthermore, the contractual service margin for a group of insurance contracts without direct participation features is adjusted for differences between any investment component expected to become payable in the period (adjusted for the effect of the time value of money and financial risk) and the actual investment component that becomes payable in the period (see 9.6 below). This means the entity would have to be able to determine the differences between any investment component expected to become payable in the period and the actual investment component that becomes payable.<sup>118</sup>

## 5.3. Goods and other than insurance contract services

After applying IFRS 9 to embedded derivatives and separating a distinct investment component from a host insurance contract, an entity is required to separate from the host insurance contract any promise to transfer to a policyholder distinct goods or services other than insurance contract services (i.e., non-insurance services) by applying the requirements of IFRS 15 *Revenue from Contracts with Customers* for a contract that is partially within the scope of IFRS 15 and partially within the scope of other standards.<sup>119</sup>

This means that, on initial recognition, an entity should:<sup>120</sup>

- ▶ Apply IFRS 15 to attribute the cash inflows between the insurance component and any promises to provide distinct goods or services other than insurance contract services; and
- ▶ Attribute the cash outflows between the insurance component and any promised goods or services other than insurance contract services accounted for applying IFRS 15 so that:
- ▶ Cash outflows that relate directly to each component are attributed to that component
- ▶ Any remaining cash outflows are attributed on a systematic and rational basis, reflecting the cash outflows the entity would expect to arise if that component were a separate contract.

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<sup>117</sup> IFRS 17.BC34.

<sup>118</sup> IFRS 17.B96.

<sup>119</sup> IFRS 17.12.

<sup>120</sup> IFRS 17.12.

The allocation of the cash inflows between the host insurance contract and the distinct good or service other than an insurance contract service should be based on the stand-alone selling price of the components. The Board believes that, in most cases, entities would be able to determine an observable stand-alone selling price for the bundled goods or services if those components meet the separation criteria.<sup>121</sup> If the stand-alone selling price is not directly observable, an entity would need to estimate the stand-alone selling price of each component to allocate the transaction price. This stand-alone selling price might not be directly observable if the entity does not sell the insurance and the goods or components separately, or if the consideration charged for the two components together differs from the stand-alone selling prices for each component. In this case, applying IFRS 15 results in any discounts and cross-subsidies being allocated to components proportionately or on the basis of observable evidence.<sup>122</sup> IFRS 17 requires that cash outflows should be allocated to their related component, and that cash outflows not clearly related to one of the components should be systematically and rationally allocated between components. Insurance acquisition cash flows and some fulfilment cash flows relating to overhead costs do not clearly relate to one of the components. A systematic and rational allocation of such cash flows is consistent with the requirements in IFRS 17 for allocating acquisition and fulfilment cash flows that cover more than one group of insurance contracts to the individual groups of contracts, and is also consistent with the requirements in other IFRSs for allocating the costs of production, e.g., the requirements in IFRS 15 and IAS 2 *Inventories*.<sup>123</sup>

For the purpose of separation, an entity should not consider activities that it must undertake to fulfil a contract unless the entity transfers a good or service other than insurance contract services to the policyholder as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the tasks are performed.<sup>124</sup>

A good or service other than an insurance contract service promised to a policyholder is distinct if the policyholder can benefit from the good or service either on its own or together with other resources readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the policyholder has already got (from the entity or from other transactions or events).<sup>125</sup>

A good or service other than insurance contract service that is promised to the policyholder is not distinct if:<sup>126</sup>

- ▶ The cash flows and risks associated with the goods or services are highly interrelated with the cash flows and risks associated with the insurance components in the contract
- ▶ The entity provides a significant service in integrating the goods or non-insurance services with the insurance components.

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<sup>121</sup> IFRS 17.BC111.

<sup>122</sup> IFRS 17.BC112.

<sup>123</sup> IFRS 17.BC113.

<sup>124</sup> IFRS 17.B33.

<sup>125</sup> IFRS 17.B34.

<sup>126</sup> IFRS 17.B35.

The Board considered, but rejected, the possibility to separate non-insurance components that are not distinct because it would not be possible to separate, in a non-arbitrary way, a component that is not distinct from the insurance contract nor would such a result be desirable.<sup>127</sup>

**Illustration 23 – Separating components from a stop-loss contract with claims processing services [Based on example 5 in the Illustrative Examples to IFRS 17, IE51-55]**

An entity issues a stop loss contract to a policyholder (which is an employer). The contract provides health coverage for the policyholder's employees, with these features:

- ▶ Insurance coverage of 100% for the aggregate claims from employees exceeding CU25m (the "stop loss" threshold). The employer will self-insure claims from employees up to CU25m.
- ▶ Claims processing services for employees' claims during the next year, regardless of whether these have exceeded the stop-loss threshold of CU25m. The entity is responsible for processing the health insurance claims of employees on behalf of the employer.

**Analysis**

The entity considers whether to separate the claims processing services from the insurance contract. Similar services to process claims on behalf of customers are available in the market.

The criteria for identifying distinct non-insurance services are met in this example because:

- ▶ Claims processing services, similar to those for employers' claims on behalf of the employer, are sold as a stand-alone service without any insurance coverage.
- ▶ These services benefit the policyholder independently of the insurance coverage. Had the entity not agreed to provide those services, the policyholder would have to process its employees' medical claims itself or engage other service providers.
- ▶ Cash flows associated with claims processing services are not highly interrelated with the cash flows of the insurance coverage, and the entity does not provide for a significant service of integrating claims processing services with the insurance components.

Accordingly, the entity separates the claims processing services (for all claims) from the insurance contract and accounts for them by applying IFRS 15.

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<sup>127</sup> IFRS 17.BC114.

**Illustration 24 – Separating components from a life insurance contract with an account balance [Based on example 4 in the Illustrative Examples to IFRS 17, IE42-50]**

An entity issues a life insurance contract with an account balance and receives a premium of CU1,000 when the contract is issued. The account balance increases annually by voluntary amounts paid by the policyholder and is credited with returns from specified assets and decreased by fees charged by the entity (e.g., asset management fees).

The contract promises to pay:

- ▶ A death benefit of CU5,000 plus the amount of the account balance, if the insured person dies during the coverage period
- ▶ The account balance, if the contract is cancelled (i.e., there are no surrender charges)

The entity uses a claims processing department to process the claims received and an asset management department to manage investments. Other financial institutions offer investment products whose terms are equivalent to the account balance, but without the insurance coverage.

**Analysis**

The existence of an investment product with equivalent terms indicates that the components may be distinct. However, if the right to provide death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance is returned, the insurance and investment components are highly interrelated and therefore not distinct. Consequently, there would be no separation of an account balance and insurance contract, and the account balance would be accounted for by applying IFRS 17. Amounts related to the investment component would not be presented as insurance revenue or insurance service expenses.

An entity must undertake claims processing and asset management activities to fulfil the contract and does not transfer distinct goods or services to the policyholder simply because the entity performs these. Thus, the entity would not separate these components from the insurance contract.

## 6. Level of aggregation

The requirements for the level of aggregation are likely to result in more granular grouping for measurement purposes and earlier recognition of losses, compared to many existing practices under IFRS 4.

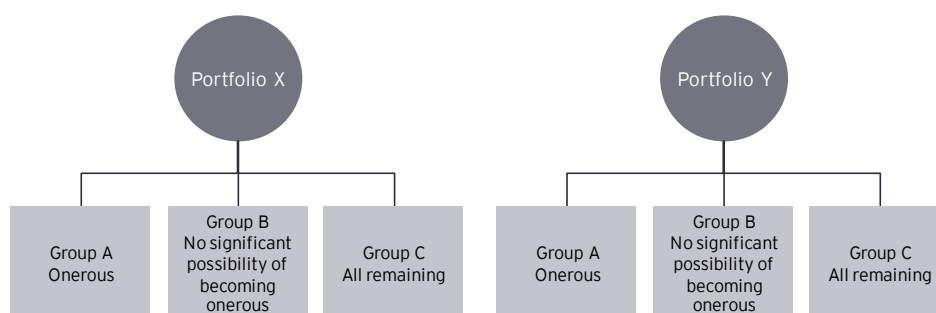
IFRS 17 defines the level of aggregation to be used for measuring insurance contracts and their related profitability. This is a key issue in identifying onerous contracts and in determining the recognition of profit or loss and presentation in the financial statements.

The starting point for aggregating contracts is to identify portfolios of insurance contracts. A portfolio comprises contracts that are subject to similar risks and managed together.<sup>128</sup>

IFRS 17 then requires an entity to divide the contracts in each portfolio on initial recognition into the following groups:<sup>129</sup>

- ▶ Those contracts that are onerous at initial recognition (except for those contracts to which an entity applies the premium allocation approach - see 9.8 below)
- ▶ Those contracts that have no significant possibility of becoming onerous subsequently
- ▶ All remaining contracts in the portfolio

This can be illustrated as follows:



An entity is permitted, but not required, to divide the portfolio into more groups based on profitability if its internal reporting provides information of profitability at a more detailed level. See 6.2.1 below.<sup>130</sup>

Groups of contracts are established at initial recognition and are not reassessed.<sup>131</sup>

An entity is prohibited from grouping contracts issued more than one year apart (except in certain circumstances when applying IFRS 17 for the first time, see 17.4 and 17.5 below).<sup>132</sup> This is commonly referred to as the 'annual cohort' requirement. See 6.2.2 below. This means that separate groups for each portfolio are created at least annually.

<sup>128</sup> IFRS 17.14.

<sup>129</sup> IFRS 17.16.

<sup>130</sup> IFRS 17.21.

<sup>131</sup> IFRS 17.24.

<sup>132</sup> IFRS 17.22.



|      | Portfolio A                                    | Portfolio B                                    | ...  |
|------|--|--|--|
|      | Portfolio A                                    | Portfolio B                                    | ...  |
|      | Portfolio A                                    | Portfolio B                                    | ...  |
| 2021 | No significant possibility of becoming onerous | No significant possibility of becoming onerous | No significant possibility of becoming onerous |
| 2022 | Other profitable                               | Other profitable                               | Other profitable                               |
| 2023 | Onerous at inception                           | Onerous at inception                           | Onerous at inception                           |

Entities implementing IFRS 17 raised concerns relating to the level of aggregation requirements. The Board, therefore, considered whether to amend the requirements, and if so, how. Having considered a number of possible amendments, the Board reaffirmed its view that the benefits of the level of aggregation requirements significantly outweigh the costs. The Board decided to retain the requirements unchanged.<sup>133</sup> See 6.2.2 below.

To measure a group of contracts, an entity may estimate the fulfilment cash flows (see section 8) at a higher level of aggregation than the group or portfolio. This assumes the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts.

<sup>133</sup> IFRS 17.B139A and BC139B.

## How we see it

- ▶ The level of aggregation is important because it determines the extent to which expected gains or losses arising from individual contracts may be offset with expected gains and losses of other contracts. It also determines the pattern of profit recognition over time.
- ▶ The definition of portfolio may differ from how this term is defined today. An entity's practice under IFRS 4 for identifying portfolios may not be consistent with the IFRS 17 requirement that contracts with different risks will be in different portfolios. Practices applied under IFRS 4 for recognising losses from onerous contracts were based on wider groupings of contracts than those in IFRS 17. For example, liability adequacy tests were often applied at product or legal entity level. We believe the level of aggregation requirements under IFRS 17 will lead to a more granular grouping and, as such, the requirements under IFRS 17 are likely to result in earlier identification of losses compared to the reporting under IFRS 4.
- ▶ Separating contracts issued more than one year apart is a new concept compared to many existing insurance accounting practices. In addition, to operational challenges, maintaining separate 'cohorts' limit an entity's ability to offset profits and losses (or spread different levels of profitability) arising from different generations of contracts in a portfolio. The application of the aggregation level under IFRS 17 will, therefore, strongly affect requirements for process, systems and data when implementing the new standard.

## 6.1. Identifying portfolios

A portfolio comprises contracts that are subject to similar risks and managed together. Contracts have similar risks if the entity expects their cash flows will respond similarly in amount and timing to changes in key assumptions. Contracts within a product line would be expected to have similar risks and, thus, would be in the same portfolio if they were managed together. Contracts in different product lines (for example, single premium-fixed annuities as opposed to regular-term life insurance) would not be expected to have similar risks and would be in different portfolios.<sup>134</sup>

Deciding which contracts have similar risks is a matter of judgement. Many insurance products provide a basic level of insurance cover with optional add-ons (or riders) at the discretion of the policyholder. For example, a homeowner insurance policy may provide legal cost protection or additional accidental damage cover at the policyholder's discretion in return for additional premiums. The question arises as to the point at which policies of a similar basic type have been tailored to the level at which the risks have become dissimilar. Rider benefits issued and priced separately from the host insurance contract may need to be accounted for as separate contracts because they, in substance, represent new contracts (see 6.1.1 below).

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<sup>134</sup> IFRS 17.14.

For presentation purposes only, insurance contracts are aggregated in the statement of financial position at portfolio level (see 15 below).

### **6.1.1. Separation of insurance components within an insurance contract**

Insurers may combine different types of products or coverages with different risks into one insurance contract. Examples include a contract for both life and disability insurance and one for both pet and home insurance. In some situations, separating a single insurance contract into separate risk components may be required for regulatory reporting purposes. Although IFRS 17 provides guidance on separating non-insurance components within an insurance contract (see 5 above), the standard is silent as to whether an insurance contract can be separated into different insurance components (i.e., allocated to different portfolios for aggregation purposes) and, if so, the basis for such a separation.<sup>135</sup>

#### **Frequently asked questions**

***Question 6-1: Is it permitted to separate different insurance components from the host insurance contract and measure the components separately? [TRG meeting February 2018 - Agenda paper no. 01, Log SO2]***

Some entities may combine, for example, home and motor insurance in a single contract for certain policyholders and also issue these products separately in the market to other policyholders. The standard seems to imply that, in these circumstances, the entity would have three portfolios (home, motor, and home and motor insurance) because the contracts contain three different types of risk. However, IFRS 17 refers to groups of insurance contracts and is silent as to whether an insurance contract may be separated into different “sub-insurance components” voluntarily. The TRG members discussed the analysis of an IASB staff paper and observed that:

- ▶ The lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components
- ▶ Entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered a single contract in substance.

However:

- ▶ There may be circumstances where the legal form of a single contract would not reflect the substance of its contractual rights and obligations
- ▶ Overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful consideration of all relevant facts and circumstances. It is not an accounting policy choice
- ▶ Combining different types of products or coverages that have different risks into one legal insurance contract is not sufficient to conclude that

<sup>135</sup> *Insurance contracts: Responding to the external editorial review*, IASB staff paper 2C, February 2017, Issue A8.

## Frequently asked questions (cont'd)

the legal form of the contract does not reflect the substance of its contractual rights and obligations. Similarly, the availability of information to separate cash flows for different risks is not sufficient to conclude that the contract does not reflect the substance of its contractual rights and obligations

- ▶ The fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

The TRG members also observed that considerations that might be relevant in the assessment of whether the legal form of a single contract reflects the substance of its contractual rights and contractual obligations include:

- ▶ Interdependency between the different risks covered
- ▶ Whether components lapse together
- ▶ Whether components can be priced and sold separately.

The TRG members considered that when more than one type of insurance cover is included in one legal contract solely for the administrative convenience of the policyholder and the price is simply the aggregate of the standalone prices for the different insurance covers provided is an example of when it may be appropriate to override the presumption that a single legal contract is the lowest unit of account.

## How we see it

- ▶ We expect that, in some cases, an insurer that issues combined contracts would choose not to separate them because of the practical difficulties in separating cash flows between components and the loss of the potential for offsetting adverse changes in assumptions on some risks with favourable changes in other risks. However, in other situations, for example, some types of group business and reinsurance contracts, the combination of different coverages into a single contract may be for the purpose of administrative convenience. In these cases, it may be a better reflection of the substance of the arrangement to record premiums and claims and manage for different risks included in one legal contract separately. Separation into sub-insurance components is an important aspect of the application of the level of aggregation under IFRS 17 and requires closer analysis to see whether and to what extent such separation should be applied.
- ▶ Some regulatory frameworks require entities to report some, or all, risks of a combined risk insurance contract separately. If accounted for as a single contract under IFRS 17, then the regulatory separation would give rise to a difference between accounting and regulatory reporting.

## 6.2. Groups of insurance contracts

A group of insurance contracts is the main unit of account for determining measurement. Measurement of insurance contracts occurs at the group level within each portfolio (see 7 below) and each portfolio, to the extent relevant, will consist usually of a minimum of three separate types of groups.

An entity will typically enter into transactions for individual contracts, not groups of contracts. Therefore, IFRS 17 includes requirements that specify how to recognise groups that include contracts issued in more than one reporting period (see 6.2.2 below) and how to derecognise contracts from within a group (see 13.3 below).<sup>136</sup>

The Board concluded that groups should be established on the basis of profitability in order to avoid offsetting of profitable and unprofitable contracts because information about onerous contracts provided useful information about an entity's pricing decisions.<sup>137</sup>

Once groups are established at initial recognition an entity should not reassess the composition of the groups subsequently. Additional contracts should be added to the group after initial recognition of the group following the criteria discussed at 7 below.<sup>138</sup> A group of contracts should comprise a single contract if that is the result of applying the requirements.<sup>139</sup>

An entity need not determine the grouping of each contract individually. If an entity has reasonable and supportable information to conclude that all contracts in a set of contracts will be in the same group, it may perform the classification based on measuring this set of contracts ('top-down'). If the entity does not have such reasonable and supportable information, it must determine the group to which contracts belong by evaluating individual contracts ('bottom-up').<sup>140</sup>

### 6.2.1. Identifying groups based on profitability

To divide a portfolio into the three minimum groups on inception based on an assessment of profitability will require judgement, using quantitative factors, qualitative factors or a combination of such factors. For example, identifying (sets of) contracts that can be grouped together could require some form of expected probability-weighted basis of assessment as insurance contracts are measured on this basis (see 9 below). Alternatively, it may be possible to do this assessment based on the characteristics of the types of policyholders that are more or less prone to make claims than other types of policyholders (e.g., based on age, gender, geographical location or occupation). Therefore, this assessment is likely to represent a significant effort for insurers and is likely to differ from any form of aggregation used previously under IFRS 4, when many entities will not have performed aggregation at a level lower than portfolio.

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<sup>136</sup> IFRS 17.BC139.

<sup>137</sup> IFRS 17.BC119.

<sup>138</sup> IFRS 17.24.

<sup>139</sup> IFRS 17.23.

<sup>140</sup> IFRS 17.17.

For contracts issued to which an entity does not apply the premium allocation approach, an entity should assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:<sup>141</sup>

- ▶ Based on the likelihood of changes in assumptions which, if they occurred, would result in the contract becoming onerous
- ▶ Using information about estimates prepared by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
  - ▶ An entity should not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous
  - ▶ But an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts

The objective of the requirement to identify contracts that are onerous at initial recognition is to identify contracts that are onerous measured as individual contracts. An entity typically issues individual contracts and it is the characteristics of the individual contracts that determine how they should be grouped. However, the Board concluded this does not mean that the contracts must be measured individually. If an entity can determine, using reasonable and supportable information, that a set of contracts will all be in the same group, the entity can measure that set to determine whether the contracts are onerous or not, because there will be no offsetting effects in the measurement of the set. The same principle applies to the identification of contracts that are not onerous at initial recognition and that have no significant possibility of becoming onerous subsequently. The objective is to identify such contracts at an individual contract level, but this objective can be achieved by assessing a set of contracts if the entity can conclude using reasonable and supportable information that the contracts in the set will all be in the same group.<sup>142</sup>

An entity is permitted, but not required, to subdivide the groups into further groups. For example, an entity may choose to divide portfolios into:<sup>143</sup>

- ▶ More groups that are not onerous at initial recognition if the entity's internal reporting provides information that distinguishes:
  - ▶ Different levels of profitabilityOr
  - ▶ Or different possibilities of contracts becoming onerous after initial recognitionAnd
- ▶ More than one group of contracts that are onerous at initial recognition if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.

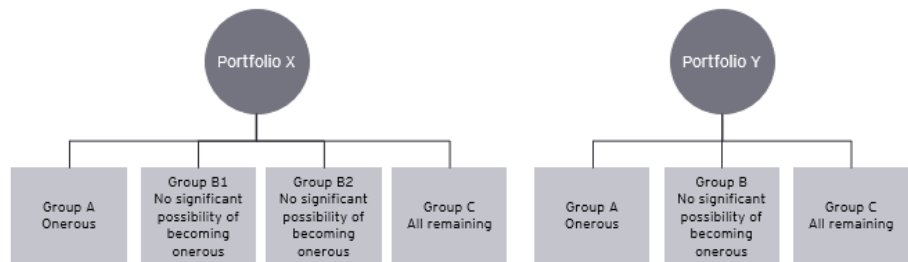
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<sup>141</sup> IFRS 17.19.

<sup>142</sup> IFRS 17.BC129.

<sup>143</sup> IFRS 17.21.

This can be illustrated, as follows:



If contracts within a portfolio fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include these contracts in the same group.<sup>144</sup> This expedient has been provided because the Board concluded that it would not provide useful information to group separately contracts that an entity is required by law or regulation to group together for determining the pricing or level of benefits. In the Board's opinion, all market participants will be constrained in the same way, particularly if such entities are unable to provide insurance coverage solely on the basis of differences in that characteristic.<sup>145</sup>

This expedient should not be applied by analogy to other items.<sup>146</sup> For example, an entity might set the price for contracts without considering differences in a specific characteristic because it believes using that characteristic in pricing may result in a law or regulation prohibiting its use in the future or because doing so is likely to fulfil a public policy objective. These practices, sometimes referred to as 'self-regulatory practices', do not qualify for grouping exception caused by regulatory constraints.<sup>147</sup>

Each group (or sub-group) of insurance contracts is measured separately (whether under the general model discussed at 9 below, the premium allocation approach discussed at 10 below, reinsurance contracts held discussed at 11 below or the variable fee approach discussed at 12.3 below).

### Frequently asked questions

**Question 6-2: How should 'no significant possibility' be interpreted, as set out in paragraph 16(b) of IFRS 17? [TRG meeting May 2018 - Agenda paper no. 07, Log S35]**

The IASB staff observed that the term 'no significant possibility' (of becoming onerous) should be interpreted in the context of the objective of the unit of account requirement. The objective is to identify contracts with no significant possibility of becoming onerous at initial recognition in order to group such contracts separately from contracts that are onerous at initial recognition and any remaining contracts in the portfolio that are not onerous at initial recognition. 'No significant possibility of becoming onerous' is different from 'significant insurance risk' and the concept of significant insurance risk should not be used by analogy.

<sup>144</sup> IFRS 17.20.

<sup>145</sup> IFRS 17.BC132.

<sup>146</sup> IFRS 17.20.

<sup>147</sup> IFRS 17.BC133.

### Illustration 25 – Identifying groups when profitability constrained by law

An insurer is not permitted by law to price car insurance based on gender. Assume that the premium/risk relationship for motor contracts differs materially depending on gender. Without the relief provided by paragraph 20 of IFRS 17, the insurer would be required to split the motor contracts into separate groups based on gender as profitability varies by gender. However, paragraph 20 of IFRS 17 allows the insurer to combine them in one group as the law constrains the entity's ability to set a different price based on gender and, hence, equalise profitability.

### How we see it

- ▶ The issuance of contracts that an entity expects to be onerous will be more visible under IFRS 17 due to the requirement to include the contracts in a separate group and disclose losses arising from onerous contracts issued in the reporting period as well as the movement in the loss component of all such contracts. Insurers may issue contracts that are priced below the amount needed to recover the expected fulfilment costs and acquisition expenses for several reasons, for example:
  - ▶ The entity may place an implicit value on expected profits from policy renewals that are outside the contract boundary (see section 7.1) but, from which, the insurer expects to make an appropriate level of profit in the longer term.
  - ▶ An individual contract may be priced to make an expected loss in the context of other contracts with the same policyholder or related parties, e.g., other family members, such that the insurer expects to make an appropriate level of profit from the package of policies.
  - ▶ An entity may price contracts at a loss based on commercial reasons, such as securing a targeted market position.
  - ▶ Cross-subsidisation between contracts is common in many industries. It is evident from the level of aggregation in IFRS 17 that the IASB wants to limit instances where profits on some insurance contracts offset expected losses on others.<sup>148</sup>
- ▶ Pricing information is important in identifying contracts or sets of contracts that an entity expects to be onerous at initial recognition. This may pose some challenges as, historically, insurers have separated pricing and reserving processes. The identification of contracts expected to be onerous when issued may require system and process changes and greater coordination between front and back office.
- ▶ IFRS 17 is clear that contracts can be grouped together if regulatory restraints on pricing or benefits are the sole reason that those contracts (or sets of contracts) would be in separate groups. Therefore, if an entity applies this expedient and groups underlying contracts together, it should be able to prove that no other factor exists that would have resulted in different groupings.

<sup>148</sup> IFRS 17.BC119.



## 6.2.2. 'Annual cohorts'

An entity is prohibited from grouping contracts *issued* (emphasis added) more than one year apart (except in certain circumstances when grouping insurance contracts on transition using either the modified retrospective approach or the fair value approach - see 17.4 and 17.5 below, respectively). To achieve this, the entity should, if necessary, further divide the groups described at 6.2.1 above.<sup>149</sup>

The prohibition on grouping together contracts that have been issued more than one year apart is one of the more contentious requirements of IFRS 17. It was included because the Board was concerned that, without it, entities could have perpetually open portfolios and this could: lead to a loss of information about the development of profitability over time; result in the contractual service margin persisting beyond the duration of contracts in the group; and consequently, result in profits not being recognised in the correct periods.<sup>150</sup> The Board acknowledges in the Basis for Conclusions that using a one-year issuing period was an operational simplification given for cost-benefit reasons.<sup>151</sup>

The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group (sometimes referred to as 'mutualisation'). Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome. However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio. Therefore, it considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements specify the amounts to be reported, but not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.<sup>152</sup>

There is no requirement in IFRS 17 that an entity must use the same issue period for each group.

In its deliberations on the June 2020 amendments to IFRS 17, the IASB considered, but rejected, a suggestion to amend the annual cohort requirement to base it on the date contracts are 'recognised', instead of the date they are 'issued'. In doing so, the Board confirmed that it intended annual cohorts to be

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<sup>149</sup> IFRS 17.22.

<sup>150</sup> IFRS 17.BC136.

<sup>151</sup> IFRS 17.BC137.

<sup>152</sup> IFRS 17.BC138.

determined based on the date of issue of the contract and not the date of initial recognition. This is because the objective of the annual cohort requirement is to facilitate timely recognition of profits, losses and trends in profitability. The profitability of a contract is initially set when the contract is issued, based on facts and circumstances at that date, for example interest rates, underwriting expectations and pricing. Hence, the Board concluded that determining annual cohorts based on the date that contracts are issued is necessary to provide useful information about trends in profitability.<sup>153</sup>

This means, for example, that a profitable contract issued on 1 January 2022 which has a coverage period beginning 1 January 2022 will be in the same annual cohort (i.e., group) as a profitable contract issued on 1 January 2022 which has a coverage period beginning on 1 January 2025 (assuming both contracts are part of the same portfolio). However, a profitable contract issued on 1 January 2023 (within the same portfolio) with a coverage period beginning 1 January 2023 will be in a different group from the other contracts as it was issued more than one year apart from the issue date of the other two contracts. As a result, if an entity issues profitable contracts for coverage that does not start for several years and premiums are not due until the coverage starts, the date of initial recognition will be several years after the date of issue.

The IASB staff acknowledge that the use of the term 'issued' has consequences for the practical relief available for determining the discount rate at the date of initial recognition of the group, since the weighted average discount rates used only cover the period that the contracts were issued which cannot exceed one year (see 9.3 below). The IASB staff observed that these effects are a consequence of the unit of account being the group of insurance contracts rather than the individual contract, and an entity could choose to further divide the annual cohort and thereby avoid these effects.

To measure a group of contracts, an entity may estimate the fulfilment cash flows (see 9.2 below) at a higher level of aggregation than the group or portfolio, provided that the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts.<sup>154</sup>

#### **6.2.2.A. Contracts with intergenerational sharing of risks**

Some stakeholders have expressed the view that the level of aggregation requirements artificially segregates portfolios and will not properly depict business performance, particularly when applying the annual cohort requirement to insurance contracts with risk sharing between different generations of policyholders. As a result, the IASB reconsidered the IFRS 17 aggregation requirements during its deliberations on the June 2020 amendments to IFRS 17, but decided that the requirements should be unchanged.

In the Board's view, intergenerational sharing of risk between policyholders is reflected in the fulfilment cash flows and therefore, also reflected in the contractual service margin of each generation of mutualised contracts, as

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<sup>153</sup> IFRS 17.BC139T.

<sup>154</sup> IFRS 17.24.

discussed at 12.1 below. However, each generation of contracts may be more or less profitable for an entity than other generations. Even if the policyholders across all annual cohorts share equally in the returns, the amount of the entity's share in those returns created by each generation may differ, reflecting the contractual terms of each annual cohort and the economic conditions during the coverage period of each annual cohort. For example, an entity's share of 20 per cent of the returns of underlying items is a higher amount for annual cohorts for which the coverage period includes periods in which the returns are 5 per cent than it is for annual cohorts for which the coverage period includes only periods in which the fair value returns are 1 per cent. Accordingly, removing the requirement for annual cohorts for those groups of contracts with intergenerational sharing of risks between policyholders would average higher or lower profits across generations, resulting in a loss of information about changes in profitability over time.<sup>155</sup>

The Basis for Conclusions notes that two aspects of applying the annual cohort requirement to some contracts with intergenerational sharing of risks between policyholders that could increase the costs of applying the requirement and reduce the benefits of the resulting information were identified. These are:<sup>156</sup>

- ▶ Distinguishing between the effect of sharing of risks and the effect of discretion
- ▶ Allocating changes in the amount of the entity's share of the fair value of underlying items across annual cohorts that share in the same pool of underlying items

The aspect of the annual cohort requirement in respect of the first bullet point above relates to circumstances in which an entity has discretion over the portion of the fair value returns on underlying items that is paid to policyholders and the portion that is retained by the entity. For example, an entity may be required under the terms of the insurance contracts to pay policyholders a minimum of 90 per cent of the total fair value returns on a specified pool of underlying items with discretion to pay more to policyholders. The Board acknowledged that an entity that has such discretion is required to apply additional judgement to allocate changes in fulfilment cash flows between groups in a way that appropriately reflects the effect of sharing of risks and the effect of the discretion. However, an entity would be required to make that judgement to measure new contracts recognised in the period even if the entity was not required to apply the annual cohort requirement.<sup>157</sup>

The concern set out in the second bullet point above relates to insurance contracts with direct participation features. For those contracts an entity adjusts the contractual service margin for changes in the amount of the entity's share of the fair value of underlying items. IFRS 17 does not include requirements on how to allocate those changes across annual cohorts that share in the same pool of underlying items. The Board observed that an entity needs to exercise judgement to identify an allocation approach that provides useful information about the participation of each annual cohort in the

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<sup>155</sup> IFRS 17.BC139J.

<sup>156</sup> IFRS 17.BC139K.

<sup>157</sup> IFRS 17.BC139L.

underlying items and to avoid allocation approaches that do not provide useful information.<sup>158</sup>

In the Board's view, the information that results from the judgements an entity makes in determining the allocation approaches discussed above will provide useful insights about how management expects businesses to develop and could assist users of financial statements to hold management to account based on those expectations.<sup>159</sup>

The Board also considered that the benefits of the information provided by the annual cohort requirement are particularly high for some specific insurance contracts with intergenerational sharing of risks. Those specific contracts:<sup>160</sup>

- ▶ Include features such as financial guarantees on the returns from underlying items and/or other cash flows that do not vary with returns on underlying items (for example, insurance claims)
- ▶ Do not share the effect of changes in those features between the entity and policyholders or share the effect between the entity and policyholders in a way that does not result in the entity's share being small

The Board observed that information about the effect of financial guarantees is particularly important in low interest rate environments. The Board acknowledged that for some insurance contracts with substantial intergenerational sharing of risks, it is likely to be rare for the effect of financial guarantees and other cash flows that do not vary with returns on underlying items to cause an annual cohort to become onerous. However, it is exactly that rarity that makes the information particularly useful to users of financial statements when such an event occurs and information about the effect of financial guarantees is particularly important when interest rates are low.<sup>161</sup>

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<sup>158</sup> IFRS 17.BC139M.

<sup>159</sup> IFRS 17.BC139N.

<sup>160</sup> IFRS 17.BC139O.

<sup>161</sup> IFRS 17.BC139P.

## How we see it

- ▶ IFRS 17 requires that groups of contracts do not include any that are issued more than one year apart. This could cause practical challenges with tracking the issue date of contracts because the date of issuance is not necessarily the same as the date of initial recognition of a contract. An example would be contracts that are expected to be profitable and which are issued in advance of the beginning of the coverage period and before the date when the first premium is due. This could give rise to practical issues, for example, if a contract is issued in one annual period, but is initially recognised in another.
- ▶ One way to divide the groups is to use an annual period that coincides with an entity's financial reporting period (e.g., contracts issued between 1 January and 31 December comprise a group for an entity with an annual reporting period ending 31 December). However, IFRS 17 does not require any particular approach and entities are also not required to use a twelve-month period when grouping insurance contracts. In addition, an entity that produces interim financial statements is not required to restrict the grouping of contracts issued to those contracts issued in that interim period. See 6 above.
- ▶ The IASB decided not to create any specific exceptions to the annual cohorts for contracts with inter-generational mutualisation (i.e., mutualised contracts). As specific practical issues may arise when applying the annual cohort requirement to these types of products, entities would need to find practical ways to apply the annual cohorts in a suitable manner considering the available guidance and the specific circumstances of their jurisdiction.

### 6.3. Identifying groups for contracts applying the premium allocation approach

For a group of insurance contracts to which the premium allocation approach applies (see 10 below), an entity assesses aggregation of insurance contracts as discussed at 6.2 above except that the entity should assume that no contracts in the portfolio are onerous at initial recognition unless facts and circumstances indicate otherwise.<sup>162</sup>

An entity should assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

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<sup>162</sup> IFRS 17.18.

## 7. Initial recognition

### 7.1. Initial recognition of insurance and reinsurance contracts issued

An entity should recognise a group of insurance contracts it issues from the earliest of the following:<sup>163</sup>

- ▶ The beginning of the coverage period of the group of contracts
- ▶ Date when the first payment from a policyholder in the group is due or when the first payment is received if there is no due date
- ▶ For a group of onerous contracts, when the group becomes onerous, if facts and circumstances indicate that the group is onerous

If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received. An entity is required to determine whether any contracts form a group of onerous contracts before the earlier of the first two dates above (i.e., before the earlier of the beginning of the coverage period and the date when the first payment from a policyholder in the group is due) if facts and circumstances indicate there is such a group.<sup>164</sup>

IFRS 17, as amended in June 2020, states that in recognising a group of insurance contracts in a reporting period, an entity must include only contracts that individually meet one of the above-mentioned recognition criteria.<sup>165</sup> This clarifies that an individual contract has to be recognised initially and measured at a time which is specific to the contract. This means that the date of initial recognition of an individual contract added to a group of insurance contracts has to be determined for that individual insurance contract using the measurement assumptions at that date rather than determined by the date of initial recognition of the group to which individual contracts will be added.

In addition, an entity must make estimates for the discount rates at the date of initial recognition (see 9.3 below) and for the coverage units provided in the reporting period (see 9.7 below).<sup>166</sup>

An entity may include more contracts in the group after the end of a reporting period (subject to the constraint that contracts within a group cannot be issued more than a year apart (See 6.2.2 above). An entity must add contracts to the group in the reporting period in which the contracts meet the recognition criteria set out above, applied to each contract individually.<sup>167</sup>

When new contracts are added to a group, this may result in a change to the determination of the weighted-average discount rates at the date of initial recognition (see 9.3 below). An entity must apply any revised discount rates from the start of the reporting period in which the new contracts are added to the group.<sup>168</sup> There is no retrospective 'catch-up' adjustment for previous

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<sup>163</sup> IFRS 17.25.

<sup>164</sup> IFRS 17.26.

<sup>165</sup> IFRS 17.28.

<sup>166</sup> IFRS 17.28.

<sup>167</sup> IFRS 17.28.

<sup>168</sup> IFRS 17.28.

reporting periods, the effect of any change in average discount rates is therefore recognised prospectively.

For reinsurance contracts held, the group consists of the reinsurance contracts, not the underlying direct contracts which are subject to the reinsurance.

#### **Illustration 26 – Determining the date of recognition of a group of insurance contracts**

##### *Example 1*

An entity issues a group of insurance contracts to policyholders beginning on 25 December 2022. The coverage period of the group begins on 1 January 2023 and the first premium from a policyholder in the group is due on 5 January 2023. The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 1 January 2023 (i.e., the start of the coverage period of the group) which is earlier than the date that the first premium is due.

##### *Example 2*

An entity issues a group of insurance contracts to policyholders beginning on 25 December 2022. The coverage period of the group begins on 1 January 2023 and the first premium from a policyholder in the group is due on 30 December 2022. The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 30 December 2022 (i.e., the date that the first premium is due) which is earlier than the date of the beginning of the coverage period. However, if the entity has a reporting date of 31 December 2022, only those contracts within the group issued as at the reporting date will be recognised in the financial statements for the period ending 31 December 2022.

##### *Example 3*

An entity issues a group of insurance contracts to policyholders beginning on 25 December 2022. On 25 December 2022, the entity determines that the group of insurance contracts is onerous. The coverage period of the group begins on 1 January 2023 and the first premium from a policyholder in the group is due on 5 January 2023.

The group of insurance contracts is recognised on 25 December 2022, which is when the group of insurance contracts is determined to be onerous. However, if the entity has a reporting date of 31 December 2022, only those contracts within the group that are issued as at the reporting date will be recognised in the financial statements for the period ending 31 December 2022.

## How we see it

- ▶ The inception date of a contract is when an entity is bound by the terms of the contract and, as such, has a contractual obligation to accept risk (also known as the issue date of a contract). The inception date is typically before the beginning of coverage and due date for the initial premium. However, IFRS 17 only requires recognition of issued insurance contracts before these dates if facts and circumstances indicate that the contracts in the group are onerous. Allowing entities to recognise insurance contracts they have issued after inception of the contracts represents a practical expedient introduced by the Board to allow entities to continue their existing recognition practices. However, an entity is required to consider whether facts and circumstances indicate that insurance contracts it has issued are onerous at inception or any other time before they would otherwise be recognised.<sup>169</sup>
- ▶ Assessing expected profitability is performed on initial recognition of contracts as they are assigned to a group of contracts. The contracts all then stay within that same group until they are derecognised. This means that it is possible within a group to offset losses on some contracts with gains on others and, therefore, to avoid the recognition of onerous contract losses, as these are determined at group level.

## 7.2. Initial recognition of reinsurance contracts held

IFRS 17 states that for a group of reinsurance contracts held the requirements discussed at 7.1 above do not apply. Instead, a group of reinsurance contracts held is recognised from the earliest of the following:<sup>170</sup>

- ▶ The beginning of the coverage period of the group of reinsurance contracts held; and
- ▶ The date on which the entity recognises an onerous group of underlying insurance contracts (see 7.1 above) if the entity entered into the related reinsurance contract held in the group of reinsurance contracts held at or before that date. (Note that a group of reinsurance contracts itself cannot be onerous, see 11.4 below.)

However, notwithstanding the above requirements, an entity should delay the recognition of a group of reinsurance contracts held that provide proportionate coverage until the date that any underlying insurance contract is initially recognised, if that date is later than the beginning of the coverage period of the group of reinsurance contracts held.<sup>171</sup>

IFRS 17 does not include guidance on when a contract provides proportionate coverage. In the Basis for Conclusions, it is observed that many reinsurance arrangements are designed to cover the claims incurred under underlying insurance contracts written during a specified period. In some cases, the reinsurance contract held covers the losses of separate contracts on a proportionate basis. In other cases, the reinsurance contract held covers

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<sup>169</sup> IFRS 17.BC140-145.

<sup>170</sup> IFRS 17.62.

<sup>171</sup> IFRS 17.62A.



aggregate losses from a group of underlying contracts that exceed a specified amount.<sup>172</sup>

When a reinsurance contract held provides proportionate coverage, the initial recognition of the (group of) reinsurance contract(s) will, as a simplification, be later than the beginning of the coverage period if no underlying contracts have been recognised as at that date.<sup>173</sup>

However, when the group of reinsurance contracts held covers aggregate losses arising from a group of insurance contracts over a specified amount, the group of reinsurance contracts held is recognised when the coverage period of the group of reinsurance contracts begins. In these contracts, the entity benefits from coverage, in case the underlying losses exceed the threshold, from the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period. In the Board's view, the coverage benefits the entity from the beginning of the coverage period of the group of reinsurance contracts held because such losses accumulate throughout the coverage period.<sup>174</sup>

**Illustration 27 – Recognition of reinsurance contract held providing proportionate coverage**

An entity holds a reinsurance contract in respect of a term life insurance portfolio on a quota share basis whereby 20% of all premiums and all claims from the underlying insurance contracts are ceded to the reinsurer. The reinsurance contract is considered to be a group for the purpose of aggregation and incepts on 1 January 2023. The first underlying insurance contract is recognised on 1 February 2023.

As the reinsurance contract held provides proportionate coverage initial recognition of the contract is delayed until the later of the beginning of the coverage period of the contract and the initial recognition of any underlying contract, i.e., 1 February 2023.

**Illustration 28 – Recognition of reinsurance contract held which does not provide proportionate coverage**

An entity holds a reinsurance contract which provides excess of loss protection for a motor insurance portfolio. In exchange for a fixed premium of CU100, the reinsurance contract provides cover for claims arising from individual events in the portfolio in excess of CU500 up to a limit of CU200. The reinsurance contract is considered to be a group for the purpose of aggregation and incepts on 1 January 2023. The first underlying motor insurance contract is recognised on 1 February 2023.

As the reinsurance contract held does not provide proportionate coverage (because neither the premiums nor the claims are a proportion of the premiums and claims from the underlying insurance contracts) the contract is recognised at the beginning of the coverage period of the contract, i.e., 1 January 2023.

<sup>172</sup> IFRS 17.BC304.

<sup>173</sup> IFRS 17.BC305(a).

<sup>174</sup> IFRS 17.BC305(b).

### **Illustration 29 – Recognition of reinsurance contract held when the underlying insurance contracts are onerous**

An entity holds a reinsurance contract in respect of a term life insurance portfolio on a quota share basis, whereby 20% of all premiums and all claims from the underlying insurance contracts are ceded to the reinsurer. The reinsurance contract is considered to be a group for the purpose of aggregation. The reinsurance contract was entered into on 1 December 2022 and incept on 1 January 2023. The first underlying insurance contract were entered into on 1 December 2022 and incept on 1 January 2023. On 15 December 2022, the group of underlying insurance contracts are determined to be onerous.

As the group of underlying insurance contracts are onerous and the reinsurance held was entered into at the same time as the underlying insurance contracts, the date of initial recognition of the reinsurance contract held is 15 December 2022.

### **How we see it**

- ▶ The recognition requirements for reinsurance contracts held that provide proportionate coverage are meant to simplify recognition and measurement for these contracts. Circumstances in which the first underlying ceded contract is issued shortly after the reinsurance contracts are written will result in similar timing of recognition for proportionate and “other-than-proportionate” reinsurance contracts. In other cases, there may be a greater difference in the timing of recognition.
- ▶ As mentioned above, IFRS 17 does not include guidance on when a contract provides proportionate coverage. Entities would, therefore, need to consider how it will determine whether a contract provides proportionate coverage or not. The guidance as per the Basis for Conclusions, paragraph BC304 referenced above, could provide a useful input to this consideration.

## **7.3. Initial recognition of insurance acquisition cash flows**

Insurance acquisition cash flows are cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.<sup>175</sup>

An entity must recognise an asset for insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised under another IFRS standard) before the related group of insurance contracts is recognised, unless it elects to expense those acquisition cash flows as incurred for premium allocation approach contracts (see 10 below). The entity should

<sup>175</sup> IFRS 17 Appendix A.

recognise such an asset for each related group of insurance contracts.<sup>176</sup> The entity needs to allocate insurance acquisition cash flows to an existing or future group of insurance contracts using a systematic and rational method.<sup>177</sup>

If an entity recognises in a reporting period only some of the insurance contracts expected to be included in the group (see 6.2 above), it should determine the related portion of an asset for insurance acquisition cash flows for the group on a systematic and rational basis considering the expected timing of recognition of contracts in the group.<sup>178</sup>

Any insurance acquisition cash flows paid at the date of initial recognition of the group of insurance contracts are recognised as part of the contractual service margin of the group of insurance contracts (see 9.5 below).

Any insurance acquisition cash flows an entity expects to pay after the related group of insurance contracts is recognised are part of the fulfilment cash flows of the group of insurance contracts (see 9.2 below).

The systematic and rational method of allocating insurance acquisition cash flows to groups referred to above shall be used to allocate:<sup>179</sup>

- ▶ Insurance acquisition cash flows that are directly attributable to a group of insurance contracts:
  - ▶ To that group; and
  - ▶ To groups that will include insurance contracts that are expected to arise from renewals of the insurance contracts in that group
- ▶ Insurance acquisition cash flows directly attributable to a portfolio of insurance contracts that are not directly attributable to individual contracts or groups of contracts to groups in the portfolio.

The last bullet point above means that insurance acquisition cash flows directly attributable to a portfolio of insurance contracts, but not directly attributable to a group of insurance contracts are systematically and rationally allocated to existing or future groups of insurance contracts in the portfolio.<sup>180</sup>

The Basis for Conclusions notes that, prior to the June 2020 amendments, IFRS 17 did not allow insurance acquisition cash flows to be allocated to expected contract renewals. However, in some situations, an entity issues an insurance contract with a short coverage period, such as one year, but might incur high up-front costs, such as commissions to sales agents, relative to the premium the entity will charge for that contract. The entity agrees to those costs because it anticipates that some policyholders will renew their contracts. Often, the costs are fully directly attributable to the initial insurance contract issued because they are non-refundable and are not contingent on the policyholder renewing the contracts. In some circumstances, such commissions are higher than the premium charged and the application of IFRS 17, as issued in May 2017, would have resulted in the contract being identified as onerous. The Board considered that recognising a loss in those circumstances would

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<sup>176</sup> IFRS 17.28B.

<sup>177</sup> IFRS 17.28A.

<sup>178</sup> IFRS 17.28D.

<sup>179</sup> IFRS 17.B35A.

<sup>180</sup> IFRS 17.BC184B.

provide useful information to policyholders as it reflects that the entity does not have the right to charge policyholders to renew the contracts or to reclaim the commission from the sales agents if policyholders choose not to renew their contracts.<sup>181</sup>

However, the Board was persuaded that an amendment to IFRS 17 requiring an entity to allocate insurance acquisition cash flows to expected renewals of contracts would also provide useful information to users of financial statements about insurance acquisition cash flows. This approach depicts the payment of up-front costs such as commission as an asset that an entity expects to recover through expected renewals of contracts. The asset reflects the right of an entity to not pay again costs it has already paid to obtain renewals. The Board noted that the information resulting from the amendment is comparable to the information provided by IFRS 15 for the incremental costs of obtaining a contract.<sup>182</sup>

The Board considered whether it should develop requirements to specify how to allocate insurance acquisition cash flows to expected renewals of contracts. However, it concluded that requiring allocation applying a systematic and rational method, consistent with the requirements for allocating fixed and variable overheads (see 9.2.3.L below), was sufficient.<sup>183</sup>

An entity might add insurance contracts to a group of insurance contracts across more than one reporting period. In such circumstances, the entity must derecognise the portion of an asset for insurance acquisition cash flows that relates to insurance contracts added to the group in that period and continue to recognise an asset for insurance acquisition cash flows to the extent that the asset relates to insurance contracts expected to be added to the group in a future reporting period.<sup>184</sup>

Impairment and derecognition of insurance acquisition cash flow assets is discussed at 9.10 and 13.4 below, respectively.

## **7.4. Initial recognition of investment contracts with discretionary participation features**

The date of initial recognition of an investment contract with discretionary participation features (see 12.3 below) is the date that the entity becomes party to the contract. This is consistent with the requirements for recognition of a financial instrument in IFRS 9 and is likely to be earlier than the date of initial recognition for an insurance contract.<sup>185</sup>

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<sup>181</sup> IFRS 17.BC184B.

<sup>182</sup> IFRS 17.BC184E.

<sup>183</sup> IFRS 17.BC184F.

<sup>184</sup> IFRS 17.B35C.

<sup>185</sup> IFRS 17.71.

## 8. Measurement – overview

IFRS 17 has a default approach to measuring groups of insurance contracts (which is the unit of account for measurement as discussed at 6.2 above) described in this publication as the ‘general model’. The general model does not distinguish between so-called short duration and long duration (or life and non-life) insurance contracts. It also does not distinguish between insurance products.

IFRS 17 also includes modifications and a simplification to the general model that are applicable in specific circumstances (see section 8.2).

The basic revenue recognition principle under IFRS 17 is that no profit is recognised on initial recognition of a group of insurance contracts, but that a loss must be recognised if the group of contracts is onerous (see 6 above for the timing of initial recognition). Subsequently, profit and revenue are recognised as services are performed under the contract.

### 8.1. Overview of the general model

The general model measures a group of insurance contracts as the sum of the following components, or ‘building blocks’, for each group of insurance contracts:<sup>186</sup>

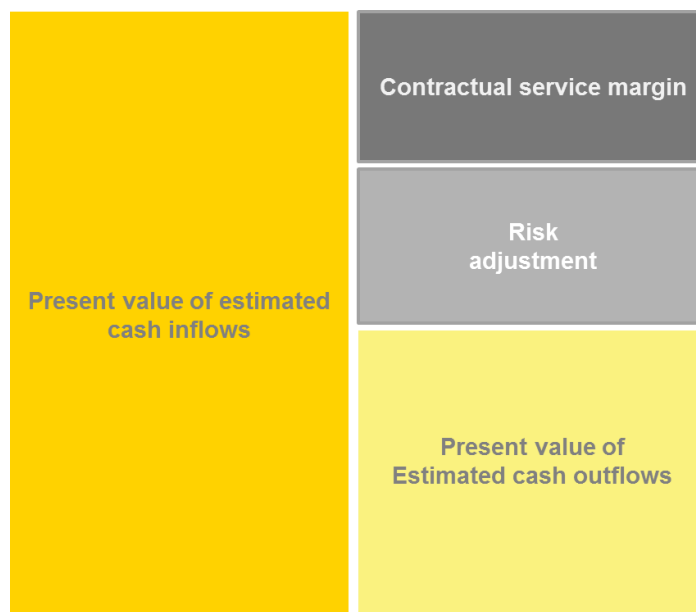
- ▶ Fulfilment cash flows, which comprise:
  - ▶ Estimates of expected future cash flows over the life of the contract (see section 9.2)
  - ▶ An adjustment to reflect the time value of money and the financial risks related to the future cash flows to the extent that the financial risks are not included in the estimates of the future cash flows (see section 9.3)
  - ▶ A risk adjustment for non-financial risk (see section 9.4)
- ▶ A contractual service margin representing unearned profit an entity will recognise as it provides service under the insurance contracts in the group (see section 9.5)

This is illustrated in the diagram below.

The building blocks are the cornerstone of the IFRS 17 measurement model. Specific modifications or simplification are applied to certain types of contract based on their characteristics.

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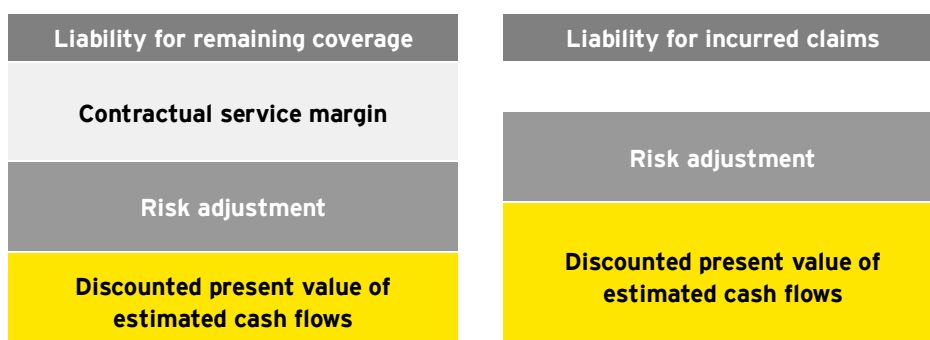
<sup>186</sup> IFRS 17.32.



After initial recognition of a group of insurance contracts, the carrying amount of the group at each reporting date is the sum of:

- ▶ The liability for remaining coverage, comprising:
  - ▶ The fulfilment cash flows related to future service allocated to the group at that date
  - ▶ The contractual service margin of the group at that date
- ▶ The liability for incurred claims comprising the fulfilment cash flows related to past service allocated to the group at that date

The components of the liability for remaining coverage and the liability for incurred claims are, as follows:



The general model is discussed further at 9 below.

## 8.2. Modification to the general model

An entity should apply the general model to all groups of insurance contracts except as follows: [IFRS 17.29]

- ▶ A simplified or premium allocation approach may be applied for groups of insurance contracts meeting either of the specified criteria for that approach (see 10 below)

- ▶ For groups of reinsurance contracts held, an entity should apply either the general model or the premium allocation approach as modified by separate measurement requirements (see 11 below)
- ▶ An adaptation of the general model, the 'variable fee approach' is applied to insurance contracts with direct participation features (see 12. below)
- ▶ For groups of investment contracts with discretionary participation features, an entity applies the general model (as modified) because of the lack of insurance risk in the contracts (see 12.4 below)

### 8.3. Insurance contracts in a foreign currency

IFRS 17 states that when applying IAS 21 - *The Effects of Changes in Foreign Exchange Rates* to a group of insurance contracts that generate cash flows in a foreign currency, an entity should treat the group of contracts, including the contractual service margin, as a monetary item.<sup>187</sup>

The Basis for Conclusions observes that the contractual service margin (see 9.5 below) might otherwise be classified as non-monetary, because it is similar to a prepayment for goods and services. However, in the Board's view, it was simpler to treat all components of the measurement of an insurance contract in the same way and, since the measurement in IFRS 17 is largely based on cash flow estimates, the Board concluded that it was more appropriate to view the insurance contract as a whole as a monetary item.<sup>188</sup> The Board's conclusion that the insurance contract is a monetary item does not change if an entity measures a group of insurance contracts using the simplified approach (i.e., the premium allocation approach) for the measurement of the liability for the remaining coverage.<sup>189</sup>

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<sup>187</sup> IFRS 17.30.

<sup>188</sup> IFRS 17.BC277.

<sup>189</sup> IFRS 17.BC278.

## How we see it

- ▶ Treating insurance contracts as monetary items means that groups of insurance contracts in a foreign currency are retranslated to the entity's functional currency using the exchange rate applying at each reporting date. Exchange differences arising on retranslation are accounted for in profit or loss. IFRS 4 contained no similar assertion and, therefore, many insurers, following the guidance on monetary and non-monetary items in IAS 21, treated unearned premium provisions (i.e., deferred revenue) and deferred acquisition costs in a foreign currency as non-monetary items and did not retranslate these balances subsequent to initial recognition.
- ▶ IFRS 17 requirements apply to groups of insurance contracts. These groups may contain cash flows in more than one currency. Neither IAS 21 nor IFRS 17 provides explicit guidance on how to apply IAS 21 to a group of insurance contracts that are impacted by cash flows of multiple currencies. This is particularly relevant to the calculation of the contractual service margin of the group of multi-currency contracts. In accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors in the absence of an IFRS that specifically applies to an event or condition, management must use judgement in developing and applying an accounting policy that results in information that is relevant and reliable. There may be several approaches to deal with 'multi-currency' groups under the general model, for example:
  - ▶ Determine the predominant currency of a group and measure the contractual service margin using that predominant currency
  - ▶ Measure the contractual service margin with all fulfilment cash flows expressed in the functional currency (i.e., measure the contractual service margin using an entity's functional currency)
  - ▶ Sub-divide the cash flows of the group of contracts by underlying currencies and measure the contractual service margin of the group using this sub-division.
- ▶ However, an entity should determine its policy with care and consider the overall requirements of both IAS 21 and IFRS 17, including the fact that the unit of account of the IFRS 17 measurement is the group of insurance contracts.
- ▶ In conjunction with the previous matter, an entity may also need to establish a policy on how it regards the effects of changes in foreign exchange rates in the financial statements. For example, to classify them as an 'exchange difference' under IAS 21 or a change in financial risk under IFRS 17. In the context of multi-currency' groups, neither IAS 21 nor IFRS 17 provide a dividing line of how the effect of a change in exchange rate should be classified. For insurance contracts without direct participation features, the classification will impact how the total differences will be disaggregated in the statement of comprehensive income between profit or loss and other comprehensive income. As neither IAS 21 nor IFRS 17 specify where exchange differences on insurance contract liabilities should be presented in the statement of financial performance, entities should apply judgement to determine the appropriate line item(s) in which exchange differences are recorded. Entities should use judgement to develop and apply an accounting policy and do so consistently. However, foreign currency risk is considered to be



financial risk by IFRS 17 and so presenting exchange differences in insurance service expenses would not be appropriate.

- ▶ For an insurance contract with direct participation features, additional considerations may be necessary as, applying IFRS 17, the contractual service margin will also be adjusted for changes in financial risks, which include changes in foreign currency rates. Also, the fair value returns from the underlying items may be subject to foreign exchange differences.

## 9. Measurement - General Model

As explained at 8.1 above, the general model is based on the following building blocks for each group of insurance contracts:<sup>190</sup>

- ▶ Fulfilment cash flows, which comprise (see 9.2 below):
  - ▶ Estimates of expected future cash flows over the life of the contract (see 9.2 below)
  - ▶ An adjustment to reflect the time value of money and the financial risks related to the future cash flows to the extent that the financial risks are not included in the estimates of the future cash flows (see 9.3 below)
  - ▶ A risk adjustment for non-financial risk (see 9.4 below)
- ▶ A contractual service margin, representing the unearned profit on the group of contracts (see 9.5 below)

The contractual service margin is released to profit or loss over the period that services are provided to the policyholder. Therefore, at initial recognition, no profit should normally be recognised. However, a loss is recognised if the group of contracts is onerous at the date that the group is determined to be onerous (see 6 above). Measurement of onerous contracts is discussed at 9.8 below. The contractual service margin for insurance contracts with direct participation features is adjusted over the service period in a different way from the contractual service margin for insurance contracts without direct participation features. Contracts with direct participation features are discussed at 12.3 below. Once the contractual service margin is utilised, the group of insurance contracts will be measured using only the fulfilment cash flows.

### 9.1. The contract boundary

This section deals with the general requirements of IFRS 17 to establish the contract boundary. Contract boundary issues specifically related to reinsurance contracts issued are discussed at 8.9.1 below. Contract boundary issues related to reinsurance contracts held are discussed at 10.2 below.

The measurement of a group of insurance contracts includes all the cash flows expected to result from the contracts in the group, reflecting estimates of policyholder behaviour. Thus, to identify the future cash flows that will arise as the entity fulfils its obligations, it is necessary to determine the contract boundary that distinguishes whether future premiums, and the resulting benefits and claims, arise from:<sup>191</sup>

- ▶ Existing insurance contracts. If so, those future premiums, and the resulting benefits and claims, are included in the measurement of the group of insurance contracts

Or

Identifying the contract boundary under IFRS 17 is fundamental to the measurement of the fulfilment cash flows of a group of contracts.

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<sup>190</sup> IFRS 17.32.

<sup>191</sup> IFRS 17.BC159.

- ▶ Future insurance contracts. If so, those future premiums, and the resulting benefits and claims, are not included in the measurement of the group of existing insurance contracts

As such, a liability or asset relating to expected premiums or expected claims outside the boundary of the existing insurance contract should not be recognised. Such amounts relate to future insurance contracts.<sup>192</sup> However, an asset should be recognised for acquisition cash flows paid before the related group of insurance contracts is recognised (see 7.3 above and 9.1.3 below).

Estimates of cash flows in a scenario should include all cash flows within the boundary of an existing contract and no other cash flows. In determining the boundary of a contract, an entity should consider its substantive rights and obligations and whether they arise from a contract, law or regulation (see 3.1 above).<sup>193</sup>

The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundary of the contract is generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. Thus:<sup>194</sup>

- ▶ The outer limit of the existing contract is the point at which the entity is no longer required to provide coverage and the policyholder has no right of renewal. Beyond that outer limit, neither party is bound.
- ▶ The entity is no longer bound by the existing contract at the point at which the contract confers on the entity the practical ability to reassess the risk presented by a policyholder and, as a result, the right to set a price that fully reflects that risk.

However, if an entity has the practical ability to reassess the risk presented by a policyholder, but does not have the right to set a price that fully reflects the reassessed risk, the contract still binds the entity. Thus, that point would lie within the boundary of the existing contract, unless the restriction on the entity's ability to reprice the contract is so minimal that it is expected to have no commercial substance (i.e., the restriction has no discernible effect on the economics of the transaction). In the Board's view, a restriction with no commercial substance does not bind the entity.<sup>195</sup>

It may be more difficult to decide the contract boundary if the contract binds one party more tightly than the other. Examples of circumstances in which it is more difficult include:<sup>196</sup>

- ▶ An entity may price a contract so that the premiums charged in early periods subsidise the premiums charged in later periods, even if the contract states that each premium relates to an equivalent period of coverage. This would be the case if the contract charges level premiums and the risks covered by the contract increase with time. The Board concluded that the premiums charged in later periods would be within the boundary of the contract because, after the first period of coverage,

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<sup>192</sup> IFRS 17.35.

<sup>193</sup> IFRS 17.B61.

<sup>194</sup> IFRS 17.BC160.

<sup>195</sup> IFRS 17.BC161.

<sup>196</sup> IFRS 17.BC162.

the policyholder has obtained something of value, namely the ability to continue coverage at a level price despite increasing risk.

- ▶ An insurance contract might bind the entity, but not the policyholder, by requiring the entity to continue to accept premiums and provide coverage (without the ability to reprice the contract) but permitting the policyholder to stop paying premiums, although possibly incurring a penalty. In the Board's view, the premiums the entity is required to accept and the resulting coverage it is required to provide fall within the boundary of the contract. When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it should assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.<sup>197</sup>
- ▶ An insurance contract may permit an entity to reprice the contract on the basis of general market experience (for example, mortality experience), without permitting the entity to reassess the individual policyholder's risk profile (for example, the policyholder's health). In this case, the insurance contract binds the entity by requiring it to provide the policyholder with something of value - continuing insurance coverage without the need to undergo underwriting again. Although the terms of the contract are such that the policyholder has a benefit in renewing the contract, and, thus, the entity expects that renewals will occur, the contract does not require the policyholder to renew the contract. Therefore, the repriced cash flows are outside the contract boundary provided both criteria for repricing at a portfolio level mentioned above are met.

As a result of the above context, IFRS 17 specifies that cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services. A substantive obligation to provide insurance contract services ends when:<sup>198</sup>

- ▶ The entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks

Or

- ▶ Both of the following criteria are satisfied:
  - ▶ The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as such, can set a price or level of benefits that fully reflects the risk of that portfolio
  - ▶ The pricing of the premiums up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date

The assessment of the contract boundary is made in each reporting period. This is because an entity updates the measurement of the group of insurance contracts to which the individual contract belongs and, hence, the portfolio of

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<sup>197</sup> IFRS 17.B63.

<sup>198</sup> IFRS 17.34.

contracts in each reporting period. For example, in one reporting period an entity may decide that a renewal premium for a portfolio of contracts is outside the contract boundary because the restriction on the entity's ability to reprice the contract has no commercial substance. However, if circumstances change so that the same restrictions on the entity's ability to reprice the portfolio take on commercial substance, the entity may conclude that future renewal premiums for that portfolio of contracts are within the boundary of the contract.<sup>199</sup>

### Frequently asked questions

***Question 9-1: How to interpret the term "contract boundary" described in paragraph 34 of IFRS 17 in the context of contracts with annual repricing mechanisms. [TRG meeting April 2019 - Agenda paper no. 02, Log S22]***

The submission describes specified fact patterns of two insurance contracts. In these fact patterns, risk is assessed at a portfolio of insurance contracts level rather than an individual contract level, and therefore paragraph 34(a) of IFRS 17 is not applicable. The contract boundary is instead determined based on the assessment of risk applying paragraph 34(b) of IFRS 17.

TRG members discussed the analysis in the staff paper and noted that:

Paragraph 34(a) of IFRS 17 refers to the practical ability to reassess the risks of the policyholder (i.e., policyholder risk). Paragraph 34(b) of IFRS 17 should be read as an extension of the risk assessment in paragraph 34(a) from the individual to portfolio level, without extending policyholder risks to all types of risks and considerations applied by an entity when pricing a contract. The staff noted that policyholder risk includes both the insurance risk and the financial risk transferred from the policyholder to the entity and, therefore, excludes lapse risk and expense risk.

- ▶ For the specified fact patterns of the two contracts described in the submission, the conclusion in the paper is that an entity can reset annually the premiums of the portfolios to which both of the example contracts belong to reflect the reassessed risk of those portfolios. The entity has the practical ability to reassess the risks of the specific portfolio of insurance contracts that contains the contract and, as a result, can set a price that fully reflects the risk of that portfolio and meets the requirements of paragraph 34(b)(i) of IFRS 17. In the fact pattern presented, premiums increase in line with age each year based on a step-rated table, i.e., the contract does not charge level premiums. Consequently, the staff analysis assumes that the requirements in paragraph 34(b)(ii) of IFRS 17 are also met. Accordingly, for those two contracts, the cash flows resulting from the renewal terms should not be included within the boundary of the existing insurance contract.
- ▶ If, conversely, the fact patterns of the two contracts described in the submission was varied such that the entity instead has a practical ability to reassess risks only at a general level (e.g., for a general community) and, as a result, can set a price for the portfolio of insurance contracts that contains the contract (e.g., using a generic

<sup>199</sup> IFRS 17.BC164.

## Frequently asked questions (cont'd)

step-rate table), then this would provide the individual policyholders within the portfolios with a substantive right and consequently, the cash flows resulting from these renewal terms should be included within the boundary of the existing contract.

- ▶ It was observed that, in practice, some entities use a step-rated premium table for pricing that averages out the pricing between the different levels on the table (i.e., between the different steps). All relevant facts and circumstances would need to be considered in assessing whether the requirements in paragraph 34(b)(ii) of IFRS 17 are met.
- ▶ TRG members also observed that the two examples described are for specific fact patterns. In practice, the features of contracts and their repricing might be different from those examples. The facts and circumstance of each contract should be assessed to reach an appropriate conclusion applying the requirements of IFRS 17.

***Question 9-2: Whether the reference to a 'portfolio of insurance contracts' in paragraph 34(b) of IFRS 17 is a 'portfolio of insurance contracts' as defined in Appendix A of IFRS 17. [TRG meeting April 2019 - Agenda paper no. 02, Log S86]***

The submission asked whether the reference to a 'portfolio of insurance contracts' in paragraph 34(b) of IFRS 17 is a 'portfolio of insurance contracts' as defined in Appendix A of IFRS 17. The submission noted the discussion of Agenda Paper 2 at the February 2018 TRG meeting and stated that some stakeholders think that a 'portfolio of insurance contracts' should be interpreted at a more granular level than is defined in Appendix A of IFRS 17 for the purpose of applying paragraph 34(b) of IFRS 17 (for example, at a group of insurance contracts level). The TRG agreed with the Staff's analysis that a 'portfolio of insurance contracts' is a defined term in Appendix A of IFRS 17. There is no difference between the use of that defined term in paragraph 14 of IFRS 17 and paragraph 34 of IFRS 17.

***Question 9-3: What is the interrelation between the requirements in paragraph 35 of IFRS 17 (cash flows that are outside the boundary of an insurance contract) and the requirements in paragraph B64 of IFRS 17 (reassessment of the boundary of an insurance contract at each reporting date)? [TRG meeting September 2018 - Agenda paper no. 05, Log S66]***

The submission considered how to account for cash flows of an insurance contract issued that, at initial recognition, are outside the boundary of the contract when facts or circumstances change over time. In particular, the staff paper considered the interaction between the statement in paragraph 35 of IFRS 17 that cash flows outside the boundary of a contract at initial recognition are cash flows of a new contract and the final sentence of paragraph B64 which permits an entity to re-assess the boundary of an insurance contract to include the effect of changes in circumstances. The IASB staff observed that:

- ▶ The requirements in the two paragraphs are different because they address two different circumstances
- ▶ When paragraph 35 of IFRS 17 applies, additional cash flows will be recognised as a new contract when the recognition criteria of a new group of contracts are met

## Frequently asked questions (cont'd)

- ▶ Paragraph B64 of IFRS 17 discusses the assessment of the practical ability of an entity to reprice a contract considering constraints that might limit that ability and, therefore, applies to the reassessment of the contract boundary in this context. For example, a contract boundary reassessment may occur when, in one reporting period, repricing restrictions that have no commercial substance but in the next reporting period, facts and circumstances come to light that would have led to a different conclusion at inception (if known then). When paragraph B64 applies, the fulfilment cash flows are updated to reflect changes in cash flows that are within the (revised) contract boundary. When such changes relate to future service, they are recognised by adjusting the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.

The TRG members agreed with the IASB staff observations, but noted the apparent conflict between the two paragraphs which stems from a lack of clarity of the meaning of paragraph B64. IASB staff observed that the meaning of the last sentence in paragraph B64 should be considered in the context of the preceding sentences in paragraph B64, paragraphs B61-B63 and the Basis for Conclusions. The TRG members also expressed different views as to the applicability of the distinction between paragraphs 35 and B64 of IFRS 17 in circumstances where cash flows that are outside the contract boundary at initial recognition relate to an additional type of coverage that may be provided over the coverage period of the contract.

***Question 9-4: Are cash flows related to free additional coverage within the boundary of the insurance contracts purchased by policyholders? [TRG meeting September 2018 - Agenda paper no. 11, Log S62]***

The IASB staff discussed a question submitted to the TRG regarding a type of entity in which parties become members by purchasing an insurance contract. Members of the entity are also provided with free additional insurance coverage. The entity can cancel the free additional insurance coverage at any time and the question arises as to whether cash flows related to the free additional coverage are within the boundary of the insurance contracts purchased by policyholders. The IASB staff concluded that the right of an entity to cancel coverage at any time means that the entity does not have a substantive obligation to provide future service related to the free additional insurance coverage. The expected cash flows related to future free additional insurance coverage are, therefore, not included in the boundary of the insurance contract and are not included in the liability for remaining coverage. If the entity has a substantive obligation for the free additional insurance coverage that has already been provided, such as unpaid claims, the cash flows related to that coverage are within the boundary of the contract and are included in the liability for incurred claims.

***Question 9-5: Are cash flows within the boundary of a group insurance contract, if those cash flows relate to periods after the entity can cancel the group insurance policy? [TRG meeting September 2018 - Agenda paper no. 08, Log S61]***

The TRG members considered an IASB staff paper which discussed a submission about the boundary of a contract for an agreement between an entity and an association or bank (referred to as a group insurance policy),

## Frequently asked questions (cont'd)

under which the entity provides insurance coverage to members of an association or to customers of a bank (referred to as 'certificate holders').

In the case of group association policies, the insurance entity has a policy with an association or bank to sell insurance coverage to individual members or customers. Although the legal contract is between the entity and the association or bank, the insurance coverage for each certificate holder is priced as if it were an individual contract. In the case of group creditor policies with a bank, the entity can sell insurance coverage to individual customers of the bank. These policies have the same facts and circumstances as the group association policy, other than insurance cover being linked to the remaining outstanding balance of the loan or mortgage issued by the bank to the certificate holder. The entity pays the remaining outstanding loan balance to the bank when an insured event occurs (rather than the certificate holder or their beneficiaries who are liable for paying the outstanding balances). In the fact pattern submitted, the entity can terminate the policy with a 90-day notice period. In such arrangements, the question arises as to whether the cash flows related to periods after the notice period of 90 days are within the boundary of an insurance contract and is the policyholder the bank or association or is it the individual certificate holders.

The TRG members agreed with the analysis and conclusion of the staff paper including the steps that an entity should perform in its analysis and observed that:

- ▶ For group insurance policies an entity should consider whether the policyholder is the association or bank, or the certificate holders. This is the case regardless of whether that compensation is received directly or indirectly by paying amounts on the policyholder's behalf
- ▶ For group insurance policies, an entity should consider whether the arrangement reflects a single insurance contract or multiple insurance contracts (i.e., with each certificate holder). Rebutting the presumption that the contract is a single contract by separating components requires judgement and careful consideration of all facts and circumstances (see 5.1.1 above)
- ▶ For the group insurance policies described in the submission, the following facts and circumstances are indicative that the arrangement reflects multiple insurance contracts (i.e., an insurance contract with each certificate holder) for the purpose of applying IFRS 17:
  - ▶ The insurance coverage is priced and sold separately
  - ▶ Other than being members of the association or customers of the bank the individuals are not related to one another
  - ▶ Purchase of the insurance coverage is an option for each individual



### Frequently asked questions (cont'd)

- ▶ An entity should assess the boundary of each insurance contract. For the group insurance policies described in the submission, the entity's substantive obligation to provide services under the contract ends at the point the entity can terminate the contract. This means that, in these examples, the substantive obligation ends after 90 days and cash flows within the boundary are those related to the obligation to provide services over the 90-day period. The certificate holder's expectation that the group insurance policy will not be terminated earlier than the contract term is not relevant to the assessment of the contract boundary.

The TRG members also observed that, in practice, there are many group insurance contracts with different terms and the assessment of whether a group insurance policy arrangement reflects a single insurance contract or multiple insurance contracts should be applied to group insurance policies considering all relevant facts and circumstances.

### Illustration 30 – Contract boundary of a stepped premium life insurance contract

An entity issues a group of annual insurance contracts which provide cover for death, and total and permanent disablement. The cover is guaranteed renewable every year (i.e., the entity must accept renewal) for twenty years regardless as to changes in health of the insured. However, the premiums increase annually with the age of the policyholder and the insurer may increase premium rates annually provided that the increase is applied to the entire portfolio of contracts (premium rates for an individual policyholder cannot be increased after the policy is underwritten).

#### *Analysis*

The contract boundary is one year.

The guaranteed renewable basis means that the entity has a substantive obligation to provide the policyholder with services. However, the substantive obligation ends at the end of each year. This is because the entity has the practical ability to reassess the risks of the portfolio that contains the contract. Therefore, the entity can set a price that reflects the risk of that portfolio and the pricing of the premiums for coverage up to the date when the risks are reassessed do not take into account the risks that relate to premiums after the reassessment date (as premiums are adjusted annually for age). Therefore, both criteria mentioned above are satisfied.

### **Illustration 31 – Contract boundary of a level premium life insurance contract**

An entity issues a group of insurance contracts which provide cover for death, and total and permanent disablement. The cover is guaranteed renewable (i.e., the entity must accept renewal) for twenty years regardless as to changes in health of the insured. The premium rates are level for the life of the policy irrespective of policyholder age. Therefore, the insurer will generally 'overcharge' younger policyholders and 'undercharge' older policyholders. In addition, the insurer may increase premium rates annually provided that the increase is applied to the entire portfolio of contracts (premium rates for an individual policyholder cannot be increased after the policy is underwritten).

#### *Analysis*

The contract boundary is twenty years.

The guaranteed renewable basis means that the entity has a substantive obligation to provide the policyholder with services. The substantive obligation does not end until the period of the guaranteed renewable basis expires. Although the entity has the practical ability to reassess the risks of the portfolio that contains the contract and, therefore, can set a price that reflects the risk of that portfolio, the pricing of the premiums does take into account the risks that relate to premiums after the reassessment date. The entity charges premiums in the early years to recover the expected cost of death claims in later years. Therefore, the second criterion in (b)(ii) above for drawing a shortened contract boundary when an entity can reassess the premiums or benefits for a portfolio of insurance contracts is not satisfied.

### **How we see it**

- ▶ In determining the contract boundary, an entity should consider the longer of the following two periods:
  - ▶ The period it can compel the policyholder to pay premiums
  - ▶ The period after which it has the practical ability to reassess the risks (individual and portfolio level)
- ▶ The outer limit of the contract boundary will often be the point in time when the entity has the practical ability to reassess the risks as contract terms that would result in the entity being able to compel the policyholder to pay premiums over a longer period are not expected to be common in practice.
- ▶ Establishing the boundary of a contract is crucial as it determines the cash flows that will be included in its measurement. Drawing a contract boundary at the point where the entity has the practical ability to reprice (or amend the benefits under the contract) to fully reflect the risks of the policyholder may not reflect the entity's expectations about future cash flows from renewals. This could result in contracts being reported as onerous even when an insurer expects to recover all costs from future renewals.
- ▶ An entity's ability to reprice an individual insurance contract (and a policyholder's option not to renew the contract) creates a contract boundary. This means that, if premiums are received from the

policyholder after the contract boundary date (i.e., the contract continues beyond the boundary period) this will be treated as the recognition of a new contract – even if the rights and obligations of the entity and the policyholder are included within the single original policy document. The result would be that payments and related future cash flows will be recognised as new separate contracts. This is likely to result in a change from how entities deal with future premiums under current practices.

### 9.1.1. Options to add insurance coverage

As discussed in Section 3 above (see Section 3.6), for some contracts, the transfer of insurance risk to the issuer occurs after a period of time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates the entity charges other new annuitants at the time the policyholder exercises that option. Such a contract transfers insurance risk to the issuer only after the option is exercised, because the entity remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to the entity at that time. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract, and before exercise, there are no insurance cash flows within the boundary of the contract. However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to the issuer because the issuer is exposed to the risk that the annuity rates will be unfavourable to the issuer when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.<sup>200</sup>

#### Frequently asked questions

**Question 9-5: How should an option to add coverage to an existing coverage on terms that are not guaranteed be accounted for? [TRG meeting May 2018 – Agenda paper no. 03, Log S36]**

The TRG discussed an IASB staff paper that analysed how to determine the contract boundary of insurance contracts that include an option to add insurance coverage at a later date. The TRG members observed that:

- ▶ An option to add insurance coverage at a future date is a feature of the insurance contract
- ▶ An entity should focus on substantive rights and obligations arising from that option to determine whether the cash flows related to the option are within or outside the contract boundary
- ▶ Unless the entity considers that an option to add coverage at a future date is a separate contract, the option is an insurance component that is not measured separately from the remainder of the insurance contract

<sup>200</sup> IFRS 17.B24.

## Frequently asked questions (cont'd)

- ▶ If an option to add insurance coverage is not a separate contract and the terms are guaranteed by the entity, the cash flows arising from the option would be within the boundary of the contract because the entity cannot reprice the contract to reflect the reassessed risks when it has guaranteed the price for one of the risks included in the contract
- ▶ If an option to add insurance coverage is not a separate contract and the terms are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary, depending on whether the entity has the practical ability to set a price that fully reflects the reassessed risks of the entire contract. The analysis in the IASB staff paper: (i) assumed that the option to add insurance coverage at a future date created substantive rights and obligations; and (ii) noted that, if an entity does not have the practical ability to reprice the whole contract when the policyholder exercises the option to add coverage, the cash flows arising from the premiums after the option exercise date would be within the contract boundary. The TRG members expressed different views about whether an option with terms that are not guaranteed by the entity would create substantive rights and obligations
- ▶ If the cash flows arising from an option to add coverage at a future date are within the contract boundary, the measurement of a group of insurance contracts is required to reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the option

***Question 9-6: Which are the cash flows within the boundary of each of two specific fact patterns of health insurance contracts for which the policyholder has a right to terminate a contract, which results in its lapse, and a right to reinstate the contract? [TRG meeting April 2019 - Agenda paper no. 02, Log S126]***

The submission describes two specific fact patterns of health insurance contracts for which the policyholder has a right to terminate a contract, which results in its lapse, and a right to reinstate the contract. The policyholder's right to reinstate the contract is either exercised by paying the premiums that were not paid since the contract has lapsed until the reinstatement date or by exercising an option that the policyholder acquired after the contract has lapsed. In the latter case, the option is repriced annually based on the latest mortality table. In both cases, when the insurance contract is reinstated, it is reinstated without further underwriting or repricing of the premiums.

The IASB staff declined to provide further analysis of the specific transaction, but observed that an entity should assess whether its substantive obligation to provide services ends when a contract with such features lapses applying the criteria set out at 9.1 above (and discussed further above) and that cash flows related to the unexpired portion of the coverage period, such as the expected reinstatement of contracts, are part of the liability for remaining coverage.

### 9.1.2. Constraints or limitations relevant in assessing repricing

An entity has the practical ability to set a price at a future date (a renewal date) that fully reflects the risk in the contract from that date, in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has the practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it should consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining service. In determining the estimates of future cash flows at the end of a reporting period, an entity should reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

#### Frequently asked questions

**Question 9-7: What constraints or limitations, other than those arising from the terms of an insurance contract, would be relevant in assessing the practical ability of an entity to reassess the risks of the particular policyholder (or of the portfolio of insurance contracts that contains the contract) and set a price or level of benefits that fully reflects those risks? [TRG meeting May 2018 - Agenda paper no. 03, Log S43 and S49]**

The TRG members observed that:

- ▶ A constraint that equally applies to new contracts and existing contracts would not limit an entity's practical ability to reprice existing contracts to reflect their reassessed risks
- ▶ When determining whether it has the practical ability to set a price at a future date that fully reflects the reassessed risks of a contract or portfolio, an entity must (i) consider contractual, legal and regulatory restrictions; and (ii) disregard restrictions that have no commercial substance
- ▶ IFRS 17 does not limit pricing constraints to contractual, legal and regulatory constraints. Market competitiveness and commercial considerations are factors that an entity typically considers when pricing new contracts and repricing existing contracts. As such, sources of constraints may also include market competitiveness and commercial considerations, but constraints are irrelevant to the contract boundary if they apply equally to new and existing policyholders in the same market
- ▶ A constraint that limits an entity's practical ability to price or reprice contracts differs from choices that an entity makes (pricing decisions) which may not limit the entity's practical ability to reprice existing contracts in the way envisaged by paragraph B64 of IFRS 17

The TRG members also observed that an entity should apply judgement to decide whether commercial considerations are relevant when considering the contract boundary requirements of IFRS 17.

### 9.1.3. *Contract boundary matters related to insurance acquisition cash flows*

As discussed at 7.3 above, in some circumstances, an insurer may pay insurance acquisition cash flows on insurance contracts which are expected to last for many years but where the contract boundary is much shorter. For example, an insurer may pay significant up-front insurance acquisition cash flows in the first year of a contract on the basis that the contract will last for a number of years, but the contract boundary may be only one year (e.g., because of the reasons explained in Illustration 30 above). In some cases, part of the commission is refundable from the agent if the future renewals do not occur as expected. In other circumstances, the commission is not refundable.

As a result of the June 2020 amendments, IFRS 17 requires an entity to allocate insurance acquisition cash flows to groups of insurance contracts using a systematic and rational method unless, as permitted under the premium allocation approach (see 10.1 below), it chooses to recognise them as an expense.<sup>201</sup> The systematic and rational method should be used to allocate:<sup>202</sup>

- ▶ Insurance acquisition cash flows directly attributable to a group of insurance contracts:
  - ▶ To that group
  - ▶ To groups that will include insurance contracts that are expected to arise from renewals of the insurance contracts in that group
- ▶ Insurance acquisition cash flows directly attributable to a portfolio of insurance contracts, other than those in the bullet points above, to groups of contracts in that portfolio

At the end of each reporting period, an entity must revise amounts allocated to each group using the systematic and rational method specified above to reflect any changes in assumptions that determine the inputs to the method of allocation used. The entity must not change amounts allocated to a group of insurance contracts after all contracts have been added to the group.<sup>203</sup>

A distinction can be made when an insurer has paid an intermediary separately for exclusivity or future services as these costs are not attributable to an insurance contract and these payments would be outside the scope of IFRS 17 and may be within the scope of another IFRS.

See Section 11.2 for a discussion on matters related to the assessment of contract boundary, specifically as they relate to reinsurance contracts held.

## 9.2. **Estimates of expected future cash flows**

The first element of the building blocks in the general model discussed at 8 above is an estimate of the future cash flows over the life of each contract.

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<sup>201</sup> IFRS 17.28A.

<sup>202</sup> IFRS 17.B35A.

<sup>203</sup> IFRS 17.B35B.

This assessment should include all the future cash flows within the boundary of each contract (see 9.1 above).<sup>204</sup> However, the fulfilment cash flows should not reflect the non-performance risk (i.e., own credit) of the entity.<sup>205</sup> As discussed at 6 above, an entity is permitted to estimate the future cash flows at a higher level of aggregation than a group and then allocate the resulting fulfilment cash flows to individual groups of contracts.

The estimates of future cash flows should:<sup>206</sup>

- ▶ Incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows. To do this, an entity should estimate the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes
- ▶ Reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see 9.2.1 below)
- ▶ Be current - the estimates should reflect conditions existing at the measurement date, including assumptions at that date about the future (see 9.2.2 below)
- ▶ Be explicit - the entity should estimate the adjustment for non-financial risk separately from the other estimates. The entity also should estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see 9.4 below)

The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information about past events and current conditions, and forecasts of future conditions. Information available from an entity's own information systems is considered to be available without undue cost or effort.<sup>207</sup>

The starting point for an estimate of future cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.<sup>208</sup>

When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the

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<sup>204</sup> IFRS 17.33.

<sup>205</sup> IFRS 17.31.

<sup>206</sup> IFRS 17.33.

<sup>207</sup> IFRS 17.B3.7

<sup>208</sup> IFRS 17.B38.

resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective.<sup>209</sup>

The scenarios developed should include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts.<sup>210</sup>

An entity should estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including:<sup>211</sup>

- ▶ Information about claims already reported by policyholders
  - ▶ Other information about the known or estimated characteristics of the insurance contracts
  - ▶ Historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:
    - ▶ The characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data
    - ▶ There are indications that historical trends will not continue, that new trends will emerge, or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts
- Or
- ▶ There have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts
  - ▶ Current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information should be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfills the underlying contracts with the policyholder.

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<sup>209</sup> IFRS 17.B39.

<sup>210</sup> IFRS 17.B40.

<sup>211</sup> IFRS 17.B41.



## How we see it

- ▶ As a change to many accounting practices under IFRS 4, no explicit deferred acquisition cost assets existed for costs which relate to contracts that have already been recognised. Instead, the insurance acquisition cash flows were included as a “negative liability” within the measurement of the contractual service margin on initial recognition. Because the contractual service margin can never be negative for insurance contracts issued, there is no longer a need to perform any separate recoverability assessments for acquisition costs deferred once they have been included in the measurement of the group of insurance contracts. A recoverability assessment is necessary for the asset for insurance acquisition cash flows which relate to contracts not yet recognised (see section 9.10).
- ▶ Some accounting practices incorporate implicit margins for risk in a best estimate liability. For example, determining the liability for incurred claims based on an undiscounted management best estimate, which often incorporates conservatism or implicit prudence. IFRS 17 requires a change to this practice such that incurred claims liabilities must be measured at the discounted probability-weighted expected present value of the cash flows, plus an explicit risk adjustment. Entities will need to be more transparent in providing information about how liabilities related to insurance contracts are made up.
- ▶ Techniques such as stochastic modelling may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances.
- ▶ The estimates of future cash flows must be on an expected value basis and, therefore, should be unbiased. This means that they should not include any additional estimates above the probability-weighted mean for ‘uncertainty’, ‘prudence’ or what is sometimes described as a ‘management loading’. Separately, a risk adjustment for non-financial risk (see 9.4 below) is determined to reflect the compensation for bearing the non-financial risk resulting from the uncertain amount and the timing of the cash flows.
- ▶ Consistent with IFRS 4, catastrophe provisions and equalisation provisions (provisions generally build up over years following a prescribed regulatory formula which are permitted to be released in years when claims experience is high or abnormal) are not permitted to the extent that they relate to contracts that are not in force at the reporting date (i.e., future claims would be outside the boundary of the existing contract). Although IFRS 17 prohibits the recognition of these provisions as a liability, it does not prohibit their segregation as a component of equity. Consequently, insurers are free to designate a proportion of their equity as an equalisation or catastrophe reserve. When a catastrophe or equalisation provision has a tax base, but is not recognised in the IFRS financial statements, then a taxable temporary difference will arise that should be accounted for under IAS 12 *Income Taxes*.

### 9.2.1. Market variables and non-market variables

IFRS 17 identifies two types of variable that can affect estimates of cash flow:<sup>212</sup>

- ▶ Market variables (i.e., those that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates))
- ▶ Non-market variables (i.e., all other variables, such as the frequency and severity of insurance claims and mortality)

Market variables will generally give rise to financial risk (e.g., observable interest rates) and non-market variables will generally give rise to non-financial risk (for example, mortality rates). However, this will not always be the case, there may be assumptions that relate to financial risks for which variables cannot be observed in, or derived directly from, markets (e.g., interest rates that cannot be observed in, or derived directly from, markets).<sup>213</sup>

#### 9.2.1.A. Market variables

Market variables are variables that can be observed in, or derived directly from markets (e.g., prices of publicly traded securities and interest rates).

Estimates of market variables should be consistent with observable market prices at the measurement date. An entity should maximise the use of observable inputs and should not substitute its own estimates for observable market data except in the limited circumstances as permitted by IFRS 13.<sup>214</sup>

Consistent with IFRS 13, if variables need to be derived (e.g., because no observable market variables exist) they should be as consistent as possible with observable market variables.<sup>215</sup>

Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Consequently, they are not a single-point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.<sup>216</sup>

An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows exactly match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows that arise from a group of insurance contracts. The fair value of that asset reflects both the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.<sup>217</sup> IFRS 17 does not

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<sup>212</sup> IFRS 17.B42.

<sup>213</sup> IFRS 17.B43.

<sup>214</sup> IFRS 13.79.

<sup>215</sup> IFRS 17.B44.

<sup>216</sup> IFRS 17.B45.

<sup>217</sup> IFRS 17.B46.

require an entity to use a replicating portfolio technique. However, if a replicating asset or portfolio does exist for some of the cash flows that arise from insurance contracts and an entity chooses to use a different technique, the entity should satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different measurement of those cash flows.<sup>218</sup>

Techniques other than a replicating portfolio technique, such as stochastic modelling techniques, may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. In particular, the technique used must result in the measurement of any options and guarantees included in the insurance contracts being consistent with observable market prices (if any) for such options and guarantees.<sup>219</sup>

### Frequently asked questions

***Question 9-8: Should 'risk neutral' or 'real world' scenarios be used for stochastic modelling techniques to project future returns on assets, applying paragraph B48 of IFRS 17? [TRG meeting May 2018 - Agenda paper no. 07, Log S14]***

The IASB staff responded to a submission to the TRG which asked whether 'risk neutral' or 'real world' scenarios should be used in stochastic modelling when, for example, measuring options and guarantees. Real world scenarios are those based on an assumed distribution that is intended to reflect realistic assumptions about actual future asset returns. Risk neutral scenarios are those based on an underlying assumption that, on average, all assets earn the same risk-free return. A risk neutral approach uses a range of scenarios reflecting the assumed volatility of returns for an asset price consistent with volatility implied by option prices. The IASB staff clarified that IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not (see 8.3 below) and, if not divided, the discount rate should be appropriate for the cash flows as a whole. The IASB staff observed that any consideration beyond this is actuarial (i.e., operational measurement implementation) in nature and, therefore, does not fall within the remit of the TRG. The TRG members did not disagree with the IASB staff's observations.

### How we see it

- ▶ The application guidance is clear that although market variables will generally provide a measurement basis for financial risks (e.g., observable interest rates) this will not always be the case. The same is true for non-financial risks and non-market variables. For example, some non-financial risks could be observable in markets, whereas not all financial risks will be observable.

<sup>218</sup> IFRS 17.B47.

<sup>219</sup> IFRS 17.B48.

- ▶ In practice, we believe that the use of a replicating portfolio approach is likely to be rare as IFRS 17 refers to the need to consider the approach only when an asset exists whose cash flows exactly match those of the liability (or a portion thereof).

### 9.2.1.B. *Non-market variables*

Non-market variables are all other variables (other than market variables) such as the frequency and severity of insurance claims and mortality.

Estimates of non-market variables should reflect all reasonable and supportable evidence available without undue cost or effort, both external and internal.<sup>220</sup>

Non-market external data (e.g., national mortality statistics) may have more or less relevance than internal data (e.g., internally developed mortality statistics), depending on the circumstances. For instance, an entity that issues life insurance contracts should not rely solely on national mortality statistics, but should consider all other reasonable and supportable internal and external sources of information available without undue cost or effort when developing unbiased estimates of probabilities for mortality scenarios for its insurance contracts. In developing those probabilities, an entity should give more weight to the more persuasive information. For example:<sup>221</sup>

- ▶ Internal mortality statistics may be more persuasive than national mortality data if national data is derived from a large population that is not representative of the insured population. This could be because the demographic characteristics of the insured population could significantly differ from those of the national population, meaning that an entity would need to place more weight on the internal data and less weight on the national statistics.
- ▶ Conversely, if the internal statistics are derived from a small population with characteristics that are believed to be close to those of the national population, and the national statistics are current, an entity should place more weight on the national statistics.

Estimated probabilities for non-market variables should not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios should be as consistent as possible with probabilities implied by market interest rates.<sup>222</sup>

In some cases, an entity may conclude that market variables vary independently of non-market variables. If so, the entity should consider scenarios that reflect the range of outcomes for the non-market variables, with each scenario using the same observed value of the market variable.<sup>223</sup>

In other cases, market variables and non-market variables may be correlated. For example, there may be evidence that lapse rates (a non-market variable) are correlated with interest rates (a market variable). Similarly, there may be

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<sup>220</sup> IFRS 17.B49.

<sup>221</sup> IFRS 17.B50.

<sup>222</sup> IFRS 17.B51.

<sup>223</sup> IFRS 17.B52.

evidence that claim levels for house or car insurance are correlated with economic cycles and, therefore, with interest rates and expense amounts. The entity should ensure that the probabilities for the scenarios and the risk adjustments for the non-financial risk that relates to the market variables are consistent with the observed market prices that depend on those market variables.<sup>224</sup>

**Illustration 32 – Persuasiveness of internal and national mortality statistics**

An entity that issues life insurance contracts should not rely solely on national mortality statistics. It should consider all other reasonable and supportable internal and external information available without undue cost or effort when developing unbiased estimates of probabilities for mortality scenarios for its insurance contracts. For example:

Internal mortality statistics may be more persuasive than national mortality data if national data is derived from a large population that is not representative of the insured population.

Conversely, if the internal statistics are derived from a small population with characteristics that are believed to be close to those of the national population, and the national statistics are current, an entity should place more weight on the national statistics.

### 9.2.2. *Using current estimates*

In estimating each cash flow scenario and its probability, an entity should use all reasonable and supportable information available without undue cost or effort.<sup>225</sup> Undue cost and effort is discussed at 17.4 below.

An entity should review the estimates that it made at the end of the previous reporting period and update them. In doing so, an entity should consider whether:<sup>226</sup>

- ▶ The updated estimates faithfully represent the conditions at the end of the reporting period

Or

- ▶ The changes in estimates faithfully represent the changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the period. If the conditions have not changed, shifting the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an entity's most recent estimates are different from its previous estimates, but conditions have not changed, it should assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity should consider both the

<sup>224</sup> IFRS 17.B53.

<sup>225</sup> IFRS 17.B54

<sup>226</sup> IFRS 17.B54

evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

The probability assigned to each scenario should reflect the conditions at the end of the reporting period. Consequently, applying IAS 10 *Events after the Reporting Period*, an event occurring after the end of the reporting period that resolves an uncertainty that existed at the end of the reporting period does not provide evidence of the conditions that existed at that date. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period but before the financial statements are authorised for issue, a major storm occurs. The fulfilment cash flows under that contract should not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement include the 20 per cent probability apparent at the end of the reporting period (with disclosure (applying IAS 10) that a non-adjusting event occurred after the end of the reporting period).<sup>227</sup>

Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience in the reporting period was 20 per cent worse than the previous mortality experience and previous expectations of mortality experience. Several factors could have caused the sudden change in experience, including:<sup>228</sup>

- ▶ Lasting changes in mortality
- ▶ Changes in the characteristics of the insured population (for example, changes in underwriting or distribution, or selective lapses by policyholders in unusually good health)
- ▶ Random fluctuations
- ▶ Identifiable non-recurring causes

An entity should investigate the reasons for the change in experience and develop new estimates of cash flows and probabilities in the light of the most recent experience, the earlier experience and other information. The result for the example above, when mortality experience worsened by 20 per cent in the reporting period, would typically be that the expected present value of death benefits changes, but not by as much as 20 per cent. However, if mortality rates continue to be significantly higher than the previous estimates for reasons that are expected to continue, the estimated probability assigned to the high-mortality scenarios will increase.<sup>229</sup>

Estimates of non-market variables should include information about the current level of insured events and information about trends. For example, mortality rates have consistently declined over long periods in many countries. The determination of the fulfilment cash flows reflects the probabilities that would be assigned to each possible trend scenario, taking account of all reasonable and supportable information available without undue cost or effort.<sup>230</sup>

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<sup>227</sup> IFRS 17.B55

<sup>228</sup> IFRS 17.B56.

<sup>229</sup> IFRS 17.B57.

<sup>230</sup> IFRS 17.B58.

In a similar manner, if cash flows allocated to a group of insurance contracts are sensitive to inflation, the determination of the fulfilment cash flows should reflect current estimates of possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, the measurement of fulfilment cash flows should reflect the probabilities for each inflation scenario in a way that is consistent with the probabilities implied by the market interest rates used in estimating the discount rate (see 9.2.1.A above).<sup>231</sup>

When estimating the cash flows, an entity should take into account current expectations of future events that might affect those cash flows. The entity should develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability of each scenario. However, an entity should not take into account current expectations of future changes in legislation that would change or discharge the present obligation or create new obligations under the existing insurance contract until the change in legislation is substantively enacted.<sup>232</sup>

**Illustration 33 – Faithful representation of conditions at the reporting date and changes in the period**

If conditions have not changed in a period, shifting a point estimate from one end of a reasonable range at the beginning of the period to the other end of the range at the end of the period would not faithfully represent what has happened during the period.

If the most recent estimates are different from previous estimates, but conditions have not changed, an entity should assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity should consider both the evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

An entity should not update probabilities for claim events to reflect actual claims that took place after the reporting date but before the financial statements are finalised. For example, there may be a 20% probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period, but before the financial statements are authorised for issue, a major storm strikes. The fulfilment cash flows under that contract should not reflect hindsight (i.e., the storm that occurred in the next period). Instead, the cash flows included in the measurement should include the 20% probability apparent at the end of the reporting period (with disclosure, applying IAS 10, that a non-adjusting event occurred after the end of the reporting period).<sup>233</sup>

### 9.2.3. Cash flows within the contract boundary

As discussed at 9.1 above, estimates of cash flows should include all cash flows within the boundary of an insurance contract and in determining the contract boundary, an entity should consider its substantive rights and obligations and whether those rights and obligations arise from contract, law or regulation.

<sup>231</sup> IFRS 17.B59.

<sup>232</sup> IFRS 17.B60.

<sup>233</sup> IFRS 17.B55 and IAS 10.10-11.

Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts should reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk (see 9.4 below) should reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. This requirement to determine the expected value applies regardless of the number of contracts in a group; for example it applies even if the group comprises a single contract. Thus, the measurement of a group of insurance contracts should not assume a 100 per cent probability that policyholders will:<sup>234</sup>

- ▶ Surrender their contracts, if there is some probability that some of the policyholders will not

Or

- ▶ Continue their contracts, if there is some probability that some of the policyholders will not

The Basis for Conclusions states that IFRS 17 does not require or allow the application of a deposit floor when measuring insurance contracts. If a deposit floor were to be applied, the resulting measurement would ignore all scenarios other than those involving the exercise of policyholder options in the way that is least favourable to the entity. This would contradict the principle that an entity should incorporate in the measurement of an insurance contract future cash flows on a probability-weighted basis.<sup>235</sup> The expected cash outflows include outflows over which the entity has discretion.<sup>236</sup> The Board considered whether payments that are subject to the entity's discretion meet the definition of a liability in the *Conceptual Framework for Financial Reporting* (the Conceptual Framework). The contract, when considered as a whole, clearly meets the Conceptual Framework's definition of a liability. Some components, if viewed in isolation, may not meet the definition of a liability. However, in the Board's view, including such components in the measurement of insurance contracts would generate more useful information for users of financial statements.<sup>237</sup>

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. IFRS 17 provides the following examples of such cash flows:<sup>238</sup>

- ▶ Premiums - see 9.2.3.A below
- ▶ Payments, including claims, to a policyholder - see 9.2.3.B below

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<sup>234</sup> IFRS 17.B62.

<sup>235</sup> IFRS 17.BC166.

<sup>236</sup> IFRS 17.BC168.

<sup>237</sup> IFRS 17.BC169.

<sup>238</sup> IFRS 17.B65.



- ▶ Payments to a policyholder that vary based on underlying items - see 9.2.3.C below
- ▶ Payments to a policyholder resulting from derivatives - see 9.2.3.D below
- ▶ Insurance acquisition cash flows - see 9.2.3.E below
- ▶ Claims handling costs - see 9.2.3.F below
- ▶ Costs incurred in providing contractual benefits in kind - see 9.2.3.G below
- ▶ Policy administration and maintenance costs - see 9.2.3.H below
- ▶ Transaction-based taxes and levies - see 9.2.3.I below
- ▶ Payments by the insurer of tax in a fiduciary capacity - see 9.2.3.J below
- ▶ Potential cash inflows from recoveries - see 9.2.3.K below
- ▶ An allocation of fixed and variable overheads - see 9.2.3.L below
- ▶ Costs the entity will incur in providing an investment activity, an investment-return service or an investment-related service - see 9.2.3.M below
- ▶ Any other costs specifically chargeable to the policyholder - see 9.2.3.N below

The Board decided not to include only insurance cash flows that are incremental at a contract level as that would mean that entities would recognise different contractual service margins and expenses depending on the way they structure their acquisition activities.<sup>239</sup> For example, different liabilities would be reported if the entity had an internal sales department rather than outsourcing sales to external agents as the costs of an internal sales department, such as fixed salaries, are less likely to be incremental than amounts paid to an agent.

At initial recognition of an insurance contract, the fulfilment cash flows will include estimates for these cash flows. Subsequently, as services are provided under the contract, the liability for remaining coverage is reduced and insurance revenue is recognised except for those changes that do not relate to services provided in the period (premiums received, investment component changes, changes related to transaction-based taxes, insurance finance income or expenses, and insurance acquisition cash flows). See 15.2.1 below.

#### Frequently asked questions

**Question 9-9: Are cash flows still within the boundary of the contract if those cash flows relate to periods when insurance coverage is no longer provided and where the policyholder bears all the risks related to the investment services? [TRG meeting September 2018 - Agenda paper no. 11, Log S79]**

The submission considered, in particular, whether cash flows should be considered to be within the boundary of the contract if those cash flows arise in periods in which the investment component exists but no insurance coverage is provided. The IASB staff observed that cash flows within the

<sup>239</sup> IFRS 17.BC182(a).

### Frequently asked questions (cont'd)

boundary of a contract may relate to periods in which coverage is no longer provided, such as when claims are expected to be settled in the future that relate to premiums that were within the boundary of the contract. Periods of coverage may also be outside the boundary of a contract if, for example, an entity can fully reprice premiums.

### How we see it

- ▶ The list of examples of cash flows within the boundary of an insurance contract is more extensive than permitted under many local GAAPs (and, hence, applied previously under IFRS 4). For example, some local GAAPs permit only incremental costs to be included. Some local GAAPs also permit entities an accounting policy choice in whether or not to treat certain costs as insurance acquisition cash flows (and, hence, deferred over the policy period). IFRS 17 does not allow a choice as to whether or not to include these cash flows that are within the boundary of the insurance contract.

#### 9.2.3.A. *Premium cash flows*

Premium cash flows include premium adjustments, instalment premiums from a policyholder and any additional cash flows that result from those premiums.

Some insurance contracts charge a higher premium to policyholders who pay by (say) monthly instalments compared to those who pay a single amount on policy inception. The increased amount billed to those paying by instalments may include an implicit interest charge. Under IFRS 4, accounting practices for the higher premium charged to those who pay by instalments have been diverse. Under IFRS 17, the fulfilment cash flows arising from any incremental premium chargeable to policyholders is insurance revenue as it does not meet the definition of insurance finance income or expenses (see 15.3 below) nor is it a distinct non-insurance service as the insurance and financing is not usually sold separately (see 5.3 above).

#### 9.2.3.B. *Payments to (or on behalf of) a policyholder*

These payments include claims that have already been reported but have not yet been paid (i.e., reported claims), incurred claims for future events that have occurred but for which claims have not been reported (i.e., incurred but not reported (IBNR) claims) and all future claims for which an entity has a substantive obligation.

#### 9.2.3.C. *Payments to (or on behalf of) a policyholder that vary depending on returns on underlying items*

Some insurance contracts give policyholders the right to share in the returns on specified underlying items. Underlying items are items that determine some of the amounts payable to a policyholder. Underlying items can comprise any

items, e.g., a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.<sup>240</sup>

Payments to policyholders that vary depending on returns from underlying items are found most frequently in contracts with participation features. These are discussed at 12 below.

#### **9.2.3.D. *Payments to (or on behalf of) a policyholder resulting from derivatives***

Examples of such derivatives include options and guarantees embedded into the contract, to the extent that those options and guarantees are not separated from the contract (see 5.1 above).

#### **9.2.3.E. *Insurance acquisition cash flows***

These cash flows comprise an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

There is no restriction on insurance acquisition cash flows to those resulting from successful efforts. So, for instance, the directly attributable costs of an underwriter of a portfolio of motor insurance contracts do not need to be apportioned between those costs relating to efforts that result in the issuance of a contract and those relating to unsuccessful efforts. The Basis for Conclusions observes that the Board considered whether to restrict insurance acquisition cash flows included in the measurement of a group of insurance contracts to those cash flows directly related to the successful acquisition of new or renewed insurance contracts. However, it was concluded that this was not consistent with an approach that measured profitability of a group of contracts over the duration of the group and, in addition, the Board wanted to avoid measuring liabilities and expenses at different amounts depending on how an entity structures its insurance activities.<sup>241</sup>

Changes in estimates of insurance acquisition cash flows are adjusted against the liability for remaining coverage, but do not adjust insurance revenue as they do not relate to services provided by the entity.<sup>242</sup> Separately, insurance revenue related to insurance acquisition cash flows is determined by allocating (or amortising) the portion of the premiums that relates to recovering these cash flows to each reporting period in a systematic way on the basis of passage of time, with a corresponding entry to insurance service expenses (i.e., DR insurance service expense, CR insurance revenue).<sup>243</sup> See 15.2.1 below.

### **How we see it**

- ▶ Insurance acquisition cash flows can also include an allocation of fixed and variable overheads, mentioned under 9.2.3.L below, that can be attributed, on a systematic and rationale basis, to the portfolio of insurance contracts as insurance acquisition cash flows.

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<sup>240</sup> IFRS 17 Appendix A.

<sup>241</sup> IFRS 17.BC183.

<sup>242</sup> IFRS 17.B123.

<sup>243</sup> IFRS 17.B125.

#### **9.2.3.F. Claims handling costs**

These are costs that an entity will incur in investigating, processing and resolving claims under existing insurance contracts (as opposed to claim payments to policyholders - see 9.2.3.B above). Claims handling costs include legal and loss adjusters' fees and the internal costs of investigating claims and processing claims payments.

#### **9.2.3.G. Costs incurred in providing contractual benefits in kind**

These costs are those related to the type of payments in kind discussed at 3.3 above.

#### **9.2.3.H. Policy administration and maintenance costs**

These costs include the costs of billing premiums and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

#### **9.2.3.I. Transaction-based taxes**

These include such taxes as premium tax, value added taxes and goods and service taxes and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis. See also 9.2.3.J below.

Premium or sales taxes are typically billed to the policyholder and then passed onto the tax authorities with the insurer usually acting as an agent for the tax authorities. The cash flows within the contract boundary would, therefore, include both the tax in-flow and the tax out-flow. Guarantee fund or similar assessments are usually billed to the insurer directly based on a calculation made by the tax authority often derived from the insurer's market share of particular types of insurance business. There is usually only a cash out-flow for these assessments.

Changes in cash flows that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) adjust the liability for remaining coverage (i.e., are included within the balance of portfolios of insurance contracts included in the statement of financial position), but do not adjust insurance revenue as these do not relate to services expected to be covered by the consideration received by the entity.<sup>244</sup>

#### **9.2.3.J. Payments by the insurer in a fiduciary capacity**

These are payments (and related receipts) made by the insurer to meet tax obligations of the policyholder. In some jurisdictions, the insurer is required to make these payments (e.g., to pay the policyholder's tax on gains made on underlying items). Income tax obligations which are not paid in a fiduciary

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<sup>244</sup> IFRS 17.B123

capacity (e.g., the insurer's own income tax obligations) are not cash flows within the boundary of an insurance contracts. See 9.2.4 below.

### 9.2.3.K. *Potential inflows from recoveries*

Some insurance contracts permit the insurer to sell, usually damaged, property acquired in settling the claim (salvage). The insurer may also have the right to pursue third parties for payment of some or all costs (subrogation). Potential cash inflows from both salvage and subrogation are included with the cash flows of the boundary of an insurance contract and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

### 9.2.3.L. *An allocation of fixed and variable overheads*

Fixed and variable overheads included in the cash flows within the boundary of an insurance contract include the directly attributable costs of:

- ▶ Accounting
- ▶ Human resources
- ▶ Information technology and support
- ▶ Building depreciation
- ▶ Rent
- ▶ Maintenance and utilities

These overheads should be allocated to groups of contracts using methods that are systematic and rational and are consistently applied to all costs that have similar characteristics.

Other IFRSs govern the accounting treatment of some of the fixed or variable overheads, for example:

| <b>Fixed and variable overheads</b> | <b>Applicable IFRS</b>  |
|-------------------------------------|---|
| Human resources                     | IAS 19 <i>Employee Benefits</i>                                     |
| Information technology              | IAS 38 <i>Intangible Assets</i>                                     |
| Depreciation                        | IAS 16 <i>Property, Plant and Equipment</i> / IFRS 16 <i>Leases</i> |
| Other allocated overhead amounts    | IFRS 9 <i>Financial Instruments</i>                                 |

IFRS 17 will therefore interact with the recognition and measurement principles of other IFRSs. For example, an entity might include building depreciation costs in the fulfilment cash flows. The entity will determine depreciation costs over the period of the useful life of the building applying the requirements of IAS 16. The entity will include those expected costs in the fulfilment cash flows. When those costs are incurred, applying IAS 16 the entity will treat them as an incurred expense under IFRS 17, i.e., the entity will reduce the liability for

remaining coverage, recognise an incurred insurance service expense and recognise revenue. See 15.2 below.

#### **9.2.3.M. *Costs incurred in providing investment activity, investment-return and investment-related services***

These are costs the entity will incur:

- ▶ Performing investment activities, to the extent the entity performs these activities to enhance benefits from insurance coverage for policyholders. Investment activities enhance benefits from insurance coverage if the entity performs those activities expecting to generate an investment return from which policyholders will benefit if an insured event occurs
- ▶ Providing investment-return services to policyholders of insurance contracts without direct participation features (see 9.7.1 below)
- ▶ Providing investment-related services to policyholders of insurance contracts with direct participation features (see 11.5. below)

Investment activity costs that an entity incurs are included in the fulfilment cash flows to the extent that the entity incurs those costs to provide investment-return services or investment-related services. It is acknowledged in the Basis for Conclusions that an entity may also incur investment activity costs to enhance benefits from insurance coverage from customers. Therefore, IFRS 17, as amended in June 2020, specifies that an entity is required to include investment activity costs in the fulfilment cash flows to the extent that the entity performs those activities to enhance benefits from insurance coverage for policyholders. In determining whether investment activity costs enhance benefits from insurance coverage for policyholders, an entity needs to apply judgement in a similar manner to when it determines whether an investment-return service exists.<sup>245</sup>

Costs resulting from investment activity performed for the benefit of shareholders, rather than policyholders, are excluded from the list above. Therefore, it can be inferred by omission that the IASB does not consider shareholder-related investment costs to be fulfilment cash flows directly related to insurance contracts.

#### **9.2.3.N. *Any other costs***

These are any other costs specifically chargeable to the policyholder under the insurance contract.

In some cases, income tax paid by an entity, even though not paid in a fiduciary capacity, is specifically chargeable to the policyholder under the terms of the contract. Such a tax, which can be described as a “policyholder tax”, arises for example, when an entity pays income tax on assets that are underlying items to insurance contracts, and charges the policyholder for its share of that income tax.

The IASB has clarified through the amendments to IFRS 17 in June 2020, that the other costs include income tax payments and receipts that are specifically

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<sup>245</sup> IFRS 17.BC283I.

chargeable to the policyholder under the terms of an insurance contract (see 9.2.4 below). The consequence of this is that:

- ▶ An entity will continue to apply IAS 12 to those income tax payments to measure the amounts of such income tax payments to be included in the fulfilment cash flows
- ▶ An entity will recognise insurance revenue for the consideration paid by the policyholder for these tax payments and receipts consistent with the recognition of insurance revenue for other incurred expenses. The IASB staff's view is that for income tax payments specifically chargeable to the policyholder under the contract terms, when the tax expense is incurred applying IAS 12, the entity will treat it as an incurred expense applying IFRS 17<sup>246</sup> (see also 15.2.1 below).

### How we see it

- ▶ The basis for recognition of expenses under IFRS 17 is when the expenses have been incurred following the provision of the insurance contract services. Where the insurance service expenses relate to costs allocated from other standards, in practice, the recognition as insurance service expense will often follow the recognition under the other standards (e.g., the IAS 16 depreciation pattern). When releasing the liability for remaining coverage for the expected insurance service expense and recognising the actual insurance service expenses in profit or loss, the liability for incurred claims is recognised under IFRS 17 for the actual expenses. See section 15.2.1 for a discussion on the interaction between IFRS 17 and other IFRSs.
- ▶ IFRS 17 paragraph B121, as amended in June 2020, distinguishes between paragraph (a)(i) 'insurance service expenses' and (a)(ia) income tax. The amendment to specifically mention income tax was needed as income tax cannot be presented as insurance services expenses as, under IAS 1, income tax needs to be presented separately in profit or loss. Therefore, incurred income tax expenses should be presented in the income tax expense line item on the face of the statement of profit or loss and not within the insurance service expenses.

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<sup>246</sup> IASB Staff paper "Other topics raised by respondents to the Exposure Draft Amendments to IFRS 17" - Agenda ref 2F paragraph 15 - February 2020.

#### 9.2.4. Cash flows excluded from the contract boundary

Having provided a list of cash flows that are within the boundary of an insurance contract, IFRS 17 then provides a list of cash flows that should not be included when estimating the cash flows that will arise as an entity fulfils an existing insurance contract. These are as follows:<sup>247</sup>

- ▶ Investment returns. Investments are recognised, measured and presented separately
- ▶ Cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately
- ▶ Cash flows that may arise from future insurance contracts, i.e. cash flows outside the boundary of existing contracts (see 9.2.3 above)
- ▶ Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred
- ▶ Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in profit or loss when incurred
- ▶ Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity or that are not specifically chargeable to the policyholder under the terms of the contract (see 9.2.3.N above)
- ▶ Cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders
- ▶ Cash flows arising from components separated from the insurance contract and accounted for using other applicable IFRSs (see 5 to 5.3 above)

IFRS 17, as amended in June 2020, resolves an inconsistency between the description of cash flows within the boundary of an insurance contract (see 9.2.3.N above) and the description of cash flows outside the boundary of an insurance contract. The Board amended IFRS 17 to clarify that income tax payments or receipts not specifically chargeable to the policyholder under the terms of the contract should be excluded from the estimate of the cash flows that will arise as the entity fulfils an insurance contract.<sup>248</sup>

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<sup>247</sup> IFRS 17.B66.

<sup>248</sup> IFRS 17.BC170A.



## How we see it

- ▶ Investment returns are not part of the fulfilment cash flows of a contract because measurement of the contract should not depend on the assets that the entity holds. However, where a contract includes participation features, the measurement of the fulfilment cash flows should include the effect of returns from underlying items in those cash flows. The “*Illustrative Examples*” that accompany IFRS 17 explain that asset management is part of the activities the entity must undertake to fulfil the contract when there is an account balance calculated using returns from specified assets and fees charged by the entity (see illustration 5 in section 3.3). In our view, an entity should incorporate asset management expenses in a way that is consistent with how it considers the returns from the assets it is holding in the estimates of fulfilment cash flows, based on the product features. As such, if investment returns from underlying items are included in fulfilment cash flows, then the asset management expenses that relate to those returns should also be included.

Discount rates will need to reflect the characteristics of the insurance contracts. Types of insurance contracts vary significantly, so there will be no single discount rate (curve) that will fit the characteristics of all insurance liabilities.

## 9.3. Discount rates

The second element of measuring fulfilment cash flows under the general model (discussed at 8 above) is an adjustment (i.e., a discount) to the estimates of future cash flows to reflect the time value of money and financial risks related to those cash flows (to the extent that they are not included in the cash flow estimates). The adjustment is made by discounting estimated future cash flows. Discount rates must:<sup>249</sup>

- ▶ Reflect the time value of money, characteristics of the cash flows and liquidity characteristics of the insurance contract
- ▶ Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts (e.g., timing, currency and liquidity)
- ▶ Exclude the effect of factors that influence such observable market prices, but do not affect the future cash flows of the insurance contracts

The discount rates calculated according to the requirements above should be determined, as follows:<sup>250</sup>

| Insurance liability measurement component   | Discount rate for liability                  |
|---|--|
| Fulfilment cash flows   | Current rate at reporting date               |
| Contractual service margin interest accretion for contracts without direct participation features (including insurance and reinsurance contracts issued and reinsurance contracts held) | Rate at date of initial recognition of group |

<sup>249</sup> IFRS 17.36.

<sup>250</sup> IFRS 17.B72-B73.

| Insurance liability measurement component  | Discount rate for liability  |
|--|--|
| Changes in the fulfilment cash flows for contracts without direct participation features which relate to future service that affect the contractual service margin (including insurance and reinsurance contracts issued and reinsurance contracts held).                | Rate at date of initial recognition of group   |
| Liability for remaining coverage under the premium allocation approach for groups of insurance contracts with a significant financing component.   | Rate at date of initial recognition of group   |
| Insurance finance income or expenses   | Discount rate used for disaggregation between profit or loss and other comprehensive income  |
| Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional and for which changes in financial risk do not have a substantial effect on amounts paid to policyholders (see 15.3.1 below)             | Rate at date of initial recognition of group   |
| Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional, and for which changes in financial risk assumptions have a significant effect on amounts paid to policyholders (see 15.3.1 below)       | Rate that allocates the remaining revised finance income or expense over the duration of the group at a constant rate ('effective yield approach') or, for contracts that use a crediting rate, uses an allocation based on the amounts credited in the period and expected to be credited in future periods ('projected crediting approach'). |
| Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional for incurred claims of groups of contracts applying the premium allocation approach (see 15.3.3 below).                                  | Rate at date of incurred claim   |
| Insurance finance income or expenses for which disaggregation between profit or loss and other comprehensive income is optional for groups of insurance contracts with direct participation features for which the entity holds the underlying items (see 15.3.4 below). | Amount that eliminates accounting mismatches with income or expenses on the underlying items, i.e., the net of the two should be nil ('current period book yield approach').   |

IFRS 17 does not specify requirements for accretion of interest on assets for insurance acquisition cash flows. The Board decided against specifying such

requirements because doing so would be inconsistent with IFRS 15.<sup>251</sup> Consequently, entities have an accounting policy choice as to whether to accrete interest on such assets and the rate to use for such accretion.

For insurance contracts without direct participation features, the Board concluded that changes in the effects of the time value of money and financial risk do not affect the amount of unearned profit. This is the case even if the payments to policyholders vary with returns on underlying items through a participation mechanism. Accordingly, the entity does not adjust the contractual service margin to reflect the effects of changes in these assumptions and hence a locked-in discount rate is used.<sup>252</sup>

Discount rates should reflect the rate at initial recognition of the group, considering that contracts may be added to the group after its initial recognition. This can be achieved by applying locked in rates that correspond to the initial recognition date over the period that the contracts in the group are issued, or a weighted-average locked-in rate that reflects these rates which apply over the period that contracts in the group are issued, which cannot exceed one year.<sup>253</sup> As explained at 7 above, this can result in a change in the discount rates during the period of the contracts as newly recognised contracts are added to the group. When contracts are added to a group in a subsequent reporting period (because the period of the group spans across two reporting periods) and weighted-average discount rates are revised, an entity should apply the revised discount rates from the start of the reporting period in which the new contracts are added to the group.<sup>254</sup> This means that there is no retrospective catch-up adjustment for previous reporting periods (see 15.4 below).

### Frequently asked questions

***Question 9-10: How to account for the difference that may arise between the current discount rate of each contract when it joins the group and the weighted average discount rates used at initial recognition? [TRG meeting April 2019 - Agenda paper no. 02, Log S93]***

The IASB staff observed that entities which apply the other comprehensive income disaggregation option use the discount rates determined at the date of initial recognition of a group of insurance contracts to determine the amounts recognised in profit or loss using a systematic allocation. An entity is permitted to use weighted-average discount rates over the period that contracts in a group are issued to determine the discount rate at the date of initial recognition of a group of contracts. The weighted average discount rate used should achieve the outcome that the amounts recognised in other comprehensive income over the duration of the group of contracts total zero.

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<sup>251</sup> IFRS 17.BC184H.

<sup>252</sup> IFRS 17.BC228.

<sup>253</sup> IFRS 17.B73.

<sup>254</sup> IFRS 17.28.

## Frequently asked questions (cont'd)

**Question 9-11: Should an entity should use an effective yield rate or a yield curve, specifically, in terms of paragraph B72(e)(i) of IFRS 17 for a group of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders? [TRG meeting May 2018 – Agenda paper no. 07, Log S29]**

IFRS 17 does not state whether the discount rate should be a yield curve or a single discount rate. The IASB staff confirmed that, in applying the discount rate determined at the date of initial recognition to nominal cash flows that do not vary based on returns from underlying items, IFRS 17 does not mandate the use of an effective yield rate or a yield curve. In response to the IASB staff, a few TRG members commented that using an effective yield rate compared to using a yield curve could result in a significant difference to insurance finance income or expense to be included in profit or loss over the reporting periods subsequent to initial recognition.

## How we see it

- ▶ As mentioned above, there is no retrospective catch-up adjustment from the weighted-average locked-in discount rates for previous reporting periods. As discussed in 15.4 below, the frequency of an entity's reporting period and the accounting policy choice available under paragraph B137, would determine what is the 'previous reporting period' in this respect. When an entity chooses a Period-To-Date (PTD) approach, the previous reporting period would be the interim reporting period, so no catch-ups are applied regarding any previous interim or annual reporting period. Conversely, if an entity chooses a Year-To-Date (YTD) approach, the previous reporting period would be determined by reference to the annual reporting period. Both approaches would however, ultimately result in the same weighted-average locked-in discount rate.
- ▶ IFRS 17 requires that the discount rates applied reflect the characteristics of the liability. One such relevant characteristic is timing and duration of the cash flows, which would be particularly prominent for long-term liabilities. Typically, the characteristics of timing and duration may be reflected through the use of a yield curve. Possible practical considerations of this might be:
  - ▶ Whether a different method could be applied to some types of (cash flows of) participating contracts
  - ▶ Whether an entity could use an approach to convert a curve into a single rate as a practical simplification for some types of products. However, this requires careful consideration as an entity would still have to substantiate in every reporting period, whether the IFRS 17 discount rate principles are satisfied. As such, there will be a number of challenges to such an approach.
  - ▶ Whether to use a flat rate for short-term liabilities as for such liabilities, the impact of the timing may not be significant. However, it would be a practical expedient that requires a definition of 'short' for these purposes. In addition, materiality aspects may have to be considered.

### 9.3.1. *Discount rates consistent with characteristics of cash flows*

Estimates of discount rates must be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions; for example:<sup>255</sup>

- ▶ Cash flows that do not vary based on the returns on any underlying items must be discounted at rates that do not reflect any such variability
- ▶ Cash flows that vary based on the returns on any financial underlying items should be:
  - ▶ Discounted using rates that reflect that variability; or
  - ▶ Adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made
- ▶ Nominal cash flows (i.e., those that include the effect of inflation) should be discounted at rates that include the effect of inflation
- ▶ Real cash flows (i.e., those that exclude the effect of inflation) must be discounted at rates that exclude the effect of inflation

However, discount rates should not reflect the non-performance (i.e., own credit) risk of the entity.<sup>256</sup> The requirement for discount rates to be consistent with the characteristics of the cash flows of insurance contracts is from the perspective of the entity. IFRS 17 requires an entity to disregard its own credit risk when measuring the fulfilment cash flows.<sup>257</sup>

Cash flows that vary based on the returns on underlying items should be discounted using rates that reflect that variability, or to be adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made. The variability is a relevant factor regardless of whether it arises because of contractual terms or because the entity exercises discretion, and regardless of whether the entity holds the underlying items.<sup>258</sup>

Cash flows that vary with returns on underlying items with variable returns, but that are subject to a guarantee of a minimum return, do not vary solely based on the returns on the underlying items, even when the guaranteed amount is lower than the expected return on the underlying items. Hence, an entity should adjust the rate that reflects the variability of the returns on the underlying items for the effect of the guarantee, even when the guaranteed amount is lower than the expected return on the underlying items.<sup>259</sup>

IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. If an entity does not divide the estimated cash flows in this way, the entity should apply discount rates appropriate for the estimated cash flows as a whole; e.g., using stochastic modelling techniques or risk-neutral measurement techniques.<sup>260</sup>

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<sup>255</sup> IFRS 17.B74.

<sup>256</sup> IFRS 17.31.

<sup>257</sup> IFRS 17.31, IFRS 17.BC197.

<sup>258</sup> IFRS 17.B75.

<sup>259</sup> IFRS 17.B76.

<sup>260</sup> IFRS 17.B77.

For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment should reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.<sup>261</sup>

### Frequently asked question

***Question 9-12: Should the liability for any minimum interest rate guarantees made to policyholders be measured through adjusting the discount rate (rather than through adjustments to the cash flows)? [TRG meeting May 2018 - Agenda paper no. 07, Log S38]***

The IASB staff stated that although IFRS 17 requires the time value of a guarantee to be reflected in the measurement of fulfilment cash flows, it does not require the use of a specific approach to achieve this objective. Financial risk is included in the estimates of future cash flows or in the discount rate used to adjust the cash flows. Judgement is required to determine the technique for measuring market variables and the technique must result in the measurement of any options and guarantees being consistent with observable market prices. Any consideration beyond this is actuarial (i.e., operational measurement implementation) in nature. The TRG members did not disagree with the IASB staff's observations.

### How we see it

- ▶ IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. By not dividing the cash flows, an entity avoids the complexity of having to disentangle cash flows that may be interrelated. However, if an entity does not divide the estimated cash flows in this way, it should apply discount rates for the estimated cash flows as a whole in a way that is consistent with the principles of the standard; for example, using stochastic modelling or risk-neutral measurement techniques. Both approaches, dividing or not dividing cash flows, have their own conceptual and practical implications, so entities should carefully assess what methods will be most suited to their particular circumstances.
- ▶ Entities should be aware that, even for participating contracts, at least some of the cash flows to policyholders are independent of returns on underlying items; for example, payments for fixed death benefit or expenses of the entity that do not vary with the underlying items.

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<sup>261</sup> IFRS 17.B79

### 9.3.2. *Current discount rates consistent with observable market prices*

Discount rates should include only relevant factors, i.e., factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Such discount rates may not be directly observable in the market. Hence, when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the insurance contracts, an entity should estimate the appropriate rates. IFRS 17 does not require a particular estimation technique for determining discount rates. In applying an estimation technique, an entity should:<sup>262</sup>

- ▶ Maximise the use of observable inputs and reflect all reasonable and supportable information on non-market variables available without undue cost or effort, both external and internal. In particular, the discount rates used should not contradict any available and relevant market data, and any non-market variables used should not contradict observable market variables;
- ▶ Reflect current market conditions from the perspective of a market participant
- ▶ Exercise judgement to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them

#### How we see it

- ▶ It is unlikely that there will be an observable market price for a financial instrument with the same characteristics as an insurance contract in terms of the timing and nature of the estimated cash flows. An entity will need to exercise judgement to assess the degree of similarity between the features of the insurance contracts measured and those of the instruments for which observable market prices are available and adjust those prices to reflect the differences.

### 9.3.3. *'Bottom-up' or 'top-down' approach*

IFRS 17 proposes two basic methods for determining discount rates for cash flows of insurance contracts that do not vary based on the returns on underlying items, as follows:

- ▶ A 'bottom-up' approach

The 'bottom-up' approach determines discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of

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<sup>262</sup> IFRS 17.B78.

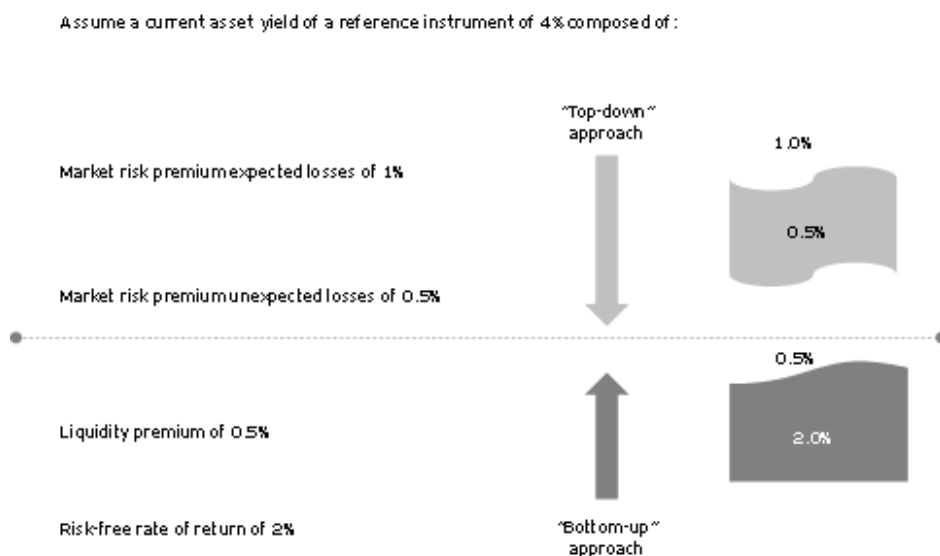
the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts.<sup>263</sup>

► A 'top-down' approach

The 'top-down' approach determines the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets. An entity should adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.<sup>264</sup>

In theory, when considering all required adjustments, both the 'top-down' and 'bottom-up' approaches should give the same result although in practice this is not necessarily the case.

An example of the approaches giving the same result is illustrated below, where the overall liability discount rate is 2.5% in each case. The example assumes that there are no differences between the liquidity characteristics of the liability and the reference portfolio of assets. The 'top down' approach starts with a current asset yielding 4% and this rate is reduced by 1.5% for expected and unexpected losses while the 'bottom up' approach starts with a risk-free rate of 2% which is increased by a liquidity premium of 0.5%.



In estimating the yield curve on a 'top down' basis, an entity should use measurement bases consistent with IFRS 13, as follows:<sup>265</sup>

- If there are observable market prices in active markets for assets in the reference portfolio, an entity should use those prices
- If a market is not active, an entity should adjust observable market prices for similar assets to make them comparable to market prices for the assets being measured

<sup>263</sup> IFRS 17.B80.

<sup>264</sup> IFRS 17.B81.

<sup>265</sup> IFRS 17.B82.



- ▶ If there is no market for assets in the reference portfolio, an entity should apply an estimation technique. For such assets an entity should:
  - ▶ Develop unobservable inputs using the best information available in the circumstances. Such inputs might include the entity's own data and, in the context of IFRS 17, the entity might place more weight on long-term estimates than on short-term fluctuations
  - ▶ Adjust the data to reflect all information about market participant assumptions that is reasonably available

In adjusting the yield curve, an entity should adjust market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, and should adjust observed market rates to reflect the degree of dissimilarity between the instrument being measured and the instrument for which transaction prices are observable. For cash flows of insurance contracts that do not vary based on the returns on the assets in the reference portfolio, such adjustments include:<sup>266</sup>

- ▶ Adjusting for differences between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts
- ▶ Excluding market risk premiums for credit risk, which are relevant only to the assets included in the reference portfolio

In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in practice, the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach.<sup>267</sup>

No restrictions are specified on the reference portfolio of assets used in the top-down approach. However, fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics. For example, if the cash flows from the insurance contracts do not vary based on the returns on underlying items, fewer adjustments would be required if an entity used debt instruments as a starting point rather than equity instruments. For debt instruments, the objective would be to eliminate from the total bond yield the effect of credit risk and other factors that are not relevant to the insurance contracts. One way to estimate the effect of credit risk is to use the market price of a credit derivative as a reference point.<sup>268</sup>

Some insurance contracts will have a contract boundary which extends beyond the period for which observable market data is available. In these situations, the entity will have to determine an extrapolation of the discount rate yield curve

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<sup>266</sup> IFRS 17.B83.

<sup>267</sup> IFRS 17.B84.

<sup>268</sup> IFRS 17.B85.

beyond that period. IFRS 17 provides no specific guidance on the estimation techniques for interest rates in these circumstances. The general guidance above for unobservable inputs is that an entity should use the best information available in the circumstances and adjust that data to reflect all information about market participant assumptions that is reasonably available.

When the Board considered feedback from entities implementing IFRS 17 as part of the June 2020 amendments, it also considered feedback from users of financial statements that the principle-based requirements for determining discount rates could limit comparability between entities. The Board made no amendments to IFRS 17 in response to that feedback. In the Board's view, requiring an entity to determine discount rates using a rules-based approach would result in outcomes that are appropriate only in some circumstances. IFRS 17 requires entities to apply judgement when determining the inputs most applicable in the circumstances. To enable users of financial statements to understand the discount rates used, and to facilitate comparability between entities, IFRS 17 requires entities to disclose information about the methods used and judgements applied.<sup>269</sup>

#### Frequently asked question

***Question 9-13: When using a top-down approach to determine discount rates, should the reference portfolio of assets reflect the liquidity characteristics of the insurance contracts? If using an own portfolio of assets as the reference portfolio, should the effect of purchasing and selling assets during the reporting period be reflected in the discount rates used for insurance contracts? [TRG meeting September 2018 - Agenda paper no. 02, Log S65, S72]***

The TRG members discussed an IASB staff paper which responded to a submission that asked whether, in applying a top-down approach to determine the discount rates for insurance contracts with cash flows that do not vary based on the returns of underlying items:

- ▶ An entity could use the assets it holds as a reference portfolio of assets
- ▶ An entity could ignore the liquidity characteristics of insurance contracts
- ▶ Changes in the assets the entity holds could result in changes in the discount rates used to measure insurance contracts under specific circumstances.

The TRG members agreed with the IASB staff analysis and conclusion in this paper that an entity can use the assets it holds as a reference portfolio when determining a top-down discount rate to measure its insurance liabilities. The TRG members observed that:

- ▶ IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying a top-down approach to determine discount rates and also does not define 'a reference portfolio of assets'. Consequently, a portfolio of assets an entity holds can be used as a reference portfolio to determine the discount rates provided that the discount rates achieve the objectives of reflecting the characteristics of the insurance contracts and are consistent with observable current market prices.

<sup>269</sup> IFRS 17.BC205A, BC205B.

### Frequently asked question (cont'd)

- ▶ IFRS 17 requires that discount rates reflect, among other factors, the liquidity characteristics of the insurance contracts. However, when using the top-down approach, as a simplification, IFRS 17 permits an entity not to adjust the yield curve derived from a reference portfolio of assets for differences between the liquidity characteristics of the insurance contracts and those of the reference portfolio. The IASB expected a reference portfolio of assets typically to have liquidity characteristics that more closely match the liquidity characteristics of a group of insurance contracts than would be the case for highly-liquid, high-quality bonds.
- ▶ In determining the appropriate discount rates for cash flows that do not vary based on underlying items, an entity ensures that at each reporting date, those discount rates reflect the characteristics of the insurance contracts, even when the entity chooses to use a portfolio of assets that it holds to determine the discount rates.
- ▶ An entity needs to make adjustments to the yield curve of the reference portfolio of assets at each reporting date to eliminate any effect on discount rates of credit risk and differences in liquidity characteristics of the insurance contracts and the reference portfolio. However, if the entity uses the simplification and does not make any adjustments to the reference portfolio curve to reflect differences in liquidity characteristics between the reference portfolio and the insurance contracts, then fluctuations in the liquidity of the reference portfolio will be mirrored in changes in discount rates used to measure the group of insurance contracts.
- ▶ The TRG members also observed that, when an entity uses the simplification related to liquidity (i.e., the top-down approach discussed above), small changes in discount rates that result from changes in the composition of the reference portfolio could result in significant changes to the insurance contract liabilities measured using those rates, particularly with respect to long-term insurance contracts.

Both the IASB staff and the TRG members note that IFRS 17 contains disclosure requirements for qualitative and quantitative information about the significant judgements and changes in those judgements (see 16.3 below) and consider that, if the effect of illiquidity were to be significant, entities would be expected to disclose such information in their financial statements.

***Question 9-14: Would it be appropriate, if applying the top-down discount rate approach, to determine discount rates at initial recognition of each group using a target asset mix that the entity plans to invest in for that group as the reference portfolio of assets, and subsequently, using the actual asset mix covering all underwriting years as the reference portfolio of assets? [TRG meeting April 2019 – Agenda paper no. 02, Log S91]***

The IASB staff observed that identifying a reference portfolio that will enable an entity to meet the objectives required for setting a discount rate is dependent on specific facts and circumstances and providing specific application guidance is not within the remit of the TRG.

## How we see it

- ▶ Some insurance contracts will have a contract boundary which extends beyond the period for which observable market data is available. In these situations, the entity will have to determine an extrapolation of the discount rate yield curve beyond that period. IFRS 17 provides no specific guidance on the estimation techniques for discount rates in these circumstances. The general guidance above for unobservable inputs is that an entity should use the best information available in the circumstances and adjust that data to reflect all information about market participant assumptions that is reasonably available. In these situations, the entity will have to extrapolate the discount rate yield curve beyond the observable period, taking care to consider the reference in IFRS 17 to the fair value methodology prescribed in IFRS 13.
- ▶ In the bottom up approach entities will need to determine an appropriate method to adjust the observable market information in a way that reflects the difference in liquidity characteristics of the insurance contracts compared to those of the observable instrument. The liquidity characteristics will depend on the specific nature of a contract. For example, annuities in payment are generally viewed as very illiquid as they cannot be surrendered and only expire on the annuitant's death. Different methods to estimate an illiquidity premium are available. For example, the spread between highly liquid assets and collateralised bonds may give an indication of the difference in liquidity between these two instruments. An alternative way to derive an illiquidity premium would be to estimate it by adjusting the observed spread between a highly liquid instrument and a corporate bond for the credit risk spread implied from the yield on credit default swaps.
- ▶ In some jurisdictions, a liquid risk-free yield curve (or interest rate) might be negative. An entity should use the current market rates even if those are negative and this results in the present value of future payments exceeding, rather than being lower than the value of the undiscounted fulfilment cash flows.
- ▶ IFRS 17 provides no specific guidance on estimation techniques to extrapolate the discount rate curve. In practice, multiple techniques exist. The general guidance in IFRS 17 indicates that applying an appropriate estimation technique requires judgement, weighing the principle to use the best information available and adjusting for information about market participant assumptions. This will require establishing a robust estimation process for discount rates, including related controls for determining the inputs to discount rates based on the conditions at the reporting date.
- ▶ Curves used for regulatory purposes may be a starting point to determine the discount rate curve (or components of that curve) for use under IFRS 17. However, an entity would have to decide if, or to what extent, such an estimate would be consistent with the requirements in IFRS 17 and make any adjustments necessary. In going through this process, entities should be aware of the reference in IFRS 17 to the requirements in IFRS 13 on the consideration of observable market prices and the use of estimation techniques.

## 9.4. Risk adjustment for non-financial risks

The third element of measuring fulfilment cash flows in the general model (see section 8) is a risk adjustment for non-financial risk.

The risk adjustment for non-financial risk is the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk.<sup>270</sup> Non-financial risk is risk arising from insurance contracts other than financial risk, which is included in the estimates of future cash flows or the discount rate used to adjust the cash flows. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk.<sup>271</sup>

In theory, the risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make it indifferent between:<sup>272</sup>

- ▶ Fulfilling a liability that has a range of possible outcomes arising from non-financial risk

And

- ▶ Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts

In developing the objective of the risk adjustment for non-financial risk, the Board concluded that a risk adjustment for non-financial risk should not represent:<sup>273</sup>

- ▶ The compensation that a market participant would require for bearing the non-financial risk that is associated with the contract. This is because the measurement model is not intended to measure the current exit value or fair value, which reflects the transfer of the liability to a market participant. Consequently, the risk adjustment for non-financial risk should be determined as the amount of compensation that the entity, not a market participant, would require
- ▶ An amount that would provide a high degree of certainty that the entity would be able to fulfil the contract. Although such an amount might be appropriate for some regulatory purposes, it is not compatible with the Board's objective of providing information that will help users of financial statements make decisions about providing resources to the entity

The risk adjustment for non-financial risk reflects the entity's perception of the economic burden of its non-financial risks; it is not a current exit value or fair value, which reflects the transfer to a market participant.<sup>274</sup> Therefore, the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount

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<sup>270</sup> IFRS 17.37.

<sup>271</sup> IFRS 17.B86.

<sup>272</sup> IFRS 17.B87.

<sup>273</sup> IFRS 17.BC209.

<sup>274</sup> IFRS 17.BC209.

and timing of the cash flows, the risk adjustment for non-financial risk also reflects:<sup>275</sup>

- ▶ The degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk
- ▶ Both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion

The purpose of the risk adjustment for non-financial risk is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk. Consequently, the risk adjustment for non-financial risk should reflect all non-financial risks associated with the insurance contracts. It should not reflect the risks that do not arise from the insurance contracts, such as general operational risk.<sup>276</sup>

The risk adjustment for non-financial risk should be included in the measurement in an explicit way. The risk adjustment for non-financial risk is conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows. The entity should not double-count the risk adjustment for non-financial risk by, for example, also including the risk adjustment for non-financial risk implicitly when determining the estimates of future cash flows or the discount rates. The yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items which are required to be disclosed (see 16.3 below) should not include any implicit adjustments for non-financial risk.<sup>277</sup>

#### Frequently asked question

**Question 9-15: Does the risk adjustment for non-financial risk take into account uncertainty related to how management will apply discretion? [TRG meeting April 2019 – Agenda paper no. 02, Log S110]**

The IASB staff observed that the risk adjustment for non-financial risk does not reflect risks that do not arise from insurance contracts such as general operational risk. Uncertainty related to how management applies discretion for a group of insurance contracts, if not considered a general operational risk, should be captured in the risk adjustment for non-financial risk (e.g. to the extent management discretion reduces the amount it would charge for uncertainty, the discretion would reduce the risk adjustment for non-financial risk). The risk adjustment for non-financial risk should reflect favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion.

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<sup>275</sup> IFRS 17.B88.

<sup>276</sup> IFRS 17.B89.

<sup>277</sup> IFRS 17.B90.

**Illustration 34 – Risk adjustment for non-financial risk  
[IFRS 17.B87]**

**Compensation an entity requires to be indifferent between fixed and variable outcomes**

The risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that, because of non-financial risk, has a 50% probability of being CU90 and a 50% probability of being CU110, and fulfilling a liability that is fixed at CU100. As a result, the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows.

**9.4.1. Techniques used to estimate the risk adjustment for non-financial risk**

IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. This is because the Board decided that a principle-based approach, rather than identifying specific techniques, would be consistent with its approach on how to determine a similar risk adjustment for non-financial risk in IFRS 13. Furthermore, the Board concluded that limiting the number of risk-adjustment techniques would conflict with its desire to set principles-based IFRSs and, given that the objective of the risk adjustment is to reflect an entity-specific perception of non-financial risk, specifying a level of aggregation that was inconsistent with the entity's view would also conflict with that requirement.<sup>278</sup>

Therefore, the risk adjustment under IFRS 17 should be determined based on the principle of the compensation that an entity requires for bearing the uncertainty arising from non-financial risk inherent in the cash flows arising from the fulfilment of the group of insurance contracts. According to this principle, the risk adjustment for non-financial risk reflects any diversification benefit the entity considers when determining the amount of compensation that it requires for bearing that uncertainty.<sup>279</sup>

IFRS 17 states that risk adjustment for non-financial risk should have the following characteristics:<sup>280</sup>

- ▶ Risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity
- ▶ For similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration
- ▶ Risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution

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<sup>278</sup> IFRS 17.BC213.

<sup>279</sup> IFRS 17.BC214.

<sup>280</sup> IFRS 17.B91.

- ▶ The less that is known about the current estimate and its trend, the higher the risk adjustment will be for non-financial risk
- ▶ To the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa

An entity should apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity should also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities.<sup>281</sup>

It is likely that some entities will want to apply a cost of capital approach technique to estimate the risk adjustment for non-financial risk because this will be the basis of local regulatory capital requirements. It is observed in the Basis for Conclusions that although the usefulness of a confidence level technique diminishes when the probability distribution is not statistically normal, as is often the case for insurance contracts, the cost of capital approach would be more complicated to calculate than a confidence level disclosure. However, the Board expects that many entities will have the information necessary to apply the cost of capital technique.<sup>282</sup> This implies that the Board is anticipating that some, or perhaps many, entities will use a cost of capital technique to measure the risk adjustment for non-financial risk.

When the Board considered feedback from entities implementing IFRS 17, it also considered feedback from users of financial statements that the principles-based requirements for determining the risk adjustment for non-financial risk could limit comparability between entities. The Board made no amendments to IFRS 17 in response to that feedback, for the same reason it made no amendments in response to similar feedback on discount rates (see 9.3 above).<sup>283</sup>

#### Frequently asked question

***Question 9-16: Which level is the risk adjustment for non-financial risk required to be determined: in the individual financial statements of entities that are part of a consolidated group (ie parent and subsidiary entities that issue insurance contracts), and in the consolidated financial statements of the group of entities? [TRG meeting May 2018 - Agenda paper no. 02, Log S46]***

IFRS 17 does not specify the level within an insurance group at which to determine the risk adjustment for non-financial risk. Therefore, the question arises as to whether, in the individual financial statements of a subsidiary, the risk adjustment for non-financial risk should reflect the degree of risk diversification available to the entity or to the consolidated group as a whole and whether, in the consolidated financial statements of a group of entities, the risk adjustment for non-financial risk issued by entities in the group should reflect the degree of risk diversification

<sup>281</sup> IFRS 17.B92.

<sup>282</sup> IFRS 17.BC217.

<sup>283</sup> IFRS 17.BC214A.



### Frequently asked question (cont'd)

available only to the consolidated group as a whole. This issue was discussed by the TRG and the results of the discussion were as follows:

- ▶ In respect of individual financial statements, the degree of risk diversification that occurs at a level higher than the issuing entity level is required to be considered if, and only if it is considered when determining the compensation the issuing entity would require for bearing non-financial risk related to the insurance contracts it issues. Equally, risk diversification that occurs at a level higher than the issuing entity level must not be considered when determining the risk adjustment for non-financial risk if it is not considered when determining the compensation the issuing entity would require for bearing non-financial risk related to the insurance contracts it issues.
- ▶ In respect of consolidated financial statements, the IASB staff opinion is that the risk adjustment for non-financial risk should be the same as the risk adjustment for non-financial risk at the individual entity level because determining the compensation that the entity would require for bearing non-financial risk related to insurance contracts issued by the entity is a single decision that is made by the entity that is party to the contract (i.e., the issuer of the insurance contract). However, differing views were expressed by TRG members. Some TRG members agreed with the IASB staff but other TRG members read the requirements as requiring different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity would require different compensation for bearing non-financial risk than the consolidated group would require. The TRG members also observed that, in some cases, the compensation an entity requires for bearing non-financial risk could be evidenced by capital allocation in a group of entities.

Subsequently, as part of the June 2020 amendments, the Board considered whether it should clarify its intention in respect of determining the risk adjustment for non-financial risk in the consolidated financial statements of a group of entities in response to those different views. The Board concluded that doing so would address only some differences that could arise in the application of the requirements for determining the risk adjustment for non-financial risk, given the high degree of judgement required to apply those requirements. The Board concluded that practice needs to develop in this area. If necessary, the Board will seek to understand how the requirements are being applied as part of the Post-implementation Review of IFRS 17.<sup>284</sup>

***Question 9-17: In the case of insurance contracts issued by an insurance pool, should the risk adjustment for non-financial risk be determined at the association (pool) level, or at the individual member entity level for members sharing in the results of the pool? Could the risk adjustment for non-financial risk be measured differently in the financial statements of the members when compared to the financial statements of the association (pool)? [TRG meeting September 2018 - Agenda paper no. 09, Log S52]***

<sup>284</sup> IFRS 17.BC214C.

### Frequently asked question (cont'd)

In the fact pattern an association manages two industry pools:

- ▶ Pool 1 - in which some members are appointed to issue contracts on behalf of all members
- ▶ Pool 2 - to which members can choose to transfer some insurance contracts they have issued

The IASB staff considered that there should be only one risk adjustment for each insurance contract and that the risk adjustment is either at an individual member level or at an association level, depending on who has issued the contract. Consistent with the discussion in question 9-16 above, some TRG members disagreed with the IASB staff's view that there is one single risk adjustment for a group of insurance contracts that reflects the degree of diversification that the issuer of the contract considers in determining the compensation required for bearing non-financial risk. Those TRG members expressed the view that each entity would consider the compensation it would require for non-financial risk, rather than the compensation required by the association. This would mean that the risk adjustment would not necessarily be determined by the entity that issued the contract (e.g., the pool or individual member of the association that priced the risk). As noted above, the IASB does not propose to amend or clarify IFRS 17 on this matter.

***Question 9-18: Should the effect of reinsurance held be considered in calculating the risk adjustment for non-financial risk for contracts that have been reinsured? [TRG meeting April 2019 - Agenda paper no. 02, Log S118]***

The IASB staff observed that the risk adjustment for non-financial risk reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk. Therefore, if an entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts, the effect of reinsurance (both cost and benefit) would be reflected in the risk adjustment for non-financial risk of the underlying insurance contracts.

The IASB staff further observed that IFRS 17 requires that the risk adjustment for non-financial risk for reinsurance contracts held represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts. Therefore, the risk adjustment for non-financial risk of the reinsurance contract held could not be nil, unless:

- ▶ The entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts
- ▶ The cost of acquiring the reinsurance is equal or less than the expected recoveries

The TRG members agreed with the IASB staff observations that if an entity considers reinsurance when determining the compensation it requires for non-financial risk, the effect of the reinsurance would be included in the risk adjustment and that the measurement of the risk adjustment for non-financial risk of a reinsurance contract held is the amount of risk transferred to the reinsurer.

## How we see it

- ▶ The standard does not prescribe particular techniques for estimating the risk adjustment of a group of contracts. The standard incorporates guidance with the aim to aid entities in selecting an appropriate method.<sup>285</sup> Selecting an appropriate technique will be a matter of judgement. In making this judgement, the entity should consider the specific risk characteristics of the group of insurance contracts under consideration.
- ▶ Changes in the risk adjustment will reflect several factors, for example: release from risk as time passes, changes in an entity's risk appetite (the amount of compensation it requires for bearing uncertainty), changes in expected variability in future cash flows, and diversification between risks. Entities will need to distinguish between changes in the risk adjustment relating to current and past service (reflected immediately in profit or loss) and those relating to future service (which adjust the contractual service margin— see section 9.5).
- ▶ Different entities may determine different risk adjustments for similar groups of insurance contracts because the risk adjustment for non-financial risk is an entity specific perception, rather than a market participant's perception, based on the compensation that a particular entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise from the non-financial risks. Accordingly, to allow users of financial statements to understand how entity-specific assessments of risk aversion might differ from entity to entity, disclosure is required of the confidence level used to determine the risk adjustment for non-financial risk or, if a technique other than confidence level is used, the technique used and the confidence level corresponding to the technique (see 16.3 below).
- ▶ The risk adjustment reflects diversification benefits the entity considers when determining the amount of compensation it requires for bearing that uncertainty. This approach implies that diversification benefits could reflect effects across groups of contracts, or diversification benefits at an even higher level of aggregation. However, when determining the risk adjustment at a level more aggregated than a group of contracts, an entity must establish an appropriate method for allocating the risk adjustment to the underlying groups. This will form part of the requirements for systems and processes that an entity will need to develop when implementing the standard.
- ▶ In addition, since IFRS 17 does not specify the level of aggregation at which to determine the risk adjustment for non-financial risk, the question arises as to whether the risk adjustment for non-financial risk could be negative for a group of insurance contracts. This situation could, in theory, arise where a diversification benefit is allocated between two or more groups of insurance contracts and the additional diversification risk for one group may be negative as the insurer would accept a lower price for taking on these liabilities given that it reduces the risk for the entity in total. IFRS 17 is silent as to whether a risk adjustment could be negative. However, a negative risk adjustment would normally be inappropriate as it would not reflect the purpose of the risk adjustment for non-financial risk which is to measure the effect of uncertainty in the cash flows (see 8.4 above). So, for example, a risk adjustment should not reduce fulfilment cash flows below the best estimate of the expected future cash flows.

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<sup>285</sup> IFRS 17.BC213-214.

#### **9.4.2. *Presentation of the risk adjustment for non-financial risk in the statement of comprehensive income***

The change in risk adjustment for non-financial risk is not required to be disaggregated between the insurance service result and the insurance finance income or expense. When an entity decides not to disaggregate the change in risk adjustment for non-financial risk, the entire change should be included as part of the insurance service result.<sup>286</sup>

When the risk adjustment for non-financial risk is disaggregated between profit or loss and other comprehensive income the method of disaggregation is determined by the disaggregation policy applied to that portfolio (see 15.3.1 below).

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<sup>286</sup> IFRS 17.81.

The contractual service margin is a new concept, introduced in IFRS 17 to identify the expected profitability of a group of contracts and recognise this profitability over time in an explicit manner.

## 9.5. Contractual service margin

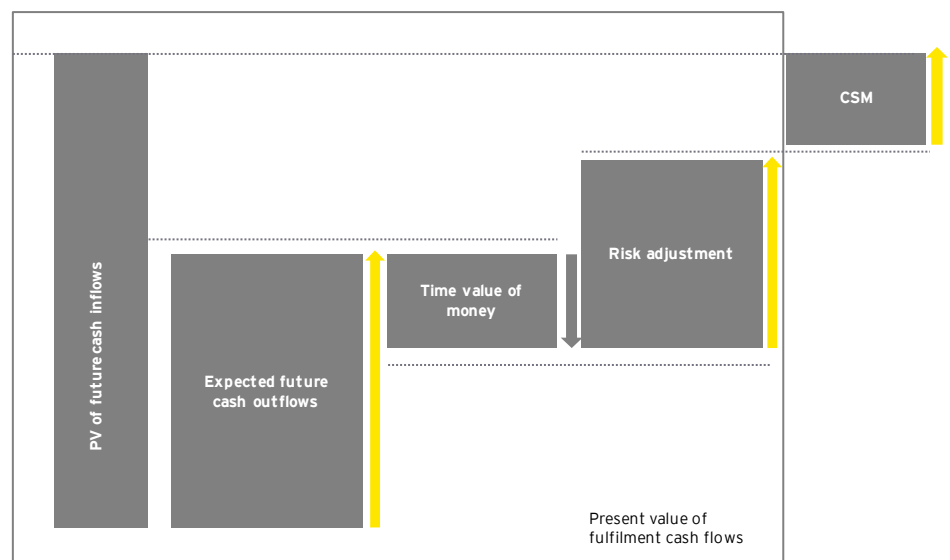
The fourth element of the building blocks in the general model (see section 8) is the contractual service margin. The contractual service margin is a new concept to IFRS, introduced in IFRS 17 to identify the expected profitability of a group of contracts and recognise this profitability over time in an explicit manner, based on the pattern of services provided under the contract.

The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides insurance contract services in the future. Hence, the contractual service margin would usually be calculated at the level of a group of insurance contracts rather than at an individual insurance contract level.

### 9.5.1. Initial recognition

An entity should measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that, unless the group of contracts is onerous (see section 9.8) or where there is insurance revenue and expenses recognised from the derecognition of an asset for other cash flows (see 15.2.1.A below), results in no income or expenses arising from:<sup>287</sup>

- ▶ Initial recognition of an amount for the fulfillment cash flows (see section 9.2)
- ▶ Any cash flows arising from the contracts in the group at that date
- ▶ The derecognition at the date of initial recognition of:
  - ▶ Any asset recognised for insurance acquisition cash flows (see section 7.3); and any other asset or liability previously recognised for cash flows related to the group of contracts.



<sup>287</sup> IFRS 17.38.

For insurance contracts acquired in a transfer of insurance contracts or in a business combination with the scope of IFRS 3, an entity must apply the above in accordance with the requirements for acquisitions of insurance contracts.<sup>288</sup>

Before the recognition of a group of insurance contracts, an entity might be required to recognise an asset or liability for cash flows related to the group of insurance contracts other than insurance acquisition cash flows either because of the occurrence of the cash flows or because of the requirements of another IFRS Standard. Cash flows are related to the group of insurance contracts if those cash flows would have been included in the fulfilment cash flows at the date of initial recognition of the group had they been paid or received after that date. To apply the requirement in the last bullet point above, an entity must derecognise such an asset or liability to the extent that the asset or liability would not be recognised separately from the group of insurance contracts if the cash flow or the application of the IFRS Standard occurred at the date of initial recognition of the group of insurance contracts.<sup>289</sup> For example, an entity that recognised a liability for premiums received in advance of the recognition of a group of insurance contracts would derecognise that liability when the entity recognises a group of insurance contracts to the extent the premiums relate to the contracts in the group. The performance obligation that was depicted by the liability would not be recognised separately from the group of insurance contracts had the premium been received on the date of initial recognition of the group. No insurance revenue arises on the derecognition of the liability.

The approach above on initial recognition applies to contracts with and without participation features, including investment contracts with discretionary participation features.

A contractual margin is not specifically identified for contracts subject to the premium allocation approach although the same principle of profit recognition applies (i.e., no day 1 profits and recognition over the coverage period as insurance contract services are provided) (see 10 below).

For groups of reinsurance contracts held, the calculation of the contractual service margin at initial recognition is modified to take into account the fact such groups are usually assets rather than liabilities and that a margin payable to the reinsurer, rather than making profits, is an implicit part of the premium (see Section 11).

For insurance contracts acquired in a business combination or transfer, the contractual service margin at initial recognition is calculated as the difference between the consideration and the fulfilment cash flows (see section 14).

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<sup>288</sup> IFRS 17.39.

<sup>289</sup> IFRS 17.B66A.

## How we see it

- ▶ As a result of the measurement requirements, the contractual service margin on initial recognition, assuming a contract is not onerous and there is no insurance revenue or expense due to derecognition of another asset, is no more than the balancing number needed to avoid a day 1 profit. The contractual service margin cannot depict unearned losses. Instead, IFRS 17 requires an entity to recognise a loss in profit or loss for onerous groups of contracts (see Section 11).
- ▶ Contracts accounted for under IFRS 17 will be the only type of contracts under IFRS that will explicitly disclose the expected remaining profitability. The notion of the contractual service margin is a unique feature of the standard. The way users will evaluate and appreciate the contractual service margin is expected to be a critical aspect of the decision-usefulness of the IFRS 17 accounting model.

## 9.6. Subsequent measurement

The carrying amount of a group of insurance contracts at the end of each reporting period should be the sum of:<sup>290</sup>

- ▶ The liability for remaining coverage comprising:
  - ▶ The fulfilment cash flows related to future service allocated to the group at that date, measured applying the requirements discussed at 9.2 above – see 9.6.1 below
  - ▶ The contractual service margin of the group at that date, measured applying the requirements discussed at 9.6.3 below
- ▶ The liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying the requirements discussed at 9.2 above – see 9.6.2 below.

Hence, after initial recognition, the fulfilment cash flows comprise two components:

- ▶ Those relating to future service (the liability for remaining coverage)
- ▶ Those relating to past service (the liability for incurred claims)

### Frequently asked question

**Question 9-19: How should the insured event and coverage period be defined for disability insurance contracts? [TRG meeting September 2018 – Agenda paper no. 01, Log S63]**

In some circumstances an incurred claim can create insurance risk for an entity that would not exist if no claim was made. Two examples cited of this situation are:

- ▶ Insurance coverage for disability that provides an annuity for the period when a policyholder is disabled

<sup>290</sup> IFRS 17.40.

### Frequently asked question (cont'd)

- ▶ Insurance coverage for fire that provides compensation for the cost of rebuilding a house after a fire.

The question, therefore, arises whether the entity's obligation to pay these amounts, that are subject to insurance risk, should be treated as a liability for incurred claims or a liability for remaining coverage. One view is that the liability for incurred claims is the entity's obligation to pay for a policyholder's claim (on becoming disabled or upon a fire occurring). The alternative view is that the liability for incurred claims is the policyholder's obligation to settle a claim that has already been made by a policyholder (for a period of disability or to pay for the cost of the house damaged by fire) and the liability for remaining coverage is the obligation to pay claims relating to future events that have not yet occurred (such as future periods of disability or claims relating to fire events that have not occurred).

The TRG members discussed an IASB staff paper which argued that both approaches represent valid interpretations of IFRS 17 and are a matter of judgement for the entity as to which interpretation provides the most useful information about the service provided to the policyholder.

The TRG members observed that:

- ▶ The classification of an obligation as a liability for incurred claims or a liability for remaining coverage does not affect the determination of fulfilment cash flows. However, the classification does affect the determination of the coverage period. Consequently, the classification affects whether some changes in fulfilment cash flows adjust the contractual service margin, as well as the allocation of the contractual service margin
- ▶ The definitions in IFRS 17 allow an entity to use judgement when determining whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of the liability for remaining coverage or liability for incurred claims
- ▶ It is a matter of judgement for an entity to develop an accounting policy that reflects the insurance service provided by the entity to the policyholder under the contract in accordance with IFRS 17. The requirements of IAS 8 apply and hence the entity should apply an approach consistently for similar transactions and over time
- ▶ Whatever approach an entity applies, IFRS 17 requires disclosure of significant judgements made in applying the standard and requires disclosures relating to the contractual service margin, which will enable users to understand the effects of the approach required
- ▶ These observations are also relevant when law or regulation impose a requirement for an entity to settle a claim by life-contingent annuity

Although leaving the decision open to the entity allows preparers to determine which approach provides more useful information given the facts and circumstances around their products, the accounting policy choice may result in identical contracts being accounted for differently in the financial statements of different insurers.



### 9.6.1. *The liability for remaining coverage*

IFRS 17, as amended in June 2020, states that the liability for remaining coverage is an entity's obligation to:<sup>291</sup>

- ▶ Investigate and pay valid claims for insured events that have not yet occurred (i.e., the obligation that relates to the unexpired portion of the insurance coverage)
  - ▶ Pay amounts under existing contracts that are not included above and that relate to:
    - ▶ Insurance contract services not yet provided (i.e., the obligations that relate to future provision of insurance contract services)
- Or
- ▶ Any investment components or other amounts that are not related to the provision of insurance contract services and that have not been transferred to the liability for incurred claims

At initial recognition, the liability for remaining coverage includes all remaining cash inflows and outflows under an insurance contract. Subsequently, at each reporting date, the liability for remaining coverage, excluding the contractual service margin, is re-measured using the fulfilment cash flow requirements discussed at 9.2 above. That is, it comprises the present value of the best estimate of the cash flows required to settle the obligation together with an adjustment for non-financial risk. The fulfilment cash flows for the liability for remaining coverage for contracts without direct participation features are discounted at the date of initial recognition of the group (under both the general model and the premium allocation approach where applicable) (see 9.3 above).

An entity should recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:<sup>292</sup>

- ▶ Insurance revenue - for the reduction in the liability for remaining coverage because of services provided in the period (see 15.2.1 below for measurement)
- ▶ Insurance service expenses - for losses on groups of onerous contracts, and reversals of such losses (see 9.8 below)
- ▶ Insurance finance income or expenses - for the effect of the time value of money and the effect of financial risk (see 15.3 below)

### 9.6.2. *The liability for incurred claims*

IFRS 17, as amended in 2020, states that the liability for incurred claims is an entity's obligation to:<sup>293</sup>

- ▶ Investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses

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<sup>291</sup> IFRS 17 Appendix A.

<sup>292</sup> IFRS 17.41.

<sup>293</sup> IFRS 17 Appendix A.

- ▶ Pay amounts that are not included above and that relate to:
  - ▶ Insurance contract services that have already been provided
 Or
  - ▶ Any investment components or other amounts that are not related to the provision of insurance contract services and that are not in the liability for remaining coverage

At initial recognition of a group of contracts, the liability for incurred claims is usually nil as no insured events covered under the contracts have occurred. Subsequently, at each reporting date, the liability for incurred claims is measured using the fulfilment cash flow requirements discussed at 9.2 and 9.4 above. That is, it comprises the present value of the expected cash flows required to settle the obligation together with an adjustment for non-financial risk. This includes unpaid incurred cash flows allocated to the group of contracts (including expenses) as discussed at 9.2.3 above.

The liability for incurred claims under the general model, including claims arising from contracts with direct participation features, is discounted at a current rate (i.e., the rate applying as at the reporting date). The liability for incurred claims under the premium allocation approach need not be discounted if certain conditions are met (see 10.5 below). Otherwise, the liability for incurred claims under the premium allocation approach is also discounted at a current rate.

There is no direct relationship between the liability for incurred claims and the liability for remaining coverage. That is, the creation of a liability for incurred claims (or a reduction in the value of incurred claims) does not necessarily result in an equal and opposite reduction to the liability for remaining coverage. There is no contractual service margin attributable to the liability for incurred claims as the contractual service margin relates to remaining (i.e., future) service provided over the coverage period and incurred claims relate to past service.

Consequently, the establishment of a liability for incurred claims should give rise to the following accounting entry:

|  | CU | CU |
|--|----|----|
| Dr. Insurance service expense - profit or loss | X  |    |
| Cr. Liability for incurred claims              |    | X  |

Subsequent to initial recognition, an entity should recognise income and expenses for the following changes in the carrying amount of the liability for incurred claims:<sup>294</sup>

- ▶ Insurance service expenses - for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components (see 15.2.2 below)

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<sup>294</sup> IFRS 17.42.

- ▶ Insurance service expenses - for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses (see 15.2.2 below)
- ▶ Insurance finance income or expenses - for the effect of the time value of money and the effect of financial risk (see 15.3 below)

Disclosure of the liability for incurred claims is required showing the development of actual claims compared with previous estimates of the liability for incurred claims, except for those claims for which uncertainty about the amount and timing of payments is typically resolved within one year (see 16.5.3 below).

### How we see it

- ▶ Usually, the fulfilment cash flows should reduce over the contract period as the insurance contract services still to be provided decline. When future insurance contract services can no longer occur, then the fulfilment cash flows of the liability for remaining coverage should be nil.
- ▶ An exception to this guideline may occur where premiums for past service remain outstanding at a reporting date. In this case, even though all insurance contract services have been provided, the liability for remaining coverage could still reflect a balance for the premiums receivable.
- ▶ IFRS 17 does not distinguish between or require separate disclosure of the components of the liability for incurred claims which represent claims notified to the insurer (sometimes described as 'outstanding claims') and claims incurred but not reported (sometimes described as 'IBNR claims'). IFRS 17 also does not distinguish between, or require, separate disclosure of those components of the liability for incurred claims that represent the entity's liability for expected payments to the policyholder and those that represent an allocation of expenses.

### 9.6.3. *Subsequent measurement of the contractual service margin (for insurance contracts without direct participation features)*

The contractual service margin at the end of the reporting period represents the profit in the group of insurance contracts that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.<sup>295</sup>

At the end of each reporting period, the carrying amount of the contractual service margin of a group of insurance contracts without direct participation features comprises the carrying amount at the start of the reporting period adjusted for:<sup>296</sup>

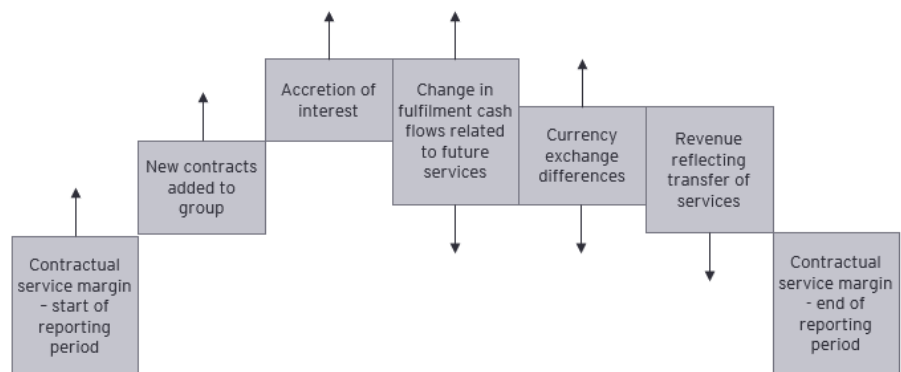
- ▶ The effect of any new contracts added to the group (see 7 above);

The adjustment of the contractual service margin results in spreading the effects of changes in estimates of future cash flows over time.

<sup>295</sup> IFRS 17.43.

<sup>296</sup> IFRS 17.44.

- ▶ interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates at initial recognition (see 9.8.3 above)
- ▶ The changes in fulfilment cash flows relating to future service (see below), except to the extent that:
  - ▶ Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see 9.8 below)
  - Or
  - ▶ Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage (see 9.8 below)
- ▶ The effect of any currency exchange differences (see 8.3 above) on the contractual service margin
- ▶ The amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period (see 9.7 below)



The changes in fulfilment cash flows that relate to future events which adjust the contractual service margin for a group of insurance contracts without direct participation features are, as follows:<sup>297</sup>

- ▶ Experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates applying at the date of initial recognition
- ▶ Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (except those changes described in paragraph B97, see below) measured at the discount rates applying at the date of initial recognition
- ▶ Differences between any investment component expected to become payable or repayable in the period and the actual investment component or loan to a policyholder that becomes payable or repayable in the period

<sup>297</sup> IFRS 17.B96.

Those differences are determined by comparing (i) the actual investment component that becomes payable in the period with (ii) the payment in the period that was expected at the start of the period plus an insurance finance income or expense related to that expected payment before it becomes payable

- ▶ Differences between any loan to a policyholder expected to become repayable in the period and the actual loan to a policyholder that becomes repayable in the period. Those differences are determined by comparing the actual loan to a policyholder that becomes repayable in a period with the repayment in the period that was expected at the start of the period plus an insurance finance income or expense related to that expected repayment before it becomes repayable
- ▶ Changes in the risk adjustment for non-financial risk that relate to future service. An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between a change related to non-financial risk and the effect of the time value of money and changes in the time value of money. If an entity makes such a disaggregation, it should adjust the contractual service margin for the change related to non-financial risk, measured at the discount rates applying at the date of initial recognition

The June 2020 amendments to IFRS 17 made several alterations including:

- ▶ Clarifying that the contractual service margin is not adjusted for insurance finance income or expenses related to expected payments on any investment component before it becomes payable
- ▶ Clarifying that the contractual service margin is also adjusted for differences between actual and expected payments relating to loans to a policyholder and that any insurance finance income or expense relating to either such policyholder loans or investment components does not affect the contractual service margin
- ▶ Addressing the treatment of changes in the risk adjustment for non-financial risk in respect of the time value of money and financial risk if they are disaggregated. IFRS 17 allows, but does not require, an entity to disaggregate changes in the risk adjustment for non-financial risk into those caused by the time value of money and those caused by changes in non-financial risk (see 9.4.2 above)

In February 2018, the IASB staff responded to a submission made to the TRG asking whether the adjustment of the contractual service margin for a difference in the investment component as a result of the acceleration or delay of repayment was appropriate since the contractual service margin is adjusted for changes solely in timing of payments which appears to conflict with the principle underlying insurance revenue recognition by referring to the Board's reasons for this treatment. The Board did not regard as useful information, for example, the recognition of a gain for a delay in repaying an investment component accompanied by a loss that adjusts the contractual service margin for the expected later repayment. Acceleration or delay in repayments of investment components only gives rise to a gain or loss for the entity to the extent that the amount of the repayment is affected by its timing. As IFRS 17 does not require an entity to determine the amount of an investment

component until a claim is incurred, accordingly, when a claim is incurred, IFRS 17 requires an entity to determine how much of that claim is an investment component, and whether it was expected to become payable in that period. IFRS 17 requires any unexpected repayment of an investment component to adjust the contractual service margin. The contractual service margin will also be adjusted for changes in future estimates of cash flows which will include (but not separately identify) the reduction in future repayments of investment components. This achieves the desired result of the net effect on the contractual service margin being the effect of the change in timing of the repayment of the investment component.<sup>298</sup> However, the Board did amend IFRS 17 to specify that the adjustment of the contractual service margin for a difference in the investment component does not apply to insurance finance income or expenses that depict the effect on the investment component of the time value of money and financial risk between the beginning of the period and the unexpected payment or non-payment of the investment component.<sup>299</sup>

The contractual service margin for contracts without direct participation features should not be adjusted for the following changes in fulfilment cash flows because they do not relate to future service:<sup>300</sup>

- ▶ The effect of the time value of money and changes in the time value of money, and the effect of financial risk and changes in financial risk. These effects comprise:
  - ▶ The effect, if any, on estimated future cash flows
  - ▶ The effect, if disaggregated, on the risk adjustment for non-financial risk
  - ▶ The effect of a change in discount rate
- ▶ Changes in estimates of fulfilment cash flows in the liability for incurred claims
- ▶ Experience adjustments, except those described above that relate to future service

IFRS 17 notes that some changes in the contractual service margin offset changes in the fulfilment cash flows for the liability for remaining coverage, resulting in no change in the total carrying amount of the liability for remaining coverage. To the extent that changes in the contractual service margin do not offset changes in the fulfilment cash flows for the liability for remaining coverage, an entity should recognise income and expenses for the changes, applying the requirements at 9.6.1 above.<sup>301</sup>

The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity should specify at inception of the contract the basis on which it expects to determine its

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<sup>298</sup> IFRS 17.BC235.

<sup>299</sup> IFRS 17.BC235fn.

<sup>300</sup> IFRS 17.B97.

<sup>301</sup> IFRS 17.46.

commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.<sup>302</sup>

An entity should use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin).<sup>303</sup>

If an entity cannot specify at inception of the contract what it regards as its commitment under the contract and what it regards as discretionary, it should regard its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk.<sup>304</sup>

### Frequently asked question

***Question 9-20: For insurance contracts without direct participation features, is a difference between the expected and the actual crediting rate applied to a policyholder's account balance included in insurance finance income or expense, or does it adjust the contractual service margin applying paragraph B96(c) of IFRS 17? [TRG meeting September 2018 - Agenda paper no. 11, Log S57]***

The IASB staff observed that paragraph 96 of IFRS 17 is applicable for differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period. However, in the fact pattern provided, the account balance is not expected to become payable in the period and does not become payable in the period and, therefore, the requirement to adjust the contractual service margin does not apply in that period.

***Question 9-21: Do all premium experience adjustments relate to future service and therefore adjust the contractual service margin, or is an entity required to identify whether the experience adjustment relates to current, past, or future service? [TRG meeting September 2018 - Agenda paper no. 11, Log S57]***

The submission asked how differences between expected premiums and actual premiums (i.e., premium experience adjustments) which relate to current or past service should be accounted for (i.e., should these adjust the contractual service margin or be recognised in the statement of profit or loss immediately as part of either insurance revenue or insurance service expenses?).

The TRG members agreed with the analysis in the IASB staff paper and observed that:

- ▶ Applying the general model, experience adjustments arising from premiums received in the period that relate to future services adjust the contractual service margin. Premium adjustments related to current or past service should be recognised immediately in the statement of profit or loss as part of insurance revenue.

<sup>302</sup> IFRS 17.B98.

<sup>303</sup> IFRS 17.B99.

<sup>304</sup> IFRS 17.B100.

### Frequently asked question (cont'd)

- ▶ Although premium experience adjustments are not specifically referenced in paragraph B124 of IFRS 17, the purpose of that paragraph is to demonstrate an alternative analysis of insurance revenue as determined by paragraph B123 of IFRS 17 (see 15.1.1 below). Hence, applying the requirements in IFRS 17 should result in premium experience adjustments relating to current and past service being included in insurance revenue despite the lack of a specific reference in paragraph B124 of IFRS 17.
- ▶ For the premium allocation approach, the requirements for allocating premium adjustments above, apply to expected premium receipts, including premium experience adjustments (see 15.1.2 below).

The TRG members also observed that:

- ▶ Given that an entity is required to disclose an analysis of insurance revenue recognised in the period, an additional line item may be necessary in the reconciliation to reflect the effect of premium experience adjustments on the revenue recognised in the period (see 16.1.1 below).
- ▶ In some circumstances, judgement may be required to determine whether premium experience adjustments relate to future service and therefore adjust the contractual service margin rather than are recognised in the statement of profit or loss.

The June 2020 amendments to IFRS 17 added a specific reference to experience adjustments for premium receipts consistent with the TRG comments. See 15.1.1 below.

### How we see it

- ▶ The requirement to accrete interest on the contractual service margin at historic rates for groups of contracts without direct participation features creates a data challenge for entities because they need to store and accurately apply a potentially large number of locked-in discount rates. Some would prefer to accrete interest on the contractual service margin at current rates to avoid the need to track historic rates. Accreting the contractual service margin at current rates, however, would create theoretical and practical issues and would not ease the data burden for entities that choose to disaggregate insurance finance expense between profit or loss and other comprehensive income.
- ▶ The number of historic discount rates that need to be tracked may be greater for participating contracts without direct participation features. The reason is that the rate applied to adjust the contractual service margin for changes in fulfilment cash flows is more likely to differ from the rate to accrete interest on the contractual service margin as the former should reflect the characteristics of the specific liabilities rather than a risk-free rate.
- ▶ Deciding whether a premium experience adjustment relates to future service, or is part of the coverage in current and past periods, is not



always clear and may require judgement. Premiums tend to be due in advance of the related service. However, this would clearly not be the case with, for example, adjustment premiums in reinsurance contracts that are determined towards or after the end of a coverage period. Attributing expected premium receipts that are overdue to past or future coverage might not be obvious in all situations.

## 9.7. Allocation of the contractual service margin to profit or loss

Determining how to release the contractual service margin to profit or loss is a key aspect of IFRS 17 and one of the key challenges implementing the standard.

The basic principle is that an amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the insurance contract services provided under the group of insurance contracts in that period.

The amount recognised in profit or loss is determined by:<sup>305</sup>

- ▶ Identifying the coverage units in the group. The number of coverage units in a group is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period
- ▶ Allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the insurance contract services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future; and
- ▶ Recognising in profit or loss the amount allocated to coverage units provided in the period

It is observed in the Basis for Conclusions that the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is the defining service provided by insurance contracts and an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, the contractual service margin should be recognised over the coverage period in a pattern that reflects the provision of coverage as required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage provided in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration and quantity of benefits provided by contracts in the group. The Board considered whether:<sup>306</sup>

- ▶ The contractual service margin should be allocated based on the pattern of expected cash flows or on the change in the risk adjustment for non-

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<sup>305</sup> IFRS 17.B119.

<sup>306</sup> IFRS 17.BC279.

financial risk caused by the release of risk. However, the Board decided the pattern of expected cash flows and the release of the risk adjustment for non-financial risk are not relevant factors in determining the satisfaction of the performance obligation of the entity. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of insurance coverage; and

- ▶ The contractual service margin should be allocated before any adjustments made because of changes in fulfilment cash flows that relate to future service. However, the Board concluded that allocating the amount of the contractual service margin adjusted for the most up-to-date assumptions provides the most relevant information about the profit earned from service provided in the period and the profit to be earned in the future from future service.

The Board also considered whether the allocation of the contractual service margin based on coverage units would result in profit being recognised too early for insurance contracts with fees determined based on the returns on underlying items. For such contracts, IFRS 17 requires the contractual service margin to be determined based on the total expected fee over the duration of the contracts, including expectations of an increase in the fee because of an increase in underlying items arising from investment returns and additional policyholder contributions over time. The Board rejected the view that the allocation based on coverage units results in premature profit recognition. The Board noted that the investment component of such contracts is accounted for as part of the insurance contract only when the cash flows from the investment component and from insurance and other services are highly interrelated and hence cannot be accounted for as distinct components. In such circumstances, the entity provides multiple services in return for an expected fee based on the expected duration of contracts, and the Board concluded the entity should recognise that fee over the coverage period as the insurance services are provided, not when the returns on the underlying items occur.<sup>307</sup>

IFRS 17 requires the contractual service margin remaining at the end of the reporting period to be allocated equally to the coverage units provided in the period and the expected remaining coverage units. IFRS 17 does not specify whether an entity should consider the time value of money in determining that equal allocation and consequently does not specify whether that equal allocation should reflect the timing of the expected provision of the coverage units. The Board concluded that should be a matter of judgement by an entity.<sup>308</sup>

Consistent with the requirements in IFRS 15, the settlement of a liability is not considered to be a service provided by the entity. Thus, the recognition period for the contractual service margin is the coverage period over which the entity provides the coverage promised in the insurance contract, rather than the period over which the liability is expected to be settled. The risk margin the entity recognises for bearing risk is recognised in profit or loss as the entity is

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<sup>307</sup> IFRS 17.BC280.

<sup>308</sup> IFRS 17.BC282.

released from risk in both the coverage period and the settlement period. For contracts with a coverage period of one year, this means that the contractual service margin will be released over that one year period (possibly, a single reporting period).<sup>309</sup> For longer-term contracts, with a coverage period lasting many years, an entity will have to use judgement in order to determine an appropriate allocation of the contractual service margin to each reporting period.

### Frequently asked questions

***Question 9-22: How to allocate the contractual service margin to coverage units provided in the current period and expected to be provided in the future applying paragraph B119(b) of IFRS 17. [TRG meeting February 2018 - Agenda paper no. 07, Log S09]***

The IASB staff observed that the contractual service margin is allocated equally to each coverage unit provided in the current period and expected to be provided in the future. Therefore, the allocation is performed at the end of the period, identifying coverage units that were actually provided in the current period and coverage units that are expected at this date to be provided in the future.

***Question 9-23: What is the definition of "quantity of benefits" in paragraph B119(a) of IFRS 17 for use in determining the amortisation pattern of the contractual service margin? [TRG meeting February 2018 and May 2018 - Agenda papers no. 05, Log S01]***

In May 2018, the TRG analysed an IASB staff paper that contained the IASB staff's views on sixteen examples of different types of insurance contracts. The TRG members observed that:

- ▶ IFRS 17 established an objective for CSM coverage units which was to reflect the services provided in a period under a group of insurance contracts. However, it does not establish detailed requirements, and it would not be possible to develop detailed requirements that would apply appropriately to the wide variety of insurance products existing globally.
- ▶ The determination of coverage units is not an accounting policy choice, but involves judgement and estimates to best achieve the principle of reflecting the services provided in each period. Those judgements and estimates should be applied systematically and rationally.
- ▶ The analysis of the examples in the IASB Staff paper depends on the fact patterns in that paper, and would not necessarily apply to other fact patterns. The method that best reflects the services provided in each period would be a matter of judgement based on facts and circumstances.
- ▶ In considering how to achieve the principle, the TRG members observed:
  - ▶ The period in which an entity bears insurance risk is not necessarily the same as the insurance coverage period

<sup>309</sup> IFRS 17.BC283.

## Frequently asked questions (cont'd)

- ▶ Expectations of lapses of contracts are included in the determination of coverage units because they affect the expected duration of the coverage. Consistently, coverage units reflect the likelihood of insured events occurring to the extent that they affect the expected duration of coverage for contracts in the group
- ▶ Because the objective is to reflect the insurance services provided in each period, different levels of service across periods should be reflected in the determination of coverage units
- ▶ Determining the quantity of benefits provided under a contract requires an entity to consider the benefits expected to be received by the policyholder, not the costs of providing those benefits expected to be incurred by the entity
- ▶ A policyholder benefits from the entity standing ready to meet valid claims, not just from making a claim if an insured event occurs. The quantity of benefits provided therefore relates to the amounts that can be claimed by the policyholder
- ▶ Different probabilities of an insured event occurring in different periods do not affect the benefit provided in those periods of the entity standing ready to meet valid claims for that insured event. Different probabilities of different *types* of insured events occurring might affect the benefit provided by the entity standing ready to meet valid claims for the different types of insured events.
- ▶ IFRS 17 does not specify a particular method or methods to determine the quantity of benefits. Different methods may achieve the objective of reflecting the services provided in each period, depending on facts and circumstances.

The TRG members considered that the following methods might achieve the objective if they are reasonable proxies for the services provided under the groups of insurance contracts in each period:

- ▶ A straight-line allocation over the passage of time, but reflecting the number of contracts in a group
- ▶ A method based on the maximum contractual cover in each period
- ▶ A method based on the amount the entity expects the policyholder to be able to validly claim in each period if an insured event occurs
- ▶ Methods based on premiums. However, premiums will not be reasonable proxies when comparing services across periods if they are receivable in different periods to those in which insurance services are provided, or if they reflect different probabilities of claims for the same type of insured event in different periods rather than different levels of service of standing ready to meet claims. Additionally, premiums will not be reasonable proxies when comparing contracts in a group if they reflect different levels of profitability in contracts. The level of profitability in a contract does not affect the services provided by the contract
- ▶ Methods based on expected cash flows. However, methods that result in no allocation of the contractual service margin to periods in which the entity is standing ready to meet valid claims do not meet the objective

The below examples apply the principles above to specific fact patterns for insurance contracts issued without direct participation features. Examples for reinsurance contracts issued and insurance contracts with direct participation features are discussed at 9.9.4 and 12.3.4 below respectively.

#### **Illustration 35 – Credit life loan insurance**

A life insurance policy pays a death benefit equal to the principal and interest outstanding on a loan at the time of death. The balance of the loan will decline because of contractually scheduled payments and cannot be increased.

Applying the principles above the method suggested for determining the quantity of benefits is the cover for the contractual balance outstanding because it is both the maximum contractual cover and the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs.

#### **Illustration 36 – Credit life product with variable amount of cover**

A credit life insurance policy where the amount payable on an insured event varies (for example, claims might relate to an outstanding credit card balance). In these cases, the sum assured will vary over time, rather than simply reducing. In addition, the sum assured may be limited based on the lender's credit limits.

Applying the principles above, the methods suggested for determining the quantity of benefits are either the constant cover of the contractual maximum amount of the credit limit or cover based on the expected credit card balances (i.e. the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs).

#### **Illustration 37 – Mortgage loss cover**

An insurance contract provides cover for five years for default losses on a mortgage, after recovering the value of the property on which the mortgage is secured. The balance of the mortgage will decline because of contractually scheduled payments and cannot be increased.

Applying the principles above, the methods suggested for determining the quantity of benefits are either the maximum contractual cover (the contractual balance of mortgage) or the amount the entity expects the policyholder to be able to make a valid claim for if the insured event occurs (the contractual balance of the mortgage less the expected value of the property).

### Illustration 38 – Product warranty

A five-year warranty coverage insurance contract provides for replacement of a purchased item if it fails to work properly within five years of the date of purchase. Claims are typically skewed toward the end of the coverage period as the purchased item ages.

Applying the principles above, the quantity of benefits is constant over the five year coverage period if the price of replacement product is expected to remain constant. However, if the cost of the replacement product rises over the coverage period (e.g., inflation costs) then the coverage units should include expectations about the cost of replacing the item.

### Illustration 39 – Extended product warranty

Extended warranty policies cover the policyholders after the manufacturer's original warranty has expired. The policies provide new for old cover in the event of a major defect to the covered asset.

Applying the principles above, the expected coverage duration does not start until the manufacturer's original warranty has expired. The policyholder cannot make a valid claim to the entity until then.

### Illustration 40 – Health cover

An insurance contract provides health cover for 10 years for specified types of medical costs up to €1m over the life of the contract, with the expected amount and expected number of claims increasing with age.

Applying the principles above, the expected coverage duration is the 10 year period during which cover is provided, adjusted for any expectations of the limit being reached during the ten years and lapses. For determining the quantity of benefits the following two methods are suggested:

- ▶ Comparing the contractual maximum amount that could have been claimed in the period with the remaining contractual maximum amount that can be claimed as a constant amount for each future coverage period. So, if a claim of €100,000 were made in the first year, at the end of the year the entity would compare €1m coverage provided in the year with coverage of €900,000 for the following nine years, resulting in an allocation of  $1/9.1$  of the contractual service margin for the first year

Or

- ▶ Comparing the maximum amount that could be claimed in the period with the expected maximum amounts that could be claimed in each of the future coverage periods, reflecting the expected reduction in cover because of claims made. This approach involves looking at the probabilities of claims in different periods to determine the expected maximum amounts in future periods. However, in this fact pattern, the probability of claims in one period affects the amount of cover for future periods, thereby affecting the level of service provided in those periods.

### Illustration 41 – Transaction liability

A transaction liability policy will pay claims for financial losses arising as a result of breaches of representations and warranties made in a specified and executed acquisition transaction. The policy period (contract term) is for 10 years from the policy start date. The insurer will pay claims for financial losses reported during the 10-year policy period up to the maximum sum insured.

Applying the principles above the insured event is the discovery of breaches of representations and warranties (consistent with the definition of title insurance - see 3.7 above). Coverage starts at the moment the contract is signed and lasts for 10 years. The IASB staff rejected the view that the coverage period is just one day (i.e., the transaction closing date, which is the date on which the representations and warranties were made).

### Illustration 42 – Combination of different types of cover

This example assumes there are five different contracts (A-E) in a single group of insurance contracts. Each contract has a different combination of four coverages (accidental death, cancer diagnosis, surgery and inpatient treatment). Each contract has a different coverage period. Coverages have a high level of interdependency in the same insurance contract; if a coverage of an insurance contract in the group of insurance contracts lapses, other coverages of the same insurance contract lapse simultaneously. Presented in the table below is the summary of the contracts:

| Contract | Coverage         |                  |              |                     | Coverage period |
|----------|------------------|------------------|--------------|---------------------|-----------------|
|          | Accidental death | Cancer diagnosis | Surgery      | Inpatient treatment |                 |
| A        | Cover of 2000    | Cover of 1000    | Cover of 500 | Cover of 50         | 2 years         |
| B        | N/A              | Cover of 1000    | Cover of 500 | N/A                 | 5 years         |
| C        | N/A              | N/A              | Cover of 500 | Cover of 50         | 2 years         |
| D        | N/A              | N/A              | Cover of 500 | Cover of 50         | 5 years         |
| E        | Cover of 2000    | N/A              | N/A          | N/A                 | 10 years        |

#### **Illustration 42 – Combination of different types of cover (cont'd)**

The entity charges the same annual premium amount for each type of cover, and the total annual premium amount for a contract is the sum of the premiums for each type of cover included in the contract.

Applying the principles above the expected coverage duration is the period in which cover is provided, adjusted for expectations of lapses. The quantity of benefits for each contract is the sum of all the levels of cover provided. So, based on the cover set out in the table, the total coverage units for contract A for each year would be CU3,550 (i.e. 2,000 + 1,000 + 500 + 50) and for contract B 1,500 (i.e. 1,000 + 500). Methods which do not reflect the different amounts of cover provided by each contract would not appear to be valid. A method based on annual premiums may be valid depending on the factors mentioned in the TRG analysis above.

In this example, in all scenarios the coverage period is the same for all coverage components so the probability of the insured event does not affect the coverage period and can be ignored. If the coverage period for the various covers is different, then the probability of the insured event becomes relevant as some coverage components will expire before other coverage components.

#### **Illustration 43 – Life contingent annuity**

A life contingent pay out annuity pays a fixed monthly amount of €10 each period until the annuitant dies.

Applying the principles above the expected coverage duration is the probability weighted average expected duration of the contract. The expected coverage duration is reassessed in each period. The quantity of benefits is the fixed monthly amount of €10. An approach that does not reassess the expected coverage period would appear to be inconsistent with the current measurement principle of IFRS 17.

The IASB staff rejected the view that there is a constant level of benefits provided over the life of the annuitant and that the contractual service margin should be amortised straight line over the remaining expected life of the annuitant (i.e. the quantity of benefits is €10 per year and the coverage period is the length of time until there will no longer be any payments made to the policyholder which is estimated at 40 years) because it does not reflect the expected duration of the contract. The IASB staff also rejected the view that the contract is a series of individual promises to pay a fixed amount at a future point in time if the annuitant is still alive at that point in time because it requires an entity to split a contract into multiple individual contracts and also does not appear to require reassessment of the expected coverage duration.



#### **Illustration 44 – Forward purchase of fixed rate annuity**

A forward contract to buy an annuity in the future at a fixed rate. The premium is payable when the annuity is bought. If the policyholder dies, or cancels the contract, before the date the annuity can be purchased, the policyholder receives no benefit.

Applying the principles above the entity bears insurance risk from the date the forward contract is issued, but the coverage period does not start until the date the annuity starts (as a claim cannot be made before that date). The insured event is that the policyholder lives long enough (i.e. survives) to receive payments under the annuity.

#### **How we see it**

- ▶ The standard is silent on whether an entity should allocate the contractual service margin to profit or loss using coverage units that reflect the time value of money. In our view, both methods (i.e., considering time value of money and not considering it) are acceptable, but an entity must apply the method consistently as an accounting policy choice.
- ▶ Following the TRG discussion referred to above, we expect practitioners will have to apply judgement based on the specific product characteristics in determining the quantity of benefits underlying coverage units in a way that best depicts the provision of insurance contract services over the coverage period of the group of contracts.

#### **9.7.1. *Allocating the contractual service margin on the basis of coverage units determined by considering both insurance coverage and any investment return service***

IFRS 17, as amended in June 2020, defines insurance contract services as the following services that an entity provides to the policyholder of an insurance contract:<sup>310</sup>

- ▶ Coverage for an insured event (insurance coverage);
- ▶ For insurance contracts without direct participation features, the generation of an investment return for the policyholder, if applicable (investment-return service); and
- ▶ For insurance contracts with direct participation features, the management of underlying items on behalf of the policyholder (investment-related service).

As the contractual service margin is recognised in profit or loss to reflect the provision of insurance contract services, this means that the period over which the contractual service margin is amortised includes both the period in which the entity provides insurance contract services and the period over which it provides an investment-return service (for insurance contracts without direct participation features) or an investment-related service (for insurance contracts

<sup>310</sup> IFRS 17 Appendix A.

with direct participation features). The coverage period of insurance contracts with direct participation features is discussed at 12.3.4 below.

In IFRS 17, as issued in 2017, the coverage period of an insurance contract without direct participation features included only the period in which an entity provided insurance contract services and did not include the period in which an entity provided investment return-services. In May 2018, most TRG members disagreed that insurance contracts under the general model should be treated as providing only insurance services. Stakeholders also expressed concerns that contracts which provide insurance coverage that ends significantly before the investment-return service ended would result in 'front-end' revenue recognition and deferred annuity contracts with an account balance accumulating in the period before the annuity payments start could result in 'back-end' revenue recognition if insurance coverage is provided only during the annuity periods. As a result, the Board was persuaded that some insurance contracts outside the scope of the variable fee approach (i.e., those that do not contain direct participation features) provide an investment-return service and that recognising the contractual service margin considering both insurance coverage and an investment-return service will provide useful information to users of the financial statements.<sup>311</sup>

Insurance contracts without direct participation features may provide an investment-return service if, and only if:<sup>312</sup>

- ▶ An investment component exists or the policyholder has a right to withdraw an amount
- ▶ The entity expects the investment component, or amount the policyholder has a right to withdraw, to include an investment return (an investment return could be below zero, for example in a negative interest rate environment)
- ▶ The entity expects to perform investment activity to generate that investment return

In this context, a 'right to withdraw an amount from the entity' includes a policyholder's right to:<sup>313</sup>

- ▶ Receive a surrender value or refund of premiums on cancellation of a policy

Or

- ▶ Transfer an amount to another insurance provider

The Board admits that specifying conditions for an investment-return service creates the risk that an appropriate outcome may not be achieved in all scenarios (for example, entities might also conclude that an investment-return service exists in circumstances in which the Board would conclude otherwise such as when an entity provides only custodial services relating to an investment component). Balancing those potential risks, the Board decided to specify conditions that are necessary to identify, but not determinative of, the existence of an investment-return service. An entity is required to apply

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<sup>311</sup> IFRS 17.BC283B.

<sup>312</sup> IFRS 17.B119B.

<sup>313</sup> IFRS 17.BC283C.

judgement, considering the facts and circumstances, to determine whether an insurance contract meets the conditions to provide an investment-return service.<sup>314</sup>

For the purpose of amortising the contractual service margin, the period of investment-return service ends at or before the date that all amounts due to current policyholders relating to those services have been paid, without considering payments to future policyholders included in the fulfilment cash flows as a result of mutualisation (see 12.1 below).<sup>315</sup>

#### Illustration 45 – Forward purchase of fixed rate annuity

An insurance contract matures in year 10 and pays the customer the account value at maturity. The contract also includes a death benefit that varies depending on which year in the 10-year period the death occurs. Specifically, if the customer dies in years 1-5, the customer's beneficiary would receive a death benefit that is the higher of 110% of the premium paid or the accumulated account value (assume that the death benefit for years 1-5 results in significant insurance risk). However, if the customer dies in years 6-10 the customer's beneficiary receives only the account value. There is no surrender penalty.

Does the insurer only have to consider years 1-5 for determining the coverage units to determine the amortisation of the contractual service margin? Or does the insurer need to consider all 10 years for determining coverage units and amortisation of the contractual service margin?

Based on IFRS 17, as amended in June 2020, the coverage units should be determined reflecting the benefits to the policyholder during the period of both the insurance coverage and the investment return services (i.e., 10 years). Under IFRS 17 as issued in 2017, the insurer would only consider years 1-5 for determining the coverage units since that is the period of the insurance benefits.

Recognition of profit considering both insurance coverage and investment-return service

| Year                              | 1                         | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|-----------------------------------|---------------------------|---|---|---|---|---|---|---|---|----|
| IFRS 17 (as amended in June 2020) | Insurance coverage        |   |   |   |   |   |   |   |   |    |
|                                   | Investment-return service |   |   |   |   |   |   |   |   |    |
|                                   | Recognition of profit     |   |   |   |   |   |   |   |   |    |

Recognition of profit considering insurance coverage only

| Year                           | 1                     | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|--------------------------------|-----------------------|---|---|---|---|---|---|---|---|----|
| IFRS 17 (as originally issued) | Insurance coverage    |   |   |   |   |   |   |   |   |    |
|                                | Investment component  |   |   |   |   |   |   |   |   |    |
|                                | Recognition of profit |   |   |   |   |   |   |   |   |    |

<sup>314</sup> IFRS 17.BC283D-E.

<sup>315</sup> IFRS 17.B119A.

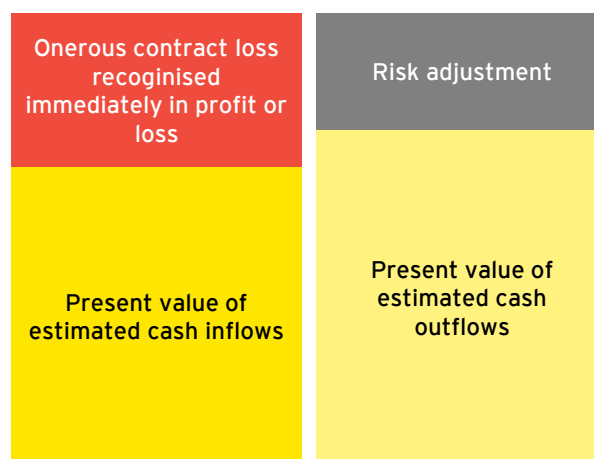
**Illustration 46 – Deferred annuity contract without an investment component which provides an investment-return service**

A deferred annuity contract is a contract under which premiums are paid up-front. The premiums earn a return during the accumulation phase and the accumulated amount can be converted into an annuity at a fixed conversion rate at a future date. The accumulation phase could be a substantial number of years. During the accumulation phase the policyholder has the right to transfer the accumulated amount to another annuity provider or to receive the accumulated amount if (s)he dies. After conversion into an annuity, there is no period of guaranteed payments, i.e., if the policyholder dies after conversion, but before the first annuity payment the policyholder receives nothing. Hence, the contract does not have an investment component. However, although there is no investment component, the policyholder has the right during the accumulation phase to withdraw an amount from the entity that includes an investment return. (An investment-return service only exists if the contract includes an investment component or if the policyholder has a right to withdraw an amount from the entity.)

## 9.8. Onerous contracts

The onerous contract test is performed at the level of the IFRS 17 group (as described in section 4). Under existing IFRS 4 reporting, entities apply liability adequacy tests at an aggregation level determined by previously grandfathered accounting policies. IFRS 17 is likely to require a more granular assessment.

An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, including any previously recognised insurance acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.



As discussed at 8 above, a loss must be recognised on initial recognition of a group of insurance contracts if that group is onerous. As discussed at 6.2 above, an entity should group such contracts in a portfolio separately from contracts that are not onerous.

When a group of insurance contracts are onerous, an entity should recognise a loss component and book the corresponding loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for remaining coverage of the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.<sup>316</sup>

Subsequent to initial recognition, a group of insurance contracts becomes onerous (or more onerous) if the following amounts exceed the carrying amount of the contractual service margin:<sup>317</sup>

- ▶ Unfavourable changes relating to future service in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows and the risk adjustment for non-financial risk
- ▶ For a group of insurance contracts with direct participation features, the decrease in the amount of the entity's share of the fair value of the underlying items

An entity should recognise a loss in profit or loss to the extent of that excess.

For losses under onerous groups of insurance contracts recognised either on initial recognition or subsequently, an entity should establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised. A 'loss component' means a notional record of the losses attributable to each group of onerous insurance contracts. The liability for the expected loss is contained within the liability for remaining

<sup>316</sup> IFRS 17.47.

<sup>317</sup> IFRS 17.48.

coverage for the onerous group (as it is within the fulfilment cash flows). Keeping a record of the loss component of the liability for remaining coverage is necessary in order to account for subsequent reversals, if any, of the onerous group and any loss component is required to be separately disclosed (see 16.1.1 below). The loss component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue and, instead, credited to insurance service expenses.<sup>318</sup>

After an entity has recognised a loss on an onerous group of insurance contracts, it should allocate:<sup>319</sup>

- ▶ The subsequent changes in fulfilment cash flows of the liability for remaining coverage on a systematic basis between:
  - ▶ The loss component of the liability for remaining coverage
  - ▶ The liability for remaining coverage, excluding the loss component
- ▶ Solely to the loss component until that component is reduced to zero:
  - ▶ Any subsequent decrease relating to future service in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows and the risk adjustment for non-financial risk
  - ▶ Any subsequent increases in the amount of the entity's share of the fair value of the underlying items

IFRS 17 does not specify the order in which an entity allocates the fulfilment cash flows in the bullet points above (i.e., whether paragraph 50(a) or 50(b) is applied first).<sup>320</sup>

An entity should adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated are:<sup>321</sup>

- ▶ Estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses
- ▶ Changes in the risk adjustment for non-financial risk recognised in profit or loss because of the release from risk
- ▶ Insurance finance income or expenses

The systematic allocation required above should result in the total amounts allocated to the loss component being equal to zero by the end of the coverage period of a group of contracts (since the loss component will have been realised in the form of incurred claims).<sup>322</sup>

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<sup>318</sup> IFRS 17.49.

<sup>319</sup> IFRS 17.50.

<sup>320</sup> IFRS 17.IE95(c).

<sup>321</sup> IFRS 17.51.

<sup>322</sup> IFRS 17.52

IFRS 17 does not prescribe specific methods to track the loss component. The IASB considered whether to require specific methods but concluded that any such methods would be inherently arbitrary. The IASB, therefore, decided to require an entity to make a systematic allocation of changes in the fulfilment cash flows for the liability for remaining coverage that could be regarded as affecting either the loss component or the rest of the liability.<sup>323</sup>

Changes in the liability for remaining coverage due to insurance finance income or expenses, release from risk, and incurred claims and other insurance service expenses, need to be allocated between the loss component and the remainder of the liability for remaining coverage on a systematic basis. An entity could allocate the effect of these changes to the loss component in proportion to the total liability, although other bases could be appropriate. Whichever approach is adopted, it should be applied consistently. This also implies that insurance finance income or expenses must be allocated to the loss component to reflect the accretion of interest.

Changes in the liability for incurred claims are not allocated to the liability for remaining coverage.

#### **Illustration 47 – Application of the loss component for a group of onerous contracts**

An entity determines that a group of insurance contracts without direct participation features is onerous at initial recognition. On initial recognition, the fulfilment cash flows (disregarding discounting and other adjustments) are a net cash outflow of CU50. Therefore, this is recognised as a loss in profit or loss. There is no contractual service margin. The loss component of the liability for remaining coverage is CU50.

At the entity's next reporting date, it calculates that the fulfilment cash flows for the liability for remaining coverage have decreased by CU60. Applying paragraph 50 of IFRS 17, the entity decides that it will first allocate the subsequent changes in fulfilment cash flows of the liability for remaining coverage in a systematic way between the loss component and the liability for remaining coverage excluding the loss component. The entity then decides to allocate any subsequent decrease relating to future service in the fulfilment cash flows solely to the loss component. As a result, CU40 adjusts the loss component of the liability for remaining coverage by a release (i.e., a credit) to profit or loss. The remaining CU20 reduction does not adjust the loss component of the liability for remaining coverage. Consequently, at the reporting date, the loss component of the liability for remaining coverage is CU10 (i.e., CU50 less CU40).

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<sup>323</sup> IFRS 17.BC287.

## How we see it

- ▶ Tracking the loss component of the liability for remaining coverage for each group of onerous contracts will be a new and complex task, particularly for many life insurers. Most non-life insurers will be familiar with the concept of running off provisions for unearned premiums and unexpired risks, and we expect that tracking a loss component should be easier for short duration contracts. Maintaining the loss component is not equivalent to maintaining a negative contractual service margin because the purpose of the loss component is to separately account for and present the shortfall in the insurance liability and, in contrast to the contractual service margin, is not directly driven by the performance of services under the group of contracts.
- ▶ The standard clearly implies that insurance finance income or expenses should be allocated to the loss component to reflect the accretion of interest. Even though the total liability for remaining coverage is measured using current rate, the standard is not explicit on what discount rate - a current rate or a rate locked-in at inception - should be used for allocating insurance finance income or expenses to the loss component. An entity should therefore make an accounting policy choice on this matter that is applied consistently for contracts accounted for under the general model.
- ▶ When the entity applies a current rate for allocating insurance finance income or expenses to the loss component, it should also determine an accounting policy on whether it records the remeasurement of the loss component in profit or loss at the current rate, or whether it disaggregates this effect between insurance service result and insurance finance income or expense using the locked-in rate determined at inception. It should apply this accounting policy consistently to contracts accounted for under the general model, see 15.2.1.A below.
- ▶ Note that for contracts with direct participation features, the loss component should be determined at the current rate, consistent with the measurement model, with the resulting effects included in insurance service result, see 12.3.3 and 15.3 below.

## 9.9. Reinsurance contracts issued

A reinsurance contract is a contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).<sup>324</sup>

The requirements for recognition and measurement of reinsurance contracts issued are the same as for insurance contracts. This means that the issuer should make an estimate of the fulfilment cash flows including estimates of expected future cash flows. At initial recognition (and at each reporting date) this will include estimates of future cash flows arising from underlying insurance contracts expected to be issued by the reinsured entity (and covered by the issued reinsurance contract) that are within the contract boundary of the

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<sup>324</sup> IFRS 17 Appendix A.



reinsurance contract. This is because the issuer of the reinsurance contract has a substantive obligation to provide insurance cover (i.e. services) for those unissued policies. However, the unit of account for measurement is the reinsurance contract rather than the underlying individual direct contracts.

### **9.9.1. *The contract boundary of a reinsurance contract issued***

The terms and conditions of reinsurance contracts create specific application questions as to the contract boundary. This section discusses the application to reinsurance contracts issued; for the general principles see 9.1 above. For the matters that relate more specifically to reinsurance contracts held, see 11.2 below.

#### **Frequently asked questions**

***Question 9-24: What is the contract boundary of a reinsurance contract that contains a break clause? [TRG meeting February 2018 - Agenda paper no. 02, Log S22]***

Some reinsurance contracts issued may contain break clauses which allow either party to cancel the contract at any time following a specified notice period. TRG members observed that, in an example of a reinsurance contract where the reinsurer can terminate coverage at any time with a three-month notice period, the initial contract boundary for the issuer of the reinsurance contract would exclude cash flows related to underlying insurance premiums outside of that three-month notice period.

***Question 9-25: From the perspective of the cedant, is there is an expectation of a symmetrical treatment of the contract boundary between the reinsurer and the cedant for the examples discussed at the May 2018 meeting for reinsurance held? [TRG meeting September 2018 - Agenda paper no. 11, Log S75]***

This example is similar to the example discussed at the May 2018 TRG meeting. See Questions 13-3 and 13-4 below. The May 2018 example was from the perspective of the cedant. The September 2018 example is from the perspective of the reinsurer. The contract boundary is the same from each perspective because:

- ▶ When the cedant has a right to receive services, the reinsurer has an obligation to provide services
- ▶ When the cedant has an obligation to pay premiums, the reinsurer has a right to compel premiums

The submission to the IASB staff in September 2018 included an additional fact pattern in which there is (or there is not) a unilateral right for the reinsurer to amend the rate of the ceding commission it pays, in addition to unilateral termination rights. The IASB staff observed that in this fact pattern, the existence of the right to terminate the contract with a three month notice period determines the cash flows within the contract boundary regardless of the existence of a right to amend the rate of the ceding commission if the contract is not terminated. Therefore, the same accounting would apply to the additional fact pattern provided.

### 9.9.2. Issued adverse loss development covers

For reinsurance contracts which cover events that have already occurred, but for which the financial effect is uncertain, IFRS 17 states that the insured event is the determination of the ultimate costs of the claim.<sup>325</sup>

#### Frequently asked questions

**Question 9-26: How should insurance revenue and insurance service expenses be presented for insurance contracts acquired in conjunction with a business combination or similar acquisition in their settlement period. More specifically, whether revenue would reflect the entire expected claims or not? [TRG meeting February 2018 - Agenda paper no. 07, Log S04]**

The IASB staff stated that for insurance contracts that cover events that have already occurred but the financial effect of which is uncertain, the claims are incurred when the financial effect is certain. This is not when an entity has a reliable estimate if there is still uncertainty involved. Conversely this is not necessarily when the claims are paid if certainty has been achieved prior to settlement. Accordingly, insurance revenue would reflect the entire expected claims as the liability for remaining coverage reduces because of services provided. If some cash flows meet the definition of an investment component, those cash flows will not be reflected in insurance revenue or insurance service expenses.

This results in entities accounting differently for similar contracts, depending on whether those contracts are issued originally by the entity or whether the entity acquired those contracts in their settlement period. Assuming a long settlement period, the potential consequences of this distinction include:

- ▶ An entity applies the general model for contracts acquired in their settlement period because the period over which claims would develop is much longer than one year, whilst entities expect to apply the premium allocation approach for similar contracts that they issue
- ▶ An entity recognises revenue for the contracts acquired in their settlement period over the period the claims are expected to develop, while revenue is no longer recognised over this period for similar contracts issued

The TRG members observed that, although the requirements in IFRS 17 are clear, applying the requirements reflects a significant change from existing practice and this change results in implementation complexities and costs.

In May 2018, the IASB staff prepared an outreach report which included implementation concerns regarding the subsequent treatment of insurance contracts issued and acquired in their settlement period. Subsequently, the IASB decided not to change IFRS 17 for this issue, but has amended IFRS 17 to provide transitional relief for these contracts when the modified

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<sup>325</sup> IFRS 17.B5.

### Frequently asked questions (cont'd)

retrospective approach (see 17.4.2 below) or the fair value approach (see 17.5 below) is applied.

This issue is not specific to reinsurance contracts issued, it is also relevant to direct adverse development covers issued.

### How we see it

- ▶ Some reinsurance contracts issued (as well as direct insurance contracts issued) may contain a mixture of both retrospective and prospective coverage. In these circumstances an entity would need to apply judgement as to: (i) the portfolio of contracts to which a contract with such a mixture should be allocated; and (ii) whether the 'mixed' contract could be split into separate retrospective and prospective components, with each component allocated to different portfolios, applying the guidance discussed at 6.1.1. above.

### 9.9.3. *Accounting for ceding commissions and reinstatement premiums*

Reinsurance contracts include common types of commissions due from a reinsurer to a cedant. These include both:

- ▶ Commissions that are not contingent on claims
- ▶ Commissions that are contingent on claims

Questions have arisen how these commissions should be accounted for in the financial statements of the reinsurer.

### Frequently asked questions

***Question 9-27: How should ceding commissions paid by the reinsurer to the cedant be treated in the reinsurer's statement of financial performance? The submission considers whether the treatment is different for fixed commissions and commissions that are not fixed [TRG meeting September 2018 - Agenda paper no. 03, Log S55]***

The submission asked how the following should be accounted for in the financial statements of the reinsurer:

- ▶ Common types of commission due to the cedant
- ▶ Reinstatement premiums charged to the cedant in order to continue coverage following the occurrence of an insured event.

The TRG members discussed the analysis in an IASB staff paper and observed that:

## Frequently asked questions (cont'd)

- ▶ The requirements in paragraph 86 of IFRS 17 for the presentation of income and expenses from reinsurance contracts held are based on the economic effects of exchanges between the reinsurer and the cedant and it would be appropriate to apply an assessment of the economic effect of such exchanges to reinsurance contracts issued as well.
- ▶ The economic effect of amounts exchanged between a reinsurer and a cedant that are not contingent on claims is equivalent to the effect of charging a different premium. Therefore, these amounts would be recognised as part of insurance revenue.
- ▶ The economic effect of amounts exchanged between a reinsurer and a cedant that are contingent on claims is equivalent to reimbursing a different amount of claims than expected. Therefore, these amounts would be recognised as part of insurance service expenses.
- ▶ Unless a cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, a ceding commission is not an insurance acquisition cash flow of the insurer. The IASB staff observed that, unlike insurance acquisition costs that are paid to a third-party intermediary, ceding commissions are paid by the reinsurer to the cedant who is the policyholder of the contract.
- ▶ Amounts exchanged between the reinsurer and the cedant that are not contingent on claims may meet the definition of an investment component if they are repaid to the cedant in all circumstances. However, an amount deducted from the initial premium up-front is not an investment component (although the impact on insurance revenue is the same).

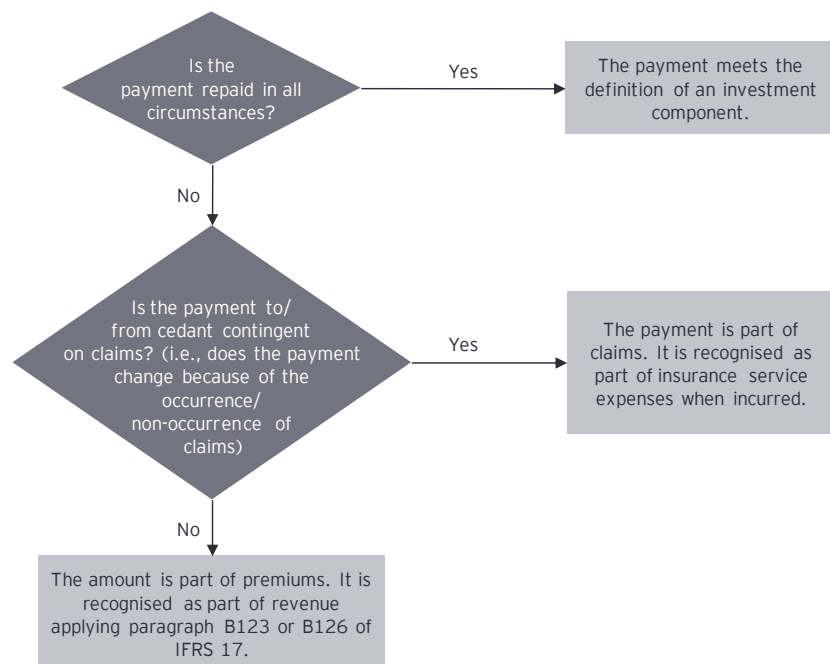
The TRG members observed that applying the requirements in IFRS 17 for amounts exchanged between a reinsurer and a cedant has practical implications because the requirements are different from existing practice. The TRG members also observed that applying the requirements of IFRS 17 may affect key performance measures currently used to assess the performance of reinsurers.

- ▶ Applying the guidance above in practice to the reinsurer:
  - ▶ A ceding commission charged as a fixed amount or as a percentage of premiums on the underlying insurance contracts is a reduction in insurance revenue. If paid after the premium is received, the ceding commission may meet the definition of an investment component, provided the amounts are repaid to the policyholder in all circumstances.
  - ▶ A ceding commission contingent on claims (i.e., excluding any minimum amounts that are, in effect, non-contingent) is part of claims and recognised as part of insurance service expenses.
  - ▶ A mandatory reinstatement premium contingent on a claim amount and settled net with the claims paid to the cedant is equivalent to reimbursing a different amount of claims to the cedant and should be recognised as part of insurance service expenses when incurred.

## Frequently asked questions (cont'd)

- ▶ A voluntary reinstatement premium which is not contingent on claims (i.e. the cedant can decide not to pay the additional premium and the contract terminates) is equivalent to the effect of charging a higher premium to extend the contract coverage to an additional period, or higher level of exposure, and is recognised as insurance revenue. The IASB staff observed that when the reinsurer has no right to exit or reprice the contract (the reinstatement premium is at predetermined rates), the expected cash flows related to the reinstatement premium are within the boundary of the initial reinsurance contract and voluntary reinstatement premiums cannot be considered cash flows related to a future contract.

The following flow chart may assist in the assessment of how to account for exchanges between a reinsurer and a cedant.



## How we see it

- ▶ During the TRG discussions, the IASB staff observed that the requirements for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant. Therefore, the assessment of the economic effect of such exchanges included in the illustration above would apply to both reinsurance contracts issued and reinsurance contracts held.

#### 9.9.4. *Determining the quantity of benefits for identifying coverage units*

As discussed at 9.7.1 above, the question of how to determine the quantity of benefits for coverage units was discussed by the TRG in both February 2018 and May 2018. In May 2018, the TRG analysed an IASB staff paper that contained the IASB staff's views on sixteen examples of different types of insurance contracts.

The following examples apply the principles discussed at 8.7.1 above to specific fact patterns for reinsurance contracts issued.

##### **Illustration 48 – Proportional reinsurance issued**

A reinsurance contract issued provides proportional cover for underlying contracts issued during the contract period. The reinsurance contract issued is for a period of one year. Underlying contracts are written uniformly throughout the year and are annual policies that are reasonably homogenous and provide relatively even cover over their one-year coverage periods.

Applying the principles at 9.7.1 above the expected coverage duration of the reinsurance contract issued is two years. This is because the reinsurer has a substantive obligation to provide services under the contract for a period of two years as the risks attaching over a single policy year will cover two years of exposure to risk. A valid method for determining the quantity of benefits (over which to amortise the CSM) is the amount for which the policyholder has the ability to make a valid claim. This is because the pattern of coverage should reflect the expected pattern of underwriting of the underlying contracts because the level of service provided depends on the number of underlying contracts in-force. Therefore, the more contracts in force, the higher the level of service.

##### **Illustration 49 – Reinsurance adverse development of claims with claim limit**

A reinsurance adverse development cover contract will pay claims in excess of a stated aggregate amount on a group of underlying property and casualty contracts where the claim event has already occurred. There is a total aggregate limit to the amount payable under the contract. Because there is uncertainty in the ultimate amount and timing of the final settlements of the underlying claims, the insured event is the determination of the ultimate cost of settling those claims.

Applying the principles at 9.7.1 above the expected coverage duration would be the period from inception of the contract to the time at which the limit of cover is expected to be reached, adjusted for expected lapses, if any. Valid methods for determining the quantity of benefits (for amortising the CSM) are:

- ▶ Comparing the contractual maximum amount that could have been claimed in the period with the remaining contractual maximum amount that can be claimed as a constant amount for each future coverage period

Or

- ▶ Comparing the expected amount of underlying claims covered in the period with the expected amount of underlying claims remaining to be covered in future periods.

#### **Illustration 49 – Reinsurance adverse development of claims with claim limit (cont'd)**

A straight-line method over the expected coverage duration might not be valid because it would not reflect the different levels of cover provided across periods.

#### **Illustration 50 – Reinsurance adverse development of claims without claim limit**

A reinsurance adverse development cover contract will pay claims in excess of a stated aggregate amount on a group of underlying property and casualty contracts where the claim event has already occurred. There is no total aggregate limit to the amount payable under the contract. Because there is uncertainty in the ultimate amount and timing of the final settlements of the underlying claims, the insured event is the determination of the ultimate cost of settling those claims.

Applying the principles at 9.7.1 above the expected coverage duration would be the period to when the financial effect of the claims becomes certain. This may be before the claims are paid if certainty has been achieved prior to the actual payment. An entity will need to estimate the expected duration of the period in which claims will be made and payments will be made to estimate the fulfilment cash flows. Valid methods for determining the quantity of benefits are:

- ▶ Equal benefits in each coverage period, which would end at the date of the last expected settlement payment
- Or
- ▶ Compare the expected amount of underlying claims covered in the period with the expected amount of underlying claims remaining to be covered in future periods
- Or
- ▶ If the underlying claims were of equal size, comparing the number of underlying claims covered in the period with the number of underlying claims remaining to be covered in future periods

### **9.10. Impairment of assets recognised for insurance acquisition cash flows**

As discussed at 7.3 above, an entity should recognise as an asset insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised under another IFRS Standard) before the related group of insurance contracts is recognised.

As a result, IFRS 17 requires, an entity to assess the recoverability of any insurance acquisition cash flow asset recognised before the related group of insurance contracts is recognised at the end of each reporting period, if facts and circumstances indicate the asset may be impaired. If an entity identifies an impairment loss, the entity should adjust the carrying amount of the asset

and recognise any impairment loss identified in profit and loss. If an impairment loss is reversed, an entity shall adjust the carrying amount of the asset and recognise the reversal of any such loss in profit and loss.<sup>326</sup>

In assessing the recoverability:<sup>327</sup>

- ▶ An entity must recognise that impairment loss in profit or loss and reduce the carrying amount of an asset for insurance acquisition cash flows so that the carrying amount of each asset does not exceed the expected net fulfilment cash inflows (see 9.2 above) for the related group of insurance contracts;
- ▶ When an entity allocates insurance acquisition cash flows to groups of insurance contracts that will include insurance contracts that are expected to arise from renewals of the insurance contracts in that group, the entity must recognise an impairment loss in profit or loss and reduce the carrying amount of the related assets for insurance acquisition cash flows to the extent that:
  - ▶ The entity expects those insurance acquisition cash flows to exceed the net fulfilment cash inflows for the expected renewals
  - ▶ The excess determined in the preceding bullet point has not already been recognised as an impairment loss applying the requirements above for assets directly attributable to a group.

An entity must recognise in profit or loss a reversal of some or all of an impairment loss previously recognised applying the requirements above and increase the carrying amount of the asset, to the extent that the impairment conditions no longer exist or have improved.<sup>328</sup>

It is observed in the Basis for Conclusions that the impairment test is intended to be consistent with the impairment test for capitalised contract costs in IFRS 15 and therefore an entity recognises an impairment loss in profit or loss and reduces the carrying amount of an asset for insurance acquisition cash flows so that it does not exceed the expected net cash inflow for the related group.<sup>329</sup>

The Basis for Conclusions also observes that an asset for insurance acquisition cash flows is measured at a group level. An impairment test at a group level compares the carrying amount of an asset for insurance acquisition cash flows allocated to a group with the expected net cash inflow of the group. That net cash inflow includes cash flows for contracts unrelated to any expected renewals but expected to be in that group. The Board, therefore, decided to require an additional impairment test specific to cash flows for expected renewals. The additional impairment test results in the recognition of any impairment losses when the entity no longer expects the renewals supporting the asset to occur or expects the net cash inflows to be lower than the amount of the asset. Without the additional impairment test, cash flows unrelated to any expected renewals might prevent the recognition of such an impairment loss.<sup>330</sup>

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<sup>326</sup> IFRS 17.28E-F.

<sup>327</sup> IFRS 17.B35D.

<sup>328</sup> IFRS 17.28F.

<sup>329</sup> IFRS 17.BC184J.

<sup>330</sup> IFRS 17.BC184K.



### Illustration 51 – Applying the two impairment tests for an insurance acquisition cash flow asset

At the beginning of Year 1 an entity pays commissions of CU38 relating to a group of contracts yet to be issued. Those commissions meet the definition of insurance acquisition cash flows.

The commissions are directly attributable to insurance contracts the entity expects to issue later in Year 1 (Group 1). The entity expects that some policyholders of those insurance contracts that will be issued in Year 1 will renew those contracts in Year 2 (Group 2), Year 3 (Group 3) and Year 4 (Group 4). Accordingly, at the beginning of Year 1, the entity allocates the commissions of CU38 on a systematic and rational basis to the expected future groups of insurance contracts as follows:

- ▶ Group 1 - CU25
- ▶ Group 2 - CU5
- ▶ Group 3 - CU5
- ▶ Group 4 - CU3

The entity recognises an asset for insurance acquisition cash flows of CU38 at the beginning of Year 1.

At the end of Year 1, the entity derecognises the asset of CU25 allocated to Group 1 and includes the insurance acquisition cash flows in the measurement of Group 1. At the end of Year 1, there are no facts and circumstances indicating that the assets for insurance acquisition cash flows allocated to each of Groups 2 to 4 may be impaired. Therefore, at the end of Year 1, the carrying amount of the asset for insurance acquisition cash flows is CU13 (i.e., CU5 + CU5 + CU3 as per above).

At the end of Year 2, the entity derecognises the asset of CU5 allocated to Group 2 and includes the insurance acquisition cash flows in the measurement of Group 2. At the end of Year 2, facts and circumstances indicate that the asset for insurance acquisition cash flows for Groups 3 and 4 may be impaired. The carrying amount of the asset for insurance acquisition cash flows subject to impairment testing is CU8 (i.e., CU5 + CU3 as per above).

To perform the impairment tests the entity estimates the following amounts:

|  | Year 3<br>(Group 3) | Year 4<br>(Group 4) |
|--|---------------------|---------------------|
|  | CU                  | CU                  |
| Expected net fulfilment cash inflows             |                     |                     |
| Expected renewals                                | 3                   | 1                   |
| Other than renewals (new contracts to be issued) | 6                   | 1                   |
| Total expected net cash inflows                  | 9                   | 2                   |
| Asset for insurance acquisition cash flows       | 5                   | 3                   |
| Impairment                                       | -                   | (1)                 |

### Illustration 51 – Applying the two impairment tests for an insurance acquisition cash flow asset (cont'd)

Applying the additional impairment test specific to insurance acquisition cash flows allocated to expected contract renewals, the entity compares the amount of insurance acquisition cash flows allocated to expected renewals to the total expected net cash inflows for those expected renewals, as follows:

|   | Year 3<br>(Group 3) | Year 4<br>(Group 4) | Total                 |
|---|---------------------|---------------------|-----------------------|
|   | CU                  | CU                  | CU                    |
| Expected net fulfilment cash inflows                                      |                     |                     |                       |
| Amount of insurance acquisition cash flows allocated to expected renewals | 5                   | 3                   | 8                     |
| Expected net cash inflows for expected renewals                           | 3                   | 1                   | 4                     |
| Impairment  | <u>          </u>   | <u>          </u>   | <u>          </u> (4) |

Accordingly, the entity recognises an expense in profit or loss an impairment of CU4 comprising of:<sup>331</sup>

- ▶ CU1 identified applied paragraph B35D(a) of IFRS 17; and
- ▶ CU4 identified applying paragraph B35D(b)(i) of IFRS 17 less CU1 already identified above applying paragraph B35D(ii) of IFRS 17.

After recognising the total impairment loss of CU4, the entity will allocate the total amount of insurance acquisition cash flows remaining in assets of CU4 to groups of contracts still to be recognised (Group 3 and Group 4) on a systematic and rational basis.

### How we see it

- ▶ As discussed at 7.3 and 9.1 above, IFRS 17 does not contain specific requirements for how to allocate the acquisition cash flows to different (future) groups of insurance contracts on a systematic and rational basis. Therefore, determining such an allocation will be a matter of judgement based on facts and circumstances.
- ▶ The standard requires that an entity an entity revises the amounts of the asset for insurance acquisition cash flows allocated to each (future) group of insurance contract according to the applied systematic and rational method. The impairment test for the insurance acquisition cash flows allocated to a (future) group would be applied after carrying through any revised allocation. Such revised allocation may reduce the risk of an impairment of the amount of insurance acquisition cash flows allocated to a particular (future) group, although the entity would have to perform any revisions consistent with the systematic and rational basis for allocation.

<sup>331</sup> IFRS 17.B35D.

## 9.11. Insurance contracts issued by mutual entities

A mutual entity accepts risks from each policyholder and pools those risks. However, a defining feature of a mutual entity is that the most residual interest of the entity is due to a policyholder and not to a shareholder. Thus, the fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there should, in principle, normally be no equity remaining and no net comprehensive income reported in any accounting period.<sup>332</sup> In addition, the Basis for Conclusions clarifies that not all entities that may be described as mutual entities have the feature that the most residual interest of the entity is due to a policyholder.<sup>333</sup>

Payments to policyholders with a residual interest in a mutual entity vary depending on the returns on underlying items - the net asset of the mutual entity. These cash flows (i.e., the payments that vary with the underlying items) are within the boundary of an insurance contract.<sup>334</sup> Although policyholders with a residual interest in the entity bear the pooled risk collectively, the mutual, as a separate entity has accepted risk from each individual policyholder and therefore the risk adjustment for non-financial risk for these contracts reflects the compensation the mutual entity requires for bearing the uncertainty from non-financial risk in those contracts. However, because the net cash flows of the mutual entity are returned to policyholders, applying IFRS 17 to contracts with policyholders with a residual interest in the mutual entity will result in no contractual service margin for those contracts.

Mutual entities may also issue insurance contracts that do not provide the policyholder with a residual interest in the mutual entity. Consequently, groups of such contracts are expected to have a contractual service margin. Determining whether a contract provides the policyholder with a residual interest in the mutual entity requires consideration of all substantive rights and obligations.

The IASB also suggested that to provide useful information about its financial position a mutual can distinguish between:

- ▶ Liabilities attributable to policyholders in their capacity as policyholders
- ▶ Liabilities attributable to policyholders with the most residual interest in the entity

The statement of financial performance could include a line item 'income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the entity'.

The IASB decided not to develop specific guidance for, or defining mutual entities because:<sup>335</sup>

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<sup>332</sup> IFRS 17.BC265.

<sup>333</sup> IFRS 17.BC265FN27.

<sup>334</sup> IFRS 17.B65(c).

<sup>335</sup> IFRS 17.BC269B.

- ▶ A core principle of IFRS 17 is the requirement to include in the fulfilment cash flows all the expected future cash flows that arise within the boundary of insurance contracts, including discretionary cash flows and those due to future policyholders
- ▶ If entities were required to account for the same insurance contract differently depending on the type of entity issuing the contract, comparability among entities would be reduced
- ▶ A robust definition of a mutual entity to which different requirements would apply would be difficult to create

## 9.12. Other matters

### 9.12.1. *Impairment of insurance receivables*

IFRS 17 does not refer to impairment of insurance receivables (e.g., amounts due from policyholders or agents in respect of insurance premiums).

A premium receivable (including premium adjustments and instalment premiums) is a right arising from an insurance (or reinsurance) contract. Rights and obligations under contracts within the scope of IFRS 17 are excluded from the scope of IFRS 9 (see 2.3 above). As a premium receivable is a cash flow it is measured on an expected present value basis (see 9.2 above) which should include an assessment of credit risk. This cash flow is remeasured at each reporting date. Receivables from insurance contracts are not required to be disclosed separately on the statement of financial position but are subsumed within the overall insurance contract balances (see 15 below).

#### How we see it

- ▶ Receivables not arising from insurance contracts (such as those arising from a contractual relationship with an intermediary) are within the scope of IFRS 9. When an insurer uses an intermediary, judgement may be required to determine whether insurance receivables from an intermediary on behalf of a policyholder are within the scope of IFRS 17 or IFRS 9. A similar judgement is necessary for other amounts held by intermediaries such as funds withheld to pay future claims as well as loans to intermediaries. For example, if the policyholder has remitted premiums due to the insurer, under the terms of an insurance contract, to an intermediary and the intermediary defaults on remitting those premiums to the insurer, can the insurer enforce payment of the premiums by the policyholder? That is, the distinguishing factor is whether the intermediary is acting on behalf of the policyholder (in which case, any balances held by the intermediary are expected to be within the scope of IFRS 17) or on behalf of the insurer (in which case, any balances held by the intermediary are expected to be within the scope of IFRS 9).

### 9.12.2. Policyholder loans

Some insurance contracts permit the policyholder to obtain a loan from the insurer with the insurance contract acting as collateral for the loan. Under IFRS 4, policyholder loans may have been separated from insurance contract balances and shown as separate assets. IFRS 17 regards a policyholder loan as an example of an investment component with interrelated cash flows which is not separated from the host insurance contract.<sup>336</sup> Consequently, a policyholder loan is included within the overall insurance contract balance and is part of the fulfilment cash flows (and is not within the scope of IFRS 9).

The repayment or receipt of amounts lent to and repaid by policyholders does not give rise to insurance revenue (see 15.1 below). However, the contractual service margin is adjusted for any difference between a loan to a policyholder expected to become payable or repayable in a period and the actual loan that becomes payable or repayable in a period, after adjusting for insurance finance income or expense related to that expected payment or repayment before it becomes payable or repayable (see 9.6.3 above).

A waiver of a loan to a policyholder would be treated the same way as any other claim.

There may be situations when an insurance policy is collateral for a stand-alone loan, not stemming from the contractual terms of an insurance contract and not highly interrelated with an insurance contract. Such a loan would be within the scope of IFRS 9.

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<sup>336</sup> IFRS 17.BC114.

## 10. Premium allocation approach

The premium allocation approach is an optional simplified form of measuring an eligible group of insurance contracts issued or reinsurance contracts held. The eligibility is assessed for each group of insurance contracts and the election is made for each eligible group. However, the ability to use the premium allocation approach for reinsurance contracts held must be assessed separately from the use of the premium allocation approach for the related underlying insurance contracts covered by reinsurance (see 11.6).

The IASB considers the premium allocation approach to be like the customer consideration approach in IFRS 15.<sup>337</sup> Therefore, compared to the general model, using the premium allocation approach results in a simpler accounting method:

- ▶ The premium allocation approach does not require separate identification of the elements (i.e., the four building blocks) of the general model until a claim is incurred. Only a total amount for a liability for remaining coverage on initial recognition is determined (see 10.3 below).
- ▶ Subsequently, the liability for remaining coverage is recognised over the coverage period on the basis of the passage of time unless the expected pattern of release from risk differs significantly from the passage of time, in which case, it is recognised based on the expected timing of incurred claims and benefits (see 10.4 below).
- ▶ 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 (see 9.8).
- ▶ An entity also has certain elections available once an entity decides to use the premium allocation approach for a group of insurance contracts (see 10.2 below).

### How we see it

- ▶ The premium allocation approach is intended to produce an accounting outcome like that which resulted from the unearned premium approach used by many non-life or short-duration insurers under IFRS 4. The results from this approach are therefore likely to be more readily understood within the context of many short-duration contracts. However, there are some important differences:
- ▶ The liability for remaining coverage is measured using premiums received minus any insurance acquisition cash flows at the measurement date. The word 'received' is interpreted literally, rather than interpreted to mean amounts due (see 12.2 below). Under IFRS 4, the unearned premium provision would have often been set up based on premiums receivable, with a separate asset recorded for the premium receivable

<sup>337</sup> IFRS 17.BC289.

- ▶ No separate asset is recognised for deferred acquisition costs, except for those assets in respect of insurance acquisition cash flows paid before the related group of insurance contracts is recognised (see 7.3 above). Instead, any acquisition cash flows are subsumed within the liability for remaining coverage, unless the entity elects to expense insurance acquisition cash flows (see 10.1 below).
- ▶ Most non-life or short-duration insurers would not usually have discounted their insurance liabilities under IFRS 4.
- ▶ The fulfilment cash flows model required for incurred claims, which is the same as the general model except for one simplification, is likely to be different than the incurred claim model used under IFRS 4.
- ▶ The liability for remaining coverage under the premium allocation approach will be the same as under the general model for groups of contracts that are onerous.

## 10.1. Criteria for use of the premium allocation approach

The premium allocation approach is permitted if, and only if, at the inception of the group of contracts one of the following conditions are met:<sup>338</sup>

- ▶ The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the measurement that would be produced applying the requirements for the general model discussed in section 7 above (i.e., the fulfilment cash flows related to future service plus the contractual service margin).
- ▶ The coverage period of each contract in the group (including insurance contract services arising from all premiums within the contract boundary determined at that date applying the requirements discussed in section 9.1) is one year or less.

The second condition means that all contracts with a one-year coverage period or less qualify for the premium allocation approach, regardless of whether the first condition is met. However, for insurance contracts with a coverage period greater than one year (e.g., long-term construction insurance contracts or extended warranty-type contracts), entities will need to apply judgement in interpreting the meaning of “that would not differ materially” (see 10.1.2 below).

The first criterion above is not met if, at the inception of the group of contracts, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for the remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:<sup>339</sup>

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<sup>338</sup> IFRS 17.53.

<sup>339</sup> IFRS 17.54.

- ▶ The extent of future cash flows related to any derivatives embedded in the contracts
- ▶ The length of the coverage period of the group of contracts

A discussion identifying the main sources of variability between the premium allocation approach and the general model is included at 10.1.1 below. A discussion of the meaning of 'differ materially in these circumstances' is included at 10.1.2 below.

### Frequently asked questions

**Question 10-1: Is an entity required or permitted to reassess a contract's eligibility for the premium allocation approach and as a result to revoke its election to apply the approach? [TRG meeting April 2019 - Agenda paper no. 2, Log S123]**

An entity may apply the premium allocation approach to some insurance contracts provided that certain criteria are met at inception. As required by paragraph 53 of IFRS 17, the criteria are assessed for each group and the election is made for each group meeting the criteria. Given the eligibility criteria are assessed *at inception*, the standard does not require or permit reassessment of the eligibility criteria or the election to apply the approach subsequent to initial recognition.

If an entity applied the premium allocation approach to a contract that is subsequently modified to such an extent that the contract no longer meets the eligibility criteria, the entity must derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable standards.<sup>340</sup>

#### **10.1.1. Main sources of difference between the premium allocation approach and the general approach**

The first criterion for use of the premium allocation approach discussed at 10.1 above involves a comparison of the liability for remaining coverage under the general model and the premium allocation approach over the expected period of the liability for remaining coverage. This assessment is made at inception and is not reassessed subsequently.

Under all situations the liability for incurred claims is the same between the premium allocation approach and general model. This means that after the coverage period has expired there will be no difference between the two approaches, unless the election not to discount incurred claims, discussed at 10.2 below, is used. However, several situations exist under which the premium allocation approach and the general model could produce different measurements for the liability for remaining coverage during the coverage period, and therefore could impact the eligibility of the premium allocation approach. These should be considered when designing the approach used for assessing the applicability of the premium allocation approach. Three examples of potential sources of differences are, as follows:

<sup>340</sup> IFRS 17.72(c).



- ▶ Changing expectations of profitability for the period of remaining coverage - see 10.1.1.A below;
- ▶ Changing interest rates - see 10.1.1.B below
- ▶ Uneven revenue recognition - see 10.1.1.C below

**10.1.1.A. *Changing expectations of profitability for the period of remaining coverage***

When the expectation of the remaining profitability changes during the coverage period of a group of insurance contracts, so that it is still profitable, the results can differ under the premium allocation approach and general model. In this situation, the premium allocation approach will not recognise this improvement or deterioration in profitability in an explicit way until the exposure is earned, whereas the general model will recognise a portion of this change in expectations now through the unwinding of the contractual service margin even though the exposure has not yet been earned.

The significance of this difference will vary depending on how likely it is that the expected profitability of the remaining coverage might change and how much it may vary by. However, if the change in expectation of future profitability is to such an extent that the contract becomes onerous under the general model, then both approaches will give the same results.

**10.1.1.B. *Changing interest rates***

Under the premium allocation approach, if there is a significant financing component, an amount should be included for accretion of interest although this is based on the interest rate at the date of initial recognition of the group (see 9.3 above). As a result, the premium allocation approach never considers the current interest rates for the liability for remaining coverage, unlike the general model. So, if the discount rate changes significantly from the initial recognition of the contract this will result in a difference in the liability for remaining coverage between the premium allocation approach and the general model. The impact of this difference and its significance will depend on various factors including how large the discounting impact was originally, how large a change might reasonably be expected in the currency of the liabilities during the coverage period and the length of term of the liabilities, as longer-tailed contracts are more likely to be affected by discounting than shorter-tailed contracts.

**10.1.1.C. *Uneven revenue recognition patterns***

Under the premium allocation approach revenue is based on the passage of time or expected pattern of release of risk (see 10.4 below). However, under the general model, the contractual service margin is allocated based on coverage units reflecting the expected quantity of benefits and duration of each group of insurance contracts (see 9.7 above).

One example of where differences in revenue recognition between the two approaches could occur is contracts where the timing of when claims occur is not evenly spread over the passage of time due to the seasonality of claims.

This could arise if the release of risk is 'significantly different from the passage of time'. For example, property insurance contracts exposed to catastrophes tend to have uneven earnings patterns.

**Illustration 52– Comparison of the liability for remaining coverage under the general model and the premium allocation approach when there are changes in expected cash flows**

Consider a group of contracts measured in accordance with the general model. A premium of CU2,000 is received at the beginning of a two-year coverage period. The entity estimates fulfilment cash flows in years 1 and 2 will be CU900 each year. The opening contractual service margin is CU200 [CU2,000 – CU900 – CU900 = CU200] (for illustration purposes, discount and risk adjustment are ignored).

The entity incurs claims in year one, as expected, of CU900. At the end of year one, the entity assumes that cash flows in the following year of coverage will increase from the previous estimate of CU900 to CU950. In terms of paragraph 44(c), this change in the fulfilment cash flows relates to future services and consequently reduces the contractual service margin from CU200 to CU150. The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119 amounts to CU75 (CU150 ÷ 2).

|                               | Contractual service margin |
|-------------------------------|----------------------------|
|                               | CU                         |
| At beginning of year 1        | 200                        |
| Adjustment for future service | (50)                       |
| Allocation to profit or loss  | (75)                       |
| At the end of year 1          | 75                         |

The liability for remaining coverage at the end of year 1, in accordance with the general model, would be CU950 + CU75 = CU1,025.

Revenue in year 1 would be CU975 [expected insurance service expense of CU900 + release of the contractual service margin of CU75]. Revenue in year 2 would be CU1,025 [expected insurance service expense of CU950 + release of the contractual service margin of CU75].

If the entity had applied the premium allocation approach, it would have allocated CU1,000 to profit or loss in year 1 (assuming that the expected release of risk would still not be differing significantly from the release of risk at the end of year 1), as revenue and the liability for remaining coverage at the end of year 1 would be CU1,000, i.e., a different amount compared with the general model.

The requirement in the general model to allocate an amount of the contractual service margin in profit or loss after making adjustments for changes in expected cash flows relating to future service can cause the liability for remaining coverage (in accordance with the general model) to differ from the liability for remaining coverage (in accordance with the premium allocation approach).

### 10.1.2. Applying materiality for the premium allocation approach eligibility assessment

In order to qualify for the premium allocation approach under the first criterion at 10.1 above, the measurement for the liability for remaining coverage should not 'differ materially' from that produced applying the general model. Materiality is defined in IAS 1 and IAS 8 (by cross reference to IAS 1) as follows: <sup>341</sup> 'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.' In addition to the general requirements of IAS 1 and IAS 8, there are specific materiality requirements in IFRS 17. Eligibility for the application of the premium allocation approach must be assessed for each group of insurance contracts<sup>342</sup> and therefore materiality should be considered at the group of contracts level. If the measurement of the liability for remaining coverage is not materially different for a group of insurance contracts measured using the premium allocation approach compared to that calculated using the general model in a range of scenarios that have a reasonable possibility of occurring, then the premium allocation approach can be adopted for that particular group.

#### How we see it

- ▶ The eligibility criteria required for use of the premium allocation approach under IFRS 17 means that not all contracts regulated as 'non-life' or 'short-duration' by local regulators will qualify for that approach.
- ▶ Contracts with a coverage period of one year or less are always eligible for the premium allocation approach. Those with a coverage period of more than a year may also be eligible. However, an entity must determine, at inception of a group of contracts, that the measurement of the liability for remaining coverage at each reporting date measured under the premium allocation approach will not be materially different from the outcome under the general model.
- ▶ IFRS 17 does not prohibit an entity from applying the premium allocation approach to eligible groups of contracts that would otherwise be required to apply the variable fee approach. However, the situations where such variable fee contracts would be eligible is likely to be limited to groups of contracts with a coverage period of one year or less. For groups of contracts with a coverage period of more than a year it will be very difficult to demonstrate that the outcome under the premium allocation approach will not be materially different from that under the variable fee model given the specific nature of contracts with direct participation features.
- ▶ As IFRS 17 does not contain any further specific guidance on how to determine whether outcomes are materially different, judgement will need to be applied in setting the thresholds and determining how these thresholds are applied.

<sup>341</sup> IAS 1.7, IAS 8.5.

<sup>342</sup> IFRS 17.53.

- ▶ IFRS 17 also does not contain any specific guidance on what 'reasonably expects' entails. Therefore, an entity needs to apply judgement in identifying the range of relevant scenarios within the context of the specific features and circumstances of the group (e.g., duration of the contracts, expected profitability, volatility of profitability, earnings pattern, payment pattern, currency, etc.). The future scenarios should reflect the variability in the fulfilment cash flows the entity expects that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.

## 10.2. Elections under the premium allocation approach

Once an entity decides to use the premium allocation approach for a group of contracts, the following elections are available for the group, in certain circumstances:

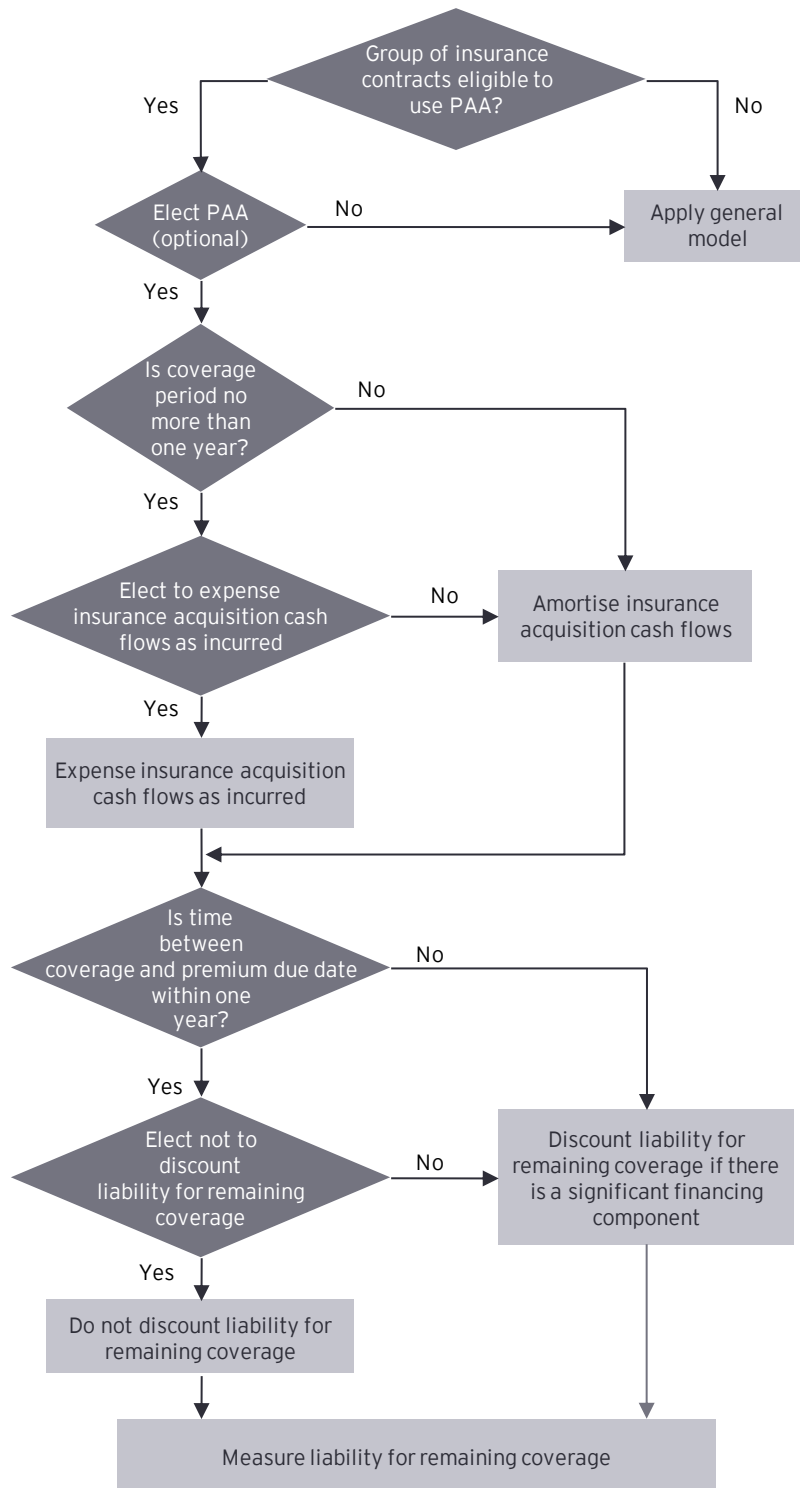
- ▶ Whether to recognise insurance acquisition cash flows as an expense when it incurs those costs or to include those cash flows within the liability for remaining coverage (and hence amortise those cash flows over the coverage period). The ability of an entity to recognise insurance acquisition cash flows as an expense when it incurs those costs is available provided that the coverage period of each contract in the group on initial recognition is no more than one year. Otherwise acquisition cash flows must be included within the liability for remaining coverage<sup>343</sup>
- ▶ Whether or not to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk. An entity is not required to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the services and the related premium due date is no more than one year. Otherwise, the liability for remaining coverage must be adjusted to reflect the time value of money and the effect of financial risk using the discount rates as determined on initial recognition if the insurance contracts in the group have a significant financing component<sup>344</sup>
- ▶ A choice to not adjust the liability for incurred claims for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received within one year or less from the date that the claims are incurred (see 10.5 below)

The diagram below shows the elections that are available for the liability for remaining coverage for groups of contracts measured in accordance with the premium allocation approach.

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<sup>343</sup> IFRS 17.59(a).

<sup>344</sup> IFRS 17.56.



### 10.3. Measurement of the liability for remaining coverage on initial recognition

An entity measures the liability for remaining coverage on initial recognition of a group of insurance contracts eligible for the PAA that are not onerous, as follows:<sup>345</sup>

- ▶ The premium, if any, received at initial recognition  
Minus
- ▶ Any insurance acquisition cash flows at that date, unless the entity is eligible and chooses to recognise the payments as an expense (coverage period of a year or less)  
Plus or minus
- ▶ Any amount arising from the derecognition at that date of:
  - ▶ Any asset for insurance acquisition cash flows that the entity paid before the related group of insurance contracts is recognised (see 7.3 above); and
  - ▶ Any other asset or liability previously recognised for cash flows related to the group of contracts (see 9.5 above).

As discussed at 10 above, premiums received means 'received' rather than receivable or due.

For contracts that are onerous, the liability for remaining coverage is determined by the fulfilment cash flows, as described in Section 9.8 below. For these contracts, a loss component is established as the excess of the fulfilment cash flows over the amount under the premium allocation approach as calculated above.

If the entity does not to use the election not to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk (see 10.2 above), the carrying amount of the liability for remaining coverage must be adjusted to reflect the time value of money and the effect of financial risk using the discount rate as determined at initial recognition of the group when the insurance contracts in the group have a significant financing component. The discount rate is the rate at the date of initial recognition of the group determined using the requirements discussed at 9.3 above.<sup>346</sup>

If the entity is not able, or chooses not to recognise insurance acquisition cash flows as an expense when incurred (see 10.2 above), then the insurance acquisition cash flows are included in the measurement of the liability for remaining coverage. The effect of recognising insurance acquisition cash flows as an expense when incurred is to increase the liability for remaining coverage and hence reduce the likelihood of any subsequent onerous contract loss. There would be an increased profit or loss expense at the date the expense is incurred (which may be before the initial recognition of the contract) followed by an

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<sup>345</sup> IFRS 17.55(a).

<sup>346</sup> IFRS 17.56.

increase in profit released from the liability for remaining coverage over the coverage period.

An entity applying the premium allocation approach should assume that no contracts in the portfolio are onerous at initial recognition unless facts and circumstances indicate otherwise. An entity should assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.<sup>347</sup>

If at any time during the coverage period, including at initial recognition, facts and circumstances indicate that a group of insurance contracts is onerous, an entity should calculate the difference between:<sup>348</sup>

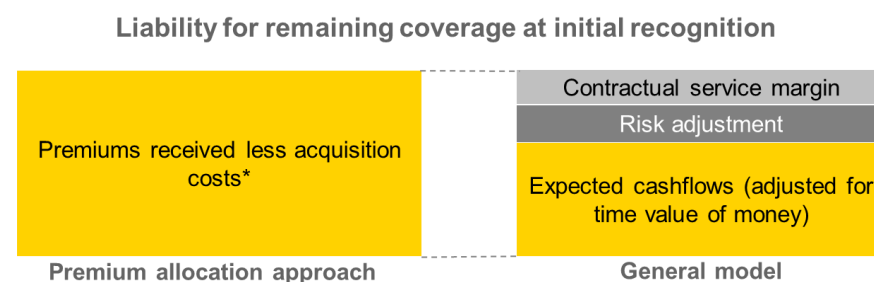
- ▶ The carrying amount of the liability for the remaining coverage as determined above

And

- ▶ The fulfilment cash flows (see 9.2 to 9.4 above) that relate to the remaining coverage of the group of contracts

Any difference arising is recognised as a loss in profit or loss and increases the liability for remaining coverage.<sup>349</sup> In performing the fulfilment cash flows calculation, above, if an entity does not adjust the liability for incurred claims to reflect the time value of money and the effect of financial risk, it should also not include any such adjustment in the fulfilment cash flows.<sup>350</sup>

The following diagram provides an overview of the premium allocation approach on initial recognition assuming the entity does not expense insurance acquisition cash flows as incurred:



*\* For groups of contracts that are not onerous and for which the entity chooses not to expense acquisition cash flows as incurred.*

<sup>347</sup> IFRS 17.18.

<sup>348</sup> IFRS 17.57.

<sup>349</sup> IFRS 17.58.

<sup>350</sup> IFRS 17.57.

## Frequently asked questions

**Question 10-2: Do paragraphs 55(a)(i) and 55(b)(i) of IFRS 17 preclude the recognition of future premiums already invoiced but not yet paid and future premiums not yet invoiced in the measurement of the liability for remaining coverage applying the premium allocation approach? [TRG meeting February 2018 - Agenda paper no. 7, Log S23 and May 2018 - Agenda paper no. 6, Appendix A, Topic 2 S27]**

The TRG members agreed with the IASB staff view that the words 'premiums, if any, received' in paragraphs 55(a) and 55(b)(i) of IFRS 17 means premiums actually received at the reporting date. It does not include premiums due or premiums expected. However, the TRG members noted that applying these requirements reflects a significant change from existing practice and this change will result in implementation complexities and costs. Subsequently, the IASB staff included this matter in an implementation challenges outreach report (issued in May 2018) which was provided to the IASB within the papers for the May 2018 IASB Board meeting. However, the IASB concluded not to amend the standard.

### **Illustration 53 – Measurement at initial recognition of a group of insurance contracts using the premium allocation approach**

An entity issues a group of insurance contracts on 1 July 2023. The insurance contracts have a coverage period of 10 months that ends on 30 April 2024. The entity's annual reporting period ends on 31 December each year and the entity prepares interim financial statements as of 30 June each year.

The entity expects to receive premiums of CU1,220 and to pay directly attributable acquisition cash flows of CU20. It is anticipated that no contracts will lapse during the coverage period and that facts and circumstances do not indicate that the group of contracts is onerous.

The group of insurance contracts qualifies for the premium allocation approach. As the time between providing each part of the coverage and the related premium due is no more than a year, the entity chooses not to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk (therefore no discounting or interest accretion is applied). Further, the entity chooses to recognise the insurance acquisition cash flows as an expense when it incurs the relevant costs. All other amounts, including the investment component, are ignored for simplicity.

On initial recognition, assuming the premiums were received and the acquisition cash flows paid, the liability for remaining coverage is CU1,220 (i.e., the premium received). The acquisition cash flows of CU20 are expensed as incurred. If the premiums were not received on initial recognition (i.e., they are receivable at a later date) then the liability for remaining coverage is CU0.



## How we see it

- ▶ If the entity does not (to the extent they do not relate to future groups of insurance contracts). The effect of recognising insurance acquisition cash flows as an expense when incurred is an increase in the liability for remaining coverage. This will reduce the likelihood of any subsequent onerous contract loss. There would be an increased profit or loss expense at the date the cost is incurred that is offset by an increase in profit released from the liability for remaining coverage over the coverage period.

### 10.4. Subsequent measurement - liability for remaining coverage

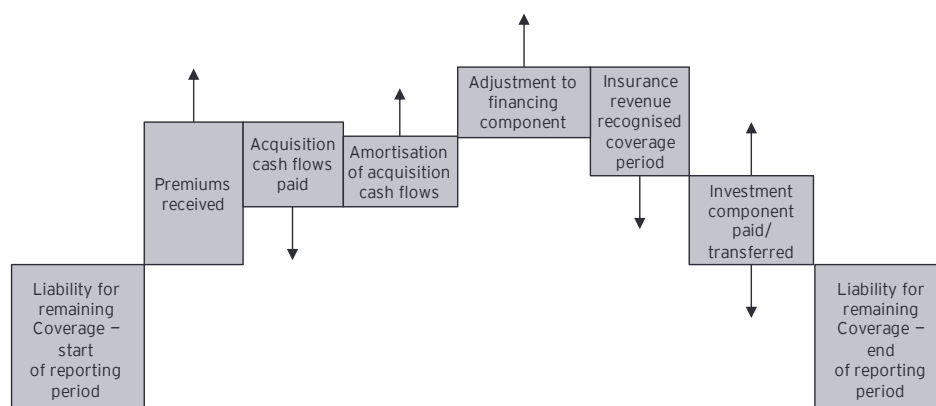
At the end of each subsequent reporting period, assuming the group of insurance contracts is not onerous, the carrying amount of the liability is the carrying amount at the start of the reporting period:<sup>351</sup>

- ▶ Plus the premiums received in the period
- ▶ Minus insurance acquisition cash flows, unless the entity is eligible and chooses to recognise the payments as an expense (see 10.1 above)
- ▶ Plus any amounts relating to amortising insurance acquisition cash flows recognised as an expense in the reporting period, unless the entity is eligible and chooses to recognise the payments as an expense
- ▶ Plus any adjustment to a financing component, if any (see below)
- ▶ Minus the amount recognised as insurance revenue for services provided in that period
- ▶ Minus any investment component paid or transferred to the liability for incurred claims

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<sup>351</sup> IFRS 17.55(b).

This can be illustrated by the following diagram:



If a group of insurance contracts was onerous at initial recognition, then an entity would continue to compare the carrying amount of the liability for remaining coverage as calculated above with the fulfilment cash flows and recognise any further deficits or surpluses (to the extent that the fulfilment cash flows still exceed the liability for remaining coverage on a cumulative basis) in profit or loss.

Under the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and after adjustment to reflect the time value of money and the effect of financial risk, if applicable) allocated to the period for services provided. An entity should allocate the expected premium receipts to each period of insurance contract services:<sup>352</sup>

- ▶ On the basis of the passage of time; but
- ▶ If the expected pattern of release of risk during the coverage period differs significantly from the passage of time (which might be the case, for example, if claims were skewed towards a particular time of year such as the ‘hurricane season’), on the basis of the expected timing of incurred insurance service expenses.

An entity should change the basis of allocation between the two methods (passage of time and incurred insurance service expenses) as necessary if facts and circumstances change.<sup>353</sup>

The following example illustrates the subsequent measurement of a group of insurance contracts using the premium allocation approach assuming the same fact pattern as Illustration 53 above.

<sup>352</sup> IFRS 17.B126.

<sup>353</sup> IFRS 17.B127.

### **Illustration 54 – Measurement subsequent to initial recognition of a group of insurance contracts using the premium allocation approach**

Assuming the same fact pattern as Illustration 53.

On initial recognition, the entity receives all premiums and pays all acquisition cash flows. The entity expects to be released from risk evenly over the 10-month contract period. At the reporting date (31 December 2023), the contract is still not expected to be onerous.

For the six-month reporting period ending on 31 December 2023, the entity recognises insurance revenue of CU 732 (i.e., 60% of CU1,220). The insurance acquisition cash flows of CU 20 are recognised as insurance service expense (as per Illustration 53 above, the entity has chosen to recognise the acquisition cash flows as incurred and not over the passage of time).

At 31 December 2023, the liability for remaining coverage is CU488 (i.e., CU 1,220 – CU 732 or 40% of CU1,220). Note that, alternatively, if premiums were not received/paid until 1 January 2024, the liability for remaining coverage would be an asset of CU 732 at 31 December 2023.

For the six-month reporting period ending 30 June 2024, the entity recognises the remaining CU 488 as insurance revenue and there is no liability for remaining coverage at 30 June 2024.

### **Frequently asked questions**

*Question 10-3: How should differences between expected premiums and actual premiums which relate to current or past service be accounted for applying the premium allocation approach? [TRG meeting September 2018 – Agenda paper no. 4, Log S53]*

The TRG agreed with an IASB staff paper which stated that any premium experience adjustments under the premium allocation approach are part of expected premium receipts. Therefore, they are allocated to insurance revenue on the basis of either the passage of time or the expected release from risk (see above). If the expected pattern of release of risk differs significantly from the passage of time, the expected premium receipts are allocated over the coverage period on the basis of the expected timing of the incurred insurance service expense.

### **How we see it**

- ▶ The liability for remaining coverage may be an asset balance if premiums are received after the recognition of revenue. This is because revenue is determined by the provision of services, independent of the receipt of cash.
- ▶ Judgement will be required in interpreting 'differs significantly from the passage of time' in order to determine the appropriate basis to allocate insurance revenue to the period for services provided.
- ▶ A change in the basis of allocating insurance between the two methods (passage of time and incurred insurance service expenses) results from new information and accordingly is not a correction of an error and will be accounted for prospectively as a change in accounting estimate.

- ▶ The approach to allocate premium experience adjustments (i.e., the difference between the premium receipt expected at the beginning of the period and the actual premium cash flows received in the period) to insurance revenue on the basis of either the passage of time or the expected release from risk does not appear to preclude an entity from allocating any premium experience adjustment to both past and future services and, hence, recognise the resulting revenue relating to past services in the current period. Splitting the premium experience adjustment between past and future periods adds complexity.
- ▶ IFRS 17 contains the principle that changes in fulfilment cash flows relating to past service should not adjust the contractual service margin but be recorded in profit or loss for the period. Considering this principle, it would be appropriate to also record changes in expected future premiums of the liability for remaining coverage that relate to past service in profit or loss as an adjustment to insurance revenue for the period (rather than as an adjustment to the contractual service margin). This would result in a treatment consistent with that of premium experience adjustments mentioned in the previous observation.

## 10.5. Subsequent measurement - liability for incurred claims

The liability for incurred claims for a group of insurance contracts subject to the premium allocation approach (which should usually be nil on initial recognition) is measured in the same way as the liability for incurred claims using the general model (i.e., a discounted estimate of future cash flows with a risk adjustment for non-financial risk). See 9.6.2 above.

However, when applying the premium allocation method to the liability for remaining coverage, an entity is, for the liability for incurred claims, an entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows (for that group of insurance contracts) are expected to be paid or received in one year or less from the date the claims are incurred.<sup>354</sup> This is a separate election from the choice not to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk at initial recognition (see 10.2 above).

When the entire insurance finance income or expenses is included in profit or loss, incurred claims are discounted at current rates (i.e., the rate at the reporting date). When insurance finance income or expenses is disaggregated between profit or loss and other comprehensive income (see 15.3 below) the amount of insurance finance income or expenses included in profit or loss is determined using the discount rate at the date of the incurred claim. See 9.3 above.

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<sup>354</sup> IFRS 17.59(b).

## Frequently asked questions

**Question 10-4: Why is the option in paragraph 59(b) where an entity is not required to adjust future cash flows in the liability for incurred claims for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred, limited to groups of contracts applying the premium allocation approach? [TRG meeting September 2018 – Agenda paper no. 11, Log S64]**

This practical expedient is a simplification that applies only to groups of insurance contracts accounted for applying the premium allocation approach which is a simplified approach. Applying the requirements of IFRS 17 to contracts applying the general model, subject to materiality considerations, an entity is required to adjust the estimates of future cash flows to reflect the time value of money and the effect of financial risk.

### **Illustration 55 – Subsequent measurement of the liability for incurred claims using the premium allocation approach**

Assuming the same fact pattern as Illustration 53.

For the six-month reporting period ending on 31 December 2023, there were claims of CU 636 incurred, including a risk adjustment for non-financial risk related to those claims of CU 36. None of the claims have been paid at the reporting date. The claims will be paid within one year after the claims are incurred. Therefore, the entity chooses not to adjust the liability for incurred claims for the time value of money and the effect of financial risk.

At 31 December 2023, the liability for incurred claims is CU 636, which is also the amount for incurred claims recorded in profit or loss as insurance service expenses.

For the six-month reporting period ending on 30 June 2024, there were claims incurred of CU 424, including a risk adjustment for non-financial risk related to those claims of CU 24. During the period claims of CU 800 were paid.

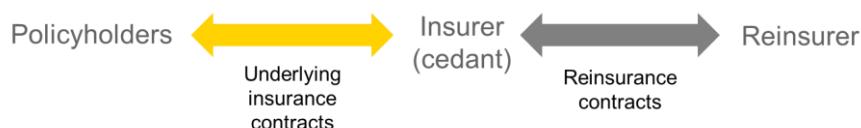
At 30 June 2024 the total liability for incurred claims and the risk adjustment for non-financial risk is CU 260 (i.e. CU 636 + CU 400 + CU 24 - CU 800). The total incurred claims recognised in profit or loss as insurance service expenses for the six-month reporting period ending on 30 June 2024 is CU 424 (i.e., CU 400 + CU 24).

## How we see it

- ▶ It is possible that a group of insurance contracts may exist for which the entity would be eligible not to adjust the liability for remaining coverage for time value of money (because the coverage period and the premium due date are within one year); but for which it may have to discount the liability for incurred claims (because the claims are not expected to settle within one year or less from the date in which they are incurred). This would likely be the case for products with short coverage periods and long-tail claim settlement periods.
- ▶ IFRS 17 does not state whether the discounting election above relating to the liability for incurred claims is irrevocable or not. There may be circumstances in which groups of claims that were expected originally to be settled within one year (and, hence, not discounted) subsequently turn out to take much longer to settle. In those circumstances, an entity should start discounting the claims in the period in which it identifies such change and account for it prospectively (as this is a change in estimate).

## 11.Reinsurance contracts held

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by the other entity (underlying contracts).<sup>355</sup>



IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract (a cedant) does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. It is acknowledged in the Basis for Conclusions that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example; on the timing of recognition, the measurement of the reinsurance contracts and the recognition of profit. However, the Board concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts.<sup>356</sup> Examples of potential accounting mismatches are:

- ▶ Contract boundaries for reinsurance held may differ from those of the underlying direct insurance contracts. As a result, accounting for reinsurance held requires the cedant (insurer) to estimate cash flows for underlying direct contracts that have not been issued yet but are within the boundary of the reinsurance contract (see 11.2 below).
- ▶ Underlying insurance contracts may meet one of the criteria to apply the premium allocation approach, but the related reinsurance contracts do not, possibly because the contract boundary of the reinsurance contract differs from that of the underlying insurance contracts (see 1.6 below).
- ▶ Reinsurance held cannot be accounted for under the variable fee approach even if the underlying direct insurance contracts are accounted for under the variable fee approach (see 11.7 below).

A modified version of the general model is applied by cedants for reinsurance contracts held. This is to reflect that:<sup>357</sup>

- ▶ Groups of reinsurance contracts held are usually assets rather than liabilities
- ▶ Entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium rather than making profits from the reinsurance contracts

<sup>355</sup> IFRS 17 Appendix A.

<sup>356</sup> IFRS 17.BC298.

<sup>357</sup> IFRS 17.BC302.

A further consideration is that most reinsurance contracts held will be 'loss making' if the underlying insurance contracts to which they relate are profitable. Given that IFRS 17 does not permit gains on initial recognition of insurance contracts issued, it would seem inappropriate to require anticipated losses on related reinsurance contracts held to be expensed on initial recognition. This would create an accounting mismatch.

The following table includes a comparison between the general model for insurance contracts issued and modifications of the general model for reinsurance contracts held:

| General model for insurance contracts issued   | Modifications of general model for reinsurance contracts held   |
|--|---|
| <b>Recognition</b>   |   |
| <p>A group of insurance contracts issued shall be recognised from the earlier of: (see 7 above)</p> <ul style="list-style-type: none"> <li>▶ The beginning of the coverage period of the group of contracts</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ The date when the first payment from a policyholder in the group becomes due</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ For a group of onerous contracts, when the group becomes onerous</li> </ul> | <p>A group of reinsurance contracts held shall be recognised from the earlier of:</p> <ul style="list-style-type: none"> <li>▶ The beginning of the coverage period of the group of reinsurance contracts held</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ Any gain on initial recognition which covers losses of onerous underlying insurance contracts</li> </ul> <p>A simplification exists for proportionate reinsurance (see 11.3 below)</p> |
| <b>Measurement</b>   |   |
| <p>The contract boundary requirements under the general model apply also to reinsurance contracts held (see 11.2 below). However, due to different terms and conditions of the reinsurance contracts held, contract boundaries for reinsurance held may differ from those of the underlying direct insurance contracts.</p>  |   |
| <p>Assumptions used for measurement should be consistent with the assumptions used for measurement of the underlying insurance contracts issued (see 11.4.1 below)</p>   |   |
| <p>The risk adjustment for non-financial risk reflects the compensation that the insurer requires for bearing the uncertainty about the amount and timing of the</p>   | <p>The risk adjustment for non-financial risk reflects the amount of the risk transferred from the insurer to the reinsurer.<sup>358</sup></p>  |

<sup>358</sup> IFRS 17.64.



| General model for insurance contracts issued  | Modifications of general model for reinsurance contracts held   |
|---|---|
| cash flows that arises from non-financial risk (see 9.4).   |   |
| The non-performance risk of the insurer must not be reflected in the fulfilment cash flows of the insurance contracts issued (see 9.2).   | Non-performance risk of the reinsurer should be included in the measurement of the fulfilment cash flows of the reinsurance contracts held (see 11.4.4 below).  |
| Day 1 gains are initially recognised in the statement of financial position as a contractual service margin and recognised in profit or loss as the insurer renders services. In contrast, all day 1 losses are recognised in profit or loss immediately. | <p>All day 1 differences are initially recognised in the statement of financial position as a contractual service margin and recognised in profit or loss as the reinsurer renders services, except for:</p> <ul style="list-style-type: none"> <li>▶ Any portion of a day 1 difference (i.e., the net cost of purchasing reinsurance cover) that relates to events before initial recognition of the reinsurance contract held</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ Any day 1 gain on initial recognition of the reinsurance contract held which is expected to recover the losses at initial recognition of onerous underlying insurance contracts. (See 11.4 below).</li> </ul> |
| Changes in the fulfilment cash flows adjust the contractual service margin if they relate to future coverage and other future services (see 9.7).   | Changes in the fulfilment cash flows adjust the contractual service margin if they relate to future coverage and other future services. However, changes in fulfilment cash flows are recognised in profit or loss if the related changes in the underlying contracts are also recognised in profit or loss when the underlying contracts are onerous (See 11.5 below).   |

## How we see it

- ▶ Key considerations arising for insurers will be the extent of any accounting mismatches arising from the different treatment of reinsurance contracts held compared to the underlying insurance contracts.
- ▶ Accounting mismatches may arise from the requirement to account for reinsurance contracts held separately from the underlying insurance contracts. One example of this is that a different measurement model (e.g., General model, Premium Allocation Approach, Variable Fee approach) could be applied to the underlying insurance contracts than that one applied to the reinsurance held.

## 11.1. Level of aggregation

An entity should divide portfolios of reinsurance contracts held by applying the same criteria as for insurance contracts issued discussed in section 6 above, with the provision that references to onerous contracts (see 9.8 above) should be replaced with a reference to contracts on which there is a net gain on initial recognition.<sup>359</sup> This appears to mean that a portfolio of reinsurance contracts held should be divided at least into:

- ▶ A group of contracts on which there is a net gain on initial recognition (i.e., a net inflow), if any
- ▶ A group of contracts that have no significant possibility of a net gain arising subsequent to initial recognition, if any
- ▶ A group of the remaining contracts in the portfolio

An entity is not allowed to group contracts purchased more than a year apart. A group of contracts is not reassessed after initial recognition. It is acknowledged by IFRS 17 that, for some reinsurance contracts held, applying the general model, as modified, will result in a group that comprises a single contract.<sup>360</sup>

A reinsurance contract held cannot be onerous. Therefore, the requirements for onerous contracts in the general model (see 9.8 above) do not apply.<sup>361</sup>

### Frequently asked questions

***Question 11-1: Should a reinsurance contract held be separated into components for measurement purposes to reflect the underlying contracts covered? For example, should a reinsurance contract held that provides coverage to underlying contracts that are included in different groups of insurance contracts be separated? [TRG meeting February 2018 – Agenda paper no. 1, Log S19]***

Within the context of considering separation of insurance components of a single insurance contract (see 6.1 above), the TRG observed that the fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not, in itself, sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

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<sup>359</sup> IFRS 17.61.

<sup>360</sup> IFRS 17.61.

<sup>361</sup> IFRS 17.68.

## 11.2. The boundary of a reinsurance contract held

The contract boundary requirements of IFRS 17 (see 9.1 above) apply also to reinsurance contracts held.

### Frequently asked questions

*Question 11-2: How should an entity read paragraph 34 of IFRS 17 regarding the boundary of an insurance contract with respect to reinsurance contracts held? [TRG meeting February 2018 - Agenda paper no. 3, Log S15 and S18; TRG meeting September 2018 - Agenda paper no. 5]*

In some cases, reinsurance contracts held will offer protection for underlying contracts that an entity has not yet issued. The question arises as to whether the boundary of a reinsurance contract held should include those anticipated cash flows from unissued underlying contracts (which will not have been recognised as underlying insurance contracts by the entity).

In February 2018, this issue was discussed by the TRG who agreed with the IASB staff's conclusion that the application of the contract boundary requirements to reinsurance contracts held means that cash flows within the boundary of a reinsurance contract held arise from substantive rights and obligations of the entity, i.e., the holder of the contract. Therefore:

- ▶ A substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk, or when the reinsurer has a substantive right to terminate the contract.
- ▶ Accordingly, the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued by the cedant in the future.

This means that an entity will need to estimate the fulfilment cash flows of contracts it expects to issue that will give rise to cash flows within the boundary of the reinsurance contracts that it holds. Some stakeholders argued that this will result in an accounting mismatch between the direct insurance contracts issued and the reinsurance contracts held. However, the Basis for Conclusions states that the IASB disagreed that differences between the carrying amount of the reinsurance contract held and the underlying insurance contracts are accounting mismatches. The carrying amount of a reinsurance contract held is nil before any cash flows occur or any service is received. Thereafter any difference that arise between the carrying amount of the reinsurance contract held and the underlying insurance contracts are not accounting mismatches, but differences caused by:<sup>362</sup>

- ▶ The provision of coverage, for example because the reinsurer provides coverage for less than 100% of the risks the entity covers
- ▶ The timing of cash flows

<sup>362</sup> IFRS 17.BC309E.

## Frequently asked questions (cont'd)

- ▶ Interest accreted on the contractual service margin of the reinsurance contract held from an earlier period than, and at a different discount rate from, the interest accreted on the contractual service margin of the underlying insurance contracts, reflecting the different effects of the time value of money on the contractual service margin and fulfilment cash flows

The TRG members observed that applying this requirement is likely to result in operational complexity because it is a change from existing practice under IFRS 4. This increase in cost and complexity resulting from a change in existing practice is acknowledged in the Basis for Conclusions, but the IASB concluded that the benefits of appropriately reflecting an entity's rights and obligations as the holder of a reinsurance contract outweigh those costs.<sup>363</sup>

In addition, some reinsurance contracts held may contain break clauses which allow either party to cancel the contract at any time following a specified notice period. The TRG members observed that, in an example of a reinsurance contract which:

- ▶ Is issued and recognised on 1 January
- ▶ Covers a proportion of all risks arising from underlying insurance contracts issued in a 24-month period
- ▶ Provides the unilateral right to both the cedant and the reinsurer to terminate the contract with a three-month notice period to the other party with respect to only new business ceded

the initial contract boundary would exclude cash flows related to premiums outside of that three-month notice period.

In September 2018, the IASB staff clarified to TRG members that if, at the end of the three months, neither the entity nor the reinsurer had given notice to terminate the reinsurance contract with respect to new business ceded, this would not cause a reassessment of the contract boundary. This is because the contract boundary determination at initial recognition (i.e., three months) was not based on an assessment of the practical ability to set a price that fully reflected the risk in the contract. (In other words, a contract boundary is only reassessed if there has been a change in circumstances which affect the assessment of whether an entity's substantive rights and obligations have commercial substance). The cash flows related to underlying contracts that are expected to be issued and ceded in the next three-month period are cash flows outside the existing contract boundary. In response to a concern that this may result in daily reinsurance contracts being recognised, the IASB staff observed that reinsurance contracts held are recognised only when the recognition criteria are met (i.e., when the coverage period begins). The contract boundary is determined at initial recognition and, in this example, that will result in a new reinsurance contract held being recognised after the end of the first three-month period with a contract boundary of cash flows arising from contracts expected to be issued in the following three months. Both of

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<sup>363</sup> IFRS 17.BC309F.

## Frequently asked questions (cont'd)

these contracts held could belong to a single annual group of contracts applying the level of aggregation criteria.

The submission to the IASB staff in September 2018 included a fact pattern in which there is a unilateral right for the reinsurer to amend the rate of the ceding commission it pays, in addition to unilateral termination rights. The IASB staff observe that in this fact pattern, the existence of the right to terminate the contract with a three-month notice period determines the cash flows within the contract boundary regardless of the existence of a right to amend the rate of the ceding commission if the contract is not terminated. Therefore, the same accounting would apply to this additional fact pattern.

***Question 11-3: How should the boundary of a reinsurance contract held be determined when the reinsurer has the right to reprice remaining coverage prospectively? [TRG meeting May 2018 - Agenda paper no. 4, Log S39]***

The TRG discussed an IASB staff paper concerning the determination of the boundary of a reinsurance contract held when the reinsurer has the right to reprice remaining coverage prospectively. In the fact pattern provided, the reinsurer can adjust premium rates at any time, subject to a minimum three-month notice period and could choose either: (i) not to exercise the right to reprice, in which case, the holder of the reinsurance contract is committed to continue paying premiums to the reinsurer; or (ii) to exercise the right to reprice, in which case, the holder has the right to terminate coverage. The TRG members observed that:

For reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity (i.e., the holder) is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.

- ▶ A right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and therefore the entity would continue to be compelled to pay premiums for the entire contractual term.
- ▶ The entity's expectations about the amount and timing of future cash flows, including with respect to the probability of the reinsurer repricing the contract, would be reflected in the fulfilment cash flows.

The TRG members also observed that, although the fact pattern in this example was limited in scope, it demonstrates the principle that both rights and obligations need to be considered when assessing the boundary of a contract.

### Illustration 56 – The contract boundary of reinsurance contracts held

On 1 January, the insurer acquires a 100% proportionate reinsurance cover for a group of underlying insurance contracts it expects to issue over the next two years. The reinsurance contract includes a unilateral right to both the cedant and the reinsurer to terminate the contract with a six-month notice period to the other party with respect to only new business ceded.

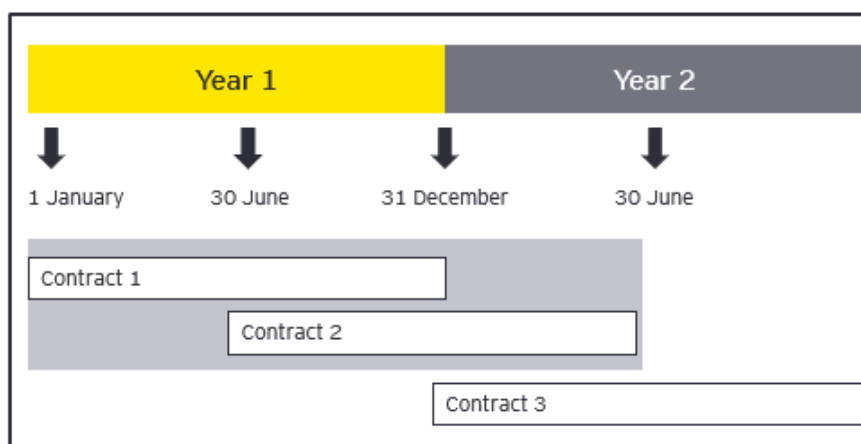
An insurer expects to issue three one-year insurance contracts all within year one of the two-year period covered by the reinsurance contract. These contracts were issued on 1 January, 30 June and 31 December in year one respectively with their coverage period starting at the same date. 1 January in year one is the beginning of the coverage period of the group of underlying insurance contracts (paragraph 25(a) of IFRS 17). The coverage period for the group of underlying insurance contracts is from 1 January in year one to 30 December in year two. Assume the group of underlying insurance contracts is measured using the general model.

The reinsurance contract held is recognised on 1 January in year one. In this example the reinsurance contract held, as a single contract, is identified as a group of insurance contracts.

The contract boundary of the reinsurance contract held recognised on 1 January in year one includes cash flows related to premiums inside the six-month notice period. In applying the measurement requirements of paragraphs 32-36 of IFRS 17 to the reinsurance contract held, the insurer uses consistent assumptions to measure the estimates of the present value of the future cash flows for the reinsurance contracts held and the estimates of the present value of the future cash flows for the first two contracts, issued on 1 January and 30 June in year one, included in the group of underlying insurance contracts. The present value of the future cash flows of the reinsurance contract held would exclude cash flows related to premiums for the third contract, issued on 31 December.

The coverage period for the reinsurance contract held recognised on 1 January in year one is equal to the coverage period for the group of underlying insurance contracts, from 1 January in year one to 29 June in year two. However, the reinsurance contract held recognised on 1 January excludes the underlying contract issued on 30 December of year one.

The contract boundary and coverage period of the reinsurance contract held recognised on 1 January in year one are illustrated by the grey block in the illustration below:



## How we see it

- ▶ In some cases, reinsurance contracts held will offer protection for underlying contracts that an entity has not yet issued. If the reinsurance cash flows arising from the anticipated underlying contracts are within the boundary of a reinsurance contract, the measurement of the reinsurance contract will reflect those cash flows – as the standard requires that future cash flows within the boundary be taken into account. An entity will need to estimate the fulfilment cash flows of contracts it expects to issue that will give rise to cash flows within the boundary of the reinsurance contracts that it holds. The estimates must be adjusted as time passes and the underlying direct contracts that are subject to reinsurance are actually issued. Reinsurance fulfilment cash flows for future underlying contracts expected to be issued include an estimate of the amount of risk adjustment an entity expects will be transferred to the reinsurer when underlying contracts are recognised, as well as future fulfilment cash flows such as estimated reinsurance premiums and claim recovery cash flows.

### 11.3. Recognition

The recognition requirements for an insurance contract issued are modified for the purposes of the recognition of reinsurance contracts held.<sup>364</sup> See section 7.2 above. In short, an entity should recognise a group of reinsurance contracts held on:

- ▶ The beginning of the coverage period of the group of reinsurance contracts held, or if the reinsurance contracts provide proportionate coverage at the later of the beginning of the coverage period of the group, or the initial recognition of any underlying contract

And

- ▶ The date the entity recognises an onerous group of underlying insurance contracts applying paragraph 25(c), if the entity entered into the related reinsurance contract held in the group of reinsurance contracts held at or before that date and, in all other cases, from the beginning of the coverage period of the group

In contrast, for contracts which do not provide proportionate coverage the recognition date is the start of the coverage period (unless the contract is onerous, in which case it is the date of signing). An example of such a contract is one that covers aggregate losses from a group of underlying contracts that exceed a specified amount.<sup>365</sup>

The coverage the entity benefits from starts at the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period.<sup>366</sup> An example of such a contract is one that provides cover

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<sup>364</sup> IFRS 17.62.

<sup>365</sup> IFRS 17.BC304.

<sup>366</sup> IFRS 17.BC305(b).

for aggregate losses from a single event, in excess of a predetermined limit and with a fixed payable premium.

## 11.4. Measurement - initial recognition

### 11.4.1. Initial measurement - fulfilment cash flows

A reinsurance contract held must be measured using the same criteria for fulfilment cash flows and contractual service margin as an insurance contract issued to the extent that the underlying contracts are also measured using this approach. However, the entity must use consistent assumptions to measure the estimates of the present value of future cash flows for the group of both the reinsurance contracts held and the underlying insurance contracts.<sup>367</sup>

#### Frequently asked questions

**Question 11-5: Paragraph 63 of IFRS 17 requires the use of assumptions for the measurement of the estimates of the present value of the future cash flows for a group of reinsurance contracts held that are consistent with those used to measure the underlying insurance contracts. Does this mean that the use of an identical discount rate is required? [TRG meeting February 2018 - Agenda paper no. 7, Log S17]**

The TRG agreed with the IASB staff that stated that 'consistent' in this context does not necessarily mean 'identical' (i.e., the use of an identical discount rate for measurement of the group of underlying insurance contracts and the related group of reinsurance contracts held was not mandated). The extent of dependency between the cash flows of the reinsurance contract held and the underlying cash flows should be evaluated in applying the requirements of paragraph 63 of IFRS 17.

**Question 11-6: What discount rate should be used to measure the present value of future cash flows of a reinsurance contract held if the liquidity characteristics of the underlying contracts are different from those of the reinsurance contract held? [TRG meeting May 2018 - Agenda paper no. 7, Log S40]**

The TRG agreed with the IASB staff when they noted that consistency is required to the extent that the same assumptions apply to both the underlying contracts and the reinsurance contracts held. In the IASB staff's view, this requirement does not require or permit the entity to use the same assumptions used (e.g., the same discount rates) for measuring the underlying contracts when measuring the reinsurance contracts held if those assumptions are not valid for the term of the reinsurance contracts held. If different assumptions apply for reinsurance contracts held, the entity uses those different assumptions when measuring the contract.

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<sup>367</sup> IFRS 17.63.



### 11.4.2. Measurement at initial recognition - contractual service margin

In determining the contractual service margin on initial recognition, the requirements of the general model are modified to reflect the fact that there is no unearned profit but, instead, a net gain or net cost on purchasing the reinsurance.

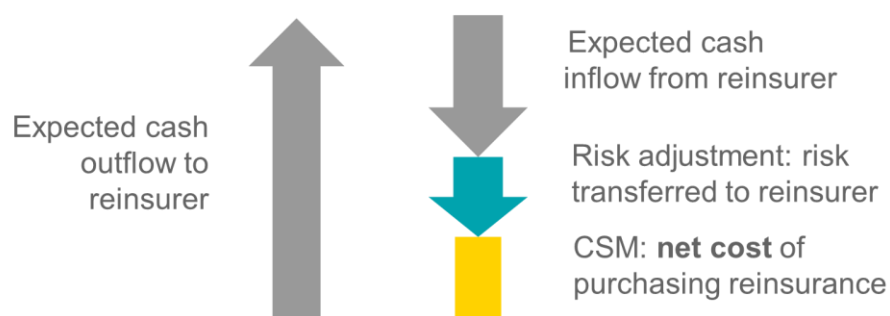
Hence, on initial recognition, unless the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, the entity should recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of:<sup>368</sup>

- ▶ The fulfilment cash flows
- ▶ The amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held
- ▶ Any cash flows arising at that date

And

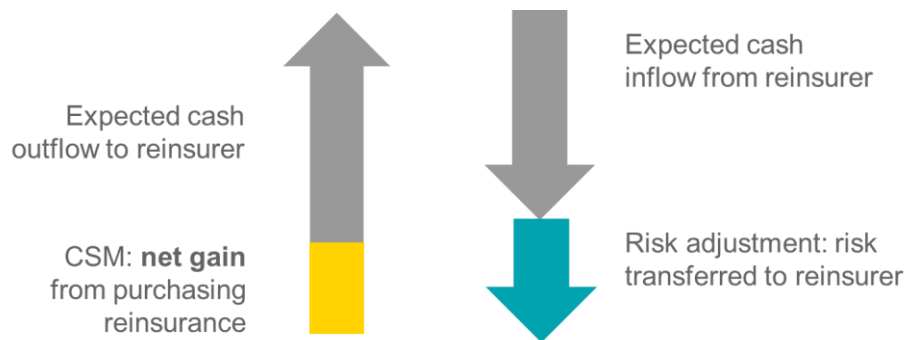
- ▶ Any income recognised in profit or loss when an entity recognises a loss on initial recognition of an onerous group of underlying contracts (see 11.4.3 below)

If expected cash outflows to a reinsurer exceed the sum of expected inflows and the risk adjustment, the contractual service margin represents a net cost of purchasing reinsurance.



If expected cash inflows from the reinsurer plus the risk adjustment exceed expected outflows, the contractual service margin represents a net gain of purchasing reinsurance.

<sup>368</sup> IFRS 17.65.



If the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts held, an entity should recognise such a cost immediately in profit or loss as an expense.<sup>369</sup>

It is stated in the Basis for Conclusions that the IASB decided that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance covers events that have already occurred. For such reinsurance contracts held, the Board concluded that entities should recognise the whole of the net expense at initial recognition, to be consistent with the treatment of the net expense of purchasing reinsurance before an insured event has occurred. The Board acknowledged that this approach does not treat the coverage period of the reinsurance contract consistently with the view that for some insurance contracts the insured event is the discovery of a loss during the term of the contract, if that loss arises from an event that had occurred before the inception of the contract. However, the Board concluded that consistency of the treatment of the net expense across all reinsurance contracts held would result in more relevant information.<sup>370</sup>

Measurement of a reinsurance contract held on initial recognition is illustrated by the following example, based on Example 11 in IFRS 17.<sup>371</sup> The initial recognition of reinsurance contracts in situations where a group of underlying insurance contracts is onerous at initial recognition as discussed at 11.4.3 below.

**Illustration 57 – Measurement on initial recognition of groups of reinsurance contracts held [Example 11 in the Illustrative Examples to IFRS 17, IE124-129]**

An entity enters into a reinsurance contract that, in return for a premium of CU300 m, covers 30% of each claim from the underlying insurance contracts. Applying the relevant criteria, the entity considers that the group comprises a single contract held. For simplicity, this example disregards the risk of non-performance of the reinsurer and all other amounts.

The entity measures the estimates of the present value of future cash flows for the group of reinsurance contracts held using assumptions consistent with those used to measure the estimates of the present value of the future cash

<sup>369</sup> IFRS 17.65A.

<sup>370</sup> IFRS 17.BC312.

<sup>371</sup> IFRS 17.IE124 129.

**Illustration 57 – Measurement on initial recognition of groups of reinsurance contracts held [Example 11 in the Illustrative Examples to IFRS 17, IE124-129] (cont'd)**

flows for the group of the underlying insurance contracts, as shown in the table below:

|   | Underlying contracts | Reinsurance contracts |
|---|----------------------|-----------------------|
|   | CU m                 | CU m                  |
| Estimates of the present value of future cash inflows               | 1,000                | 270                   |
| Estimates of the present value of future cash outflows/premium paid | (900)                | (300)                 |
| Risk adjustment for non-financial risk                              | (60)                 | 18                    |
| Contractual service margin  | (40)                 | 12                    |
| Insurance contract asset/(liability) on initial recognition         | –                    | –                     |

The entity measures the present value of the future cash inflows consistent with the assumptions of the cash outflows of the underlying insurance contracts. Consequently, the estimate of cash inflows is CU270 m (i.e., 30% of CU900 m). The risk adjustment is determined to represent the amount of risk being transferred by the holder of the reinsurance contract to the issuer of the contract. Consequently, the risk adjustment, which is treated as an inflow rather than an outflow, is CU18 m (i.e., estimated to be 30% of 60).

The contractual service margin is an amount equal to the sum of the fulfilment cash flows and any cash flows arising at that date. In this example, there is a net loss on purchasing the reinsurance and the contractual service margin is an asset.

If the premium was only CU260 m, there would be a net gain of CU28 m on purchasing the reinsurance (i.e., inflows of CU270 m, plus the risk adjustment of CU18 m less outflows of CU260 m) and the contractual service margin would represent a liability of CU28 m to eliminate the net gain on inception.

### How we see it

- ▶ IFRS 17 provides no guidance as to how a cedant should account for the net cost of a reinsurance contract held, which provides both prospective and retrospective coverage. In these circumstances, an entity would need to apply judgement as to the portfolio to which a contract providing both prospective and retrospective coverage should be allocated and whether the legal contract could be split into separate retrospective and prospective insurance components, with each component allocated to different portfolios as an in-substance separate contract for accounting purposes, applying the guidance discussed at 6.1.1 above.

### **11.4.3. Initial measurement of reinsurance held of underlying insurance contracts that are onerous at initial recognition**

An entity should adjust the contractual service margin of a group of reinsurance contracts held. As a result, it should recognise income when the entity recognises a loss on initial recognition of an onerous group of underlying contracts or on addition of onerous underlying insurance contracts to that group.<sup>372</sup> This requirement applies to all reinsurance contracts held and is irrespective of the measurement model used by the underlying contracts.

It is clarified in the Basis of Conclusions that, for this accounting to apply, an entity must enter into the reinsurance contract held before or at the same time as it recognises the onerous underlying insurance contracts. The Board concluded that it would not be appropriate for an entity to recognise a recovery of loss when the entity does not hold a reinsurance contract.<sup>373</sup> This does not preclude the entity from recognising the gain for underlying contracts that are added to the group subsequently, as these contracts are initially recognised after the entity entered into the reinsurance contract held.

The amount of the adjustment to the contractual service margin of a group of reinsurance contracts held and resulting income is determined by multiplying:<sup>374</sup>

- ▶ The loss recognised on the underlying contracts

And

- ▶ The percentage of claims on underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

An entity should also establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held depicting the recovery of losses recognised applying the requirements above. The loss-recovery component determines the amounts that are presented in profit or loss as reversals of recoveries of losses from reinsurance contracts held and are, consequently, excluded from the allocation of premiums paid to the reinsurer.<sup>375</sup>

An entity might include in an onerous group of insurance contracts, both onerous insurance contracts covered by a group of reinsurance contracts held and onerous insurance contracts not covered by the group of reinsurance contracts held. In such cases, the entity must apply a systematic and rational method of allocation to determine the portion of losses recognised on the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held.<sup>376</sup>

IFRS 17 does not require an entity to track insurance contracts at a lower level than the level of the group of insurance contracts. Accordingly, the Board specified that, in these circumstances, an entity applies a systematic and rational method of allocation to determine the portion of losses on a group

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<sup>372</sup> IFRS 17.66A.

<sup>373</sup> IFRS 17.BC315C.

<sup>374</sup> IFRS 17.B119D.

<sup>375</sup> IFRS 17.66B.

<sup>376</sup> IFRS 17.B119E.

of insurance contracts that relates to underlying insurance contracts covered by a reinsurance contract held. Requiring a systematic and rational method of allocation is consistent with other requirements in IFRS 17.<sup>377</sup>

The loss recovery requirements add complexity to IFRS 17 because they require an entity to track a loss-recovery component. However, the Board concluded that the added complexity was justified given the strong stakeholder support for the information that entities will provide to users of financial statements as a result of the amendment. In addition, the Board noted that the loss-recovery component of a reinsurance contract held is treated similarly to the loss component on insurance contracts issued.<sup>378</sup>

The following example, based on Example 12C in the Illustrative Examples on IFRS 17, shows the application of these requirements at initial measurement.<sup>379</sup>

**Illustration 58 – Initial measurement of a group of reinsurance contracts held that provides coverage for groups of underlying insurance contracts, including an onerous group [Example 12 in the Illustrative Examples to IFRS 17, IE138A-138K]**

At the beginning of Year 1, an entity enters into a reinsurance contract that in return for a fixed premium covers 30 per cent of each claim from the groups of underlying insurance contracts. The reinsurance held is the only contract in the group. The underlying insurance contracts are issued at the same time as the entity enters into the reinsurance contract held. For simplicity it is assumed that no contracts will lapse before the end of the coverage period, there are no changes in estimates and all other amounts, including the effect of discounting, the risk adjustment for non-performance risk and the risk of non-performance of the reinsurer are ignored.

Some of the underlying insurance contracts are onerous at initial recognition. Thus, the entity establishes a group comprising the onerous contracts. The remainder of the underlying insurance contracts are expected to be profitable and, in this example, the entity establishes a single group comprising the profitable contracts. The coverage period of the underlying insurance contracts and the reinsurance contract held is three years from the beginning of Year one. Services is provided evenly over the coverage periods.

The entity expects to receive CU1,110 on the underlying insurance contracts immediately after initial recognition. Claims on the underlying insurance contracts are expected to be incurred evenly across the coverage period and are paid immediately after claims are incurred.

The entity measures the group of underlying insurance contracts on initial recognition, as follows:

<sup>377</sup> IFRS 17.BC315H.

<sup>378</sup> IFRS 17.BC315G.

<sup>379</sup> IFRS 17.IE138A 138K.

**Illustration 58 – Initial measurement of a group of reinsurance contracts held that provides coverage for groups of underlying insurance contracts, including an onerous group [Example 12 in the Illustrative Examples to IFRS 17, IE138A-138K] (cont'd)**

|   | Profitable group of insurance contracts | Onerous group of insurance contracts | Total |
|---|---|--------------------------------------|-------|
|   | CU                                      | CU                                   | CU    |
| Estimates of the present value of future cash inflows       | 900                                     | 210                                  | 1,110 |
| Estimates of the present value of future cash outflows      | (600)                                   | (300)                                | (900) |
| Fulfilment cash flows                                       | 300                                     | (90)                                 | 210   |
| Contractual service margin                                  | (300)                                   | -                                    | (300) |
| Insurance contract asset/(liability) on initial recognition | -                                       | (90)                                 | (90)  |
| Loss on initial recognition                                 | -                                       | 90                                   | 90    |

The entity establishes a group comprising a single reinsurance contract held that provides proportionate coverage. The entity pays a premium of CU315 to the reinsurer immediately after initial recognition. The entity expects to receive recoveries of claims from the reinsurer on the same day that the entity pays claims on the underlying insurance contracts.

Applying IFRS 17, the entity measures the estimates of the present value of the future cash flows for the group of reinsurance contracts held using assumptions consistent with those used to measure the estimates of the present value of the future cash flows for the groups of underlying insurance contracts. Consequently, the estimate of the present value of the future cash inflows is CU270 (recovery of 30 per cent of the estimates of the present value of the future cash outflows for the groups of underlying insurance contracts of CU900).

The entity measures the group of reinsurance contracts held on initial recognition as follows:

**Illustration 58 – Initial measurement of a group of reinsurance contracts held that provides coverage for groups of underlying insurance contracts, including an onerous group [Example 12 in the Illustrative Examples to IFRS 17, IE138A-138K] (cont'd)**

|   | Initial recognition |
|---|---------------------|
|   | CU                  |
| Estimates of present value of future cash inflows (recoveries) being 900*30%                      | 270                 |
| Estimates of present value of future cash outflows (premiums)                                     | (315)               |
| Fulfilment cash flows   | (45)                |
| Contractual service margin of the reinsurance contract held (before the loss recovery adjustment) | 45                  |
| Loss-recovery component (being 90*30%)  | 27                  |
| Contractual service margin of the reinsurance contract held (after the loss-recovery adjustment)  | 72                  |
| Reinsurance contract asset on initial recognition   | 27                  |
| Income on initial recognition   | (27)                |

Applying IFRS 17, the entity adjusts the contractual service margin of the reinsurance contract held and recognises income to reflect the loss recovery. The entity determines the adjustment to the contractual service margin and the income recognised as CU27 (the loss of CU90 recognised for the onerous group of underlying insurance contracts multiplied by 30 per cent, the fixed percentage of claims the entity expects has the right to recover). The contractual service margin of CU45 is adjusted by CU27, resulting in a contractual service margin of CU72, reflecting a net cost on the reinsurance contract held. The reinsurance contract asset of CU27 comprises the fulfilment cash flows of CU45 (net outflows) and a contractual service margin reflecting a net cost of CU72. The entity establishes a loss-recovery component of the asset for remaining coverage of CU27 depicting the recovery of losses recognised.

## How we see it

- ▶ A question arises about how to account for changes in the loss component of an underlying group of insurance contracts, that are covered by reinsurance held, when changes in the loss component result from non-covered cash flows (i.e., claims and expenses that are not recoverable from reinsurers). IFRS 17 sets out that reversals of a loss-recovery component of a group of reinsurance contracts held that arise from non-covered cash flows should adjust the contractual service margin of the group of reinsurance contracts held. However, IFRS 17 does not, within this context, refer to increases in the loss-recovery component that arise from non-covered cash flows. This appears to indicate that, after initial recognition, a loss-recovery component of a group of reinsurance contracts held is only adjusted for changes in non-covered cash flows when those changes result in a decrease in the loss component on the underlying group of contracts. For subsequent measurement, the loss recovery guidance of IFRS 17 can only result in decreases of the loss component for changes in non-recoverable cash flows, but not increases. The loss-recovery component can subsequently only be increased for changes in cash flows that are recoverable under the terms of the reinsurance contract held.
- ▶ This subsequent treatment of the loss-recovery component differs from the way that a loss-recovery component is set up on initial recognition. On initial recognition, an entity can apply the simplifying assumption that the loss-recovery component is determined by multiplying the loss recognised on the underlying insurance contracts by the percentage of claims on the underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held. This initial recognition makes no distinction between cash flows on the underlying group of insurance contracts which are covered by the reinsurance contract and those that are not. Presumably this is because at initial recognition it would be difficult to identify what proportion of a loss on a group of underlying contracts results from covered cash flows and what proportion arises from uncovered cash flows.
- ▶ Reinsurance contracts may provide cover across different groups of insurance contracts. For example, a motor reinsurance contract is likely to provide protection for underlying insurance contracts within a portfolio comprising both onerous contracts and those not expected to become onerous. Some reinsurance contracts are written on a “whole account” basis and cover all of an insurer’s underlying groups of insurance contracts. IFRS 17 does not provide guidance as to how to measure the reinsurance contract in these circumstances. Consequently, an insurer will have to use judgement in weighting the underlying cash flows from different insurance groups to the reinsurance contract.
- ▶ Under the loss recovery requirements of IFRS 17, changes in fulfilment cash flows of a group of reinsurance contracts held that are caused by changes related to future services of onerous groups of underlying insurance contracts recognised immediately in profit or loss, are also recognized in profit or loss (rather than being offset against the contractual service margin of the reinsurance contract held). Insurers will therefore need to identify the extent to which changes in fulfilment cash flows of a group reinsurance contracts held relate to corresponding changes of underlying groups of contracts that have been recognised in



profit or loss. Where an onerous group of insurance contracts includes both onerous contracts covered by the reinsurance contracts held, and onerous contracts not covered by the reinsurance contracts held, this will require a means of allocating the changes in fulfilment cash flows of an onerous group of underlying contracts between them. This could give rise to significant operational complexity. An entity could consider subdividing into further groups of insurance contracts issued and/or groups of reinsurance contracts held in order to facilitate such allocations.

#### **11.4.4. Initial measurement of the effect of the risk of non-performance**

In addition to using consistent assumptions, an entity should make the following modifications in calculating the fulfilment cash flows:

- ▶ Estimates of the present value of the future cash flows for the group of reinsurance contracts held must reflect the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.<sup>380</sup> This is because an entity holding a reinsurance contract faces the risk that the reinsurer may default or may dispute whether a valid claim exists for an insured event.<sup>381</sup> The estimates of expected losses from non-performance risk are based on expected values over the lifetime of the reinsurance asset.
- ▶ The estimate of the risk adjustment for non-financial risk must be determined to represent the amount of risk being transferred by the cedant to the reinsurer.<sup>382</sup>

The requirement to reflect the non-performance risk on an expected value basis is similar to the requirement of IFRS 9 to provide for expected credit losses on certain financial instruments. However, IFRS 9 does not apply to rights under a contract within the scope of IFRS 17, such as a receivable due under a reinsurance contract held (see section 2). Consequently, the IFRS 9 credit loss model does not apply. Instead, non-performance risk is reflected on an expected value basis over the estimated lifetime of the insurance contract using the guidance for expected values as part of the fulfilment cash flows (see section 7 above).

#### **Frequently asked questions**

**Question 11-7: For reinsurance contracts held, is the risk of non-performance of the reinsurer considered within the estimates of the present value of future cash flows or the risk adjustment for non-financial risk? [TRG meeting May 2018 - Agenda paper no. 7, Log S42]**

The TRG agreed with the IASB staff when they noted that the risk adjustment does not include an adjustment for the risk of non-performance. The adjustment should be contained within the estimates of the present value of future cash flows.

<sup>380</sup> IFRS 17.63.

<sup>381</sup> IFRS 17.BC308.

<sup>382</sup> IFRS 17.64.

## Frequently asked questions (cont'd)

**Question 11-8: Non-performance risk of a reinsurer may incorporate different risks such as insolvency risk and the risks related to disputes. Should these risks be identified as financial or non-financial risks? What impact does this determination have on the measurement of the risk adjustment for reinsurance contracts held when determining the risk being transferred applying paragraph 64 of IFRS 17? [TRG meeting April 2019 – Agenda paper no. 2, Log S119]**

The IASB staff observed that for reinsurance contracts held, applying paragraph 64 of IFRS 17 rather than paragraph 37 of IFRS 17, an entity determines the risk adjustment for non-financial risk at the amount of the risk being transferred by the policyholder of the group of reinsurance contracts held to the issuer of those contracts. Paragraph 63 of IFRS 17 discusses the estimates of the present value of the future cash flows of a reinsurance contract held and specifically requires that those estimates should include the effect of any risk of non-performance by the issuer of the reinsurance contract including the effects of collateral and losses from disputes. Thus, the risk adjustment for non-financial risk of a reinsurance contract held reflects only the risks that the cedant transfers to the reinsurer. The risk of non-performance by the reinsurer is not a risk transferred to the reinsurer, nor does it reduce the risk transferred to the reinsurer. It is only reflected in the present value of the future cash flows of the reinsurance contract held, similar to the treatment of financial risks. Paragraph 63 of IFRS 17 does not provide specific requirements on how to determine the effect of any risk of non-performance. Paragraph 67 of IFRS 17 requires that changes in the fulfilment cash flows related to the risk of non-performance do not adjust the contractual service margin, therefore an entity recognises them in profit or loss. This treatment is consistent with the accounting treatment for financial risks.

## How we see it

- ▶ IFRS 17 requires insurers to account for, and disclose in the notes to the financial statements, the changes in fulfilment cash flows that result from changes in the risk of non-performance by reinsurers in respect of reinsurance contracts held. IFRS 17 also states that changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the CSM. Hence, these changes should be recognised in the statement of comprehensive income in the period in which these effects occur. According to IFRS 13, the risk of non-performance is the risk that an entity will not fulfill its obligation. This risk includes, but may not be limited to, an entity's own credit risk. IFRS 17 requires that an entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held, the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes. As such, the risks of an entity not fulfilling its obligation could be influenced by different factors (including both the ability to pay and dispute over the amount contractually due). Evaluating what gives rise to the risk of non-performance involves the application of judgement because it depends on the specific circumstances of the reinsurance arrangement.

- ▶ Even though the risk of non-performance should not be incorporated in the risk adjustment, changes in fulfilment cash flows that relate to the risk of non-performance will affect the measurement of the risk adjustment for non-financial risk to the extent that the underlying expected cash flows have reduced (e.g., because of insolvency of a reinsurer). This is because the risk inherent in those revised cash flows may have changed. As a result, we would expect the risk adjustment for non-financial risk to be calculated on the expected fulfilment cash flows after the fulfilment cash flows have been adjusted for the effect of non-performance.

## 11.5. Subsequent measurement of reinsurance contracts held

Instead of applying the subsequent measurement requirements of the general model, an entity must measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as follows:<sup>383</sup>

| Change in the carrying amount of the contractual service margin of a group of reinsurance contracts held in a period  |       |
|---|-------|
| The carrying amount determined at the start of the reporting period.  | X/(X) |
| The effect of new contracts added to the group.   | X/(X) |
| Interest accreted on the carrying amount of the contractual service margin, measured at discount rates determined at the date of initial recognition of a group of contracts using the discount rates as determined by the general model (see 9.3 above).   | X/(X) |
| Income recognised in profit or loss when an entity offsets a loss on an onerous group of underlying contracts (see 11.4.3 above).   | (X)   |
| Reversals of a loss-recovery component recognised (see 11.4.3 above) to the extent those reversals are not changes in the fulfilment cash flows of the group of reinsurance contracts held.   | X     |
| Change in fulfilment cash flows measured at the discount rates applying on initial recognition (see 9.3 above) to the extent that the change relates to future service, unless (see 11.5.1 below): <ul style="list-style-type: none"> <li>▶ The change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts</li> </ul> | X/(X) |

<sup>383</sup> IFRS 17.66.

| Change in the carrying amount of the contractual service margin of a group of reinsurance contracts held in a period   |       |
|--|-------|
| Or   |       |
| <ul style="list-style-type: none"> <li>▶ The change results from applying the onerous contract requirements to the measurement of a group of underlying insurance contracts using the premium allocation approach.</li> </ul>  |       |
| The effect of currency exchange differences.   | X/(X) |
| The amount recognised in profit or loss because of services received in the period determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held (see 11.5.2 below). | (X)/X |
| The carrying amount determined at the end of the reporting period.   | X/(X) |

**11.5.1. Changes to the contractual service margin that result from changes in estimates of cash flows**

The contractual service margin of a group of insurance contracts issued can never be negative. In contrast, IFRS 17 does not include a limit on the amount by which the contractual service margin of a group of reinsurance contracts held could be adjusted as a result of changes in estimates of cash flows. In the Board’s view, the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued – the contractual service margin for the group of reinsurance contracts held depicts the expense the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. Accordingly, the Board placed no limit on the amount of the adjustment to the contractual service margin for the group of reinsurance contracts held, subject to the amount of premium paid to the reinsurer.<sup>384</sup>

It is stated in the Basis for Conclusions in IFRS 17 that the Board considered the situation that arises when the underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows relating to future service. In such a situation, the entity recognises a loss on the group of underlying insurance contracts (this situation would also apply to the subsequent accounting of underlying direct contracts that were already onerous at their initial recognition). The Board concluded that corresponding changes in cash inflows from a group of reinsurance contracts held should not adjust the contractual service margin of the group of reinsurance contracts held, with the result that the entity recognises no net effect of the loss and gain in the profit or loss for the period. This means that, to the extent that the change in the fulfilment cash flows of the group of

<sup>384</sup> IFRS 17.BC314.

underlying contracts is matched with a change in fulfilment cash flows on the group of reinsurance contracts held, there is no net effect on profit or loss.<sup>385</sup>

These requirements are illustrated by the following example, based on Examples 12A and 12B in IFRS 17.

**Illustration 59 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12A and 12B in the Illustrative Examples to IFRS 17, IE130-138]**

An entity enters into a reinsurance contract that, in return for a fixed premium, covers 30% of each claim from the underlying insurance contracts (the entity assumes that it could transfer 30% of non-financial risk from the underlying contracts to the reinsurer). In this example, the effect of discounting, the risk of the reinsurer's non-performance, and other amounts are disregarded for simplicity. Applying the relevant criteria, the entity considers that the group comprises a single contract held.

Immediately before the end of year one, the entity measures the group of underlying insurance contracts and the reinsurance contract held, as follows:

|  | Insurance contract liability | Reinsurance contract asset |
|--|------------------------------|----------------------------|
|  | CUm                          | CUm                        |
| Fulfilment cash flows (before the effect of any change in estimates)                               | 300                          | (90)                       |
| Contractual service margin   | 100                          | (25)                       |
| Insurance contract liability / (reinsurance contract asset) immediately before the end of year one | 400                          | (115)                      |

In this example, the difference between the contractual service margin for the reinsurance contract held of CU25m and 30% of the underlying group of insurance contracts of CU30m (30% X CU100) arises because of a different pricing policy between the underlying group of insurance contracts and the reinsurance contract held.

*Example A*

At the end of year one, the entity revises its estimates of the fulfilment cash flows of the underlying group of contracts. The entity estimates there is an increase in the fulfilment cash flows of the underlying contracts of CU50m and a decrease in the contractual service margin by the same amount (the group of underlying insurance contracts is not onerous).

The entity increases the fulfilment cash flows of the reinsurance contract held by 30 per cent of the change in fulfilment cash flows of the underlying group of insurance contracts (\$15m = 30% of \$50m).

Applying paragraph 66, the entity adjusts the contractual service margin of the reinsurance contract held by the whole amount of the change in the fulfilment cash flows of this reinsurance contract held of CU15 m from

<sup>385</sup> IFRS 17.BC315.

**Illustration 59 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12A and 12B in the Illustrative Examples to IFRS 17, IE130-138] (cont'd)**

CU(25) m to CU(10) m. This is because the whole change in the fulfilment cash flows allocated to the group of underlying insurance contracts adjusts the contractual service margin of those underlying insurance contracts.

Therefore, at the end of year 1, the entity measures the insurance contracts liability and the reinsurance contract asset, as follows:

|  | Insurance contract liability | Reinsurance contract asset |
|--|------------------------------|----------------------------|
|  | CUm                          | CUm                        |
| Fulfilment cash flows (including the effect of any change in estimates)                          | 350                          | (105)                      |
| Contractual service margin   | 50                           | (10)                       |
| Insurance contract liability / (reinsurance contract asset) immediately before the end of year 1 | 400                          | (115)                      |

These changes do not affect estimates of profit and loss as all changes in the fulfilment cash flows go to the contractual service margin.

*Example B*

At the end of year one, the entity revises its estimates of the fulfilment cash flows of the underlying group of contracts. The entity estimates that there is an increase in the fulfilment cash flows of the underlying group of insurance contracts of CU160 m. This change makes the underlying group of insurance contracts onerous and the entity decreases the contractual service margin by CU100 m to zero and recognises the remaining CU60 m as a loss in profit or loss.

The entity increases the fulfilment cash flows of the reinsurance contract held by CU48 m which equals 30 per cent of the fulfilment cash flows of the underlying group of insurance contracts (CU48 m=30% of CU160 m).

Applying paragraph 66, the entity adjusts the contractual service margin of the reinsurance contract held for the change in fulfilment cash flows that relate to future services to the extent this change results from a change in the fulfilment cash flows of the group of underlying insurance contracts that adjusts the contractual service margin for that group.

Consequently, the change in the fulfilment cash flows of the reinsurance contract held of CU48 m are recognised as follows by:

- ▶ Adjusting the contractual service margin of the reinsurance contract held for CU30 m of the change in the fulfilment cash flows. The CU30 m is equivalent to the change in the fulfilment cash flows that adjusts the contractual service margin of the underlying contracts of CU100 m (CU30 m = 30% x CU100 m). Consequently, the contractual service margin of the reinsurance contract held of CU5 m equals the contractual service margin on initial recognition of CU25 m adjusted for the part of the change

**Illustration 59 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12A and 12B in the Illustrative Examples to IFRS 17, IE130-138] (cont'd)**

in the fulfilment cash flows of CU30 m (CU5 m = CU(25) m + CU30 m). This represents a contractual service margin 'asset'.

- ▶ Recognising the remaining change in the fulfilment cash flows of the reinsurance contract held, CU18 m (i.e. CU48 m - CU30 m) immediately in profit or loss.

Therefore, at the end of year one, using these alternative estimates, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

|  | Insurance contract liability | Reinsurance contract asset |
|--|------------------------------|----------------------------|
|  | CUm                          | CUm                        |
| Fulfilment cash flows (including the effect of any change in estimates)          | 460                          | (138)                      |
| Contractual service margin   | –                            | 5                          |
| Insurance contract liability / (reinsurance contract asset) at the end of year 1 | 460                          | (133)                      |
| The effect on profit or loss will be:  | –                            |                            |
| Profit (loss) at the end of year one   | (60)                         | 18                         |

**11.5.1.A. Subsequent measurement of non-performance risk**

Any changes in expected credit losses are economic events that should be reflected as gains and losses in profit or loss when they occur. To this end, IFRS 17 prohibits changes in fulfilment cash flows that relate to the risk of non-performance adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service.<sup>386</sup> Accordingly, this results in consistent accounting for expected credit losses between reinsurance contracts held and purchased, and originated credit-impaired financial assets accounted for in accordance with IFRS 9 (which does not apply to rights and obligations arising under a contract within the scope of IFRS 17 such as a receivable due under a reinsurance contract held - see 2.3 above).<sup>387</sup>

As noted at 11.4.4 above, the risk adjustment for non-financial risk does not include an adjustment for the risk of non-performance (which is already contained within the estimates of the present value of future cash flows). However, changes in fulfilment cash flows that relate to the risk of non-performance will affect the risk adjustment for non-financial risk to the extent

<sup>386</sup> IFRS 17.67.

<sup>387</sup> IFRS 17.BC309.

that the underlying expected cash flows have reduced because the risk inherent in those revised cash flows has changed.

**Illustration 60 – Changes in reinsurance contract held balances caused by non-performance**

An insurer holds a 100% quota share reinsurance contract. Assume the group of reinsurance contracts held consists of this single contract. Further assume that the present value of future cash inflows of the reinsurance contract held amounts to CU73, that consists of CU75, less CU2 as an estimate of non-performance. The risk adjustment for non-financial risk of the reinsurance contract held amounts to CU10. As a result, the reinsurance contract asset amounts to CU83.

As a result of a credit event, the reinsurer becomes insolvent and the insurer now estimates that the present value of future cash flows amounts to CU15, consisting of CU75, less CU60 as an estimate of non-performance.

The insurer is an ordinary creditor of the reinsurer and its best estimate is that it will receive only 20% in any CU of the 'gross' claim of CU75. Assume that under the entity's method for estimating the risk adjustment, an expected cash flow of CU15 would result in a risk adjustment for non-financial risk of 2.

The risk adjustment for non-financial risk following the credit event amounts to CU2 as the insurer should calculate the risk adjustment for non-financial risk using the fulfilment cash flows it expects, which in this case would be the net cash flows of CU15. As a result, the reinsurance contract asset now amounts to CU17.

**11.5.1.B. Subsequent measurement of a loss-recovery component**

As discussed at 11.4.3 above, at initial recognition, an entity must establish (or adjust) a loss-recovery component of the asset for remaining coverage for a group of reinsurance contracts held depicting the recovery of losses recognised. This loss-recovery component should be accounted for in a manner consistent with the loss component of the group of underlying insurance contracts issued. As such, after the entity has established a loss component, it should adjust the loss-recovery component to reflect changes in the loss component of an onerous group of underlying insurance contracts.

The carrying amount of the loss-recovery component must not exceed the portion of the carrying amount of the loss component of the onerous group of underlying insurance contracts that the entity expects to recover from the group of reinsurance contracts held.<sup>388</sup>

A loss-recovery component reverses, consistent with reversal of the loss component of underlying groups of contracts issued, even when those reversals are not changes in the fulfilment cash flows of the group of reinsurance contracts held. Such reversals adjust the contractual service margin.<sup>389</sup> For example, a loss-recovery component might be reversed by a change in

<sup>388</sup> IFRS 17.B119F.

<sup>389</sup> IFRS 17.66(bb).



fulfilment cash flows in the underlying group of insurance contracts that has no corresponding change in fulfilment cash flows in the reinsurance contract held (e.g., because of a favourable change in expense assumptions not covered under the reinsurance agreement).

The following example based on Example 12C in the Illustrative Examples on IFRS 17 show how this operates in practice.

**Illustration 61 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12C in the Illustrative Examples to IFRS 17, IE138L-138M]**

Assuming the same fact pattern as Illustration 59 above.

At the end of Year one, the entity measures the insurance contract liability and the reinsurance contract asset as follows:

|  | Insurance contract liability            |                                      | Reinsurance contract asset |
|--|---|--------------------------------------|----------------------------|
|  | Profitable group of insurance contracts | Onerous group of insurance contracts |                            |
|  | CU m                                    | CU m                                 | CU m                       |
| Estimates of future cash inflows (recoveries)  | -                                       | -                                    | (180)                      |
| Estimates of present value of future cash outflows (claims)  | 400                                     | 200                                  | -                          |
| Contractual service margin   | 200                                     | -                                    | (48)                       |
| Insurance contract liability / (reinsurance contract asset) immediately before the end of year one | 600                                     | 200                                  | (228)                      |

Applying paragraphs 66(e) and B119 of IFRS 17, the entity determines the amount of the contractual service margin recognised in profit or loss for the service received in Year one as CU24 m, which is calculated by dividing the contractual service margin on initial recognition of CU72 m by the coverage period of three years. Consequently, the contractual service margin of the reinsurance contract held at the end of Year one of CU48 m equals the contractual service margin on initial recognition of CU72 m minus CU24 m.

At the end of Year 2, the entity revises its estimates of the remaining fulfilment cash outflows of the groups of underlying insurance contracts. The entity estimates that the fulfilment cash flows of the groups of underlying insurance contracts increase by 10 per cent, from future cash outflows of CU300 m (see Illustration 59) to future cash outflows of CU330 m (see below). Consequently, the entity estimates the fulfilment cash flows of the reinsurance contract held also increase from future cash inflows of CU90 m to future cash inflows of CU99 m.

**Illustration 61 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12C in the Illustrative Examples to IFRS 17, IE138L-138M] (cont'd)**

At the end of Year two, the entity measures the insurance contract liability and the reinsurance contract asset, as follows:

|   | Insurance contract liability            |                                      | Reinsurance contract asset |
|---|---|--------------------------------------|----------------------------|
|   | Profitable group of insurance contracts | Onerous group of insurance contracts |                            |
|   | CU m                                    | CU m                                 | CU m                       |
| Estimates of future cash inflows (recoveries)               | -                                       | -                                    | (99)                       |
| Estimates of present value of future cash outflows (claims) | 220                                     | 110                                  | -                          |
| Contractual service margin                                  | 90                                      | -                                    | (21)                       |
| Insurance contract liability / (reinsurance contract asset) | 310                                     | 110                                  | (120)                      |
| Recognition of loss and recovery of loss                    |   | (10)                                 | 3                          |

As a result of the changes in the estimates of the remaining fulfilment cash flows:

- ▶ The entity increases the expected remaining cash outflows of the groups of underlying insurance contracts by 10 per cent for each group (CU30 m in total) and increases the expected remaining cash inflows of the reinsurance contract held by 10 per cent of the expected recoveries of CU90 m (CU9 m).
- ▶ Applying paragraph 44(c) of IFRS 17, the entity adjusts the carrying amount of the contractual service margin of the profitable group of underlying insurance contracts of CU200 m by CU20 m for the changes in fulfilment cash flows relating to future service. Applying paragraph 44(e), the entity also adjusts the carrying amount of the contractual service margin by CU90 m for the amount recognised as insurance revenue ((CU200 m - CU20 m = CU180 m) ÷ 2). The resulting contractual service margin at the end of year 2 is CU90 m (CU200 m - CU20 m - CU90 m).
- ▶ Applying paragraph 48 of IFRS 17, the entity recognises in profit or loss an amount of CU10 for the changes in the fulfilment cash flows relating to future services of the onerous group of underlying insurance contracts.

**Illustration 61 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12C in the Illustrative Examples to IFRS 17, IE138L-138M] (cont'd)**

- ▶ Applying paragraph 66(c)(i) of IFRS 17, the entity adjusts the contractual service margin of the reinsurance contract held for the change in fulfilment cash flows that relate to future service unless the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for that group. Consequently, the entity recognises the change in the fulfilment cash flows of the reinsurance contract held of CU9 m by:
- ▶ Recognising immediately in profit or loss CU3 of the change in the fulfilment cash flows of the reinsurance contract held (30 per cent of the CU10 m change in the fulfilment cash flows of the onerous group of underlying insurance contracts that does not adjust the contractual service margin of those contracts); and
- ▶ Adjusting the contractual service margin of the reinsurance contract held by CU6 m of the change in the fulfilment cash flows (CU9 m - CU3 m).
- ▶ Consequently, the contractual service margin of the reinsurance contract held of CU(21)m equals the contractual service margin at the end of Year one of CU(48 m) adjusted for CU6 m and for CU21 m of the contractual service margin recognised for the service received in Year 2 (CU(21)m = (CU(48)m + CU6 m) ÷ 2).

As discussed at 11.4.3 above, an entity might include in an onerous group of insurance contracts both onerous insurance contracts covered by a group of reinsurance contracts held and onerous insurance contracts not covered by the group of reinsurance contracts held. To adjust the contractual service margin for changes in fulfilment cash flows allocated to a group of underlying insurance contracts that do not adjust the contractual service margin for that group of underlying insurance contracts, an entity should apply a systematic and rational method of allocation to determine the portion of losses recognised on the group of insurance contracts that relate to insurance contracts covered by the group of reinsurance contracts held.<sup>390</sup>

**11.5.2. Allocation of the contractual service margin to profit or loss**

The principles for release of the contractual service margin for reinsurance contracts held follows the same principles as for insurance and reinsurance contracts issued, i.e., the contractual service margin is released to revenue as the reinsurer renders service. For a reinsurance contract held, the period that the reinsurer renders service is the coverage period of the reinsurance contract which includes both the period of insurance coverage as well as the period of any investment return service.

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<sup>390</sup> IFRS 17.B119E.

## Frequently asked questions

**Question 11-10: For reinsurance contracts held, are coverage units determined based on the services provided by the reinsurer, or the coverage units of the underlying insurance contracts? [TRG meeting, May 2018 – Agenda paper no. 7, Log S41]**

Applying paragraph B119 of IFRS 17, the coverage units of a group of insurance contracts are determined based on the quantity of coverage provided by the contracts in that group. For a group of reinsurance contracts held, this is the coverage received by the insurer from the reinsurer under those reinsurance contracts held, and not the coverage provided by the insurer to its policyholders through the underlying insurance contracts. When determining the quantity of benefits received from a reinsurance contract held, an entity may consider relevant facts and circumstances related to the underlying insurance contracts.

See 9.9.4 above for an example of determining the quantity of benefits for identifying coverage units in proportional reinsurance coverage

### **Illustration 62 – Coverage period for proportional reinsurance treaty that protects an insurer for contracts it issues in a year**

An insurer holds a proportional reinsurance treaty that protects it for claims arising from underlying insurance contracts it issues in a year. Each of the underlying insurance contracts has a coverage period of one year. However, the reinsurance treaty provides coverage for claim events that can occur in a period of up to two years. Consequently, the coverage period for the reinsurance contract held is the two-year period.

#### **11.5.2.A. Retroactive reinsurance**

For retroactive reinsurance contracts held, the coverage period of the underlying insurance contracts may have expired prior to the inception of the reinsurance contract held. In respect of these contracts, the coverage is provided against an adverse development of an event that has already occurred.<sup>391</sup> This means that the contractual service margin should be released over the expected settlement period of the claims of the underlying insurance contracts (since that is, in effect, the coverage period for the reinsurance contract).

Since incurred claims are treated as a liability for incurred claims on the underlying direct/assumed side, but as part of the liability for remaining coverage on the reinsurance held side, the question arises as to whether this creates an asymmetry in the recognition of changes in claims between the direct contract issued (relating to past service) and the reinsurance contract held. There should be no asymmetry because paragraph 66 of IFRS 17 (see 11.5.1 above) indicates that the contractual service of reinsurance contracts held is not adjusted by the change that results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not

<sup>391</sup> IFRS 17.B5.

adjust the contractual service margin for the group of underlying insurance contracts. These fulfilment cash flows include the liability for incurred claims, as changes in the liability for incurred claims do not adjust the contractual service margin for the underlying contracts as there is no contractual service margin on the liability for incurred claims. Accordingly, any change in the fulfilment cashflows of the reinsurance contract held due to the changes of the liability for incurred claims of the underlying contracts will impact profit and loss and not the contractual service margin of the reinsurance contract held. This is illustrated by the following example:

**Illustration 63 – Treatment of changes in reinsurance recoveries arising from past events**

Company A (the cedant) has a liability for incurred claims of CU100. It decides to enter into a reinsurance contract under which it cedes 50% of the liability for incurred claims.

The cedant pays a reinsurance premium of CU55 to the reinsurer at inception and cedes an amount of CU50 (i.e., 50%) of its liability for incurred claims. This results in a net cost of reinsurance of CU5 at initial recognition. The net cost of CU5 goes immediately through profit and loss following paragraph 65A of IFRS 17 (net cost of purchasing reinsurance coverage recognised as an expense).

In Year one, the liability for incurred claims of the underlying direct contracts increases from CU100 to CU115. As a consequence, the share of liability for incurred claims ceded to the reinsurer increases by CU7.5 (50% of CU15) and implies a favourable change (increase) in the asset for remaining coverage of the reinsurance contract held of \$7.5.

The favourable change in the asset for remaining coverage of \$7.5 should be credited direct to profit or loss to match the treatment for the change of the underlying liability for incurred claims and not to the contractual service margin. This accounting (i.e., direct to profit or loss) should be the same if the deviation was unfavourable.

## 11.6. Premium allocation approach for reinsurance contracts held

An entity may use the premium allocation approach (see section 10 above), adapted

to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example, the generation of expenses or a reduction in expenses rather than revenue, to simplify the measurement of a group of reinsurance contracts held if, at the inception of the group:<sup>392</sup>

- ▶ The entity reasonably expects that the resulting measurement would not differ materially from the result of applying the requirements in the general model for reinsurance contracts held, as discussed above

Or

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<sup>392</sup> IFRS 17.69.

- ▶ The coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying the definition in the general model) is one year or less.

Assessment of eligibility for groups of reinsurance contracts held to be able to use the premium allocation approach is independent of whether the entity applies the premium allocation approach to the underlying groups of insurance contracts issued by an entity. Therefore, for example, reinsurance contracts which are written on a twelve months risks attaching basis (i.e. the underlying insurance contracts subject to the reinsurance contract incept over a twelve month period) will have a contract boundary of up to two years if each of the underlying insurance contracts have a coverage period of one year. The two year contract boundary means that those reinsurance contracts held will not meet the twelve month criterion for use of the premium allocation approach and would have to qualify for the premium allocation approach on the basis that the resulting measurement would not differ materially from the result of applying the requirements in the general model. As a consequence, a mismatch in measurement models may arise if the underlying contracts are accounted for under the premium allocation approach.

IFRS 17 confirms that an entity cannot meet the first condition above if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:<sup>393</sup>

- ▶ The extent of future cash flows relating to any derivatives embedded in the contracts
- ▶ The length of the coverage period of the group of reinsurance contracts held

When a group of reinsurance contracts held is accounted for applying the premium allocation approach and an entity has a group of underlying insurance contracts that are onerous on initial recognition (see 11.4.3 above), the carrying amount of the asset for remaining coverage is adjusted instead of the contractual service margin.<sup>394</sup>

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<sup>393</sup> IFRS 17.70.

<sup>394</sup> IFRS 17.70A.

## How we see it

- ▶ A one-year 'risks attaching' reinsurance contract should be treated as a contract with a coverage period of more than one year, because the reinsurance coverage is provided for all direct contracts written by a cedant in that underwriting year. A one-year direct contract issued on the last day of the underwriting year will have a coverage period that extends until the end of the next year. Therefore, the reinsurer is providing coverage to the cedant for up to two years.
- ▶ The two-year coverage period means that those reinsurance contracts held will not meet the 'one year or less' criterion for use of the premium allocation approach and would have to qualify for the premium allocation approach on the basis that the resulting measurement would not differ materially from the result of applying the requirements in the general model. As a consequence, a mismatch in measurement models may arise if the underlying contracts are accounted for under the premium allocation approach while the reinsurance contract held has to apply the general model.
- ▶ IFRS 17 provides for the recognition of a reinsurance loss-recovery component at initial recognition of a group of onerous underlying insurance contracts when the group of reinsurance contracts held is accounted for under the premium allocation approach. However, the standard does not include guidance on the *subsequent* treatment of a loss-recovery component when the group of reinsurance contracts held is accounted for under the premium allocation approach. Following the requirements for the loss-recovery component under the general model, the carrying amount of the loss-recovery component shall not exceed the portion of the carrying amount of the loss component of the onerous group of underlying insurance contracts that an entity expects to recover from the group of reinsurance contracts held. Therefore, the loss-recovery component should be nil if the loss component of the onerous group of underlying insurance contracts is nil. On this basis, the loss-recovery component recognised at initial recognition should be reduced to nil in line with reductions in the onerous group of underlying insurance contracts.
- ▶ Furthermore, analogising from the requirements for the loss-recovery component under the general model, the standard would not preclude an entity from subsequently recording or increasing a loss-recovery component for changes in the loss component of an onerous group of underlying contracts when a group of reinsurance contracts held is accounted for under the premium allocation approach. In doing so, any entity would need to determine the loss-recovery component in way that is adapted to the specific mechanics of the premium allocation approach but consistent with the principles of the loss-recovery component under the general model.

## 11.7. Reinsurance contracts held and the variable fee approach

An entity is not permitted to use the variable fee approach for reinsurance contracts held. The variable fee approach also cannot be applied to reinsurance contracts issued.<sup>395</sup> Therefore, this will cause an accounting mismatch when an entity has reinsured contracts subject to the variable fee approach discussed at 12.3 below. It is stated in the Basis for Conclusions that the IASB considers that the entity and the reinsurer do not share in the returns on underlying items and, as such, the criteria for the variable fee approach are not met, even if the underlying insurance contracts issued are insurance contracts with direct participation features. The IASB decided not to modify the scope of the variable fee approach to include reinsurance contracts held as it was considered that such an approach would be inconsistent with the Board's view that a reinsurance contract held should be accounted for separately from the underlying contracts issued.<sup>396</sup>

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<sup>395</sup> IFRS 17.B109.

<sup>396</sup> [IFRS 17.BC248.



## 12. Measurement of contracts with participation features

Many entities issue participating contracts (referred to in the standard as contracts with participation features), that is, to say, contracts in which both the policyholder and the entity benefit from the financial return on the premiums paid by sharing the performance of the underlying items over the contract period. Participating contracts can include cash flows with different characteristics, for example:

- ▶ Cash flows that do not vary with returns from underlying items, e.g., death benefits and financial guarantees
- ▶ Cash flows that vary with returns from underlying items – either via a contractual link to the returns on underlying items or through an entity's right to exercise discretion in determining payments to policyholders

Insurance entities in many countries have issued contracts with participation features. An example of an insurance contract with a participation feature is a contract with a death cover in which the policyholder pays annual premiums into an account held by the insurer and receives the higher of a specified death benefit or the account balance (less fees), the return on which is based on the return generated by specified investments. Participating contracts may also contain discretionary participation features. In some countries, insurance companies must return to the policyholders at least a specified proportion of the investment profits on certain contracts but may give more. In other countries, bonuses are added to the policyholder account at the discretion of the insurer. In a third example, insurance companies distribute realised investment gains to the policyholder, but the entities have discretion over the timing of realising the gains. These gains are normally based on the investment return generated by the underlying assets but sometimes include allowance for profits made on other contracts.

For measurement and presentation purposes, IFRS 17 does not distinguish between those participating insurance contracts that have discretionary features and those insurance contracts which do not have discretionary features. This is a change from IFRS 4 which had separate requirements for insurance contracts with discretionary participating features.

IFRS 17 includes:

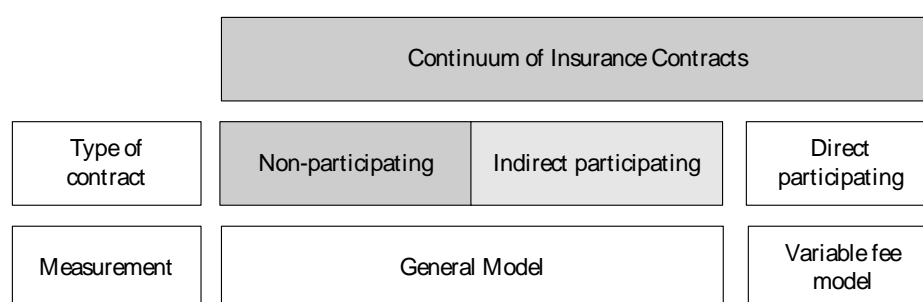
- ▶ A mandatory adaptation to the general model (the variable fee approach) for insurance contracts that include direct participation features (see 12.3 below). In addition, within the variable fee approach, contracts with certain features are permitted to use a different method to calculate the insurance finance income or expenses through profit or loss when insurance finance income or expenses is disaggregated between profit or loss and other comprehensive income (see 15.3 below)
- ▶ Specific requirements within the general model for investment contracts with discretionary participation features (see 12.4 below)

Insurance contracts without direct participation features are not permitted to be accounted for under the variable fee approach, even if such contracts

contain participation features (sometimes referred to as indirect participating contracts). For example, an insurance contract where the profit sharing is not based on a share of a clearly identified pool of underlying items. Consequently, there will be a difference between the recognition of insurance revenue for insurance contracts without direct participation features but that have some asset dependent cash flows and for insurance contracts with direct participation features accounted for using the variable fee approach, not least because different discount rates should be used for re-measuring the contractual service margin (see 9.3 above).

Contracts with participation features, including those contracts that meet the criteria for the variable fee approach, are not excluded from applying the premium allocation approach, but IFRS 17 appears to assume that they will typically not meet the eligibility criteria (as the coverage period may be significantly in excess of one year).

The following diagram compares accounting for direct participating contracts to other insurance contracts (assuming the premium allocation approach is not applied).



Reinsurance contracts issued and held cannot be insurance contracts with direct participation features for the purposes of IFRS 17. (see 11.7 above).<sup>397</sup>

Many participation contracts also contain an element of discretion which means that the entity can choose whether to pay additional benefits to policyholders. However, contracts without participation features may also contain an element of discretion. As discussed at 9.2 above, the expected cash outflows of an insurance contract should include outflows over which the entity has discretion. IFRS 4 permitted the discretionary component of an insurance contract with participation features to be classified in its entirety as either a liability or as equity.<sup>398</sup> As a result, under IFRS 4, many insurers classified the entire contract (including amounts potentially due to shareholders) as a liability. This treatment is not available under IFRS 17. Under IFRS 17, entities must make a best estimate of the liability due to policyholders (both current and future) under the contracts and amounts attributable to shareholders are part of shareholders' equity.

<sup>397</sup> IFRS 17.B109.

<sup>398</sup> IFRS 4.34(b).

The following are two examples of contracts with a participation features:

#### **Illustration 64 – Unitised with-profits policy**

Premiums paid by the policyholder are used to purchase units in a 'with-profits' fund at the current unit price. The insurer guarantees that each unit added to the fund will have a minimum value which is the bid price of the unit. This is the guaranteed amount. In addition, the insurer may add two types of bonuses to the with-profits units. These are a regular bonus, which may be added daily as a permanent increase to the guaranteed amount, and a final bonus that may be added on top of those guaranteed amounts when the with-profits units are cashed in. Levels of regular and final bonuses are adjusted twice per year. Both regular and final bonuses are discretionary amounts and are generally set based on expected future returns generated by the funds.

#### **Illustration 65 – Participation policy with minimum interest rates**

An insurance contract provides that the insurer must annually credit each policyholder's 'account' with a minimum interest rate (3%). This is the guaranteed amount. The insurer then has discretion regarding whether and what amount of the remaining undistributed realised investment returns from the assets backing the participating policies are distributed to policyholders in addition to the minimum. The contract states that the insurer's shareholders are only entitled to share up to 10% in the underlying investment results associated with the participating policies. As that entitlement is up to 10%, the insurer can decide to credit the policyholders with more than the minimum sharing rate of 90%. Once any additional interest above the minimum interest rate of 3% is credited to the policyholder it becomes a guaranteed liability.

### **How we see it**

- ▶ Determining how to faithfully represent the complex features of some participating contracts was one of the greatest challenges the IASB faced in finalising IFRS 17.
- ▶ It is important to note that the differences between the variable fee approach for direct participation contracts and the general model applied to all other contracts exist for subsequent measurement only. As the requirements for initial measurement are the same for both models, any differences in measurement on initial recognition between contracts would be the result of differences in the terms and conditions of those contracts, but not the application of the two different measurement models.

## 12.1. Contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts (mutualisation)

Entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. In practice, this effect is often referred to as “mutualisation”, even though this term is not defined in IFRS 17. The standard uses the term ‘risk sharing’. The economic effect of risk sharing is that a large population of policyholders effectively act together as a loss-absorbing ‘buffer’ when an adverse event occurs. The insurer itself incurs a loss only if the loss-absorbing capacity of the large population of policyholders is exhausted (i.e., the insurer, and ultimately its shareholders, act as risk-taker of last resort). As such, mutualised contracts result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk.

IFRS 17 observes that some insurance contracts affect the cash flows to policyholders of other contracts by requiring:<sup>399</sup>

- ▶ The policyholder to share the returns on some specified pool of underlying items, and
- ▶ Either:
  - ▶ The policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts

Or

- ▶ Policyholders of other contracts bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder

Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence, the fulfilment cash flows for a group:<sup>400</sup>

- ▶ Include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders
- ▶ Exclude payments to policyholders in the group that have been included in the fulfilment cash flows of another group

The reference to future policyholders is necessary because sometimes the terms of an existing contract are such that the entity is obliged to pay to policyholders amounts based on underlying items, but with discretion over the timing of the payments. That means that some of the amounts based on

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<sup>399</sup> IFRS 17.B67.

<sup>400</sup> IFRS 17.B68.

underlying items may be paid to policyholders of contracts that will be issued in the future that share in the returns on the same underlying items, rather than to existing policyholders. From the entity's perspective, the terms of the existing contract require it to pay the amounts, even though it does not yet know when or to whom it will make the payments.<sup>401</sup>

For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (i.e., would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.<sup>402</sup>

#### **Illustration 66 – Risk sharing and guarantees**

An insurer has issued participating contracts to two policyholders, A and B, that share in the same pool of underlying assets. The insurer has discretion as to how to share the returns of the underlying assets, but is bound by the minimum return guarantee in each individual contract. The terms of the contracts are the same, except that A's minimum return guarantee is 10% and B's is 5%. The pay-out of the returns to policyholder A and B are interdependent as both policyholders share in the same pool of underlying assets.

Assume the actual return from the underlying items is 8%. For A, the 8% of actual return from the underlying items is less than the minimum return guarantee of 10%. The opposite is true for B. Based on the contractual terms for both policyholders, A receives 10% (minimum return guarantee), and B receives the residual return of 6% (8% less 2% additional return paid to A). Thus, the amount paid to B is reduced in order to satisfy the minimum return promised to A, i.e., there is interdependency between the two pay-outs.

The insurer does not have to pay the difference between the actual returns and the minimum return guarantee to A. So, policyholder B absorbs a loss (or rather, misses out on an opportunity gain) to the benefit of the shareholders of the insurer. However, the insurer would need to pay where the return from the underlying assets is insufficient to pay the minimum return guarantee of both policyholders. In this case, if the return is less than 7.5%, B would be unable to absorb the additional losses and the insurer would need to step in.

Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity should allocate the effect of the change in the underlying items to each group on a systematic and rational basis.<sup>403</sup>

After all insurance contract services have been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not

<sup>401</sup> IFRS 17.BC172.

<sup>402</sup> IFRS 17.B69.

<sup>403</sup> IFRS 17.B70.

required to continue to allocate such fulfilment cash flows to specific groups, but can, instead, recognise and measure a liability for such fulfilment cash flows arising from all groups.<sup>404</sup>

The Board considered whether to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. It concluded that it would not. In principle, IFRS 17 requires an entity to estimate the cash flows in each scenario. If that requires difficult judgements or involves unusual levels of uncertainty, an entity would consider those matters in deciding what disclosures it must provide to satisfy the disclosure objective in IFRS 17 (see 16 below).<sup>405</sup>

The Board also considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect, or are affected by, cash flows to policyholders in another group. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio and therefore considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Nonetheless, the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.<sup>406</sup> Further detail about IFRS 17's requirements for annual cohorts and inter-generational sharing of risk is contained at 6.2.2.A above.

### Frequently asked questions

***Question 12-1: For annual groups of contracts that all share in the return of a specified pool of underlying items, with some of the return contractually passing from one group of policyholders to another, in what circumstances would measuring the contractual service margin at a higher level than an annual cohort level, such as a portfolio level, achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level applying paragraph 22 of IFRS 17? [TRG meeting September 2018 - Agenda paper no. 10, Log S74]***

The TRG members discussed an IASB staff paper which considered a submission about annual groups of contracts which all share in the return on a specified pool of underlying items with some of the return contractually passing from one group of policyholders to another. The question asked in what circumstances measuring the contractual service margin at a higher level than an annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level. The TRG members observed that:

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<sup>404</sup> IFRS 17.B71.

<sup>405</sup> IFRS 17.BC170.

<sup>406</sup> IFRS 17.BC138

### Frequently asked questions (cont'd)

- ▶ When a specified pool of underlying items consists of insurance contracts issued to the policyholders that share in the returns of that pool, the criteria for mutualisation are met regardless of whether the policyholders' share is 100% of the return of the pool of underlying items or only part of the pool of underlying items.
- ▶ The criteria for mutualisation are also met when a specified pool of underlying items do not include the insurance contracts issued to those policyholders (for example, where underlying items are financial assets), if the contracts require policyholders to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool.
- ▶ For contracts that share in 100% of the return of a pool of underlying items consisting of insurance contracts issued to those policyholders, the contractual service margin will be nil. Therefore, measuring the contractual service margin at a higher level than the annual cohort level, such as a portfolio level, would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level
- ▶ Conversely when contracts share to a lesser extent in the return on a pool of underlying items consisting of insurance contracts issued to those policyholders, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts (at annual cohort level) may differ from the contractual service margin measured at a higher level, such as a portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be (i.e., the accounting outcome would need to be the same in all circumstances, regardless of how assumptions and experience develop over the life of the contract).

However, TRG members expressed concern that, in practice, cash flows would be determined at a higher level of measurement than in the examples provided in the IASB staff paper and then the entity would have to allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

## How we see it

- ▶ Mutualisation only applies in the specific circumstances where policyholders are contractually required to share with policyholders of other contracts the returns on the same specified pool of underlying items. Cash flows to policyholders of contracts without participation features will typically be independent of amounts paid to other contracts. For example, holders of motor insurance contracts are generally not affected by amounts paid to holders of other motor insurance contracts issued by the same entity.
- ▶ The standard does not limit the application of mutualisation to contracts with direct participation features, so, in principle, it could apply to other types of participating contracts too. However, meeting the criteria of mutualisation will arguably be more challenging the more the contract features are dissimilar to those of a contract with direct participation features.
- ▶ To the extent mutualisation applies across groups of contracts written in different reporting periods, an entity will be able to offset losses on some groups with profits from other groups when measuring the affected groups. The question arises as to whether an entity will achieve the same outcome by measuring the affected groups together on the basis of the combined risk sharing of those groups. Although the standard does not prohibit the use of practical expedients that would achieve the same outcome, an entity would have to substantiate the measurement outcome in the same way, taking into account all relevant aspects of the measurement. For example, an entity must not only consider the effect of loss recognition, but also the release pattern of the contractual service margin over the coverage period.

## 12.2. Participating insurance contracts without direct participation features

Insurance contracts without direct participation features must apply the general model without adaptation, even though such contracts may have participation features (also referred to as indirect participating contracts).

The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in discretionary cash flows is regarded as relating to future service, and, accordingly, adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity should specify at inception of the contract, the basis on which it expects to determine its commitment under the contract, for example, the commitment could be based on a fixed interest rate, or returns that vary based on specified asset returns.<sup>407</sup>

An entity should use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of

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<sup>407</sup> IFRS 17.B98.



discretionary changes to that commitment (which adjust the contractual service margin).<sup>408</sup>

If an entity cannot specify at inception of the contract, what it regards as its commitment under the contract and what it regards as discretionary, it must consider its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions for financial risk.<sup>409</sup>

#### **Illustration 67 – Adjust the contractual service margin for the effects of a change in discretionary cash flows**

Entities A and B issue identical groups of insurance contracts without direct participation features one day before a reporting period ends. The contracts have a coverage period of five years. The policyholder receives the higher of a fixed death benefit or an account balance if he or she dies during the coverage period or an account balance at the end of the coverage period if he or she survives the coverage period. The contract transfers significant insurance risk, although for the purposes of illustrating the effect of discretion over amounts credited to policyholder account balances, we disregard the death benefit cost.

At contract inception, the entities:

- ▶ Receive premiums of CU1,000
- ▶ Specify that their commitment under the contract is to credit interest to the account balances at a rate equal to the return on an internally specified pool of assets, minus a 2% spread
- ▶ Expect investment returns from the specified pools of assets to be 10% a year
- ▶ Expect to pay benefits at maturity of the contracts of CU1,469 (i.e., to credit interest at the rate of 8% a year for five years ( $CU1,000 \times 1.08^5 = CU1,469$ ))
- ▶ Recognise fulfilment cash flows of CU912 ( $CU1,469 \div 1.1^5$ )
- ▶ Recognise a contractual service margin of CU88 ( $CU1,000 - CU912$ )

At the first subsequent reporting date (one day later), both entities revise their expectations of returns from the specified pool of assets downward from 10% to 9% a year

Entity A's stated policy is that it will maintain its 2% spread. Therefore, Entity A:

- ▶ Expects to credit interest to the account balances of its policyholders at the rate of 7% a year
- ▶ Expects to pay benefits at maturity of CU1,403 ( $CU1,000 \times 1.07^5 = CU1,403$ )

<sup>408</sup> IFRS 17.B99.

<sup>409</sup> IFRS 17.B100.

### Illustration 67 – Adjust the contractual service margin for the effects of a change in discretionary cash flows (cont'd)

- ▶ Measures fulfilment cash flows at the reporting date of CU912 ( $CU1,403 \div 1.09^5 = CU912$ )
- ▶ Maintains the contractual service margin of the group of contracts at CU88 because the measurement of fulfilment cash flows has not changed (assume accretion of interest and release of contractual service margin to profit or loss in one day is insignificant)

Entity B decides to apply its discretion and reduce the spread that it deducts from the return on the specified pool of assets from 2% to 1% a year. Therefore, Entity B:

- ▶ Expects to credit interest to the account balances of its policyholders at the rate of 8% a year (9% expected annual return, minus 1% spread)
- ▶ Expects to pay benefits at maturity of CU1,469
- ▶ Measures fulfilment cash flows at the reporting date of CU956 ( $CU1,469 \div 1.09^5 = CU956$ )
- ▶ Adjusts the contractual service margin for the group of contracts from CU88 to CU44 to reflect the adjustment to fulfilment cash flows resulting from an increase in fulfilment cash flows caused by its discretion to change the basis of policyholder payments ( $CU912 - CU956 = -CU44$ , contractual service margin of  $CU88 - CU44 = CU44$ )

## 12.3. Contracts with direct participation features

IFRS 17 identifies a separate set of insurance contracts with participation features described as insurance contracts with direct participation features. These contracts apply an adapted version of the general model, commonly referred to as the 'variable fee' approach.

For contracts using the variable fee approach, the changes in the contractual service margin are mostly driven by the movements in the assets 'backing' the contracts or other profit-sharing items (referred to as 'underlying items') rather than by the fulfilment cash flows of the insurance contract liability. Use of the variable fee approach instead of the general model is mandatory for those insurance contracts that meet the criteria of the variable fee approach (see 12.3.1 below). The assessment of eligibility for the variable fee approach should be performed at individual contract level although in practice this could be applied to 'clusters' of contracts as long as the outcome would not be different. The Board observed that one assessment should be sufficient for an entity to determine whether the criteria are met for each contract in a set of homogenous contracts issued in the same market conditions and priced on the same basis.<sup>410</sup>

The variable fee approach applies to insurance contracts that meet its criteria; the fact that participation features are discretionary does not necessarily preclude contracts from meeting the criteria. However, contracts with

<sup>410</sup> IFRS 17.BC249D.

participation features are significantly different across jurisdictions. Not all contracts with participation features will meet the criteria to be accounted for as direct participation contracts.

Conceptually, insurance contracts with direct participation features are contracts under which an entity's obligation to the policyholder is the net of:<sup>411</sup>

- ▶ The obligation to pay the policyholder an amount equal to the fair value of the underlying items
- ▶ A variable fee that the entity will deduct from the obligation in exchange for the future service provided by the insurance contract comprising:
  - ▶ The amount of the entity's share of the fair value of the underlying items, less
  - ▶ Fulfilment cash flows that do not vary based on the returns on underlying items

The Board concluded that returns to the entity from underlying items should be viewed as part of the compensation the entity charges the policyholder for service provided under the insurance contract, rather than as a share of returns from an unrelated investment, in a narrow set of circumstances in which the policyholders directly participate in a share of the returns on the underlying items. In such cases, the fact that the fee for the contract is determined by reference to a share of the returns on the underlying items is incidental to its nature as a fee. The Board concluded, therefore, that depicting the gains and losses on the entity's share of the underlying items as part of a variable fee for service faithfully represents the nature of the contractual arrangement.<sup>412</sup>

IFRS 17 requires the contractual service margin for insurance contracts with direct participation features to be updated for more changes than those affecting the contractual service margin for other insurance contracts. In addition to the adjustments made for other insurance contracts, the contractual service margin for insurance contracts with direct participation features is also adjusted for the effect of changes in:<sup>413</sup>

- ▶ The entity's share of the underlying items
- ▶ Financial risks other than those arising from the underlying items, for example, the effect of financial guarantees

The Board decided that these differences are necessary to give a faithful representation of the different nature of the fee in these contracts. The Board concluded that, for many insurance contracts, it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts.<sup>414</sup>

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<sup>411</sup> IFRS 17.B104.

<sup>412</sup> IFRS 17.BC244.

<sup>413</sup> IFRS 17.BC240.

<sup>414</sup> IFRS 17.BC241.

### Illustration 68 – The ‘variable fee approach’ compared to the general model

A group of contracts with participating features was written at the beginning of the year, in which the entity received premiums totalled CU1,000, which was used to purchase financial assets. The policyholder participates in 90% and the entity in 10% of the assets’ return.

At initial recognition, the expected present value of the cash outflows is CU900 and the contractual service margin is CU100. Assume the CU900 represents a non-distinct investment component.

Over the contract term of three years, the change in the fair value of the underlying financial assets amount to a net gain of CU30, of which the policyholders received CU27 (90% x CU30) and the entity CU3 (10% x CU30).

In addition, the entity incurred, cumulatively over the three-year period, cash flows that do not vary based on the returns on underlying items of CU2.

Assuming the impact of all other variables over the three-year period to be negligible, the cumulative results reported in the entity’s statement of profit or loss can be illustrated, as follows:

|                               | Cumulative results over the three-year term |                       |
|-------------------------------|---|-----------------------|
|                               | General model                               | Variable fee approach |
|                               | CUm   | CUm                   |
| Insurance revenue*            | 100   | 103                   |
| Insurance services expenses*  | (2)   | (2)                   |
| Insurance services result     | 98  | 101                   |
| Investment income (IFRS 9)    | 30  | 30                    |
| Insurance finance and expense | (27)  | (30)                  |
| Net financial result          | 3   | -                     |

\*The insurance revenue and insurance services expenses exclude the non-distinct investment component of CU900.

Under the general model, the subsequent change in the entity’s share of the underlying items would not form part of the contractual service margin and would have emerged as part of the net finance result as incurred. In terms of the ‘variable fee approach’, a change in the entity’s share of the underlying items forms part of the contractual service margin and subsequently released to insurance revenue over the coverage period.

### **12.3.1. Definition of an insurance contract with direct participation features**

An entity shall assess whether a contract has direct participation features using its expectations at inception of the contract and shall not reassess the conditions, unless the contract is modified (see 13.1 below for modifications).<sup>415</sup> As noted at 12.3 above, the assessment is made at individual contract level.

Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items (i.e., items that determine some of the amounts payable to a policyholder). Hence, these contracts are defined as insurance contracts for which:<sup>416</sup>

- ▶ The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see 12.3.1.A below).
- ▶ The entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns from the underlying items (see 1.3.1.B below).
- ▶ The entity expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in fair value of the underlying items (see 12.3.1.C below).

When an insurance contract is acquired in a business combination or transfer, the criteria as to whether the contract applies the variable fee approach should be assessed at the business combination or transfer date (see 14 below).

Situations where cash flows of insurance contracts in a group affect the cash flows of contracts in other groups are discussed at 12.1 above.

#### **12.3.1.A. A share of a clearly defined pool of underlying items**

The pool of underlying items can comprise any items, for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items (although there are accounting consequences of this - see 15.3.1 below). However, a clearly identified pool of underlying items does not exist when:<sup>417</sup>

- ▶ An entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect
- ▶ There are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set by the entity at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.

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<sup>415</sup> IFRS 17.B102.

<sup>416</sup> IFRS 17.B101.

<sup>417</sup> IFRS 17.B106.

The word 'share' referred to in the section heading above does not preclude the existence of the entity's discretion to vary amounts paid to the policyholder. However, the link to the underlying items must be enforceable.<sup>418</sup>

For the variable fee approach to be applied, the contract must specify a determinable fee and because of this a clearly identified pool of underlying items must exist. Without a determinable fee, which can be expressed as a percentage of portfolio returns or portfolio asset values rather than only as a monetary amount, the share of the return on the underlying items the entity retains would be entirely at the discretion of the entity and, in the Board's view, this would not be consistent with being equivalent to a fee.<sup>419</sup> However, IFRS 17 does not mention a stated minimum determinable fee.

The standard does not require that an entity measures the underlying items at fair value in the statement of financial position. There is also no restriction on the type of asset which can be an underlying item. This means that underlying items can be, for example, a subsidiary of the group, assets such as financial assets measured at amortised cost or non-participating insurance contracts measured in accordance with the general model in IFRS 17. In February 2020, the IASB confirmed that non-participating insurance contracts held as underlying items should be measured in accordance with IFRS 17 rather than at fair value on the grounds that creating an exception for these assets would add significant complexity to IFRS 17.<sup>420</sup> However, as discussed at 1.3.1.B below, a substantial portion of the fair value returns of underlying items, regardless as to how they are measured for accounting purposes, must be payable to the policyholder.

#### **12.3.1.B. A substantial share of the fair value returns on the underlying items**

The entity should expect to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items. It further observes that it would not be a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items if the policyholder does not expect to receive a substantial part of the fair value returns on the underlying items.<sup>421</sup>

IFRS 17 provides no specific quantitative threshold for 'substantial'. However, an entity should interpret the word 'substantial' as in both 'substantial share' and 'substantial proportion' (see 11.2.1.C below):<sup>422</sup>

- ▶ In the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items

And

- ▶ Assess the variability in the amounts:

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<sup>418</sup> IFRS 17.B105.

<sup>419</sup> IFRS 17.BC245(a).

<sup>420</sup> IASB staff Paper 2F, *Amendments to IFRS 17: Other topics raised by respondents to the Exposure Draft*, IASB, February 2020, Appendix A, p.11.

<sup>421</sup> IFRS 17.BC245(b)(i).

<sup>422</sup> IFRS 17.B107.

- ▶ Over the duration of the insurance contract
- ▶ On a present value probability-weighted average basis, not a best or worst outcome basis

IFRS 17 further explains that if, for example, the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which:<sup>423</sup>

- ▶ The cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items
- ▶ The cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items

The entity's assessment of the variability will reflect a present value probability-weighted average of all these scenarios.

As many participation contracts contain guarantees, the question as to whether a contract is one with direct participation features or not depends on the effect of the guarantee on the expected value of the cash flows at inception. It does not mean that there can be no scenarios in which the guarantee 'kicks in'. Instead, it does mean that the effect of those scenarios on a probability-weighted basis should be such that a substantial share of the expected returns payable to the policyholder are still based on the fair value of the underlying items. Considering the impact of options and guarantees on the eligibility criteria will have to be based on the specific facts and circumstances and requires the use of judgement.

When the cash flows of insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see 12.1 above), an entity should assess whether the conditions for meeting the classification of the contracts as insurance contracts with direct participation features are met by considering the cash flows that the entity expects to pay to the policyholders.<sup>424</sup>

### Frequently asked questions

**Question 12-2: Would contracts where the return is based on an amortised cost measurement of the underlying items fail the definition of insurance contract with direct participation features? [TRG meeting February 2018 - Agenda paper no. 7, Log S26]**

The IASB staff observed that contracts which provide a return that is based on an amortised cost measurement of the underlying items would not automatically fail the definition of an insurance contract with direct participation features. Entities' expectations of returns would be assessed over the duration of the contract and, therefore, returns based on an amortised cost measurement might equal returns based on the fair value of

<sup>423</sup> IFRS 17.B108.

<sup>424</sup> IFRS 17.B103.

## Frequently asked questions (cont'd)

the underlying items over the contract duration. The TRG members agreed with the IASB staff's conclusion that the variable fee approach could be met when the return is based on amortised cost measurement of the underlying items.

***Question 12-3: For a unit-linked insurance contract for which the entity charges an asset management fee, determined as a percentage of the fair value of the underlying items at the end of each period, and a premium for mortality cover, by reducing the underlying items at the beginning of each period, how does the entity apply paragraph B101(b)? [TRG meeting April 2019 - Agenda paper no. 2, Log S115]***

The submission asked, firstly, how to determine the share of the fair value returns on the underlying items ignoring the fixed premium charge for mortality cover and, secondly, whether and how the premium for mortality cover deducted from the underlying items impacts the calculation of the fair value returns. Paragraph B101(b) of IFRS 17 requires that the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items as a condition for meeting the definition of an insurance contract with direct participation features. The IASB staff stated that, in this example, the fixed annual charge for mortality cover is, in effect, an amount paid out of the policyholder's share and, therefore, the policyholder's share includes that charge.

However, to determine whether the definition of an insurance contract with direct participation features is met, an entity also needs to consider whether it expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in the fair value of the underlying items (see 14.3.1.C below). For the purposes of this condition, an entity considers changes in any amounts to be paid to the policyholder regardless of whether they have been paid from the underlying items or not. The TRG members observed that a distinguishing feature in this example is that the premium for mortality is fixed rather than varying with the fair value of the underlying items. The IASB staff confirmed that the analysis might differ had the charge varied with the fair value of the underlying items. The TRG members also observed that when determining whether an insurance contract is in the scope of the variable fee approach, in some circumstances it may be necessary to consider the way a charge is determined, rather than the way it is labelled in the contract, to identify what the charge represents. The IASB staff also noted that one of the other conditions of assessing eligibility for the variable fee approach is that a substantial proportion of the changes in amounts paid to policyholders should vary with the changes in the fair value of the underlying items, regardless of whether they have been paid from the underlying items or not.



### Illustration 69 – Calculation of the expected fair value returns with and without mortality charge

This illustration shows how an entity calculates the expected fair value returns on the underlying items applying IFRS 17.B101(b).

#### *Without mortality charge*

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the assets. The expected duration of the contract is five years and the expected annual returns on underlying items are 5%. The expected account balance is calculated in the following table:

| Year                        | 1      | 2      | 3      | 4      | 5      | Total |
|-----------------------------|--------|--------|--------|--------|--------|-------|
|                             | CU     | CU     | CU     | CU     | CU     | CU    |
| Opening balance             | 15,000 | 15,632 | 16,290 | 16,977 | 17,692 |       |
| Returns on underlying items | 750    | 782    | 815    | 849    | 885    | 4,081 |
| Annual management fee       | (118)  | (123)  | (128)  | (134)  | (139)  | (642) |
| Closing balance             | 15,632 | 16,290 | 16,977 | 17,692 | 18,437 |       |

To apply paragraph B101(b) of IFRS 17, the expected fair value returns are CU4,081, of which the entity expects to pay to the policyholder CU3,437 (CU18,437 - CU15,000)

#### *With mortality charge*

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the fair value of the underlying items. The expected duration of the contract is 5 years and the expected annual returns on underlying items are 5%. An annual charge for mortality cover of CU100 reduces the underlying items at the start of each year. The expected account balance is calculated in the following table:

| Year                        | 1      | 2      | 3      | 4      | 5      | Total |
|-----------------------------|--------|--------|--------|--------|--------|-------|
|                             | CU     | CU     | CU     | CU     | CU     | CU    |
| Opening balance             | 15,000 | 15,527 | 16,076 | 16,648 | 17,245 |       |
| Mortality charge            | (100)  | (100)  | (100)  | (100)  | (100)  | (500) |
| Returns on underlying items | 745    | 771    | 799    | 827    | 857    | 3,999 |
| Annual management fee       | (118)  | (122)  | (127)  | (131)  | (136)  | (634) |
| Closing balance             | 15,527 | 16,067 | 16,648 | 17,245 | 17,866 |       |

To apply paragraph B101(b) of IFRS 17, the expected fair value returns are CU3,999. The entity expects to pay to the policyholders CU2,866 (CU17,866 - CU15,000) having deducted the mortality charge. Hence, in total, the share of the fair value returns the entity expects to pay to the policyholder is CU3,366 (CU2,866 + CU500).

**12.3.1.C. A substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items**

The entity should expect that a substantial proportion of any change in the amounts to be paid to the policyholder varies with the change in fair value of the underlying items. It would not be a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items if the entity were not to expect changes in the amount to be paid to vary with the change in fair value of the underlying items.<sup>425</sup>

The discussion at 12.3.1.B applies here also, including how to apply the words 'substantial proportion'.

### How we see it

- ▶ Participating contracts differ significantly between jurisdictions. Not all participating contracts will meet the criteria to be accounted for under the variable fee approach. An entity will need to exercise judgement when deciding whether a contract contains direct participation features and, therefore, will be eligible to apply the variable fee approach. However, while the degree to which a contract may meet or fail the eligibility criteria will vary, the outcome is binary. Examples of products that are generally expected to be in scope are UK-style with-profits contracts, unit-linked contracts and Continental European contracts with 90% participation.
- ▶ If underlying items are not measured on a fair value basis in an entity's financial statements, this does not preclude them from qualifying for the variable fee approach. The eligibility depends on the expectation of payments of a substantial share of the fair value returns to the policyholder rather than the accounting measurement of the underlying items.
- ▶ Many participating contracts contain options and guarantees. An option may, for example, include a policyholder's right to change a particular financial benefit to another type of financial benefit under potentially favourable terms. A guarantee could entitle the policyholder to a specified minimum annual return. An entity would need to apply IFRS 9 to determine whether, and if so, how an embedded derivative is required to be separated.
- ▶ The impact that options and guarantees that are not separated as embedded derivatives have on the eligibility criteria for the variable fee approach will require the use of judgement. The question as to whether a contract includes direct participation features can depend on the effect of these guarantees and options on the expected value of the cash flows at inception. In order to qualify for the variable fee approach the effect of scenarios that result in the guarantee being payable, on a probability-weighted basis, should be such that a substantial share of the expected returns payable to the policyholder are still based on the fair value of the underlying items.

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<sup>425</sup> IFRS 17.BC245(b)(ii).

### ***12.3.2. Measurement of the risk adjustment for non-financial risk using the variable fee approach***

IFRS 17's guidance for the measurement of the risk adjustment for non-financial risk (see 9.4 above) does not prescribe how the risk adjustment should be calculated for contracts where the entity shares in the results from underlying items with policyholders. However, the risk adjustment for non-financial risk is the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk as the entity fulfils the insurance contract. Consequently, the risk adjustment for non-financial risk should reflect only the risk of the entity and not also the additional risk of the policyholder. However, the entity's risk is not limited to the shareholder's share in the underlying items, but would also include the risk of any returns which do not vary with underlying items (e.g., the effect of guarantees).

### ***12.3.3. Measurement of the contractual service margin using the variable fee approach***

At initial recognition, the contractual service margin for a group of insurance contracts with direct participation features is measured in the same way as a group of insurance contracts without direct participation features (i.e., as a balancing figure intended to eliminate any day 1 profits unless the contract is onerous - see 9.5 above). However, the contractual service margin is adjusted based on changes in the fair value of underlying items, which includes the impact of discount rate changes rather than discount rates at the measurement date of the group (see 9.3above).<sup>426</sup>

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<sup>426</sup> IFRS 17.B113(a).

At the end of a reporting period, for insurance contracts with direct participation features, the carrying amount of a group of contracts equals the carrying amount at the start of the reporting period adjusted, as follows:<sup>427</sup>

| <b>Change in the carrying amount of the contractual service margin in a period under the variable fee approach</b>  |       |
|---|-------|
| Contractual service margin at the beginning of the period   | X     |
| Effect of new contracts added to the group (see 7 above)  | X/(X) |
| Change in the amount of the entity's share of the change in the fair value of the underlying items (see 12.3.1 above), except to the extent that: <ul style="list-style-type: none"> <li>▶ The entity elects to and applies risk mitigation (see 12.3.5 below)</li> <li>▶ The decrease in the amount of the entity's share of the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to an onerous contract loss (see 9.8 above)</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ The increase in the amount of the entity's share of the fair value of the underlying items reverses any onerous contract loss above.</li> </ul> | X/(X) |
| Change in fulfilment cash flows relating to future service, except to the extent that: <ul style="list-style-type: none"> <li>▶ Risk mitigation is applied (see 12.3.5 below)</li> <li>▶ Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to an onerous contract loss (see 9.8 above)</li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>▶ Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage.</li> </ul>  | X/(X) |
| Effect of currency exchange differences (see 8.3 above)   | X/(X) |
| The amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period.  | (X)   |
| Contractual service margin at the end of the period   | X     |

<sup>427</sup> IFRS 17.45.

IFRS 17 further states that:

- ▶ Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items do not relate to future service and do not adjust the contractual service margin<sup>428</sup>
- ▶ Changes in the amount of the entity's share of the fair value of the underlying items relate to future service and adjust the contractual service margin<sup>429</sup>

Changes in fulfilment cash flows that do not vary based on returns on underlying items comprise:<sup>430</sup>

- ▶ The change in the effect of the time value of money and financial risks not arising from the underlying items. An example of this would be the effect of financial guarantees. These relate to future service and adjust the contractual service margin except to the extent that the entity applies risk mitigation
- ▶ Other changes in estimates of fulfilment cash flows. An entity applies the same requirements consistent with insurance contracts without direct participation features to determine what extent they relate to future service and therefore adjust the contractual service margin (see 9.6.3 above)

An entity is not required to identify the separate components of the adjustments to the contractual service margin resulting from changes in the entity's share of the fair value of underlying items that relate to future service and changes in the fulfilment cash flows relating to future service. Instead, a combined amount may be determined for some or all of the adjustments.<sup>431</sup>

Except in situations when a group of contracts is onerous, or to the extent the entity applies the risk mitigation exception (see 12.3.5 below), the effect of the general model and the variable fee approach may be compared, as follows:

| Comparison of   | General model  | Variable fee approach  |
|---|--|--|
| Insurance finance income or expenses (total) recognised in statement of financial performance | <ul style="list-style-type: none"> <li>▶ Change in the carrying amount of fulfilment cash flows arising from the time value of money and financial risk</li> <li>▶ Accretion of interest on the contractual service margin at rate locked-in at initial recognition</li> <li>▶ Any difference between the present value of a change in fulfilment cash flows measured at current rates and locked-in rates that adjust the contractual service margin</li> </ul> | <ul style="list-style-type: none"> <li>▶ Change in the fair value of underlying items</li> </ul> |

<sup>428</sup> IFRS 17.B111.

<sup>429</sup> IFRS 17.B112.

<sup>430</sup> IFRS 17.B113.

<sup>431</sup> IFRS 17.B114.

| Comparison of   | General model   | Variable fee approach  |
|---|---|--|
| Changes in the carrying amount of fulfilment cash flows arising from the time value of money and financial risk | Recognised immediately in the statement of financial performance <sup>432</sup> | Adjusts the contractual service margin unless risk mitigation applies (in which case it adjusts profit or loss or other comprehensive income) <sup>433</sup> |
| Discount rates for accretion of, and adjustment to, the contractual service margin                              | Rates determined at initial recognition   | Rate included in the balance sheet measurement (i.e., current rates) <sup>434</sup>  |

## How we see it

- ▶ Under the variable fee approach, an entity is not required to identify the separate components of the adjustments to the contractual service margin resulting from changes in the entity's share of the fair value of underlying items that relate to future service and changes in the fulfilment cash flows relating to future service. Not making this split might be easier administratively. However, disaggregating this change might provide useful information, better reflect the sources of measurement changes, and result in greater consistency with the insurance contract roll-forward analyses for contracts accounted for under the general model.
- ▶ An entity that does not separate the changes in its share of the fair value of underlying items from changes in the policyholder's share is likely to need to disclose the roll-forward of the carrying amount of insurance contracts with direct participation features separately from the roll-forward for other insurance contracts, because the gross amounts of insurance finance income or expenses and changes in fulfilment cash flows relating to future services (including the policyholders' share of the change in the fair value of underlying items), may be significantly different in size and nature from corresponding amounts for contracts subject to the general model.

<sup>432</sup> IFRS 17.87-89.

<sup>433</sup> IFRS 17.87(c), B113(b).

<sup>434</sup> IFRS 17.B113(a).

#### 12.3.4. Allocation of the contractual service margin to profit or loss

The contractual service margin for an insurance contract with direct participation features is allocated to profit or loss using the same methodology discussed at 9.7 above for the general model. That is, by identifying the coverage units in the group and releasing the contractual service margin in profit and loss to reflect the insurance contract services in the period.

IFRS 17 defines insurance contract services in respect of contracts with direct participation features as:<sup>435</sup>

- ▶ Coverage for an insured event (insurance coverage)
- ▶ The management of underlying items on behalf of the policyholder (investment-related service)

This means that the period over which the contractual service margin is amortised for contracts with direct participation features includes both the period in which the entity provides coverage and the period over which it provides an investment-related service.

For the purpose of amortising the contractual service margin, the period of investment-related service ends at or before the date that all amounts due to current policyholders relating to those services have been paid, without considering payments to future policyholders included in the fulfilment cash flows as a result of mutualisation (see 12.1 above).<sup>436</sup>

#### **Illustration 70 – Insurance services and investment component with different durations**

An insurance contract with direct participation features matures in year 10 and pays the customer the account value at maturity. The contract also includes a death benefit that varies depending on which year in the 10-year period the death occurs. Specifically, if the customer dies in years 1 to 5, the customer's beneficiary would receive a death benefit that is the higher of 110% of the premium paid or the accumulated account value (assume that the death benefit for years 1 to 5 results in significant insurance risk). However, if the customer dies in years 6 to 10 the customer's beneficiary receives only the account value. There is no surrender penalty.

The insurer needs to consider all 10 years for determining coverage units and amortisation of the contractual service margin as over that period insurance contract services are provided rather than only during years 1-5 .

<sup>435</sup> IFRS 17.Appendix A.

<sup>436</sup> IFRS 17.B119A.

See also 12.2 above for discussion of insurance contracts without direct participation features.

### **12.3.5. Risk mitigation**

For contracts with direct participation features, IFRS 17 requires changes in the shareholder's share of underlying items and cash flows that do not vary with underlying items (together part of the variable fee of a such contract) to adjust the contractual service margin (see 12.3.3 above). However, amounts payable to policyholders that do not vary with underlying items create risks for an entity, particularly if the amounts payable are independent of the amounts that the entity receives from investments, for example, if the insurance contract includes guarantees. An entity is also at risk from possible changes in its share of the fair value returns on underlying items and may purchase derivatives to mitigate such risks. When applying IFRS 9, such derivatives are measured at fair value through profit or loss. Consequently, an accounting mismatch arises because the change in the carrying amount of the insurance liability (i.e., the hedged item) does not go through profit or loss. A similar accounting mismatch arises if the entity uses instruments other than derivatives to mitigate risk such as reinsurance contracts held because the variable fee approach cannot be used for reinsurance contracts held.<sup>437</sup>

To address these mismatches, IFRS 17 permits entities relief from the requirements of the variable fee approach. This relief allows an entity to choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the time value of money or the effect of financial risk on:<sup>438</sup>

- ▶ The amount of the entity's share of the underlying items if the entity mitigates the effect of financial risk on that amount using derivatives or reinsurance contracts held
- ▶ The changes in fulfilment cash flows that do not vary based on the returns on underlying items arising from a change in the effect of the time value of money and financial risk, for example, the effect of financial guarantees, if the entity mitigates the effect of financial risk on those fulfilment cash flows using derivatives, non-derivative financial instruments measured at fair value through profit or loss, or reinsurance contracts held

See illustration 68 above for a comparison between the general model and the variable fee approach.

An entity that elects to use this approach should determine the eligible fulfilment cash flows in a group of contracts in a consistent manner in each reporting period.<sup>439</sup>

When risk mitigation is applied using derivatives or non-derivative financial instruments, any insurance finance income or expenses arising should be included in profit or loss. If an entity mitigates the effect of financial risk using reinsurance contracts held, it should apply the same accounting policy for the presentation of insurance finance income or expenses as the entity applies to the reinsurance contracts held (i.e., profit and loss if disaggregation is not

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<sup>437</sup> IFRS 17.BC250-BC253.

<sup>438</sup> IFRS 17.B115.

<sup>439</sup> IFRS 17.B117.



applied or split between profit and loss and other comprehensive income if disaggregation is applied - see 15.3 below).<sup>440</sup>

Use of this relief is conditional on the entity having a previously documented risk management objective and strategy for mitigating the financial risk described above. In applying that objective and strategy:<sup>441</sup>

- ▶ An economic offset exists between the insurance contracts and the derivative, non-derivative financial instrument measured at fair value, or reinsurance contract held (i.e., the values of the insurance contracts and the risk mitigating items generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated). An entity should not consider accounting measurement differences in assessing the economic offset.
- ▶ Credit risk does not dominate the economic offset.

If, and only if, any of the conditions above cease to be met, an entity must cease to apply the risk mitigation accounting prospectively from that date. An entity must not make any adjustment for changes previously recognised in profit or loss.<sup>442</sup> This means that an entity can discontinue the use of risk mitigation option only if any of the eligibility criteria cease to apply and not on a voluntary basis. The application of risk mitigation is intended to be aligned with the hedge accounting requirements in IFRS 9 and IFRS 9 does not allow an entity to discontinue hedge accounting unless the hedging relationship ceases to meet the qualifying criteria.<sup>443</sup>

IFRS 17, as issued in May 2017, permitted the risk mitigation exception to apply only to derivatives. The Board received feedback that applying the requirements in IFRS 17 when an entity holds a reinsurance contract that covers insurance contracts with direct participation features results in an accounting mismatch. The underlying insurance contracts issued are accounted for applying the variable fee approach and the reinsurance contract held is not. Reinsurance contracts that cover insurance contracts with direct participation features transfer both non-financial risk and financial risk to the reinsurer. However, the Board rejected a suggestion to permit an entity to apply the variable fee approach to those reinsurance contracts held. Despite this, the Board acknowledged that an accounting mismatch could arise when an entity mitigates the effect of financial risk using a reinsurance contract held that is similar to the mismatch that could arise when an entity uses derivatives. Accordingly, the Board amended IFRS 17 so that the risk mitigation also applies when an entity uses reinsurance.<sup>444</sup>

The Board also received feedback that some entities mitigate the effect of some financial risk on fulfilment cash flows that do not vary with returns on underlying items using non-derivative financial instruments. The Board was persuaded that if those non-derivative financial instruments are measured at fair value through profit or loss, an accounting mismatch could arise, which is similar to the accounting mismatch for derivatives. Accordingly, the Board

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<sup>440</sup> IFRS 17.B117A.

<sup>441</sup> IFRS 17.B116.

<sup>442</sup> IFRS 17.B118.

<sup>443</sup> *Amendments to IFRS 17 Insurance Contracts - Annual improvements*, IASB staff paper 2D, April 2019. p.3.

<sup>444</sup> IFRS 17.BC256B.

extended the risk mitigation option to apply in that circumstance. The Board decided to limit the extension to only those non-derivative financial instruments measured at fair value through profit or loss. For those non-derivative financial instruments, the extension resolves the accounting mismatch in the same way it resolves the accounting mismatch for derivatives (measured at fair value through profit or loss).<sup>445</sup>

In contrast, the Board considered but rejected a suggestion that an entity should be permitted to apply the risk mitigation option when it uses non-derivative financial instruments measured at fair value through other comprehensive income. The Board noted that, in most circumstances, the risk mitigation option would not resolve perceived mismatches between amounts recognised in profit or loss for insurance contracts with direct participation features using the other comprehensive income option in IFRS 17 and assets measured at fair value through other comprehensive income. Further, the suggestion would have resulted in the ineffectiveness of the risk mitigation strategy being recognised in other comprehensive income. That would be inconsistent with the hedge accounting requirements in IFRS 9. The Board observed that an entity could avoid mismatches by applying both the fair value option in IFRS 9 (to designate financial assets at fair value through profit or loss) and the risk mitigation option in IFRS 17. The Board was also not persuaded by the view that an entity should be permitted to apply the risk mitigation option when it uses non-derivative financial instruments to mitigate the effect of financial risk on the entity's share of the fair value of the underlying items. For instance, when the entity mitigates such financial risk by investing premiums in assets other than the underlying items, e.g., through an investment in fixed rate bonds. In the Board's view, permitting an entity to apply the risk mitigation option in that circumstance would contradict the principle that an entity need not hold the underlying items for the variable fee approach to apply.<sup>446</sup>

## How we see it

- ▶ The exemption, in the case of risk mitigation, from the requirement of the variable fee approach to adjust the contractual service margin for changes in financial assumptions relating to future service is an important feature. It was introduced to reduce accounting mismatches that would otherwise arise from economic risk mitigation where movements in the fair value of derivatives, reinsurance contracts held, or non-derivative financial instruments are reported in profit and loss. The guidance in the standard raises some questions about the practical application of this approach. For example, how to interpret and apply the provision for "some or all" changes in the time value of money or financial risk to be excluded from the contractual service margin when an entity mitigates financial risk using the eligible instruments.

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<sup>445</sup> IFRS 17.BC256C.

<sup>446</sup> IFRS 17.BC256D-E.

### **12.3.6. Disaggregation of insurance finance income or expenses between profit or loss and other comprehensive income**

As discussed at 15.3 below, entities have an accounting policy choice, per portfolio of insurance contracts, between:

- ▶ Including insurance finance income or expenses in profit or loss

Or

- ▶ Disaggregating insurance finance income or expenses between profit or loss and other comprehensive income

For insurance contracts with direct participation features, when disaggregation is selected, allocation of the insurance finance income or expenses between profit or loss and other comprehensive income is different depending on whether or not the underlying items are held, as follows:

- ▶ If the underlying items are not held, then the insurance finance income or expenses included in profit or loss is calculated using a systematic allocation arising from the estimates of future cash flows that that can be determined in one of two ways (known as the 'effective yield approach' and the 'projected crediting approach'). See 15.3.2 below.
- ▶ If the underlying items are held, then the insurance finance income or expenses included in profit or loss is an amount that eliminates accounting mismatches with income and expenses on the underlying items held. This means that the expenses or income from the movement of the insurance liability should exactly match the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil. This approach is sometimes referred to as the 'current period book yield approach'. (see 15.3.4. below).

## Frequently asked questions

*Question 12-4: For a direct participating contract that shares returns with policyholders by paying dividends, should the adjustment to the CSM reflect changes related to non-economic experience on underlying items be measured based on a statutory basis used to determine dividends, an IFRS measure, or a fair value measurement? In addition, in applying the current period book yield approach under paragraphs 89 and B134 of IFRS 17 to disaggregate insurance finance income or expense between profit or loss and other comprehensive income, is the adjustment limited to financial income or expenses on underlying items held? [TRG meeting April 2019 – Agenda paper no. 2, Log S114]*

The submission described a specific fact pattern for a contract applying the variable fee approach where the entity shares returns on underlying items with policyholders by paying dividends. The dividend scale varies based on the market value returns with respect to economic experience of the investments, and on a statutory basis for the non-economic experience (such as from expenses and reinsurance contracts held). Two questions were asked. Firstly, in determining the adjustment to be made to the contractual service margin under the variable fee approach for the shareholder's share in underlying items, should the change in the non-economic experience on the underlying items be determined on an IFRS, statutory or fair value basis? Secondly, when an entity applies the current period book yield approach under paragraph 89 of IFRS 17 to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, is this limited to financial income or expense on underlying items held or should it include all income or expense arising from underlying items?

The IASB staff observed that under the variable fee approach an entity adjusts the contractual service margin of a group of contracts based on changes in the fair value of underlying items. Therefore, a statutory basis or an IFRS measure (which are not fair value measurements) cannot be used to determine the adjustment to the contractual service margin. The IASB staff also observed that, when disaggregation is applied under paragraphs 89 and B134 of IFRS 17, the amount of income or expense included in profit or loss should exactly match the income or expense included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil. Therefore, income or expense on underlying items is not limited to financial income or expense.

## 12.4. Investment contracts with discretionary participation features

An investment contract with discretionary participation features does not contain significant insurance risk and is, therefore, a financial instrument. Nevertheless, these contracts are within the scope of IFRS 17, provided the entity also issues insurance contracts.<sup>447</sup>

There is no *de minimis* limit on the number of insurance contracts that an entity must issue in order to ensure that its investment contracts with discretionary participation features are within the scope of IFRS 17. In theory, an entity need only issue one insurance contract.

An investment contract with discretionary participation features is a financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:<sup>448</sup>

- ▶ That are expected to be a significant portion of the total contractual benefits
  - ▶ The timing or size of these amounts are contractually at the discretion of the issuer
  - ▶ That are contractually based on:
    - ▶ The returns on a specified pool of contracts or a specified type of contract
    - ▶ Realised and/or unrealised investment returns on a specified pool of assets held by the issuer
- Or
- ▶ The profit or loss of the entity or fund that issues the contract

Although investment contracts with discretionary participation features do not meet the definition of insurance contracts, the advantages of treating them the same as insurance contracts rather than as financial instruments when they are issued by entities that issue insurance contracts include:<sup>449</sup>

- ▶ Investment contracts with discretionary participation features and insurance contracts that specify a link to returns on underlying items are sometimes linked to the same underlying pool of assets. Sometimes investment contracts with discretionary participation features share in the performance of insurance contracts. Using the same accounting for both types of contracts will produce more useful information for users of financial statements because it enhances comparability within an entity. It also simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate both for insurance contracts that specify a link to returns on underlying items and for investment contracts with discretionary participation features. This

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<sup>447</sup> IFRS 17.3(c).

<sup>448</sup> IFRS 17 Appendix A.

<sup>449</sup> IFRS 17.BC83.

makes it challenging to apply different accounting models to different parts of that aggregate participation.

- ▶ Both of these types of contract often have characteristics, such as long maturities, recurring premiums and high acquisition cash flows, that are more commonly found in insurance contracts than in most other financial instruments. The Board developed the model for insurance contracts specifically to generate useful information about contracts containing such features.
- ▶ If investment contracts with discretionary participation features were not accounted for by applying IFRS 17, some of the discretionary participation features might be separated into an equity component in accordance with the Board's existing requirements for financial instruments. Splitting these contracts into components with different accounting treatments would cause the same problems that would arise if insurance contracts were separated. Also, in the Board's view, the accounting model it has developed for insurance contracts, including the treatment of discretionary cash flows is more appropriate than using any other model for these types of contracts.

Investment contracts with discretionary participation features are accounted for in the same way as other insurance contracts. That is to say, the general model is applied (as discussed at 9 above) and, at initial recognition, an entity should assess whether the contracts contain direct participation features and hence should apply the variable fee approach (discussed at 12.3 above).

However, as investment contracts with discretionary participation features do not transfer insurance risk, IFRS 17 requires certain modifications:<sup>450</sup>

- ▶ The date of initial recognition is the date the entity becomes party to the contract (see section 7).
- ▶ The contract boundary (see section 9.1) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.
- ▶ The allocation of the contractual service margin is modified so that the entity recognises the contractual service margin over the duration of a group of contracts in a systematic way that reflects the transfer of investment services under the contract.

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<sup>450</sup> IFRS 17.71.

## Frequently asked questions

*Question 12-5: Does an investment contract that contains a crediting rate meet the third criteria of the definition of an investment contract with discretionary participation features in IFRS 17? The question was asked in the light of the fact that paragraph BC162 of the Basis for Conclusions on IFRS 4 noted that the definition does not capture unconstrained contractual discretion to set a crediting rate that is used to credit interest or other returns to policyholders. [TRG meeting April 2019 – Agenda paper no. 2, Log S94]*

The Basis for Conclusions of IFRS 4 states that: “The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a ‘crediting rate’ that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as ‘universal life’ contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer’s resources”.

The submission asked whether an example contract met the third requirement in IFRS 17 to qualify as an investment contract with discretionary participation features relating to the contractual basis for the discretionary returns. The crediting rate in the example was based on returns of assets held as well as the weighted average rates on local treasury bonds. The crediting rate could be adjusted by the entity to some extent, based on future expected revenue and returns (the discretionary feature). The submissions assumed that the contract meets the first and second criteria of the definition of an investment contract with discretionary participation features in IFRS 17.

The IASB staff observed that the definition of an investment contract with discretionary participation features in IFRS 17 is consistent with the definition in IFRS 4. Both require that the additional discretionary amounts are contractually based on specified pools of contracts, specified pools of assets, or the profit or loss of the entity or fund that issues the contract. Any discretionary features in each investment contract need to be assessed against these criteria considering all relevant facts and circumstances. It appears that the IASB staff were sceptical that the investment contract in the example met the criteria of an investment contract with discretionary participation features.

## How we see it

- ▶ The release of the contractual service margin for investment contracts with discretionary participation features is not based on coverage units (see section 9.7), rather it is based on the investment services provided over the life of the contracts. It appears that this requirement is similar to the revenue recognition guidance contained in IFRS 15. Given that IFRS 15 would apply to investment contracts without discretionary participation features, it makes sense for this to be consistent with other investment management contracts.

### 12.4.1. Contracts with switching features

Some contracts may contain options for the policyholder to switch between funds over the lifetime of the contract and therefore change from holding an investment contract measured under IFRS 9 to holding an investment contract with discretionary participation features measured under IFRS 17 (or *vice versa*) provided the entity also issues insurance contracts. Where the assessment at contract inception has concluded that the contract is not an investment contract with discretionary participation features the question arises as to whether the existence of the option means that the contract is accounted for under IFRS 17 (as an investment contract with discretionary participation features. If the option contains features (for example in terms of pricing) that require it to be considered within the boundary of the contract (see 9.1 above) the option may already scope the contract within IFRS 17 from inception as an investment contract with discretionary participation features.

IFRS 17 states that once a contract is within its scope then it is not subsequently reassessed even if, at a later date, it is no longer a contract within its scope if the contract would have been reassessed at that date.<sup>451</sup> Therefore, investment contracts with discretionary participation features, issued by an entity that also issues insurance contracts, that subsequently lose their 'discretionary feature' as the result of the exercise of a policyholder option will remain within the scope of IFRS 17.

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<sup>451</sup> IFRS 17.B25.



## 13. Contract modification and derecognition

A contract that qualifies as an insurance contract remains so until all rights and obligations are extinguished (i.e., discharged, cancelled or expired) unless the contract is derecognised because of a contract modification.<sup>452</sup>

IFRS 4 contained no guidance on when or whether a modification of an insurance contract might cause derecognition of that contract. Therefore, prior to IFRS 17, most insurers would have applied the requirements, if any, contained in local GAAP.

### 13.1. Modifications of insurance contracts

An insurance contract may be modified, either by agreement between the parties or as result of regulation. If the terms are modified, an entity must derecognise the original insurance contract and recognise the modified contract as a new contract, if and only if, any of the conditions listed below are satisfied.<sup>453</sup>

- ▶ If the modified terms were included at contract inception:
  - ▶ The modified contract would have been excluded from the scope of IFRS 17.
  - ▶ An entity would have separated different components from the host insurance contract (see section 5) resulting in a different insurance contract to which IFRS 17 would have applied.
  - ▶ The modified contract would have had a substantially different contract boundary (see section 9.1).
  - ▶ The modified contract would have been included in a different group of contracts at initial recognition (e.g., the contracts would have been onerous at initial recognition rather than having no significant possibility of being onerous subsequently) (see section 6).
- ▶ The original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition or *vice versa*.
- ▶ The entity applied the premium allocation approach (see section 10) to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach.

In summary, any contract modification that changes the accounting model or the applicable standard for measuring the components of the insurance contract, is likely to result in derecognition.

If a contract modification meets none of the conditions above for derecognition, the entity should treat any changes in cash flows caused by the modification as changes in the estimates of the fulfilment cash flows.<sup>454</sup>

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<sup>452</sup> IFRS 17.B25.

<sup>453</sup> IFRS 17.72.

<sup>454</sup> IFRS 17.73.

In practical terms, this means that an entity will need to determine whether the change in the estimate of the fulfilment cash flows arising from the modification is a past service event (which affects profit or loss in the current period) or a future service event (which affects the contractual service margin). For contracts applying the premium allocation approach any adjustments to premium receipts or insurance acquisition cash flows arising from a modification adjust the liability for remaining coverage and insurance revenue is allocated to the period for services provided (which would also require judgement in determining the period to which the modification applies). See 9.6, 10.4 and 12.3.3 above for the accounting for changes in the fulfilment cash flows.

The exercise of a right included in the terms of a contract is not a modification.<sup>455</sup> This includes the exercise of a right that could change the nature of the insurance contract. In February 2020, the IASB discussed a staff paper prepared on this issue as a result of feedback from respondents who stated that an accounting mismatch could arise from a contract that changes in nature over time. Such a contract could change its nature due to the policyholder exercising an option. An example of such a contract noted in the staff paper is a contract with a savings phase with profit sharing that provides the policyholder with an option to subsequently convert the account balance into an annuity at a guaranteed rate. At inception, that contract might meet the requirements to be accounted for under the variable fee approach. Subsequently, when the policyholder exercises the annuity option, the entity will still be required to continue applying the variable fee approach. In contrast, at inception of an annuity contract without a savings phase the entity would normally apply the general model.

The IASB staff observed that different respondents favoured different suggested ways of amending IFRS 17 issued in 2018 to address this matter such as to exclude cash flows generated from exercising some options from the contract boundary, providing an accounting election to separate some components of an insurance contract or other changes. In conclusion, the IASB agreed with the IASB staff recommendation not to amend IFRS 17 as the suggested changes touched on key aspects of IFRS 17 and the IASB staff believed these were likely to result in unintended consequences and some of the options suggested would significantly reduce comparability across entities and would increase the complexity of IFRS 17. In addition, the IASB agreed with the IASB staff decision to decline to provide further application guidance or educational material on the matter, as suggested by some respondents, on the grounds that such guidance could be disruptive at this stage of IFRS 17 implementation.<sup>456</sup>

Accounting for derecognition of a modified contract is discussed at 13.3 below.

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<sup>455</sup> IFRS 17.72.

<sup>456</sup> IASB staff Paper 2F, *Amendments to IFRS 17: Other topics raised by respondents to the Exposure Draft*, IASB, February 2020, pp.7-8.

## How we see it

- ▶ The guidance on contract modification and derecognition under IFRS 17 is likely to result in differences from current practices applied under IFRS 4. In particular, derecognition of a contract can only happen from a modification or extinguishment, and not from the exercise of an option in a contract. This can lead to different accounting practices from those adopted currently for example for contracts that change their nature over time. A contract that is accounted for under the variable fee approach may have an accumulation phase, where the policyholder receives the returns from a pool of underlying items, and a payout phase, where the accumulated contract value is exchanged for a life contingent payout annuity at guaranteed rates. Because the option to take out the annuity was included in the original contract, the exercise of that option by the policyholder is not a modification. Therefore, when the contract moves into the payout annuity phase, it would not result in a derecognition of the accumulation contract and recognition of a new payout annuity contract. The contract would also continue to be accounted for under the variable fee approach. This is the case even though a contract that only contained a life contingent payout annuity would not meet the definition of a direct participating contract and would, therefore, be accounted for under the general model if it was issued separately.

## 13.2. Derecognition of insurance contracts

An insurance contract is derecognised when, and only when:<sup>457</sup>

- ▶ It is extinguished, i.e., when the obligation specified in the insurance contract expires or is discharged or cancelled

Or

- ▶ Any of the conditions for modifications which result in derecognition are met (see 13.1)

The treatment of contract derecognition differs depending on which of the two scenarios above applies (See 13.3 below).

When an insurance contract is extinguished, the entity is no longer at risk and not required to transfer economic resources to satisfy the contract. Therefore, the settlement of the last claim outstanding on a contract does not necessarily result in derecognition of the contract per se, although it may result in the remaining fulfilment cash flows under a contract being immaterial. For derecognition to occur, all obligations must be discharged or cancelled. When an entity purchases reinsurance, it should derecognise the underlying insurance contracts only when those underlying insurance contracts are extinguished.<sup>458</sup>

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<sup>457</sup> IFRS 17.74.

<sup>458</sup> IFRS 17.75.

## 13.3. Accounting for derecognition

IFRS 17 contains three different ways to treat the derecognition of a contract, depending on the circumstances.

The reclassification of balances previously recognised in other comprehensive income as a result of derecognition is discussed at 13.3.4 below.

### 13.3.1. *Derecognition resulting from extinguishment*

An entity derecognises an insurance contract from within a group of insurance contracts by applying the following requirements:<sup>459</sup>

- ▶ The fulfilment cash flows allocated to the group for both the liability for remaining coverage and the liability for incurred claims are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group
- ▶ The contractual service margin of the group is adjusted for the change in fulfilment cash flows described above, to the extent required by the general model, as discussed at sections 9.6 (for contracts without direct participation features) and 12.3 (for contracts with direct participation features)
- ▶ The number of coverage units for expected remaining insurance contract services is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number to reflect services provided in the period (see 9.7 above).

In practice, contracts derecognised as a result of extinguishment should no longer have a contractual service margin (or liability for remaining coverage). In these circumstances, extinguishment will result in the elimination of any fulfilment cash flows for the liability for incurred claims with a corresponding adjustment to profit or loss. An entity might not know whether a liability has been extinguished because claims are sometimes reported years after the end of the coverage period. As a result, an entity might be unable to derecognise those liabilities. Ignoring contractual obligations that remain in existence and may generate valid claims would not give a faithful representation of an entity's financial position. However, it is expected that when the entity has no information to suggest there are unasserted claims on a contract with an expired coverage period, the entity would measure the insurance contract liability at a very low amount. Accordingly, there may be little practical difference between recognising an insurance liability measured at a very low amount and derecognising the liability.<sup>460</sup>

### 13.3.2. *Derecognition resulting from transfer*

When an entity derecognises an insurance contract because it transfers the contract to a third party, the entity should:<sup>461</sup>

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<sup>459</sup> IFRS 17.76.

<sup>460</sup> IFRS 17.BC322.

<sup>461</sup> IFRS 17.77.

- ▶ Adjust the fulfilment cash flows allocated to the group for the rights and obligations that have been derecognised, as discussed at 13.3.1 above
- ▶ Adjust the contractual service margin of the group from which the contract has been derecognised for the difference between the change in the contractual cash flows resulting from derecognition and the premium charged by the third party (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage).

If there is no contractual service margin to be adjusted, then the difference between the fulfilment cash flows derecognised and the premium charged by the third party is recognised in profit or loss.

### **13.3.3. Derecognition resulting from modification**

When an entity derecognises an insurance contract and recognises a new insurance contract as a result of a modification described in 13.1 above, the entity should:<sup>462</sup>

- ▶ Adjust the fulfilment cash flows allocated to the group relating to the rights and obligations that have been derecognised, as discussed in 13.3.1 above
- ▶ Adjust the contractual service margin of the group, from which the contract has been derecognised for the difference between the change in the contractual cash flows resulting from derecognition and the hypothetical premium the entity would have charged, had it entered into a contract with terms equivalent to the new contract at the date of the contract modification, less any additional premium charged for the modification (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage)

And

- ▶ Measure the new contract recognised assuming the entity received the hypothetical premium that it would have charged, had it entered into the modified contract at the date of the contract modification

#### **Illustration 71 – Contract derecognition resulting from modification**

An entity modifies an insurance contract issued such that the modified contract would have been included in a different group of contracts and, applying the guidance in IFRS 17, determines that the contract should be derecognised and replaced by a new contract. The original contract was part of a group of insurance contracts that was not onerous. The group of contracts that the modified contract joins is also not onerous.

At the date of modification, the fulfilment cash flows of the contract were CU100 and the additional premium received at that date for the contract modification is CU20. The entity estimates that a hypothetical premium that it would have charged had it entered into the modified contract at that date was CU112. The fulfilment cash flows of the newly recognised contract were CU105

<sup>462</sup> IFRS 17.77.

### Illustration 71 – Contract derecognition resulting from modification (cont'd)

This gives rise to the following accounting entries:

|   | DR  | CR  |
|---|-----|-----|
| Cash  | 20  |     |
| Derecognition of fulfilment cash flows in the group from which the contract is derecognised                             | 100 |     |
| Adjustment to contractual service margin of the group from which the modified contract is derecognised (20 + 100 – 112) |     | 8   |
| Recognition of fulfilment cash flows of modified contract   |     | 105 |
| Addition to the contractual service margin of the group that the modified contract joins (112 – 105)                    |     | 7   |

### Frequently asked questions

**Question 13-1: Is a new contract recognised as a result of a modification accounted for similarly to contracts acquired in their settlement period applying paragraph B5 of IFRS 17 and how are the coverage units identified? [TRG meeting April 2019 - Agenda paper no. 2, Log S82]**

The IASB staff clarified that when an entity recognises new contracts that are in their settlement period, as a result of a modification that results in a derecognition of an existing contract, and which, therefore, cover events that have already occurred but the financial effect of which is uncertain, the insured event is the determination of the ultimate cost of the claims. This means that an entity recognises a liability for remaining coverage rather than a liability for incurred claims. See section 14.2 below.

### How we see it

- ▶ Determining any hypothetical premium will require the exercise of judgement by the reporting entity. This judgement may require input from an entity's pricing information and may place higher demands on data and systems. The estimate of the hypothetical premium is also a key input in determining the derecognition effect that will be adjusted against the contractual service margin of the original group of contracts and the contractual service margin that the newly recognised contract will add to the group of contracts of which it becomes a part.

#### **13.3.4. *Reclassification adjustments arising from derecognition***

When an entity transfers a group of insurance contracts, or derecognises an insurance contract because it either transfers that contract to a third party (see 13.3.2 above), or derecognises the insurance contract and recognises a new insurance contract (see 13.3.3 below), it must:<sup>463</sup>

- ▶ For insurance contracts without direct participation features or contracts with direct participation features where the entity does not hold the underlying items, reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice, if any, to disaggregate the finance income or expenses of a group of insurance contracts (see 15.3.2 below)

Or

- ▶ For insurance contracts with direct participation features contracts where the entity holds the underlying item (i.e. it applies the current book yield approach), not reclassify to profit or loss, as a reclassification adjustment, any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice, if any, to disaggregate the finance income or expenses of a group of insurance contracts (see 15.3.4 below).

#### **13.3.5. *Contracts applying the premium allocation approach that are derecognised***

IFRS 17 does not contain guidance on how contracts accounted for under the premium allocation approach (see 10 above) should apply the requirements at 15.3.1 to 15.3.3 above in circumstances in which the derecognised contracts are part of a group which has a liability for remaining coverage but no separate contractual service margin (as a contractual service margin is not recognised separately under the premium allocation approach).

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<sup>463</sup> IFRS 17.91.

### **13.4. Derecognition of assets for insurance acquisition cash flows paid before the related group of insurance contracts is recognised as an asset**

An entity should derecognise an asset recognised for insurance acquisition cash flows paid before the related group of insurance contracts is recognised as an asset when the insurance acquisition cash flows allocated to the group of insurance contracts are included in the measurement of the group. The derecognition should be allocated against the contractual margin and not taken to profit or loss unless the contract is onerous (see 9.8 above).<sup>464</sup>

If an entity recognises in a reporting period only some of the insurance contracts expected to be included in the group, the entity should determine the related portion of an asset for insurance acquisition cash flows for the group on a systematic and rational basis considering the expected timing of recognition of contracts in the group. The entity should derecognise that portion of the asset and include it in the measurement of a group of insurance contracts as above.<sup>465</sup> In this situation it would also be necessary to perform an impairment test on any remaining asset for acquisition cash flows that relates to the group (see 9.10 above).

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<sup>464</sup> IFRS 17.28C.

<sup>465</sup> IFRS 17.28C.



## 14. Acquisition of insurance contracts

Insurance contracts may be acquired in a transfer (often referred to as a portfolio transfer) or in a business combination, as defined in IFRS 3.

In summary, insurance contracts acquired in a transfer or a business combination are classified and measured in the same way as those issued by the entity at the date of the combination or transfer, except that the fulfilment cash flows are recognised at the date of the combination or transfer. IFRS 3 requires a group of insurance contracts acquired in a business combination to be measured at the acquisition date under IFRS 17 rather than at fair value.<sup>466</sup>

This results in the following key differences for insurance contracts acquired in a business combination within the scope of IFRS 3 compared with the accounting used previously under IFRS 4:

- ▶ Contracts acquired in a business combination within the scope of IFRS 3 after the date of initial application of IFRS 17 (i.e., accounting periods beginning on or after 1 January 2023) are classified as insurance contracts based on the contractual terms, economic conditions, operating or accounting policies and other pertinent factors and conditions as they exist at the acquisition date.<sup>467</sup> Previously, when IFRS 4 applied, IFRS 3 contained an exception from this requirement for insurance contracts and stated that insurance contracts acquired in a business combination within its scope should be classified on the basis of the contractual terms and other factors at the inception of the contract rather than at the date of acquisition. Other assessments like the eligibility for the premium allocation approach or variable fee approach for direct participation contracts should be based on the contractual terms and conditions at the date of acquisition.
- ▶ Contracts acquired in a transfer that is not a business combination are classified as insurance contracts based on the contractual terms, economic conditions, operating or accounting policies and other pertinent factors and conditions as they exist at the acquisition date (i.e., there is no transitional relief - see 17.2 below).
- ▶ Contracts are measured under the IFRS 17 requirements, rather than at fair value. Consequently, no option is available to split the value of the acquired insurance contracts into two components, as was permitted under IFRS 4 (i.e., between a liability in accordance with the insurer's accounting policies and an intangible asset representing the difference between fair value and the value of that liability under the IFRS 17 measurement model).

IFRS 17 does not explicitly state that contracts acquired in a business combination within the scope of IFRS 3 should be classified based on the contractual terms and conditions as they exist at the acquisition date. However, neither do other standards in similar circumstances. The amendments to IFRS 3 which apply upon the application of IFRS 17 are clear that, in a business combination, an entity is required to classify contracts (i.e., assess whether a contract transfers significant insurance risk or is an investment contract with discretionary participation features) based on the contractual terms and other

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<sup>466</sup> IFRS 3.31A.

<sup>467</sup> IFRS 3.15, 64N.

factors at the date of acquisition rather than the original inception date of the contract.<sup>468</sup>

When considering feedback from entities implementing IFRS 17, the Board considered but rejected a suggestion to reinstate the previous IFRS 4 exception in IFRS 3. In the Board's view, by removing the exception, IFRS 17 makes the accounting for the acquisition of insurance contracts consistent with the accounting for acquisitions of other contracts acquired in a business combination. The Board was not persuaded by the argument that applying the requirement will result in differences in accounting between an acquirer's consolidated financial statements and an acquiree's financial statements. In the Board's view, differences in accounting between an acquirer's financial statements and an acquiree's financial statements depict differences arising from the economics of the acquisition, they are not unique to insurance contracts and are not unusual when applying IFRS Standards. Those differences reflect changes in facts and circumstances at the acquisition date compared to facts and circumstances at the date the acquiree recognised the contracts. In addition, differences between an acquirer's financial statements and an acquiree's financial statements can arise for other reasons, for example, because of the elimination of intragroup transactions.<sup>469</sup>

IFRS 17 requires an entity to treat the consideration received or paid for insurance contracts acquired in a transfer of business or a business combination within the scope of IFRS 3, including contracts in their settlement period, as a proxy for the premiums received. This means that the entity determines the contractual service margin in accordance with all other requirements of IFRS 17 in a way that reflects the premium paid for the contracts. In a business combination within the scope of IFRS 3, the consideration received or paid is the fair value of the contracts at that date. However, IFRS 17 states that the entity does not apply the requirement in IFRS 13 *Fair Value Measurement* and that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.<sup>470</sup>

The consideration received or paid for the contracts excludes the consideration received or paid for any other assets or liabilities acquired in the same transaction. Therefore, an acquirer will have to allocate the consideration received or paid between contracts within the scope of IFRS 17, other assets and liabilities outside the scope of IFRS 17 and goodwill, if any.<sup>471</sup>

For insurance contracts measured using the general model, including the variable fee approach, on initial recognition (i.e., acquisition) the contractual service margin is calculated:<sup>472</sup>

- ▶ For acquired insurance contracts issued based on the requirements of the general model (see 9 above)
- ▶ For acquired reinsurance contracts held based on the requirements of the general model as modified (see 11 above) using the consideration received

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<sup>468</sup> Insurance contracts: *Responding to the external editorial review*, IASB staff paper 2C, February 2017, Issue A12.

<sup>469</sup> IFRS 17.BC327B-C.

<sup>470</sup> IFRS 17.B94.

<sup>471</sup> IFRS 17.B94.

<sup>472</sup> IFRS 17.B95.

or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition

If the premium allocation approach applies to insurance contracts acquired in a transfer or business combination then the premium received is the initial carrying amount of the liability for remaining coverage and the liability for incurred claims.<sup>473</sup> If facts and circumstances indicate that the contract is onerous, the difference between the carrying amount of the liability for remaining coverage and the fulfilment cash flows that relate to the remaining coverage should be treated the same way as a contract under the general model (i.e. recognised within goodwill or the gain on bargain purchase in a business combination or recognised as a loss in profit or loss on a transfer).

If the acquired insurance contracts issued are onerous:<sup>474</sup>

- ▶ For contracts acquired in a business combination within the scope of IFRS 3, the excess of the fulfilment cash flows over the consideration paid or received should be recognised as part of goodwill or the gain on a bargain purchase

Or

- ▶ For contracts acquired in a transfer, the excess of the fulfilment cash flows over the consideration paid or received is recognised as a loss in profit or loss. The entity should establish a loss component of the liability for remaining coverage for that excess (i.e., the onerous group) and apply the guidance discussed at 8.8 above to allocate subsequent changes in fulfilment cash flows to that loss component.

For a group of reinsurance contracts held when the underlying insurance contracts issued are onerous and a loss-recovery component has been recognised, an entity shall determine the loss-recovery component of the asset for remaining coverage at the date of transaction by multiplying:<sup>475</sup>

- ▶ The loss component of the liability for remaining coverage of the group of underlying insurance contracts at the date of transaction
- ▶ The percentage of claims on the underlying insurance contracts the entity expects at the date of transaction to recover from the group of reinsurance contracts held

Any loss-recovery component determined above is part of goodwill or the gain on a bargain purchase for reinsurance contracts held acquired in a business combination within the scope of IFRS 3, or as income in profit or loss for contracts acquired in a transfer.<sup>476</sup>

At the date of the transaction, onerous underlying insurance contracts might be included in a group of insurance contracts with other onerous contracts not covered by the group of reinsurance contracts held. In that situation, for the purposes of applying the requirements above, the entity must use a systematic and rational allocation basis to determine the portion of the loss component of

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<sup>473</sup> IFRS 17.B94.

<sup>474</sup> IFRS 17.B95A.

<sup>475</sup> IFRS 17.B95B.

<sup>476</sup> IFRS 17.B95C.

the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held.<sup>477</sup>

Investment contracts within the scope of IFRS 9 are required to be measured at fair value when acquired in a business combination.

The two following examples, based on Illustrative Examples 13 and 14 of IFRS 17, demonstrate the measurement on initial recognition for insurance contracts acquired:

**Illustration 72 – Measurement on initial recognition of insurance contracts acquired in a transfer that is not a business combination [Based on example 13 in the Illustrative Examples to IFRS 17, IE139-145]**

An entity acquires insurance contracts in a portfolio transfer from another entity. The seller pays CU30 to the entity to take on those insurance contracts. The entity determines that the acquired contracts form a group, as if it had entered into the contracts on the date of the transaction. The entity applies the general model to the measurement of the insurance contracts.

On initial recognition, the entity estimates that the fair value (i.e., deemed premium) of the group of insurance contracts is CU30 and the fulfilment cash flows are, as follows:

- ▶ Example A – outflow (or liability) of CU20
- ▶ Example B – outflow (or liability) of CU45.

For simplicity, this example ignores all other amounts.

The consideration of CU30 received from the seller is a proxy for the fair value of the group of contracts. Consequently, on initial recognition, the entity measures the liability for the group of contracts, as follows:

|   | Example A | Example B |
|---|-----------|-----------|
|   | CU        | CU        |
| Fulfilment cash flows                               | 20        | 45        |
| Contractual service margin                          | 10        | -         |
| Insurance contract liability on initial recognition | 30        | 45        |
| The effect on profit or loss will be:               |           |           |
| 'Profit (loss) on initial recognition'              |           | (15)      |

For contracts that are not onerous, the contractual service margin is the difference between the premium and the fulfilment cash flows (i.e., CU30 less CU20 resulting in a contractual service margin of CU10 in Example A). Consequently, in Example A, the total insurance contract liability is equal to the premium received.

In Example B, the premium received (CU30) is less than the fulfilment cash flows (CU45). Therefore, the entity concludes that the contract is onerous. Consequently, the difference between CU30 and CU45 (CU15) is an expense in profit or loss and the insurance contract liability is equal to the fulfilment cash flows. The entity also establishes a loss component of CU15.

<sup>477</sup> IFRS 17.B95D.

**Illustration 73 – Measurement on initial recognition of insurance contracts acquired in a business combination [Based on example 14 in the Illustrative Examples to IFRS 17, IE146-151]**

An entity acquires insurance contracts as part of a business combination within the scope of IFRS 3 and estimates that the transaction results in goodwill when it applies IFRS 3. The entity determines that the acquired contracts form a group, as if it had entered into the contracts on the date of the transaction. The entity applies the general model to the measurement of the insurance contracts.

On initial recognition, the entity estimates that the fair value (i.e., deemed premium) of the group of insurance contracts is CU30 and the fulfilment cash flows are, as follows:

- ▶ Example A – outflow (or liability) of CU20
- ▶ Example B – outflow (or liability) of CU45.

For simplicity, this example ignores all other amounts.

The consideration of CU30 received from the seller is a proxy for the fair value of the group of contracts. Consequently, on initial recognition, the entity measures the liability for the group of contracts, as follows:

|   | Example A | Example B |
|---|-----------|-----------|
|   | CU        | CU        |
| Fulfilment cash flows                               | 20        | 45        |
| Contractual service margin                          | 10        | -         |
| Insurance contract liability on initial recognition | 30        | 45        |
| The effect on profit or loss will be:               |           |           |
| 'Profit (loss) on initial recognition'              | -         | -         |

In Example A, the entity measures the contractual service margin as the difference between the deemed premium (CU30) and the fulfilment cash flows (CU20). Consequently, in Example A the contractual service margin is CU10 and the total insurance contract liability is equal to the deemed premium.

In Example B, the fulfilment cash flows exceed the deemed premium. Consequently, the contractual service margin is zero and the excess of the fulfilment cash flows (CU45) over the deemed premium (CU30) is an adjustment against goodwill since there cannot be a loss on initial recognition of a business combination. The entity also establishes a loss component of CU15.

## How we see it

- ▶ When insurance contracts issued or reinsurance contracts held are acquired in a transfer of insurance contracts that does not form a business, or in a business combination within the scope of IFRS 3, an entity should also apply the aggregation requirements for the identification of portfolios of insurance contracts and divide those into groupings, as explained at 5 above, as if it had entered into the contracts on the date of transaction. This implies that contract classifications and eligibility assessments relevant to such acquired contracts (i.e., significant insurance risk, direct participation features, eligibility for the premium allocation approach) are based on the terms and conditions at the acquisition date.
- ▶ As IFRS 3 also refers to 'groupings' and 'operating and accounting policies', this implies that other assessments like the eligibility for the premium allocation approach or variable fee approach for direct participation contracts (see 10.1 and 12.3.1 above) should be based on the contractual terms and conditions at the date of acquisition rather than at the date of the original inception of the contract. This approach may result in, for example, contracts that are insurance contracts of the acquiree being investment contracts of the acquirer. Consequently, there will be a different accounting treatment between the consolidated financial statements that includes the acquiree and the separate financial statements of the acquiree. However, this would reflect the substance that the acquirer has purchased investment contracts rather than insurance contracts.

### 14.1. Assets for insurance acquisition cash flows acquired in a business combination within the scope of IFRS 3 or a transfer

The asset for insurance acquisition cash flows should be excluded from in the measurement of insurance contracts acquired in a business combination within the scope of IFRS 3 or in a transfer of insurance contracts that do not form a business.<sup>478</sup>

However, when an entity acquires insurance contracts in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3, the entity should recognise an asset for insurance acquisition cash flows at fair value at the date of transaction for the rights to obtain:<sup>479</sup>

- ▶ Future insurance contracts that are renewals of insurance contracts recognised at the date of transaction
- ▶ Future insurance contracts, other than those above, after the date of the transaction without paying again insurance acquisition cash flows the acquiree has already paid that are directly attributable to the related portfolio of insurance contracts.

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<sup>478</sup> IFRS 17.B95F.

<sup>479</sup> IFRS 17.B95E.

These insurance acquisition cash flow assets recognised for the rights to obtain future insurance contracts are excluded from the scope of IAS 38.<sup>480</sup>

IFRS 17, as issued in May 2017, did not specify any requirements in respect of assets for insurance acquisition cash flows acquired in a transfer or business or business combination. The IASB concluded that requiring an entity to recognise assets for insurance acquisition cash flows for rights to obtain future insurance contracts and future renewals at the acquisition date ensures that the contractual service margin of groups of insurance contracts the entity recognises subsequent to the acquisition appropriately reflect the rights the entity paid for relating to those future groups as part of the consideration for the acquisition. Requiring an entity to recognise any such assets at the acquisition date is consistent with the other requirements in IFRS 17 for recognising an asset for insurance acquisition cash flows (see 7.3 above). The Board decided that to achieve that consistency, it is necessary to determine the rights described in the first bullet point above by reference to insurance acquisition cash flows the acquiree has already paid. Otherwise broader rights to obtain future contracts from intangible assets such as customer relationships, unconnected to any previously paid insurance acquisition cash flows, could be included in the insurance acquisition cash flow assets. In contrast, the Board decided that such reference is not needed to determine the rights described in the subsequent bullet point above. The fact that these rights relate only to renewals means they are sufficiently constrained.<sup>481</sup>

## 14.2. Subsequent treatment of contracts acquired in their settlement period

For retroactive insurance contracts that cover events that have already occurred, but for which, the financial effect is uncertain, IFRS 17 states that the insured event is the determination of the ultimate costs of the claim.<sup>482</sup> As the claim has occurred already, the question arises as to how insurance revenue and insurance service expense should be presented for these insurance contracts when they are acquired in a business combination or similar acquisition in their settlement period. More specifically, whether insurance revenue should reflect the entire expected claims or not.

In February 2018, this question was submitted to the TRG and the IASB staff stated that acquiring contracts in their settlement period is essentially providing coverage for the adverse development of claims. Therefore, the settlement period for the entity that issued the original contract becomes the coverage period for the entity that acquires the contracts. As such, contracts acquired in their settlement period will be considered part of the liability for remaining coverage for the entity that acquired the contract and not part of the liability for incurred claims. Accordingly, insurance revenue would reflect the entire expected claims as the liability for remaining coverage reduces because of services provided. If some cash flows meet the definition of an investment component, they will not be reflected in insurance revenue or insurance service expenses.

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<sup>480</sup> IAS 38.3(g).

<sup>481</sup> IFRS 17.BC327I.

<sup>482</sup> IFRS 17.B5.

This results in entities accounting differently for similar contracts, depending on whether the contracts are issued by the entity or whether the entity acquired those contracts in their settlement period. The most notable outcomes of this distinction include:

- ▶ An entity applies the general model for contracts acquired in their settlement period, because the period over which claims could develop is longer than one year whilst the entity would expect to apply the premium allocation approach for similar contracts that it issues
- ▶ An entity recognises revenue for the contracts acquired in their settlement period over the period the claims can develop, while revenue is no longer recognised over this period for similar contracts issued

In May 2018, in response to a TRG submission, the IASB staff further clarified that, for contracts acquired in their settlement period, claims are incurred (and, hence, the liability for remaining coverage is reduced) when the financial effect becomes certain. This is not when the entity has a reliable estimate if there is still uncertainty involved. Conversely, this is not necessarily when the claims are paid if certainty has been achieved prior to the actual payment. Additionally, for contracts acquired in their settlement period where the liability for remaining coverage is determined to have nil contractual service margin at initial recognition (i.e., insurance contracts are measured at zero with nil contractual service margin) and estimates of future cash flows decrease subsequently (i.e., positive fulfilment cash flows), the IASB staff stated that a contractual service margin larger than zero may be recognised post acquisition.

The TRG members had no specific comments on the IASB staff observations although the TRG members had previously observed that the requirements reflect a significant change from existing practice and this change results in implementation complexities and costs. In May 2018, the IASB staff prepared an outreach report which included implementation concerns regarding the subsequent treatment of insurance contracts acquired in their settlement period. However, the IASB declined to create an exception to the general classification and measurement requirements in IFRS 17 for contracts acquired in their settlement period. The Board concluded that an entity that acquires a contract should, at the acquisition date, apply the requirements for identifying whether a contract has an insured event and meets the definition of an insurance contract, just as an entity that issues a contract applies the requirement at the issue date.<sup>483</sup>

Some contracts acquired in their settlement period will not meet the definition of an insurance contract at the acquisition date. This is because, in some circumstances, all claim amounts are known at the acquisition date but remain unpaid. In such circumstances, the acquirer is not providing insurance coverage, the contract does not meet the definition of an insurance contract and the acquirer would account for the contract as a financial liability applying IFRS 3 and subsequently IFRS 9. The Board also observed that for contracts that meet the definition of an insurance contract at the acquisition date, an entity would need to consider whether any amounts payable to the policyholder

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<sup>483</sup> IFRS 17.BC327E.



meet the definition of an investment component (and are therefore excluded from insurance revenue).<sup>484</sup>

However, the IASB amended IFRS 17 to provide transitional relief for the settlement of claims incurred before an insurance contract is acquired when the modified retrospective approach or the fair value approach is used (see 17.4 and 17.5 below). Furthermore, the IASB also provided transition relief that allows entities to continue to apply their previous IFRS 4 classification of contracts acquired in a business combination before the date of initial application of IFRS 17 (see 17.2.1.C below).

### 14.3. Business combinations under common control

IFRS 3 does not apply to a combination of entities or businesses under common control (i.e., a common control business combination).<sup>485</sup>

Similarly, IFRS 17 limits the accounting requirements in respect of business combinations (discussed at 14 above) to a 'business combination in the scope of IFRS 3'. This requirement excludes business combinations outside the scope of IFRS 3, such as business combinations under common control, from the specific requirements of IFRS 17 for determining the contractual service margin for insurance contracts acquired in a transfer of insurance contracts or a business combination. IFRS 17, as issued in 2017, did not mention common control business combinations as such and the requirements for accounting for business combinations were stated to apply to a 'business combination' without any qualification.<sup>486</sup>

#### How we see it

- ▶ Business combinations under common control are outside the scope of IFRS 17. Consequently, an entity will need to develop an appropriate accounting policy for business combinations under common control. Currently, there is no guidance in IFRS Standards for business combinations under common control, i.e., transactions in which the combining businesses are ultimately controlled by the same party both before and after the combination. The International Accounting Standards Board (the Board) has published a discussion paper, which includes proposed reporting requirements for such transactions. The Board's objective is to reduce diversity in practice and improve comparability and transparency.

## 14.4. Portfolio transfers- practical issues

### 14.4.1. *The difference between a business combination and a transfer*

When an entity acquires a portfolio of insurance contracts, the main accounting consideration is to determine whether that acquisition meets the definition of a

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<sup>484</sup> IFRS 17.BC327G.

<sup>485</sup> IFRS 3.2(c).

<sup>486</sup> IFRS 17.BC327A.

business. IFRS 3 defines a business as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends, or interest) or generating other income from ordinary activities'.<sup>487</sup> The application guidance to IFRS 3 notes that a business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs they are not required for an integrated set of assets and activities to be a business.<sup>488</sup> Where it is considered that a business is acquired, goodwill may need to be recognised, as may deferred tax liabilities, in respect of any acquired intangibles. For an isolated transfer, neither goodwill nor deferred tax should be recognised.

Rights to issue or renew contracts in the future (as opposed to existing insurance contracts) are separate intangible assets and the accounting for the acquisition of such rights is discussed at 14.4.3 below.

An entity should recognise an asset at fair value for insurance acquisition cash flows that relate to future insurance contracts and future renewals acquired in a transfer that is not a business as discussed at 14.1 above.

### How we see it

- The determination of whether a portfolio of contracts or a business has been acquired will be a matter of judgement based on the facts and circumstances. Acquisitions of contracts that also include the acquisition of underwriting systems and/or the related organised workforce are more likely to meet the definition of a business than merely the acquisition of individual or multiple contracts.

#### 14.4.2. *Deferred taxation*

For transactions that meet the definition of a business combination, IAS 12 requires deferred tax to be recognised in respect of temporary differences arising in business combinations, for example if the tax base of the asset or liability remains at cost when the carrying amount is fair value. IFRS 17 contains no exemption from these requirements. Therefore, deferred tax will often arise on temporary differences created by the recognition of insurance contracts at a value different from that applied previously by the acquiree (e.g., because the fulfilment cash flows at the date of acquisition for the insurance contracts acquired, calculated on the basis of the contractual terms at the date of the acquisition, is different from the carrying value of the fulfilment cash flows calculated by the acquiree on the basis of contractual terms on initial recognition of the insurance contract). The deferred tax adjusts the amount of goodwill recognised. For transactions that do not meet the definition of a business combination, the initial recognition exemption applies and no deferred tax is recognised on initial recognition (as discussed at 14.4.1 above).

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<sup>487</sup> IFRS 3 Appendix A.

<sup>488</sup> IFRS 3.B7 8.

### **14.4.3. Customer lists and relationships not connected to insurance contracts**

The requirements discussed at 164 above apply only to insurance contracts that exist at the date of a business combination or transfer and the requirements discussed at 13.1 above apply to insurance acquisition cash flows related for the rights to obtain future insurance contracts.

Therefore, they do not apply to customer lists and customer relationships reflecting the expectation of future insurance contracts and related insurance acquisition cash flows that do not meet the IFRS 17 recognition criteria. IAS 36 and IAS 38 apply to such transactions as they apply to other intangible assets.

The following example deals with customer relationships acquired together with a portfolio of one-year motor insurance contracts.

#### **Illustration 74 – Purchase of portfolio of one-year motor insurance contracts**

Parent A obtained control of insurer B in a business combination on 31 December 2023. B has a portfolio of one-year motor insurance contracts that policyholders may cancel annually.

Because Insurer B establishes its relationships with policyholders through insurance contracts, the customer relationship with the policyholders meets the contractual-legal criterion for recognition as an intangible asset. IAS 36 and IAS 38 apply to the customer relationship intangible asset.<sup>489</sup>

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<sup>489</sup> IFRS 3.IE30(d.)

## 15. Presentation

IFRS 17 specifies minimum amounts of information that need to be presented on the face of the statement of financial position and statement of financial performance. These are supplemented by disclosures to explain the amounts recognised on the face of the primary financial statements (see section 16 below).

IFRS 17 requires separate presentation of amounts relating to insurance contracts issued and reinsurance contracts held in the primary statements. There is nothing to prevent an entity from providing further sub-analysis of the required line items (which may make the relationship of the reconciliations to the face of the statement of financial position more understandable). Indeed, IAS 1 *Presentation of Financial Statements* requires presentation of additional line items (including the disaggregation of line items specifically required), headings and subtotals on the face of the statements of financial position and financial performance when such presentation is relevant to an understanding of the entity's financial position or financial performance.<sup>490</sup>

### 15.1. Statement of financial position

For presentation in the statement of financial position, IFRS 17 and IAS 1 require insurance contracts to be aggregated by portfolios and presented separately, as follows:<sup>491</sup>

- ▶ Insurance contracts issued that are assets
- ▶ Insurance contracts issued that are liabilities
- ▶ Reinsurance contracts held that are assets
- ▶ Reinsurance contracts held that are liabilities

A portfolio is a group of insurance contracts that are subject to similar risks and managed together (see 6.1 above).<sup>492</sup>

The requirement to present insurance contracts assets and liabilities at a portfolio level provides significant operational relief and does not significantly diminish the usefulness of information compared to a requirement to present assets and liabilities at a group of insurance contract level.<sup>493</sup>

Any assets or liabilities for insurance acquisition cash flows (see 7.3 above) and any other assets or liabilities for cash flows related to a group of contracts that occur before the group is recognised are subsumed in the carrying amount of the related portfolios of insurance contracts issued, and any other assets or liabilities for cash flows related to portfolios of reinsurance contracts held are subsumed in the carrying amount of the portfolios of reinsurance contracts held.<sup>494</sup>

There is no requirement for disclosure of balances on respect of the general model, premium allocation approach, or variable fee approach to be shown

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<sup>490</sup> IAS 1.54-56, 82-86.

<sup>491</sup> IFRS 17.78, IAS 1.54(da) and 54(ma).

<sup>492</sup> IFRS 17.14.

<sup>493</sup> IFRS 17.BC330B.

<sup>494</sup> IFRS 17.79.

separately on the face of the statement of financial position. Nor is there a requirement for the components of the balances (such as the contractual service margin or the risk adjustment for non-financial risk) to be presented separately on the face of the statement of financial position.

However, an entity should disclose reconciliations in the notes to the financial statements that show how the amounts disclosed on the face of the statement of financial position (i.e., the net carrying amount of contracts within the scope of IFRS 17) changed during the reporting period because of cash flows and income and expenses recognised in the statement of financial performance. Separate reconciliations are required for insurance contracts issued and reinsurance contracts held.<sup>495</sup> The detailed requirements of these reconciliations are discussed at 16.1 below. In summary, separate reconciliations are required for contracts subject to the general model and the premium allocation approach together with reconciliations for the individual components of the contract balances. An entity is required to consider the level of aggregation of these reconciliations necessary to meet the overall disclosure objectives of the disclosure requirements of IFRS 17.<sup>496</sup>

Applying IFRS 4, some entities presented separately in the statement of financial position different amounts arising from an insurance contract, as if those different amounts were separate assets or liabilities. For example, some entities presented line items labelled as premiums receivable, claims payable and deferred acquisition costs separately from the insurance contract liability. Different entities presented different line items and had different definitions of what those line items were (for example, some entities presented as premiums receivable amounts that were not yet billed while other entities presented only billed amounts that remain outstanding). Some stakeholders expressed the view that they would like to continue that practice of further disaggregation because they view such disaggregated line items as providing meaningful information to users of financial statements. However, the Board disagreed with this approach to presentation because it could result in the presentation of amounts that are not separable assets or liabilities. For example, premiums receivable for future coverage is not a gross asset separable from the related liability for the future coverage.<sup>497</sup> IAS 1 permits the presentation of additional line items (including by disaggregation of line items), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.<sup>498</sup>

The Board also considered some stakeholders' suggestions that entities should be permitted to present one insurance contract asset or liability for all insurance contracts issued by the entity (that is, present insurance contracts at an entity level). The Board rejected that suggestion because that would risk an unacceptable loss of useful information for users of financial statements.<sup>499</sup>

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<sup>495</sup> IFRS 17.98.

<sup>496</sup> IFRS 17.95.

<sup>497</sup> IFRS 17.BC330D.

<sup>498</sup> IAS 1.55.

<sup>499</sup> IFRS 17.BC330C.

In addition, the statement of financial position should include, among others, line items that present the following amounts, including those that back policyholder liabilities:<sup>500</sup>

- ▶ Investment property
- ▶ Intangible assets
- ▶ Financial assets, with separate presentation of trade and other receivables and cash and cash equivalents
- ▶ Financial liabilities, with separate presentation of trade and other payables
- ▶ Liabilities and assets for current tax, as defined in IAS 12
- ▶ Deferred tax liabilities and deferred tax assets, as defined in IAS 12

### How we see it

- ▶ The presentation requirements are significantly different from those required by IFRS 9 for financial instruments. They are also likely to differ significantly from any presentation applied previously by an insurer under IFRS 4. For example, individual positive and negative contract balances with different counterparties within one portfolio are aggregated (netted) on the statement of financial position.
- ▶ All rights and obligations arising from an insurance contract are included in the presentation of the portfolio on a net basis, unless the components of the contract are separated and accounted for under a different IFRS (see 6.1.1 above). The rights and obligations presented net would include all related non-distinct elements, for example, policyholder loans, insurance premiums receivable, liabilities for incurred claims and insurance acquisition cash flows that have been included in the measurement of the contractual service margin.
- ▶ The fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there should, in principle, be no equity and no net comprehensive income reported in any accounting period. Mutual insurers may choose to present additional line items and sub totals on the face of their statement of financial position. This would distinguish amounts due to or from policyholders, in their capacity as policyholders, from amounts due to, or from, qualifying mutual policyholders (including future policyholders) in their capacity as holders of the most residual interest in the entity.

## 15.2. Statement of financial performance

An entity is required to disaggregate the amounts recognised in the statement of profit and loss and the statement of other comprehensive income (collectively, referred to in the standard as the statement of financial performance) into:<sup>501</sup>

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<sup>500</sup> IAS 1.54.

<sup>501</sup> IFRS 17.80.

- ▶ Insurance service result comprised of:
  - ▶ Insurance revenue; and
  - ▶ insurance service expenses.
- ▶ Insurance finance income or expenses.

Income or expenses from reinsurance contracts held should be presented separately from the expenses or income from insurance contracts issued.<sup>502</sup> This presentation is also required by IAS 1<sup>503</sup>

An entity may present the income or expense from a group of reinsurance contracts held, other than insurance finance income or expenses, as either:<sup>504</sup>

- ▶ A single amount (net presentation)
- Or
- ▶ Separately (gross presentation):
  - ▶ The amounts recovered from the reinsurer
  - ▶ An allocation of the premium paid

When the gross presentation for reinsurance held is used, an entity is not allowed to present the allocation of the reinsurance premiums paid as a reduction in revenue.<sup>505</sup>

Insurance finance income or expenses must be presented separately for insurance contracts issued and reinsurance contracts held on the face of the statement of profit or loss.<sup>506</sup> When insurance finance income or expenses is disaggregated it must also be shown separately for insurance contracts issued and reinsurance contracts held in other comprehensive income, within items of other comprehensive income that will be classified subsequently to profit or loss when specific conditions are met.<sup>507</sup>

In addition, the profit or loss section or the statement of profit or loss shall include, among others, line items that present the following amounts for the period:<sup>508</sup>

- ▶ Revenue, presenting separately
- ▶ Interest revenue calculated using the effective interest method
- ▶ Insurance revenue
- ▶ Gains and losses arising from the derecognition of financial assets measured at amortised cost
- ▶ Finance costs
- ▶ Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with section 5.5 of IFRS 9

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<sup>502</sup> IFRS 17.82.

<sup>503</sup> IAS 1.82(a)(ii), (ab)-(ac).

<sup>504</sup> IFRS 17.86.

<sup>505</sup> IFRS 17.86(c).

<sup>506</sup> IAS 1.82(bb)-(bc).

<sup>507</sup> IAS 1.7(i)-(j).

<sup>508</sup> IAS 1.82.

- ▶ Tax expense, being the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax

The following table illustrates a summary statement of financial performance under IFRS 17.

| <b>Illustration 75 – Illustrative statement of financial performance</b>               |              |             |
|--|--------------|-------------|
| <b>Statement of profit or loss and other comprehensive income</b>                      | <b>2021</b>  | <b>2020</b> |
|  | CU'm         | CU'm        |
| <i>Insurance revenue</i>   | 10,304       | 8,894       |
| <i>Insurance service expenses</i>  | (9,069)      | (8,489)     |
| <b>Insurance service results before reinsurance contracts held</b>                     | <b>1,235</b> | <b>405</b>  |
| <i>Income (expenses) from reinsurance contracts held</i>                               | (448)        | (327)       |
| <b>Insurance service result</b>  | <b>787</b>   | <b>78</b>   |
| Insurance finance income or expenses from contracts issued within the scope of IFRS 17 | 394          | 353         |
| Finance income or expenses from reinsurance contracts held                             | 200          | 300         |
| <b>Net financial result</b>  | <b>594</b>   | <b>653</b>  |
| <b>Profit before tax</b>   | <b>1,381</b> | <b>731</b>  |
| <b>Other comprehensive income</b>  |              |             |
| <i>Items that may be reclassified subsequently to profit or loss</i>                   |              |             |
| Insurance finance income or expenses from contracts issued within the scope of IFRS 17 | 50           | (25)        |
| Finance income or expenses from reinsurance contracts held                             | (25)         | 50          |
| <b>Other comprehensive income for the year net of tax</b>                              | <b>25</b>    | <b>25</b>   |
| <b>Total comprehensive income for the year</b>   | <b>1,406</b> | <b>746</b>  |

The following example illustrates the presentation of the insurance service result if the result from reinsurance contracts held is shown on a gross basis.



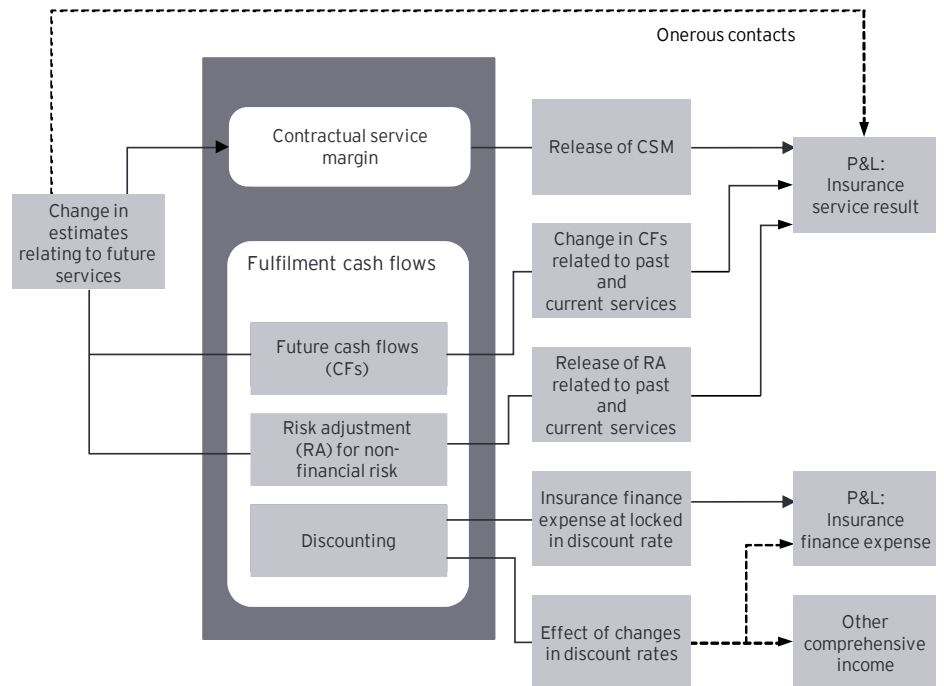
**Illustration 76 – insurance service result if the result from reinsurance contracts held is shown on a gross basis**

| Statement of profit or loss and other comprehensive income         | 2021         | 2020       |
|--|--------------|------------|
|  | CU'm         | CU'm       |
| <i>Insurance revenue</i>   | 10,304       | 8,894      |
| <i>Insurance service expenses</i>                                  | (9,069)      | (8,489)    |
| <b>Insurance service results before reinsurance contracts held</b> | <b>1,235</b> | <b>405</b> |
| <i>Income (expenses) from reinsurance contracts held</i>           |              |            |
| <i>Amounts recovered from the reinsurer</i>                        | 300          | 200        |
| <i>Allocation of reinsurance premiums paid</i>                     | (748)        | (527)      |
| Reinsurance held subtotal  | (448)        | (327)      |
| <b>Insurance service result</b>                                    | <b>787</b>   | <b>78</b>  |

There is nothing to prevent an entity from providing further sub-analysis of the components of the insurance service result (which may make the relationship of the reconciliations discussed at section 16.1 below to the face of the statement of financial performance more understandable). Indeed, IAS 1 states that an entity should present additional line items (including by disaggregating line items specified by the standard), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.<sup>509</sup>

The following diagram illustrates the high-level relationship of the movements in the building blocks of the general model (discussed at 8 above) and their relationship with the presentation in the statement of financial performance.

<sup>509</sup> IAS 1.85



Each of the amounts required to be reported in the statement of financial performance are discussed at 15.2.1 to 15.2.3 below.

### 15.2.1. Insurance revenue

Insurance revenue depicts the provision of services arising from a group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.<sup>510</sup>

Insurance revenue from a group of insurance contracts is therefore the consideration for the contracts, i.e., the amount of premiums paid to the entity:<sup>511</sup>

- ▶ Adjusted for financing effect (the time value of money)
- ▶ Excluding any investment components

Investment components are accounted for separately and are not part of the insurance service result.

The amount of insurance revenue recognised in a period depicts the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following:<sup>512</sup>

- ▶ Amounts related to the provision of services, comprising:
  - ▶ Insurance service expenses, excluding any amounts related to the risk adjustment for non-financial risk included below and any amounts allocated to the loss component of the liability for remaining coverage

<sup>510</sup> IFRS 17.83.

<sup>511</sup> IFRS 17.B120.

<sup>512</sup> IFRS 17.B121.

- ▶ Amounts related to income tax that are specifically chargeable to the policyholder
- ▶ The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage
- ▶ The contractual service margin
- ▶ Amounts related to insurance acquisition cash flows

Expected costs for insurance service expenses will be included in the fulfilment cash flows. For example, an entity might include building costs in the fulfilment cash flows (see 9.2.3 above). The entity will determine depreciation costs over the period of the useful life of the building applying the requirements of IAS 16. When these costs are incurred applying IAS 16, the entity will treat them as an incurred expense under IFRS 17, i.e., the entity will reduce the liability for remaining coverage and recognise revenue. An entity accounts for income tax applying IAS 12. When income tax expenses that are specifically chargeable to the policyholder under the terms of an insurance contract are recognised applying IAS 12, an entity recognises insurance revenue for the consideration paid by the policyholder for such income tax amounts when the entity recognises in profit or loss the income tax amounts. This means that when an entity incurs income tax expenses that are specifically chargeable to the policyholder under the terms of an insurance contract, the entity will need to reduce the liability for remaining coverage and recognise insurance revenue accordingly.<sup>513</sup> As IAS 1 requires a separate presentation of the tax expense, the related income tax amount incurred in the period is reported as part of the tax expense line item.<sup>514</sup>

#### Illustration 77 – Interaction between IFRS 17 other IFRSs

At 31 December 2023 (Q4/H2), Entity A recognised a liability for a group of insurance contracts on the face of its statement of financial position.

**Note:** All other amounts apart from those mentioned below are ignored for simplicity.

The fulfilment cash flows of the liability for remaining coverage at 31 December 2023 include the following:

|   | CU  |
|---|-----|
| Allocated depreciation of right-of-use asset expected to be incurred during 2024 <sup>1</sup> | 218 |
| Expected income tax payment for 2024, chargeable to the policyholder                          | 120 |

<sup>1</sup>At 31 December Entity A has recognised a right-of-use asset (CU436) and a corresponding lease liability (CU446) related to the current lease contract as required by IFRS 16.

<sup>513</sup> *Amendments to IFRS 17 - Sweep issues*, IASB staff paper 2, May 2020, p.6.

<sup>514</sup> IAS 1.82(d).

### Illustration 77 – Interaction between IFRS 17 other IFRSs (cont'd)

The actual expenses incurred during 2024 amount to:

|   | CU  |
|---|-----|
| Income tax expense recognised and measured in terms of IAS 12 <i>Income Tax</i> |     |
| Current tax   | 120 |
| Amortisation of right-of-use asset  | 218 |

The journal entries to account for the consequences of the actual expenses incurred within 2024 may be presented (assuming no differences between actual and expected expenses), as follows:

|  | CU  | CU  |
|--|-----|-----|
| <b>DEPRECIATION</b>  |     |     |
| Amortisation expense   | 218 |     |
| Right-of-use asset - accumulated amortisation  |     | 218 |
| <i>Application of IFRS 16</i>  |     |     |
| Liability for remaining coverage   | 218 |     |
| Insurance revenue  |     | 218 |
| <i>Application of IFRS 17.41(a)</i>  |     |     |
| Insurance service expenses   | 218 |     |
| Liability for incurred claims  |     | 218 |
| <i>Application of IFRS 17.42(a)</i>  |     |     |
| Liability for incurred claims  | 218 |     |
| Amortisation expense   |     | 218 |
| <i>Deemed settlement of liability for incurred claims when expense is incurred under IFRS 16</i> |     |     |
| <b>INCOME TAX</b>  |     |     |
| Liability for remaining coverage   | 120 |     |
| Insurance revenue  |     | 120 |
| <i>Application of IFRS 17.41(a) and B121(a)(IA)</i>  |     |     |
| Income tax expense   | 120 |     |
| Current tax liability  |     | 120 |
| <i>Application of IAS 12 Income Tax</i>  |     |     |

The above journal entries may result in the following line items in the statement of profit or loss for the period ended 31 December 2024:

|                               | IAS 1 ref | CU    |
|-------------------------------|-----------|-------|
| Insurance revenue (120 + 218) | 82(a)(ii) | 338   |
| Insurance service expenses    | 82(ab)    | (218) |
| Underwriting result           |           | 120   |
| Tax expense                   | 82(d)     | (120) |

### **15.2.1.A. Insurance revenue related to the provision of services in a period**

When an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises revenue. This is consistent with revenue recognition under IFRS 15 in which an entity recognises revenue and derecognises the performance obligation for services that it provides.<sup>515</sup>

The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. These are changes that:<sup>516</sup>

- ▶ Do not relate to services provided in the period, for example:
  - ▶ Changes resulting from cash inflows from premiums received
  - ▶ Changes that relate to investment components in that period
  - ▶ Changes resulting from cash flows from loans to policyholders
  - ▶ Changes that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes)
- ▶ Insurance finance income or expenses
- ▶ Insurance acquisition cash flows
- ▶ Derecognition of liabilities transferred to a third party
- ▶ Relate to services, but for which the entity does not expect consideration, i.e., increases and decreases in the loss component of the liability for remaining coverage.

Additionally, any insurance revenue presented in profit or loss should exclude any investment components as well as amounts not arising from the provision of insurance services.<sup>517</sup>

To the extent that an entity derecognises an asset for cash flows other than insurance acquisition cash flows at the date of initial recognition of a group of insurance contracts (see 9.5.1), it should recognise insurance revenue and expenses for the amount derecognised at that date.<sup>518</sup>

After having explained what insurance revenue is not, IFRS 17 then explains which changes in the liability for remaining coverage in the period relates to services for which the entity expects to receive compensation. Those changes are:<sup>519</sup>

- ▶ Insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:

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<sup>515</sup> IFRS 17.B123.

<sup>516</sup> IFRS 17.B123.

<sup>517</sup> IFRS 17.85.

<sup>518</sup> IFRS 17.B123A.

<sup>519</sup> IFRS 17.B124.

- ▶ Amounts allocated to the loss component of the liability for remaining coverage
- ▶ Repayments of investment components
- ▶ Amounts related to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes)
- ▶ Insurance acquisition expenses
- ▶ The amount related to the risk adjustment for non-financial risk
- ▶ The change in risk adjustment for non-financial risk, excluding:
  - ▶ Changes included in insurance finance income or expenses
  - ▶ Changes that adjust the contractual service margin because they relate to future service
  - ▶ Amounts allocated to the loss component of the liability for remaining coverage
- ▶ The amount of the contractual service margin recognised in profit or loss in the period
- ▶ Other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service

Insurance revenue related to insurance acquisition cash flows should be determined by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of passage of time. An entity should recognise the same amount as insurance service expenses.<sup>520</sup> The purpose of this is to separately identify and recognise the recovery of the insurance acquisition cash flows through insurance revenue over the coverage period. The following example illustrates how insurance acquisition cash flows are allocated to revenue.

### Frequently asked questions

**Question 15-1: Can experience adjustments relate to insurance acquisition cash flows and how do they align to the definition of insurance acquisition cash flows? [TRG meeting September 2018 - Agenda paper no. 6, Log S80]**

The IASB staff paper noted that insurance acquisition cash flows are included in the determination of the contractual service margin or loss component for a group of insurance contracts on initial recognition. They are treated the same way as other cash flows incurred in fulfilling insurance contracts. An entity is, therefore, not required to identify whether it will recover the acquisition cash flows at each reporting date since the measurement model captures any lack of recoverability automatically. It does this by limiting the contractual service margin from becoming negative. When expected cash inflows are less than the total of expected cash outflows (including acquisition cash flows) and the risk adjustment for non-financial risk, a loss component is recognised along with a charge to profit or loss.

<sup>520</sup> IFRS 17.B125.

## Frequently asked questions (cont'd)

The TRG members observed that:

- ▶ An entity is not required separately to identify whether it will recover insurance acquisition cash flows at each reporting date.
- ▶ IFRS 17 assumes that the portion of premiums relating to the recovery of insurance acquisition cash flows is equal to the current estimate of total expected insurance acquisition cash flows at each reporting period.

The TRG members also noted that experience adjustments arising from premiums received in the period that relate to future service, and the related cash flows such as insurance acquisition cash flows, adjust the contractual service margin.

This means that, for example, if initial estimates of acquisition cash flows, payable at the end of a one-year coverage period, were CU100 and, at six months into the coverage period, the entity now expects to pay CU120 for acquisition cash flows at the end of the coverage period compared to the initial expectation of CU100; then the amount of insurance service expenses related to the amortisation of acquisition cash flows (and insurance revenue recognised) at six months is CU60 (CU120 x 6/12).

***Question 15-2: Does IFRS 17 require or permit an entity to accrete interest on the amount of acquisition cash flows paid for determining the insurance revenue and insurance services expenses applying paragraph B125? [TRG meeting April 2019 - Agenda paper no. 2, Log S121]***

The IASB staff observed that an entity is required to determine insurance revenue related to insurance acquisition cash flows by allocating the portion of premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of passage of time. Such a systematic way does not preclude consideration of interest accretion.

### **Illustration 78 – Allocating a portion of premiums to recovery of insurance acquisition cash flows**

An entity issues a group of insurance contracts with a coverage period of four years. The entity pays initial acquisition cash flows of CU200 and expects to pay trail commission of CU50 at the end of year 4. The group of contracts is not determined to be onerous. The entity estimates, at the time of initial recognition of the group of contracts, that the discount rate that applies to nominal cash flows that do not vary based on the returns on any underlying items is 3% per year.

The present value of expected insurance acquisition cash flows at initial recognition is CU244 [CU200 + (CU50 ÷ 1.03<sup>4</sup>)] which is part of the initial liability for remaining coverage. This is reduced when the insurance acquisition cash flows occur. The entity elects to accrete interest on the insurance acquisition cash flows (see 9.3 above) and estimates the portion of premiums that relates to the recovery of insurance acquisition cash flows in each of the four years of coverage after accreting interest on the opening balance to be CU63, CU65, CU67 and CU68. The entity recognises the same amounts as insurance service expenses in each year (i.e., insurance revenue and insurance service expenses are grossed up for the same amount of CU263).

**Illustration 78 – Allocating a portion of premiums to recovery of insurance acquisition cash flows (cont'd)**

|  | Year 1 | Year 2 | Year 3 | Year 4 |
|--|--------|--------|--------|--------|
| A. Memorandum balance at the beginning of the year of coverage                   | 244    | 188    | 129    | 66     |
| B. Accretion of interest at 3% per year  | 7      | 6      | 4      | 2      |
| C. Amount allocated for the year (A+B)/the number of remaining years of coverage | (63)   | (65)   | (67)   | (68)   |
| D. Memorandum balance at the end of the year                                     | 188    | 129    | 66     | 0      |

### How we see it

- ▶ Revenue recognition will be different from practice under IFRS 4, particularly for life contracts where the accounting practice in many jurisdictions is to recognise premiums due in a period as equivalent to revenue. Revenue in IFRS 17 excludes investment components and recognises revenue as service is provided, instead of when premiums are due to be received. Maintaining records of the liability for remaining coverage for each group of insurance contracts, including any loss component, over the course of the coverage period, and adjusting the amount recognised in profit or loss in each period as revenue for investment components will call for new systems and processes.
- ▶ The new measurement of insurance revenue is also likely to change reported metrics and even impact on the perceived size of entities where this is based on the amount of revenue reported.
- ▶ Insurance revenue should also incorporate a financing effect (i.e., the adjustment for the effect of time value of money, see 15.2.1 above), with a corresponding effect reflected in insurance service expenses. The Standard is clear that for contracts with direct participation feature this effect is determined using a current discount rate. The Standard is also clear that for contracts accounted for under the premium allocation approach the financing effect (if any) should be determined using the discount rate locked-in at initial recognition of the group of contracts. However, the Standard is not clear on whether the financing effect for contracts accounted for under the general model should be based on current rates or locked-in rates. An entity would therefore have to make an accounting policy choice between a current rate and a locked-in for determining the financing effect under the general model and apply this choice consistently to contracts accounted for under the general model.
- ▶ An entity must allocate the portion of the premium that relates to recovering the insurance acquisition cash flows in a systematic way on the basis of time over the coverage period. Such a pattern does not necessarily have to be purely time-proportionate but could also



be another systematic basis that appropriately considers the passage of time, like coverage units. Further, as observed by the TRG and as mentioned under 9.3 above, the standard does not preclude determining this basis in a way that considers the accretion of interest. This means an entity will have to determine its accounting policy on accreting interest to the memorandum balance of insurance acquisition cash flows.

#### **15.2.1.B. Revenue under the premium allocation approach**

When an entity applies the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable) allocated to the period. The entity should allocate the expected premium receipts to each period of insurance contract services:<sup>521</sup>

- ▶ On the basis of the passage of time; but
- ▶ If the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

An entity should change the basis of allocation between the two methods above, as necessary, if facts and circumstances change.<sup>522</sup> Any change must be reflected in the basis of allocation as a change in accounting estimate and applied prospectively (see section 10.3).

If an entity using the premium allocation approach does not expense insurance acquisition cash flows as incurred (see 10.2 above), the same guidance applies for allocating these to revenue as discussed at 15.2.1 above for the general approach.

#### **How we see it**

- ▶ The premium allocation approach has many similarities with current practice for non-life insurance based on the unearned premium reserve (UPR) method. However, entities should determine whether the allocation guidance in IFRS 17 requires a change in the revenue recognition pattern. This would be the case if, for example, the expected pattern of release of risk during the coverage period differs significantly from the passage of time, but the entity currently recognises revenue based on the passage of time.
- ▶ The standard is silent on how to apply the systematic way on the basis of passage of time for allocating the insurance acquisition over the coverage period. The standard, therefore, does not appear to preclude applying this allocation pattern in a way that is consistent with the pattern for recognising insurance revenue under the premium allocation approach. This could be administratively easier for entities as they can then determine revenue on a 'net' basis (i.e., the premium amount less insurance acquisition cash flows) and then 'gross up' insurance revenue and insurance service expenses for the amount of insurance acquisition

<sup>521</sup> IFRS 17.B126.

<sup>522</sup> IFRS 17.B127.

cash flows allocated to the period for presentation in the income statement.

#### **15.2.1.C. Income or expense from reinsurance contracts held**

IFRS 17 permits an entity to present income or expenses from a group of reinsurance contracts held, other than insurance finance income or expenses, either:<sup>523</sup>

- ▶ As a single amount

Or

- ▶ Separately, the amounts recovered from the reinsurer and an allocation of the premiums paid that, together, give a net amount equal to that single amount

If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it should:<sup>524</sup>

- ▶ Treat reinsurance cash flows that are contingent on claims on the underlying contracts (which would include profit commission payable or receivable) as part of the claims that are expected to be reimbursed under the reinsurance contract held
- ▶ Treat amounts from the reinsurer that it expects to receive that are not contingent on the claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer
- ▶ Treat amounts recognised relating to recovery of losses when an entity has a group of reinsurance contracts held providing coverage for an onerous group of underlying insurance contracts as amounts recovered from the reinsurer (see 11.4.2 above)
- ▶ Not present the allocation of premiums paid as a reduction in revenue

#### **15.2.2. Insurance service expense**

Insurance service expenses comprise the following:<sup>525</sup>

- ▶ Incurred claims (excluding repayments of investment components) and other incurred service expenses
- ▶ Amortisation of insurance acquisition cash flows
- ▶ Changes in fulfilment cash flows that relate to past services, i.e., relating to the liability for incurred claims
- ▶ Changes in fulfilment cash flows that relate to future service, but which do not adjust the contractual service margin, i.e., losses on onerous groups of contracts and reversals of such losses

An entity needs to disaggregate this information (for example, to show insurance acquisition cash flows separately from other insurance service

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<sup>523</sup> IFRS 17.86.

<sup>524</sup> IFRS 17.86.

<sup>525</sup> IFRS 17.84.

expenses) when it is relevant to understanding the entity's financial performance (see 15.2 above).

With respect to the change in risk adjustment for non-financial risk, the entire change is included as part of insurance service result unless the entity has decided to disaggregate this change between the insurance service result and the insurance finance income or expense.<sup>526</sup>

### 15.3. Insurance finance income or expenses

Insurance finance income or expenses comprise the change in the carrying amount of the group of insurance contracts arising from:<sup>527</sup>

- ▶ The effect of the time value of money and changes in the time value of money; and
- ▶ The effect of financial risk and changes in financial risk; but
- ▶ Exclude any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin, but do not do so in certain circumstances and are included in insurance service expenses instead. These circumstances occur when:
  - ▶ The entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual margin and gives rise to a loss, or an increase in the amount of the entity's share of the fair value that causes a reversal of that loss
  - ▶ Increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin and give rise to a loss, or decreases in fulfilment cash flows are allocated to the loss component of the liability for remaining coverage

Insurance finance income or expenses do not include income or expenses related to financial assets or liabilities within the scope of IFRS 9, such as investment finance income on underlying items. This is disclosed separately under IAS 1 (see 5.2 above).

An entity is required to include in insurance finance income or expenses the effect of the time value of money and financial risk and changes therein. For this purpose:<sup>528</sup>

- ▶ Assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk
- ▶ Assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk
- ▶ Changes in the measurement of a group of insurance contracts caused by changes in the value of underlying items (excluding additions and

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<sup>526</sup> IFRS 17.81.

<sup>527</sup> IFRS 17.87.

<sup>528</sup> IFRS 17.B128

withdrawals) are changes arising from the effect of the time value of money and financial risk and changes therein.

The words in the last bullet point above mean that changes in the measurement of insurance contracts arising from changes in underlying items, including changes in the value of underlying items not caused by the time value of money or the effect of financial risks, for example, where the underlying items include non-financial assets, should be treated as insurance finance income or expenses. This is because the underlying items are regarded as investments that determine the amount of some payments to policyholders. The underlying items referred to are those that affect measurement of all insurance contracts and not only underlying items in respect of contracts with direct participation features. The Basis for Conclusions observes that, without this requirement, changes in underlying items could adjust the contractual service margin of insurance contracts without direct participation features. The Board considered a view that, although it would be complex, the effects of changes in cash flows from participating in underlying items that are not financial in nature (for example, insurance contracts) should be presented within the insurance service result, rather than within insurance finance income or expenses. The Board disagreed with this view because the requirement to reflect changes from participation in underlying items in insurance finance income or expenses appropriately depicts the nature of the participation, as an investment. In the Board's view, policyholder participation in underlying items that are not solely financial in nature, such as insurance contracts, should not change the underlying insurance service result. Further, splitting the effect of changes in cash flows resulting from the participation in underlying items that are not solely financial in nature into an amount that should be included in the insurance service result and an amount that should be included in insurance finance income or expense would be complex and could disrupt implementation for some entities.<sup>529</sup>

Exchange differences on changes in the carrying amount of groups of insurance contracts, including the contractual service margin, are included in the statement of profit or loss, unless they relate to changes in the carrying amount of groups of insurance contracts in other comprehensive income, in which case, they should be included in other comprehensive income.<sup>530</sup> Neither IAS 21 *The Effects of Changes in Foreign Currency Rates* nor IFRS 17 specify where, in profit or loss, exchange differences should be presented – see 8.3 above.

### Frequently asked questions

***Question 15-3: Are changes in fulfilment cash flows as a result of changes in inflation assumptions treated as changes in non-financial risk (which may adjust the contractual service margin) or changes in financial risk for contracts measured under the general model? [TRG meeting April 2019 – Agenda paper no. 2, Log S122]***

The submission provided examples of cash flows such as claims contractually linked to a specified consumer price inflation index and cash flows that are not contractually linked to an index, but which are expected to increase with inflation. The IASB staff observed that cash flows that

<sup>529</sup> IFRS 17.BC342A.

<sup>530</sup> IFRS 17.92.

an entity expects to increase with an index are an assumption that relates to financial risks, even if the cash flows are not contractually linked to a specific index. The TRG members did not disagree with the IASB staff's observation.

### 15.3.1. *Presentation of insurance finance income or expenses in the statement of comprehensive income*

Except for insurance finance income or expenses arising from insurance contracts under the variable fee approach when risk mitigation is applied, entities have an accounting policy choice between presenting insurance finance income or expenses in profit or loss, or disaggregated between profit or loss and other comprehensive income.<sup>531</sup>

If an entity mitigates the effect of financial risk under the variable fee approach (see 12.3.5 above) using derivatives and non-derivative financial assets measured at fair value through profit or loss, it should include insurance finance income or expenses for the period in profit or loss. If an entity mitigates the effect of financial risk using reinsurance contracts held insurance finance income or expenses should be allocated between profit and loss and other comprehensive income on the basis of the allocation used by the reinsurance contract.<sup>532</sup>

An entity should apply its choice of accounting policy to portfolios of insurance contracts. The choice is then applied to all groups of contracts within that portfolio. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the entity should consider for each portfolio the assets that the entity holds and how it accounts for those assets.<sup>533</sup>

A summary of the policy choices that apply when allocating insurance finance income or expenses in the statement of comprehensive income are, as follows:

| Type of contract                       | Accounting  | Unit of account                     |
|--|---|-------------------------------------|
| <i>General model</i>                   |   |                                     |
| Present value of future cash flows     | All in profit or loss unless disaggregated between profit and loss and other comprehensive income                             | Disaggregation choice per portfolio |
| Risk adjustment for non-financial risk | Follows the present value of future cash flows as per above for insurance finance income or expenses (i.e., all in profit and | Disaggregation choice per portfolio |

<sup>531</sup> IFRS 17.88 and 89.

<sup>532</sup> IFRS 17.B117A.

<sup>533</sup> IFRS 17.B129.

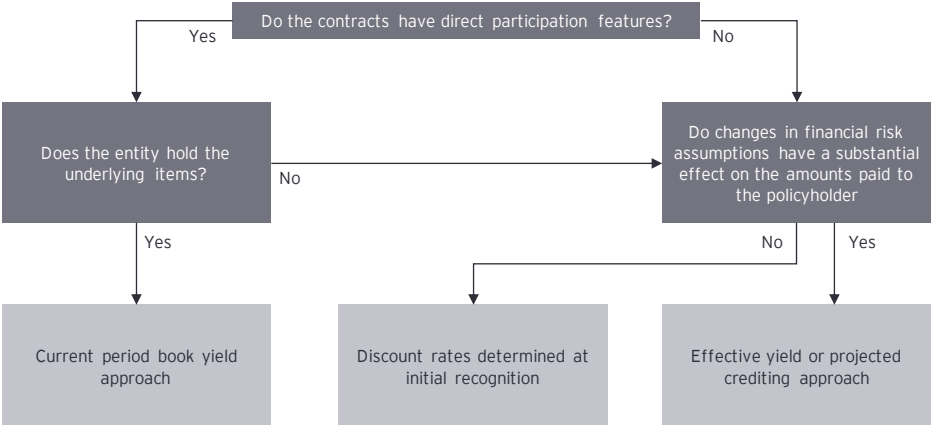
| Type of contract                       | Accounting  | Unit of account                     |
|--|---|-------------------------------------|
|  | loss or disaggregated) if the entity has elected to disaggregate the risk adjustment between insurance service result and insurance finance income or expenses (see 15.3.1 above)   |                                     |
| Contractual service margin             | All in profit and loss as not revalued at current interest rates  | N/A                                 |
| <i>Premium allocation approach</i>     |   |                                     |
| Liability for remaining coverage       | All in profit and loss as not revalued at current interest rates  | N/A                                 |
| Liability for incurred claims          | All in profit or loss unless disaggregated between profit and loss and other comprehensive income   | Disaggregation choice per portfolio |
| <i>Variable fee approach</i>           |   |                                     |
| Present value of future cash flows     | All in profit or loss unless disaggregated between profit and loss and other comprehensive income   | Disaggregation choice per portfolio |
| Risk adjustment for non-financial risk | Follows the present value of future cash flows for insurance finance income or expenses as per above (i.e., all in profit and loss or disaggregated) if the entity has elected to disaggregate the risk adjustment between insurance service result and insurance finance income or expenses (see 15.3.1 above) | Disaggregation choice per portfolio |

| Type of contract           | Accounting  | Unit of account |
|----------------------------|---|-----------------|
| Contractual service margin | The contractual service margin is at current interest rates so this leads to an offset between fulfilment cash flows and contractual service margin rather than being presented in insurance finance income or expenses | Not applicable  |

When disaggregation is selected, the methodology required for allocating insurance finance income or expenses between profit and loss and other comprehensive income is different depending on the entity’s accounting policy choices based on the nature of the insurance contract liabilities in the portfolio.

The disaggregation approaches for each type of insurance contract are discussed at 15.3.2 to 15.3.4 below.

In summary, the approaches determining what portion of insurance finance income or expenses is attributed to profit and loss for portfolios of contracts, except those to which risk mitigation is applied, under the variable fee approach is, as follows:



This can be further illustrated, as follows:

| Contract type  | Amount recognised in profit or loss  | OCI element recycled |
|--|--|----------------------|
| Groups of insurance contracts without direct participating features where the effect of financial risk assumptions does not have a substantial effect on the policyholder                          | Using discount rates determined on initial recognition   | Yes                  |
| Groups of insurance contracts without direct participating features where the effect of financial risk assumptions has a substantial effect on the policyholder                                    | Choice of (a) effective yield or (b) projected crediting approach                                | Yes                  |
| Contracts accounted for under the premium allocation approach (incurred claims)  | Using discount rates determined at date of incurred claim  | Yes                  |
| Groups of insurance contracts with direct participating features where the underlying items are not held but the effect of financial risk assumptions has a substantial effect on the policyholder | Choice of (a) effective yield or (b) projected crediting approach                                | Yes                  |
| Groups of insurance contracts with direct participating features where the underlying items are held   | Current period book yield approach (i.e., net profit or loss impact in the period should be nil) | No                   |

### Frequently asked questions

**Question 15-4:** *In a situation in which portfolios of insurance contracts change due to the manner in which the entity manages its contracts, what is the impact of such a change on the group unit of account or the application of the option to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income? [TRG meeting April 2019 – Agenda paper no. 2, Log S106]*



## Frequently asked questions (cont'd)

The IASB staff observed that paragraph 24 of IFRS 17 requires that an entity establishes groups of contracts at initial recognition and does not reassess the composition of the groups subsequently. Paragraph B129 of IFRS 17 states that the option to disaggregate insurance finance income or expense between profit or loss and other comprehensive income is a policy choice applied to portfolios of insurance contracts. Applying paragraph 13 of IAS 8 means that an entity selects and applies its accounting policy consistently for similar portfolios of insurance contracts. The requirements of IAS 8 are applicable for changes in accounting policies. This implies that when an entity decides to choose a policy of disaggregation (or decides to cease a policy of disaggregation) that policy change or choice should be applied to all similar portfolios.

## How we see it

- ▶ Allowing entities to choose between recognising insurance finance income or expenses wholly in profit or loss, or disaggregating it between profit or loss and other comprehensive income, significantly reduces the comparability of profits between entities that apply IFRS 17. There is a trade-off between ensuring comparability between entities and allowing entities to choose how to present insurance finance income or expenses in the accounting in a way that, together with the accounting for their assets backing the insurance liabilities, best fits with how they manage financial risk.
- ▶ Entities would typically try to minimise accounting mismatches between assets and liabilities. For example, entities that have financial assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and, therefore, record the effect of fair value fluctuations on those securities in other comprehensive income under IFRS 9, would be expected to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income on related insurance contract liabilities to minimise accounting mismatches. Conversely, an entity would be less inclined to disaggregate insurance finance income or expenses for portfolios of insurance contracts where the assets backing those liabilities include a substantial proportion of financial instruments which are held at fair value with changes in fair value through profit or loss under IFRS 9.
- ▶ In presenting insurance finance income or expense, an entity is permitted, but not required, to disaggregate the change in risk adjustment for non-financial risk between the insurance service result and insurance finance income or expenses. The risk adjustment reflects the uncertainty of the present value of cash flows. Consequently, its measurement implicitly reflects the time value of money. Permitting entities, as an accounting policy choice, to disaggregate a financing element of changes in the risk adjustment for non-financial risks gives them the opportunity to select their preferred way of reporting the effects of changes in the risk adjustment. However, given the fact that IFRS 17 does not prescribe any specific methods for estimating the adjustment, many may choose not to disaggregate the time value element of changes in the carrying amount of the risk adjustment for non-financial risk. In that case, the entity should include the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

### **15.3.2. Allocating insurance finance income or expenses for contracts except those with direct participation features for which the entity does not hold the underlying items**

For insurance contracts without direct participation features and contracts with direct participation features where the entity does not hold the underlying items (i.e., all insurance contracts except those with direct participation features for which the entity holds the underlying items), an entity should make an accounting policy choice between:<sup>534</sup>

- ▶ Including insurance finance income or expenses for the period in profit or loss

And

- ▶ Disaggregating insurance finance income or expenses for the period to include in profit in loss, an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts

When an entity chooses a disaggregation policy for a portfolio, the amount included in other comprehensive income is the difference between the insurance finance income or expenses included in profit and loss measured on a systematic allocation basis (see 15.3.1 above) and the total insurance finance income or expenses in the period, i.e., the amount included in other comprehensive income is the balancing figure.<sup>535</sup>

This approach applies to both the liability for remaining coverage and the liability for incurred claims under the general model. Under the premium allocation model, it applies only to the liability for incurred claims. It does not apply to the liability for remaining coverage under the premium allocation approach unless the group of contracts becomes onerous as the liability for remaining coverage is discounted using the rates at initial recognition of the group and not at current rates. Disaggregating discount rates for the liability for incurred claims under the premium allocation approach is discussed at 15.3.3 below.

A systematic allocation means an allocation of the total expected insurance finance income or expenses of a group of insurance contracts over the duration of the group that:<sup>536</sup>

- ▶ Is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts. For example, the allocation of the insurance finance income or expenses should not be based on expected recognised returns on assets if those expected recognised returns do not affect the cash flows of the contracts in the group
- ▶ Results in the amounts recognised in other comprehensive income over the duration of the group of contracts totaling zero. The cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation.

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<sup>534</sup> IFRS 17.88.

<sup>535</sup> IFRS 17.90.

<sup>536</sup> IFRS 17.B130.

When an entity that has disaggregated insurance finance income or expenses of a group of insurance contracts transfers that group of insurance contracts or derecognises an insurance contract as a result of a modification or transfer (see 13.3.4 above), it should reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice.<sup>537</sup>

**15.3.2.A. *Allocating insurance finance income or expenses for contracts for which changes that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder***

For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation (i.e., the amount presented in profit or loss) is determined using the discount rates at the date of initial recognition of the group of contracts.<sup>538</sup>

For contracts applying the general model, as the contractual service margin is not remeasured using current rates, all insurance finance income or expenses arising from the accretion of interest of the contractual service margin is recorded in profit or loss.

#### Frequently asked questions

***Question 15-5: For contracts measured applying the general model, when an entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (OCI), should accumulated OCI on insurance contracts be reclassified to profit or loss when experience does not unfold as expected, and if so, how.? [TRG meeting April 2019 - Agenda paper no. 2, Log S102]***

Under IFRS 17, the amount of insurance finance income or expenses allocated to profit or loss is determined by a systematic allocation of the expected total finance income or expenses over the duration of the group. This results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling zero. The IASB staff observed that the cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation of the expected total insurance finance or expenses over the duration of the group. That is, when the insurance liability is increased or decreased as a result of experience adjustments, the discount rate used for the systematic allocation of the expected total insurance finance income or expenses continues to be calculated as before (e.g., based on the discount rates determined at initial recognition for a group of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder) and a reclassification adjustment occurs only on derecognition.

<sup>537</sup> IFRS 17.91(a).

<sup>538</sup> IFRS 17.B131.

**Illustration 79– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders is not substantial**

On initial recognition of a group of insurance contracts an entity expects to pay policyholders CU1,890 at the end of Year 3. The impact of financial risk on the amounts paid to the policyholders is not substantial and is not affected by changes in discount rates. The interest rate at initial recognition of the group of contracts is 10% and there are no changes to this applying a weighted average discount rate. For simplicity it is assumed that all premiums (cash inflows) are received at the date of initial recognition and all other amounts, including the risk adjustment for non-financial risk, are ignored. Applying paragraph B131 of IFRS 17, the entity disaggregates insurance finance income or expense using the discount rates determined on initial recognition of the group.

At initial recognition, the present value of expected future cash flows is CU1,420 (i.e., CU1,890 discounted for 3 years at 10% being CU1,562 after one year, CU1,718 after 2 years and CU1,890 after 3 years).

At the end of year 1, the present value of expected future cash flows is CU1,562 (i.e., CU1,890 discounted for 2 years at 10%). The insurance finance income or expenses of CU142 (i.e., CU1,562 less CU1,420) is debited to profit or loss as there is no difference between current discount rates and the discount rate at initial recognition.

At the end of year 2, market interest rates have reduced to 5%. As a result, the present value of expected future cash flows at the end of year 2 is CU1,800. The insurance finance income or expenses of CU238 (i.e., CU1,800 less CU1,562) is allocated, as follows:

- ▶ CU156 is debited to profit or loss being the difference between CU1,800 and CU1,562 at the discount rate at initial recognition of 10%.
- ▶ CU82 is debited to other comprehensive income being the difference being total insurance finance income or expenses of CU238 and the amount allocated to profit or loss of CU156.

At the end of year 3, market interest rates are still 5%. As a result, the insurance finance income or expenses of CU90 (i.e., CU1,890 less CU1,800) is allocated, as follows:

- ▶ CU172 is debited to profit or loss being the difference between CU1,718 and CU1,890 using the discount rate and cash flows at initial recognition of 10%.
- ▶ CU82 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU90 and the amount allocated to profit or loss of CU172.

The net cumulative amount in other comprehensive income at the end of year 3 is CU nil.

**15.3.2.B. Allocating insurance finance income or expense for contracts for which changes in assumptions that relate to financial risk have a substantial effect on amounts paid to policyholders**

For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders, which will include contracts with direct participation features for which the underlying items are not held, a systematic allocation for the finance income or expenses arising from the estimates of future cash flows can be determined in one of the following ways:<sup>539</sup>

- ▶ Using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate ('effective yield approach')

Or

- ▶ For contracts that use a crediting rate to determine amounts due to the policyholders, using an allocation that is based on the amounts credited in the period and expected to be credited in future periods to the policyholder ('projected crediting approach')

IFRS 17 does not provide guidance on how to determine 'substantial effect' although it is presumably intended to be interpreted similarly to the words 'substantial share' and 'substantial proportion' discussed in the context of insurance contracts with direct participation features at 12.3.1 above. A group of insurance contracts with direct participation features will usually be a group for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders. In addition, a group of insurance contracts that have failed to meet the criteria for applying the variable fee approach because of, for example, a lack of a clearly identified pool of underlying items (see 12.3.1 above) might also be groups of contracts for which changes in assumptions that relate to financial risk (e.g., a change in the crediting rate or dividend amount) have a substantial effect on the amounts paid to policyholders.

The decision to elect either an effective yield approach or a projected crediting approach is an accounting policy choice and is applied to eligible groups according to the criteria in IAS 8.

A systematic allocation for the finance income or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk, is determined using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.<sup>540</sup>

A systematic allocation for the finance income or expenses arising from the contractual service margin is determined.<sup>541</sup>

- ▶ For insurance contracts that do not have direct participation features, using the discount rates determined at the date of initial recognition of the group of contracts (which results in the entire insurance finance income or

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<sup>539</sup> IFRS 17.B132(a).

<sup>540</sup> IFRS 17.B132(b).

<sup>541</sup> IFRS 17.B132(c).

expenses allocated to profit or loss since the contractual service margin is not remeasured at current rates)

- ▶ For insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the interest income or expenses arising from future cash flows

**Illustration 80– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders not substantial – effective yield approach [Based on example 15A in the Illustrative Examples to IFRS 17, IE155-IE164]**

On initial recognition of a group of insurance contracts an entity expects to pay policyholders CU1,890 at the end of Year 3. The interest rate at initial recognition of the group of contracts is 10% and there are no changes to this applying a weighted average discount rate. For simplicity it is assumed that all premiums (cash inflows) are received at the date of initial recognition and all other amounts, including the risk adjustment for non-financial risk, are ignored. The entity chooses to disaggregate insurance finance income or expenses using a systematic allocation of the total expected insurance finance income or expenses over the remaining duration of the group.

At initial recognition, the present value of expected future cash flows is CU1,420 (i.e., €1,890 discounted for 3 years at 10%, being CU1,562 after one year, CU1,718 after 2 years and CU1,890 after 3 years)).

At the end of year 1, market interest rates have reduced to 5%. Consequently, the entity revises its expectations as to the future cash flows it will pay its policyholders and now expects to pay only CU1,802 at the end of year 3. The revised constant interest rate is calculated at 7.42% a year (i.e., the rate required to accrete CU1,562 up to CU1,802). As a result, the revised present value of future cash flows at the end of year 1 is CU1,635.

Applying paragraph B132(a)(i), the entity recognises in profit or loss the insurance finance income or expenses calculated as the change in estimates of the present value of the future cash flows at the constant rate of return. In year 1, the finance expenses of CU142 in profit or loss is the difference between the estimates of the present value of future cash flows at the original constant rate of 10% at the end of the year 1 of CU1,562 and the corresponding amount at the beginning of the period of CU1,420. Applying paragraph B130(b), the entity recognises in other comprehensive income the difference between the total insurance finance expense of CU215 (i.e., the difference between opening fulfilment cash flows of €1,420 and the current fulfilment cash flows of CU1,635) and the amount included in profit or loss of €142, i.e., CU73.

At the end of year 2, market interest rates are still 5%. The present value of expected future cash flows discounted at current rates is CU1,716. The insurance finance income or expenses of CU81 (i.e., the difference between CU1,716 and the opening revised cash flows of CU1,635) is allocated, as follows:

- ▶ CU116 is debited to profit or loss being the difference between the estimates of future cash flows of CU1,562 and CU1,678 using the constant rate of return of 7.34%

**Illustration 80– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders not substantial – effective yield approach [Based on example 15A in the Illustrative Examples to IFRS 17, IE155-IE164] (cont'd)**

- ▶ CU35 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU81 and the amount allocated to profit or loss of CU116.

At the end of year 3, market interest rates are still 5%. As a result, the insurance finance income or expenses of CU86 (i.e., CU1,802 less CU1,716) is allocated, as follows:

- ▶ CU124 is debited to profit or loss being the difference between the final cash flows of CU1,802 and the previous discounted figure of CU1,678 using the constant rate of return of 7.34%
- ▶ CU38 is credited to other comprehensive income being the difference being total insurance finance income or expenses of CU86 and the amount allocated to profit or loss of CU124

The net cumulative amount in other comprehensive income at the end of year 3 is nil.

**Illustration 81– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders not substantial – projected crediting rate approach [Based on example 15B in the Illustrative Examples to IFRS 17, IE165-IE172]**

On initial recognition of a group of insurance contracts, an entity receives a single premium of CU15 for 100 insurance contracts with a coverage period of three years. The total premium for the group of contracts is CU1,500. On initial recognition, the entity expects to achieve rate of return on underlying items of 10% each year and to credit the policyholder account balances by 8% each year (the expected crediting rate). Consequently, the entity expects to pay policyholders CU1,890 at the end of Year 3 ( $CU1,500 \times 1.08 \times 1.08 \times 1.08$ ). At initial recognition, the present value of the expected cash flow at the end of year three amounts to CU1,420 ( $CU1,890 \div ((1 + 0.10)^3)$ ).

In Year 1, the entity credits the policyholder account balances with a return of 8% a year, as expected at the date of initial recognition.

At the end of Year 1, the market interest rate falls from 10% per year to 5% per year. Consequently, the entity revises its expectations about cash flows, as follows:

- ▶ It will achieve a return of 5% in Year 3 after reinvesting the maturity proceeds of the bonds that mature at the end of Year 2
- ▶ It will credit the policyholder account balances 8% in Year 2 and 3% in Year 3
- ▶ It will pay policyholders CU1,802 at the end of Year 3 ( $CU1,500 \times 1.08 \times 1.08 \times 1.03$ )

**Illustration 81– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders not substantial – projected crediting rate approach [Based on example 15B in the Illustrative Examples to IFRS 17, IE165-IE172] (cont'd)**

The entity elects to disaggregate insurance finance income or expenses using an allocation to profit or loss based on amounts credited in the period and expected to be credited in future periods (a 'projected crediting rate approach').

Therefore, the entity allocates the remaining expected insurance finance income or expenses over the remaining life of the contracts using the series of discount rates calculated as the projected crediting rates multiplied by the constant factor. The constant factor and the series of discount rates based on crediting rates at the end of Year 1 are, as follows:

- ▶ The product of the actual crediting rate in Year 1 and the expected crediting rates in Years 2 and 3 equals 1.20 (1.08 x 1.08 x 1.03)
- ▶ The carrying amount of the liability increases by a factor of 1.269 over three years because of the interest accretion (CU1,802 ÷ CU1,420)
- ▶ Consequently, each crediting rate needs to be adjusted by a constant factor (K), as follows  $1.08K \times 1.08K \times 1.08K = 1.269$
- ▶ The constant K equals 1.0184 calculated as  $(1.269 / 1.20)^{1/3}$
- ▶ The resulting interest accretion rate for Year 1 is 10% (calculated as  $1.08 \times 1.0184$ )

The carrying amount of the liability at the end of Year 1 for the purposes of allocating insurance finance income or expenses to profit or loss is CU1,562 (CU1,420 x 1.08 x 1.0184).

The actual crediting rate for Years 2 and 3 are as expected at the end of Year 1. The resulting accretion rate for Year 2 is 10% (calculated as  $(1.08 \times 1.0184) - 1$ ) and for Year 3 is 4.9% (calculated as  $(1.03 \times 1.0184) - 1$ ).

|   | Initial recognition | Year 1 | Year 2 | Year 3 |
|---|---------------------|--------|--------|--------|
|   | CU                  | CU     | CU     | CU     |
| Estimates of future cash flows at the end of Year 3                               | 1,890               | 1,802  | 1,802  | 1,802  |
| Estimates of the present value of future cash flows at current discount rates (A) | 1,420               | 1,635  | 1,716  | 1,802  |
| Estimates of future cash flows at discount rates based on projected crediting (B) | 1,420               | 1,562  | 1,718  | 1,802  |
| Amount accumulated in other comprehensive income (A-B)                            | -                   | 73     | (2)    | -      |



**Illustration 81– Allocating insurance finance income or expenses for contracts where the impact of financial risk on the amounts paid to policyholders not substantial – projected crediting rate approach [Based on example 15B in the Illustrative Examples to IFRS 17, IE165-IE172] (cont'd)**

In the table above, CU1,716 equals the estimate of the future cash flows at the end of Year 3 of CU1,802 discounted at the current market rate of 5% per year, i.e.,  $CU1,802 \div 1.05 = CU1,716$ .

CU1,718 equals the estimates of future cash flows at the end of Year 3 of CU1,802 discounted at the projected crediting rate of 4.9% per year, i.e.,  $CU1,802 \div 1.049 = CU1,718$ .

There is an amount of CU2 accumulated in other comprehensive income at the end of Year 2 because the discount rate based on projected crediting rate of 4.9% per year ( $1.03 \times K$ ) is different from the current discount rate of 5% per year.

The insurance finance income or expenses included in profit or loss and other comprehensive income are, as follows:

|  | Year 1 | Year 2 | Year 3 |
|--|--------|--------|--------|
| <b><i>Insurance income and expensed arising from fulfilment cash flows</i></b> |        |        |        |
|  | CU     | CU     | CU     |
| Profit or loss   | (142)  | (156)  | (84)   |
| Other comprehensive income   | (73)   | 75     | (2)    |
| Total comprehensive income   | (215)  | (81)   | (86)   |

The entity recognises in profit or loss the insurance finance expenses calculated as the change in the estimates of the present value of the future cash flows at the projected crediting rate. In Year 1, insurance finance expenses of CU142 is the difference between the estimates of the present value of the future cash flows at the original crediting rate of 10 per cent at the end of Year 1 of CU1,562 and the corresponding amount at the beginning of the period of CU1,420.

The entity includes in other comprehensive income, the difference between the amount recognised in total comprehensive income and the amount recognised in profit or loss. In Year 1, for example, the amount included in other comprehensive income of CU(73) is CU(215) minus CU(142). In Years 1-3, the total other comprehensive income equals zero ( $CU0 = CU(73) + CU75 + CU(2)$ ).

The entity recognises, in total comprehensive income, the change in estimates of the present value of the future cash flows at the current discount rate. In Year 1, the total insurance finance expenses of CU(215) is the difference between the estimates of the present value of the future cash flows at the current discount rate at the beginning of Year 1 of CU1,420 and the corresponding amount at the end of Year 1 of CU1,635.

### **15.3.3. Allocating insurance finance income or expenses for incurred claims when applying the premium allocation approach**

When the premium allocation approach is applied (see 9 above), an entity may be required, or may choose to discount the liability for incurred claims (see 9.4 above). In such cases, it may also choose to disaggregate the insurance finance income or expenses as discussed at 15.3.1 above. If the entity makes this choice, it should determine the insurance finance income or expenses in profit or loss using the discount rate determined at the date of the incurred claim.<sup>542</sup>

### **15.3.4. Allocating finance income or expenses for insurance contracts with direct participation features for which the entity holds the underlying items**

For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity should make an accounting policy choice between:<sup>543</sup>

- ▶ Including insurance finance income or expenses for the period in profit or loss

Or

- ▶ Disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches, with income or expenses included in profit or loss on the underlying items held

This means that, when disaggregation is applied, the amount included in profit or loss for insurance finance income or expenses for insurance contracts with direct participation features exactly matches the insurance finance income or expenses included in profit or loss for the underlying items, resulting in the net of the separately presented items being nil.<sup>544</sup> This is sometimes referred to as the current period book yield approach.

An entity may qualify for the current period book-yield approach in some periods but not in others, because of a change in whether it holds the underlying items. If such a change occurs, the accounting policy choice available to the entity changes from that set out above to that set out at 15.3.1 above or vice versa. Hence, an entity might change its accounting policy between that set out above and that set out at 15.3.1 above. In making such a change, an entity should:<sup>545</sup>

- ▶ Include the accumulated amount previously included in other comprehensive income at the date of the change as a reclassification adjustment in profit or loss in the period of change and in future periods, as follows:
  - ▶ If the entity had previously applied the requirements described at 15.3.1 above, it should include in profit or loss the accumulated amount included in other comprehensive income before the change

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<sup>542</sup> IFRS 17.B133.

<sup>543</sup> IFRS 17.89.

<sup>544</sup> IFRS 17.B134.

<sup>545</sup> IFRS 17.B135.

as if it were continuing the approach described at 15.3.1 above based on the assumptions that applied immediately before the change; and

- ▶ If the entity had previously applied the requirements above, it should include in profit or loss the accumulated amount included in other comprehensive income before the change as if it were continuing the approach above based on the assumptions that applied immediately before the change.
- ▶ Not restate prior period comparatives information

An entity should not recalculate the accumulated amount previously included in other comprehensive income as if the new disaggregation had always applied; nor update the assumptions used for the reclassification in future periods after the date of the change.<sup>546</sup>

When an entity that has disaggregated the insurance finance income or expenses of a group of insurance contracts with direct participation features using the current book yield approach and transfers that group of insurance contracts or derecognises an insurance contract due to a modification (see 13.3.4 above), it should not reclassify to profit or loss as a reclassification adjustment any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice.<sup>547</sup> This is a different accounting treatment than for contracts which do not apply the current book yield approach (see 15.3.2 above).

**Illustration 82 – Allocating insurance finance income or expense for contracts using the current book yield approach [Based on example 16 in the Illustrative Examples to IFRS 17, IE173-IE185]**

An entity issues 100 insurance contracts with a coverage period of three years. The coverage period starts when the insurance contracts are issued. The contracts meet the criteria for insurance contracts with direct participation features.

The entity receives a single premium of CU15 for each contract at the beginning of the coverage period (total future cash inflows of CU1,500). The entity promises to pay policyholders on maturity of the contract, an accumulated amount of returns on a specified pool of bonds minus a charge equal to 5% of the premium and accumulated returns calculated at that date. Thus, policyholders that survive to maturity of the contract receive 95% of the premium and accumulated returns. In this example, all other amounts, including the risk adjustment for non-financial risk are ignored for simplicity.

The entity invests premiums received of CU1,500 in zero coupon fixed income bonds with a duration of three years (the same as the returns promised to policyholders). The bonds return a market interest rate of 10% per year. At the end of Year 1, market interest rates fall from 10% a year to 5% per year. The entity measures the bonds at fair value through other comprehensive income applying IFRS 9. The effective interest rate of the bonds acquired is 10% per year, and that rate is used to calculate investment

<sup>546</sup> IFRS 17.B136.

<sup>547</sup> IFRS 17.91(b).

**Illustration 82 – Allocating insurance finance income or expense for contracts using the current book yield approach [Based on example 16 in the Illustrative Examples to IFRS 17, IE173-IE185] (cont'd)**

income in profit or loss. For simplicity, this example excludes the effect of accounting for expected credit losses on financial assets. The value of the bonds held by the entity is illustrated in the table below:

|  | Initial recognition | Year 1 | Year 2 | Year 3 |
|--|---------------------|--------|--------|--------|
|  | CU                  | CU     | CU     | CU     |
| Fair value   | 1,500               | 1,811  | 1,902  | 1,997  |
| Amortised cost   | 1,500               | 1,650  | 1,815  | 1,997  |
| Cumulative amounts recognised in other comprehensive income              | -                   | 161    | 87     | -      |
| Change in other comprehensive income                                     |                     | 161    | (74)   | (87)   |
| Investment income recognised in profit or loss (effective interest rate) |                     | 150    | 165    | 182    |

The entity elects to disaggregate insurance finance income or expenses for each period to include in profit or loss an amount that eliminates accounting mismatches with income or expense included in profit or loss on underlying items held. Therefore, the entity needs to analyse the changes in fulfilment cash flows to decide whether each change adjusts the contractual service margin. The source of the fulfilment cash flows is, as follows:

|  | Year 1 | Year 2 | Year 3  |
|--|--------|--------|---------|
| <b>Fulfilment cash flows</b>   |        |        |         |
|  | CU     | CU     | CU      |
| Opening balance  | -      | 1,720  | 1,806   |
| Change related to future service: new contracts                              | (75)   | -      | -       |
| Change in the policyholders' share in the fair value of the underlying items | 295    | 86     | 90      |
| Cash flows   | 1,500  | -      | (1,896) |
| Closing balance  | 1,720  | 1,806  | -       |

Fulfilment cash flows are the estimate of the present value of the future cash inflows and the estimate of the present value of the future cash outflows (in this example, all cash outflows vary based on the returns on underlying items). For example, at initial recognition the fulfilment cash flows of CU(75) are the sum of the estimates of the present value of the future cash inflows of CU(1,500) and the estimates of the present value of the future cash outflows of CU1,425 (the policyholders' share of 95% of the fair value of the underlying items at initial recognition of CU1,500).

**Illustration 82 – Allocating insurance finance income or expense for contracts using the current book yield approach [Based on example 16 in the Illustrative Examples to IFRS 17, IE173-IE185] (cont'd)**

The change in the policyholders' share in the fair value of the underlying items is 95% of the change in fair value of the underlying items. For example, in Year 1, the change in the policyholders' share in the underlying items of CU295 is 95% of the change in fair value in Year 1 of CU311 (CU1,811 - CU1,500). The entity does not adjust the contractual service margin for the change in the obligation to pay policyholders an amount equal to the fair value of the underlying items because it does not relate to future service.

The entity determines the carrying amount of the contractual service margin at the end of each reporting period, as follows:

|  | Year 1 | Year 2 | Year 3 |
|--|--------|--------|--------|
| <b>Contractual service margin</b>  |        |        |        |
|  | CU     | CU     | CU     |
| Opening balance  | -      | 61     | 33     |
| Change related to future service: new contracts  | 75     | -      | -      |
| Change in the entity's share in the fair value of the underlying items                     | 16     | 5      | 6      |
| Change relating to current service: recognition in profit or loss for the service provided | (30)   | (33)   | (38)   |
| Closing balance  | 61     | 33     | -      |

The entity adjusts the contractual service margin for the change in the amount of the entity's share of the fair value of the underlying items because those changes relate to future service. For example, in Year 1 the change in the amount of the entity's share of the fair value of the underlying items of CU16 is 5% of the change in fair value of the underlying items of CU311 (CU1,811 - CU1,500). This example does not include cash flows that do not vary based on the returns on underlying items.

The entity determines the amount of contractual service margin recognised in profit or loss by allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss) equally to each coverage unit provided in the current period and expected to be provided in the future. In this example, the coverage provided in each period is assumed to be the same. Hence, the contractual service margin recognised in profit or loss for Year 1 of CU30 is the contractual service margin before allocation of CU91 (CU75 + CU16), divided by three years of coverage.

The amounts recognised in the statement(s) of financial performance for the periods are, as follows:

**Illustration 82 – Allocating insurance finance income or expense for contracts using the current book yield approach [Based on example 16 in the Illustrative Examples to IFRS 17, IE173-IE185] (cont'd)**

|  | Year 1    | Year 2    | Year 3    |
|--|-----------|-----------|-----------|
| <i>Statement(s) of financial performance</i>   |           |           |           |
|  | CU        | CU        | CU        |
| <i>Profit or loss</i>  |           |           |           |
| Contractual service margin recognised in profit or loss for the service provided   | 30        | 33        | 38        |
| <b>Insurance service result</b>  | <b>30</b> | <b>33</b> | <b>38</b> |
| Investment income  | 150       | 165       | 182       |
| Insurance finance expense  | (150)     | (165)     | (182)     |
| <b>Profit</b>  | <b>30</b> | <b>33</b> | <b>38</b> |
| <i>Other comprehensive income</i>  |           |           |           |
| Gain/(loss) on financial assets measured at fair value through other comprehensive income  | 161       | (74)      | (87)      |
| Gain/(loss) on insurance contracts   | (161)     | 74        | 87        |
| <b>Total other comprehensive income</b>  | <b>-</b>  | <b>-</b>  | <b>-</b>  |
| <p>The entity does not adjust the contractual service margin for the changes in the obligation to pay the policyholders an amount equal to the fair value of the underlying items because those changes do not relate to future service. Consequently, the entity recognises those changes as insurance finance income or expenses in the statement(s) of financial performance. For example, in Year 1, the change in fair value of the underlying items is CU311 (CU1,811 - CU1,500).</p> <p>Furthermore, the entity disaggregates the insurance finance income or expenses for the period between profit or loss and other comprehensive income to include in profit or loss an amount that eliminates accounting mismatches with the income or expenses included in profit or loss on the underlying items held. This amount exactly matches the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being zero. For example, in Year 1, the total amount of the insurance finance income or expenses of CU311 is disaggregated and the entity presents in profit or loss the amount of CU150 that equals the amount of finance income for the underlying items. The remaining amount of insurance finance income or expenses of CU161 is recognised in other comprehensive income.</p> |           |           |           |

## 15.4. Reporting the contractual service margin in interim financial statements

IFRS 17 states that if an entity prepares interim financial statements applying IAS 34, it must make an accounting policy choice as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements and in the annual reporting period. The entity must apply its choice of accounting policy to all groups of insurance contracts that it issues and groups of reinsurance contracts it holds.<sup>548</sup>

An entity which elects not to change the treatment of estimates made in previous interim financial statements is likely to have a different accounting result than an entity which does change estimates made in previous interim reporting periods. This is because adjusting the contractual service margin for changes in estimates of the fulfilment cash flows but not for experience adjustments has the consequence that the accounting depends on the timing of a reporting date.<sup>549</sup>

When an entity elects not to change estimates made in previous interim financial statements, the amounts presented in any annual report should equal the values as of the end of the last interim period and the cumulative profit or loss for the year should be the sum of the profit or loss amounts for each interim period. Each interim period is determined separately as if it were a discrete period and the annual period is simply the total of the profit or loss of the discrete interim periods.

“When an entity does restate estimates made in previous interim periods, each interim report includes information which, in aggregate, results in the year-to-date figures in that interim report being equal to the value which would have resulted if IFRS 17 had been applied to the full year to date period without any interim periods. The cumulative profit and loss to date of the interim period would equal the cumulative amount on an annual basis to date.

The Board concluded that permitting an accounting policy choice would ease IFRS 17 implementation by enabling an entity to assess which accounting policy is less burdensome. To avoid a significant loss of useful information for users of financial statements, the Board concluded that the entity is required to apply consistently its choice of accounting policy to all groups of insurance contracts it issues and groups of reinsurance contracts it holds (i.e., accounting policy choice at reporting entity level).<sup>550</sup>

There is also related transitional relief available upon applying IFRS 17 for entities applying the modified retrospective approach that elect an accounting policy not to change the treatment of estimates made in previous interim reporting periods. See 17.4 below.

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<sup>548</sup> IFRS 17.B137.

<sup>549</sup> IFRS 17.BC236.

<sup>550</sup> IFRS 17.BC236B-C.

## Frequently asked questions

**Question 15-6: The submission asked for the requirements in paragraph B137 of IFRS 17 to be extended to apply to monthly reporting that is prepared for internal management reporting and external regulatory reporting. The submission notes the operational issues and the complexity involved in developing systems considering the disparity in procedures between monthly closing and quarterly interim reporting [TRG meeting September 2018 – Agenda paper no. 11, Log S56]**

The IASB staff confirmed that the requirements of paragraph B137 of IFRS 17 described above apply only to interim reports prepared applying IAS 34 *Interim Financial Reporting*. This can cause a particular issue for groups where the parent does, but the subsidiary does not, prepare IAS 34 interim financial statements. If the parent prepares IAS 34 interim financial statements, but the subsidiary does not, (e.g., the subsidiary prepares interim internal management reports that do not comply with IAS 34) then the choice of changing the treatment of previous estimates in subsequent interim financial statements is available only to the parent and not applicable to the subsidiary. The TRG members agreed with the IASB staff's interpretation, but highlighted the significant operational challenges of applying it in practice.

### Illustration 83 – The contractual service margin and interim reporting

This example focuses on the impact of the release of the contractual service margin on insurance revenue and not on the impact on profit or loss of other components of an insurance contract liability. The example also assumes there are no other changes in expectations and ignores accretion of interest for simplicity

An entity with an annual reporting period ending on 31 December publishes half-yearly interim financial statements.

At 31 December 2023, the entity has issued a group of insurance contracts with a contractual service margin of CU1,200 and an expected coverage period of two years. The entity expects to provide coverage evenly over the coverage period and expects to incur claims in H2 2023 of CU300.

At the end of H1 2024, the entity increases its estimate of claims to be incurred in H2 of 2024 by CU200 to CU500. The entity adjusts (reduces) the related contractual service margin by CU200 and reduces the contractual service margin by CU250 for services provided in H1 (CU1,200 - CU200) / 4. At the end of H1 2024, the entity carries forward a contractual service margin of CU750.

The entity incurs claims in H2 2024 of CU300 (as originally expected).

*Option A - the entity elects not to change the treatment of its previous estimates in subsequent interim financial statements and in the annual financial report*

As a result of incurring claims in H2 2024 of CU300, the entity recognises a favourable experience adjustment in profit or loss (i.e., a credit to insurance service expenses) of CU200 in H2.



### **Illustration 83 – The contractual service margin and interim reporting (cont'd)**

The entity releases CU250 from the contractual service margin to profit or loss (insurance revenue) in H2 and carries forward a contractual service margin of CU500 (CU750 - CU250) at 31 December 2024 in the H2 2024 interim as well as annual 2024 financial statements.

In summary, in 2024, the entity recognises CU500 as part of insurance revenue, a positive experience adjustment in profit or loss of CU200 and carries forward a contractual service margin of CU500 in both its interim financial statements for H2 2024, as well as its annual financial statements for that year.

*Option B - the entity elects to change the treatment of its previous estimates in subsequent interim financial statements and in the annual financial report*

If the entity does change its previous estimates, then the position at the end of the H2 2024 interims and the 2024 financial report is the cumulative result for the calendar year. Therefore, the impact on the annual financial statements is as follows:

- ▶ There is no experience adjustment in the year - claims in 2024 are as expected at 31 December 2023.
- ▶ The entity would release CU600 from the contractual service margin to profit or loss in the calendar year 2024 and would carry forward a contractual service margin of CU600 (CU1,200 brought forward - CU600 release to P&L = CU600).

In summary, in 2024 the entity recognises CU600 as part of insurance revenue in 2024 and carries forward a contractual service margin of CU600 at 31 December 2024 instead of recognising insurance revenue of CU500 and a positive experience adjustment in insurance service expenses of CU200 and carrying forward a contractual service margin of CU500 under option A above.

## 16. Disclosure

One of the main objectives of IFRS 17 is to establish principles for the disclosure of insurance contracts which gives a basis for users of the financial statements to assess the effect that insurance contracts have on an entity's financial position, financial performance and cash flows.<sup>551</sup>

Hence, the objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement(s) of financial performance and statement of cash flows, gives a basis for users of financial statements to assess the effect of contracts within the scope of IFRS 17. To achieve that objective, an entity should disclose qualitative and quantitative information about:<sup>552</sup>

- ▶ The amounts recognised in its financial statements for contracts within the scope of IFRS 17 (see 16.1 below)
- ▶ Disclosures showing the effect of transition (see 16.2 below)
- ▶ The significant judgements, and changes in those judgements, when applying IFRS 17 (see 16.3 below)
- ▶ The nature and extent of risks arising from contracts within the scope of IFRS 17 (see 16.4 below)

The disclosure objective is supplemented with some specific disclosure requirements designed to help the entity satisfy this objective. By specifying the objective of the disclosures, the Board aims to ensure that entities provide the information that is most relevant for their circumstances and to emphasise the importance of communication to users of financial statements rather than compliance with detailed and prescriptive disclosure requirements. In situations in which the information provided to meet the specific disclosure requirements is not sufficient to meet the disclosure objective, the entity is required to disclose additional information necessary to achieve that objective.<sup>553</sup>

The Board used the disclosure requirements in IFRS 4, including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by cross-reference, as a basis for the requirements in IFRS 17. This is because stakeholders have indicated that such disclosures provide useful information to users of financial statements for understanding the amount, timing and uncertainty of future cash flows from insurance contracts. The disclosure requirements brought forward from IFRS 4 include information about significant judgements in applying the standard as well as most of the disclosures about the nature and extent of risks that arise from insurance contracts.<sup>554</sup> In addition, when developing IFRS 17, the Board identified key items it views as critical to understanding the financial statements of entities issuing insurance contracts, in the light of the requirement to update the measurement of insurance

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<sup>551</sup> IFRS 17.1.

<sup>552</sup> IFRS 17.93.

<sup>553</sup> IFRS 17.BC347.

<sup>554</sup> IFRS 17.BC348.

contracts at each reporting date. Consequently, additional disclosures have been added requiring:<sup>555</sup>

- ▶ Reconciliations of opening to closing balances of the various components of the liability for remaining coverage and the liability for incurred claims
- ▶ An analysis of insurance revenue
- ▶ Information about initial recognition of insurance contracts in the statement of financial position
- ▶ An explanation of when an entity expects to recognise the contractual service margin remaining at the end of the reporting period in profit or loss
- ▶ An explanation of the total amount of insurance finance income or expenses in profit or loss and the composition and fair value of underlying items for contracts with direct participation features
- ▶ Information about the entity's approach to determining various inputs into the fulfilment cash flows
- ▶ The confidence level used to determine the risk adjustment for non-financial risk
- ▶ Information about yield curves used to discount cash flows that do not vary based on returns from underlying items
- ▶ Information about the effect of the regulatory framework in which the entity operates

The result of this is that the disclosure requirements of IFRS 17 are likely to be more extensive compared to the requirements of IFRS 4. They comprise forty paragraphs of the standard and many of these disclosures will not have previously been applied by insurance entities. In summary, complying with the disclosure requirements will be challenging.

IFRS 17 requires a reporting entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. Preparers are informed that if the mandatory disclosures required are not enough to meet the disclosure objective, additional information should be disclosed as necessary to meet that objective.<sup>556</sup>

An entity should aggregate or disaggregate information so that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics.<sup>557</sup>

Preparers are also reminded of the requirements in IAS 1 relating to materiality and aggregation of information. IFRS 17 states that examples of aggregation bases that might be appropriate for information disclosed about insurance contracts include:<sup>558</sup>

- ▶ Type of contract (e.g., major product lines)
- ▶ Geographical area (e.g., country or region)
- ▶ Reportable segment, as defined in IFRS 8

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<sup>555</sup> IFRS 17.BC349.

<sup>556</sup> IFRS 17.94.

<sup>557</sup> IFRS 17.95.

<sup>558</sup> IFRS 17.96.

## How we see it

- ▶ The disclosure requirements of IFRS 17 are more extensive compared with those in IFRS 4, they comprise 40 paragraphs of the standard. Insurance entities have not applied many of these disclosures in the past, so complying with the disclosure requirements will be a challenge for data, systems and processes.
- ▶ Entities need to apply judgement in how they break down the required disclosures into separate lines of business, reportable segment, or geographical areas. Entities will need to determine this based on the objective of providing decision useful information to the users of the financial statements in accordance with the disclosure principles of IFRS 17.
- ▶ Applying the concept of materiality, a specific disclosure otherwise required by an IFRS Standard in the financial statements, need not be provided if the information resulting from that disclosure is not material. This is the case even if the IFRS Standard contains a list of specific requirements, or describes them as minimum requirements. In September 2017, the IASB published Practice statement 2 - *making Materiality Judgements*. This is a non-mandatory statement that entities may apply to assist in making materiality judgements.
- ▶ The provision of additional disclosures should be considered when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. This point is explicitly made in para 94 of IFRS 17.

### 16.1. Explanation of recognised amounts

The first part of the disclosure objective established by the standard is that an entity should disclose qualitative and quantitative information about the amounts recognised in its financial statements for contracts within its scope.<sup>559</sup>

The principal method by which the disclosure objective is achieved is by the disclosure of reconciliations that show how the net carrying amounts of contracts within the scope of IFRS 17 changed during the period because of cash flows and income and expenses recognised in the statement(s) of financial performance. Separate reconciliations should be disclosed for insurance contracts issued and reinsurance contracts held. An entity should adapt the requirements of the reconciliations described below to reflect the features of reinsurance contracts held that differ from insurance contracts issued; for example, the generation of expenses or reduction in expenses rather than revenue.<sup>560</sup>

Enough information should be provided in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are

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<sup>559</sup> IFRS 17.93.

<sup>560</sup> IFRS 17.98.

recognised in the statement(s) of financial performance. To comply with this requirement, an entity should:<sup>561</sup>

- ▶ Disclose, in a table, the reconciliations set out at 16.1.1 to 16.1.2 below
- ▶ For each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for portfolios of contracts that are assets and a total for portfolios of contracts that are liabilities, that equal the amounts presented in the statement of financial position as set out at 15.1 above.

The objective of the reconciliations detailed in 16.1.1 to 16.1.2 below is to provide different types of information about the insurance service result.<sup>562</sup>

### **16.1.1. Reconciliations required for contracts applying the general model**

These reconciliations are required for all contracts other than those to which the premium allocation approach is applied including contracts with direct participation features.

Firstly, an entity must provide overall reconciliations from the opening to the closing balances separately for each of:<sup>563</sup>

- ▶ The net liabilities (or assets) for the remaining coverage component, excluding any loss component
- ▶ Any loss component (see 9.8 above)
- ▶ The liabilities for incurred claims

Within the overall reconciliations above, an entity should separately disclose each of the following amounts related to insurance contract services, if applicable:<sup>564</sup>

- ▶ Insurance revenue
- ▶ Insurance service expenses, showing separately:
  - ▶ Incurred claims (excluding investment components) and other incurred insurance service expenses
  - ▶ Amortisation of insurance acquisition cash flows
  - ▶ Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims
  - ▶ Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses
- ▶ Investment components excluded from insurance revenue and insurance service expenses (combined with refunds of premiums unless refunds of premiums are presented as part of the cash flows in the period)

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<sup>561</sup> IFRS 17.99.

<sup>562</sup> IFRS 17.102.

<sup>563</sup> IFRS 17.100.

<sup>564</sup> IFRS 17.103.

Below is an example of this overall reconciliation, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*.

|  | Liability for remaining coverage      |                             |                                 | Total    |
|--|---------------------------------------|-----------------------------|---------------------------------|----------|
|  | Excluding onerous contracts component | Onerous contracts component | Liabilities for incurred claims |          |
| Insurance contract liabilities 2023  | 161,938                               | 15,859                      | 1,021                           | 178,818  |
| Insurance revenue  | (9,856)                               |                             |                                 | (9,856)  |
| Insurance services expenses  | 1,259                                 | (623)                       | 7,985                           | 8,621    |
| Incurred claims and other expenses   |                                       | (840)                       | 7,945                           | 7,105    |
| Acquisition expenses   | 1,259                                 |                             |                                 | 1,259    |
| Changes that relate to future service: loss on onerous contracts and reversals of those losses |                                       | 217                         |                                 | 217      |
| Changes that relate to past service: changes to liability for incurred claims                  |                                       |                             | 40                              | 40       |
| Investment components  | (6,465)                               |                             | 6,465                           | 0        |
| Insurance service result   | (15,062)                              | (623)                       | 14,450                          | (1,235)  |
| Insurance finance expenses   | 8,393                                 | 860                         | 55                              | 9,308    |
| Total changes in the statement of comprehensive income   | (6,669)                               | 237                         | 14,505                          | 8,073    |
| Cash flows   |                                       |                             |                                 |          |
| Premiums received  | 33,570                                |                             |                                 | 33,570   |
| Claims, benefits and other expenses paid   |                                       |                             | (14,336)                        | (14,336) |
| Acquisition cash flows paid  | (401)                                 |                             |                                 | (401)    |
| Total cash flows   | 33,169                                | -                           | (14,336)                        | 18,833   |
| Insurance contract liabilities 2024  | 188,438                               | 16,096                      | 1,190                           | 205,724  |

Secondly, an entity should also disclose reconciliations from the opening to the closing balances separately for each of:<sup>565</sup>

- ▶ The estimates of the present value of the future cash flows

<sup>565</sup> IFRS 17.101.

- ▶ The risk adjustment for non-financial risk
- ▶ The contractual service margin

Within these reconciliations, an entity should disclose the following amounts related to services, if applicable:<sup>566</sup>

- ▶ Changes that relate to future service, showing separately:
  - ▶ Changes in estimates that adjust the contractual service margin
  - ▶ Changes in estimates that do not adjust the contractual service margin, i.e., losses on groups of onerous contracts and reversals of such losses
  - ▶ The effects of contracts initially recognised in the period
- ▶ Changes that relate to current service, i.e.:
  - ▶ The amount of the contractual service margin recognised in profit or loss to reflect the transfer of services
  - ▶ The change in the risk adjustment for non-financial risk that does not relate to future service or past service
  - ▶ Experience adjustments, excluding amounts relating to the risk adjustment for non-financial risk included above
- ▶ Changes that relate to past service, i.e., changes in fulfilment cash flows relating to incurred claims

Below is an example of these reconciliations, based on an illustrative disclosure in the IASB's *IFRS 17* Effects Analysis:

|  | Estimates of the present value of future cash flows | Risk adjustment | Contractual service margin | Total          |
|--|---|-----------------|----------------------------|----------------|
| <b>Insurance contract liabilities 2023</b>                       | <b>163,962</b>                                      | <b>5,998</b>    | <b>8,858</b>               | <b>178,818</b> |
| <b>Changes that relate to current service</b>                    | <b>35</b>   | <b>(604)</b>    | <b>(923)</b>               | <b>(1,492)</b> |
| Contractual service margin recognised for service period         |   |                 | (923)                      | (923)          |
| Risk adjustment recognised for the risk expired                  |   | (604)           |                            | (604)          |
| Experience adjustments   | 35  |                 |                            | 35             |
| <b>Changes that relate to future service</b>                     | <b>(784)</b>  | <b>1,117</b>    | <b>(116)</b>               | <b>217</b>     |
| Contracts initially recognised in the period                     | (2,329)   | 1,077           | 1,375                      | 123            |
| Changes in estimates reflected in the contractual service margin | 1,452   | 39              | (1,491)                    | -              |
| Changes in estimates that result in onerous contract losses      | 93  | 1               |                            | 94             |

<sup>566</sup> IFRS 17.104.

|  | Estimates of the present value of future cash flows | Risk adjustment | Contractual service margin | Total   |
|--|---|-----------------|----------------------------|---------|
| Changes that relate to past service                    | 47  | (7)             |                            | 40      |
| Adjustments to liabilities for incurred claims         | 47  | (7)             |                            | 40      |
| Insurance service result                               | (702)   | 506             | (1,039)                    | (1,235) |
| Insurance finance expenses                             | 9,087   | –               | 221                        | 9,308   |
| Total changes in the statement of comprehensive income | 8,385   | 506             | (818)                      | 8,073   |
| Cash flows   | 18,833  |                 |                            | 18,833  |
| Insurance contract liabilities 2024                    | 191,180   | 6,504           | 8,040                      | 205,724 |

In addition, to complete the reconciliations above, an entity should also disclose separately each of the following amounts not related to services provided in the period, if applicable:<sup>567</sup>

- ▶ Cash flows in the period, including:
  - ▶ Premiums received for insurance contracts issued (or paid for reinsurance contracts held)
  - ▶ Insurance acquisition cash flows
  - ▶ Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows
- ▶ The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held
- ▶ Insurance finance income or expense
- ▶ Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts

When an entity recognises an asset for insurance acquisition cash flows paid for existing or future groups of insurance contracts before those insurance contracts are recognised (see 7.3 above), it should disclose a reconciliation from the opening to the closing balance of assets recognised for those insurance acquisition cash flows. The information should be aggregated at a level which is consistent with that for the other reconciliations of insurance contracts discussed above.<sup>568</sup>

The reconciliation of the insurance acquisition cash flows above should disclose separately any recognition of impairment losses and reversals of impairment losses of the insurance acquisition cash flow assets.<sup>569</sup>

<sup>567</sup> IFRS 17.105.

<sup>568</sup> IFRS 17.105A.

<sup>569</sup> IFRS 17.105B.



In respect of insurance revenue recognised in the period, entities need to provide the following analysis:<sup>570</sup>

- ▶ The amounts relating to the changes in the liability for remaining coverage as discussed at 15.2.1 above, separately disclosing:
  - ▶ The insurance service expenses incurred during the period
  - ▶ The change in the risk adjustment for non-financial risk
  - ▶ The amount of the contractual service margin recognised in profit or loss because of the transfer of insurance contract services in the period
  - ▶ Other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service
- ▶ The allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flow.

Below is an example of this insurance revenue analysis, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*.

|  | 2023         |
|--|--------------|
| <b>Amounts related to liabilities for remaining coverage</b> | <b>8,597</b> |
| Expected incurred claims and other expenses                  | 7,070        |
| Contractual service margin for the service provided          | 923          |
| Risk adjustment for the risk expired                         | 604          |
| <b>Recovery of acquisition cash flows</b>                    | <b>1,259</b> |
| <b>Insurance revenue</b>                                     | <b>9,856</b> |

The effect on the statement of financial position for insurance contracts issued and reinsurance contracts held that are initially recognised in the period, should be shown separately, disclosing the effect at initial recognition on:<sup>571</sup>

- ▶ The estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows
- ▶ The estimates of the present value of future cash inflows
- ▶ The risk adjustment for non-financial risk
- ▶ The contractual service margin

In the reconciliation showing the effect of insurance contracts issued and reinsurance contracts held, there should be separate disclosure of:<sup>572</sup>

- ▶ Contracts acquired from other entities in transfers of insurance contracts or business combinations

<sup>570</sup> IFRS 17.106.

<sup>571</sup> IFRS 17.107.

<sup>572</sup> IFRS 17.108.

- Groups of contracts that are onerous

Below is an example of this analysis, based on an illustrative disclosure in the IASB's *IFRS 17 Effects Analysis*. The example shows insurance contracts issued only for an entity which has not acquired contracts in the period via transfers or business combinations.

|  | Total      | Of which contracts acquired | Of which onerous contracts |
|--|------------|-----------------------------|----------------------------|
| <b>Contracts initially recognised in 2023</b>          |            |                             |                            |
| Estimates of the present value of futures cash inflows | (33,570)   | (19,155)                    | (1,716)                    |
| Estimates of the present value of future cash outflows |            |                             |                            |
| Insurance acquisition cash flows                       | 401        | 122                         | 27                         |
| Claims payable and other expenses                      | 30,840     | 17,501                      | 1,704                      |
| Risk adjustment  | 1,077      | 658                         | 108                        |
| Contractual service margin                             | 1,375      | 896                         | -                          |
| <b>Total</b>   | <b>123</b> | <b>22</b>                   | <b>123</b>                 |

Additionally, an entity should disclose *quantitatively* (emphasis added) when it expects to recognise the contractual service margin remaining at the end of the reporting period in profit or loss in appropriate time bands. Such information should be provided separately for insurance contracts issued and reinsurance contracts held.<sup>573</sup>

An entity is also required to disclose quantitatively, in appropriate time bands, when it expects to derecognise an asset for insurance acquisition cash flows.<sup>574</sup>

### Frequently asked questions

**Question 16-1:** *The submission questions the sequence to be applied to adjusting a loss component in a financial period when one experience adjustment that relates to future service would increase a loss component, while another would decrease it; and asks whether a gross disclosure should be provided applying paragraphs 103(b) and 104(a) of IFRS 17. [TRG meeting April 2019 – Agenda paper no. 02, Log S125]*

In the example submitted, there was a premium experience adjustment related to future service that would increase a loss component and a change in fulfilment cash flows related to future service that would decrease a loss component. The IASB staff observed that IFRS 17 requires an entity to provide disclosure of changes that relate to future service separately from those related to current or past service and in the example submitted all changes relate to future service. That is, no sub-analysis of

<sup>573</sup> IFRS 17.109.

<sup>574</sup> IFRS 17.109A.

## Frequently asked questions (cont'd)

the changes that relate to future service was required for the example included in the submission.

**Question 16-2: How should the reconciliation of estimates of the present value of future cash flows applying paragraphs 101 and 104 of IFRS 17 for the annual reporting period be disclosed, considering the requirements in paragraph B137 of IFRS 17 relating to interim financial statements. [TRG meeting April 2019 - Agenda paper no. 02, Log S83]**

The submission asks, for example, whether changes disclosed as relating to past service in an interim reporting period should be disclosed as changes relating to current service in the annual reporting. The IASB staff stated the amounts disclosed in the reconciliations in paragraphs 101 and 104 reflected the amounts included in the measurement of insurance contracts and that the description of the amount as relating to past or current service does not affect the measurement as both are treated in the same way when determining the fulfilment cash flows and any effect of changes in fulfilment cash flows on the contractual service margin.

## How we see it

- ▶ The roll forward reconciliations are detailed analyses of movements in the carrying amounts of insurance contracts issued and reinsurance contracts held. They will provide more information and transparency to users than they currently receive from IFRS financial statements. An entity is required to provide analyses of the change in the carrying amount that view insurance contracts in two ways:
  - ▶ The building blocks view (present value of expected future cash flows, risk adjustment for non-financial risk, and the contractual service margin)
  - ▶ By type of insurance obligation (the liability for incurred claims and the liability for remaining coverage split between the loss component and the non-loss component)
- ▶ The reconciliations are two views of the same events in a reporting period. Entities need to decide to what extent they build the reconciliations from low-level detailed data on changes in the carrying amounts of insurance contracts maintained in a general ledger (and/or data warehouse) versus maintaining high-level data in the general ledger and taking a top-down approach to analysing movements and obtaining the required movements data from other sources. On one hand, a bottom-up approach to maintaining movement data in the general ledger/data warehouse represents a significant data and process challenge. On the other hand, a top-down approach risks an entity being unable to provide the analyses in a robust and timely way.

## **16.1.2. Information about contracts to which the entity applies the premium allocation approach**

### **16.1.2.A. Accounting policies adopted for contracts applying the premium allocation approach**

When an entity uses the premium allocation approach, it must disclose the following:<sup>575</sup>

- ▶ Which of the criteria for the use of the premium allocation approach for insurance contracts issued and reinsurance contracts held it has satisfied
- ▶ Whether it makes an adjustment for the time value of money and the effect of financial risk for the liability for remaining coverage and the liability for incurred claims
- ▶ Whether it recognises insurance acquisition cash flows as expenses when it incurs those costs or amortises insurance acquisition cash flows over the coverage period

These choices are discussed at 10.1 and 10.4 above.

### **16.1.2.B. Reconciliations required for contracts applying the premium allocation approach**

The reconciliations described below apply to contracts using the premium allocation approach. Most also apply for contracts using the general model (see 16.1.1 above). As with the general model, for each reconciliation, an entity should present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for portfolios of contracts that are assets and a total for portfolios of contracts that are liabilities, that equal the amounts presented in the statement of financial position as set out at 15.1 above.<sup>576</sup>

Overall reconciliations from the opening to the closing balances are required separately for each of:<sup>577</sup>

- ▶ The net liabilities (or assets) for the remaining coverage component, excluding any loss component
- ▶ Any loss component (see 8.8 above)
- ▶ The liabilities for incurred claims with separate reconciliations for:
  - ▶ The estimates of the present value of the future cash flows
  - ▶ The risk adjustment for non-financial risk

Within the overall reconciliations above, separate disclosure of each of the following amounts related to services, if applicable:<sup>578</sup>

- ▶ Insurance revenue
- ▶ Insurance service expenses, showing separately:
  - ▶ Incurred claims (excluding investment components) and other incurred insurance service expenses

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<sup>575</sup> IFRS 17.97.

<sup>576</sup> IFRS 17.99.

<sup>577</sup> IFRS 17.100.

<sup>578</sup> IFRS 17.103.

- ▶ Amortisation of insurance acquisition cash flows
- ▶ Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims
- ▶ Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses
- ▶ Investment components excluded from insurance revenue and insurance service expenses (combined with refunds of premiums unless refunds of premiums are presented as part of the cash flows in the period)

Disclosure is also required of each of the following amounts that are not related to services provided in the period, if applicable:<sup>579</sup>

- ▶ Cash flows in the period, including:
  - ▶ Premiums received for insurance contracts issued (or paid for reinsurance contracts held)
  - ▶ Insurance acquisition cash flows
  - ▶ Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows
- ▶ The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held
- ▶ Insurance finance income or expenses
- ▶ Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts

The disclosures required when an entity recognises an asset for acquisition cash flows paid for existing or future groups of insurance contracts before those insurance contracts are recognised insurance acquisition cash flow assets also apply to contracts accounted for under the premium allocation approach (see 16.1.1 above).

### **16.1.3. Explanation of the total amount of insurance finance income or expenses in each reporting period**

The total amount of insurance finance income or expenses in the reporting period must be disclosed and explained. In particular, an entity must explain the relationship between insurance finance income or expenses and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance income or expenses recognised in profit or loss and other comprehensive income.<sup>580</sup>

Specifically, for contracts with direct participation features, an entity must:<sup>581</sup>

- ▶ Describe the composition of the underlying items and disclose their fair value.
- ▶ Disclose the effect of any adjustment to the contractual service margin in the current period as a result of the application of risk mitigation whereby a

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<sup>579</sup> IFRS 17.105.

<sup>580</sup> IFRS 17.110.

<sup>581</sup> IFRS 17.111-113.

choice not to adjust the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of underlying items for the effect of the time value of money and financial risks not arising from the underlying items (see section 12.3.6 above).

- ▶ Disclose, in the period when the entity changes the basis of disaggregation of insurance finance income or expense between profit or loss and other comprehensive income because of a change in whether it holds the underlying items (see 15.3.4 above):
  - ▶ The reason why the entity was required to change the basis of aggregation
  - ▶ The amount of any adjustment for each financial statement line item affected
  - ▶ The carrying amount of the group of insurance contracts to which the change applied at the date of the change

## 16.2. Transition amounts

An entity must provide disclosures that enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date when applying the modified retrospective approach (see section 17.4 below) or the fair value approach (see section 17.5) below on the contractual service margin and insurance revenue in subsequent periods. To achieve this, IFRS 17 requires various disclosures to be made each reporting period until the contracts which exist at transition have expired or been extinguished.

Hence, an entity must disclose the reconciliation of the contractual service margin and the amount of insurance revenue at 16.1.1 above separately for:<sup>582</sup>

- ▶ Insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach
- ▶ Insurance contracts that existed at the transition date to which the entity has applied the fair value approach
- ▶ All other insurance contracts (i.e., including those to which the entity has accounted for fully)

In addition, for all periods in which disclosures are made for contracts that, on transition, were accounted for using either the modified retrospective approach or the fair value approach, an entity must explain how it determined the measurement of insurance contracts at the transition date. The purpose of this is to enable users of financial statements to understand the nature and significance of the methods used and judgements applied in determining the transition amounts.<sup>583</sup>

An entity that chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income applies the requirements discussed at section 17.4.4 below (for the modified retrospective approach) or 17.5.1 below (for the fair value approach). This is to determine the cumulative difference between the insurance finance income or expenses that would have been recognised in profit or loss and the total

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<sup>582</sup> IFRS 17.114.

<sup>583</sup> IFRS 17.115.

insurance finance income or expenses at the transition date for the groups of insurance contracts to which the disaggregation applies. For all periods in which amounts determined applying these alternative transitional approaches exist, the entity should disclose a reconciliation of the opening to the closing balance of the cumulative amounts included in other comprehensive income for financial assets measured at fair value through other comprehensive income related to the groups of insurance contracts. The reconciliation should include, for example, gains or losses recognised in other comprehensive income in the period and gains or losses previously recognised in other comprehensive income in previous periods reclassified in the period to profit or loss.<sup>584</sup>

### How we see it

- ▶ Transition disclosures will require considerable effort. Entities need to think about their solutions for identifying and tracking these amounts carefully. They will need to continue separately disclosing the contractual service margin for contracts in force at transition in the years after transition, and must consider this requirement when building their financial reporting processes and systems. The effort of tracking the contractual service margins for groups of contracts present at transition that are not determined on a fully retrospective basis needs to be considered together with the effort of applying a fully retrospective approach at transition.

## 16.3. Significant judgements made in applying IFRS 17

IAS 1 requires that an entity should disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.<sup>585</sup>

Consistent with IAS 1, the second part of the disclosure objective established by IFRS 17 is that an entity should disclose the significant judgements and changes in judgements made by an entity in applying the standard.<sup>586</sup>

Specifically, an entity must disclose the inputs, assumptions and estimation techniques it has used, including:<sup>587</sup>

- ▶ The methods used to measure insurance contracts within the scope of IFRS 17 and processes to estimate the inputs to those methods. Unless impracticable, an entity must also provide quantitative information about those inputs
- ▶ Any changes in methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected

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<sup>584</sup> IFRS 17.116.

<sup>585</sup> IAS 1.122.

<sup>586</sup> IFRS 17.93(b).

<sup>587</sup> IFRS 17.117.

- ▶ To the extent not covered above, the approach used:
  - ▶ To distinguish changes in estimates of future cash flows arising from exercising discretion from other changes in estimates of future cash flows for contracts without direct participation features
  - ▶ To determine the risk adjustment for non-financial risk, including whether changes in the risk adjustment for non-financial risk are disaggregated into an insurance service component and an insurance finance component, or are presented in full in the insurance service result
  - ▶ To determine discount rates
  - ▶ To determine investment components
  - ▶ To determine the relative weighting of the benefits provided by insurance coverage and investment-return service (for insurance contracts without direct participation features) or insurance coverage and investment-related service (for insurance contracts with direct participation features).

If an entity chooses to disaggregate insurance finance income or expenses into amounts presented in profit or loss and in other comprehensive income (see section 15.3.1 to 15.3.4 above), it must disclose an explanation of the methods used to determine the insurance finance income or expenses recognised in profit or loss.<sup>588</sup>

An entity must also disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique, it must disclose:

- ▶ The technique used
- ▶ The confidence level corresponding to the results of that technique<sup>589</sup>

An entity must disclose the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items. When an entity provides this disclosure in aggregate for a number of groups of insurance contracts, it must provide such disclosures in the form of weighted averages, or relatively narrow ranges.<sup>590</sup>

## 16.4. Disclosure of accounting policies

Unlike IFRS 4, IFRS 17 does not contain an explicit requirement for an insurer's accounting policies for insurance contracts and related liabilities, income and expense to be disclosed. However, IAS 1 requires an entity to disclose its significant accounting policies comprising:<sup>591</sup>

- ▶ The measurement basis (or bases) used in preparing the financial statements
- ▶ The other accounting policies used that are relevant to an understanding of the financial statements

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<sup>588</sup> IFRS 17.118.

<sup>589</sup> IFRS 17.119.

<sup>590</sup> IFRS 17.120.

<sup>591</sup> IAS 1.117.



In addition, certain specific disclosures concerning accounting policy choices in respect of discounting and insurance acquisition cash flows are required when the premium allocation approach is used (see 16.1.2.A above).

IFRS 17 contains a number of specific accounting policy elections, the exercise of which (or not) may be relevant to an understanding of the financial statements. Some of these are contained in the table below. Accounting policy elections applicable only on transition are discussed at 17 below.

| Accounting policy choice   | Unit of Account                                      | Revocable?                                      |
|--|--|---|
| Election to apply IFRS 17 or IAS 32/IFRS 9 to financial guarantee contracts if previously asserted to be insurance contracts (see 2.3.1.B above)   | Individual contract                                  | No  |
| Election to apply either IFRS 15 or IFRS 17 to certain fixed-fee service contracts (see 2.3.2 above)   | Individual contract                                  | No  |
| Election to apply either IFRS 17 or IFRS 9 to certain loan contracts that only transfer insurance risk on settlement (see 2.3.3 above)   | Accounting policy at level of portfolio of contracts | No  |
| Period of cohort - group of contracts can be grouped into any period of one year or less (see 6.2.2 above)   | IAS 8 applies  | IAS 8 applies                                   |
| Accretion of interest on insurance acquisition cash flows - voluntary election (see 7.3 above)   | IAS 8 applies  | IAS 8 applies                                   |
| Use of the premium allocation approach (see 10 above)  | Group of contracts                                   | No - unless contract modified (see 13.1 above). |
| Premium allocation approach - election to expense insurance acquisition cash flows as incurred for contracts where coverage period of each contract in group is no more than one year as opposed to including within the liability for remaining coverage (see 10.2 above) | Group of contracts                                   | No  |

| Accounting policy choice  | Unit of Account        | Revocable?   |
|---|------------------------|--|
| Premium allocation approach - election to not adjust the liability for remaining coverage to reflect the time value of money and effect of financial risk if, on initial recognition, the time between providing services and premium due date is no more than one year (see 10.2 above). | Group of contracts     | No   |
| Premium allocation approach - election not to adjust the liability for incurred claims to reflect the time value of money and effect of financial risk if the cash flows are expected to be paid or received in one year or less from the date the claims are incurred (see 10.5 above).  | Group of contracts     | Yes - if eligibility criteria failed in subsequent periods   |
| Use of risk mitigation for eligible contracts applying the variable fee approach (see 12.3.5 above)   | Group of contracts     | If, and only if, conditions cease to apply (see 12.3.5 above).   |
| Present changes in the risk adjustment for non-financial risk in insurance service expenses or disaggregate between insurance service expenses and insurance finance income or expenses (see 15.2.2 above)  | IAS 8 applies          | IAS 8 applies  |
| Present insurance finance income or expenses in profit or loss or disaggregate between profit or loss and other comprehensive income (see 15.3.1 above)   | Portfolio of contracts | Yes - provided change satisfies IAS 8 criteria.<br><br>If underlying items now held or no longer held by variable fee approach change is compulsory (see 12.3.6 above) |
| Election as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent  | Reporting entity       | IAS 8 applies  |

| Accounting policy choice   | Unit of Account  | Revocable?    |
|--|------------------|---------------|
| interim financial statements and in the annual reporting period (see 15.4 above) |                  |               |
| Net or gross presentation of reinsurance held in profit or loss (see 15 above)   | Reporting entity | IAS 8 applies |

## 16.5. Disclosure about the nature and extent of risks

The third part of the disclosure objective established by IFRS 17 is that an entity is required to disclose the nature and extent of the risks from contracts within the scope of the standard.<sup>592</sup>

To comply with this objective, an entity should disclose information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of IFRS 17.<sup>593</sup>

The disclosures detailed below are considered to be those that would normally be necessary to meet this requirement. These disclosures focus on the insurance and financial risks that arise from insurance contracts and how they have been managed. Financial risks typically include, but are not limited to, credit risk, liquidity risk and market risk.<sup>594</sup> Many similar disclosures were contained in IFRS 4, often phrased to the effect that an insurer should make disclosures about insurance contracts assuming that insurance contracts were within the scope of IFRS 7. The equivalent disclosures required by IFRS 17 are tailored to the recognition and measurement of the standard and do not cross-refer to IFRS 7.

For each type of risk arising from contracts within the scope of IFRS 17, an entity must disclose:<sup>595</sup>

- ▶ The exposures to risks and how they arise
- ▶ The entity's objectives, policies and processes for managing the risks and methods used to measure them
- ▶ Any changes in the above from the previous period.

An entity should also disclose, for each type of risk:<sup>596</sup>

- ▶ Summary quantitative information about its exposure to that risk at the end of the reporting period, with disclosure based on information provided internally to the entity's key management personnel
- ▶ The disclosures detailed at 16.5.1 to 16.5.5 below, to the extent not provided by the summary quantitative information required above

<sup>592</sup> IFRS 17.93.

<sup>593</sup> IFRS 17.121.

<sup>594</sup> IFRS 17.122.

<sup>595</sup> IFRS 17.124.

<sup>596</sup> IFRS 17.125.

If the information disclosed about an entity's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, the entity should disclose that fact, the reason why the period-end exposure is not representative, and further information that is representative of its risk exposure during the period.<sup>597</sup>

Disclosure of an entity's objectives, policies and processes for managing risks and the methods used to manage the risk provides an additional perspective that complements information about contracts outstanding at a particular time and might include information about:

- ▶ The structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability
- ▶ The scope and nature of its risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing, and how these are integrated into the entity's operating activities. Useful disclosures might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach
- ▶ The processes for accepting, measuring, monitoring and controlling insurance risks and the entity's underwriting strategy to ensure that there are appropriate risk classification and premium levels
- ▶ The extent to which insurance risks are assessed and managed on an entity-wide basis
- ▶ The methods employed to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance
- ▶ Asset and liability management (ALM) techniques
- ▶ The processes for managing, monitoring and controlling commitments received (or given) to accept (or contribute) additional debt or equity capital when specified events occur

Additionally, it might be useful to provide disclosures both for individual types of risks insured and overall. These disclosures might include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the contracts and their relative significance to the insurer.

Quantitative information about exposure to insurance risk might include:

- ▶ Information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability)
- ▶ Information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities. This might include the general nature of any formula for the participation and the extent of any discretion held by the insurer

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<sup>597</sup> IFRS 17.123.

- ▶ Information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds established by law which are within the scope of IAS 37.

### **16.5.1. Concentrations of risk**

An entity should disclose information about concentrations of risk arising from contracts within the scope of IFRS 17, including a description of how the entity determines the concentrations, and a description of the shared characteristic that identifies each concentration (for example, the type of insured event, industry, geographical area, or currency).

It is further explained that concentrations of financial risk might arise, for example, from interest-rate guarantees that come into effect at the same level for a large number of contracts. Concentrations of financial risk might also arise from concentrations of non-financial risk, e.g., if an entity provides product liability protection to pharmaceutical companies and also holds investments in those companies (i.e., a sectoral concentration).<sup>598</sup>

Other concentrations could arise from, for example:

- ▶ A single insurance contract, or a small number of related contracts, for example when an insurance contract covers low-frequency, high-severity risks such as earthquakes
- ▶ Single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability
- ▶ Exposure to unexpected changes in trends, for example unexpected changes in human mortality or in policyholder behaviour
- ▶ Exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses
- ▶ Significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts
- ▶ Correlations and interdependencies between different risks
- ▶ Significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows
- ▶ Geographical concentrations

Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic.

Disclosure of the historical performance of low-frequency, high-severity risks might be one way to help users assess cash flow uncertainty associated with those risks. For example, an insurance contract may cover an earthquake that

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<sup>598</sup> IFRS 17.127.

is expected to happen, on average, once every 50 years. If the earthquake occurs during the current reporting period, the insurer will report a large loss. If the earthquake does not occur during the current reporting period, the insurer will report a profit. Without adequate disclosure of long-term historical performance, it could be misleading to report 49 years of large profits, followed by one large loss, because users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, describing the extent of the exposure to risks of this kind and the estimated frequency of losses might be useful. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies. However, there is no specific requirement to disclose a probable maximum loss (PML) in the event of a catastrophe.

### **16.5.2. Insurance and market risks - sensitivity analysis**

An entity should disclose information about sensitivities to changes in risk variables arising from contracts within the scope of IFRS 17. To comply with this requirement, an entity should disclose:<sup>599</sup>

- ▶ A sensitivity analysis that shows how profit or loss and equity would have been affected by changes in risk variables that were reasonably possible at the end of the reporting period:
  - ▶ For insurance risk - showing the effect for insurance contracts issued, before and after risk mitigation by reinsurance contracts held
  - ▶ For each type of market risk - in a way that explains the relationship between the sensitivities to changes in risk variables arising from insurance contracts and those arising from financial assets held by the entity
- ▶ The methods and assumptions used in preparing the sensitivity analysis
- ▶ Changes from the previous period in the methods and assumptions used in preparing the sensitivity analysis, and the reasons for such changes

Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.<sup>600</sup>

If an entity prepares a sensitivity analysis (e.g., an embedded value analysis) that shows how amounts different from those above are affected by changes in risk variables and uses that sensitivity analysis to manage risks arising from contracts within the scope of IFRS 17, it may use that sensitivity analysis in place of the analysis specified above. The entity should also disclose:<sup>601</sup>

- ▶ An explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the information provided
- ▶ An explanation of the objective of the method used and of any limitations that may result in the information provided

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<sup>599</sup> IFRS 17.128.

<sup>600</sup> IFRS 7 Appendix A.

<sup>601</sup> IFRS 17.129.

### 16.5.3. Insurance risk - claims development

An entity should disclose actual claims compared with previous estimates of the undiscounted amount of the claims (i.e., claims development). The disclosure regarding claims development should start with the period when the earliest material claim(s) arose and for which there is still uncertainty about the amount and timing of the claims payments at the end of the reporting period. But the disclosure is not required to start more than 10 years before the end of the reporting period (although there is transitional relief for first-time adopters - see 17.2.1.A below). An entity is not required to disclose information about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year.<sup>602</sup>

An entity should reconcile the disclosure about claims development with the aggregate carrying amount of the groups of insurance contracts which comprise the liabilities for incurred claims (see 16.1.1 and 16.1.2 above).<sup>603</sup> Hence, only incurred claims are required to be compared with previous estimates and not any amounts within the liability for remaining coverage. In this context, incurred claims appear to include those arising from reinsurance contracts held as well as those arising from insurance and reinsurance contracts issued.<sup>604</sup>

These requirements apply to incurred claims arising from all models (i.e., general model, premium allocation approach and variable fee approach). However, because insurers need not disclose the information about claims for which uncertainty about the amount and timing of payments is typically resolved within a year, it is unlikely that many life insurers will need to give the disclosure.

The claims development table is required to be shown undiscounted. Hence, any discounting adjustment will be a reconciling item between the claims development table and the carrying amount of the liability for incurred claims. In addition, given the long tail nature of many non-life insurance claims liabilities, it is likely that many non-life insurers will have claims outstanding at the reporting date that are more than ten years old and which will also need to be included in a reconciliation of the claims development table to the carrying amount of the liability for incurred claims.

IFRS 17 does not contain an illustrative example of a claims development table (or, indeed, specifically require disclosure in a tabular format). The example below is based on an illustrative example contained in the Implementation Guidance to IFRS 4. This example, as a simplification for illustration purposes, presents five years of claims development information by underwriting year, although the standard itself requires ten (subject to the transitional relief upon first-time adoption) and assumes no reinsurance held. Other formats are permitted, including, for example, presenting information by accident year or reporting period rather than underwriting year.

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<sup>602</sup> IFRS 17.130.

<sup>603</sup> IFRS 17.130.

<sup>604</sup> IFRS 17.100.

### Illustration 84 – Disclosure of claims development

The top half of the table shows how the insurer's estimates of incurred claims for each underwriting year develop over time. For example, at the end of 2019, the insurer's estimate of the undiscounted liability for incurred claims that it would pay for insured events relating to insurance contracts underwritten in 2019 was CU680. By the end of 2020, the insurer had revised the estimate of incurred claims (both those paid and those still to be paid) to CU673.

The lower half of the table reconciles the cumulative incurred claims to the amount appearing in the statement of financial position. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, the effect of discounting is deducted to give the carrying amount in the statement of financial position.

| Incurred claim year   | 2019  | 2020  | 2021  | 2022  | 2023  | Total |
|---|-------|-------|-------|-------|-------|-------|
|   | CU    | CU    | CU    | CU    | CU    | CU    |
| Estimate of incurred claims:  |       |       |       |       |       |       |
| At end of underwriting year   | 680   | 790   | 823   | 920   | 968   |       |
| One year later  | 673   | 785   | 840   | 903   |       |       |
| Two years later   | 692   | 776   | 845   |       |       |       |
| Three years later   | 697   | 771   |       |       |       |       |
| Four years later  | 702   |       |       |       |       |       |
| Estimate of incurred claims   | 702   | 771   | 845   | 903   | 968   |       |
| Cumulative payments   | (702) | (689) | (570) | (350) | (217) |       |
|   | -     | 82    | 275   | 553   | 751   | 1,661 |
| Effect of discounting   | -     | (14)  | (68)  | (175) | (265) | (562) |
| Liabilities for which uncertainty is expected to be settled within one year       |       |       |       |       |       | 20    |
| Liabilities for incurred claims recognised in the statement of financial position | -     | 68    | 207   | 378   | 486   | 1,119 |



## How we see it

IFRS 17 does not address the presentation in the claims development table of:

- ▶ Exchange differences associated with insurance liabilities arising on retranslation (e.g., whether previous years' incurred claims should be retranslated at the current reporting period date)
- ▶ Claims liabilities acquired in a business combination or transfer (as discussed at 14.2 above, for contracts acquired in their settlement period, claims are incurred only when the financial effect becomes certain)
- ▶ Claims liabilities disposed of in a business disposal or transfer
- ▶ Whether claims should include expenses or could be defined as comprising claims payment amounts only
- ▶ Whether claims development should be provided on both a gross and net of reinsurance basis.

As IFRS 17 is silent on these matters, a variety of treatments would appear to be permissible, provided they are adequately explained to the users of the financial statements and consistently applied in each reporting period.

### 16.5.4. Credit risk – other information

For credit risk that arises from contracts within the scope of IFRS 17, an entity should disclose:<sup>605</sup>

- ▶ The amount that best represents its maximum exposure to credit risk at the end of the reporting period, separately for insurance contracts issued and reinsurance contracts held
- ▶ Information about the credit quality of reinsurance contracts held that are assets.

Credit risk is defined in IFRS 7 as 'the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss'. IFRS 17 provides no further detail about what is considered to be the maximum exposure to credit risk for an insurance contract or reinsurance contract held at the end of the reporting period (such as whether it is the maximum possible loss, the maximum probable loss or the fulfilment cash flows). The equivalent IFRS 7 requirement for financial instruments requires disclosure of credit risk gross of collateral or other credit enhancements.<sup>606</sup> However, IFRS 17 does not specify that the maximum credit risk should be disclosed gross of collateral or other credit enhancements.

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<sup>605</sup> IFRS 17.131.

<sup>606</sup> IFRS 7.35K(a).

Information about the credit quality of reinsurance could be provided by an analysis based on credit risk rating grades.

#### **16.5.5. Liquidity risk - other information**

For liquidity risk arising from contracts within the scope of IFRS 17, an entity should disclose:<sup>607</sup>

- ▶ A description of how it manages the liquidity risk
  - ▶ Separate maturity analyses for portfolios of insurance contracts issued that are liabilities and portfolios of reinsurance contracts held that are liabilities that show, as a minimum, net cash flows of the portfolios for each of the first five years after the reporting date and in aggregate beyond the first five years. An entity is not required to include in these analyses liabilities for remaining coverage measured applying the premium allocation approach. The analyses may take the form of:
    - ▶ An analysis by the estimated timing of the remaining contractual undiscounted net cash flows
- Or
- ▶ An analysis by the estimated timing of the estimates of the present value of the future cash flows
  - ▶ The amounts that are payable on demand, explaining the relationship between such amounts and the carrying amount of the related portfolios of contracts, if not disclosed in the maturity analysis above.

There is no equivalent disclosure required for portfolios of insurance contracts and reinsurance contracts held that are in an asset position.

IFRS 7 does not contain an equivalent requirement to disclose 'amounts that are payable on demand'. As such, the nature of this requirement in IFRS 17 is not entirely clear (i.e., whether it is intended to include gross liabilities payable at the reporting date in respect of portfolios of insurance contracts and reinsurance assets held that are assets or whether the requirement is intended to show only those net cash outflows payable at the reporting date included within the maturity analysis).

#### **16.5.6. Regulatory disclosures**

Most insurance entities are exposed to externally imposed capital requirements. Therefore, the IAS 1 disclosures in respect of these requirements are likely to be applicable.

Where an entity is subject to externally imposed capital requirements, disclosure must be made of the nature of these requirements and how these requirements are incorporated into the management of capital. Whether or not these requirements have been complied with in the reporting period and, where they have not been complied with, the consequences of such non-compliance must also be disclosed.<sup>608</sup>

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<sup>607</sup> IFRS 17.132.

<sup>608</sup> IAS 1.135.

Many insurance entities operate in several jurisdictions. Where an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, separate information should be disclosed for each capital requirement to which an entity is subject.<sup>609</sup>

In addition to the requirements of IAS 1, an entity should disclose information about the effect of the regulatory frameworks in which it operates, for example, minimum capital requirements or required interest-rate guarantees.<sup>610</sup> These extra disclosures do not contain an explicit requirement for an insurer to quantify its regulatory capital requirements. The IASB considered whether to add a requirement for insurers to quantify regulatory capital on the grounds that such disclosures might be useful for all entities operating in a regulated environment. However, the Board was concerned about developing such disclosures in isolation in a project on accounting for insurance contracts that would go beyond the existing requirements in IAS 1. Accordingly, the Board decided to limit the disclosures about regulation to those set out above.<sup>611</sup>

Additionally, if an entity includes contracts within the same group which would have been in different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics (see 6 above), it should disclose that fact.<sup>612</sup>

#### **16.5.7. Disclosures required by IFRS 7 and IFRS 13**

Contracts within the scope of IFRS 17 are not excluded from the scope of IFRS 13. Therefore, any of those contracts measured at fair value are also subject to the disclosures required by IFRS 13. IFRS 17, however, does not require contracts within its scope to be measured at fair value. In addition, all contracts within the scope of IFRS 17 are excluded from the scope of IFRS 7.<sup>613</sup> Under IFRS 4, investment contracts with a discretionary participation features were within the scope of IFRS 7.

However, IFRS 7 applies to:<sup>614</sup>

- ▶ Derivatives that are embedded in contracts within the scope of IFRS 17, if IFRS 9 requires the entity to account for them separately
- ▶ Investment components that are separated from contracts within the scope of IFRS 17, if IFRS 17 requires such separation

#### **16.5.8. Key performance indicators**

IFRS 17 does not require disclosure of key performance indicators. However, such disclosures might be a useful way for an insurer to explain its financial performance during the period and to give an insight into the risks arising from insurance contracts.

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<sup>609</sup> IAS 1.136.

<sup>610</sup> IFRS 17.126.

<sup>611</sup> IFRS 17.BC369-371.

<sup>612</sup> IFRS 17.126.

<sup>613</sup> IFRS 7.3(d).

<sup>614</sup> IFRS 7.3(d).

# 17. Effective date and transition

## 17.1. Effective date

An entity should apply IFRS 17 for annual reporting periods beginning on or after 1 January 2023.<sup>615</sup> When IFRS 17 is applied, IFRS 4 is withdrawn.<sup>616</sup>

If an entity applies IFRS 17 earlier than reporting periods beginning on or after 1 January 2023 it should disclose that fact. However, early application is permitted only for entities that also apply IFRS 9 on or before the date of initial application of IFRS 17.<sup>617</sup>

For the purposes of the transition requirements discussed at 17.2 below:<sup>618</sup>

- ▶ The date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 17 (i.e., 1 January 2023 for an entity first applying the standard with an annual reporting period ending 31 December 2023)
- ▶ The transition date is the beginning of the annual reporting period immediately preceding the date of initial application (i.e., 1 January 2022 for an entity first applying the standard with an annual reporting period ending 31 December 2023 which reports only one comparative period)

## 17.2. Transition - general requirements

An entity should apply IFRS 17 retrospectively from the transition date unless:<sup>619</sup>

- ▶ Impracticable

Or

- ▶ The entity chooses to apply the fair value approach for a group of insurance contracts with direct participation features (to which it could apply IFRS 17 retrospectively) when risk mitigation has been applied prospectively to the group from the transition date and the entity has used derivatives, non-derivative financial instruments measured at fair value through profit or loss, or reinsurance contracts held or to mitigate financial risk arising from that group of contracts before transition date.<sup>620</sup>

Notwithstanding the requirement for retrospective application, if it is impracticable (as defined in IAS 8), to apply IFRS 17 retrospectively for a group of insurance contracts, an entity should apply one of the two following approaches instead:<sup>621</sup>

- ▶ A modified retrospective approach (see 17.4 below)

Or

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<sup>615</sup> IFRS 17.C1.

<sup>616</sup> IFRS 17.C34.

<sup>617</sup> IFRS 17.C1.

<sup>618</sup> IFRS 17.C2.

<sup>619</sup> IFRS 17.C3.

<sup>620</sup> IFRS 17.C5A.

<sup>621</sup> IFRS 17.C5.

- ▶ A fair value approach (see 17.5 below)

An entity should also apply either the modified retrospective approach or the fair value approach to measure an asset for insurance acquisition cash flows if, and only if, it is impracticable to identify, recognise and measure any assets for insurance acquisition cash flows retrospectively.<sup>622</sup>

IAS 8 states that applying a requirement is 'impracticable' when an entity cannot apply it after making every reasonable effort to do so.<sup>623</sup>

The Board permitted these alternative options to the full retrospective approach on the grounds that measuring the remaining amount of the contractual service margin for contracts acquired in prior periods, as well as the information needed in the statement of financial performance in subsequent periods, was likely to be challenging for preparers. This is because these amounts reflect a revision of estimates for all periods after the initial recognition of a group of contracts.<sup>624</sup> In the Board's opinion, measuring the following amounts needed for retrospective application would often be impracticable:<sup>625</sup>

- ▶ The estimates of cash flows at the date of initial recognition
- ▶ The risk adjustment for non-financial risk at the date of initial recognition
- ▶ The changes in estimates that would have been recognised in profit or loss for each accounting period because they did not relate to future service, and the extent to which changes in the fulfilment cash flows would have been allocated to the loss component
- ▶ The discount rates at the date of initial recognition
- ▶ The effect of changes in discount rates on estimates of future cash flows for contracts for which changes in financial assumptions have a substantial effect on the amounts paid to policyholders

The choice of applying either a modified retrospective approach or a fair value approach exists separately for each group of insurance contracts when it is impracticable to apply IFRS 17 retrospectively to that group. An entity is permitted to use either of these two methods although use of the modified retrospective approach is conditional on the availability of reasonable and supportable information.<sup>626</sup>

Within the two permitted methods there are also measurement choices available depending on the level of prior year information. Consequently, there is likely to be considerable diversity of practice across entities in calculating the contractual service margin at transition date. In turn, this will result in potentially different releases of the contractual service margin (i.e., different profit) for similar types of contract in subsequent accounting periods. The Board has acknowledged that the choice of transition methods results in a lack of comparability of transition amounts.<sup>627</sup> This explains why the Board included a requirement for disclosures that track the effects of the modified

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<sup>622</sup> IFRS 17.C5B.

<sup>623</sup> IAS 8.5.

<sup>624</sup> IFRS 17.BC377.

<sup>625</sup> IFRS 17.BC378.

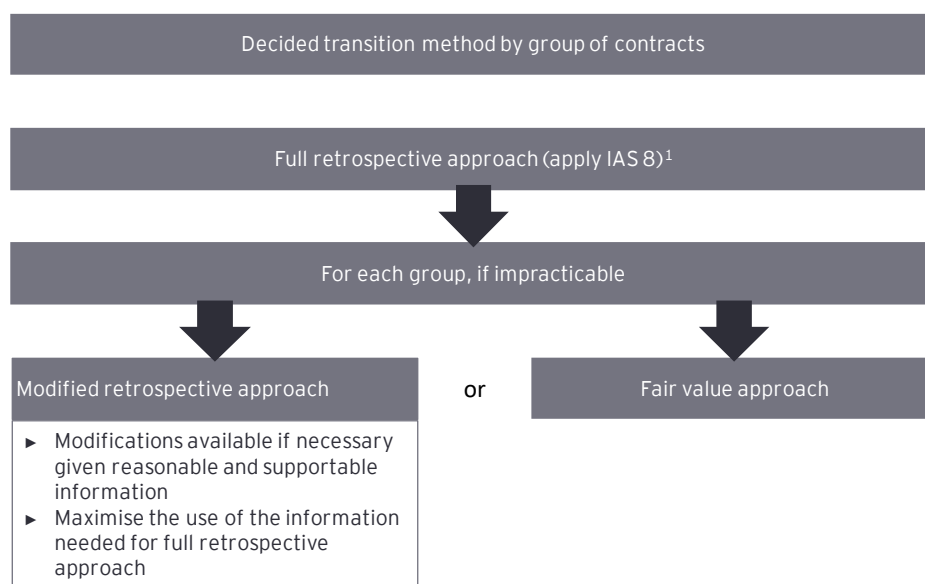
<sup>626</sup> IFRS 17.C6(a).

<sup>627</sup> IFRS 17.BC373.

retrospective approach and the fair value approach on the contractual service margin and insurance revenue in future periods (see 16.2 above).

It is observed in the Basis for Conclusions that no simplification has been provided for contracts that have been derecognised before transition. This is because the Board considers that reflecting the effect of contracts derecognised before the transition date on the remaining contractual service margin was necessary to provide a faithful representation of the remaining profit of the group of insurance contracts.<sup>628</sup>

An overview of the transition methods is illustrated below:



<sup>1</sup>An entity eligible to apply the full retrospective approach can also elect to use the fair value approach for a group of insurance contracts with direct participation features when risk mitigation has been applied prospectively to the group from the transition date.

**Illustration 85 – Guidance on meaning of ‘impracticable’**

IAS 8 does not require the restatement of prior periods following a change in accounting policy or the correction of material errors if such a restatement is impracticable.

The standard devotes a considerable amount of guidance to discussing what ‘impracticable’ means for these purposes.

The standard states that applying a requirement is impracticable when an entity cannot apply it after making every reasonable effort to do so. It goes on to note that, for a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- ▶ The effects of the retrospective application or retrospective restatement are not determinable

<sup>628</sup> IFRS 17.BC390.

#### Illustration 85 – Guidance on meaning of 'impracticable' (cont'd)

- ▶ The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period

Or

- ▶ The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
- ▶ Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed
- ▶ Would have been available when the financial statements for that prior period were authorised for issue from other information.

An example of a scenario covered by the first bullet above, as set out in the standard, is that, in some circumstances, it may be impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period because data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (or its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.

IAS 8 observes that it is frequently necessary to make estimates in applying an accounting policy and that estimation is inherently subjective, and that estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred.

However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred. Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. However, the fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that:

- ▶ Provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred; and
- ▶ Would have been available when the financial statements for that prior period were authorised for issue, from other information. The standard states that for some types of estimates, it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

### **17.2.1. Transitional relief and prohibition – all entities**

IFRS 17 provides disclosure exemptions for all entities, a prohibition from applying risk mitigation retrospectively prior to the transition date and measurement exemptions or modifications on transition. Consequential amendments to IFRS 3 provide transitional relief for business combinations within the scope of IFRS 3 prior to the date of initial application of IFRS 17.

#### **17.2.1.A. Disclosure relief**

IFRS 17 contains the following disclosure relief on transition:

- ▶ An entity is exempt from the IAS 8 requirement to present the amount of the adjustment resulting from applying IFRS 17 affecting each financial line item to either the current period or each prior period presented and the impact of applying IFRS 17 in those periods on earnings per share.<sup>629</sup>
- ▶ An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies IFRS 17 (i.e. information about claims that occurred prior to 1 January 2019 for an entity first applying the standard with an annual reporting period ending 31 December 2023). An entity that elects to take advantage of this disclosure relief should disclose that fact.<sup>630</sup>

#### **17.2.1.B. Prohibition from applying the risk mitigation prior to the transition date**

An entity must not apply the risk mitigation option available for insurance contracts with direct participation features (see 12.3.5 above) before the transition date of IFRS 17. An entity may apply the risk mitigation option prospectively on or after the transition date if, and only if, the entity designates risk mitigation relationships at or before it applies the option.<sup>631</sup>

The Board was aware that some stakeholders would have preferred that the Board amend IFRS 17 to permit retrospective application of the risk mitigation option. In the view of those stakeholders, permitting retrospective application of the option would be the optimal approach to achieve comparability between the information provided about risk mitigation activities that took place before and after the transition date. Acknowledging that view, the Board considered whether it should amend IFRS 17 to permit retrospective application of the risk mitigation option. However, the Board noted that if an entity was permitted to apply the option retrospectively, it could freely decide the extent to which to reflect risk mitigation activities in the contractual service margin based on a known accounting outcome. The entity could do this in a way that would not reflect how the entity would have applied the option in previous periods, without hindsight, had it always applied IFRS 17. Such a risk would affect the credibility of information presented on transition to IFRS 17 and in subsequent periods in which those groups of insurance contracts continue to exist. In the Board's view, these costs would outweigh the benefits of permitting retrospective application of the option. Therefore, the Board reaffirmed its decision to prohibit retrospective application of the option because of the risk of

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<sup>629</sup> IFRS 17.C3(a).

<sup>630</sup> IFRS 17.C28.

<sup>631</sup> IFRS 17.C3(b).



the use of hindsight.<sup>632</sup> Some stakeholders suggested alternative approaches that would avoid the risk of the use of hindsight. However, the Board also rejected these approaches as unworkable.<sup>633</sup>

#### **17.2.1.C. Business combinations within the scope of IFRS 3**

For contracts acquired in business combinations within the scope of IFRS 3 before the date of initial application of IFRS 17, an entity classifies and groups those contracts based on the contractual terms, economic conditions, operating or accounting policies or other factors as they existed at the date of initial recognition of those contracts rather than at the acquisition date of the business combination.<sup>634</sup> This relief allows entities to continue to apply their previous IFRS 4 classification of contracts acquired in a business combination before the date of initial application of IFRS 17.

This relief applies only to business combinations. It does not apply to other transfers of contracts (e.g., portfolio transfers) that are not business combinations.

#### **17.2.2. Disclosures about the effect of transition**

At transition to IFRS 17, entities should provide the disclosures required by IAS 8 applicable to changes in accounting policies apart from the exemption discussed above (i.e., there is no requirement to present the amount of the adjustment resulting from applying IFRS 17 affecting each financial line item to either the current period or each prior period presented and the impact of applying IFRS 17 in those periods on earnings per share).

IAS 8 requires the following disclosures upon initial application of an IFRS:<sup>635</sup>

- ▶ The title of the IFRS Standard (i.e., IFRS 17)
- ▶ A statement that the change in accounting policy is made in accordance with the transitional provisions
- ▶ The nature of the change in accounting policy
- ▶ Where applicable, a description of the transitional provisions (which means that an entity would need to explain whether and how it had applied the retrospective, modified retrospective and fair value approaches)
- ▶ When applicable, the transitional provisions that might have an effect on future periods
- ▶ The amount of any adjustment relating to periods prior to the accounting periods presented in the financial statements, to the extent practicable
- ▶ If retrospective application is impracticable, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy is consistently applied

In addition, as discussed at 16.2 above, entities are required to provide disclosures to enable users of the financial statements to identify the effects of groups of insurance contracts measured at transition date applying the

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<sup>632</sup> IFRS 17.BC393C.

<sup>633</sup> IFRS 17.BC393D-E.

<sup>634</sup> IFRS 3.64N.

<sup>635</sup> IAS 8.28.

modified retrospective approach or the fair value approach on the contractual service margin in subsequent periods. This information is provided in the form of reconciliations. In all periods for which disclosures are made for those contracts which used the modified retrospective or fair value approach on transition, an entity should continue to explain how it determined the measurement requirements at transition date.

### 17.3. Retrospective application of transition

When applying IFRS 17 retrospectively, an entity should:<sup>636</sup>

- ▶ Identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied
- ▶ Identify, recognise and measure any assets for insurance acquisition cash flows as if IFRS 17 had always applied (except that an entity is not required to apply the recoverability assessment test discussed at 8.10 above before the transition date)
- ▶ Derecognise any existing balances that would not exist had IFRS 17 always applied
- ▶ Recognise any resulting net difference in equity

The balances derecognised upon application of IFRS 17 would include balances recognised previously under IFRS 4, as well as items such as deferred acquisition costs, deferred origination costs (for investment contracts with discretionary participation features) and some intangible assets that relate solely to existing contracts. The requirement to recognise any net difference in equity means that no adjustment is made to the carrying amounts of goodwill from any previous business combination.<sup>637</sup> However, the value of contracts within the scope of IFRS 17 that were acquired in prior period business combinations or transfers would have to be adjusted by the acquiring entity from the date of acquisition (i.e., initial recognition of the contracts) together with any intangible related to those in-force contracts (see section 14).

Any intangible asset derecognised would include an intangible asset that represented the difference between the fair value of insurance contracts acquired in a business combination or transfer. It would also include a liability measured in accordance with an insurer's previous accounting practices for insurance contracts where an insurer previously chose the option in IFRS 4 to use an expanded presentation that split the fair value of acquired insurance contracts into two components.<sup>638</sup>

Applying the standard retrospectively means that the comparative period (i.e., the annual reporting period immediately preceding the date of initial application) must be restated and comparative disclosures made in full in the first year of application subject to the exemptions noted below. An entity may also present adjusted comparative information applying IFRS 17 for any earlier periods (i.e., earlier than the annual reporting period immediately preceding the date of initial application) but is not required to do so. If an entity does present adjusted comparative information for any prior periods, the reference

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<sup>636</sup> IFRS 17.C4.

<sup>637</sup> IFRS 17.BC374.

<sup>638</sup> IFRS 4.31.

to “the beginning of the annual reporting period immediately preceding the date of initial application” (see 19.1 above) must be read as “the beginning of the earliest adjusted comparative period presented.”<sup>639</sup> However, an entity is not required to provide the disclosures specified at 16 above for any period presented before the beginning of the annual accounting period immediately preceding the date of initial application.<sup>640</sup> This relief is intended for entities that are required to present more than one comparative period in their annual financial statements.

If an entity presents unadjusted comparative information and disclosures for any earlier periods, it should clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis.<sup>641</sup>

The requirement to apply IFRS 17 retrospectively as if it has always applied means that an entity that elects not to change estimates made in previous interim financial statements (see 15.4 above) should estimate the contractual service margin for all individual interim periods previously presented, in order to get to a number for the contractual service margin that reflects that as if IFRS 17 had always been applied.<sup>642</sup> This is based on the fact that only a fully retrospective interim contractual service margin roll-forward would provide the outcome that corresponds to a situation as if IFRS 17 had always been applied. Retrospective application of the standard by an entity that issues interim financial statements may present significant additional operational challenges for insurers upon transition. This is because the contractual service margin for each interim reporting period subsequent to initial recognition of a group of contracts would need to be tracked and estimated in accordance with the requirements in IFRS 17 to determine the contractual service margin on transition date. Therefore, for entities applying the modified retrospective approach, transitional relief is available from this requirement (see 17.4 below).

The IASB considered that some stakeholders implementing IFRS 17 thought that the inclusion of specified modifications in IFRS 17 implies that an entity cannot make estimates in applying IFRS 17 retrospectively. The Board noted that paragraph 51 of IAS 8, which states that ‘...the objective of estimates related to prior periods remains the same as estimates related to the current period, namely, for the estimates to reflect the circumstances that existed when the transaction, other event or condition occurred’ specifically acknowledges the need for estimates in retrospective application and that this paragraph applies to entities that apply IFRS 17 for the first time, just as it does to entities that apply other IFRS Standards for the first time.<sup>643</sup>

In addition, some stakeholders suggested that the Board could reduce the burden of applying the transition requirements by specifying methods that can be used, for example, methods using information from embedded value reporting or information prepared for regulatory reporting purposes. However, the Board rejected this suggestion. The Board concluded that specifying methods would conflict with the approach in IFRS 17 of establishing

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<sup>639</sup> IFRS 17.C25.

<sup>640</sup> IFRS 17.C26.

<sup>641</sup> IFRS 17.C27.

<sup>642</sup> IFRS 17.B137.

<sup>643</sup> IFRS 17.BC380C.

measurement objectives that can be satisfied using different approaches. In particular situations, some methods may be more applicable, or may be easier to implement, and it would not be practicable for an IFRS Standard to specify in detail every situation in which particular methods would be appropriate. The appropriateness of any method depends on the particular facts and circumstances. Furthermore, specifying methods could risk incorrectly implying other methods that would satisfy the requirements of IFRS 17 cannot be used.<sup>644</sup>

### How we see it

- ▶ IFRS 17 does not include, unlike some other IFRS Standards, a simplification for contracts that have been derecognised before transition date. This is due to the inherent reliance of the model on the contractual service margin at initial recognition of a group of contracts, combined with the long-term nature of many insurance contracts. The consequence is that full retrospective application will be impracticable in more situations because entities will not have sufficient historic information for contracts that were derecognised in the past.
- ▶ There is likely to be considerable diversity of practice across entities in calculating the contractual service margin at transition date. This will result in potentially different releases of the contractual service margin (i.e., different profit) for similar types of contracts in subsequent accounting periods. This explains why the Board included a requirement for disclosures that track the effects of the modified retrospective approach and the fair value approach on the contractual service margin and insurance revenue in future periods (see section 16.2).
- ▶ Full retrospective application is based on a revision of estimates for all periods after the initial recognition of a group of contracts, requiring the use of historical data. Particularly for long-duration contracts, full retrospective application is likely to be impracticable in many cases, because an entity would have to use hindsight if some of the historical data is lacking.

## 17.4. Modified retrospective approach

This approach contains a series of permitted modifications to (full) retrospective application, as follows:<sup>645</sup>

- ▶ Assessment of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition (see 17.4.1)
- ▶ Amounts related to the contractual service margin or loss component for insurance contracts without direct participation features (see 17.4.2)
- ▶ Amounts related to the contractual service margin or loss component for insurance contracts with direct participation features (see 17.4.3)

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<sup>644</sup> IFRS 17.BC380D.

<sup>645</sup> IFRS 17.C7.

- ▶ Insurance finance income or expenses (see 17.4.4)

An entity is permitted to use each modification listed above only to the extent that it does not have reasonable and supportable information to apply a full retrospective approach.<sup>646</sup>

The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. Accordingly, in applying this approach, an entity must:<sup>647</sup>

- ▶ Use reasonable and supportable information. If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it should apply the fair value approach
- ▶ Maximise the use of information that would have been used to apply a fully retrospective approach, but only use information available without undue cost or effort.

'Undue cost and effort' is not defined in IFRS. However, *IFRS for Small and Medium-sized Entities (IFRS for SMEs)* states that considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by a small and medium sized entity (SME) if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits those that are expected to use the SME's financial statements would receive from having the information. The Basis for Conclusions to the *IFRS for SMEs* further observes that:

- ▶ The undue cost or effort exemption is not intended to be a low hurdle. This is because an entity is required to carefully weigh the expected effects of applying the exemption on the users of the financial statements against the cost or effort of complying with the related requirement. In particular, the IASB observed that it would expect that if an entity already had, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. This is because, in that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the entity

And

- ▶ That an entity must make a new assessment of whether a requirement will involve undue cost or effort at each reporting date

The IASB's Conceptual Framework also notes that although cost is a pervasive constraint on the information provided by financial reporting and that the cost of producing information must be justified by the benefits that it provides, the

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<sup>646</sup> IFRS 17.C8.

<sup>647</sup> IFRS 17.C6.

cost is ultimately borne by the users (not the preparers) and implies that any cost constraint should be seen from a user's viewpoint.

To use each modification, an entity must have the reasonable and supportable information necessary to apply that modification. If not, the entity is required to apply the fair value approach to the group of insurance contracts. The Basis for Conclusions observes that the Board expects that estimates will often be needed when applying a specified modification in the modified retrospective approach.<sup>648</sup>

The Board considered feedback from entities implementing IFRS 17 that said the requirement to use reasonable and supportable information significantly increases the costs of applying the modified retrospective approach. The Board acknowledged that removing the requirements relating to the use of reasonable and supportable information might provide significant cost relief for those entities. However, the Board disagreed with suggestions to amend IFRS 17 in that regard because, in its view, entities should use information that is reasonable and supportable. Permitting an entity to use information that is not reasonable and supportable would undermine the credibility of the information that results from applying IFRS 17. In addition, permitting an entity to ignore reasonable and supportable information available without undue cost or effort that the entity would have used to apply a retrospective approach would be contrary to the objective of the modified retrospective approach and would reduce comparability between contracts issued before and after the transition date.<sup>649</sup>

#### **17.4.1. Assessments at inception or initial recognition**

When it is impracticable for an entity to apply the retrospective approach to a group of contracts at initial recognition, it should determine the following by using information available at the transition date:<sup>650</sup>

- ▶ How to identify groups of contracts (see section 6)
- ▶ Whether an insurance contract meets the definition of an insurance contract with direct participation features (see section 12.3.1X)
- ▶ how to identify discretionary cash flows for insurance contracts without direct participation features (see section 12.2X)
- ▶ Whether an investment contract meets the definition of an investment contract with discretionary participation features (see 12.4 above)

To apply IFRS 17 retrospectively, an entity needs to determine the group of insurance contracts to which individual contracts would have belonged on initial recognition. IFRS 17 requires entities to group only contracts written within one year.<sup>651</sup> The IASB considered that it may not always be practicable for entities to group contracts written in the same one year period retrospectively.<sup>652</sup> Consequently, in aggregating contracts when it is impracticable to apply a

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<sup>648</sup> IFRS 17.BC380A, C.

<sup>649</sup> IFRS 17.BC380B.

<sup>650</sup> IFRS 17.C9.

<sup>651</sup> IFRS 17.BC391.

<sup>652</sup> IFRS 17.BC392.

retrospective approach, an entity is permitted (to the extent that reasonable and supportable information does not exist) to aggregate contracts in a portfolio issued more than one year apart into a single group.<sup>653</sup> This may mean that a single group of, say, term life contracts, could span many years to the extent that reasonable and supportable information would not be available to aggregate the contracts into groups that only contain contracts issued within one year.

To the extent there is no reasonable and supportable information, as discussed above, an entity should classify as a liability for incurred claims, a liability for settlement of claims incurred before an insurance contract was acquired in a transfer of business contracts that do not form a business or in a business combination within the scope of IFRS 3 (see 14.2 above).<sup>654</sup> This relief was added in June 2020 in response to feedback that suggested that it would often be impracticable for an entity to apply IFRS 17 retrospectively to contracts acquired before the transition date (that is, to classify and measure those contracts as a liability for remaining coverage).<sup>655</sup>

#### ***17.4.2. Determining the contractual service margin or loss component for groups of insurance contracts without direct participation features***

When it is impracticable for an entity to apply the full retrospective approach at initial recognition to determine the contractual service margin or the loss component of the liability for remaining coverage, it is permitted to determine these at transition date using a modified approach to determine the components of the liability for remaining coverage.<sup>656</sup>

The modified retrospective approach requires that reasonable and supportable information exists for the cash flows prior to transition up until the date of initial recognition (i.e., the date past which reasonable and supportable information is no longer available). This means all of the cash flows within the boundary of the insurance contract, as discussed at 9.1 above, including, for example, internally allocated directly attributable insurance acquisition cash flows, claims handling costs, policy maintenance and administration costs and an allocation of fixed and variable overheads.

The modified retrospective approach allows considerable judgement as it permits an entity to go back as far as it is able in order to determine reliable accounting estimates for the fulfilment cash flows. Inevitably, this will result in diversity in practice by first time adopters and some lack of comparability in the release of the contractual margin in future periods between entities with longer-term contracts.

The process applied is as follows:

- ▶ The future cash flows at the date of initial recognition of a group of insurance contracts must be estimated as the amount of the future cash flows at the transition date (or earlier, if the future cash flows at the earlier date can be determined retrospectively), adjusted by the cash flows that

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<sup>653</sup> IFRS 17.C10.

<sup>654</sup> IFRS 17.C9A.

<sup>655</sup> IFRS 17.BC382A.

<sup>656</sup> IFRS 17.C11.

have occurred between the date of initial recognition of a group of insurance contracts and the transition date (or earlier date). The cash flows known to have occurred include those resulting from contracts that were derecognised before the transition date.<sup>657</sup>

- ▶ The discount rates that applied at the date of initial recognition of a group of insurance contracts (or subsequently) should be determined:<sup>658</sup>
- ▶ Using an observable yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying a basis comparable with the general approach to calculating discount rates (see section 9.3), if such an observable yield curve exists

Or

- ▶ If the observable yield curve described above does not exist, the discount rates that applied at the date of initial recognition, or subsequently, should be estimated by determining an average spread between an observable yield curve and the yield curve estimated applying the general approach, and applying that spread to that observable yield curve. That spread should be an average over at least three years immediately before the transition date.
- ▶ The risk adjustment for non-financial risk at the date of initial recognition of a group of insurance contracts, or subsequently, should be determined by adjusting the risk adjustment for non-financial risk at the transition date by the expected release of risk before the transition date. The expected release of risk should be determined by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.<sup>659</sup>

An entity should use the same systematic and rational method that it expects to use after transition date to allocate any insurance acquisition cash flows paid (or for which a liability has been recognised applying another IFRS Standard) before the transition date (excluding any amount relating to insurance contracts that ceased to exist before the transition date) to:<sup>660</sup>

- ▶ Groups of insurance contracts recognised at the transition date
- ▶ Groups of insurance contracts that are expected to be recognised after the transition date

Insurance acquisition cash flows paid before the transition date that are allocated to a group of insurance contracts that is recognised at the transition date adjust the contractual service margin of that group, to the extent insurance contracts expected to be in the group have been recognised at that date. Other insurance acquisition cash flows paid before the transition date, including those that are allocated to a group of insurance contracts that is expected to be recognised after the transition date, are also recognised as an asset (see 7.3 above).<sup>661</sup>

This systematic and rational method mentioned above should be the same systematic and rational method as the entity expects to apply after the

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<sup>657</sup> IFRS 17.C12.

<sup>658</sup> IFRS 17.C13.

<sup>659</sup> IFRS 17.C14.

<sup>660</sup> IFRS 17.C14B.

<sup>661</sup> IFRS 17.C14C.



transition date (see 7.3 above). To the extent that the entity does not have reasonable and supportable information to use a systematic and rational method, the following amounts should be determined to be nil at the transition date:<sup>662</sup>

- ▶ The adjustment to the contractual service margin of groups of insurance contracts that are recognised at the transition date and any asset for insurance acquisition costs relating to that group
- ▶ The asset for insurance acquisition cash flows for groups of insurance contracts that are expected to be recognised after the transition date

An entity that makes an accounting policy choice not to change the treatment of accounting estimates made in previous interim financial statements (see 15.4 above) should determine the contractual service margin or loss component at the transition date as if it has not prepared interim financial statements before the transition date, if there is not reasonable and supportable information to apply a retrospective approach.<sup>663</sup> This means that entities without reasonable and supportable retrospective information do not have to recalculate insurance contract liabilities prior to transition date on a more frequent basis than annual.

If applying the modified requirements above results in a contractual service margin at initial recognition, then the entity should determine the contractual service margin at transition date, as follows:<sup>664</sup>

- ▶ Use the modified discount rates calculated above to accrete interest on the contractual service margin
- ▶ Determine the amount of the contractual service margin recognised in profit or loss because of the transfer of services before the transition date, by comparing the remaining coverage units at that date with the coverage units provided under the group of contracts before the transition date (see 9.7 above)

If applying the modified requirements above results in a loss component of that liability for remaining coverage at the date of initial recognition, an entity should determine any amounts allocated to that loss component before the transition date applying the modified requirements above and using a systematic basis of allocation.<sup>665</sup>

For a group of reinsurance contracts held that provides coverage for an onerous group of insurance contracts and was acquired before or at the same time that the insurance contracts were issued, an entity should establish a loss-recovery component of the asset for remaining coverage at the transition date (see 11.4.3 above). To the extent that there is not reasonable and supportable information to apply a retrospective approach, the entity must determine the loss-recovery component by multiplying:<sup>666</sup>

- ▶ The loss component of the liability for remaining coverage for the underlying insurance contracts at the transition date

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<sup>662</sup> IFRS 17.C14D.

<sup>663</sup> IFRS 17.C14A.

<sup>664</sup> IFRS 17.C15.

<sup>665</sup> IFRS 17.C16.

<sup>666</sup> IFRS 17.C16A.

- ▶ The percentage of claims for the group of underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

However, if an entity does not have reasonable and supportable information to determine the loss recovery, it is not permitted to identify a loss-recovery component for the group of reinsurance contracts held.<sup>667</sup>

At the transition date onerous underlying insurance contracts might include in an onerous group of insurance contracts both onerous insurance contracts covered by the group of reinsurance contracts held and onerous insurance contracts not covered by a group of reinsurance contracts held. In that case, for the purpose of determining the loss-recovery component, the entity should use a systematic and rational basis of allocation to determine the portion of the loss component of the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held.<sup>668</sup>

The following example illustrates the measurement of contracts without direct participation features at the transition date using the modified retrospective approach:

**Illustration 86 – Measurement of groups of insurance contracts without direct participation features applying the modified retrospective approach [Based on example 17 in the Illustrative Examples to IFRS 17.IE186-191]**

An entity issues insurance contracts without direct participation features and aggregates those contracts into groups. The entity estimates the fulfilment cash flows at the transition date applying the general model as the sum of:

- ▶ An estimate of the present value of future cash flows of CU620 (including the effect of discounting of CU(150)); and
- ▶ A risk adjustment for non-financial risk of CU100.

The entity concludes that it is impracticable to apply IFRS 17 retrospectively. As a result, the entity chooses to apply the modified retrospective approach to measure the contractual service margin at the transition date. The entity uses reasonable and supportable information to achieve the closest outcome to retrospective application.

**Analysis**

The entity determines the contractual service margin at the transition date by estimating the fulfilment cash flows on initial recognition, as follows:

Future cash flows at the date of initial recognition of the group of insurance contracts are estimated to be the sum of future cash flows of CU770 at the transition date and cash flows of CU800 that are known to have occurred between the date of initial recognition of the group of insurance contracts and transition date. This includes premiums paid on initial recognition of CU1,000 and cash outflows of CU200 paid during the period. This amount includes cash flows resulting from contracts that ceased to exist before the transition date.

<sup>667</sup> IFRS 17.C16C.

<sup>668</sup> IFRS 17.C16B.

**Illustration 86 – Measurement of groups of insurance contracts without direct participation features applying the modified retrospective approach [Based on example 17 in the Illustrative Examples to IFRS 17.IE186-191] (cont'd)**

- ▶ The entity determines the effect of discounting at the date of initial recognition of the group of insurance contracts to equal CU(200), calculated as the discounting effect on estimates of future cash flows at the date of initial recognition determined above. The entity determines the effect of discounting by using a yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying the methodology described (see 8.2). The entity estimates this amount to equal CU50, reflecting that the premium received on initial recognition; thus, the discounting effect relates only to future cash outflows.
- ▶ The entity determines the risk adjustment for non-financial risk on initial recognition of CU120, as the risk adjustment for the non-financial risk at the transition date of CU100 adjusted by CU20 to reflect the expected release of risk before the transition date. The entity determines the expected release of risk by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.
- ▶ The contractual service margin on initial recognition is CU110, the amount that would result in no profit or loss on initial recognition of the fulfilment cash flows of CU110. The subsequent movement in the contractual service margin uses the discount rates derived above to accrete interest and recognises the amount in profit or loss because of the transfer of services. Comparing the remaining coverage units at the transition date with the coverage units provided by the group before the transition date results in CU90. Consequently, the contractual service margin on the transition date is CU20.

This is illustrated, as follows:

|  | Transition date | Adjustment to initial recognition | Initial recognition |
|--|-----------------|-----------------------------------|---------------------|
|  | CU              | CU                                | CU                  |
| Estimates of future cash flows         | 770             | (800)                             | (30)                |
| Effect of discounting                  | (150)           | (50)                              | (200)               |
| Risk adjustment for non-financial risk | 100             | 20                                | 120                 |
| Fulfilment cash flows                  | 720             | (830)                             | (110)               |
| Contractual service margin             | 20              | 90                                | 110                 |
| Liability for remaining coverage       | 740             |                                   | –                   |

## How we see it

- ▶ The modified retrospective approach allows considerable judgement, as it permits an entity to use historical data to determine reliable accounting estimates for the fulfilment cash flows. Inevitably, this will result in diversity in practice that reduces the comparability in the release of the contractual service margin in future periods between entities with longer-term contracts.
- ▶ IFRS 17 paragraph BC380C articulates the IASB's intent that an entity is allowed to make estimates when applying a specified modification in the modified retrospective approach. This clarification of intent will greatly assist entities in applying the modified retrospective approach.

### **17.4.3. Determining the contractual service margin or loss component for groups of insurance contracts with direct participation features**

When it is impracticable for an entity to apply the full retrospective approach, at initial recognition, to determine the contractual service margin or the loss component of the liability for remaining coverage for groups of contracts with direct participation features, these should be determined, as:<sup>669</sup>

- ▶ The total fair value of the underlying items at the transition date (A in the table below); minus
- ▶ The fulfilment cash flows at the transition date (B); plus or minus
- ▶ An adjustment for (C):
  - ▶ Amounts charged by the entity to policyholders (including amounts deducted from the underlying items) before that date
  - ▶ Amounts paid before that date that would not have varied based on the underlying items
  - ▶ The change in the risk adjustment for non-financial risk caused by the release from risk before that date. An entity should estimate this amount by reference to the release of risk for similar insurance contracts that the entity issues at the transition date
  - ▶ Insurance acquisition cash flows paid (for which a liability has been recognised under another IFRS Standard) before the transition date that are allocated to the group
- ▶ If the sum of (A) - (C) above results in a contractual service margin - minus the amount of the contractual service margin that relates to services provided before that date. The sum of (A)-(C) is a proxy for the total contractual service margin for all services to be provided under the group of contracts, i.e., before any amounts that would have been recognised in profit or loss for services provided. An entity should estimate the amounts that would have been recognised in profit or loss for services provided by comparing the remaining coverage units at the transition date with the

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<sup>669</sup> IFRS 17.C17.

coverage units provided under the group of contracts before the transition date

Or

- ▶ If the sum of (A) - (C) results in a loss component, adjust the loss component to nil and increase the liability for remaining coverage excluding the loss component by the same amount.

The following example illustrates how to apply the modified retrospective approach to contracts with direct participation features at the transition.

**Illustration 87 – Measurement of groups of insurance contracts with direct participation features applying the modified retrospective approach [Based on example 18 in the Illustrative Examples to IFRS 17, IE192-199]**

An entity issues 100 insurance contracts with direct participation features five years before the transition date and aggregates these contracts into a group. Under the terms of the contracts:

- ▶ A single premium is paid at the beginning of the coverage period of 10 years.
- ▶ The entity maintains account balances for policyholders and deducts charges from those account balances at the end of each year.
- ▶ A policyholder will receive an amount equal to the higher of the account balance and the minimum death benefit, if an insured person dies during the coverage period.
- ▶ If an insured person survives the coverage period, the policyholder receives the value of the account balance.

The following events occurred in the five-year period prior to the transition date:

- ▶ The entity paid death benefits and other expenses of CU239 comprising:
- ▶ CU216 of cash flows that vary based on returns from underlying items; and
- ▶ CU23 of cash flows that do not vary based on the returns from underlying items; and
- ▶ The entity deducted charges from the underlying items of CU55.

The entity estimates the fulfilment cash flows at the transition date to be CU922, comprising the estimates of the present value of the future cash flows of CU910 and a risk adjustment for non-financial risk of CU12. The fair value of the underlying items at that date is CU948.

The entity makes the following estimates:

- ▶ Based on an analysis of similar contracts that the entity issues at transition date, the estimated change in the risk adjustment for non-financial risk caused by the release from risk in the five-year period before transition date is CU14; and

**Illustration 87 – Measurement of groups of insurance contracts with direct participation features applying the modified retrospective approach [Based on example 18 in the Illustrative Examples to IFRS 17, IE192-199] (cont'd)**

- ▶ The units of coverage provided before the transition date is approximately 60% of the total coverage units of the group of contracts.

**Analysis**

The entity applies a modified retrospective approach to determine the contractual service margin at transition date. It determines that the contractual service margin for services provided before the transition date of CU26 is the percentage of the coverage units provided before the transition date, and the total coverage units of 60% multiplied by the contractual service margin before recognition in profit or loss of is CU44. This is illustrated, as follows:

|   | CU    |
|---|-------|
| Fair value of the underlying items at transition date   | 948   |
| Fulfilment cash flows at the transition date  | (922) |
| Adjustments:  |       |
| Charges deducted from underlying items before the transition date   | 55    |
| Amounts paid before transition date that would not have varied based on the returns on underlying items               | (23)  |
| Estimated change in the risk adjustment for non-financial risk caused by the release from risk before transition date | (14)  |
| Contractual service margin of the group of contracts before recognition in profit or loss                             | 44    |
| Estimated amount of the contractual service margin that relates to services provided before the transition date       | (26)  |
| Estimated contractual service margin at the transition date   | 18    |

The total insurance contract liability at the transition date is CU940, which is the sum of the fulfilment cash flows of CU922 and the contractual service margin of CU18.

In addition, an entity should apply the same methodology described at 17.4.2 above to recognise an asset for insurance acquisition cash flows, and any adjustment to the contractual service margin of a group of insurance contracts with direct participation features for insurance acquisition cash flows.<sup>670</sup>

<sup>670</sup> IFRS 17.C17A.

## How we see it

- ▶ For the variable fee approach, even though the modified retrospective approach focuses on the contractual service margin for the open contracts at transition, historical information and estimates of certain effects, for example fees charged to policyholders or death benefits paid before the transition date, are still required for all contracts, including derecognised contracts, in order to estimate the contractual service margin at transition.
- ▶ Another important feature of the variable fee approach is that no loss component will exist at transition when the modified retrospective approach is applied. As a result, the possibility of an entity being able to establish a contractual service margin in case of favourable changes in circumstances after transition increases.

### **17.4.4. Insurance finance income or expenses**

The modified requirements for insurance finance income or expenses differ depending on whether, as a result of applying the modified retrospective approach, groups of insurance contracts include those issued more than one year apart (see 17.4.1 above).

#### **17.4.4.A. Groups of insurance contracts that include contracts issued more than one year apart**

When an entity has aggregated a group of insurance contracts on a basis that includes contracts issued more than one year apart in the same group:<sup>671</sup>

- ▶ The entity is permitted to determine the discount rates at the date of initial recognition for the contractual service margin, the liability for remaining coverage and for incurred claims for contracts applying the premium allocation approach, as at the transition date instead of at the date of initial recognition or incurred claim date
- ▶ If an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income (see 15.3.1 to 15.3.4 above), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date in order to be able to reclassify any remaining amounts from other comprehensive income to profit or loss upon subsequent transfer or derecognition. The entity is permitted to determine the cumulative difference on transition either by:
  - ▶ Applying the requirements for groups of contracts that do not include contracts issued more than one year apart - see 17.4.4.B belowOr
  - ▶ As nil; except for  
Insurance contracts with direct participation features where the entity holds the underlying items when the cumulative difference is equal to

<sup>671</sup> IFRS 17.C18.

the cumulative amount recognised in other comprehensive income on the underlying items.

The table below provides a summary of the requirements:

|  | Groups at transition date   |   |
|--|---|---|
|  | Include contracts issued more than one year apart   | Do not include contracts issued more than one year apart  |
| 1. Discount rates to determine insurance finance income or expenses subsequent to transition   | Permitted to determine the discount rate at initial recognition and, for incurred claims, at the transition date instead of at the date of initial recognition or incurred claims | If an entity is applying the permitted modification in determining the discount rate at initial recognition (or subsequently), it must determine other discount rates in the same way |
| 2. Cumulative other comprehensive income at transition date for:   | Equal to the cumulative amount recognised in other comprehensive income on the underlying items   |   |
| A) Groups of direct participating contracts for which entity holds underlying items  |   |   |
| B) Groups of other contracts for which changes in financial assumptions have a substantial effect on the amounts paid to policyholders | Set to nil  | Set to nil  |
| C) Other groups of contracts subject to general model  | Set to nil; or apply fully retrospective or modified retrospective approach to estimating discount rates at initial recognition   | Determine cumulative difference by applying fully retrospective or modified retrospective approach to estimating discount rates at initial recognition                                |
| D) Groups of contracts subject to PAA – entity disaggregates interest expense on incurred claims                                       | Set to nil, or apply retrospective approach.  | Determine cumulative difference by applying fully retrospective or modified retrospective approach to estimating discount rates when claims incurred                                  |



## How we see it

- ▶ When an entity applies the modified retrospective approach under IFRS 17, a modification relevant for disaggregating insurance finance income or expenses at transition between amounts included in profit or loss and amounts included in other comprehensive income exists. For groups of insurance contracts with direct participation for which the entity holds the underlying items (i.e., applies the current period book yield approach), this modification would allow the entity to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date equal to the cumulative amount recognised in OCI on the underlying items at that date. In certain circumstances, the interaction of this provision with the initial application of IFRS 9 could result in mismatches between amounts accumulated in OCI for the underlying items and the amounts accumulated in OCI for insurance contracts on the date of initial application. This is because the modification is applied at the date of transition to IFRS 17 (1 January 2022) whereas the date of initial application of IFRS 9 is 1 January 2023. To the extent the amount recognised in OCI under the modification exceeds the amount recognised in OCI for the underlying items at the date of initial application, an entity could elect to transfer amounts recognised in OCI for the insurance liabilities to another part of equity. This is because this mismatch would reflect amounts that would not be reclassified to profit or loss in a future period and IFRS 17 or another IFRS Standard would not prohibit transferring such an amount from OCI to other parts of equity. Entities would have to consider any specific capital requirements that apply under local law and regulations.

### **17.4.4.B. Groups of insurance contracts that do not include contracts issued more than one year apart**

When an entity has aggregated a group of insurance contracts on a basis that does not include contracts issued more than one year apart in the same group:<sup>672</sup>

- ▶ If an entity applies the requirements at 17.4.2 above for groups of insurance contracts without direct participation features to estimate the discount rates that applied at initial recognition (or subsequently), it should also determine the discount rates specified for accreting the interest on the contractual service margin, measuring the changes in the contractual service margin, discounting the liability for remaining coverage under the premium allocation approach and for disaggregated insurance finance income or expenses in the same way
- ▶ If an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income (see 15.3.1 to 15.3.4 above), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date in order to be able to reclassify any remaining amounts from other comprehensive

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<sup>672</sup> IFRS 17.C19.

income to profit or loss upon subsequent transfer or derecognition in future periods. The entity should determine the cumulative difference:

- ▶ For insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders - if it applies the requirements at 17.4.2 above to estimate the discount rates at initial recognition - using the discount rates that applied at the date of initial recognition, also applying the requirements at 17.4.2 above
- ▶ For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, i.e., as nil
- ▶ For insurance contracts for which an entity will apply the premium allocation approach to discount the liability for incurred claims - if the entity applies the requirements at 17.4.2 above to estimate the discount rates at initial recognition (or subsequently) - using the discount rates that applied at the date of the incurred claim, also applying the requirements at 17.4.2 above
- ▶ For insurance contracts with direct participation features where the entity holds the underlying items - as equal to the cumulative amount recognised in other comprehensive income on the underlying items

Although entities are permitted to set the cumulative balance in other comprehensive income for disaggregated insurance finance income or expenses at nil on transition in certain circumstances, the same option is not permitted under IFRS 9 for any related financial assets. Therefore, an accounting mismatch will arise. It is observed in the Basis for Conclusions that the Board considered feedback from some stakeholders that preferred alternative modifications to those modifications set out above for determining the amount of insurance finance income or expenses accumulated in other comprehensive income at the transition date in order to resolve the accounting mismatch. The Board disagreed with these suggestions on various grounds and declined to amend either IFRS 9 or IFRS 17.<sup>673</sup>

In addition, to the extent that an entity has made an accounting policy choice not to change the treatment of accounting estimates made in previous interim financial statements and is unable to apply this treatment retrospectively (see 17.4.1 above) it should determine amounts related to insurance finance income or expenses at the transition date as if it had not prepared interim financial statements before the transition date.

### How we see it

- ▶ The possibility and, in some cases, the requirement, to set OCI related to insurance liabilities on transition to nil, sometimes referred to as the “fresh start” approach may be viewed as an important aspect to managing the transition effects of IFRS 17. In particular, this will be the case in jurisdictions where interest rates guaranteed in the past are

<sup>673</sup> IFRS 17.BC384A-B.

relatively high compared with the existing low interest rate environment that may still apply at transition. This approach would immediately affect shareholder's equity at transition, but more favourably impact profit or loss in the years after transition due to a lower interest accretion on the insurance liabilities. If setting OCI balances to nil, entities should carefully consider what locked-in rate will be used for disaggregating insurance finance income or expenses after transition. Under the modified retrospective approach, the standard allows entities to set the locked-in rate at the transition date rather than at the inception date. Using the rate at transition would, in our view, best align with an OCI balance of nil as the rate at the transition date would be consistent with a transition OCI balance of nil under the IFRS 17 model.

- ▶ For contracts with direct participation features applying the current period book-yield approach, the simplification to set the OCI balance for the insurance liabilities at the amount of the underlying items at transition seems logical. Where the interaction of this provision with the initial application of IFRS 9 results in mismatches between amounts accumulated in OCI for the underlying items and the amounts accumulated in OCI for insurance contracts on the date of initial application, an entity could elect to transfer amounts recognised in OCI for the insurance liabilities to another part of equity (see our comment under section 17.4.4.A above).

## 17.5. Fair value approach

The fair value approach is:

- ▶ Permitted as an alternative to the modified retrospective approach for a group of contracts when full retrospective application of that group of contracts is impracticable (see 17.2 above)

Or

- ▶ Required when full retrospective application of a group of contracts is impracticable and an entity cannot obtain reasonable and supportable information for that group of contracts to use the modified retrospective approach (see 17.3 above)

Or

- ▶ Permitted for a group of insurance contracts with direct participation features when risk mitigation has been applied prospectively to the group from the transition date and the entity has used derivatives, reinsurance contracts held or non-derivative financial instruments at fair value through profit or loss to mitigate financial risk arising from that group of contracts before transition date. (see 12.3.5 above)

To apply the fair value approach, an entity should determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts and the fulfilment cash flows measured at that date. In determining fair value, an entity must apply the requirements of IFRS 13. This excludes the requirement that the fair value of a financial liability with a demand feature (e.g., a demand deposit floor) cannot be less than the amount payable on

demand, discounted from the first date that the amount could be required to be paid.<sup>674</sup> This means that insurance contract liabilities can be measured at an amount lower than the discounted amount repayable on demand.

For a group of reinsurance contracts held to which the underlying insurance contracts are onerous at the transition date, an entity should determine the loss-recovery component of the asset for remaining coverage by multiplying:<sup>675</sup>

- ▶ The loss component for the liability for remaining coverage for the underlying insurance contracts at the transition date
- ▶ The percentage of claims for the group of underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held

At the transition date, onerous underlying insurance contracts might be included in a group of insurance contracts with other onerous insurance contracts that are not covered by the group of reinsurance contracts held. In that case, for the purpose of applying the calculation above, an entity should use a systematic and rational basis of allocation to determine the portion of the loss component of the group of insurance contracts that relates to insurance contracts covered by the group of reinsurance contracts held.<sup>676</sup>

In applying the fair value approach, an entity may use reasonable and supportable information for what the entity would have determined, given the terms of the contract and market conditions at the date of inception or initial recognition, as appropriate or, alternatively, reasonable and supportable information at the transition date in determining:<sup>677</sup>

- ▶ How to identify groups of insurance contracts
- ▶ Whether an insurance contract meets the definition of an insurance contract with direct participation features
- ▶ How to identify discretionary cash flows for insurance contracts without direct participation features
- ▶ Whether an investment contract meets the definition of an investment contract with discretionary participation features (see 12.4 above)

In addition, the general requirements of IFRS 17 are modified when the fair value approach is used:<sup>678</sup>

- ▶ An entity may choose to classify as a liability for incurred claims, a liability for settlement of claims incurred before an insurance contract was acquired in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3.<sup>679</sup>
- ▶ When determining groups of insurance contracts, an entity may include those issued more than one year apart. An entity is only allowed to divide groups into those that include contracts issued within a year or less if it has reasonable and supportable information to make the decision. This reflects the Board's expectation that grouping of contracts issued within a year (or

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<sup>674</sup> IFRS 17.C20.

<sup>675</sup> IFRS 17.C20A.

<sup>676</sup> IFRS 17.C20B.

<sup>677</sup> IFRS 17.C21-C22.

<sup>678</sup> IFRS 17.C23.

<sup>679</sup> IFRS 17.C22A.

less) will be challenging in situations where the fair value approach is applied.<sup>680</sup>

- ▶ An entity determines the discount rate at the date of initial recognition of a group of contracts and discount rates of the date of incurred claims under the premium allocation approach (when discounting has been elected - see 10.5 above) at the transition date instead of the date of the initial recognition or incurred claim.<sup>681</sup>

### Frequently asked questions

**Question 17-1: In applying the fair value approach to transition, should the fair value reflect the non-performance risk of the entity? [TRG meeting April 2019 - Agenda paper no. 02, Log S127]**

The IASB staff confirmed that when, applying the fair value approach, an entity determines the contractual service margin by comparing the fulfilment cash flows and the fair value of a group of insurance contracts. The fair value measurement in this situation reflects the effect of non-performance risk as required by IFRS 13 (but not the requirements relating to demand features). However, the fulfilment cash flows of an entity do not reflect the non-performance risk of the entity and this applies also to the fulfilment cash flows of an entity using the fair value approach on transition (i.e., the fulfilment cash flows of an entity that applies the fair value approach on transition exclude non-performance risk, but non-performance risk is considered when determining the fair value of a group of contracts at transition date for the purpose of the calculation of the contractual service margin as the difference between the fulfilment cash flows and fair value).

### Illustration 88– The fair value framework

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.<sup>682</sup>

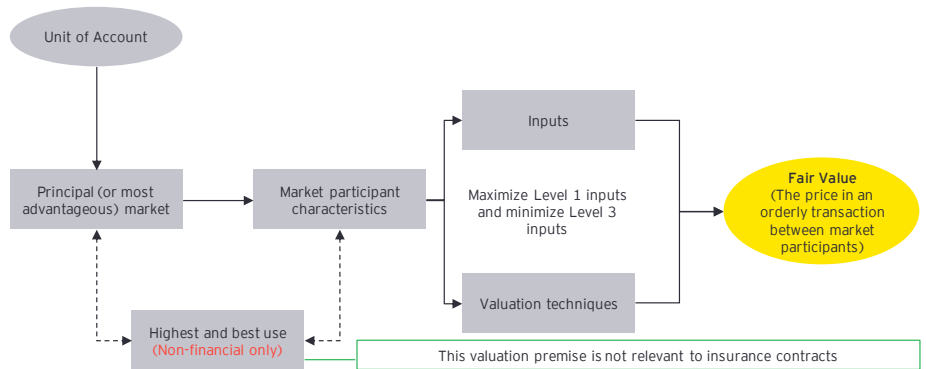
This diagram below illustrates the interdependence of the various components of the fair value measurement principles in IFRS 13. All of these interdependent components need to be considered. A decision on one will impact another and, thus, conclusions will require refinement as each component is considered.

<sup>680</sup> IFRS 17.C23.

<sup>681</sup> IFRS 17.C23.

<sup>682</sup> IFRS 13.B2.

### Illustration 88– The fair value framework (cont'd)



- ▶ The unit of account determines the level at which an asset or liability is aggregated or disaggregated for financial reporting purposes. IFRS 17 determines the unit of account to determine the fair value of a group of insurance contracts for both business combinations (see section 14 above) and transition purposes.

The reference market determines the possible source of market data (whether observable or estimated using a valuation technique) that can be used within the fair value calculation as well as the characteristics of a hypothetical market participant. If there is a principal market for the asset or liability being measured, fair value should be determined using the price in that market, even if a price in a different market is more advantageous at the measurement date. Only in situations where there is no principal market for the asset or liability being measured, can an entity consider the most advantageous market. The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability. The entity must have access to the market at the measurement date.

- ▶ Market participants are other entities with whom the entity would enter into a transaction in the reference market. Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:<sup>683</sup>
  - ▶ Independent of each other
  - ▶ Knowledgeable, having a reasonable understanding about the asset or liability
  - ▶ Willing to enter into a transaction for the asset or liability
  - ▶ Able to enter into a transaction
- ▶ Three widely used valuation techniques are the market approach, the cost approach and the income approach. An entity must use valuation techniques consistent with one or more of those approaches to measure fair value.<sup>684</sup>

Some of the key differences between the measurement model under IFRS 17 fulfilment cash flows and the fair value measurement approach under IFRS 13 are:

<sup>683</sup> IFRS 13.BC55-BC59.

<sup>684</sup> IFRS 13.62.

| <b>Illustration 88– The fair value framework (cont'd)</b> |   |  |
|---|---|--|
|   | <b>IFRS 17 fulfilment cash flows</b>  | <b>IFRS 13 fair value</b>                            |
| Overall objective   | Fulfilment of insurance contract, but considering consistency with market information where necessary | View of a (hypothetical) market participant          |
| Entity's own risk of non-performance                      | Excludes own risk of non-performance  | Includes own risk of non-performance                 |
| Adjustment for risk                                       | Reflecting the entity's perception of non-financial risk  | Reflecting a market participant's perception of risk |
| Service margin  | N/A   | Service margin required by a market participant      |
|   |   |  |

## How we see it

- ▶ Determining fair value will pose many challenges and require significant judgement. An important area is the level of aggregation and its impact on diversification. The fair value of a single group of insurance contracts may not take into account any benefits of diversification which would likely be considered by entities when determining the fulfilment cash flows.
- ▶ IFRS 13 includes a requirement on demand deposits, which means that the fair value of a financial liability with a demand feature can never be less than present value of the amount payable on demand. This requirement does not have to be applied when calculating the fair value of insurance contracts at transition. However, all other IFRS 13 requirements must be applied in determining fair value, including the requirement to consider the entity's own non-performance risk.

### ***17.5.1. Disaggregated insurance finance income or expenses using the fair value approach***

If an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, it is permitted to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date:<sup>685</sup>

- ▶ Retrospectively, but only if it has reasonable and supportable information to do so

Or

- ▶ As nil, unless the below applies
- ▶ For insurance contracts with direct participation features where the entity holds the underlying items, as equal to the cumulative amount recognised in other comprehensive income from the underlying items.

## How we see it

- ▶ Although the above-mentioned option allows for other comprehensive income to be set at nil on transition, no equivalent option exists under transition to IFRS 9 for financial assets held at fair value through other comprehensive income. Entities should, therefore, carefully evaluate the combined transition impact of IFRS 17 and IFRS 9 and determine a transition approach that results in a useful depiction of this relationship in the years after transition.

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<sup>685</sup> IFRS 17.C24.



### 17.5.2. Asset for insurance acquisition cash flows using the fair value approach

The amount of any asset for insurance acquisition cash flows should not be included in the measurement of any groups of insurance contracts recognised at the transition date.<sup>686</sup>

In applying the fair value approach for an asset for insurance acquisition cash flows, an entity should determine an asset for insurance acquisition cash flows at the transition date at an amount equal to the amount of insurance acquisition cash flows the entity would incur at the transition date for the rights to obtain:<sup>687</sup>

- ▶ Recoveries of insurance acquisition cash flows from premiums of insurance contracts issued before the transition date but not yet recognised at the transition date (a)
- ▶ Future insurance contracts that are renewals of insurance contracts recognised at the date of transition and insurance contracts described in (a) above, (b)
- ▶ Future insurance contracts, other than those in (b) above, after the date of transition without paying again insurance acquisition cash flows the entity has already paid that are directly attributable to the related portfolio of insurance contracts:

#### Frequently asked questions

**Question 17-2: When the fair value approach to transition is applied are insurance acquisition cash flows that occurred prior to the transition date recognised as revenue and expenses in the statement of financial performance applying paragraphs B121(b) and B125 of IFRS 17 for reporting periods subsequent to the transition date? [TRG meeting February 2018 - Agenda paper no. 06, Log S05]**

The TRG members noted that:

- ▶ Applying the fair value transition approach means that the amount of insurance acquisition cash flows included in the measurement of the contractual service margin will be only amounts occurring after the transition date that are also included in the fulfilment cash flows. When this approach to transition is applied, an entity is not permitted to include in the measurement of the contractual service margin any insurance acquisition cash flows occurring prior to the date of transition
- ▶ The fair value approach is intended to provide an entity with a 'fresh start' approach to transition
- ▶ Since insurance acquisition cash flows that occurred prior to the transition date are not included in the measurement of the contractual service margin at the transition date, they are not included in the presentation of insurance revenue and expenses for reporting periods subsequent to the transition date.

The IASB staff noted that this analysis applies in all situations that the fair value transition approach is taken, irrespective of whether the entity can identify and measure the insurance acquisition cash flows that applied prior to the transition date.

<sup>686</sup> IFRS 17.C24B.

<sup>687</sup> IFRS 17.C24A.

## How we see it

- ▶ Even though the fair value transition approach of IFRS 17 was amended in June 2020 to allow for the recognition of an asset for insurance acquisition cash flows for contracts to be recognised *after the transition date* (see section 7.3 above), no insurance acquisition cash flows should be included in the measurement of any groups of insurance contracts already recognised at the transition date.

## 17.6. Redesignation of financial assets and financial liabilities - when IFRS 9 has been applied previously

IFRS 17 allows a generous degree of dispensation for entities to redesignate their financial assets within the scope of IFRS 9 when IFRS 17 is applied. In addition, a consequential change to IFRS 9 allows redesignation of financial liabilities in certain circumstances.

### 17.6.1. Redesignation of financial assets

At the date of initial application of IFRS 17, an entity that had applied IFRS 9 to annual reporting periods before the initial application of IFRS 17:<sup>688</sup>

- ▶ May reassess whether an eligible financial asset meets the condition to be held within a business model whose objective is to hold financial assets in order to collect contractual cash flows, or is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. A financial asset is eligible only if the financial asset is held for an activity that is connected with contracts within the scope of IFRS 17. Examples of financial assets that would not be eligible for reassessment are financial assets held for banking activities or financial assets held for investment contracts that are outside the scope of IFRS 17
- ▶ Should revoke its designation of a financial asset measured at fair value through profit or loss if the original designation was made to avoid or reduce an accounting mismatch and that accounting mismatch no longer exists because of the application of IFRS 17
- ▶ May designate a financial asset as measured at fair value through profit or loss if, in doing so, it eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on different bases
- ▶ May irrevocably elect to designate an investment in an equity instrument at fair value through other comprehensive income, provided that equity instrument is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies;
- ▶ May revoke its previous designation of an investment in an equity instrument at fair value through other comprehensive income

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<sup>688</sup> IFRS 17.C29.

An entity must apply the above based on the facts and circumstances that exist at the date of initial application of IFRS 17. An entity must apply these designations and classifications retrospectively. In doing so, it must apply the relevant requirements in IFRS 9. The date of initial application for that purpose is deemed to be the date of initial application of IFRS 17.<sup>689</sup>

Any changes resulting from applying the above do not require the restatement of prior periods. However, the entity may restate prior periods only if it is possible without the use of hindsight. This may result in a situation whereby the comparative period is restated for IFRS 17 (which may include changes that affect financial instruments within the scope of IFRS 9). For example, accounting for investment components that are separated, but not for consequential changes resulting in the classification of financial assets (this situation will also potentially arise when an entity has not previously applied IFRS 9 (see 17.7 below). If an entity restates prior periods, the restated financial statements must reflect all IFRS 9 requirements for those affected financial assets. If an entity does not restate prior periods, the entity should recognise, in the opening restated earnings (or other component of equity, as appropriate) at the date of initial application, any difference between:

- ▶ The previous carrying amount of those financial assets; and
- ▶ The carrying amount of those financial assets at the date of initial application.<sup>690</sup>

Other disclosure requirements when redesignation of financial assets is applied are, as follows:

- ▶ The basis for determining financial assets eligible for redesignation
- ▶ The measurement category and carrying amount of the affected financial assets determined immediately before the date of initial application of IFRS 17
- ▶ The new measurement category and carrying amount of the affected financial assets determined after redesignation
- ▶ The carrying amount of financial assets in the statement of financial position that were previously designated as measured at fair value through profit or loss in order to significantly reduce or avoid an accounting mismatch that no longer exists<sup>691</sup>
- ▶ Qualitative information that would enable financial statement users to understand:<sup>692</sup>
- ▶ How the entity applied the various options available for reassessment, revocation and designation described above
- ▶ Reasons for any designation or de-designation of financial assets measured at fair value through profit or loss in order to significantly reduce or avoid an accounting mismatch

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<sup>689</sup> IFRS 17.C30.

<sup>690</sup> IFRS 17.C31.

<sup>691</sup> IFRS 17.C32.

<sup>692</sup> IFRS 17.C33.

- ▶ Why the entity reached a different conclusion in the new assessments, applying the requirements of the business model test.

A simplified summary of the IFRS 9 redesignations above when initially applying IFRS 17 is, as follows:

| IFRS 9 asset class  | Re-designate?   | New category   |
|---|---|--|
| Amortised cost  | Yes - mandatory reclassification if business model has changed and assets held in respect of an activity that is connected with contracts within the scope of IFRS 17 | Fair value through other comprehensive income or fair value through profit or loss depending on the business model |
|   | Yes - instrument by instrument election if eliminates or reduces an accounting mismatch that would otherwise arise from amortised cost measurement                    | Fair value through profit or loss  |
| Fair value through other comprehensive income (debt securities)   | Yes - mandatory if business model has changed and assets held in respect of an activity that is connected with contracts are within the scope of IFRS 17              | Amortised cost or fair value through profit or loss depending on the business model                                |
|   | Yes - if eliminates or reduces an accounting mismatch that would otherwise arise from fair value through other comprehensive income measurement                       | Fair value through profit or loss  |
| Fair value through profit or loss (debt securities)               | Yes - instrument-by-instrument election if designated due to accounting mismatch and accounting mismatch has ceased   | Amortised cost or fair value through other comprehensive income depending on business model                        |
| Fair value through profit or loss (equity securities)             | Yes - free election instrument by instrument  | Fair value through other comprehensive income  |
| Fair value through other comprehensive income (equity securities) | Yes - free election instrument by instrument  | Fair value through profit or loss  |

## 17.6.2. Redesignation of financial liabilities

When IFRS 17 is applied, IFRS 9 states that:

- ▶ A previous designation of a financial liability measured at fair value through profit or loss should be revoked if that designation was previously made in order to eliminate or reduce an accounting mismatch, but the condition which caused the mismatch is no longer satisfied as a result of the application of IFRS 17.
- ▶ A financial liability may be designated as measured at fair value through profit or loss if that designation would not have previously been permitted because it did not satisfy the condition (i.e., because there was no accounting mismatch) and that condition is now satisfied as a result of the application of these amendments.

Such a designation and revocation should be made on the basis of the facts and circumstances that exist at the date of initial application of these amendments. That classification must be applied retrospectively.<sup>693</sup> However, prior periods may only be restated if it is possible to do so without the use of hindsight.<sup>694</sup>

## 17.7. Entities that have not previously applied IFRS 9

An entity that adopts IFRS 9 at the same time that it adopts IFRS 17 may assess financial asset classifications, elections and designations while, at the same time, assessing the implications of the requirements of IFRS 17. An entity adopting IFRS 9 at the same time that it adopts IFRS 17 applies the transitional provisions of IFRS 9, which include a number of elections and (de)designations.

IFRS 17 requires any net differences resulting from its application to be recorded in net equity at the date of transition (i.e., 1 January 2022 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2023). In contrast, IFRS 9's starting point records net differences resulting from its application in net equity at the date of initial application (i.e., 1 January 2023 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2023). Comparative periods may be restated if it is possible to do so without the use of hindsight.<sup>695</sup>

However, even if comparative periods are restated, IFRS 9 cannot be applied to items already derecognised at the date of initial application (i.e., 1 January 2023 if IFRS 9 is first applied in a calendar year ending 31 December 2023).<sup>696</sup> This means that IAS 39 accounting, for example, available-for-sale accounting, will remain in the comparative statement of comprehensive income for financial assets derecognised in that comparative period. The Board considered feedback from entities who were implementing IFRS 17 suggesting that an entity that, on initial application of IFRS 17, first applied IFRS 9 at the same time that it first applied IFRS 17, should be permitted to apply IFRS 9 to financial assets that were derecognised during the IFRS 17 comparative period. However, the Board disagreed with the suggestion on the grounds that the requirements in IFRS 9 relating to transition were subject to extensive deliberation and consultation by the Board.<sup>697</sup>

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<sup>693</sup> IFRS 9.7.2.39.

<sup>694</sup> IFRS 9.7.2.40.

<sup>695</sup> IFRS 9.7.2.15.

<sup>696</sup> IFRS 9.7.2.1.

<sup>697</sup> IFRS 17.BC398A-B.

## How we see it

- ▶ The interaction between the measurement of the insurance liabilities and measurement of the financial assets backing those liabilities, as well as differences between the transition guidance in IFRS 17 and IFRS 9, may make it challenging to explain the presentation of financial instruments in the comparative period to users of the financial statements in the year of initial application of IFRS 17.

## Appendix A: IFRS 17 - Defined terms

| Term                                | Definition   |
|-------------------------------------|--|
| <i>Contractual service margin</i>   | A component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned profit the entity will recognise as it provides insurance contract services under the insurance contracts in the group.  |
| <i>Coverage period</i>              | The period during which the entity provides insurance contract services. This period includes the insurance contract services that relate to all premiums within the boundary of the insurance contract.   |
| <i>Experience adjustment</i>        | A difference between: <ul style="list-style-type: none"> <li>(a) For premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes) – the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or</li> <li>(b) For insurance, service expenses (excluding insurance acquisition expenses) – the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.</li> </ul> |
| <i>Financial risk</i>               | The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.   |
| <i>Fulfilment cash flows</i>        | An explicit, unbiased and probability-weighted estimate (i.e., expected value) of the present value of the future cash outflows minus the present value of the future cash inflows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk.  |
| <i>Group of insurance contracts</i> | A set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts issued within a period of no longer than one year and that, at initial recognition: <ul style="list-style-type: none"> <li>(a) Are onerous, if any</li> <li>(b) Have no significant possibility of becoming onerous subsequently, if any; or</li> <li>(c) Do not fall into either (a) or (b), if any</li> </ul>   |

| Term  | Definition  |
|---|---|
| <i>Insurance acquisition cash flows</i>                         | Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts (issued or expected to be issued) that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.  |
| <i>Insurance contract</i>                                       | A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.   |
| <i>Insurance contract services</i>                              | The following services that an entity provides to a policyholder of an insurance contract: <ul style="list-style-type: none"> <li>(a) Coverage for an insured event (insurance coverage)</li> <li>(b) For insurance contracts without direct participation features, the generation of an investment return for the policyholder, if applicable (investment-return service)</li> <li>(c) For insurance contracts with direct participation features, the management of underlying items on behalf of the policyholder (investment-related service)</li> </ul>   |
| <i>Insurance contract with direct participation features</i>    | An insurance contract for which, at inception: <ul style="list-style-type: none"> <li>(a) Contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items</li> <li>(b) The entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying items</li> <li>(c) The entity expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in the fair value of the underlying items</li> </ul> |
| <i>Insurance contract without direct participation features</i> | An insurance contract that is not an insurance contract with direct participation features.   |
| <i>Insurance risk</i>   | Risk, other than financial risk, transferred from the holder of a contract to the issuer.   |
| <i>Insured event</i>  | An uncertain future event covered by an insurance contract that creates insurance risk.   |



| Term   | Definition   |
|--|--|
| <i>Investment component</i>  | The amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances, regardless of whether an insured event occurs.   |
| <i>Investment contract with discretionary participation features</i> | <p>A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:</p> <ul style="list-style-type: none"> <li>(a) That are expected to be a significant portion of the total contractual benefits</li> <li>(b) The timing or amount of which are contractually at the discretion of the issuer</li> <li>(c) That are contractually based on: <ul style="list-style-type: none"> <li>(i) The returns on a specified pool of contracts or a specified type of contract</li> <li>(ii) Realised and/or unrealised investment returns on a specified pool of assets held by the issuer</li> </ul> </li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>(iii) The profit or loss of the entity or fund that issues the contract</li> </ul> |
| <i>Liability for incurred claims</i>                                 | <p>An entity's obligation to:</p> <ul style="list-style-type: none"> <li>(a) Investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses</li> <li>(b) Pay amounts that are not included in (a) and that relate to: <ul style="list-style-type: none"> <li>(i) insurance contract services that have already been provided</li> </ul> </li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>(ii) Any investment components or other amounts That are not related to the provision of insurance Contract services and that are not in the liability for remaining coverage.</li> </ul>   |

| Term  | Definition   |
|---|--|
| <i>Liability for remaining coverage</i>       | <p>An entity's obligation to:</p> <ul style="list-style-type: none"> <li>(a) Investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (i.e., the obligation that relates to the unexpired portion of the insurance coverage)</li> <li>(b) Pay amounts under existing insurance contracts that are not included in (a) and that relate to: <ul style="list-style-type: none"> <li>(i) Insurance contract services not yet provided (i.e., the obligations that relate to future provision of insurance contract services)</li> </ul> </li> </ul> <p>Or</p> <ul style="list-style-type: none"> <li>(ii) Any investment components or other amounts that are not related to the provision of insurance contract services and that have not been transferred to the liability for incurred claims.</li> </ul> |
| <i>Policyholder</i>                           | A party that has a right to compensation under an insurance contract if an insured event occurs.   |
| <i>Portfolio of insurance contracts</i>       | Insurance contracts subject to similar risks and managed together.   |
| <i>Reinsurance contract</i>                   | An insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).  |
| <i>Risk adjustment for non-financial risk</i> | The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.   |
| <i>Underlying items</i>                       | Items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.  |

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