

Applying IFRS 17

A closer look at the new
Insurance Contracts
Standard

May 2018



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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.
- ▶ IFRS 17 will become effective for annual reporting periods beginning on or after 1 January 2021, 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 probability-weighted current estimates of future cash flows, an adjustment for 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 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 participation features; and for reinsurance contracts held.
- ▶ The standard contains a simplified model, 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 in profit or loss or in other comprehensive income.

Introduction

The International Accounting Standards Board (IASB) issued IFRS17 *Insurance Contracts* (the standard) in May 2017, effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. IFRS 17 supersedes IFRS 4 *Insurance Contracts*, an interim standard issued in 2004 that allows entities to use a wide variety of accounting practices for insurance contracts.

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.

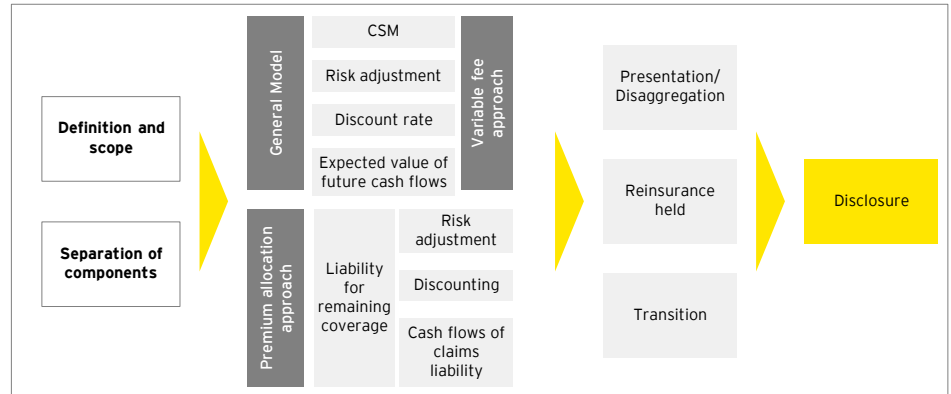
The new standard applies a current value approach to measuring insurance contracts and recognises profit as insurers provide services and are released from risk. The profit or loss earned from underwriting activities are reported separately from financing activities. Detailed note disclosures explain 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. This is why the IASB has allowed more than three years after issue date for the standard to become effective.

The change 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.

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 an entity issues.



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

The key principles of IFRS 17 are that an entity:

- ▶ Identifies insurance contracts as those under which the entity 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
- ▶ Separates specified embedded derivatives, distinct investment components and distinct (i.e., non-insurance) goods or services from insurance contracts
- ▶ Divides the contracts into groups it will recognise and measure
- ▶ Recognises and measures groups of insurance contracts at:
 - ▶ A risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all available information about the fulfilment cash flows in a way that is consistent with observable market information
 - Plus
 - ▶ An amount representing the unearned profit in the group of contracts (the contractual service margin or CSM)
- ▶ Recognises profit from a group of insurance contracts over the period the entity provides insurance coverage, and as the entity is released from risk. If a group of contracts is expected to be onerous (i.e., loss-making) over the remaining coverage period, an entity recognises the loss immediately
- ▶ Presents insurance revenue, insurance service expenses and insurance finance income or expenses separately
- ▶ Discloses information to enable financial statement users to assess the effect that contracts within the scope of IFRS 17 have on an entity's financial position, financial performance and cash flows. Thus, an entity discloses qualitative and quantitative information about:
 - ▶ Amounts recognised in its financial statements from insurance contracts

- ▶ Significant judgements, and changes in those judgments, when applying the standard
- ▶ The nature and extent of the risks from contracts within the scope of this standard

The standard contains a core measurement approach that we will refer to in this document as the 'general model'. The standard includes an adaptation of the general model, the 'variable fee approach' that should be applied to certain types of contracts with direct participation features (see section 14). If certain criteria are met, an entity may apply a simplified measurement approach (premium allocation approach (PAA) – see section 12). This approach allows an entity to measure the amount of remaining coverage by allocating the premium over the coverage period.

For reinsurance contracts held, an entity should apply either a modified version of the general model or the premium allocation approach. The general model is modified because the CSM for reinsurance contracts held can be either a net cost or net gain of purchasing reinsurance for services yet to be received. In contrast, the CSM for insurance contracts issued can only be the unearned profit for services yet to be provided. For investment contracts with discretionary participation features, an entity applies a modified general model because of the absence of significant insurance risk in the contracts (see section 14.4).

2. Scope and definition

An entity applies IFRS 17 to insurance contracts, including reinsurance contracts, it issues, reinsurance contracts it holds, and Investment contracts with discretionary participation features that it issues, provided the entity also issues insurance contracts.¹

2.1. Definition of an insurance contract

Extract from IFRS 17

Appendix A

Insurance contract

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.

The definition of an insurance contract is, in essence, the same as for IFRS 4.² Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., scenarios with no discernible effect on the economics of the transaction). IFRS 17 clarifies this to require that:³

- ▶ An insurer must consider the time value of money in assessing whether the additional amounts payable in any scenario are significant.
- ▶ 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.

If an insurance contract requires payment when an event with uncertain timing occurs and 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. It is certain that the policyholder will die, but the date of death is uncertain. If the policyholder dies earlier than expected significant insurance risk could exist, as those payments are not adjusted for the time value of money, even if there is no overall loss on the portfolio of contracts.⁴

¹ IFRS 17.3

² IFRS 4.Appendix A

³ IFRS 17.B17

⁴ IFRS 17.B20

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 IAS 18 *Revenue*/IFRS 15 *Revenue from Contracts with Customers*). Banks and service companies issuing contracts within the scope of IFRS 4 applied accounting treatments that were similar to 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 IFRS 17 requirements instead. Examples of the contracts issued by non-insurers that may meet the definition of insurance contracts include loans with a waiver on death of the borrower and service contracts with a fixed fee, although some scope exemptions apply. The effect of applying IFRS 17 to such contracts could be significant for non-insurance entities.

2.2. Reinsurance contracts

Extract from IFRS 17

Appendix A

Reinsurance contract

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).

A reinsurer accepts significant insurance risk from the issuer of underlying insurance contracts (a cedant) via a reinsurance contract and applies IFRS 17 to the reinsurance contracts it issues. A cedant applies IFRS 17 to reinsurance contracts that it holds (see section 13). The requirement that a reinsurance contract transfers significant insurance risk is the same as for an insurance contract. 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 substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts to the reinsurer.

2.3. Investment contracts with discretionary participation features

Extract from IFRS 17

Appendix A

Investment contracts with discretionary participation features

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:

- (a) that are expected to be a significant portion of the total contractual benefits;
- (b) the timing or amount of which are contractually at the discretion of the issuer; and
- (c) that are contractually based on:
 - (i) the returns on a specified pool of contracts or a specified type of contract;
 - (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
 - (iii) the profit or loss of the entity or fund that issues the contract

Investment contracts with discretionary participation features do not include a transfer of significant insurance risk. These contracts are included within the scope of IFRS 17, provided the entity also issues insurance contracts, for the following reasons:⁵

- ▶ 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 (one provides additional insurance benefits and the other does not). Using the same accounting for both types of contracts simplifies the accounting and enhances comparability within an entity.
- ▶ Both types of contracts often have characteristics (long maturities, recurring premiums and high acquisition cash flows) that appear more frequently in insurance contracts than in most other financial instruments. The accounting model in IFRS 17 specifically generates useful information about contracts containing such features.
- ▶ The accounting model in IFRS 17 provides more appropriate treatment of discretionary cash flows than any other model for these types of contracts.

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

⁵ IFRS 17.BC83

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 retain investment contracts within the scope of the insurance contracts standard means entities may continue the accounting for these contracts under the insurance contract guidance. 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.

2.4. Scope exclusions

IFRS 17 excludes the following transactions that may meet the definition of insurance contracts:⁶

- ▶ Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see IFRS 15 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)
- ▶ Employers’ assets and liabilities that arise from employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (see IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payments* 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 (see IFRS 15, IAS 38 *Intangible Assets* and IFRS 16 *Leases*)
- ▶ Residual value guarantees provided by the manufacturer, dealer or retailer and lessees’ residual value guarantees embedded in a lease (see IFRS 15 and IFRS 16)
- ▶ 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 discussion in section 2.5)
- ▶ Contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*)
- ▶ Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held

The list of items excluded from the scope of IFRS 17 is similar to IFRS 4 except for the addition of residual value guarantees provided by a manufacturer, dealer or retailer. Stand-alone residual value guarantees that transfer insurance risk are within the scope of IFRS 17.

⁶ IFRS 17.7

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 to avoid some of the complexities of IFRS 17, such as the CSM.

2.5. Financial guarantee contracts

IFRS standards define a financial guarantee contract 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. These contracts transfer credit risk and may take various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract.⁷ IFRS 17 excludes financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used the applicable accounting model. If so, the issuer may elect to apply either IFRS 17 or IAS 32 *Financial Instruments: Presentation*, IFRS 7 *Financial Instruments: Disclosures* 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.⁸ This accounting policy election is the same as it was in IFRS 4.

2.6. 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 to repair specified equipment after a malfunction. Such contracts can meet the definition of an insurance contract because:⁹

- ▶ 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

⁷ IFRS 17.BC91

⁸ IFRS 17.7(e)

⁹ IFRS 17.BC95

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:¹⁰

- ▶ 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.

How we see it

- ▶ 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 each policyholder the same fee to service the same asset, 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), this would appear to be an individual risk assessment that reflects the characteristics 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.

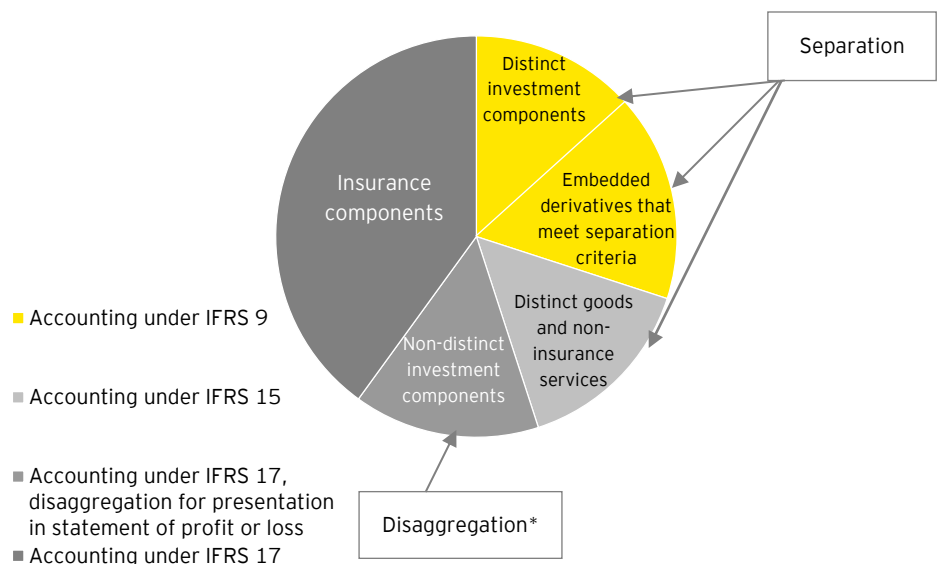
¹⁰ IFRS 17.8

3. Separating components from an insurance contract and combining insurance contracts

Insurance contracts create rights and obligations that work together to generate cash inflows and outflows. Some insurance contracts may:

- ▶ Contain embedded derivatives that, if bifurcated, would be within the scope of IFRS 9 (See 3.1 below)
- ▶ Include investment components that, if provided under separate contracts, would be within the scope of IFRS 9 (See 3.2 below)
- ▶ Provide goods and non-insurance services that, if provided under separate contracts, would be within the scope of IFRS 15 (See 3.3 below)

IFRS 17 requires an insurer to identify and separate distinct components in certain circumstances. When separated, those components are accounted for under the relevant IFRS (i.e., not under IFRS 17).¹¹ The IASB considers that accounting for such components separately using other applicable IFRSs makes them more comparable. It also offers users of financial statements a better way to compare the risks of similar contracts issued by entities in different businesses or industries¹². After separating the distinct components described above, an entity should apply IFRS 17 to all remaining components of the (host) insurance contract.¹³ The diagram below illustrates the approach to separating non-insurance components.



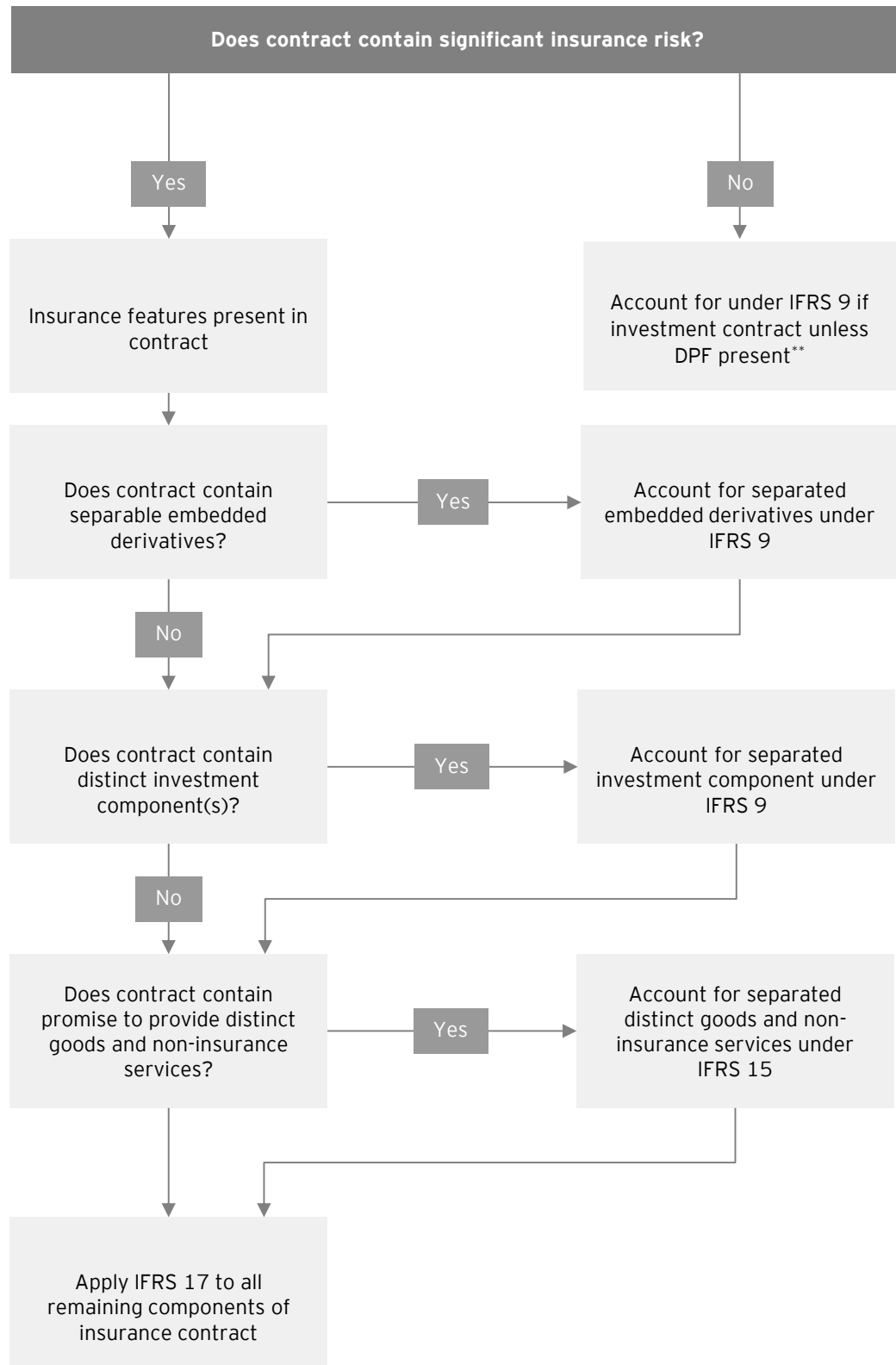
* Disaggregation is the exclusion of an unseparated investment component from insurance revenue and insurance service expenses

¹¹ IFRS 17.10

¹² IFRS 17.BC99

¹³ IFRS 17.13

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



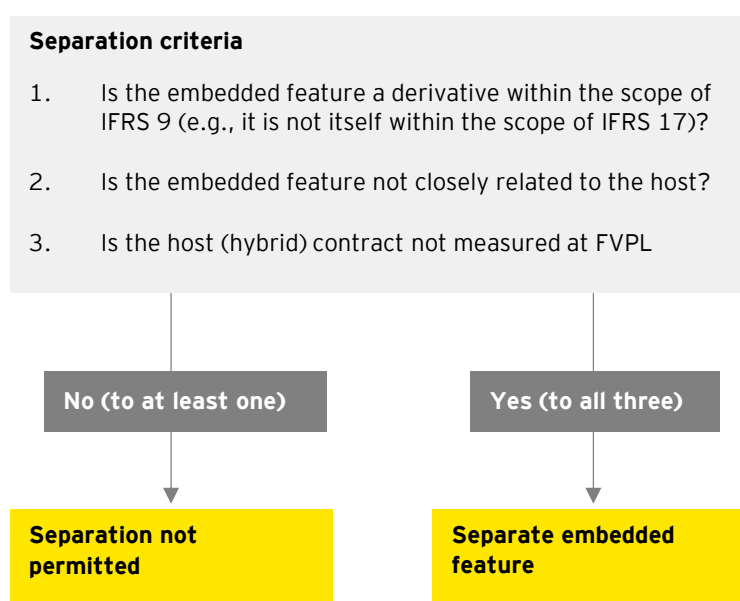
** Investment contracts with Discretionary Participation Features (DPF) are within the scope of IFRS 17 if the entity that issues them also issues insurance contracts. See sections 2.3 and 14.2.

3.1. Embedded derivatives

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.¹⁴

IFRS 9 requires separation of an embedded derivative from its host if:¹⁵

- ▶ 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; and
- ▶ The hybrid contract is not measured at fair value through profit or loss (FVPL).



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).¹⁶

¹⁴ IFRS 9.4.3.1

¹⁵ IFRS 9.4.3.3

¹⁶ IFRS 9.B4.3.8(h)

Illustration 1 – 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.

Many types of embedded derivatives are included in insurance contracts.

Illustration 2 – Examples of embedded derivatives in insurance contracts

- ▶ Death benefits and other benefits, linked to equity prices or an equity index
- ▶ Options to take life-contingent annuities at guaranteed interest 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, which can be specified in a schedule, based on the fair value of a pool of interest-bearing securities or 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
- ▶ An inflation index affecting policy deductibles
- ▶ Contracts where the currency of claims settlement differs from the currency of loss, and those with fixed foreign currency rates

An entity would have to assess whether such a derivative would be separated based on the criteria described above.

How we see it

- ▶ IFRS 4 includes an exception to the requirements in IFRS 9 that an insurer needs 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). This exception applies even if the exercise price differs from the carrying amount of the host insurance liability.¹⁷ The exception has not been carried forward to IFRS 17. However, the value of a typical surrender option and the host

¹⁷ IFRS 4.8

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.

3.2. Investment components

IFRS 4 referred to the notion of a deposit component.¹⁸ 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 even if an insured event does not occur. An example of an investment component is an insurance contract where premiums are paid into an account balance and that balance (or a portion thereof) is guaranteed to be repaid to the policyholder on maturity or surrender of the contract, i.e., even if an insured event such as death does not occur (See illustration 3 below).

IFRS 17 requires an entity to separate distinct investment components from the host insurance contract.¹⁹ An investment component is distinct if both of the following conditions are met:²⁰

- ▶ 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

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:²¹

- ▶ 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.

¹⁸ IFRS 4.10-12, 20D and B28

¹⁹ IFRS 17.11

²⁰ IFRS 17.B31

²¹ IFRS 17.B32

Illustration 3 – Insurance contract with an account balance and a minimum death benefit

Consider an insurance contract with an account balance that guarantees to pay at least a minimum benefit on the death of the policyholder regardless of the account balance.^{a)} The insurance cover and the right to receive that balance lapse together on termination of the contract.

There is a minimum death benefit equal to the excess of the guaranteed amount over the account balance when a death occurs. An entity would not separate the investment component because it is highly interrelated with the insurance component for two reasons, as shown in this example:

- ▶ The entity could not measure the minimum death benefit without considering the amount of the account balance.
- ▶ The policyholder is unable to benefit from one component unless the other is also present.

Therefore, the entity accounts for the investment components under IFRS 17 as a non-distinct investment component.

^{a)} *The minimum death benefit guarantee transfers significant insurance risk*

How we see it

- ▶ While an account balance in a savings-type insurance contract is a clear example of an investment component, other less obvious items may also meet the definition. An example of an investment component is a no-claims bonus that guarantees the policyholder a refund of the premium if no claims are paid on the contract.
- ▶ However, a no-claims discount, i.e., a promise to give a policyholder a discount on renewal of a future insurance contract (repricing outside the boundary of the existing contract – see section 7.1) based on the claims experience of an existing contract, is not an investment component as any cash flows resulting from the promise are not within the contract boundary.

Non-distinct investment components (e.g., some surrender values, account balances, no claims bonuses or profit commissions) are not separated from the measurement of the liabilities for insurance contracts, but are excluded from insurance revenue and insurance service expenses in the statement of profit or loss (see section 17.3). The IASB decided that including receipts and repayments of such investment components in revenue and incurred claims would not faithfully represent the similarities between financial instruments within the scope of IFRS 9 and investment components embedded in insurance contracts within the scope of IFRS 17.²²

²² IFRS 17.BC33

3.3. Goods and non-insurance 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 any promise to transfer distinct goods or services to a policyholder from the host insurance contract. Activities an entity needs to perform to fulfil the contract, for example, administrative tasks to set up a contract or claims processing, that do not transfer a service to the policyholder as they are performed, should not be separated.²³

Goods or non-insurance services promised to a policyholder are distinct if the policyholder can benefit from them either on its own or with other readily available resources.²⁴

A promised good or non-insurance service to the policyholder is not distinct if:²⁵

- ▶ 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, and
- ▶ The entity provides a significant service in integrating the goods or non-insurance services with the insurance components.

An entity applies the principles in IFRS 15 on how to separate a contract with a customer that is partially within the scope of IFRS 15 and partially within the scope of other standards. The allocation of cash flows between the host insurance contract and the distinct goods or non-insurance services must be based on the stand-alone selling price of the components. In the absence of stand-alone selling prices that are directly observable, an entity must estimate the stand-alone selling prices to allocate the transaction price to each of the components. Cash outflows must be allocated to their related component, or, if not clearly related to one of the components, systematically and rationally allocated between components.²⁶

Illustration 4 – 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

²³ IFRS 17.B33

²⁴ IFRS 17.B34

²⁵ IFRS 17.B35

²⁶ IFRS 17.12

Illustration 4 – Separating components from a stop-loss contract with claims processing services [Based on example 5 in the Illustrative Examples to IFRS 17, IE51-55]

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.

Illustration 5 – 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

Illustration 5 – Separating components from a life insurance contract with an account balance [Based on example 4 in the Illustrative Examples to IFRS 17, IE42-50]

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.

3.4. Voluntary separation of components of an insurance contract

The IASB 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 IASB concluded that it would not be possible to separate a component in a non-arbitrary way that is not distinct from the insurance contract nor would such a result be desirable.²⁷

IFRS 17 applies to all components of insurance contracts that are not required to be separated. Whereas IFRS 17 specifically prohibits voluntary separation of non-insurance components that are not required to be separated, IFRS 17 is silent on whether an entity is permitted to voluntarily separate 'sub-insurance' components of an insurance contract and to apply IFRS 17 to those components separately or together in new groups. This issue could be relevant in determining the groups under IFRS 17 (see section 4 on level of aggregation).

How we see it

- ▶ Generally, IFRS 4 permits voluntary separation of non-insurance components in an insurance contract where separation (referred to as "unbundling") is not required.²⁸ 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

²⁷ IFRS 17. BC114

²⁸ IFRS 4.10(b)

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.

3.5. Combination of insurance contracts

A set, or series, of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, a single overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.²⁹

²⁹ IFRS 17.9

4. 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.

The level of aggregation deals with grouping individual insurance contracts for the purposes of recognising losses when a group of contracts is onerous and the timing of the recognition of profits arising from a group of profitable contracts.

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.³⁰ IFRS 17 then requires an entity to divide the contracts in each portfolio on initial recognition into the following groups:³¹

- ▶ Contracts that are onerous at initial recognition, if any
- ▶ Contracts that have no significant possibility of becoming onerous subsequently, if any
- ▶ Remaining contracts in the portfolio, if any

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 section 19).³²

	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

Groups of contracts are established on initial recognition and are not reassessed.³³ An entity is permitted, but not required, to subdivide contracts into further groups based on information from its internal reporting, if that information meets certain criteria.³⁴

To measure a group of contracts, an entity may estimate the fulfilment cash flows (see section 7) at a higher level of aggregation than the group or portfolio.

³⁰ IFRS 17.14

³¹ IFRS 17.16

³² IFRS 17.22

³³ IFRS 17.24

³⁴ IFRS 17.21

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.

How we see it

- ▶ Current practices applied under IFRS 4 for recognising losses from onerous contracts are based on wider groupings of contracts than those in IFRS 17. For example, liability adequacy tests are 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 current 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.

4.1. 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.³⁵

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.

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. IFRS 17 is silent as to

³⁵ IFRS 17.14

whether an insurance contract can be separated into different insurance components and, if so, the basis for such a separation.³⁶

Some entities may combine, for example, home and motor insurance into a single contract and also issue these products separately. 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.

This topic was addressed at the February 2018 meeting of the Transition Resources Group. The discussion implied that the lowest unit of account in IFRS 17 was the insurance contract and that there was not an accounting policy choice to further subdivide a single contract and allocate the pieces to different portfolios. However if it could be shown that, in substance, the single contract combined a number of individual contracts into one document, then separation may be required to reflect economic substance. Factors that should be taken into account when making this assessment include: (i) interaction between the different claim payments of the components, (ii) whether premiums relating to different investment components were invested in different underlying assets, (iii) whether components are distinct, e.g., they do not lapse together, any combined discount is small, etc.

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, in some group business and reinsurance contracts, the combination of different coverages into a single contract may be an administrative convenience. In these cases, the entity may record premiums and claims and manage different risks separately. Separation into sub-insurance components is an important aspect of the application of the level of aggregation that requires closer analysis to see whether separation is permitted.
- ▶ Some regulatory frameworks require entities to report some, or all, risks of a combined risk 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.

³⁶ *Insurance contracts: Responding to the external editorial review*, IASB staff paper 2C, February 2017, Issue A8

4.2. Grouping contracts at initial recognition according to expected profitability

The requirement to identify contracts that are onerous at initial recognition, or contracts that have no significant possibility of becoming onerous subsequently, applies to individual contracts.

Extract from IFRS 17

Minimum grouping of contracts

16. An entity shall divide a portfolio of insurance contracts issued into a minimum of:

- ▶ (a) a group of contracts that are onerous at initial recognition, if any;
- ▶ (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
- ▶ (c) a group of the remaining contracts in the portfolio, if any.

An entity need not determine the grouping of each contract individually. If an entity has reasonable and supportable information to conclude that a set of contracts will be in the same group, it may measure them as a set to determine to which group they belong (top down). If the entity does not have such reasonable and supportable information, it must make the determination by evaluating individual contracts (bottom-up).³⁷

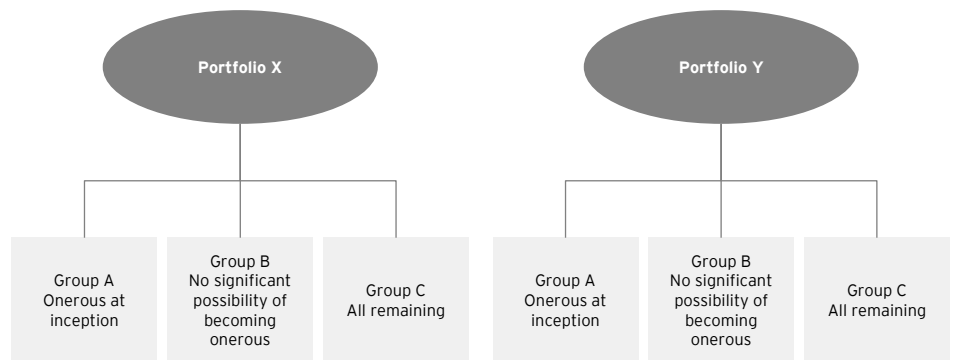
For contracts that are not onerous at inception, an entity will need to distinguish, at initial recognition, between profitable contracts with no significant possibility of becoming onerous subsequently and other contracts expected to be profitable. Assessing whether a contract, or set of contracts, has no significant risk of subsequently becoming onerous should:³⁸

- ▶ Be based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous
- ▶ Use information about estimates provided by the entity's internal reporting

An entity is not required to gather additional information beyond its internal reporting of the effect of changes in assumptions on different contracts. Conversely, it should not disregard information provided by its internal reporting about changes in assumptions on different contracts that potentially could become onerous.

³⁷ IFRS 17.17

³⁸ IFRS 17.19



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 place the contracts in a separate group and disclose losses arising from onerous contracts issued in the reporting period. 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 market position.
- ▶ Issuing a contract to anticipate achieving a profit from future renewals that are outside the IFRS 17 contract boundary will result in the recognition of losses at inception. For example, an insurer may pay acquisition costs on the assumption that the policyholder will renew its relationship (purchase a renewal) for several years. However, if the insurer has the right to reprice the renewal contract to fully reflect all of the risks, it cannot include the expected cash flows from the future contracts in measuring the existing contracts.
- ▶ 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 conceal expected losses on others.³⁹
- ▶ 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.

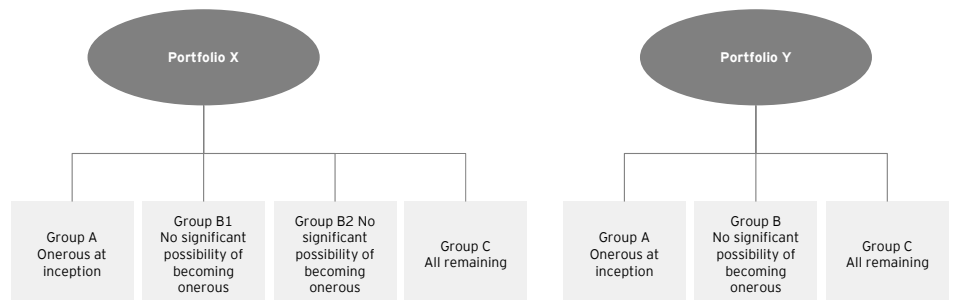
³⁹ IFRS 17.BC119

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. However, this expedient should not be applied by analogy to other items.⁴⁰ For example, an entity might set the price for contracts without considering differences in a specific characteristic because it thinks 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.⁴¹

How we see it

- ▶ 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.

An entity is permitted, but not required, to subdivide the above groups into further groups based on information from its internal reporting, if that information meets certain criteria. For example, an entity may choose to divide portfolios into more groups that are not onerous at initial recognition if the entity’s internal reporting provides information that distinguishes different levels of profitability or possibilities of contracts becoming onerous after initial recognition (see the illustration below).⁴²



⁴⁰ IFRS 17.20

⁴¹ IFRS 17.BC133

⁴² IFRS 17.21

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.
- ▶ Differences will arise compared to current liability adequacy test groupings.
- ▶ The definition of portfolio may also be different to how this term is defined today. An entity's current practice for identifying portfolios may not be consistent with the IFRS 17 requirement that contracts with different risks will be in different portfolios.
- ▶ The application of the aggregation level under IFRS 17 will strongly affect requirements for process, systems and data when implementing the new standard.

4.3. Cohorts

An entity is prohibited from grouping contracts issued more than one year apart (except in certain circumstances at transition to IFRS 17 – see section 19).⁴³ This restriction was included because the IASB was concerned that, without it, entities could, in effect, have perpetually open portfolios. This could lead to the loss of information about the development of profitability over time, cause the CSM to persist beyond the duration of contracts in the group, and, consequently, result in profits not being recognised in the correct periods.⁴⁴

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 not required to use a 12-month period when grouping insurance contracts.

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. For example, 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.

⁴³ IFRS 17.22

⁴⁴ IFRS 17.BC136

5. Initial recognition

An entity should recognise a group of insurance contracts it issues from the earliest of the following:⁴⁵

- ▶ 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

Illustration 6 – Determining the date of recognition of a group of insurance contracts

Example 1

An entity issues insurance contracts, that form a group, to policyholders beginning on 25 December 2020. The coverage period of the group begins on 1 January 2021 and the first premium from a policyholder in the group is due 5 January 2021. The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 1 January 2021 (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 insurance contracts, that form a group, to policyholders beginning on 25 December 2021. The coverage period of the group begins on 1 January 2022 and the first premium from a policyholder in the group is due on 30 December 2021. The group of insurance contracts is not onerous.

The group of insurance contracts is recognised on 30 December 2021 (i.e., the date that the first premium is due), which is before the coverage period begins. However, if the entity has a reporting date of 31 December 2021, only those contracts within the group issued as of the reporting date will be recognised in the financial statements for the period ending 31 December 2021.

Example 3

An entity issues insurance contracts, that form a group, to policyholders beginning on 25 December 2022. On that day, 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 issued as at the reporting date will be recognised in the financial statements for the period ending 31 December 2022.

⁴⁵ IFRS 17.25

How we see it

- ▶ The inception date of a contract is when an entity 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.⁴⁶

An insurance contract may, at initial recognition, join an existing group of insurance contracts if all the contracts have similar expected profitability at the time of initial recognition and are issued within a year of each other (i.e., same cohort – see section 4.3). When contracts are added to a group in a subsequent reporting period, this may result in a change in determining discount rates at the date of initial recognition of the group as discount rates may be determined using weighted average rates over the period that contracts in the group are issued (see Section 8). When this occurs, an entity should apply the revised (weighted average) discount rates from the start of the reporting period in which the new contracts are added to the group. There is no retrospective catch-up adjustment.⁴⁷

How we see it

- ▶ 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.

In some cases, an entity will pay or receive insurance acquisition cash flows for contracts issued prior to the date of recognition of the group of insurance contracts to which those insurance acquisition cash flows are attributable (unless the insurer chooses to recognise these as expenses or income under the premium allocation approach – see section 12). In these situations, an insurer should recognise an asset or a liability for these cash flows (i.e., a prepayment or an accrual). When the group of insurance contracts to which the insurance acquisition cash flows are allocated is recognised, the asset or liability should be derecognised (because the insurance acquisition cash flows are now part of the cash flows of the group of insurance contracts).⁴⁸

⁴⁶ IFRS 17.BC140-145

⁴⁷ IFRS 17.28

⁴⁸ IFRS 17.27

6. Measurement – overview

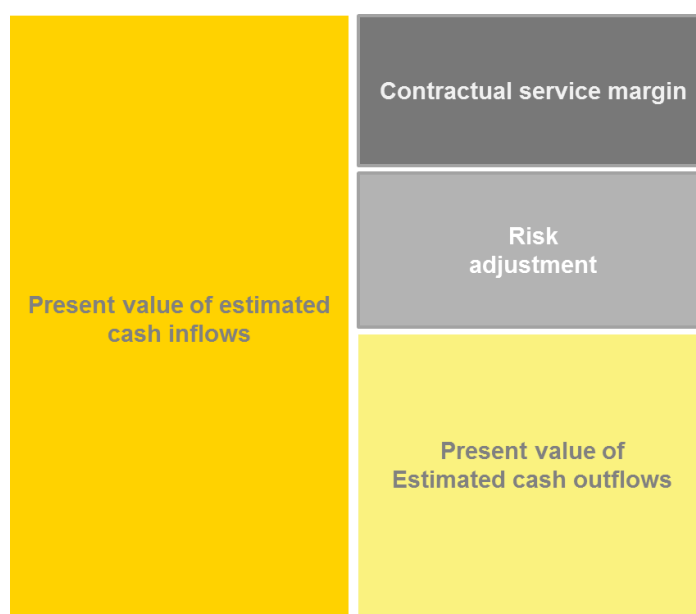
The core approach to the measurement of insurance contracts in IFRS 17 is referred to throughout this publication as the 'general model'. IFRS 17 includes modifications and a simplification to the general model that are applicable in specified circumstances.

6.1. Overview of the general model

The general model measures a group of insurance contracts as the sum of the following 'building blocks':⁴⁹

- ▶ Fulfilment cash flows, comprising
 - ▶ An unbiased and probability-weighted estimate of future cash flows (see section 7)
 - ▶ A discount adjustment to present value to reflect the time value of money and financial risks (see section 8)
 - ▶ A risk adjustment for non-financial risk (see section 9)
- ▶ A CSM representing unearned profit an entity will recognise as it provides service under the insurance contracts in the group (see section 10)

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.



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 CSM of the group at that date

And

⁴⁹ IFRS 17.32

- ▶ The liability for incurred claims comprising the fulfilment cash flows related to past service allocated to the group at that date

Liability for remaining coverage	Liability for incurred claims
CSM	
Risk adjustment	Risk adjustment
Discounted present value of estimated cash flows	Discounted present value of estimated cash flows

Extract from IFRS 17

Appendix A

Liability for remaining coverage

An entity's obligation to 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 coverage period).

Liability for incurred claims

An entity's obligation to 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.

6.2. Modification to the general model

Modifications to the general model apply to the following groups of contracts:

- ▶ Reinsurance contracts held (see section 13)
- ▶ Investment contracts with discretionary participation features (see section 14.4)
- ▶ Contracts with direct participation features (see section 14.2)

6.3. Simplification to the general model

An entity is permitted to simplify the measurement of eligible groups of insurance contracts by applying an approach referred to as 'the premium allocation approach'. The premium allocation approach does not require an entity to measure the CSM explicitly or update the liability for remaining coverage for changes in discount rates and other financial variables. This approach contains other practical expedients that are discussed in section 12 below.

7. Estimates of future cash flows

The first element of measuring fulfilment cash flows in the general model is an estimate of future cash flows within the contract boundary period of each contract in a group. Estimates of future cash flows should:⁵⁰

- ▶ Include all cash flows that are within the contract boundary (see 7.1 and 7.2 below)
- ▶ 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 (see 7.3 below)
- ▶ Reflect the perspective of the entity, provided that estimates of any relevant market variables are consistent with observable market prices for those variables (see 7.4 below)
- ▶ Be current (see 7.5 below), and explicit (see 7.6 below)

An entity may 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.

7.1. Contract boundary

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 services. A substantive obligation to provide services ends when:⁵¹

- ▶ 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 a result, can set a price or level of benefits that fully reflects the risk of that portfolio.
 - ▶ The pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

A liability or asset relating to expected premiums or claims outside the boundary of the insurance contract must not be recognised. Such amounts relate to future insurance contracts.⁵²

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

⁵⁰ IFRS 17.33

⁵¹ IFRS 17.34

⁵² IFRS 17.35

IFRS 17 does not explicitly state whether the boundary condition relating to repricing for risk refers to insurance risk only or whether it also reflects other types of risk under the contract. At the February 2018 meeting of the Transition Resources Group, the IASB staff expressed the view that it was only the policyholder risk that would be relevant. This is risk that the policyholder transfers to the insurer under the contract. Lapse risk therefore would not be considered (except in the case of a reinsurance contract).

How we see it

- ▶ 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 consequence 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.
- ▶ An entity might expect renewal of contracts subject to repricing and, consequently, would be willing to pay commissions and other acquisition expenses to acquire a contract that it may be unable to claw back if a contract does not renew. Accounting for the payment of insurance acquisition cash flows on insurance contracts which are expected to last for many years, but where the contract boundary is much shorter, may cause a profit or loss mismatch. For example, an insurer may pay significant up-front insurance acquisition cash flows in the first year of a contract on the basis of the expectation that the contract will renew for a number of years, but the contract boundary may be only one year. Absent claw-back provisions that would permit the insurer to recoup some of these cash flows in the event of non-renewal, the size of the acquisition cash flows may mean that the one-year contract is onerous.

Illustration 7 – Contract boundary of a stepped premium life insurance contract

An entity issues a group of insurance contracts that provide cover for death, and total and permanent disablement. The cover is guaranteed renewable (i.e., the entity must accept renewal) for 20 years regardless of changes in the insured's health. However, the premiums increase annually with the age of the policyholder and the insurer may increase premium rates annually so long as 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, it can set a price that reflects the risk of that portfolio. The pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to premiums after the reassessment date (as premiums are adjusted annually for age). Therefore, both criteria in paragraph 34(b) (ii) (see above) are satisfied.

Illustration 8 – Contract boundary of a level premium life insurance contract

An entity issues a group of insurance contracts that provide cover for death, and total and permanent disablement. The cover is guaranteed renewable (i.e., the entity must accept renewal) for 20 years regardless of changes in the insured's health. The premium rates are level for the life of the policy irrespective of policyholder age. Therefore, the entity generally will "overcharge" in the early years of a contract and "undercharge" in the later years. In addition, the insurer may increase the remaining year's level premium annually so long as 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 20 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 for drawing a shortened contract boundary when an entity can reassess the premiums or benefits for a portfolio of insurance contracts is not satisfied.

7.2. Cash flows within the contract boundary

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including those for which the entity has discretion over the amount or timing. IFRS 17 provides the following examples of such cash flows:⁵³

- ▶ Premiums and related cash flows
- ▶ Claims and benefits, including reported claims not yet paid, incurred claims not yet reported and expected future claims within the contract boundary
- ▶ Payments to policyholders (or on behalf of policyholders) that vary depending on underlying items
- ▶ Payments to policyholders resulting from embedded derivatives, for example, options and guarantees
- ▶ An allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs
- ▶ Claims handling costs
- ▶ Contractual benefit costs paid in kind
- ▶ Policy administration and maintenance costs, including recurring commissions that are expected to be paid to intermediaries
- ▶ Transaction-based taxes and levies (such as premium taxes)
- ▶ Payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts
- ▶ Claim recoveries, such as salvage and subrogation (to the extent they are not recognised as separate assets)
- ▶ An allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts. (Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics)
- ▶ Any other costs that may be charged specifically to the policyholder under the terms of the contract

Insurance acquisition cash flows are those arising from the cost 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.⁵⁴

There is no restriction of insurance acquisition cash flows to only those resulting from successful efforts. Therefore, the directly attributable costs of an underwriter of a portfolio of motor insurance contracts, for example, need

⁵³ IFRS 17.B65

⁵⁴ IFRS 17.Appendix A

not be apportioned between costs for contracts issued and the cost of efforts that did not result in the issuance of a contract.

IFRS 17 provides a list of cash flows that should not be included in cash flows that arise as an entity fulfils an existing insurance contract, these include, for example:⁵⁵

- ▶ Investment returns (accounted for separately under applicable IFRSs)
- ▶ Cash flows (payments or receipts) that arise under reinsurance contracts held (accounted for separately)
- ▶ Cash flows that may arise from future insurance contracts, i.e., cash flows outside the boundary of existing contracts
- ▶ 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; these 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
- ▶ Cash flows between different components of the reporting entity, such as policyholder and shareholder funds, if these cash flows do not change the amounts paid to policyholders
- ▶ Cash flows arising from components separated from the insurance contract and accounted for using other applicable IFRSs

⁵⁵ IFRS 17.B66

How we see it

- ▶ As a change to many existing accounting practices under IFRS 4, no explicit deferred acquisition cost assets exist. Instead, the insurance acquisition cash flows are included as a “negative liability” within the measurement of the CSM on initial recognition. Because the CSM can never be negative, there is no longer a need to perform any recoverability assessments for acquisition costs deferred.
- ▶ 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. So 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.

7.3. Incorporate all reasonable and supportable information available without undue cost or effort

The objective of estimating future cash flows is to determine the expected value, or the 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.⁵⁶

An entity need not identify every possible scenario. The complexity of techniques an entity uses to estimate the full range of outcomes will depend on the complexity of the cash flows of a group of insurance contracts and the underlying factors that drive cash flows. 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 occur if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, it is likely that more sophisticated stochastic modelling will be necessary to satisfy the measurement objective.

The future cash flow estimates must be on an expected value basis and be unbiased. This means that they should exclude any additional estimates above the probability-weighted mean for “uncertainty”, “prudence” or what

⁵⁶ IFRS 17.B37

is sometimes described as “management loading”. The risk adjustment for non-financial risk (see section 9) is intended to reflect the compensation for bearing the non-financial risk resulting from the uncertain amount and the timing of cash flows.

Reasonable and supportable information available at the reporting date without undue cost or effort includes information available from an entity’s own information systems about past events and current conditions, and forecasts of future conditions. An entity should estimate the probabilities and amounts of future payments under existing contracts based on information obtained, including:⁵⁷

- ▶ 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 data from other sources. Historical data is adjusted to reflect current conditions, for example, if:
 - ▶ 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.
 - ▶ There have been changes in items such as underwriting and claims management procedures that may affect the relevance of historical data to the insurance contracts.
- ▶ Current price information, if available. The standard refers to 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.

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, e.g., renewal, surrender and conversion options, and options to stop paying premiums while still receiving benefits under the contracts (see section 9).

⁵⁷ IFRS 17.B41

How we see it

- ▶ 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.
- ▶ Some insurers currently include management loadings or other forms of prudence within insurance liabilities. Implicit prudence in reserving tends to reduce volatility in profits. IFRS 17 requires calculation and disclosure of a point estimate of the mean of the expected future cash flows discounted to the reporting date with an explicit risk margin for non-financial risk. Insurers will need to educate investors about the potential effect of IFRS 17 on reported profits if they expect that the volatility of their results is likely to increase when they apply IFRS 17.

7.4. Market variables and non-market variables

IFRS 17 identifies two types of variable that can affect cash flow estimates:⁵⁸

- ▶ 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)

7.4.1. Market variables

Market variables affect estimates of cash flows in participating contracts (contracts with participation features), and non-participating contracts, e.g., if cash flows vary with changes in an index for price inflation.

Estimated cash flows reflect the perspective of the entity, provided that estimates of any relevant market variables are consistent with observable market prices for those variables. IFRS 17 has similar requirements to IFRS 13 *Fair Value Measurement* for maximising the use of observable inputs when estimating market variables.⁵⁹ Consistent with IFRS 13, if variables need to be derived (for example, because no observable market variables exist) they need to be as consistent as possible with observable market variables.⁶⁰

The standard refers to the notion of a replicating asset or replicating portfolio of assets as a means of measuring the liability based on market information. 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

⁵⁸ IFRS 17.B42

⁵⁹ IFRS 13.3

⁶⁰ IFRS 17.B44

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.⁶¹

IFRS 17 does not require an entity to use a replicating portfolio technique. 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.⁶²

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.
- ▶ In practice, we believe that the use of a replicating portfolio is likely to be rare as IFRS 17 refers to an asset whose cash flows exactly match those of the liability.

7.4.2. Non-market variables

Estimates of non-market variables should reflect all reasonable and supportable evidence available without undue internal or external cost or effort.⁶³ Entities need to assess the persuasiveness of information from different sources, as shown in the illustration 9 below:

Illustration 9 – Persuasiveness of internal and national mortality statistics [IFRS 17.B50]

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.

⁶¹ IFRS 17.B46

⁶² IFRS 17.B48

⁶³ IFRS 17.B49

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.⁶⁴

In some 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).⁶⁵ Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and therefore with interest rate inflation. The entity should ensure that the probabilities for scenarios and risk adjustments for non-financial risk that relate to market variables are consistent with the observed market prices that depend on those variables.⁶⁶

7.5. Using current estimates

Estimated cash flows should be current, i.e., reflect conditions existing at the measurement date, including assumptions about the future. An entity should review and update its estimates from the close of the previous reporting period. In doing so, an entity should consider whether updated estimates faithfully represent the conditions at the end of the reporting period and changes during the period.⁶⁷

Illustration 10 – 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

⁶⁴ IFRS 17.B51

⁶⁵ IFRS 17.B52

⁶⁶ IFRS 17.B53

⁶⁷ IFRS 17.B54

Illustration 10 – Faithful representation of conditions at the reporting date and changes in the period

apparent at the end of the reporting period (with disclosure applying IAS 10 *Events After the Reporting Date* that a non-adjusting event occurred after the end of the reporting period).⁶⁸

7.6. Explicit cash flows

An entity estimates future cash flows separately from other estimates, e.g., the risk adjustment for non-financial risk or the adjustment to reflect the time value of money and financial risks. There is an exception if the entity uses the fair value of a replicating portfolio of assets to measure some of the cash flows that arise from insurance contracts. This will combine the cash flows and the adjustment to reflect the time value of money and financial risks. The fair value of a replicating portfolio of assets reflects both the expected present value of cash flows from the portfolio of assets and the associated risk (see section 7.4.1).

How we see it

- ▶ Some existing 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 appears to require 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.

⁶⁸ IFRS 17.B55 and IAS 10.10-11

8. Discount rates

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.

The second element of measuring fulfilment cash flows under the general model is an adjustment 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:⁶⁹

- ▶ Reflect the time value of money, characteristics of the cash flows and liquidity characteristics of the insurance contracts
- ▶ 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

Discount rates used to measure the present value of future cash flows should reflect the characteristics of the cash flows; for example, in terms of currency and timing of cash flows and uncertainty due to financial risk. The effects of uncertainty in cash flows due to non-financial risks are included in the risk adjustment for non-financial risk.

The discount rates calculated according to the requirements above should be determined, as follows:⁷⁰

<i>Insurance liability measurement component</i>	<i>Discount rate</i>
Fulfilment cash flows	Current rate at reporting date
Contractual service margin interest accretion for contracts without direct participation features	Rate at date of initial recognition of group
Changes in the contractual service margin for contracts without direct participation features	Rate at date of initial recognition of group
Changes in the contractual service margin for contracts with direct participation features	A rate consistent with that used for the allocation of finance income or expenses
Liability for remaining coverage under premium allocation approach	Rate at date of initial recognition of group
Profit or loss component	
Disaggregated insurance finance income included in profit or loss for groups of contracts for which changes in financial risk do not have a significant effect on amounts paid to policyholders (see section 17.6)	Rate at date of initial recognition of group
Disaggregated insurance finance income included in profit or loss for groups of contracts for which changes in financial risk assumptions have a significant effect on amounts paid to policyholders (see section 17.6.1)	Rate that allocates the remaining revised finance income or expense over the duration of the group at a constant rate or, for contracts that use a crediting rate, uses an

⁶⁹ IFRS 17.36

⁷⁰ IFRS 17.B72

	allocation based on the amounts credited in the period and expected to be credited in future periods
Disaggregated insurance finance income included in profit or loss for groups of contracts applying the premium allocation approach (see section 17.6.2)	Rate at date of incurred claim

To determine the discount rates at the date of initial recognition of a group of contracts described above, an entity may use weighted-average discount rates over the period that contracts in the group are issued, which cannot exceed one year.⁷¹ This can result in a change in the discount rates during the period of the contracts. When contracts are added to a group in a subsequent reporting period (because the period of the group spans two reporting periods) and 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.⁷² This means that there is no retrospective catch-up adjustment.

For insurance contracts with direct participation features, the contractual service margin is adjusted based on changes in the fair value of underlying items, which includes the impact of discount rate changes (see section 14.2).

8.1. 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:⁷³

- ▶ 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 must 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.
- ▶ Nominal cash flows (i.e., those that include the effect of inflation) must 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.

Cash flows can vary based on returns from financial underlying items due to a contractual link to underlying items, or because the entity exercises discretion in providing policyholders with a financial return on premium paid. An entity

⁷¹ IFRS 17.B73

⁷² IFRS 17.28

⁷³ IFRS 17.B74

need not hold related underlying items for cash flows to vary based on returns from underlying items.⁷⁴

When some of the cash flows vary based on returns from underlying items and others do not (e.g., a participating contract has fixed or guaranteed cash flows in addition to providing policyholders with financial returns), an entity may:⁷⁵

- ▶ Divide the estimated cash flows and apply appropriate discount rates to each type

Or

- ▶ Apply discount rates appropriate for the estimated cash flows as a whole (e.g., using weighted average rates, stochastic modelling or risk-neutral measurement techniques)

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.⁷⁶

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 the 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.

8.2. Current discount rates consistent with observable market prices

An entity should discount cash flows using current discount rates that reflect the time value of money, characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Discount rates should be consistent with observable market prices. The use of current discount rates that are consistent with observable market prices is in line with the requirement that entities should use current estimates of cash flows in the measurement of

⁷⁴ IFRS 17.B75

⁷⁵ IFRS 17.B76-B77

⁷⁶ IFRS 17.31, IFRS 17.BC197

insurance contracts and estimates of any relevant market variables should be consistent with observable market prices for those variables.

An entity should maximise the use of observable inputs and reflect all reasonable and supportable internal and external information on non-market variables available without undue cost or effort. 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.⁷⁷

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.
- ▶ The standard refers to yield curves in several places, without specifying that discount rates should be a curve or a representative single rate. However, 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. IFRS 17 therefore seems to raise the expectation that, typically, the characteristics of timing and duration need to be reflected through the use of a curve. Notwithstanding the expectation of using a curve to adequately reflect timing and duration of the insurance liability, possible practical considerations 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 in 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. In addition, this method differs from the approach followed to discounting in the Solvency II regulatory regime
 - ▶ 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

⁷⁷ IFRS 17.B78

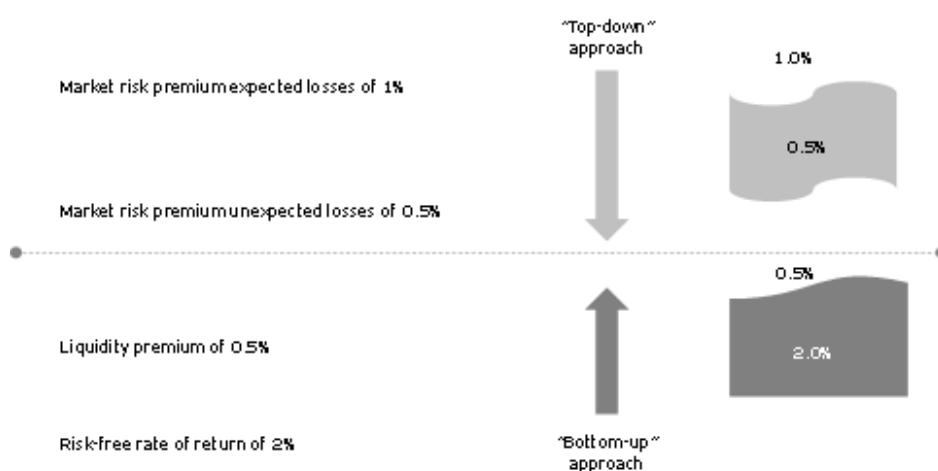
8.2.1. Bottom up approach

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 must 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 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.⁷⁸ For cash flows of insurance contracts that do not vary based on the returns on underlying items, an entity may determine discount rates by adjusting a liquid risk-free yield curve to reflect the differences between liquidity characteristics of the financial instruments that underlie the rates observed in the market and liquidity characteristics of the insurance contracts.⁷⁹

8.2.2. Top down approach

Alternatively, an entity may determine 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 (a top-down approach). 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.⁸⁰

Assume a current asset yield of a reference instrument of 4% composed of:



⁷⁸ IFRS 17.B79

⁷⁹ IFRS 17.B80

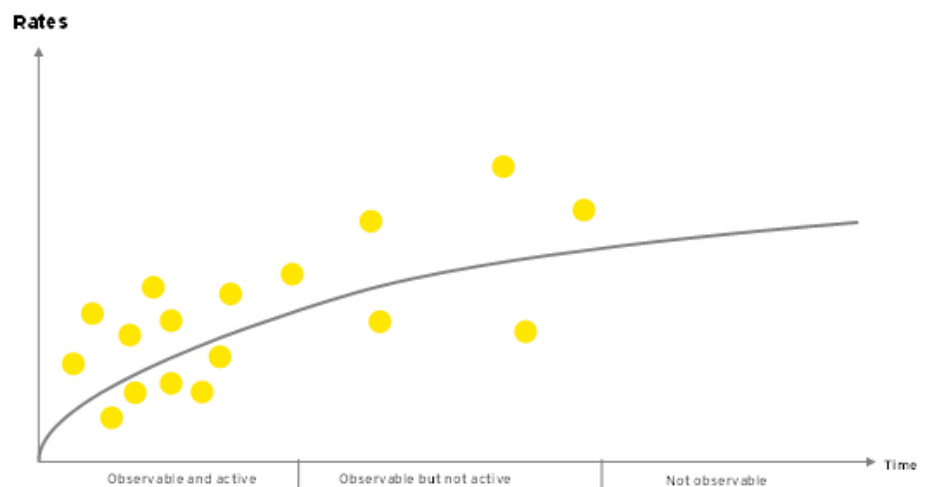
⁸⁰ IFRS 17.B81

In principle, a single illiquid risk-free yield curve should eliminate uncertainty about the amount and timing for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio. However, in practice, the top-down and 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 that of another approach.⁸¹

How we see it

- ▶ Entities will need to determine an appropriate method to adjust the observable market information in a way that reflects the illiquidity characteristics of the insurance contracts. The illiquidity 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, it can be derived from collateralised bonds or estimating it by adjusting a spread in an instrument for credit risk spreads based on credit default swaps.

8.2.3. Discount rates beyond the market observable range



Some insurance contracts will have a contract boundary that extends beyond the period for which observable market data is available (see sections 7.1 and 7.2). In these situations, the entity will have to extrapolate the discount rate yield curve beyond that period, as illustrated in the diagram below.

⁸¹ IFRS 17.B84

An entity must apply the following guidance for estimating the discount rate curve:⁸²

- ▶ Use observable market prices in active markets for assets in the reference portfolio where they exist
- ▶ 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 measured
- ▶ If there is no market for assets in the reference portfolio, an entity must apply an estimation technique. For such assets:
 - ▶ Develop unobservable inputs using the best information available. 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 data to reflect all information about market participant assumptions that is reasonably available

How we see it

- ▶ 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) under IFRS 17. However, an entity would have to decide if an estimate is consistent with the requirements in IFRS 17 and make necessary adjustments.

⁸² IFRS 17.B82

9. Risk adjustment for non-financial risks

The third element of measuring fulfilment cash flows in the general model (see section 6.1) 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.⁸³ 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.⁸⁴

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:⁸⁵

- ▶ Fulfilling a liability that has a range of possible outcomes arising from non-financial risk
- ▶ Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts

Illustration 11 – 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.

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.⁸⁶ The risk adjustment for non-financial risk reflects:⁸⁷

- ▶ 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

⁸³ IFRS 17.37

⁸⁴ IFRS 17.B86

⁸⁵ IFRS 17.B87

⁸⁶ IFRS 17.BC209

⁸⁷ IFRS 17.B88

IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, the risk adjustment for non-financial risk must have the following characteristics:

- ▶ Risks with low frequency and high severity generally will result in higher risk adjustments for non-financial risk than those with high frequency and low severity.
- ▶ For similar risks, contracts with a longer duration generally will result in higher risk adjustments for non-financial risk than contracts with a shorter duration.
- ▶ Risks with a wider probability distribution generally will result in higher risk adjustments for non-financial risk than those with a narrower distribution.
- ▶ The less that is known about underlying assumptions used to determine the current estimate and its trend, the higher the risk adjustment 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. IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. Because the risk adjustment for non-financial risk is an entity-specific perception, rather than a market participant's perception, different entities may determine different risk adjustments for similar groups of insurance contracts. Accordingly, to enable users of financial statements to understand how entity-specific assessments of risk aversion might differ from entity to entity, the entity must disclose the confidence level used to determine the risk adjustment for non-financial risk or, if a technique other than confidence level is used, the entity must disclose the technique used and the confidence level corresponding to the technique (see section 18.2).

How we see it

- ▶ 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 even a higher level of aggregation. However, when determining the risk adjustment at a level more aggregated than a group of contracts, an entity must establish a 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.
- ▶ 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 CSM – see section 10).
- ▶ The standard does not prescribe particular techniques for estimating the risk adjustment for a group of contracts. The standard incorporates guidance with the aim to aid companies in selecting an appropriate method.⁸⁸

⁸⁸ IFRS 17.BC213-214

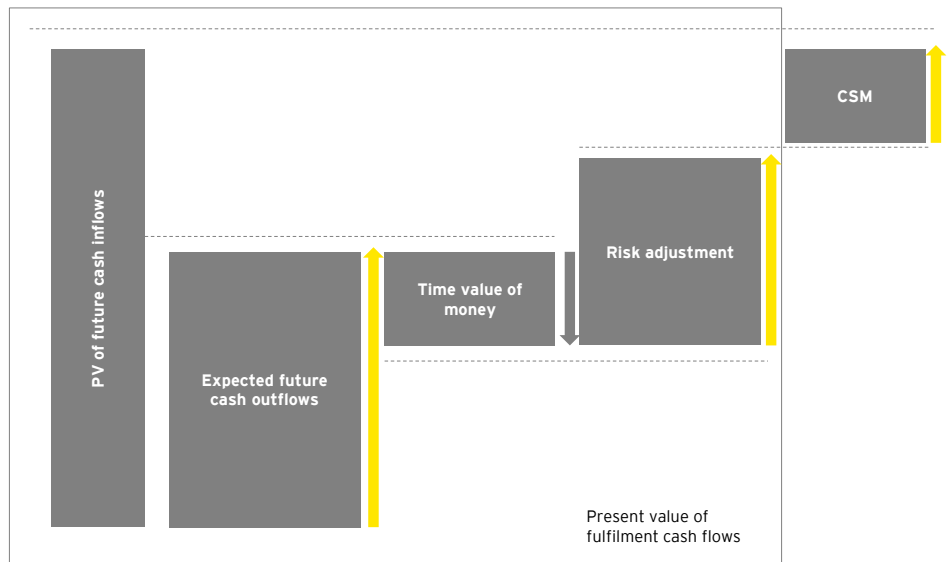
10. Contractual service margin

The fourth element of the building blocks in the general model (see section 6.1) is the contractual service margin (the CSM). This 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 services in the future.

10.1. Initial recognition

An entity should measure the CSM on initial recognition of a group of insurance contracts at an amount that, unless the group of contracts is onerous (see section 11), results in no income or expenses arising from:⁸⁹

- ▶ Initial recognition of an amount for the fulfilment cash flows (see section 7)
- ▶ Derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows (see section 15.2)
- ▶ Any cash flows arising from the contracts in the group at that date



Therefore, the CSM on initial recognition, assuming a contract is not onerous, is no more than the balancing number needed to avoid a day 1 profit. The CSM 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).

The approach above on initial recognition applies to contracts with and without participation features, including investment contracts with discretionary participation features.

For groups of reinsurance contracts held, the calculation of the CSM 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 13.3).

⁸⁹ IFRS 17.38

A CSM is not specifically identified for contracts subject to the premium allocation approach, although the same underlying principle of profit recognition (i.e., no day 1 profit) applies (see Section 12.2).

For insurance contracts acquired in a business combination or transfer, the CSM at initial recognition is calculated as the difference between the consideration and the fulfilment cash flows (see section 16.1).

How we see it

- ▶ 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 CSM is a unique feature of the standard. The way users will evaluate and appreciate the CSM may be a critical aspect of the decision-usefulness of the IFRS 17 accounting model.

10.2. Subsequent measurement

The CSM 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.

For a group of insurance contracts without direct participation features, the carrying amount of the CSM of the group at the end of the reporting period equals the carrying amount at the beginning of the reporting period adjusted, as follows:⁹⁰

Change in the carrying amount of the CSM in a period	
A) CSM at the beginning of the period	X
B) Effect of new contracts added to the group	X
C) Interest accreted on the CSM in the period	X
D) Change in fulfilment cash flows relating to future service	X/(X)
E) Effect of currency exchange differences	X/(X)
F) Amount of CSM recognised in profit or loss as insurance revenue because of the transfer of services in the period	(X)
G) CSM at the end of the period	X

10.2.1. Interest accretion

For insurance contracts without direct participation features, interest is accreted on the carrying amount of the CSM at discount rates determined at the date of initial recognition (“locked-in discount rate”) of a group of contracts applicable to nominal cash flows that do not vary based on the returns on any underlying items.

The adjustment of the CSM results in spreading the effects of changes in estimates of future cash flows over time.

⁹⁰ IFRS 17.44

The locked-in discount rate applicable to a group of contracts can be the weighted average of the rates applicable at the date of initial recognition of contracts that can join a group over a 12-month period (see section 8).

How we see it

- ▶ The requirement to accrete interest on the CSM 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 discount rates. Some would prefer to accrete interest on the CSM at current rates to avoid the need to track historic rates. Accreting the CSM 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.
- ▶ As noted below, the number of historic discount rates that need to be tracked is greater for participating contracts without direct participation features. The reason is that the rate applied to adjust the CSM for changes in fulfilment cash flows is likely to differ from the rate to accrete interest on the CSM as the former should reflect the characteristics of the specific liabilities rather than a risk-free rate.

10.2.2. *Adjust CSM for changes in fulfilment cash flows relating to future service*

An entity adjusts the CSM for changes in fulfilment cash flows relating to future service, except to the extent that:⁹¹

- ▶ Such increases in the fulfilment cash flows exceed the carrying amount of the CSM, giving rise to a loss
- Or
- ▶ Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage (see section 11).

For insurance contracts without direct participation features, changes in fulfilment cash flows relating to future service that adjust the CSM comprise:⁹²

- ▶ 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).
- ▶ Changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those relating to the time value of money and changes in financial risk (recognised in the statement of profit or loss and other comprehensive income rather than adjusting the CSM).

⁹¹ IFRS 17.44

⁹² IFRS 17.B96

- ▶ Differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period.
- ▶ Changes in the risk adjustment for non-financial risk that relate to future service.

Except for changes in the risk adjustment, adjustments to the CSM noted above are measured at discount rates that reflect the characteristics of the cash flows of the group of insurance contracts at initial recognition (see section 8).

For participating contracts without direct participation features this discount rate (i.e., the rate that reflects the characteristics of the cash-flows on initial recognition) will be made up of a mix of an asset-based discount rate (for asset-dependent cash flows) and a rate for cash flows that are not asset-dependant (calculated using either the “top down” or “bottom-up” approaches). This rate will therefore be different from the rate used to accrete interest on the carrying amount of the CSM. Interest is accreted in the CSM using either the top down or bottom-up approach locked in at inception.

An experience adjustment is a difference between:

- ▶ 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

- ▶ 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

Experience adjustments generally relate to current or past service and are recognised immediately in profit or loss. However, experience adjustments for premiums received (or due) for future coverage relate to future service and consequently adjust the CSM.

How we see it

- ▶ 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 is clearly not the case, for example, with adjustment premiums in reinsurance contracts that are often determined after the end of a coverage period. Attributing expected premium receipts that are overdue to past or future coverage might not be obvious.

As noted in section 3.2, investment components are amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. IFRS 17 requires any unexpected repayment of an investment component to adjust the CSM (see above). The CSM also will 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.

Consequently, the net effect on the CSM of a delay or acceleration of repayment of an investment component is the effect of the change in timing of the repayment.

The terms of some insurance contracts without direct participation features give an entity discretion over the payments to policyholders. A change in the discretionary cash flows is regarded as relating to future service and, therefore, adjusts the CSM and will be reflected in profit or loss over time. Discretionary cash flows are discussed further in section 14.4

10.2.3. Currency exchange differences

The carrying amount of a group of insurance contracts that generate cash flows in a foreign currency, including the CSM, is treated as a monetary item when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.⁹³ 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 and are accounted for under IAS 21.

10.2.4. Release of the CSM in profit or loss

An amount of the CSM for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period. The amount is determined by:⁹⁴

- ▶ Identifying the coverage units in the group
- ▶ Allocating the CSM at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future
- ▶ Recognising in profit or loss the amount allocated to coverage units provided in the period

The number of coverage units in a group is the quantity of coverage 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 duration.

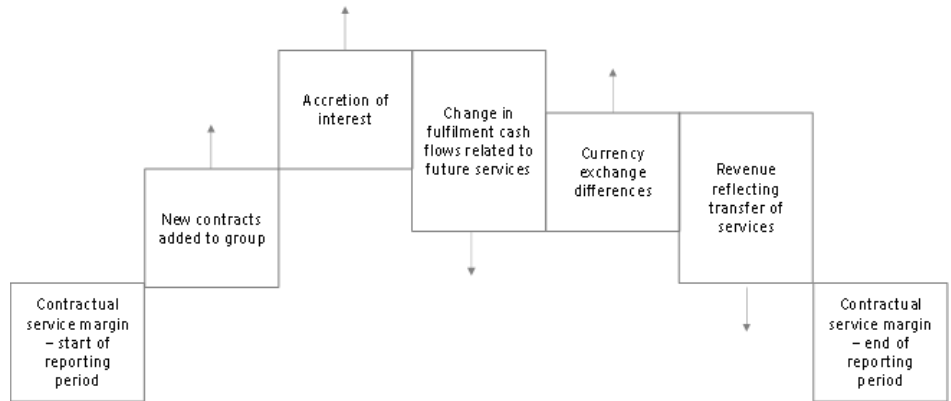
The CSM is recognised over the expected period of coverage for a group of contracts. The CSM remaining at the end of the reporting period is allocated to the services provided in the current period and the services expected to be provided in future periods based on coverage units. IFRS 17 does not specify whether an entity should consider the time value of money in determining the allocation and, consequently, does not specify whether the allocation should reflect the timing of the expected provision of the coverage units. For example, an entity could place more weight on the current period of coverage compared

⁹³ IFRS 17.30

⁹⁴ IFRS 17.B119

with expected coverage in the future, by reflecting the time value. The Board concluded it should be a matter of judgement.⁹⁵

The movements in the CSM for subsequent measurement are summarised below⁹⁶:



How we see it

- ▶ The wording in IFRS 17 suggests that the allocation of the CSM to profit or loss for groups of insurance contracts should be based solely on insurance coverage. The allocation disregards other services provided to policyholders. This approach can lead to surprising patterns of profit recognition in contracts that provide insurance coverage for only part of a contract's term. Some also question whether this approach faithfully represents profit for contracts with direct participation features that the standard describes as substantially investment-related service contracts. It also creates a difference with the approach that will be followed for investment contracts with discretionary participation contracts that are also in the scope of the standard. For these groups of contracts, the CSM will be spread on the basis of investment services.
- ▶ Whether an entity allocates the CSM to profit or loss to reflect the time value of money is a matter of judgement. 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.
- ▶ We expect practitioners will ask for more guidance on how to determine coverage units and the meaning of the quantity of benefits. For example, does a contract that would pay a large amount in relation to a very unlikely insured event provide a greater quantity of benefit than a similar contract that pays a smaller amount for a more likely event?

⁹⁵ IFRS 17.BC282

⁹⁶ Agenda Paper 7 of February 2018 TRG meeting. Question S09

10.2.5. Subsequent measurement of the CSM and interim reporting

The CSM is adjusted for changes in estimates of future fulfilment cash flows, whereas experience adjustments relating to current or past service are recognised in profit or loss instead of the CSM. One of the consequences is that the total liability and profit reported will be influenced by the frequency of reporting and the reporting date. An entity that publishes interim financial statements (see Illustration 12 below) would therefore ordinarily need to maintain separate carrying amounts for CSMs for purposes of interim and annual financial statements to meet the requirement in IAS 34 *Interim Financial Reporting* that the frequency of an entity's reporting should not affect the measurement of its annual results.⁹⁷ IFRS 17 avoids a requirement to maintain separate CSMs for annual and interim reporting, by making an exception to the requirement of IAS 34. It prohibits entities from changing the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or in the annual reporting period.⁹⁸

Illustration 12 – CSM and interim reporting

An entity with an annual reporting period ending on 31 December publishes half-yearly interim financial statements.

- ▶ At 31 December 20X0, the entity has issued a group of insurance contracts with a CSM of CU1,200 and an expected remaining coverage period of two years. The entity expects to provide coverage evenly over the remaining coverage period, and expects to incur claims in H2 20X1 of CU300.
- ▶ At the end of H1 20X1, the entity increases its estimate of claims to be incurred in H2 of 20X1 by CU200 to CU500. The entity adjusts (reduces) the related CSM by CU200 and releases CSM of CU250 for services provided in H1 $(CU1,200 - CU200)/4$. At the end of H1 20X1, the entity carries forward a CSM of CU750.
- ▶ The entity incurs claims in H2 20X1 of CU300 (as originally expected) and, consequently, recognises a favourable experience adjustment in profit or loss of CU200 in its H2 interim financial statements.
- ▶ The entity releases CU250 from the CSM to profit or loss in H2 and carries forward a CSM of CU500 $(CU750 - CU250)$ at 31 December 20X1 in the interim financial statements.
- ▶ In summary, in 20X1 the entity recognises revenue of CU500, a positive experience adjustment in profit or loss of CU200 and carries forward a carrying amount for CSM of CU500 in both its interim financial statements for H2 20X1, as well as its annual financial statements for that year.

⁹⁷ IAS 34.28 and IFRIC 10.9

⁹⁸ IFRS 17.B137, BC236

Illustration 12 – CSM and interim reporting

If the entity maintained a CSM for annual reporting purposes independent of the CSM for interim reporting:

- ▶ There is no experience adjustment in the year – claims in 20X1 are as expected at 31 December 20X0.
- ▶ The entity would release CSM to profit or loss in the calendar year 20X1 of CU600 and would carry forward a CSM of CU600 (CU1,200 brought forward – CU600 release to P&L = CU600).
- ▶ In summary, the entity would recognise revenue of CU600 in 20X1 and carry forward a CSM of CU600 at 31 December 20X1.

IFRS 17 requires the entity in this example to include the change in estimate made in H1 for the purposes of its annual financial statements. The entity would have the same result and amount of CSM at 31 December 20X1 in its interim and annual financial statements.

[The example assumes there are no other changes in expectations and ignores accretion of interest for simplicity]

How we see it

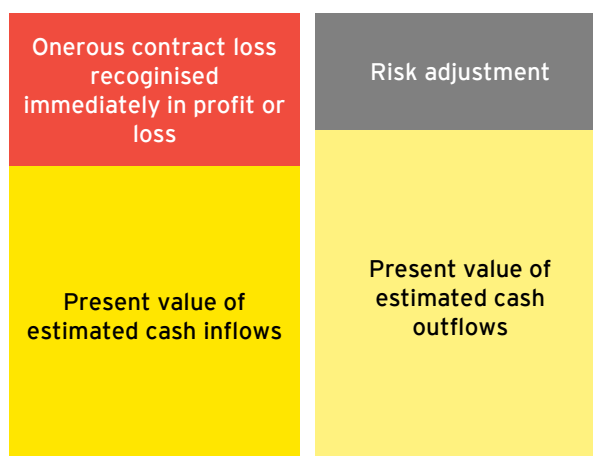
- ▶ The requirement not to change the treatment of accounting estimates made in previous interim financial statements is a significant exception from the requirements in IAS 34 Interim Financial Reporting. Entities may welcome this exception as a simplification that allows them to maintain a single CSM for interim and annual reporting. However, the consequence is that entities with different interim reporting periods, but are equal in all other aspects, are likely to report different results. Furthermore, for subsidiaries issuing their own IFRS financial statements, differences with the numbers reported for consolidation purposes are likely to emerge if the frequency of the reporting of a subsidiary's own financial statements differs from the reporting frequency of the consolidated accounts of the group.

11. Onerous contracts

11.1. Initial recognition

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 acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.



An entity must group contracts that are onerous at initial recognition separately from contracts in the same portfolio that are not onerous at initial recognition (see section 4). An entity must:⁹⁹

- ▶ Recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the CSM of the group equalling zero
- ▶ Establish a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised

A loss component is a notional record of the losses attributable to each group of onerous insurance contracts. The liability for the expected loss is included within the liability for remaining coverage for the onerous group (as it is within the fulfilment cash flows). It is necessary to keep a record of the loss component of the liability for remaining coverage to account for subsequent changes in the fulfilment cash flows of the liability for remaining coverage and to disclose separately their effect on the loss component (see section 18.1). The loss component determines the amount presented in profit or loss as a reversal of losses on onerous groups, and is excluded when determining insurance revenue (see section 17.3).¹⁰⁰

11.2. Subsequent measurement

A group of insurance contracts to which an entity applies the general model, becomes onerous (or more onerous) on subsequent measurement if unfavourable changes in the fulfilment cash flows allocated to the group arising

⁹⁹ IFRS 17.48

¹⁰⁰ IFRS 17.49

from changes in estimates of future cash flows relating to future service exceed the carrying amount of the CSM. (Onerous contracts to which an entity applies the premium allocation approach or the variable fee approach are discussed in sections 12.2 and 14.2.2, respectively).

After an entity has recognised a loss on an onerous group of insurance contracts, it should allocate subsequent changes in the liability for remaining coverage noted below between the loss component and the liability for remaining coverage, excluding the loss component, on a systematic basis.¹⁰¹

Changes in the liability for remaining coverage that are allocated on a systematic basis between the loss component and the remaining (non-loss) component are:¹⁰²

- ▶ 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 risk adjustment for non-financial risk recognised in profit or loss because of the release from risk
- ▶ Insurance finance income or expenses

As required by IFRS 17, the systematic allocation of these changes to the liability for remaining coverage should result in the total amounts allocated to the loss being equal to zero for a group of contracts by the end of the coverage period.¹⁰³

Subsequent increases or decreases in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows for future service should be allocated solely to the loss component until that component is reduced to zero. The decreases in fulfilment cash flows for future service, in excess of amounts that reduce the loss component of the liability for remaining coverage to nil, re-establish a CSM.

¹⁰¹ IFRS 17.50

¹⁰² IFRS 17.51

¹⁰³ IFRS 17.52

Illustration 13 – 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 CSM. 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. CU40 adjusts the loss component of the liability for remaining coverage by 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). The remaining loss component of CU 10 will be reduced to nil in future reporting periods.

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.
- ▶ 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, though other bases could be appropriate. Whichever approach is adopted, it should be applied consistently.
- ▶ Entities will need to track the loss component from formation through run-off during the remaining coverage period of a group of insurance contracts. This will be a new systems and process requirement for most insurers. Tracking the loss component is not equivalent to maintaining a negative CSM.

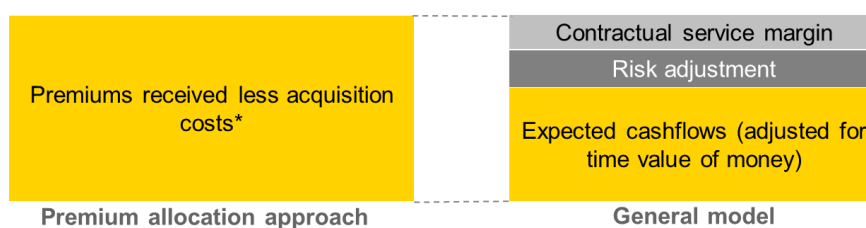
12. Premium allocation approach

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

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

- ▶ Simplified measurement of the liability for remaining coverage for groups of insurance contracts that are not onerous. The overall liability measurement of the premium allocation approach and the general model would be the same for groups of contracts that are onerous (see section 11 and 12.2 below).
- ▶ An option not to adjust future cash flows in the liability for incurred claims for the effect of the time value of money and financial risk if those cash flows are expected to be paid or received in one year or less from the date they are incurred (see 12.2 below).
- ▶ An option to recognise any insurance acquisition cash flows as expenses when these costs are incurred, provided that the coverage period of each contract in the group is no more than a year (rather than adjust the liability for remaining coverage) – see 12.2 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 section 11.

Liability for remaining coverage at initial recognition



* For groups of contracts that are not onerous and for which the entity chooses not to expense acquisition cash flows

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

- ▶ Presentation in the balance sheet
 - ▶ No separate asset is recognised for deferred acquisition costs. Instead, deferred acquisition costs are subsumed into the insurance liability for remaining coverage.

- ▶ No separate presentation of a premium receivable asset in the balance sheet under IFRS 17 (implicitly included in the insurance liability for remaining coverage)
- ▶ Measurement of the liability for remaining coverage includes an explicit risk adjustment for non-financial risk when a group of contracts is onerous
- ▶ Measurement of the liability for incurred claims includes an explicit risk adjustment for non-financial risk and is subject to discounting (an entity need not discount the liability for incurred claims if settlement is expected within a year)

12.1. Eligibility for 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:¹⁰⁴

- ▶ 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 CSM).
- ▶ The coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying the requirements discussed in section 7.1) 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. Therefore, 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”.

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:¹⁰⁵

- ▶ 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

An entity would need to consider all relevant facts and circumstances to assess whether measurement differences between the two approaches do not “differ materially”. Examples of factors that may result in measurement differences between the two approaches are:

- ▶ A difference between the pattern of recognition of the CSM over the coverage period under the general model and the recognition as insurance

¹⁰⁴ IFRS 17.53

¹⁰⁵ IFRS 17.54

revenue of expected premium receipts over the coverage period under the premium allocation approach (see 12.2 below)

- ▶ The effect of changes in discount rates during the coverage period

Illustration 14– 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 CSM is CU200 [CU2,000 – CU900 – CU900 = CU200].

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.

	CSM
	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

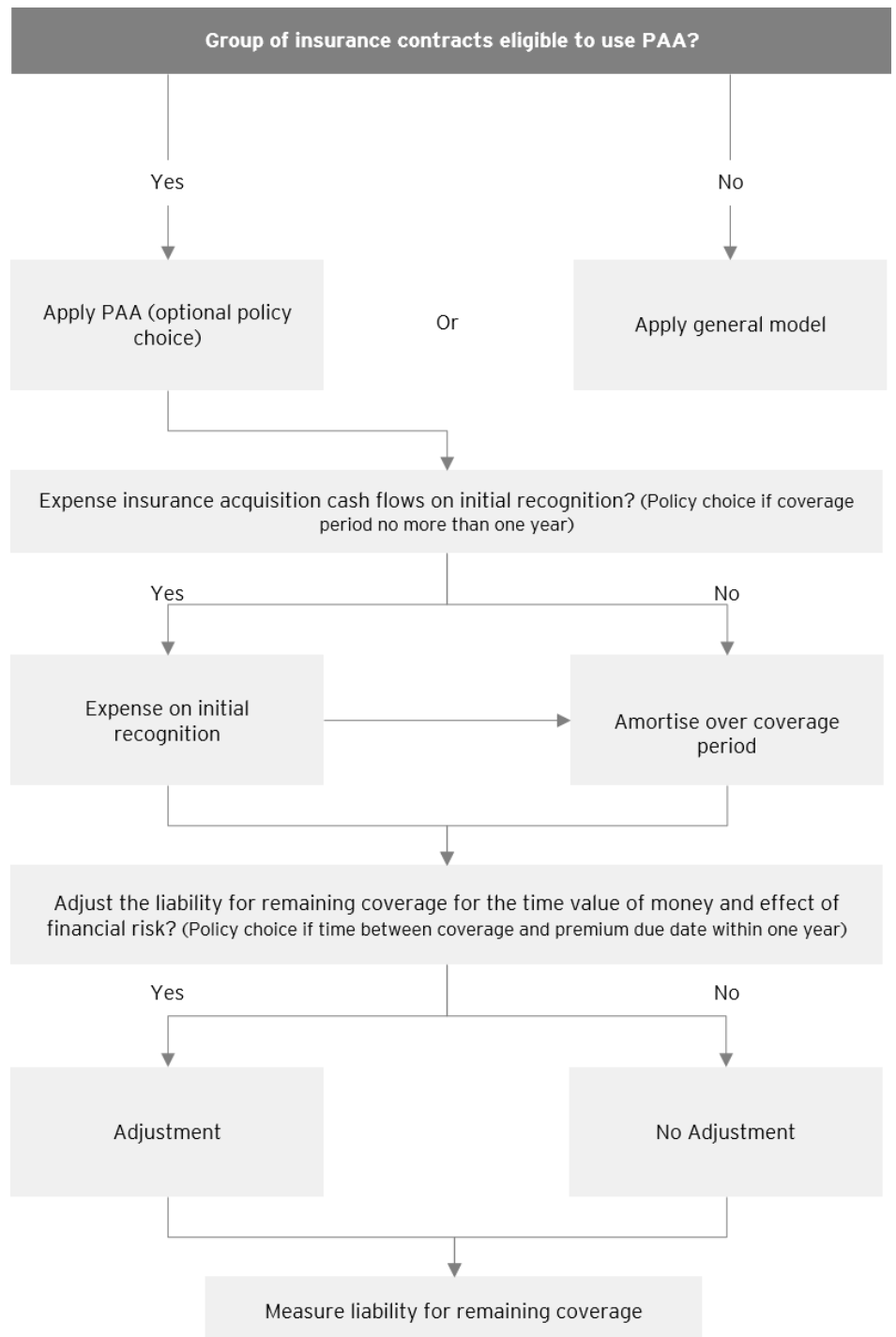
The liability for remaining coverage at the end of year 1, in accordance with the general model, would be CU950 + CU75 = CU1,025.

Revenue in year 1 would be CU975 [expected insurance service expense of CU900 + CSM release of CU75]. Revenue in year 2 would be CU1,025 [expected insurance service expense of CU950 + CSM release of CU75].

If the entity had applied the premium allocation approach, it would have allocated CU1,000 to profit or loss in 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 CSM 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).

The diagram below shows accounting policy choices that are available for groups of contracts measured in accordance with the premium allocation approach.



How we see it

- ▶ 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.

- ▶ The liability for remaining coverage under the premium allocation approach will be the same as the general model for groups of contracts that are onerous.
- ▶ Differences can arise subsequent to initial recognition for groups of contracts that are not onerous. Key differences in measurement of the liability for remaining coverage may be due to:
 - ▶ Differences in the pattern of release of the liability for remaining coverage to profit or loss as revenue. Allocation of the liability for remaining coverage for a group of contracts applying the premium allocation approach on the basis of expected timing of incurred insurance service expenses¹⁰⁶ may give a different result to the general model
 - ▶ Effect of changes in estimates of future cash flows that adjust the release of the contractual service margin in the current period (without a corresponding change in revenue under the premium allocation approach) – see illustration 14 above
 - ▶ Changes in discount rates (the liability for remaining coverage under the general model is measured using current rates at each reporting date (while, under the premium allocation approach, discount rates are not updated)
- ▶ Determining whether a difference in measuring the liability for remaining coverage under the two approaches is material will be a matter of judgement. IFRS 17 does not specify what it means for an entity to “reasonably expect” a particular outcome. In our view, an entity can demonstrate whether it reasonably expects that the liability for remaining coverage under the general model and the premium allocation approach is not materially different by comparing the outcomes under a range of reasonable scenarios. These scenarios will reflect changes in expected cash flows, risk adjustment and discount rates during the coverage period. We anticipate that market practice will develop to help preparers and users of financial statements to interpret this requirement.

12.2. Measurement of the liability for remaining coverage

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:¹⁰⁷

- ▶ The premium, if any, received at initial recognition
- Minus

¹⁰⁶ IFRS 17 B126

¹⁰⁷ IFRS 17.55

- ▶ 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, the asset or liability recognised for insurance acquisition cash flows that the entity pays or receives before the group of insurance contracts is recognised (see section 5)

For contracts that are onerous, the liability for remaining coverage is determined by the fulfilment cash flows, as described in Section 11. For these contracts, a loss component is established as the excess of the fulfilment cash flows over the amount calculated above.

Illustration 15 – 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 2021 that have a coverage period of 10 months ending 30 April 2022. The annual reporting period ends 31 December each year and the entity prepares interim financial statements as of 30 June.

On initial recognition, the entity receives a premiums of CU1,220 and pays directly attributable acquisition cash flows of CU20. No contracts are expected to lapse during the coverage period and the 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). Furthermore, the entity chooses to recognise the insurance cash flows as an expense when it incurs the relevant costs. For simplicity, all other amounts, including the investment component, are disregarded.

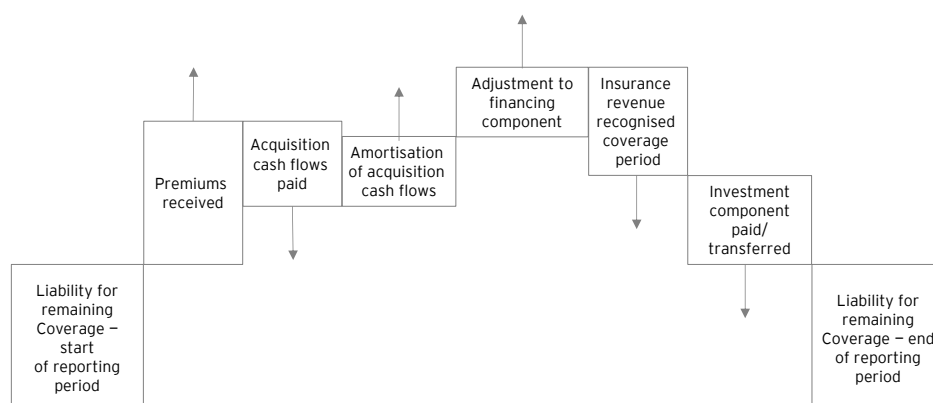
On initial recognition, the liability for remaining coverage is CU1,220 (i.e., the premium received of CU1,220 on XXX).

At the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:¹⁰⁸

- ▶ 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
- ▶ 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

¹⁰⁸ IFRS 17.55(b)

- ▶ Plus any adjustment to a financing component, if any (see below)
- ▶ Minus the amount recognised as insurance revenue for coverage provided in that period
- ▶ Minus any investment component paid or transferred to the liability for incurred claims



If insurance contracts in the group have a significant financing component, an entity must adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using discount rates that reflect the characteristics of the cash flows of the group of insurance contracts at initial recognition. The entity is not required to adjust the carrying amount of 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 coverage and the related premium due date is no more than a year.¹⁰⁹

Illustration 16 – Measurement subsequent to initial recognition of a group of insurance contracts using the premium allocation approach

Assuming the same fact pattern as Illustration 15.

On initial recognition, the entity receives the premium 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 2021), the contract is still not expected to be onerous.

For the six-month reporting period ending on 31 December 2021, the entity recognises insurance revenue of CU732 (i.e., 60% of CU1,220). The insurance acquisition expenses of CU20 are recognised as insurance service expense (the entity has chosen to recognise the costs as incurred and not over the passage of time).

At 31 December 2021, the liability for remaining coverage is CU488 (i.e., CU 1,220 – CU 732 or 40% of CU1.220).

For the six-month reporting period ending 30 June 2022, the entity recognises the remaining CU488 as insurance revenue and there is no liability for remaining coverage at 30 June 2022.

¹⁰⁹ IFRS 17.56

If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity must calculate the difference between:¹¹⁰

- ▶ The carrying amount of the liability for remaining coverage applying the premium allocation approach

And

- ▶ The fulfilment cash flows that relate to remaining coverage of the group applying the general model. However, if the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk in applying the premium allocation approach, it shall not include such adjustments in the fulfilment cash flows

To the extent that the fulfilment cash flows described above exceed the carrying amount of the liability for remaining coverage by applying the premium allocation approach, the entity must recognise a loss in profit or loss and increase the liability for remaining coverage.¹¹¹

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 coverage on the basis of the passage of time. However, if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then the expected premium receipts must be allocated to each period of coverage on the basis of the expected timing of incurred insurance service expenses.¹¹² An entity should change the basis for allocating revenue between the passage of time and expected timing of incurred insurance service expense (and vice versa) if facts and circumstances change.¹¹³

In applying the premium allocation approach, an entity may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.¹¹⁴ If the entity is not able or chooses not to use the policy choice to recognise insurance acquisition cash flows as an expense, then the acquisition cash flows are included within the liability for remaining coverage. The effect of recognising insurance acquisition cash flows as an expense on initial recognition of group of insurance contracts is to increase the liability for remaining coverage on initial recognition and reduce the likelihood of any subsequent onerous contract loss. There would be an increased charge to profit or loss on initial recognition, due to expensing acquisition cash flows, offset by an increase in profit released over the coverage period.

¹¹⁰ IFRS 17.57

¹¹¹ IFRS 17.58

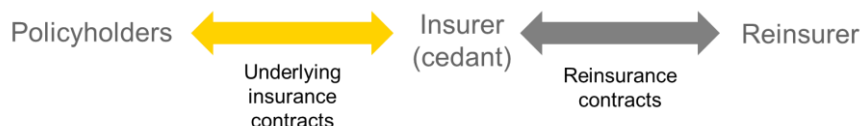
¹¹² IFRS 17.B126

¹¹³ IFRS 17.B127

¹¹⁴ IFRS 17.59

13. 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).



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.

A cedant measures reinsurance contracts it holds by applying a modified version of the general model or, if the contract is eligible, the premium allocation approach. The requirements of the general model are modified for reinsurance contracts held to reflect that:¹¹⁵

- ▶ 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
- ▶ Mismatches can arise from accounting for reinsurance contracts held separately from the underlying insurance contracts. The general model has been adjusted to reduce some of those mismatches.

The overall result of the modifications of the general model for reinsurance contracts held are that:

- ▶ Both day 1 gains and day 1 losses 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 any portion of a day 1 loss that relates to events before initial recognition. This is quite different from the accounting for (re)insurance contracts issued, where all day 1 losses are recognised in profit or loss immediately
- ▶ Assumptions used for measurement should be consistent with those for measurement of the underlying insurance contracts issued.
- ▶ Non-performance risk of the reinsurer should be included in the measurement of the performance cash flows (non-performance risk is not included within the measurement of the underlying insurance contracts issued).
- ▶ The risk adjustment for non-financial risk reflects the amount of risk transferred from the insurer to the reinsurer.

¹¹⁵ IFRS 17.BC302

- ▶ 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 arising on the underlying ceded contracts have been recognised in profit or loss. This would usually be the case when the underlying ceded contracts are onerous.

13.1. Level of aggregation

An entity should divide portfolios of reinsurance contracts held applying the same criteria as for insurance contracts issued discussed in section 4. If a portfolio of reinsurance contracts held includes more than one contract, it must be divided into one of the following:¹¹⁶

- ▶ 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 for which there is a net cost of purchasing reinsurance (i.e., a net outflow) with no significant possibility of a net gain arising subsequent to initial recognition, if any
- ▶ A group of the other contracts for which there is a net cost of purchasing reinsurance with a significant possibility of a net gain arising subsequent to initial recognition, if any

An entity is not allowed to group contracts purchased more than a year apart. A group of contracts is not reassessed after initial recognition. We believe that, for a number of reinsurance contracts (e.g., reinsurance treaties), a group will comprise a single contract.

13.2. Recognition

Instead of applying the recognition requirements for an insurance contract issued (see section 5), an entity should recognise a group of reinsurance contracts held:¹¹⁷

- ▶ 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
- ▶ In all other cases, from the beginning of the coverage period of the group

Proportionate coverage includes reinsurance contracts held to cover the losses of underlying contracts on a proportionate basis.¹¹⁸ Therefore, this refers to reinsurance contracts where the cash flows paid or received are a proportion of the cash flows from the underlying insurance contracts covered by the reinsurance arrangement. An example would be a quota share contract where a fixed percentage of premiums and claims from certain insurance contracts are paid to, or received from, the reinsurer. Proportionate reinsurance contracts could be written on a treaty basis where a reinsurer accepts a share of all

¹¹⁶ IFRS 17.61

¹¹⁷ IFRS 17.62

¹¹⁸ IFRS 17.BC304

policies written over a specified time period; or they could be facultative where they cover a specified risk or contract.

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 of that date.¹¹⁹

Illustration 17 – 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 claims from the underlying insurance contracts are ceded to the reinsurer. The reinsurance contract is considered a group for the purpose of aggregation and is effective 1 January 2021. The first underlying insurance contract is recognised on 1 February 2021.

As the reinsurance contract held provides proportionate coverage, the contract is recognised at the later of the beginning of the coverage period and the initial recognition of any underlying contract, i.e., 1 February 2021.

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.¹²⁰

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.¹²¹ An example of such a contract is one that provides cover for aggregate losses from a single event, excess of a predetermined limit and with a fixed payable premium.

Illustration 18 – Recognition of reinsurance contract held that does not provide proportionate coverage

An entity holds a reinsurance contract that 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 a group for the purpose of aggregation and is effective 1 January 2021. The first underlying motor insurance contract is recognised 1 February 2021.

As the reinsurance contract held does not provide proportionate coverage (because neither the premiums nor claims are a proportion of those from the underlying insurance contracts), the contract is recognised at the beginning of the coverage period, i.e., 1 January 2021.

¹¹⁹ IFRS 17.BC305(a)

¹²⁰ IFRS 17.BC304

¹²¹ IFRS 17.BC305(b)

How we see it

- ▶ The recognition requirements for reinsurance contracts held that provide proportionate coverage are meant to simplify recognition and measurement for proportionate reinsurance contracts held. Circumstances in which the first underlying attaching 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.

13.3. Measurement of reinsurance contracts held at initial recognition

A reinsurance contract held must be measured using the same criteria for fulfilment cash flows and CSM 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.¹²²

Fulfilment cash flows must also take into consideration that:

- ▶ 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.¹²³ 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.¹²⁴ The estimates of expected credit losses are based on expected values.
- ▶ The estimate of the risk adjustment for non-financial risk must be determined to represent the amount of risk being transferred by the holder of the group of insurance contracts to the issuer of those contracts.¹²⁵

The expected value measurement of credit losses is similar to the requirements of IFRS 9, which requires credit loss provisions for financial instruments on an expected loss basis. 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, credit losses have an expected value basis over the estimated lifetime of the contract using the guidance for expected values as part of the fulfilment cash flows (see section 7).

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

¹²² IFRS 17.63

¹²³ IFRS 17.63

¹²⁴ IFRS 17.BC308

¹²⁵ IFRS 17.64

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.

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 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. We think that 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 estimated reinsurance premiums and claim recovery cash flows.
- ▶ Many reinsurance contracts contain a break clause which allows either party to cancel the contract at any time following a 90-day notice period. This creates a contract boundary for any new business written by the cedant beyond the 90-day period from the reporting date. The question arises about how to treat what is effectively a rolling contract boundary in the next reporting period. Should coverage related to the period after the initial boundary be reported as new contracts, or do they reflect changes in assumptions about new business on the original contract? Allied to this question is which discount rate to use when determining the CSM for coverage beyond the initial boundary. Should this be the rate at inception of the contract, or a rate based on the revised boundary date?

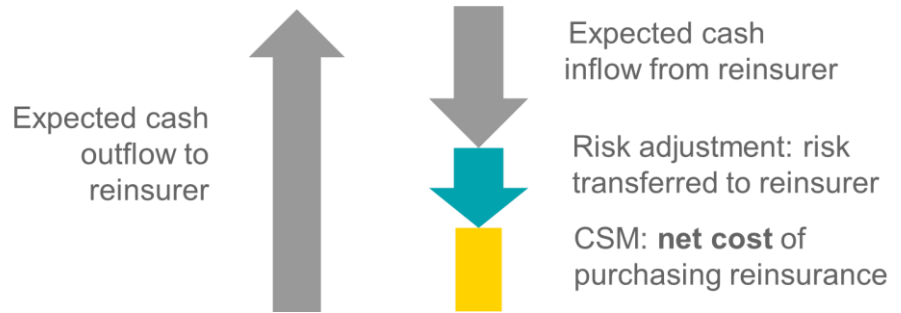
The CSM for reinsurance contracts held can be either a net cost or net gain of purchasing reinsurance for services yet to be received. In contrast, the CSM for insurance contracts issued can only be the unearned profit for services yet to be provided. This represents a modification to the general model for the purposes of measuring reinsurance contracts held.¹²⁶

An entity should recognise any net cost or net gain on purchasing a group of reinsurance contracts held as a CSM. It is measured at an amount equal to: the sum of the fulfilment cash flows, the amount derecognised at that date of any

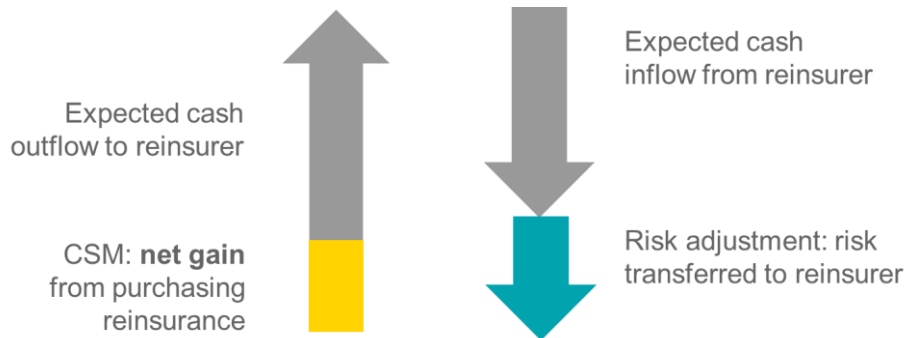
¹²⁶ IFRS 17.65

asset or liability previously recognised for cash flows for the group of reinsurance contracts held, and any cash flows arising at that date.

If expected cash outflows to a reinsurer exceed the sum of expected inflows and the risk adjustment, the CSM represents a net cost of purchasing reinsurance.



If expected cash inflows from the reinsurer plus the risk adjustment exceed expected outflows, the CSM represents a net gain of purchasing reinsurance.



An exception to measuring the CSM of a group of reinsurance contracts held occurs when the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts (retroactive reinsurance). In this case, the entity must recognise such a cost immediately in profit or loss as an expense.

Illustration 19 – 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 CU300m, covers 30% of each claim from the underlying reinsurance 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 flows for the group of the underlying insurance contracts, as shown in the table below.

	Underlying contracts	Reinsurance contracts
	CUm	CUm
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
CSM	(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 CU270m (i.e., 30% of CU900m). 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 CU18m (i.e., estimated to be 30% of 60).

The CSM 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 CSM is an asset.

If the premium was only CU260m, there would be a net gain of CU28m on purchasing the reinsurance (i.e., inflows of CU270m, plus the risk adjustment of CU18m less outflows of CU260m) and the CSM would represent a liability of CU28m to eliminate the net gain on inception.

13.4. Subsequent measure of reinsurance contracts held

Instead of applying the subsequent measurement requirements of the general model, an entity must measure the CSM at the end of the reporting period for a group of reinsurance contracts held:¹²⁷

Change in the carrying amount of the CSM of a group of reinsurance contracts held in a period	
A) CSM at the beginning of the period	X/(X)
B) Effect of new contracts added to the group	X/(X)
C) Interest accreted on the CSM in the period [measured at discount rates determined at the date of initial recognition of a group of contracts applicable to nominal cash flows that do not vary based on the returns on any underlying items]	X/(X)
D) Change in fulfilment cash flows relating 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 CSM for the group of underlying insurance contracts	X/(X)
E) Effect of currency exchange differences	X/(X)
F) Amount of CSM recognised in profit or loss because of services received in the period	(X)/X
G) CSM at the end of the period	X/(X)

Illustration 20 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12 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.

¹²⁷ IFRS 17.66

Illustration 20 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12 in the Illustrative Examples to IFRS 17, IE130-138]

Immediately before the end of year 1, 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)
CSM	100	(25)
Insurance contract liability (reinsurance contract asset) immediately before the end of year 1	400	(115)

In this example, the difference between the CSM 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.

At the end of year 1, the entity recalculates its estimates of the fulfilment cash flows of the underlying group of contracts and estimates an increase of CU50m and a decrease in the CSM by the same amount (the group of underlying insurance contracts is not onerous). As a result, the entity increases the fulfilment cash flows of the reinsurance contract held by 30% of the change in fulfilment cash flows of the underlying group of insurance contracts (CU15 = 30% of CU50). The CSM is adjusted by the whole amount of the change in the fulfilment cash flows because the whole change of the fulfilment cash flows allocated to the group of underlying contracts adjusts the CSM of those underlying contracts.

Therefore, at the end of year 1, the entity measures the insurance contracts liabilities 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)
CSM	50	(10)
Insurance contract liability/(reinsurance contract asset) at the end of year 1	400	(115)

Illustration 20 – Measurement subsequent to initial recognition of groups of reinsurance contracts held [Example 12 in the Illustrative Examples to IFRS 17, IE130-138]

These changes do not affect estimates of profit or loss as all changes in the fulfilment cash flows go to the CSM. The result would differ slightly if the change in the underlying fulfilment cash flows did not wholly affect the CSM.

Suppose, at the end of year 1, the entity estimates an increase in the fulfilment cash flows of the underlying group of insurance contracts of CU160m. This change makes the group of underlying insurance contracts onerous and the entity decreases the original CSM of CU100m to zero and recognises the remaining CU60m as a loss. As a result, the entity increases the fulfilment cash flows of the reinsurance contract held by CU48m (i.e., 30% of CU160). The entity then adjusts the CSM of the reinsurance contract held for the change in fulfilment cash flows that relate future service to the extent this change results from a change in the fulfilment cash flows of the group of the underlying insurance contracts that adjusts the CSM for that group.

Consequently, the change in the fulfilment cash flows of the reinsurance contract held of CU48m are recognised by adjusting the CSM of the reinsurance contract for the equivalent of the change in the fulfilment cash flows that adjusts the CSM of the underlying contracts. This results in a reduction of the CSM by CU30m (i.e., 30% of CU100), represents a CSM asset and the remaining change in the fulfilment cash flows of the reinsurance contract held, CU18m (i.e., 48m-30m) is recognised immediately in profit or loss.

Therefore, at the end of year 1, using these alternative estimates, the entity measures the insurance contract liabilities 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)
CSM	–	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 1	60	18

13.4.1. Exception to general principle for adjusting the CSM

There is an exception to the general principle of adjusting the CSM when changes in fulfilment cash flows for reinsurance contracts held represent future service from the reinsurer. If the change in reinsurance contract cash flows relate to changes in fulfilment cash flows allocated to a group of underlying insurance contracts that are recognised in profit or loss, rather than adjusting the CSM of the underlying insurance contracts, the change in reinsurance contract cash flows is also recognised in profit or loss. This exception to the general principle aims to avoid an accounting mismatch in profit or loss between the accounting for changes in expected cash flows for underlying insurance contracts an entity issues and reinsurance contracts it holds.

How we see it

- ▶ Changes in fulfilment cash flows relating to future service to groups of underlying insurance contracts are recognised immediately in profit or loss (rather than being offset against the CSM) when the underlying groups of contracts are onerous. Insurers will need to identify the extent to which changes in fulfilment cash flows for reinsurance contracts held relate to corresponding changes in underlying contracts recognised in profit or loss. This will require a means of allocating changes in fulfilment cash flows of an onerous group of underlying contracts to those that are protected by reinsurance. This might not be straightforward, e.g., when only some of the underlying contracts in a group are reinsured by a particular group of reinsurance contracts held. An entity might choose to subdivide groups of issued contracts and/or groups of reinsurance contracts held in order to facilitate matching.
- ▶ The general model is designed to avoid mismatches in profit or loss arising from subsequent measurement of insurance contracts an entity issues and changes in fulfilment cash flows of reinsurance contracts held. Mismatches in profit or loss between onerous insurance contracts and corresponding reinsurance contracts held may, however, occur at initial recognition. The effect of this mismatch at initial recognition will affect subsequent reporting periods too as the CSM on the reinsurance contracts is released to profit or loss over time, without a corresponding release on the underlying direct contracts.

13.4.2. Release of the CSM for reinsurance contracts held

The CSM is released to profit or loss as the insurer receives coverage from the reinsurer. Generally, the period in which the reinsurer renders services is the coverage period of the reinsurance contract. This is the time when insured events within the reinsurance contract can occur and is determined by the boundary of the reinsurance contract held.

Illustration 21 – 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.

13.5. Premium allocation approach for reinsurance contracts held

An entity may use the premium allocation approach (see section 12), 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:¹²⁸

- ▶ 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

- ▶ 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

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:¹²⁹

- ▶ 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

Assessment of eligibility for reinsurance contracts held to the premium allocation approach is independent of whether the entity applies the premium allocation approach to the underlying insurance contracts it issues. Reinsurance contracts written on a 12-month risk-attaching basis (i.e., the underlying insurance contracts subject to the reinsurance contract issued over a 12-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.

¹²⁸ IFRS 17.69

¹²⁹ IFRS 17.70

How we see it

- ▶ We believe that one-year 'risks attaching' reinsurance contracts have a coverage period of more than one year, because the coverage is provided on all direct contracts written by a cedant in that underwriting year. A one-year 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 for up to two years. This means that these contracts will not meet the requirements to use the premium allocation approach by definition. Therefore, risks attaching reinsurance contracts would have to qualify for the premium allocation approach on the basis that the resulting measurement of the liability for remaining coverage would not differ materially from the result of applying the general model. A mismatch in measurement models may arise if the underlying contracts are accounted for under the premium allocation approach while the reinsurance contract has to use the general model.

14. Measurement of contracts with participation features

Entities that issue participating contracts (referred to in the standard as contracts with participation features) provide policyholders with a financial return on the premiums they pay by sharing the performance of underlying items with policyholders. 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

The cash flows of some contracts can affect the cash flows to other contracts via a process sometimes referred to as "mutualisation".

IFRS 17 includes an adaptation to the general model to cater for some of these features. It distinguishes two types of contracts with participation features that are eligible for modifications to the general model: insurance contracts with direct participation features; and investment contracts with discretionary participation features. Direct participation features and discretionary participation features are explained below (see 14.2 and 14.4).

Insurance contracts with direct participation features apply a modified version of the general model called the variable fee approach (14.2 below). Insurance contracts without direct participation features must apply the general model without adaptation even though such contracts may have participation features (see 14.1 below). Participating contracts are not excluded from applying the premium allocation approach, but they may be unlikely to meet the eligibility criteria (as the coverage period may be significantly in excess of one year).

Participating contracts

There is a wide variety of participating contracts in issue worldwide. For example, in Germany, insurance companies must return at least 90% of the investment profits on certain contracts to the policyholders, but may give more. In other European countries, realised investment gains are distributed to the policyholder, but the insurance company has discretion over the timing of realising the gains. In the United Kingdom, bonuses are added to the policyholder account at the discretion of the insurer. Typically, these are based on the investment return generated by the underlying assets, but sometimes they include allowance for profits from other contracts.

Participation in underlying items can be discretionary (e.g., in the case of with-profit or universal life contracts); or they can be non-discretionary (e.g., in the case of unit linked contracts, where all returns on underlying items are paid to policyholders without the exercise of discretion).

For IFRS 17 measurement purposes the distinction between contracts with direct participation features, and those without direct participation features is important.

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 different measurement models.

14.1. 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 CSM. 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.

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 CSM) and the effect of discretionary changes to that commitment (which adjust the CSM) – see section 6.1.

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.

Illustration 22 – Adjust the CSM 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 CSM 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 ($CU1,000 \times 1.07^5 = CU1,403$)
- ▶ Measures fulfilment cash flows at the reporting date of CU912 ($CU1,403 \div 1.09^5 = CU912$)

Illustration 22 – Adjust the CSM for the effects of a change in discretionary cash flows

- ▶ Maintains the CSM of the group of contracts at CU88 because the measurement of fulfilment cash flows has not changed (assume accretion of interest and release of CSM 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 CSM 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 ($CU912 - CU956 = -CU44$, CSM of CU88 – CU44 = CU44)

14.2. Contracts with direct participation features

Insurance contracts with direct participation features apply a modified version of the general model called the variable fee approach. One of the concerns that respondents had with the application of the general model to insurance contracts with participation features was that it could result in the reporting of artificial volatility in profit or loss. This volatility could arise from a mismatch between the accounting treatment of investment gains and losses on underlying items attributable to policyholders, and the accounting treatment of the liability to those policyholders. The requirement in the general model to report the impacts of all changes in financial assumptions in comprehensive income (rather than by adjusting the CSM) was also considered to create artificial profit volatility in cases where the returns from underlying items would be paid to policyholders.

The variable fee approach therefore addresses these concerns by adjusting the general model as explained in section 14.2.2 below.

Insurance contracts with direct participation features (direct participating contracts) 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, on inception all of the following apply:¹³⁰

- ▶ The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items.

¹³⁰ IFRS 17.B101

- ▶ The entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns from the underlying items.
- ▶ 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.

The variable fee approach considers the share that an entity has of the underlying items to represent a fee for investment and other services that it provided to the policyholders. An entity can have a share in the fair value of underlying items through a number of mechanisms. For example, it may maintain an account balance for each policyholder to which it credits premiums paid and returns from underlying items and deducts charges that are a proportion of the underlying items or a proportion of the returns on the underlying items. The entity's interest in underlying items is not treated as equivalent to a direct holding in those underlying items in the variable approach, but as a variable fee that the entity charges the policyholder, expressed as a share of the fair value of the underlying items.

An entity's obligation to the policyholder in contracts with direct participation features is considered to be the net amount of:¹³¹

- ▶ An obligation to pay the policyholder an amount equal to the fair value of the underlying items
- And
- ▶ A variable fee the entity will deduct from the fair value of underlying items comprising the entity's share of the fair value of underlying items, less fulfilment cash flows that do not vary based on the returns on underlying items
 - ▶ Since the entity's share in the underlying items is considered a variable fee for investment management and other services, changes in the expected value of this fee for services to be provided in the future are adjusted against the contractual service margin

14.2.1. Assessing eligibility for the variable fee approach

An entity assesses whether a contract has direct participation features using its expectations at inception of the contract and does not reassess the conditions, unless the contract is modified.¹³²

A contractual right for policyholders to participate in a clearly identified pool of underlying items can arise from the terms of the contract or from law or regulation. The key point is that the policyholder's right to participate in the returns of the pool of underlying items is enforceable.¹³³

Underlying items are defined as items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items, for example, a reference portfolio of assets, net assets of the entity, or a specified subset of the entity's net assets. An entity does not need to hold the underlying

¹³¹ IFRS 17.B104

¹³² IFRS 17.B102

¹³³ IFRS 17.B105

items to be eligible for the variable fee approach. However, whether an entity holds the underlying item or not is relevant to the presentation of insurance finance income and expense (see section 17.6).

A clearly identified pool of underlying items does not exist when:¹³⁴

- ▶ 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 those of a subset of assets the entity holds.

To treat an entity's share in underlying items as a fee, analogous to fees charged by an investment manager in an investment management contract, IFRS 17 requires that the entity should expect:

- ▶ To pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying items.
- ▶ A substantial proportion of any changes in the amounts to be paid to the policyholders to vary with the changes in the fair value of underlying items.

IFRS 17 provides guidance that the term "substantial" in both requirements should be considered 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. An entity's expectations | of the proportion of changes in the fair value of underlying items accruing to policyholders in different scenarios is considered over the duration of the group of insurance contracts on a present value probability-weighted average basis.¹³⁵

For example, if 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:¹³⁶

- ▶ Cash flows that the entity expects to pay to the policyholder vary with 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.
- ▶ 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 of contracts that include such guarantees will reflect a present value probability-weighted average of all scenarios.

¹³⁴ IFRS 17.B106

¹³⁵ IFRS 17.B107

¹³⁶ IFRS 17.B108

How we see it

- ▶ Participating contracts differ significantly between jurisdictions. Not all participating contracts will meet the criteria to be accounted for as direct participation contracts. 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, for example, minimum return guarantees and guaranteed annuity options. The impact of options and guarantees 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. 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.

An entity is not permitted to use the variable fee approach for reinsurance contracts held or to apply that approach to reinsurance contracts issued.¹³⁷

14.2.2. *Subsequent measurement of the CSM in accordance with the variable fee approach*

The variable fee approach differs from the general model in the measurement of the CSM subsequent to initial recognition of a group of contracts.

¹³⁷ IFRS 17.B109, BC248-249

For a group of insurance contracts with direct participation features, the carrying amount of the CSM of the group at the end of the reporting period equals the carrying amount at the beginning of the reporting period adjusted, as follows:¹³⁸

Change in the carrying amount of the CSM in a period under the VFA	
A) CSM at the beginning of the period	X
B) Effect of new contracts added to the group	X
C) Entity's share of the change in the fair value of underlying items (see exceptions and alternative calculation below)	X/(X)
D) Change in fulfilment cash flows relating to future service (see exceptions and alternative calculation below)	X/(X)
E) Effect of currency exchange differences	X/(X)
F) Amount of CSM recognised in profit or loss as insurance revenue because of the transfer of services in the period	(X)
G) CSM at the end of the period	X

An entity's share of the change in the fair value of underlying items reflects changes in the fair value of underlying items and changes in the proportion of underlying items the entity expects to receive, e.g., in the form of future charges it expects to deduct from policyholder account balances. The entity's expected share of underlying items would change if it changes its assumptions regarding, inter alia, the expected duration (persistence) of contracts.

The entity adjusts the carrying amount of the CSM at the beginning of a reporting period by the entity's share of the change in the fair value of underlying items, except to the extent that:¹³⁹

- ▶ The entity applies the risk mitigation exception for risks arising from its share of the fair value return on underlying items (see 14.2.3 below),
- ▶ The entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the CSM, giving rise to a loss recognised as part of the insurance service result (the group is or becomes onerous in the period), or
- ▶ The entity's share of an increase in the fair value of the underlying items reverses losses recognised in prior periods.

The entity adjusts the carrying amount of the CSM at the beginning of a reporting period by the changes in fulfilment cash flows relating to future service, except to the extent that:¹⁴⁰

¹³⁸ IFRS 17.45

¹³⁹ IFRS 17.45(b)

¹⁴⁰ IFRS 17.45(c)

- ▶ The entity applies the risk mitigation exception in respect of financial guarantees (see 14.2.3 below),
- ▶ Increases in the fulfilment cash flows exceed the carrying amount of the CSM, giving rise to a loss as part of the insurance service result (the group is, or becomes, onerous in the period), or
- ▶ Decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage.

An entity is not required to identify the adjustments to the CSM separately. For example, an entity can combine items (C) and (D) in the table above and achieve the same net adjustment to the CSM of a group of contracts as:¹⁴¹

- ▶ The change in the total fair value of the underlying items (equals the change in the entity's share plus the obligation to pay to the policyholders their share of the fair value of the underlying items).
- ▶ The change in the total fulfilment cash flows in the period (equals the change in fulfilment cash flows relating to future service plus the obligation to pay to the policyholders their share of the fair value of the underlying items).

How we see it

- ▶ Calculating the total change in the fair value of underlying items and the total change in fulfilment cash flows in a period might be easier administratively than separating the policyholder's share of the change in the fair value of underlying items from each of these ("gross") items. 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.

¹⁴¹ IFRS 17.B114

Except in situations when a group of contracts is onerous, or to the extent the entity applies the risk mitigation exception (see 14.2.3 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"> ▶ Change in the carrying amount of fulfilment cash flows arising from the time value of money and financial risk ▶ Accretion of interest on the CSM at rate locked at initial recognition ▶ Any difference between the present value of a change in fulfilment cash flows measured at current rates and locked rates that adjust the CSM 	▶ Change in the fair value of underlying items
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 ¹⁴²	Adjusts the CSM ¹⁴³
Discount rates for accretion of, and adjustment to, the CSM	Rates determined at initial recognition	Rate included in the balance sheet measurement (i.e., current rates) ¹⁴⁴

14.2.3. Mitigating financial risks with derivatives

Amounts payable to policyholders 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.¹⁴⁵

For contracts with direct participation features, the CSM is adjusted for the changes in the fulfilment cash flows, including changes that the derivatives are intended to mitigate (unlike contracts without direct participating features

¹⁴² IFRS 17.87-89

¹⁴³ IFRS 17.87(c), B113(b)

¹⁴⁴ IFRS 17.B113(a)

¹⁴⁵ IFRS 17.BC250

where the CSM is not adjusted for such changes). Consequently, the change in the value of the derivative would be recognised in profit or loss. However, unless the group of insurance contracts was onerous, there would be no equivalent charge or credit in profit or loss to reflect changes in the carrying amount of the fulfilments cash flows, creating an accounting mismatch. A similar accounting mismatch arises if the entity uses derivatives to mitigate risk arising from its share of the fair value return on underlying items.¹⁴⁶

An entity can choose not to adjust the CSM to reflect some or all of the changes to fulfilment cash flow or the entity's share of underlying items resulting from financial risk.¹⁴⁷ The choice is only permitted if the entity has a previously documented risk management objective and strategy for using derivatives to mitigate financial risk arising from insurance contracts and, in applying that objective and strategy:¹⁴⁸

- ▶ The entity uses a derivative to manage the financial risk arising from the insurance contracts.
- ▶ An economic offset exists between the insurance contracts and the derivative; i.e., the values of the insurance contract and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity must not consider accounting measurement differences in assessing the economic offset.
- ▶ Credit risk does not dominate the economic offset.

If any of the conditions above are no longer met, an entity must not apply the risk mitigation accounting from that date, nor make any adjustments for changes previously recognised in profit or loss.¹⁴⁹

¹⁴⁶ IFRS 17.BC251-253

¹⁴⁷ IFRS 17.B115

¹⁴⁸ IFRS 17.B116

¹⁴⁹ IFRS 17.B118

How we see it

- ▶ The exemption, in the case of risk mitigation, from the requirement of the variable fee approach to adjust the CSM 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 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” to be excluded from CSM when determining the effects from financial risks to report in profit or loss.
- ▶ The standard does not explain how the change in the fulfilment cash flows related to the financial risks covered by the risk mitigation approach should be presented. The objective of the risk mitigating approach is to avoid mismatches in profit or loss arising from the profit and loss treatment of the derivatives used for risk mitigation. Therefore, presenting the identified changes in the fulfilment cash flows as part of insurance finance income or expense would be logical.

14.3. Contracts with cash flows that can affect, or be affected by, the cash flows to other contracts

The cash flows of some contracts can affect the cash flows to other contracts via a process sometimes referred to as “mutualisation”. Contracts are mutualised if they 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. Some contracts require the policyholder to share the returns on some specified pool of underlying items with policyholders of other contracts and, either:¹⁵⁰

- ▶ The policyholder bears a reduction in the 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.

If the contracts are in different groups, the fulfilment cash flows of each group reflect the extent to which cash flows of a group are affected by cash flows to policyholders in other groups. The fulfilment cash flows for a group:¹⁵¹

- ▶ 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.

¹⁵⁰ IFRS 17.B67

¹⁵¹ IFRS 17.B68

- ▶ Exclude payments to policyholders in the group that have been included in the fulfilment cash flows of another group.

Illustration 23 – Modification of an insurance contract [IFRS 17.B69]

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). The fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.

Different practical approaches may 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 must allocate the effect of the change in the underlying items to each group on a systematic and rational basis.¹⁵²

After all coverage has 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 required to continue to allocate such fulfilment cash flows to specific groups, but instead, may recognise and measure a liability for such fulfilment cash flows arising from all groups.¹⁵³

¹⁵² IFRS 17.B70

¹⁵³ IFRS 17.B71

How we see it

- ▶ Entities should be aware that “mutualisation” only applies in the specific circumstances where policyholders have subordinated their claims to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk. 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 direct participating contracts, so, in principle, it could apply to other types of participating contracts too. However, meeting the contractual criteria of mutualisation will arguably be more challenging the more the contract features are dissimilar to those of a direct participating contract.
- ▶ 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 CSM over the coverage period.

14.4. Investment contracts with discretionary participation features

An investment contract with discretionary participation features does not contain significant insurance risk. Nevertheless, these contracts are within the scope of IFRS 17, provided the entity also issues insurance contracts.¹⁵⁴

A financial instrument 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:

- ▶ 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
- And
- ▶ That are contractually based on:

¹⁵⁴ IFRS 17.3(c)

- ▶ 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 contract¹⁵⁵

As investment contracts without discretionary participation features do not transfer insurance risk, IFRS 17 requires certain modifications:¹⁵⁶

- ▶ The date of initial recognition is the date 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 (see section 5).
- ▶ The contract boundary (see section 7.1) 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 CSM is modified so that the entity recognises the CSM over the duration of a group of contracts in a systematic way that reflects the transfer of investment services under the contract.

How we see it

- ▶ The release of the CSM for investment contracts with discretionary participation features is not driven by coverage units (see section 10.2.4), but by investment services provided over the life of the contracts. It appears as if 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 may make sense for this to be consistent with other investment management contracts.

¹⁵⁵ IFRS 17 Appendix A

¹⁵⁶ IFRS 17.71

15. 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.¹⁵⁷

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.

15.1. 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.¹⁵⁸

- ▶ 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 3) 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 7.1).
 - ▶ 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 4).
- ▶ 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 12) 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. The standard clarifies that the exercise of a right included in the terms of a contract is not a modification.

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. See sections 11.2 and

¹⁵⁷ IFRS 17.B25

¹⁵⁸ IFRS 17.72

14.2.3 for the accounting for changes in the fulfilment cash flows. Accounting for derecognition of a modified contract is discussed in 15.3 below.

How we see it

- ▶ The guidance on contract modification and derecognition under IFRS 17 is likely to be different from current practices applied under IFRS 4. Entities should also consider whether changes to the terms and conditions of contracts prior to the transition date exist that would result in modification or derecognition of that contract. Such events could have a significant impact on the CSM on transition. (Refer to Section 19 for more details on the requirements on transition to the new standard).

15.2. Derecognition of insurance contracts

An insurance contract is derecognised when, and only when:¹⁵⁹

- ▶ 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 15.1)

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.¹⁶⁰

15.3. Accounting for derecognition

There are three different ways to treat the derecognition of a contract, depending on the circumstances: extinguishment (see 15.3.1), transfer (see 15.3.2) or modification (see 15.3.3).

15.3.1. Derecognition resulting from extinguishment

An entity derecognises an insurance contract from within a group of insurance contracts by applying the following requirements:¹⁶¹

- ▶ 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.

¹⁵⁹ IFRS 17.74

¹⁶⁰ IFRS 17.75

¹⁶¹ IFRS 17.76

- ▶ The CSM 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 11.2 (for contracts without direct participation features) and 14.2 (for contracts with direct participation features).
- ▶ The number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the CSM recognised in profit or loss in the period is based on that adjusted number to reflect services provided in the period.

In practice, derecognition resulting from extinguishment will mostly occur on contracts where a CSM (or liability for remaining coverage) no longer exists. 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, and it may be unable to derecognise those liabilities. In the IASB's view, 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, when the entity has no information to suggest there are unasserted claims on a contract with an expired coverage period, it is expected that 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.¹⁶²

15.3.2. Derecognition resulting from transfer

When an entity derecognises an insurance contract because it transfers the contract to a third party, the entity must:¹⁶³

- ▶ Adjust the fulfilment cash flows allocated to the group for the rights and obligations that have been derecognised, as discussed at 15.3.1.
- ▶ Adjust the CSM 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 CSM 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.

In addition, when an entity derecognises an insurance contract because it transfers that contract to a third party:

- ▶ It must reclassify to profit or loss any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income as a result of its accounting policy choice to disaggregate the finance income or expenses of a group of insurance contracts. This means that the OCI balance remaining is released to profit and loss.

¹⁶² IFRS 17.BC322

¹⁶³ IFRS 17.77

- ▶ However, if an entity holds the underlying items and, accordingly, uses the current period book yield approach for contracts with direct participation features (see section 17.6), it must not make any reclassification to profit and loss of remaining amounts for the group (or contract) that were previously recognised in other comprehensive income¹⁶⁴

15.3.3. 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 15.1 above, the entity must:¹⁶⁵

- ▶ Adjust the fulfilment cash flows allocated to the group relating to the rights and obligations that have been derecognised, as discussed in 15.3.1 above.
- ▶ Adjust the CSM 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).
- ▶ Measure the new contract recognised, assuming that 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.

¹⁶⁴ IFRS 17.91

¹⁶⁵ IFRS 17.77

Illustration 24 – 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

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 CSM of the group from which the modified contract is derecognised (20 + 100 – 112)		8
Recognition of fulfilment cash flows of modified contract		105
Adjustment to the CSM of the group that the modified contract joins (112 – 105)		7

When an entity derecognises an insurance contract due to a modification and recognises a new one, it should treat any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income in the same way as described for derecognitions resulting from transfer (see Section 15.3.2).

How we see it

- ▶ The guidance on contract modification and derecognition under IFRS 17 is likely to be different from current practices applied under IFRS 4. Entities should also consider whether changes to the terms and conditions of contracts prior to the transition date exist that would result in modification or derecognition of that contract. Such events could have a significant impact on the CSM on transition. (Refer to Section 19 for more details on the requirements on transition to the new standard).

IFRS 17 does not explicitly provide guidance on derecognition and modification of contracts in a group to which the entity applies the premium allocation approach. Therefore it appears that the principles relating to groups of contracts accounted for under the general model would be applied by analogy.

16. 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 *Business Combinations*.

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 that date.

16.1. Business combinations

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,¹⁶⁶ resulting in key differences for insurance contracts acquired in a business combination compared with the accounting used previously under IFRS 4, as follows:

- ▶ Contracts are classified and grouped based on the contractual terms, economic conditions, operating or accounting policies and other pertinent factors and conditions as they exist at the acquisition date.¹⁶⁷ 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. This exception in IFRS 3 is withdrawn when IFRS 17 is applied.
- ▶ 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 (i.e., 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, commonly referred to as "Value of Business Acquired").

¹⁶⁶ IFRS 3.31A

¹⁶⁷ IFRS 3.15

How we see it

- ▶ In our preliminary view, the consequential amendments to IFRS 3 require that, in a business combination, an entity should classify contracts (i.e., assess significant insurance risk in a contract) based on the contractual terms and other factors at the date of acquisition, rather than the original inception date of the contract. In our provisional view, this also implies that other assessments, such as eligibility for the variable fee approach for direct participation contracts or the premium allocation approach (see sections 14.2 and 12.1, respectively) 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, 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 include the acquiree and the separate financial statements of the acquiree. However, this would reflect that the acquirer has purchased investment contracts rather than insurance contracts.
- ▶ Rights to issue or renew contracts in the future (as opposed to existing insurance contracts) would not be part of the consideration paid or received for the contracts at the acquisition date. These separate intangible assets would have to be accounted for under IAS 38.

IFRS 17 requires an entity to treat the consideration received or paid for insurance contracts acquired in a business combination, including contracts in their settlement period, as a proxy for the premiums received. Thus, the entity determines the CSM in accordance with all other requirements of IFRS 17 in a way that reflects the premium paid for the contracts. In a business combination, 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 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 (i.e., a demand deposit floor).¹⁶⁸

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.¹⁶⁹

For acquired insurance and reinsurance contracts measured using the general model, on initial recognition (i.e., acquisition) the CSM is calculated using the requirements described in sections 10 and 13, respectively. If insurance contracts acquired in a business combination are onerous at the date of acquisition, 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.¹⁷⁰

¹⁶⁸ IFRS 17.B94

¹⁶⁹ IFRS 17.B94

¹⁷⁰ IFRS 17.B95

If the premium allocation approach applies to insurance contracts acquired in a portfolio transfer or business combination, then the premium received is applied to determine the initial carrying amounts of the liability for remaining coverage and the liability for incurred claims.

If facts and circumstances indicate that a contract is onerous, the difference between the carrying amount of the liability for remaining coverage (as determined by applying the paragraph above) and the fulfilment cash flows that relate to the remaining coverage should be treated in 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).

Investment contracts within the scope of IFRS 9 are measured initially at fair value when acquired in a business combination.

Illustration 25 – 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 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
CSM	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 CSM as the difference between the deemed premium (30) and the fulfilment cash flows (20). Consequently, in Example A the CSM is 10 and the total insurance contract liability is equal to the deemed premium.

Illustration 25 – 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]

In Example B, the fulfilment cash flows exceed the deemed premium. Consequently, the CSM is zero and the excess of the fulfilment cash flows (45) over the deemed premium (30) is an adjustment against goodwill since there cannot be a loss on initial recognition of a business combination.

How we see it

- ▶ In our preliminary view, the assessment as to whether a contract is eligible for the PAA should take place at the date of the transfer, consistent with any other assessment. Such assessment is expected to result in many of the liabilities for incurred claims becoming liabilities for remaining coverage for the acquirer. This is because the discovery of the loss, or the amount for that loss, for a past event would represent the insured event as a result of the transfer (and thus the service that the acquirer is providing). In case of long-tail settlements, these contracts are unlikely to qualify for the PAA and, in that case, would need to be accounted for under the general model.

16.1.1. 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).¹⁷¹ IFRS 17 does not make any distinction between business combinations under common control and other business combinations. This raises the question as to whether insurance contracts acquired in a common control business combination should be recognised and measured by the acquirer based on the conditions at the date of acquisition (as for a business combination within the scope of IFRS 3 discussed in 16.1 above), or whether some form of predecessor accounting (also referred to as pooling of interests or merger accounting) can be used.

How we see it

- ▶ In our preliminary view, the requirements above for business combinations were intended to apply only to business combinations within the scope of IFRS 3.

16.2. Portfolio transfers

When insurance contracts or reinsurance contracts held are acquired in a transfer that is not a business combination, IFRS 17 requires that an entity applies the aggregation requirements for the identification of portfolios of insurance contracts and divides those into groups as if it had entered into

¹⁷¹ IFRS 3.2(c)

the contracts on the date of acquisition. The consideration paid or received for the acquired contracts should be used as the proxy for the premiums received under the contracts.

This means an entity should apply the same approach to measuring contracts acquired in a portfolio transfer as for contracts acquired in a business combination, as described above. However, for contracts acquired in a portfolio transfer, the excess of the fulfilment cash flows over the consideration paid or received is not recognised as an adjustment to goodwill, but as a loss in profit or loss (i.e., treated as onerous contracts at initial recognition) instead. 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 in section 11 to allocate subsequent changes in fulfilment cash flows to that loss component.

Illustration 26 – Measurement on initial recognition of insurance contracts acquired in portfolio transfer [Based on example 13 in the Illustrative Examples to IFRS 17, IE139-145]

An entity acquires insurance contracts in a 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 the fulfilment cash flows to be:

- ▶ Example A – net outflow (or liability) of CU20
- ▶ Example B – net outflow (or liability) of CU45

For simplicity, this example disregards all other amounts.

The consideration of CU30 received from the seller is a proxy for the premium received. Consequently, on initial recognition, the entity measures the insurance contract liability, as follows:

	Example A	Example B
	CU	CU
Fulfilment cash flows	20	45
CSM	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 CSM is the difference between the premium and the fulfilment cash flows (i.e., 30 less 20 resulting in a CSM of 10 in Example A). Consequently, in Example A, the total insurance contract liability is equal to the premium received.

In Example B, the premium received (30) is less than the fulfilment cash flows (45). Therefore, the entity concludes that the contract is onerous. Consequently, the difference between 30 and 45 (15) is an expense in profit or loss and the insurance contract liability is equal to the fulfilment cash flows.

How we see it

- ▶ In our preliminary view, when insurance contracts or reinsurance contracts held are acquired in a transfer that is not a business combination, these contracts should be classified (i.e., assessed for significant insurance risk and eligibility for the variable fee approach and the premium allocation approach) based on the terms and conditions at the transfer date, consistent with contracts that are acquired in a business combination.

16.3. Customer lists and relationships not connected to insurance contracts

The requirements discussed (see above) apply only to insurance contracts that exist at the date of a business combination or transfer. Therefore, they do not apply to customer lists and customer relationships reflecting the expectation of future contracts that do not meet the IFRS 17 recognition criteria. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* 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 27 – Purchase of portfolio of one-year motor insurance contracts

Background

Parent A obtained control of insurer B in a business combination on 31 December 2021. B has a portfolio of one-year motor insurance contracts that policyholders may cancel annually.

Analysis

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.¹⁷²

¹⁷² IFRS 3.IE30(d)

17. 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 18).

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.¹⁷³

17.1. Statement of financial position

An entity is required to aggregate groups of insurance contracts issued and reinsurance contracts held that are in an asset or liability position at each reporting date in order to present separately on the Statement of financial position groups of:¹⁷⁴

- ▶ Insurance contracts issued that are assets, and those that are liabilities
- ▶ Reinsurance contracts held that are assets, and those that are liabilities

Any assets or liabilities for insurance acquisition cash flows recognised before the corresponding insurance contracts are recognised (see section 5) are to be included in the carrying amount of the related groups of insurance contracts issued.¹⁷⁵

The presentation requirements differ significantly from those required by IFRS 9 in respect of financial instruments. They are also likely to differ significantly from those applied previously by an insurer under IFRS 4, for example under IFRS 17:

- ▶ Individual positive and negative contract balances within a group will be aggregated (netted) on the statement of financial position
- ▶ All rights and obligations arising from an insurance contract are presented net in one line of the statement of financial position unless the components of the contract are separated and accounted for under a different IFRS (see section 3). The rights and obligations presented net would include, for example, policyholder loans, insurance premiums receivable, liabilities for incurred claims and deferred acquisition costs.

There is no requirement for disclosure of balances for the general model, premium allocation approach, or variable fee approach to be shown separately on the face of the statement of financial position. Nor is there a requirement for

¹⁷³ IAS 1.54-56, 82-86

¹⁷⁴ IFRS 17.78, IAS 1.54(da) and 54(ma)

¹⁷⁵ IFRS 17.79

the components of the contract balances (for example, the CSM) to be presented on the face of the statement of financial position.

There is nothing to prevent an entity from providing further sub-analysis of the insurance and reinsurance assets and liabilities (which may make the relationship of the reconciliations to the face of the statement of financial position more understandable). Indeed, IAS 1 states that additional line items (including the disaggregation of those items specifically required), headings and sub totals should be presented on the face of the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.¹⁷⁶

How we see it

- ▶ IFRS 17 nets all future cash flows within the contract boundary of insurance contracts to form part of a single carrying amount for each group of contracts. Many existing accounting frameworks for insurance contracts require separate presentation of premiums due, estimated claims payments and claims handling costs, policy loans, and separate amounts for deferred acquisition costs and other intangible assets. IFRS 17's presentation is very different. We expect that some insurers will continue the industry practice of breaking down balances as supplementary information.
- ▶ Some insurers (e.g., those applying the premium allocation approach) may wish to continue to hold disaggregated cash flow information in their accounting systems and combine them for the purposes of calculating the CSM for each group. Keeping records at the level of groups of contracts, to identify those that are net assets and net liabilities, could be challenging.
- ▶ The fulfilment cash flows of an insurer that is a mutual entity generally includes 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 remaining 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.

17.2. 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:¹⁷⁷

¹⁷⁶ IAS 1.55

¹⁷⁷ IFRS 17.80

- ▶ Insurance service result comprised of:
 - ▶ Insurance revenue; and insurance service expenses

And

 - ▶ 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.¹⁷⁸ An entity may present the income or expense from a group of reinsurance contracts held, other than finance income and expense, as either:¹⁷⁹

- ▶ A single amount (net presentation)
- Or
- ▶ Separately (gross presentation):
 - ▶ The amounts recovered from the reinsurer
 - ▶ An allocation of the premium paid

An entity that applies a gross presentation for insurance service expense arising from reinsurance contracts held should:

- ▶ Provide a sub total equal to the single amount
- ▶ Treat reinsurance cash flows contingent on claims on the underlying insurance contracts as part of claims that are expected to be reimbursed (i.e., as part of reinsurance recoveries), for example, some types of profit commission
- ▶ Treat amounts it expects to receive that are not contingent on claims on the underlying contracts as a reduction in premium to be paid to the reinsurer, for example, some forms of ceding commission
- ▶ Not present the allocation of premium paid as a reduction in revenue.

IAS 1 requires a split of insurance finance income and expense between contracts issued within the scope of IFRS 17 and reinsurance contracts held on the face of the statement of profit or loss¹⁸⁰

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.¹⁸¹

The overview from the IASB's IFRS 17 *Effects Analysis* illustrates a summary statement of financial performance under IFRS 17.

¹⁷⁸ IFRS 17.82

¹⁷⁹ IFRS 17.86

¹⁸⁰ IAS 1.82(bb), (bc)

¹⁸¹ IFRS 17.81

Illustration 28 – Illustrative statement of financial performance

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)
<i>Incurred claims and insurance contracts expenses</i>	(7,362)	(7,012)
<i>Insurance contract acquisition cash flows</i>	(1,259)	(1,150)
Insurance service results before reinsurance contracts held	1,235	405
<i>Income (expenses) from reinsurance contracts held</i>	(448)	(327)
Insurance service result	787	78
Finance income/expense from contracts issued within the scope of IFRS 17	394	353
Finance income and expense from reinsurance contracts held	200	300
Net financial result	594	653
Profit before tax	1,381	731
Other comprehensive income		
<i>Items that may be reclassified subsequently to profit or loss</i>		
Finance income and expense from contracts issued within the scope of IFRS 17	50	(25)
Finance income and expense from reinsurance contracts held	(25)	50
Other comprehensive income for the year net of tax	25	25
Total comprehensive income for the year	1,406	746

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 18 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.¹⁸²

¹⁸² IAS 1.85

17.3. Insurance revenue

Insurance revenue depicts the provision of coverage and other 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.¹⁸³

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 adjusted for financing effect (the time value of money) and excluding any investment components.¹⁸⁴

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:¹⁸⁵

- ▶ Amounts related to the provision of services, comprising:
 - ▶ Insurance service expenses, excluding any amounts allocated to the loss component of the liability for remaining coverage
 - ▶ The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage
 - ▶ The CSM
- ▶ Amounts related to insurance acquisition cash flows

17.3.1. 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.¹⁸⁶

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:¹⁸⁷

- ▶ 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

¹⁸³ IFRS 17.83

¹⁸⁴ IFRS 17.B120

¹⁸⁵ IFRS 17.B121

¹⁸⁶ IFRS 17.B123

¹⁸⁷ IFRS 17.B123

- ▶ 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

Changes in the liability for remaining coverage in the period that relate to services for which the entity expects to receive compensation include:¹⁸⁸

- ▶ Insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:
 - ▶ 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 change in risk adjustment for non-financial risk, excluding:
 - ▶ Changes included in insurance finance income or expenses
 - ▶ Changes that adjust the CSM because they relate to future service
 - ▶ Amounts allocated to the loss component of the liability for remaining coverage
- ▶ The amount of the CSM recognised in profit or loss in the period

How we see it

- ▶ Revenue recognition will be different from current practice under IFRS 4, particularly for life contracts. Existing accounting practices for life insurance in many jurisdictions recognises 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 revenue is also likely to change reported metrics and even impact on the perceived size of organisations where this is based on the amount of revenue reported.

¹⁸⁸ IFRS 17.B124

An entity includes in revenue in each period under the General Model an amount relating to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows. An entity recognises the same amount as insurance service expense. The net effect of these adjustments on profit or loss in a period is nil. This 'gross up' of an allocation of acquisition cash flows between revenue and expenses allows the users of the financial statements to assess the significance of acquisition costs and is needed to allow revenue to equal total premiums received adjusted for the time value of money.¹⁸⁹

Illustration 29 – An allocation of 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 expenses 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.

Applying paragraph B125 of IFRS 17, the entity determines the insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relates to recovering those cash flows to each accounting period in a systematic way on the basis of the passage of time. The entity recognises the same amount as insurance service expenses. The entity chooses to reflect financing effects in determining the expense and offsetting amount in revenue in each year.

The present value of expected insurance acquisition cash flows at initial recognition is CU244 [CU200 + (CU50 ÷ 1.03⁴)]. The entity estimates the portion of premiums that relates to the recovery of insurance acquisition cash flows in each of the four years of coverage to be CU63, CU65, CU67 and CU68. The entity recognises the same amounts as insurance service expenses in each year.

	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

¹⁸⁹ IFRS 17.B125

17.3.2. 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 coverage:¹⁹⁰

- ▶ 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.¹⁹¹ Any change must be reflected in the basis of allocation as a change in accounting estimate and applied prospectively (see section 12.2).

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 on the basis of passage of time.

17.4. Insurance service expense

Insurance service expenses comprise:¹⁹²

- ▶ 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 CSM, 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 expenses) when it is relevant to understanding the entity's financial performance (see 17.2 above).

¹⁹⁰ IFRS 17.B126

¹⁹¹ IFRS 17.B127

¹⁹² IFRS 17.84

An entity may present the income or expenses from a group of reinsurance contracts held, other than insurance finance income or expenses, as a single amount or separately as:¹⁹³

- ▶ Amounts recovered from the reinsurer
- ▶ An allocation of the premiums paid that together result in 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:

- ▶ Treat reinsurance cash flows that are contingent on claims on the underlying contracts 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 claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in premiums to be paid to the reinsurer
- ▶ Not present the allocation of premiums paid as a reduction in revenue

17.5. 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:¹⁹⁴

- ▶ 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 CSM, but do not do so because the groups of contracts are onerous and consequently there is no contractual service margin. These are included in insurance service expenses

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. However, assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.¹⁹⁵

Insurance finance income or expenses comprise changes in the carrying amount of groups of insurance contracts due to accretion of interest, changes in discount rates and financial risk. Changes in financial risk include changes in the time value of options and guarantees for contracts that are not in scope of the Variable Fee Approach. Entities are required to make 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.¹⁹⁶

¹⁹³ IFRS 17.86

¹⁹⁴ IFRS 17.87

¹⁹⁵ IFRS 17.B128

¹⁹⁶ IFRS 17.88 and 89

An entity applies its choice of accounting policy to portfolios of insurance contracts. In assessing the appropriate accounting policy for each portfolio (see section 4), applying paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity should consider what assets it holds and how it accounts for them.¹⁹⁷

The amount included in other comprehensive income in a period is the difference between total insurance finance income or expenses and the amount included in profit or loss.¹⁹⁸

How we see it

- ▶ Allowing entities to choose between recognising insurance finance income or expenses wholly in profit or loss, or disaggregated 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 how they manage financial risk.
- ▶ An entity should consider, for each portfolio, the assets that it holds and how it accounts for them. Entities will seek to minimise accounting mismatches between assets and liabilities. We expect that entities with a tradition of recording the effect of market fluctuations in other comprehensive income will choose the same approach for insurance contract liabilities, if unavoidable mismatches in profit or loss are at a level that is acceptable to them. Entities that have classified equities as available-for-sale under IAS 39 may be reluctant to classify equities at fair value through other comprehensive income. This is because under IFRS 9 fair value gains and losses on FVOCI equities are not recycled to income on disposal. An entity might choose a fair value through profit or loss (FVPL) approach to assets and liabilities for portfolios of insurance contracts where assets backing liabilities include substantial amounts of equity instruments.
- ▶ Entities that have traditionally measured assets at FVPL and used current discount rates to measure insurance contract liabilities might elect not to disaggregate insurance finance expense and to invoke the fair value option for financial assets that otherwise would be measured in accordance with IFRS 9 at amortised cost or fair value through other comprehensive income (FVOCI).

17.6. Disaggregating insurance finance income or expenses between profit or loss and other comprehensive income

When an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, the methods for determining the amount presented in profit or loss depend on whether the insurance contracts have direct participation features and the entity holds the underlying items. If not, it depends on whether changes in assumptions that

¹⁹⁷ IFRS 17.B129

¹⁹⁸ IFRS 17.90

relate to financial risk have a substantial effect on the amounts paid to the policyholders.

For insurance contracts with direct participation features for which the entity holds the underlying items, an entity that makes the disaggregation choice includes in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held (sometimes referred to as the “current period book yield approach”).¹⁹⁹

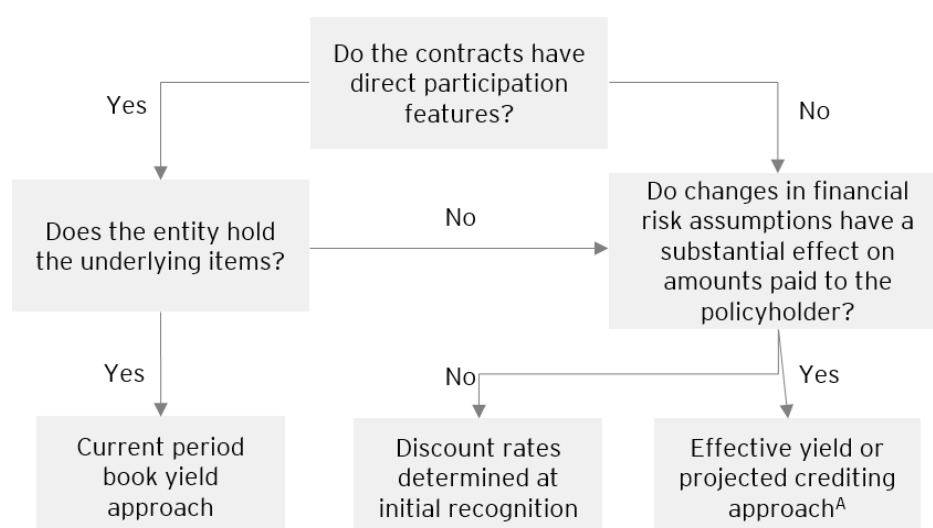
In all other circumstances, where an entity decides to disaggregate between profit or loss and OCI, IFRS 17 requires that entities must determine amounts presented in profit or loss in a period determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts. IFRS 17 specifies that such systematic approaches must:²⁰⁰

- ▶ Be based on the characteristics of the contracts without reference to factors that do not affect the cash flows expected to arise under the contracts; e.g., the allocation must not be based on expected recognised returns on assets if those returns do not affect the cash flows of the contracts in the group
- ▶ Result in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling to 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.

¹⁹⁹ IFRS 17.B134-B136

²⁰⁰ IFRS 17.B130

The disaggregation approaches, and the rates used to determine insurance finance expense recognised in profit or loss in each reporting period, as prescribed in IFRS 17 are summarised below:



A These approaches apply to fulfilment cash flows. The systematic allocation for the finance income or expenses arising from the CSM depends on if the contracts have direct participation features – see section 14.

How we see it

- ▶ 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 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

17.6.1. Contracts for which changes in financial assumptions do not have a substantial effect on 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 is determined using the discount rates at the date of initial recognition of the group of contracts.²⁰¹

When the premium allocation approach is applied (see section 12.1), an entity may be required, or may choose, to discount the liability for incurred claims (see section 12.2). In such cases, the entity may also choose to disaggregate the insurance finance income or expenses between profit or loss and other comprehensive income. If the entity makes this choice, it must determine the insurance finance income or expenses in profit or loss using the discount rate determined at the date of the incurred claim.²⁰²

Illustration 30 – Disaggregating insurance finance income or expenses

An entity issues a group of insurance contracts with a coverage of period of three years. The entity receives a premium of CU900 at the start of the coverage period, and estimates it will incur and pay claims of CU1,000 at the end of the coverage period. The contracts do not have participation features. The discount that reflects the nature of the cash flows of the contract at inception is 10% a year. The discount rate falls to 4% at the end of year 1 and stays at 4% to the end of year 3. The entity elects to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income.

As expected, the entity incurs and pays claims of CU1,000 at the end of year 3. For simplicity, we assume that the risk adjustment for non-financial risks is negligible.

	Start of Year 1	End of Year 1	End of Year 2	End of Year 3
Present value of expected cash outflows at current rates	751	925	962	1,000
Present value of expected cash outflows at locked rate of 10%	751	826	909	1,000
	Year 1	Year 2	Year 3	
Change in the present value of expected cash flows at current rates (A)	174	37	38	
Change in the present value of expected cash flows at locked-in rates (B)	75	83	91	
	Year 1	Year 2	Year 3	

²⁰¹ IFRS 17.B131

²⁰² IFRS 17.B133

Illustration 30 – Disaggregating insurance finance income or expenses
Disaggregation of insurance finance expense

Profit or loss (B)	75	83	91
Other comprehensive income (=A-B)	99	(46)	(52)
Total comprehensive income (A)	174	37	39
Contractual service margin			
At inception (=900-751)/Opening balance at start of year (C)	149	109	60
Insurance finance expense (=10% of C) (D)	15	11	6
Allocation to profit or loss =(C+D)/(number of years coverage remaining +1) (E)	(55)	(60)	(66)
End of year (=C+D+E)	109	60	0

The entity uses the premium to purchase zero coupon bonds with an effective interest rate of 10% a year that mature at the end of year 3. It measures the bonds at fair value through other comprehensive income. The statement of profit or loss and other comprehensive income for the period could include the following:

	Year 1	Year 2	Year 3
Insurance revenue (allocation of CSM) (=E) (F)	55	60	66
Investment income (G)	90	99	109
Insurance finance expense (includes accretion of interest on CSM) (=B+D) (H)	(90)	(94)	(97)
Profit (=F+G+H)	55	65	78
Other comprehensive income			
Unrealised gains from bonds	118	(55)	(63)
Insurance finance income or expenses (=A-B)	(99)	46	53
Total comprehensive income	74	56	68

17.6.2. Contracts for which changes in financial assumptions have a substantial effect on amounts paid to the policyholder

For groups of insurance contracts for which changes in assumptions relating to financial risk have a substantial effect on the amounts paid to the policyholders:²⁰³

- ▶ 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:
 - ▶ 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)
 - ▶ 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 (projected crediting approach)
- ▶ A systematic allocation for the insurance 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 of the finance income or expenses arising from the future cash flows.
- ▶ A systematic allocation for the finance income or expenses arising from the CSM is determined:
 - ▶ For insurance contracts without direct participation features, using the discount rates determined at the date of initial recognition of the group of contracts
 - ▶ For insurance contracts with direct participation features where the entity does not hold the underlying items, using an allocation consistent with that used for the allocation for the interest income or expenses arising from future cash flows

17.6.3. Contracts with direct participation features where 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:²⁰⁴

- ▶ 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,

²⁰³ IFRS 17.B132

²⁰⁴ IFRS 17.88

with income or expenses included in profit or loss on the underlying items held (current period book yield approach)

This means that, when disaggregation is applied, the amount included in profit or loss for finance income or expenses for insurance contracts with direct participation features exactly matches the finance income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil.²⁰⁵

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 applying the current period book yield approach to an effective yield or projected crediting rate approach²⁰⁶ and potentially the opposite approach if the entity subsequently holds the underlying items.²⁰⁷

In making such a change, an entity must:

- ▶ 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:²⁰⁸
 - ▶ If the entity previously applied, for example, an effective yield approach, it must include in profit or loss the accumulated amount in other comprehensive income before the change, as if the entity were continuing the effective yield approach based on the assumptions that applied immediately before the change
 - ▶ If the entity previously applied the current period book yield approach, it must include in profit or loss the accumulated amount included in other comprehensive income before the change as if the entity were continuing that approach based on the assumptions that applied immediately before the change
- ▶ Not restate prior period comparatives information

An entity must 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.²⁰⁹

²⁰⁵ IFRS 17.B134

²⁰⁶ See IFRS 17.B132(a)(i)-(ii), example 15 in IFRS 17.IE152-171

²⁰⁷ IFRS 17.B135

²⁰⁸ IFRS 17.B135

²⁰⁹ IFRS 17.B136

18. Disclosure

The disclosure requirements in IFRS 17 aim to provide users of the financial statements with a basis to assess the effect that contracts within the scope of the standard have on an entity's financial position, financial performance and cash flows.

The standard requires disclosure of qualitative and quantitative information about:²¹⁰

- ▶ Amounts recognised in its financial statements for contracts within the scope of IFRS 17 (see 18.1 below)
- ▶ Significant judgements, and changes in those judgements, when applying IFRS 17 (see 18.2 below)
- ▶ The nature and extent of risks arising from contracts within the scope of IFRS 17 (see 18.3 below)

The standard does not specify the level of aggregation an entity should apply when making disclosures, although it gives the following examples of aggregation bases that might be appropriate for information disclosed about insurance contracts:²¹¹

- ▶ Type of contract (e.g., major product lines)
- ▶ Geographical area (e.g., country or region)
- ▶ Reportable segment, as defined in IFRS 8 *Operating Segments*

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, or even whether, they break down the required disclosures into separate lines of business or geographical areas. Entities may find minimum disclosure attractive when they first implement IFRS 17 because of uncertainty about the effort or even feasibility of providing separate disclosures in time for initial application in 2021.

18.1. Explanation of recognised amounts

An entity is required to disclose the following:

- ▶ Reconciliations that show how the net carrying amount of contracts within the scope of IFRS 17 changed during each period (see 18.1.1 below)

²¹⁰ IFRS 17.93

²¹¹ IFRS 17.96

- ▶ Disclosures for contracts other than those to which the entity applies the premium allocation approach:
 - ▶ Analysis of insurance revenue recognised in the period for contracts (see 18.1.2 below)
 - ▶ Analysis of the effect of contracts initially recognised in each period (see 18.1.3 below)
 - ▶ Explanation of when the entity expects to recognise the CSM at the end of the reporting period in profit or loss (see 18.1.4 below)
- ▶ Information about contracts to which the entity applies the premium allocation approach (see 18.1.5 below)
- ▶ An explanation of the total amount of insurance finance income or expenses in the reporting period (see 18.1.6 below)
- ▶ Disclosures that help users of financial statements understand the effect on the CSM and revenue, in each subsequent period, of groups of contracts measured at the transition date, applying the modified retrospective approach or the fair value approach (see 18.1.7 below).

18.1.1. Roll forward reconciliations of the carrying amounts of contracts within the scope of IFRS 17

An entity is required to disclose reconciliations in tabular format that show how the net carrying amount of contracts within the scope of IFRS 17 changed during each period due to 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. For each reconciliation, an entity should disaggregate the net amounts at the beginning and end of each period into a total for groups of contracts that are assets and a total for groups of contracts that are liabilities.²¹²

The required reconciliations provide two different perspectives of the change in net carrying amounts in a period:²¹³

- ▶ Analysis of insurance obligations, comprising liability for remaining coverage, excluding any loss component; the loss component (if any); and the liability for incurred claims
- ▶ Analysis of the components of the carrying amounts, comprising estimates of the present value of future cash flows, risk adjustment for non-financial risk, and the CSM

Reconciliations for groups of contracts to which an entity applies the premium allocation approach need only provide a breakdown in the change in the components of the liability for incurred claims (i.e., changes in the estimated present value of the future cash flows of incurred claims and the related risk adjustment for non-financial risk).²¹⁴

²¹² IFRS 17.98-99

²¹³ IFRS 17.100

²¹⁴ IFRS 17.101

The standard prescribes separate items that should be included in each of the reconciliations. One way to present the reconciliation by insurance obligation, included in IASB's IFRS 17 *Effects Analysis* (Illustration 31), is shown below:

	Liability for remaining coverage		Liabilities for incurred claims	Total
	Excluding onerous contracts component	Onerous contracts component		
Insurance contract liabilities 2020	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	1,259
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 2021	188,438	16,096	1,190	205,724

The IASB's IFRS 17 *Effects Analysis* also includes an illustration of how to present a reconciliation based on components of the carrying amount:

	Estimates of the present value of future cash flows	Risk adjustment	Contractual service margin	Total
Insurance contract liabilities 2020	163,962	5,998	8,858	178,818
Changes that relate to current service	35	(604)	(923)	(1,492)
CSM recognised for service period			(923)	(923)
Risk adjustment recognised for the risk expired		(604)		(604)
Experience adjustments	35			35
Changes that relate to future service	(784)	1,117	(116)	217
Contracts initially recognised in the period	(2,239)	1,077	1,375	123
Changes in estimates reflected in the CSM	1,452	39	(1,491)	-
Changes in estimates that result in onerous contract losses	93	1		94
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 2021	191,180	6,504	8,040	205,724

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 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 cash flows, risk adjustment for non-financial risk, and the CSM)
- ▶ 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.

18.1.2. Analysis of insurance revenue

For insurance contracts issued, other than those to which the entity applies the premium allocation approach, entities need to provide the following analysis of insurance revenue recognised in the period:²¹⁵

- ▶ Amounts relating to changes in the liability for remaining coverage, separately disclosing:
 - ▶ Insurance service expenses incurred during the period
 - ▶ Change in the risk adjustment for non-financial risk
 - ▶ Amount of the CSM recognised in profit or loss because of the transfer of services in the period
- ▶ Allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows

18.1.3. Analysis of the effect of contracts initially recognised in each period

For contracts, other than those to which the entity applies the premium allocation approach, it needs to disclose the effect on the statement

²¹⁵ IFRS 17.106

of financial position of contracts initially recognised in each period, showing the effect at initial recognition on:²¹⁶

- ▶ Estimates of the present value of future cash outflows, showing separately the amount of insurance acquisition cash flows
- ▶ Estimates of the present value of future cash inflows
- ▶ Risk adjustment for non-financial risk
- ▶ The CSM

In this disclosure above, entities must separately disclose amounts resulting from:

- ▶ Contracts acquired from other entities in transfers of insurance contracts or business combinations
- ▶ Groups of contracts that are onerous²¹⁷

Separate disclosures are required for insurance contracts issued and reinsurance contracts held.

18.1.4. Explanation of expected CSM recognition in profit or loss

An entity must disclose an explanation of when it expects to recognise the CSM remaining at the end of the reporting period in profit or loss, either quantitatively, in appropriate time bands, or by providing qualitative information. Such information must be provided separately for insurance contracts issued and reinsurance contracts held.²¹⁸

18.1.5. Information about contracts to which the entity applies the premium allocation approach

When an entity uses the premium allocation approach, it must disclose the following:²¹⁹

- ▶ 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

²¹⁶ IFRS 17.107

²¹⁷ IFRS 17.108

²¹⁸ IFRS 17.109

²¹⁹ IFRS 17.97

18.1.6. 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.²²⁰

Specifically, for contracts with direct participation features, an entity must:²²¹

- ▶ Describe the composition of the underlying items and disclose their fair value
- ▶ Disclose the effect of any adjustment to the CSM in the current period resulting from any choice not to adjust the CSM to reflect some of 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 14.2.3)
- ▶ Disclose, in the period when it changes the basis of disaggregation of insurance finance income or expense between profit or loss and other comprehensive income:
 - ▶ 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

18.1.7. 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 19.2) or the fair value approach (see section 19.3) on the CSM 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. An entity must disclose the reconciliation of the CSM and the amount of insurance revenue required separately for:²²²

- ▶ 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)

²²⁰ IFRS 17.110

²²¹ IFRS 17.111-113

²²² IFRS 17.114

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.²²³

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 19.2 (for the modified retrospective approach) or 19.3 (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 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 from 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.²²⁴ See section 19.4 for disclosure relief on transition.

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 CSM 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 CSMs 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.

18.2. Significant judgements in applying IFRS 17

Consistent with IAS 1, IFRS 17 requires disclosure of significant judgement and changes in judgment that an entity makes in applying the standard.²²⁵ Specifically, an entity must disclose the inputs, assumptions and estimation techniques it has used, including:²²⁶

- ▶ Methods 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.

²²³ IFRS 17.115

²²⁴ IFRS 17.116

²²⁵ IAS 1.122, IFRS 17.93

²²⁶ IFRS 17.117

- ▶ Any changes in methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected.
- ▶ 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

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 17.6), it must disclose an explanation of the methods used to determine the insurance finance income or expenses recognised in profit or loss.²²⁷

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, and the confidence level corresponding to the results of that technique.²²⁸

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.²²⁹

How we see it

- ▶ Unlike IFRS 4, IFRS 17 does not include an explicit disclosure requirement for an insurer's accounting policies for insurance contracts and related liabilities, income and expense. However, IAS 1 requires an entity to disclose its significant accounting policies.

18.3. Disclosure about the nature and extent of risks

An entity needs to disclose information that enables financial statement users to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of IFRS 17.²³⁰

²²⁷ IFRS 17.118

²²⁸ IFRS 17.119

²²⁹ IFRS 17.120

²³⁰ IFRS 17.93, 121

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.²³¹ Many similar disclosures were included in IFRS 4, often phrased to the effect that an insurer should make disclosures about insurance contracts, assuming that these were within the scope of IFRS 7. The equivalent disclosures now required by IFRS 17 are more specific to the circumstances of the measurement of insurance contracts in the standard, with no cross reference to IFRS 7.

For each type of risk arising from contracts within the scope of IFRS 17, an entity must disclose:²³²

- ▶ 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
- ▶ 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

Specific disclosure requirements in IFRS include:²³³

- ▶ Concentration of risks
- ▶ Sensitivity analyses for insurance and finance risks
- ▶ Claims development
- ▶ Credit risk – including maximum exposures and credit quality
- ▶ Liquidity risk
- ▶ The effect of regulatory frameworks in which the entity operates, e.g., minimum capital requirements or required interest-rate guarantees

²³¹ IFRS 17.122

²³² IFRS 17.124

²³³ IFRS 17.126-132 and IAS 1.135-136

19. Effective date and transition

An entity must apply IFRS 17 for annual reporting periods beginning on or after 1 January 2021. IFRS 17 supersedes IFRS 4.²³⁴ Early application of IFRS 17 is permitted if an entity also applies IFRS 9 and IFRS 15 on or before the date of initial application of IFRS 17.²³⁵

For the purposes of the transition requirements in IFRS 17, 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 2021 for an entity first applying the standard with an annual reporting period ending 31 December 2021). IFRS 17 also refers to the transition date as the beginning of the annual reporting period immediately preceding the date of initial application (i.e., 1 January 2020 for an entity first applying the standard with an annual reporting period ending 31 December 2021, which reports only one comparative period).²³⁶

An entity should apply IFRS 17 retrospectively from the transition date unless impracticable and:²³⁷

- ▶ Identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied
- ▶ Derecognise any existing balances that would not exist had IFRS 17 always applied
- ▶ Recognise any resulting net difference in equity

This means 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.²³⁸ 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 16).

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.²³⁹

Applying the standard retrospectively means that the comparative period (i.e., the annual reporting period immediately preceding the date of initial

²³⁴ IFRS 17.C34

²³⁵ IFRS 17.C1

²³⁶ IFRS 17.C2

²³⁷ IFRS 17.C4

²³⁸ IFRS 17.BC374

²³⁹ IFRS 4.31

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). If an entity does present adjusted comparative information for any prior periods, the reference to ‘the beginning of the annual reporting period immediately preceding the date of initial application’ (see above) must be read as ‘the beginning of the earliest adjusted comparative period presented.’²⁴⁰

The measurement of fulfilment cash flows (risk adjusted present value of expected cash flows) in IFRS 17 is prospective. Consequently, the measurement of fulfilment cash flows at the transition date for contracts recognised before that date is a relatively straightforward application of IFRS 17. However, measurement of the CSM, identification of the loss component of the liability for remaining coverage and accumulated other comprehensive income at the transition date (for the purposes of subsequent presentation of revenue and insurance finance income or expenses) depend on past events. These aspects of the measurement and subsequent presentation of contracts in force at the transition date require historical information and make retrospective application of IFRS 17 challenging, particularly for entities that have issued or purchased long-duration contracts for many years prior to transition.

How we see it

- ▶ IFRS 17 does not include, unlike some other IFRS standards, a simplification for contracts that have been derecognised before transition. This is due to the inherent reliance of the model on the CSM 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.

19.1. Alternative transition approaches

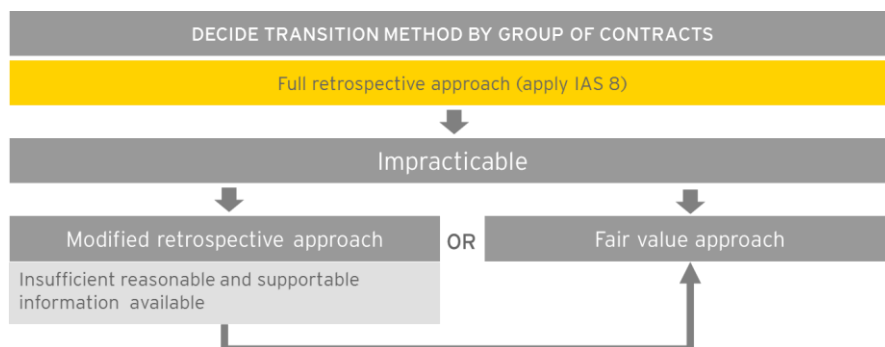
Notwithstanding the requirement for retrospective application, as described above, if it is impracticable (as defined in IAS 8) to apply IFRS 17 retrospectively for a group of insurance contracts, an entity must apply one of two alternative approaches instead: the modified retrospective approach (see 19.2 below); or the fair value approach (see 19.3 below) to that group of insurance contracts.

The choice between the modified retrospective and fair value approaches is made separately for each group of insurance contracts for which 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. If an entity does not have reasonable and supportable information to apply the modified retrospective approach, it would have to

²⁴⁰ IFRS 17.C25-C26

apply the fair value approach.²⁴¹ Within the two permitted methods, there are also measurement choices available, depending on the level of prior year information.

An overview of the transition methods is illustrated below:



How we see it

- ▶ There is likely to be considerable diversity of practice across entities in calculating the CSM at transition date. This will result in potentially different releases of the CSM (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 CSM and insurance revenue in future periods (see section 18.1.7).
- ▶ 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. 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.

19.2. Modified retrospective approach

This approach contains a series of permitted modifications to (full) retrospective application, as follows:

- ▶ Assessment of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition (see 19.2.1)
- ▶ Amounts related to the CSM or loss component for insurance contracts without direct participation features (see 19.2.2)
- ▶ Amounts related to the CSM or loss component for insurance contracts with direct participation features (see 19.2.3)
- ▶ Insurance finance income or expenses (see 19.2.4)

²⁴¹ IFRS 17.C8

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 the full retrospective approach.²⁴²

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:²⁴³

- ▶ Use reasonable and supportable information; if it cannot do so, 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

Full IFRS does not define undue cost and effort. However, the *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 management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those expected to use the financial statements could be affected by not having that information. The *Basis for Conclusions to IFRS for SMEs* further mentions that the undue cost or effort exemption is not intended to be a low hurdle. An entity is required to weigh the expected effects of applying the exemption against the cost or effort of complying with the related requirement. The IASB's conceptual framework also notes that, although cost is a pervasive constraint on the information provided by financial reporting and must be justified by the benefits that it provides, the cost is ultimately born by the users (not the preparers) and implies that any cost constraint should be considered from their perspective.

19.2.1. 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:²⁴⁴

- ▶ How to identify groups of contracts (see section 4)
- ▶ Whether an insurance contract meets the definition of an insurance contract with direct participation features (see section 14)
- ▶ How to identify discretionary cash flows for insurance contracts without direct participation features (see section 7)

In aggregating contracts when it is impracticable to apply a retrospective approach, an entity is permitted (to the extent that reasonable and supportable information for grouping contracts retrospectively does not exist) to aggregate contracts issued more than one year apart into a single group.²⁴⁵

²⁴² IFRS 17.C8

²⁴³ IFRS 17.C6

²⁴⁴ IFRS 17.C9

²⁴⁵ IFRS 17.C10, BC392

19.2.2. Determining the CSM 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 CSM 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.²⁴⁶

As permitted by the requirements of the modified retrospective approach, the following measurement simplifications are applied by the entity:

- ▶ 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 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.²⁴⁷
- ▶ Discount rates that applied at the date of initial recognition of a group of insurance contracts (or subsequently) should be determined:²⁴⁸
 - ▶ 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 8.2), if such an observable yield curve exists.
 - ▶ 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.
- ▶ 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.²⁴⁹

If applying the modified requirements above results in a CSM at initial recognition, then the entity should determine the CSM at transition date, as follows:²⁵⁰

²⁴⁶ IFRS 17.C11

²⁴⁷ IFRS 17.C12

²⁴⁸ IFRS 17.C13

²⁴⁹ IFRS 17.C14

²⁵⁰ IFRS 17.C15

- ▶ Use the modified discount rates calculated above to accrete interest on the CSM
- ▶ Apply the amount of the CSM 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

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.²⁵¹

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).

The following example illustrates the measurement of contracts without direct participation features at the transition date using the modified retrospective approach:

Illustration 32 – Measurement of groups of insurance contracts without direct participation features applying the modified retrospective approach [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 CSM at the transition date. The entity uses reasonable and supportable information to achieve the closest outcome to retrospective application.

Analysis

The entity determines the CSM 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.

²⁵¹ IFRS 17.C16

- ▶ 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 CSM 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 CSM 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 CSM 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)
CSM	20	90	110
Liability for remaining coverage	740		–

How we see it

- ▶ The modified retrospective approach allows considerable judgement, as it permits an entity 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 CSM in future periods between entities with longer-term contracts.

19.2.3. Determining the CSM 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 CSM or the loss component of the liability for remaining coverage for groups of contracts with direct participation features, these should be determined, as follows:²⁵²

- ▶ Total fair value of the underlying items at the transition date (A in the table below)
Minus
- ▶ Fulfilment cash flows at the transition date (B)
Plus or minus
- ▶ An adjustment for:
 - ▶ Amounts charged by the entity to policyholders (including amounts deducted from the underlying items) before that date (D)
 - ▶ Amounts paid before that date that would not have varied based on the underlying items (E)
 - ▶ 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 (F)

This will give an estimated result for the CSM at transition before consideration of the amount of CSM recognised in profit or loss before transition date (G). This total is then reduced by an estimate of the amount of the CSM that would have been recognised in profit or loss based on amount of coverage provided in the period before the transition date (H).

This is illustrated in the table below:

At transition		
Fair value of underlying items	A	
Fulfilment cash flows	(B)	
Entity's share of underlying items		C
Charges deducted prior to transition		D
Payments made prior to transition that do not vary with underlying items		(E)

²⁵² IFRS 17.C17

Estimated reduction in risk adjustment for non-financial risk prior to transition		(F)
Estimate of CSM at transition before any recognition in profit or loss		G
Estimated amount of CSM that relates to period before transition		(H)
Estimated CSM at transition		J

The following example illustrates how to apply the modified retrospective approach to contracts with direct participation features at the transition.

Illustration 33 – 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

- ▶ 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 CSM at transition date. It determines that the CSM 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 CSM 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)
CSM of the group of contracts before recognition in profit or loss	44
Estimated amount of the CSM that relates to services provided before the transition date	(26)
Estimated CSM 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 CSM of CU18.

If the above calculation results in a loss component, it is adjusted to nil, with an increase in liability for remaining coverage, excluding the loss component, in the same amount.

19.2.4. Insurance finance income or expenses

The modified requirements for insurance finance income or expenses differ depending on whether groups of insurance contracts include those issued more than one year apart, as summarised below:²⁵³

²⁵³ IFRS 17.C18-C19

	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

19.2.5. 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:²⁵⁴

- ▶ The entity is permitted to determine the discount rates at the date of initial recognition for the CSM, for 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.
- ▶ An entity may choose to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income (see section 17). If it chooses this option, it must 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 those issued more than one year apart (see 19.2.6 below)Or
 - ▶ As nil, except for insurance contracts with direct participation features where the entity holds the underlying items when the cumulative difference is equal to the cumulative amount recognised in other comprehensive income on the underlying items.

19.2.6. 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:²⁵⁵

- ▶ It may apply the modified retrospective approach to determining discount rates for groups of insurance contracts without direct participation features to estimate the discount rates that applied at initial recognition, or subsequently. If so, it also needs to determine the discount rates specified for accreting the interest on the CSM, measuring changes in the CSM, discounting the liability for remaining coverage under the premium allocation approach and for disaggregated insurance finance and income in the same way
- And
- ▶ 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 section 17.6), it needs to determine the cumulative amount of insurance finance income or expenses recognised

²⁵⁴ IFRS 17.C18

²⁵⁵ IFRS 17.C19

in other comprehensive income at the transition date in order to reclassify any remaining amounts from other comprehensive income to profit or loss upon subsequent transfer or derecognition in future periods. The entity should determine that 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 (i.e., a locked-in rate or yield curve), if the entity applies the modified retrospective approach, as described in Section 19.2.2, to estimate the discount rates at initial recognition (e.g., to adjust an observable yield curve), those estimated rates must be used to calculate the amount of accumulated OCI at transition.
- ▶ 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., 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 modified retrospective approach 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 modified retrospective approach 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

How we see it

- ▶ The possibility and, in some cases, the requirement, to set transition OCI at nil, sometimes referred to as the “fresh start” approach in practice, will 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 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 and expense 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.
- ▶ For contracts with direct participation features, applying the current period book-yield approach, the simplification to set OCI at the amount of the underlying items seems logical.

19.3. 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 19.1 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 19.2 above).

To apply the fair value approach, an entity should determine the CSM 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.²⁵⁶ This means that insurance contract liabilities can be measured at an amount lower than the discounted amount repayable on demand. The requirements to estimate the fair value on transition for a group of insurance contracts apply to both contracts with and without direct participation features.

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:²⁵⁷

- ▶ How to identify groups of insurance contracts (initial recognition)
- ▶ Whether an insurance contract meets the definition of an insurance contract with direct participation features (inception)
- ▶ How to identify discretionary cash flows for insurance contracts without direct participation features (inception)

In addition, the general requirements of IFRS 17 are modified when the fair value approach is used:²⁵⁸

- ▶ 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.
- ▶ 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) at

²⁵⁶ IFRS 17.C20

²⁵⁷ IFRS 17.C21-C22

²⁵⁸ IFRS 17.C23

the transition date instead of the date of the initial recognition or incurred claim.

If an entity chooses to disaggregate insurance finance income or expense between profit or loss and other comprehensive income, it is permitted to determine the cumulative amount of insurance finance income or expense recognised in other comprehensive income at the transition date:²⁵⁹

- ▶ Retrospectively, but only if it has reasonable and supportable information to do so

Or

- ▶ As nil, unless the below applies

And

- ▶ 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

- ▶ Determining fair value will pose many challenges and require significant judgement. An important area is the level of aggregation and its impact on the risk adjustment. 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.
- ▶ Note that core deposit requirements in IFRS 13 (the fair value of a financial liability with a demand feature can never be less than present value of the amount payable on demand) do not have to be applied when calculating the fair value of insurance contracts at transition. However, all other IFRS 13 requirements must be applied, including the requirements for consideration of non-performance risk in determining fair value.

19.4. Disclosure relief on transition

On transition to IFRS 17, entities must provide the disclosures required by IAS 8 that are applicable to changes in accounting policies, apart from two exceptions. Firstly, there is no requirement to disclose the amount of the adjustment resulting from applying IFRS 17 affecting each financial line item to either the current period or any prior period presented. Secondly, there is no requirement to disclose the impact of applying IFRS 17 in those periods on earnings per share.²⁶⁰

An entity is not required to provide the disclosures specified above for any period presented before the beginning of the annual accounting period immediately preceding the date of initial application. If an entity presents unadjusted comparative information and disclosures for any earlier periods,

²⁵⁹ IFRS 17.C24

²⁶⁰ IFRS 17.C3(a)

it must clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain the basis.²⁶¹

An entity is not required to 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 17.²⁶² For example, it is not required to disclose information about claims that occurred prior to 1 January 2017 for an entity first applying the standard with an annual reporting period ending 31 December 2021. An entity that elects to apply this disclosure relief must disclose that fact.

19.5. Redesignation of financial assets

Most entities meeting the eligibility criteria for the temporary exemption from IFRS 9 in IFRS 4 are expected to elect to defer IFRS 9 until IFRS 17 becomes effective.²⁶³ Those entities potentially may apply the transitional provisions of IFRS 9 when adopting IFRS 9 together with IFRS 17.

19.5.1. *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 2020 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2021). 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 2021 for an entity applying IFRS 17 for the first time in its annual reporting period ending 31 December 2021). Comparative periods may be restated only without the use of hindsight.²⁶⁴ Some care may be needed to explain the presentation of comparative results to users of the financial statements in the year of initial application of IFRS 17.

19.5.2. *Entities that have previously applied IFRS 9*

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 17:²⁶⁵

- ▶ May reassess whether an eligible financial asset is 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

²⁶¹ IFRS 17.C25-C27

²⁶² IFRS 17.C28

²⁶³ IFRS 4.20A-20K

²⁶⁴ IFRS 9.7.2.15

²⁶⁵ IFRS 17.C29

are financial assets held for banking activities or financial assets held for investment contracts that are outside the scope of IFRS 17

- ▶ Must 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

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 17.²⁶⁶

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 19.5.1 above). 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
- ▶ The carrying amount of those financial assets at the date of initial application²⁶⁷

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

²⁶⁶ IFRS 17.C30

²⁶⁷ IFRS 17.C31

- ▶ 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 exists²⁶⁸
- ▶ Qualitative information that would enable financial statement users to understand:²⁶⁹
 - ▶ 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
 - ▶ Why the entity reached a different conclusion in the new assessments, applying the requirements of the business model test

²⁶⁸ IFRS 17.C32

²⁶⁹ IFRS 17.C33

Appendix A: IFRS 17: Defined terms

Term	Definition
<i>CSM</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 services under the insurance contracts in the group.
<i>Coverage period</i>	The period during which the entity provides coverage for insured events, including coverage that relates to all premiums within the boundary of the insurance contract.
<i>Experience adjustment</i>	A difference between: <ul style="list-style-type: none"> (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 (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.
<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 written within a period of no longer than one year and that, at initial recognition: <ul style="list-style-type: none"> (a) Are onerous, if any (b) Have no significant possibility of becoming onerous subsequently, if any; or (c) Do not fall into either (a) or (b), if any

<i>Insurance acquisition cash flows</i>	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.
<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 with direct participation features</i>	An insurance contract for which, at inception: <ul style="list-style-type: none"> (a) Contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items; (b) The entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and (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.
<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.
<i>Investment component</i>	The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

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