Accounting treatment for onerous contracts under the IFRS 17 general measurement model[1]

Background

IFRS 17 requires a loss component (LC) to be set up in subsequent measurement when there are unfavourable changes in fulfilment cash flows (FCF) arising from changes in estimate of future cash flows relating to future service exceeding the carrying amount of the contractual service margin (CSM). This LC would subsequently change when there are unfavourable or favourable changes in FCF that relate to future services. These changes are reported in profit or loss as additional losses or reversal of losses. The LC is derecognised following the recognition of incurred claims and/or favourable changes in FCF that reverse the onerous status of the group of contracts.

Accounting Question 1

For those changes of FCF arising from changes in estimate of future cash flows relating to future service that establish, increase or reverse a LC, what discount rates should be used to calculate the changes to be reported in profit or loss? In other words, should it be the current rate or the locked-in rate applicable at initial recognition of the group of contracts?

Accounting Question 2

Should the measurement of the LC for presentation in the statement of financial position use the same or a different discount rate as the rate referred to in question 1?

Accounting Question 3

If the answer to question 1 is the current rate for the P&L, then when the CSM is re-established following a loss reversal event, what is the locked-in discount rate to be used for CSM interest accretion and for measuring the unlocking of CSM from that date?

Responses to questions 1 and 2

View A

Response to question 1 – It should be the locked-in rate described in IFRS 17:B72(c).

Supporters of this view argue that the CSM adjustments mandated in IFRS 17:44(c) are calculated based on the locked-in rate required in IFRS 17:B96, which stipulates that changes in FCF that relate to future service comprise of change in the present value of future cash flows from the liability for remaining coverage (LRC) discounted at the locked-in rate. Furthermore, IFRS 17:B97(a) stipulates that changes in time value of money do not relate to future service.

Response to question 2 – The LC is measured in the statement of financial position using the current rate

The revaluation of the LC using current rates would be recognised as insurance finance income or expense (IFIE). This amount will be presented in profit or loss or allocated

[1] This document is inclusive of the author's consideration of the expected amendments to IFRS 17 as documented in the Exposure Draft and taking into account the subsequent IASB deliberations, as applicable.

between profit or loss and other comprehensive income ("OCI") based on the accounting policy choice the insurer has made for the portfolio in which the onerous group of contracts belongs.

Changes in FCF arising from changes in estimate of future cash flows relating to future service should always be measured at the locked-in rate even when the changes result in an onerous group of contracts only when they are measured at the current rate. In this case the recognition of what could be seen as a LC in the statement of financial position would be entirely against IFIE in profit or loss or in OCI if the insurer has elected the presentation accounting policy from IFRS 17:88 (the so called "OCI option").

Supporters of this view conclude that unless there is an onerous loss presented in the insurance service result the disclosures on the carrying amount of the liability for remaining coverage and its movements do not display a LC balance if the LC can only be recognised when discounted with current rates.

View B

Response to question 1 – It should be the current rate described in IFRS 17:B72(a).

Supporters of this view argue that:

1. The LC is part of the FCF, and IFRS 17:B72(a) requires the measurement of FCF to be done always using the current rate.
2. IFRS 17:51 requires the IFIE to be split systematically between the LC and the LRC excluding LC, which means that the total IFIE from the FCF needs to be allocated between the LC and the LRC excluding LC. This is different to the treatment of the CSM and implicitly confirms the need of the LC discount rate to be on a current rate basis.
3. If the insurer has elected to apply the "OCI option" under IFRS 17:88 the presentation of the IFIE there are two views: B and C. This point is further explained in the response to question 2 below.
4. Under IFRS 17 profit is deferred but losses are immediately recognised. It follows that the LC should be measured under the current rate, to reflect the most up to date information in the insurance service result to the users in terms of how much loss the insurer expects for an onerous groups of contracts.

Response to question 2 – The LC is measured in the statement of financial position using the current rate

Supporters of this view consider that the LC is measured at the same rate in the statement of financial position using the same rate mandated in IFRS 17:B72(a).

They also believe that the onerous nature of the group of contracts and the requirement to always present in profit or loss the current measure of the LC has a consequence on how the insurer applies the accounting policy choice available in IFRS 17:88. An insurer that has elected to apply the policy under IFRS 17:88 to present the time value of money disaggregated between profit or loss and OCI will apply this policy only to the LRC excluding the LC.

The LC is always measured in both the statement of financial position and profit or loss using the current rate with the IFIE in profit or loss comprising both the amounts noted in IFRS 17:87(a)-(b).

View C

Response to question 1 – It should be the current rate described in IFRS 17:B72(a).

Supporters of view C have the same response to this question as supporters of view B.

Response to question 2 – The LC is measured in the statement of financial position using the current rate

Supporters of view C believe that the requirements of IFRS 17:88 apply to the LRC in its totality, inclusive of when it incorporates a LC.

However, they argue that the application to the LC of IFRS 17:88 requires the consideration of the date when the LC was first recognised using IFRS 17:B72(a). The disaggregation of the time value of money arising from the LC must be calculated with reference to that rate (i.e. the time when the LC was recognised for the first time using an all-current set of financial and non-financial variables for both balance sheet and P&L). This means that the insurer will report the effect of time value of money in OCI by reference to two non-current rates: one for the LRC without the LC, which is set at initial recognition date of the group of contracts under IFRS 17:B72(a), and another one for the LC, which is set at the date when the LC is recognised for the first time also under IFRS 17:B72(a).

Response to question 3

Question 3

If the answer to question 1 is the current rate for the P&L (View B and View C), then when the CSM is re-established following a loss reversal event, what is the locked-in discount rate to be used for CSM interest accretion and for measuring the unlocking of CSM from that date?

View 1

IFRS 17:B72(b)-(c) explicitly state that CSM interest accretion and changes which adjust CSM are done using the interest rate at initial recognition and this is the only rate that can be used for CSM interest rate accretion and to account for changes in FCF which adjust CSM. This includes when a new CSM has been recognised after a loss reversal event.

Supporters of this view would account for the change of the cash flows in the LRC at the current rate but report in the insurance service expenses the changes measured at the locked-in rate and the difference in IFIE.

View 2

The CSM is re-established following a loss reversal event when favourable changes in the estimate in FCF are greater than LC.

The re-established CSM amount arises from the positive difference between the changes in FCF less the LC balance.

Therefore, given the CSM is the amount of re-estimated deferred profit as at reporting date following a loss reversal event, a new locked-in rate needs to be established and needs to be consistent with the rate which CSM is being measured, hence it should be the current rate as of the date the loss reversal occurred.

Technical references

IFRS 17 paragraph 44 [emphasis added]

"For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

a) *the effect of any new contracts added to the group (see paragraph 28);*
b) *interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);*
c) *the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:*
    (i) *such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or*
    (ii) *such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).*
d) *the effect of any currency exchange differences on the contractual service margin; and*
e) *the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119."*

IFRS 17 paragraph 47

"An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, 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. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall 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 contractual service margin of the group being zero."

IFRS 17 paragraph 48

"A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:

a) *unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and*
b) *for a group of insurance contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items.*

An entity shall recognise a loss in profit or loss to the extent of that excess."

IFRS 17 paragraph 49

"An entity shall establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised. The loss component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue."

IFRS 17 paragraph 50

"After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:

- *(a) the subsequent changes in fulfilment cash flows of the liability for remaining coverage on a systematic basis between:*
  - *(i) the loss component of the liability for remaining coverage; and*
  - *(ii) the liability for remaining coverage, excluding the loss component.*
- *(b) any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity's share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component."*

IFRS 17 paragraph 51

"The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying the requirement above are:

- *(a) 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;*
- *(b) changes in the risk adjustment for non-financial risk recognised in profit or loss because of the release from risk; and*
- *(c) insurance finance income or expenses."*

IFRS 17 paragraph 52

"The systematic allocation required by paragraph 50(a) shall result in the total amounts allocated to the loss component in accordance with paragraphs 48–50 being equal to zero by the end of the coverage period of a group of contracts."

IFRS 17 paragraph 88

"Unless paragraph 89 applies, an entity shall make an accounting policy choice between:

- *(a) "including insurance finance income or expenses for the period in profit or loss; or*
- *(b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts, applying paragraphs B130–B133."*

IFRS 17 paragraph B72

"An entity shall use the following discount rates in applying IFRS 17:

- *(a) to measure the fulfilment cash flows—current discount rates applying paragraph 36;*
- *(b) to determine the interest to accrete on the contractual service margin applying paragraph 44(b) for insurance contracts without direct participation features—discount rates determined at the*

date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(c) to measure the changes to the contractual service margin applying paragraph B96(a)–B96(c) for insurance contracts without direct participation features—discount rates applying paragraph 36 determined on initial recognition;"

IFRS 17 paragraph 36

"An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

(a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
(b) 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, in terms of, for example, timing, currency and liquidity; and
(c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts."

IFRS 17 paragraph B96

"For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c);
(b) changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);
(c) differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);
(d) changes in the risk adjustment for non-financial risk that relate to future service. An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between (i) a change related to non-financial risk and (ii) the effect of the time value of money and changes in the time value of money. If an entity makes such a disaggregation, it shall adjust the contractual service margin for the change related to non-financial risk, measured at the discount rates specified in paragraph B72(c)."

IFRS 17 paragraph B97

"An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:

(a) 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 (being the effect, if any, on estimated future cash flows and the effect of a change in discount rate);
(b) 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 (being (i) the effect, if any, on estimated future cash

flows; (ii) if the effect is disaggregated, on the risk adjustment for non-financial risk; and (iii) the effect of a change in discount rate);

(c) changes in estimates of fulfilment cash flows in the liability for incurred claims; and

(d) experience adjustments, except those described in paragraph B96(a)."