Potential Implementation Question

IFRS 17:74 provides that an entity shall derecognize an insurance contract when, and only when, the insurance contract is extinguished or when any of the conditions set out in IFRS 17:72 relating to contract modifications are met.

IFRS 17:76(c) further provides that when an entity derecognizes an insurance contract from within a group of insurance contracts (emphasis added), "*the number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognized from the group, **and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number**, applying IFRS 17, para. B119.*"

The phrase "the ***amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number***" can be interpreted in different ways.

Question:
What is the amount to be recognised in profit or loss associated with the coverage units from derecognised contracts in the period applying IFRS 17:76(c) and IFRS 17:B119?

Quoted paragraphs of IFRS 17 *Insurance Contracts*

IFRS 17:72
If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied. The exercise of a right included in the terms of a contract is not a modification. The conditions are that:

a. if the modified terms had been included at contract inception:
    i. the modified contract would have been excluded from the scope of IFRS 17, applying paragraphs 3–8;
    ii. an entity would have separated different components from the host insurance contract applying paragraphs 10–13, resulting in a different insurance contract to which IFRS 17 would have applied;
    iii. the modified contract would have had a substantially different contract boundary applying paragraph 34; or
    iv. the modified contract would have been included in a different group of contracts applying paragraphs 14–24.
b. 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; or
c. the entity applied the premium allocation approach in paragraphs 53–59 or paragraphs 69–70 to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach in paragraph 53 or paragraph 69.

IFRS 17:74
An entity shall derecognise an insurance contract when, and only when:
a. it is extinguished, ie when the obligation specified in the insurance contract expires or is discharged or cancelled; or

b. any of the conditions in paragraph 72 are met.

IFRS 17:76
An entity derecognizes an insurance contract from within a group of contracts by applying the following requirements in IFRS 17:

a. the fulfilment cash flows allocated to the group 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 derecognized from the group, applying paragraphs 40(a) (i) and 40(b);
b. the contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and
c. the number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognized from the group, and the amount of the contractual service margin recognized in profit or loss in the period is based on that adjusted number, applying paragraph B119.

IFRS 17:40
The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:

a. the liability for remaining coverage comprising:
   i. the fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92;
   ii. the contractual service margin of the group at that date, measured applying paragraphs 43–46; and
b. the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.

IFRS 17:44(c)
[omitted]

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. [omitted]

IFRS 17:45(c)
[omitted]

c. the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:
   i. paragraph B115 (on risk mitigation) applies;
   ii. such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or
   iii. such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
d. [omitted]

IFRS 17:B96(a)
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. [omitted]

IFRS 17:B97(c)
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. [omitted]
b. [omitted]
c. experience adjustments, except those described in paragraph B96(a).

IFRS 17:B119
An amount of the contractual service margin for a group of insurance contracts is recognized in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

a. identifying the coverage units in the group. 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.
b. allocating the contractual service margin 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.
c. recognising in profit or loss the amount allocated to coverage units provided in the period.

Analysis of the question

Consider the following scenario:

- Entity A issues a group of two contracts, each providing two years of life insurance coverage without participating features and accounted for by applying the general measurement model. For simplicity, the effect of discounting and time value of money is ignored.

- The premium of each contract CU100 fully paid in advance of the start of the coverage period. The death benefit is CU150.

- At inception of the group, Entity A expects that both policyholders would survive the two-year period. At inception, the insurance contract liability balance is CU200, with contractual service margin of CU160.

- The quantity of coverage units determined at inception is four - one coverage unit per each year per each contract. At initial recognition:

Total expected cash inflows	Dr	200
Total expected cash outflows		Nil
Risk adjustment	Cr	(40)
Contractual service margin	Cr	(160)

- At initial recognition, the CSM expected to be released in Year 1 and Year 2 as follows:

Opening balance year 1	160
Release in year 1	(80)
Closing balance year 1	80
Release in year 2	(80)
Closing balance in year 2	Nil

- However, at the end of year 1, policyholder of Contract 1 dies. Entity A pays the death benefit of CU150 and the contract is derecognised.

Preliminary accounting analysis

The experience adjustment due to the unexpected death is recognized in profit or loss as a CU150 insurance service expense and as a liability for incurred claims that is paid immediately. Given the immediate payment there is nil risk adjustment (RA) included in the liability for incurred claims and the corresponding amount recognised in the insurance service expense. This is because there is no uncertainty associated with the amount and the timing of the payment of the incurred death benefit.

We refer to IFRS 17:76 for guidance in accounting for derecognized contracts. IFRS 17:76(a) requires the fulfilment cash flows allocated for the group of contracts be adjusted by the present value of future cash flows and risk adjustments relating to the derecognized contract. In the example scenario above, the adjustment applying IFRS 17:76(a) is equal to CU10 representing CU0[1] for present value of future cash flows plus the risk adjustment for non-financial risk related to derecognised contract.

At the time of death (end of year 1) the risk adjustment carrying amount is CU10. Then, applying IFRS 17:76(b), the contractual service margin is not adjusted in compliance with IFRS 17:B97(c) as referred to by IFRS 17:44(c). The risk adjustment is thus recognised in profit or loss as insurance revenue given the coverage has expired with the death of the policyholder and the associated service is fully rendered.

IFRS 17:76(c) requires that the number of coverage units for expected remaining coverage be adjusted to reflect the coverage units derecognised from the group, and the

[1] There is CU0 adjustment relating to the present value of future cash flows because the original expectation is that policyholder of Contract 1 survives at the end of the coverage period thus CU0 of death benefit was included in the original estimates. The present value of future cash flows for the remaining contract continues to be CU0 as the expectation continues to be the same, i.e. that the remaining policyholder will continue to survive and that no death benefit will be paid.

amount of the contractual service margin recognised in profit or loss in the period is allocated based on that adjusted number, applying IFRS 17:B119.

We refer to the views set out by the IASB Staff in Agenda Paper 2A of the IASB February 2017 meeting, as follow:

(30) The staff believes that it is necessary to adjust the number of coverage units to reflect experience in the current period BEFORE determining the amount of contractual service margin to be recognized in profit or loss in the current period. For example, if the number of claim events in the period is higher than expected, and this causes more contracts to be derecognized in the period than expected, ***the amount of the contractual service margin allocated to coverage units in the current period should increase*** *because the number of coverage units in future periods would decrease as a direct consequence of the experience adjustment.*

…

(34) …the allocation of the contractual service margin is calculated after adjusting the contractual service margin and the number of coverage units to reflect the experience up to the end of the period. It would be consistent with this approach to update the contractual service margin and the number of coverage units to reflect the current conditions as at the end of the period before determining the allocation of the contractual service margin to the current period. It would be inconsistent to treat a change in conditions that may have occurred over time during the current period as if it had occurred at the end of the current accounting period.

There are two views for interpreting the requirements of IFRS 17:76(c).

View 1 – The amount of contractual service margin recognised in profit or loss includes the coverage units that are no longer going to be provided (because they relate to derecognised contracts).

Applying View 1, the total number of coverage units for the group as a whole remains unchanged (i.e. 4 coverage units) and the amount of contractual service margin that relates to the coverage units from the derecognized contracts will be released in the period when the derecognition has occurred because no further services are to be provided under the contract.

Applying para. 76(c), the remaining units are adjusted for the derecognised units and at the reporting date there is only one coverage unit for the remaining coverage. The coverage units consumed during the period are also adjusted for the derecognized contract. Thus, applying IFRS 17, para. B119 the CSM allocation formula for View 1 is as follows:

$$\text{CSM to be released to P\&L for period 1} \quad \frac{\text{(2 expected coverage units consumed in the period + 1 derecognised coverage unit)}}{\text{4 total units for the group at the beginning of the period}} = 75\%$$

The amount to be recognized in profit or loss for year 1 is CU120 (CU160 *75%).

The remaining CSM balance at the end of year 1 will reflect the CSM and coverage unit relating to the remaining in-force contract only.

The result of applying View 1 is reflective of the fact that no further services are expected from Contract 1 - the impact of derecognizing Contract 1 is recognized immediately through profit or loss and removes all associated balances with the derecognized contract. This is also consistent with the Conceptual Framework for Financial Reporting (2018) para. 5.26, which provides the definition of derecognition as "the removal of all or part of a recognized asset or liability from the entity's statement of financial position… (b) for a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognized liability."

Applying View 1 will also avoid double counting of CSM relating to the derecognized contracts, where the contract modification results in derecognition of the old contract and recognition of a new contract. This is because the View 1 effectively eliminates all associated account balances relating to the derecognised contracts.

Year 1 financial statements

Income statement

Insurance revenue		150
Expected release of risk adjustment	20	
Unexpected release of risk adjustment	10	
Expected release of CSM	80	
Unexpected release of CSM	40	
Insurance service expense		(150)
Insurance service result		Nil

Statement of financial position

Assets		
Cash at bank		50
Liabilities		
Insurance contracts		50
FCF	10	
CSM	40	
Retained earnings		Nil

Year 2 financial statements

Income statement

Insurance revenue		50
Expected release of risk adjustment	10	
Expected release of CSM	40	
Insurance service expense		Nil
Insurance service result		50

Statement of financial position

Assets		
Cash at bank		50
Retained earnings		50

View 2 – The amount of contractual service margin recognised in profit or loss includes the effect of coverage units that are no longer going to be provided because they relate to derecognised contracts.

Applying View 2, the amount of the contractual service margin is adjusted to eliminate the coverage units relating to the derecognized contracts from the total number of coverage units in the group.

During its November 2016 and February 2017 meetings, the IASB noted that that there is a need to make an assumption in terms of the timing of the occurrence of changes in assumptions as it will be an operational burden to require to monitor the timing. The IASB decided to treat the changes as if they occurred at the beginning of the period.

When applying IFRS 17:76 both the requirements under (a) and (b) can be interpreted as referring to the balance as at the beginning of the period. A consistent interpretation of para. 76(c) would require the number of coverage units for expected remaining coverage at the beginning of the period (i.e. 4 units) to be adjusted to reflect the coverage units derecognized from the group, i.e. removing or eliminating the coverage units relating to derecognized units (i.e. 1 unit).

Applying View 2, the derecognized units are eliminated from the total coverage units provided by the group, and this view assumes that it has been known at the beginning that the death of the policyholder of Contract 1 will occur by the end of year 1.

Thus, applying IFRS 17, para. B119 the CSM allocation formula for View 2 is as follows:

$$\text{CSM to be released to P\&L for period 1} \quad \frac{\text{2 expected coverage units consumed in the period}}{\text{4 total units for the group at the beginning of the period} - \text{1 derecognised coverage unit}} = 67\%$$

Thus, applying View 2, the amount to be recognized in profit or loss for year 1 is CU (CU160 *67%) = CU107.2

The implication of applying View 2 is that a portion of the CSM relating to the derecognized units remains to be allocated across the remaining coverage period despite the fact that Contract 1 has been derecognized. This is illustrated in the example, whereby had the actual amounts equalled the expected amounts, the CSM relating to each of the contract at Year 2 would have been CU40 each. In applying View 2, the remaining contract has been allocated a portion of CSM from the derecognized unit resulting in CSM of CU52.8 at the end of Year 1 for the remaining contract.

Year 1 financial statements

Income statement

Insurance revenue		137.2
Expected release of risk adjustment	20	
Unexpected release of risk adjustment	10	
Expected release of CSM	80	
Unexpected release of CSM	27.2	
Insurance service expense		(150)
Insurance service result		(12.8)

Statement of financial position

Assets		
Cash at bank		50
Liabilities		
Insurance contracts		62.8
FCF	10	
CSM	52.8	
Retained loss		(12.8)

Year 2 financial statements

Income statement

Insurance revenue		62.8
Expected release of risk adjustment	10	
Expected release of CSM	52.8	
Insurance service expense		Nil
Insurance service result		62.8

Statement of financial position

Assets		
Cash at bank		50
Retained earnings		50