

## AGENDA [30/11/2018]

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**Date** 11-13 December 2018

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**Location** IASB, Boardroom,  
Columbus Building | 7 Westferry Circus |  
Canary Wharf | London E14 4HD | UK

Agenda timings or topics may change as the meeting progresses. To receive real-time updates, follow us on [Twitter](#) at [@IFRSFoundation](#) using the hashtag [#IFRSMeetings](#).

**Tuesday 11 December**

Time UK	Agenda item	Agenda ref.	Presenter at table	Remote participation
15.30-16.00	<b>IFRS 17 Insurance Contracts</b> [Education Session]	2	Insurance Team	N/A

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**Date** 11-13 December 2018

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**Location** IASB, Boardroom,  
Columbus Building | 7 Westferry Circus |  
Canary Wharf | London E14 4HD | UK**Wednesday 12 December**

Time UK	Agenda item	Agenda ref.
10.15-10.45	Updating a reference to the Conceptual Framework (Amendments to IFRS 3)	10
10.45-11.00	Provisions	22
11.00-11.30	Dynamic Risk Management	4
11.30-12.30	Business Combinations under Common Control	23
12.30-13.15	Lunch	
13.15-15.15	Primary Financial Statements	21
15.15-15.30	Break	
15.30-15.45	Research Programme	8
15.45-16.00	Pensions Benefits that Depend on Asset Returns	29
16.00-17.00	IBOR Reform and the Effects on Financial Reporting	14

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# AGENDA [30/11/2018]

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## Thursday 13 December

Time UK	Agenda item	Agenda ref.
09.30-11.30	<b>IFRS 17 Insurance Contracts</b>	2
11.30-11.45	<b>Break</b>	
11.45-12.45	<b>Disclosure Initiative</b>	11
12.45-13.45	<b>Lunch</b>	
13.45-15.15	<b>Rate-regulated Activities</b>	9
15.15-15.30	<b>Break</b>	
15.30-17.00	<b>Implementation Matters</b>	12

## STAFF PAPER

December 2018

IASB<sup>®</sup> meeting

Project	Insurance Contracts		
Paper topic	Cover note		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

## Introduction

1. The papers for this meeting:
  - (a) provide an analysis of some of the concerns and implementation challenges raised by stakeholders about the requirements in IFRS 17 *Insurance Contracts* since the Standard was issued; and
  - (b) ask whether the International Accounting Standards Board (Board) agrees with the staff recommendations:
    - (i) to amend the requirements in IFRS 17 for the presentation of insurance contracts on the statement of financial position as discussed in Agenda Paper 2A *Presentation of insurance contracts on the statement of financial position*; and
    - (ii) not to amend the requirements in IFRS 17 for the other topics discussed in Agenda Papers 2A–2F.
2. This cover note provides:
  - (a) background information about the tentative decisions made by the Board at its recent meetings;

- (b) a list of the papers for this meeting with a table of concordance of the topics discussed at the October 2018 Board meeting; and
- (c) an outline of the next steps.

## Background

3. The Board has concluded that applying IFRS 17 for the first time will result in significant costs for some entities, but overall the benefits of IFRS 17 will outweigh the costs (for discussion of the costs and benefits of IFRS 17 refer to the *Effects Analysis on IFRS 17*).
4. At its October 2018 meeting, the Board discussed an overview of the main concerns and implementation challenges raised by stakeholders about requirements in IFRS 17. The Board was not asked to make any decisions about those concerns and implementation challenges.
5. At the same meeting, the Board tentatively decided that, when proposing any amendment to IFRS 17, in addition to demonstrating a need for the amendment, the staff must show that any proposal meets the following criteria:
  - (a) the amendments would not result in significant loss of useful information relative to that which would otherwise be provided by IFRS 17 for users of financial statements—any amendments would avoid:
    - (i) reducing the relevance and faithful representation of information in the financial statements of entities applying IFRS 17;
    - (ii) causing reduced comparability or introducing internal inconsistency in IFRS Standards, including within IFRS 17; or
    - (iii) increasing complexity for users of financial statements, thus reducing understandability.
  - (b) the amendments would not unduly disrupt implementation already under way or risk undue delays in the effective date of this Standard, which is needed to address many inadequacies in the existing wide range of insurance accounting practices.

6. At its November 2018 meeting, the Board tentatively decided to propose a one-year deferral of the effective date of IFRS 17. Accordingly, entities would be required to apply IFRS 17—and any amendment to IFRS 17—for annual periods beginning on or after 1 January 2022. The Board noted that a deferral of the effective date of IFRS 17 for one year would not unduly disrupt implementation—ie it would meet the criterion mentioned in paragraph 5(b) of this paper.
7. The staff observe that the Board generally allows at least 12 to 18 months between the publication of new requirements and their mandatory effective date. Therefore, any proposed amendments to IFRS 17 would need to be finalised on a timely basis to allow for this period before 1 January 2022.

### **Papers for this meeting**

8. The papers for this meeting provide an updated analysis about 13 of the 25 topics discussed in Agenda Paper 2D *Concerns and implementation challenges* for the October 2018 Board meeting. For this meeting, those 13 topics have been grouped by content in the following papers:
  - (a) Agenda Paper 2A *Presentation of insurance contracts on the statement of financial position*;
  - (b) Agenda Paper 2B *Discount rates, risk adjustment and OCI option*;
  - (c) Agenda Paper 2C *Variable fee approach*;
  - (d) Agenda Paper 2D *Business combinations*;
  - (e) Agenda Paper 2E *Future cash flows in the measurement of reinsurance contracts held*; and
  - (f) Agenda Paper 2F *The treatment of accounting estimates in interim financial statements*.
9. The following table shows how the topics discussed in Agenda Paper 2D for the October 2018 Board meeting and the papers for this meeting correspond.

<b>October 2018 Board meeting (Agenda Paper 2D)</b>	<b>December 2018 Board meeting</b>
1—Scope of IFRS 17   Loans and other forms of credit that transfer insurance risk	Discussion planned at future meetings
2—Level of aggregation of insurance contracts	Discussion planned at future meetings
3—Measurement   Acquisition cash flows for renewals outside the contract boundary	Discussion planned at future meetings
<b>4—Measurement   Use of locked-in discount rates to adjust the contractual service margin</b>	<b>Agenda Paper 2B</b>
<b>5—Measurement   Subjectivity   Discount rates and risk adjustment</b>	<b>Agenda Paper 2B</b>
<b>6—Measurement   Risk adjustment in a group of entities</b>	<b>Agenda Paper 2B</b>
7—Measurement   Contractual service margin: coverage units in the general model	Discussion planned at future meetings
<b>8—Measurement   Contractual service margin: limited applicability of risk mitigation exception</b>	<b>Agenda Paper 2C</b>
<b>9—Measurement   Premium allocation approach: premiums received</b>	<b>Agenda Paper 2A</b>
<b>10—Measurement   Business combinations: classification of contracts</b>	<b>Agenda Paper 2D</b>
<b>11—Measurement   Business combinations: contracts acquired during the settlement period</b>	<b>Agenda Paper 2D</b>
12—Measurement   Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous	Discussion planned at future meetings
13—Measurement   Reinsurance contracts held: ineligibility for the variable fee approach	Discussion planned at future meetings
<b>14—Measurement   Reinsurance contracts held: expected cash flows arising from underlying insurance contracts not yet issued</b>	<b>Agenda Paper 2E</b>
<b>15—Presentation in the statement of financial position   Separate presentation of groups of assets and groups of liabilities</b>	<b>Agenda Paper 2A</b>
<b>16—Presentation in the statement of financial position   Premiums receivable</b>	<b>Agenda Paper 2A</b>

October 2018 Board meeting (Agenda Paper 2D)	December 2018 Board meeting
<b>17—Presentation in the statement(s) of financial performance   OCI option for insurance finance income or expenses</b>	<b>Agenda Paper 2B</b>
<b>18—Defined terms   Insurance contract with direct participation features</b>	<b>Agenda Paper 2C</b>
<b>19—Interim financial statements   Treatment of accounting estimates</b>	<b>Agenda Paper 2F</b>
20—Effective date   Date of initial application of IFRS 17	Tentative decisions made at the November 2018 Board meeting
21—Effective date   Comparative information	Discussion planned at future meetings
22—Effective date   Temporary exemption from applying IFRS 9	Tentative decisions made at the November 2018 Board meeting
23—Transition   Optionality	Discussion planned at future meetings
24—Transition   Modified retrospective approach: further modifications	Discussion planned at future meetings
25—Transition   Fair value approach: OCI on related financial assets	Discussion planned at future meetings

### Next steps

10. At future meetings, the staff will bring papers on the remaining topics.
11. After the Board has considered all the individual topics, the Board plans to consider the package of amendments as a whole before concluding whether the benefits of making the amendments outweigh the costs.

## STAFF PAPER

December 2018

## IASB® meeting

Project	Insurance Contracts		
Paper topic	Presentation of insurance contracts on the statement of financial position		
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**Purpose and structure of the paper**

1. This paper discusses the following topics:
  - (a) the need to allocate premium cash flows and the liability for incurred claims to each group of insurance contracts; and
  - (b) separate presentation and measurement of premiums receivable and claims payable.
2. For each topic, this paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendations and a question for Board members.
3. Appendix A to this paper includes extracts from Agenda Paper 2C *Implementation challenges outreach report* which was discussed at the May 2018 Board meeting. That report provides a wider context of the implementation challenges related to the

topics discussed in this paper, and examples of the PAA mechanics with comparison to the accounting under existing practice.

## **Summary of staff recommendations**

4. The staff recommend that the Board should:
  - (a) amend paragraph 78 of IFRS 17 to require that an entity presents separately in the statement of financial position the carrying amount of portfolios of:
    - (i) insurance contracts issued that are assets;
    - (ii) insurance contracts issued that are liabilities;
    - (iii) reinsurance contracts held that are assets; and
    - (iv) reinsurance contracts held that are liabilities.
  - (b) not amend the requirements in IFRS 17 to require separate presentation and measurement of premiums receivable and claims payable.

## **The need to allocate premium cash flows and the liability for incurred claims to each group of insurance contracts**

### ***IFRS 17 requirements***

5. IFRS 17 specifies requirements for the recognition, measurement, presentation and disclosure of groups of insurance contracts. Those requirements reflect all the rights and obligations arising from a group of insurance contracts as a single asset or liability. In other words, the unit of account for IFRS 17 is a group of insurance contracts.
6. Applying the general model, an entity is required to include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group. Those future cash flows include premiums expected to be received and claims and expenses expected to be paid.
7. The measurement of a group of contracts can be disaggregated into two components: a liability for remaining coverage (which includes the fulfilment cash flows and the

contractual service margin related to future coverage) and a liability for incurred claims (which includes the fulfilment cash flows relating to claims for insured events that have occurred).

8. Paragraph 78 of IFRS 17 states:

An entity shall present separately in the statement of financial position the carrying amount of groups of:

- (a) insurance contracts issued that are assets;
- (b) insurance contracts issued that are liabilities;
- (c) reinsurance contracts held that are assets; and
- (d) reinsurance contracts held that are liabilities.

9. Therefore, IFRS 17:

- (a) requires an entity to present the combination of rights and obligations arising from a group of insurance contracts as a single asset or liability for insurance contracts; and
- (b) prohibits the entity from offsetting groups of insurance contracts in an asset position with groups of insurance contracts in a liability position.

*Premium allocation approach*

- 10. The PAA in IFRS 17 simplifies the measurement of the liability for remaining coverage for contracts meeting specified criteria. IFRS 17 permits, but does not require, an entity to apply the PAA when that approach provides a reasonable approximation to the general model in IFRS 17.
- 11. Applying the PAA, an entity measures the liability for remaining coverage of a group of insurance contracts on initial recognition at the premiums received less any insurance acquisition cash flows paid. Subsequently, the liability for remaining coverage of a group of insurance contracts increases with premiums received and decreases to reflect an allocation of the total amount of the expected premiums receipts to profit or loss as insurance services are provided. Appendix A to this paper

include examples of the PAA mechanics with comparison to the accounting under existing practice.

12. The requirements for the presentation on the statement of financial position and the unit of account for contracts to which the PAA applies are the same as in the general model. Therefore, the PAA applies to a group of contracts and offsetting of groups of contracts to which the PAA applies is prohibited.

### ***Board's rationale***

13. A group of insurance contracts is the unit of account applying IFRS 17.

Paragraph BC328 of the Basis for Conclusions on IFRS 17 explains:

IFRS 17 requires an entity to present the combination of rights and obligations arising from a group of insurance contracts as a single insurance contract asset or liability in the statement of financial position. This requirement is consistent with the measurement of a group of insurance contracts as a package of cash inflows and cash outflows. Consistent with the requirement in IAS 1 [*Presentation of Financial Statements*] that an entity not offset assets and liabilities, IFRS 17 prohibits entities from offsetting groups of insurance contracts in an asset position with groups of insurance contracts in a liability position.

14. This requirement is also consistent with the *Conceptual Framework for Financial Reporting*, which states:

The unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied.<sup>1</sup>

Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the statement of financial position. Offsetting classifies dissimilar items together and therefore is generally not appropriate.

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<sup>1</sup> Paragraph 4.48 of the *Conceptual Framework for Financial Reporting*.

Offsetting assets and liabilities differs from treating a set of rights and obligations as a single unit of account.<sup>2</sup>

### *Premium allocation approach*

15. The Board views the PAA as a simplification of the general model requirements. Accordingly, the level of aggregation requirements and the presentation in the statement of financial position requirements described in paragraphs 8–9 of this paper are equally applicable when applying the PAA.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

16. Some stakeholders state that a significant implementation challenge arises because IFRS 17 requires entities to present groups of contracts that are in an asset position separately from groups of contracts in a liability position in the statement of financial position. This requirement results in the need for an entity to allocate premium cash flows and the liability for incurred claims to each group of insurance contracts to determine if that group of insurance contracts is in an asset or a liability position.
17. Those stakeholders observe that when applying many existing insurance accounting practices, insurance line items on the statement of financial position reflect a high level of aggregation (for example, at an entity level). However, separate line items are presented for different amounts arising from insurance contracts and those line items reflect a level of aggregation that is consistent with the way that entities manage their operations and systems. For example, entities typically manage separately and at a high level of aggregation the information about premiums receivable and claims payable, and, therefore entities maintain information about cash receipts and payments only at this aggregated level. Similarly, entities typically record the liability for incurred claims only at an aggregated level.

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<sup>2</sup> Paragraphs 7.10–7.11 of the *Conceptual Framework for Financial Reporting*.

18. The following illustration shows the likely changes introduced by the IFRS 17 presentation requirements:

<b>Today*</b>	<b>IFRS 17</b>
<b>Assets</b>	<b>Assets</b>
Deferred acquisition costs Premiums receivable	Insurance contract assets (for groups that are assets)
<b>Liabilities</b>	<b>Liabilities</b>
Insurance contract liabilities Unearned premiums Claims payable	Insurance contract liabilities (for groups that are liabilities)

(\*) Common presentation in the statement of financial position applying IFRS 4 *Insurance Contracts*

19. Some stakeholders are concerned that they will need to develop new systems to identify premiums received, claims incurred and other separately managed balances (such as insurance acquisition cash flows or collateral deposits related to reinsurance) for each group of contracts so that they can allocate these amounts to each group of contracts. Those stakeholders state that the need to identify such amounts at a group of contracts level represents a significant implementation challenge because:
- (a) existing systems do not typically link the system that registers premiums received and the system that generates the information necessary to measure the insurance contracts asset or liability. The latter processes information based on the assumption that premiums were received or are received when due.
  - (b) existing systems typically manage and administer claims in separate, independent systems that are not linked to the system that generates the information necessary to determine the liability for remaining coverage.
20. Some stakeholders think the presentation requirements in IFRS 17 would result in significant additional costs related to new systems or significant changes to existing systems. For many types of insurance contracts they think that they could apply the

requirements of IFRS 17 other than the presentation requirements without the need to allocate premiums received and claims incurred to groups of contracts.

21. Developing new systems is likely to be complex and costly. Consequently, stakeholders question whether the usefulness of the information to the users of financial statements arising from applying the presentation requirements is sufficient to justify such costs.
22. Feedback so far indicates that users of financial statements may not regard the presentation of insurance contract assets and liabilities at a portfolio level, rather than a group level, as significantly diminishing the usefulness of information.
23. Some stakeholders think that IFRS 17 should be amended to require aggregation at a portfolio or entity level for presentation purposes. Some stakeholders told us that even though they would prefer a presentation on an entity level, a presentation at a portfolio level will significantly reduce their implementation costs.
24. Some stakeholders suggest that the challenge of identifying premiums received and incurred claims for groups of contracts is relevant for all insurance contracts. Other stakeholders suggest that this challenge is more relevant to contracts measured applying the PAA. Some stakeholders also think that the PAA results in a measurement that is based on a cash flow basis rather than accrual basis and therefore suggest amending the measurement requirements of the PAA.

### ***Staff analysis and recommendation***

#### *Premiums*

25. In both the general model and the PAA, insurance revenue is recognised as services are provided and the receipt of premium does not affect the timing of revenue recognition.
26. However, the measurement of the insurance contract asset or liability is affected by the receipt of premiums. This is because the insurance contract asset or liability reflects the financial position resulting from an entity's rights and obligations at the reporting date. In the general model, when premiums are received those amounts are

no longer included in the fulfilment cash flows of a group of insurance contracts. This reflects that the premiums received are no longer future cash flows. In other words, the cash asset increases and the insurance liability increases. Consistently, applying the PAA, when premiums are received the cash asset increases and the insurance liability increases.

### *Incurred claims*

27. The measurement of an insurance contract asset or liability can be disaggregated into two components: a liability for remaining coverage and a liability for incurred claims. In the statement of financial position:
- (a) the liability for incurred claims is a credit.
  - (b) the liability for remaining coverage may be a debit or a credit as it is affected by the timing of cash flows received and paid for a group of insurance contracts. If, for example, an entity pays expenses sooner than it receives premiums, the liability for remaining coverage may be a debit.
28. Since the insurance contract asset or liability includes both a liability for remaining coverage and a liability for incurred claims, the measurement of the insurance contract balance as an overall asset (debit) or liability (credit) can only be determined if the liability for remaining coverage and the liability for incurred claims are identified for each group of contracts.
29. In addition, to determine the liability for incurred claims—similar to premium receipts—any payments relating to claims or expenses need to be allocated to each group of contracts.
30. However, applying IFRS 17, claims and expenses (including any subsequent change in the liability for incurred claims)<sup>3</sup> are recognised as insurance service expenses in the period they are incurred. Therefore the identification of the liability for incurred

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<sup>3</sup> The effect of time value of money and the effect of financial risk are recognised as insurance finance income or expenses.

claims and the related payments with each group of contracts has no direct effect on the determination of the insurance service result.

### *Staff recommendations*

31. The staff observe that stakeholders made two different suggestions to address the implementation challenges discussed in paragraphs 19–24 of this paper.
32. With respect to the suggestion to change the measurement requirements of the PAA, the staff observe that:
  - (a) applying the PAA, consistently with the general model, insurance revenue is recognised as services are provided and the receipt of premiums does not affect the timing of revenue recognition. Therefore, the PAA does not result in revenue that is determined on a cash flow basis.
  - (b) applying the PAA, consistently with the general model, when premiums are received the cash asset increases and the insurance liability increases. Therefore, the receipt of premiums does not have an effect on the net asset or liability position of the entity.
  - (a) the Board view's the PAA as a simplification of the requirements in the general model. To change the measurement requirements for the PAA would result in the PAA being a different measurement model.
33. With respect to the suggestion to amend the level of aggregation requirements for presentation purposes, the staff think that there is merit in providing a practical relief for entities by requiring entities to present insurance contracts at a higher level of aggregation than the group level.
34. The question then arises as to which level would be appropriate. The staff considered only presentation at a portfolio level or at an entity level, because these are levels of aggregation already specified in IFRS 17.
35. The staff observe that offsetting generally does not meet the objective of financial reporting as set out in the *Conceptual Framework*. Presenting items on a net basis might:

- (a) obscure the existence of some transactions and change amounts often used as an indication of the size of an entity, for example, total assets; and
  - (b) detract from the ability of users of financial statements to understand the transactions and to assess an entity's future cash flows, except when offsetting reflects the substance of the transaction or other event.
- 36. The staff therefore note that any practical relief the Board provides would be contrary to the general requirements of the *Conceptual Framework*. Although it will be more costly to implement the requirements at a portfolio level when compared to an entity level, the staff think that any practical relief should limit the loss of information for users of financial statements.
- 37. On balance, the staff recommend that entities are required to offset groups at the portfolio level for presentation purposes. This means that an entity would present separately assets and liabilities for insurance contracts subject to similar risks that are managed together. The staff think that offsetting at an entity level risks a greater loss of useful information. The staff also note that in the 2010 Exposure Draft *Insurance Contracts* and 2013 Exposure Draft *Insurance Contracts*, the Board proposed presentation at a portfolio level when the unit of account was a single contract.
- 38. The staff consider the proposed amendment against the criteria set by the Board at its October 2018 meeting and observe that:
  - (a) although offsetting groups in the statement of financial position would result in a loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements, preliminary discussions with users of financial statements suggest that the loss of information could be regarded as acceptable when balanced against the significant cost relief for preparers of financial statements; and
  - (b) amending IFRS 17 in this way would not unduly disrupt implementation processes that are already under way—the staff have been told that such an amendment might significantly reduce implementation costs and simplify implementation for many entities.

39. The staff note that, in some circumstances an entity would need to identify premiums received and the liability for incurred claims at the level of a group of contracts regardless of the presentation requirements. This is because such amounts may affect the measurement of a group of contracts and the amounts recognised in the statement(s) of financial performance. For example, when applying the other comprehensive income (OCI) option for disaggregating insurance finance income or expenses to specific types of contracts that are measured using the general model, the discount rate used for recognising insurance finance income or expenses in profit or loss is determined by reference to the discount rates determined at the date of initial recognition of a group of contracts. Therefore, identifying the liability for incurred claims with the relevant group is essential to determine the appropriate discount rate to measure the insurance finance income or expenses in profit or loss.

**Question 1 for Board members**

Do you agree that the Board should amend paragraph 78 of IFRS 17 as follows?

An entity shall present separately in the statement of financial position the carrying amount of ~~groups~~ portfolios of:

- (a) insurance contracts issued that are assets;
- (b) insurance contracts issued that are liabilities;
- (c) reinsurance contracts held that are assets; and
- (d) reinsurance contracts held that are liabilities.

**Separate presentation and measurement of premiums receivable and claims payable**

***IFRS 17 requirements***

40. IFRS 17 requires an entity to measure a group of insurance contracts on the basis of all the cash flows expected to arise from fulfilling the contracts in the group, including premiums receivable and claims payable.

### **Board's rationale**

41. The fundamental principle in IFRS 17 is that an insurance contract should be measured using a current estimate of all expected cash flows within the contract boundary that will arise as the contract is fulfilled. Consistent with that measurement approach, the presentation in the statement of financial position reflects the combination of rights and obligations created by the contract as giving rise to a single insurance contract asset or liability.

### **Concerns and implementation challenges expressed since IFRS 17 was issued**

42. Some stakeholders express concern that the rights and obligations of a group of insurance contracts is measured as a whole and presented as a single line item representing the insurance contract asset or liability in the statement of financial position.
43. As illustrated in paragraph 18 of this paper, many entities currently account for premiums receivable as financial assets and claims payable as a liability, separate from the rest of the insurance contract liability.
44. Some stakeholders think that the nature of premiums receivable and claims payable would be better reflected if entities were to measure and present them separately applying IFRS 9 *Financial Instruments*. The remaining insurance contract asset or liability would be measured applying IFRS 17 assuming amounts are received and paid when they are due to be received or due to be paid.
45. Those stakeholders suggest that measuring and presenting such amounts applying IFRS 9 would provide better information about the risks relating to those amounts, particularly their credit risk. They note that measuring and presenting such amounts applying IFRS 9 would also alleviate their implementation challenges.

### **Staff analysis and recommendation**

46. The measurement of a group of insurance contracts applying IFRS 17:

- (a) includes an estimate of the expected present value of the cash flows generated by the contracts. The expected present value is the probability-weighted mean of the present value of the possible cash flows, discounted using current estimates of discount rates. The measurement model in IFRS 17 therefore reflects the risk of non-payment of premiums by policyholders.
  - (b) reflects current estimates of the expected future cash flows relating to claims measured using the discount rates applied to future cash flows. Therefore, future cash flows related to the settlement of claims are also measured at a current value basis, compared to most types of financial liabilities measured applying IFRS 9 which are measured on a cost basis.
- 47. The staff think that measuring premiums receivable and claims payable separately from insurance contracts would result in internal inconsistencies in IFRS 17. The principle of IFRS 17 recognises that a contract, and by extension groups of contracts, create a single bundle of rights and obligations. Measuring premiums receivable and claims payable separately and differently from the corresponding obligations and rights is inconsistent with this principle.
- 48. The requirements for the measurement of groups of insurance contracts are a fundamental feature of IFRS 17. The staff do not think that the concerns raised by some stakeholders warrant a significant change to the measurement principle in IFRS 17. This principle has been subject to extensive discussions and has remained substantially unchanged since the initial proposals of the Board.
- 49. In developing the Standard, the Board considered whether to retain presentation approaches, commonly used in many existing accounting practices, that measure and present components of insurance contracts as separate line items. The Board concluded that measuring and presenting components of the net insurance contract asset or liability as separate assets and liabilities in the statement of financial position suggests that those assets and liabilities are different and are not related to each other. In particular, showing a component of the overall insurance contract asset or liability as a separate line item could be misleading if that asset were not measured as a standalone asset, but rather would be measured on an expected basis together with other insurance expected cash flows.

50. The staff think that amending IFRS 17 to require the separate presentation of premiums receivable and claims payable from the insurance contract asset or liability could:
- (a) reduce comparability between entities—the staff understand that systems currently used by entities recognise premiums receivable over different periods for different contracts. For example, one entity may only recognise premiums due in the current month that were not yet received, while another entity may reflect premiums due in the next 12 months in premiums receivable.
  - (b) unduly disrupt implementation already under way and risk undue delays in the effective date of IFRS 17 if the Board were to develop a consistent definition of premiums receivable and claims payable.
51. The staff note that paragraph 55 of IAS 1 *Presentation of Financial Statements* permits the presentation of additional line items including by disaggregation of required line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity’s financial position. Applying that requirement, an entity may be able to present a disaggregation which shows the components of each of those line items (for example, to present the amounts of premiums receivable and claims payable included in the carrying amount of the insurance contract liability). The staff observe that requirement does not permit an entity to present premiums receivable or claims payable as separate line items, it only permits for the required line items to be disaggregated when such presentation is relevant to an understanding of the entity’s financial position.

**Question 2 for Board members**

Do you agree that the Board should not amend the requirements of IFRS 17 to require separate presentation and measurement of premiums receivable and claims payable?

**Appendix A—Extracts from Agenda paper 2C *Implementation challenges outreach report* of the May 2018 Board meeting**

**Level of aggregation**

***Applying the requirements of IFRS 17***

- A1. Paragraph 78 of IFRS 17 requires an entity to present separately in the statement of financial position the carrying amount of groups of insurance contracts issued that are assets and those that are liabilities. This requirement applies both when a group of contracts is measured using the general model, or when measured using the PAA.
- A2. A group of insurance contracts (either asset or liability) is disaggregated into a liability for remaining coverage and a liability for incurred claims. Both components need to be identified at the level of a group of insurance contracts.
- A3. The receipt of premiums during each reporting period affects the measurement of the liability for remaining coverage, as follows:
- (a) applying the general model in paragraphs 33–37 of IFRS 17, the liability for remaining coverage of each group is measured using the fulfilment cash flows, which reflects the current estimate of future cash flows, and the contractual service margin (CSM) for each group. In other words, the measurement excludes the premiums already received and includes premiums that are due but that have not been received.
  - (b) applying the PAA, the liability for remaining coverage is measured based on the premiums received less those that have been recognised as revenue.
- A4. Accordingly, the requirements in IFRS 17 would require entities to identify premiums received for a group of insurance contracts.
- A5. In contrast, the revenue recognised in each reporting period is not based on actual receipts of premium at each reporting period (see examples in Appendix A to this paper), both applying the requirements of the general model in paragraphs 83 and B120–B125 of IFRS 17 and the requirements of the PAA in paragraphs 55(b)(v) and B126–127 of IFRS 17.

- A6. TRG members observed that to identify the premiums received for a group of insurance contracts, amounts that they previously presented aggregated as line items (see paragraph A8 of this appendix) would need to be disaggregated into groups of insurance contracts that are assets and groups of insurance contracts that are liabilities.
- A7. A few TRG members suggested that IFRS 17 should be amended to require aggregation at a portfolio or entity level for presentation purposes.

***Applying existing practice***

- A8. TRG members explained that under existing practice, line items of the statement of financial position reflect a relatively high level of aggregation of insurance contracts (for example, at an entity level) however, they are disaggregated in a manner that is consistent with the way that entities manage their operations and systems. For example, these line items identify separately:
- (a) insurance receivables—produced by cash management/credit management systems. These represent the amounts due to be received, including overdue amounts and invoiced that are outstanding.
  - (b) unearned premium reserve (UPR) and other insurance reserves that relate to future coverage—produced by the policy administration system or an earning engine. The UPR is the amount that reflects the contract premium received or due to be received that has yet to be recognised as revenue. It is primarily used for non-life contracts.
  - (c) liability for incurred claims, including incurred but not reported claims (IBNR)—based on claims management systems and actuarial models. This represents the obligation to pay claims that have been incurred but not paid at the reporting date.
  - (d) deferred acquisition costs—based on commission administration systems or general cost administration system.
- A9. A few TRG members explained that under their existing practice for non-life contracts and some protection life contracts, the presentation in the statements of financial position reflects a gross presentation of the premiums invoiced to the

policyholders and a liability that reflects the unearned premium. This method of presentation is illustrated in the examples in Appendix A to this paper.

A10. TRG members explained that the presentation of these disaggregated line items at an entity level under existing practice reflects critical measures used for both internal and external users of financial statements. In particular, they regard the following as key management metrics for non-life contracts and some protection life contracts:

- (a) premiums receivable—provides information about the entity’s exposure to credit risk; and
- (b) UPR—provides information about the entity’s obligation to fulfil the contracts.

A11. Some TRG members expressed concern that this information would be lost in applying IFRS 17. Furthermore, some TRG members noted that in their view, users of financial statements may consider the information provided by the requirement to present groups of insurance contracts that are assets separately from groups of contracts that are liabilities less relevant. Additionally, in their view, users of financial statements may misinterpret this information.

A12. In addition:

- (a) some TRG members stated that since the actual receipt of premiums affects the measurement of the group of contracts, a group can change from asset position to liability position over time;
- (b) a few TRG members noted that they believe that investors and prudential regulators are likely to demand information that is based on existing practice and that preparers would continue producing this information for management purposes;
- (c) a few TRG members suggested that the existing practice reflects the information on an accrual basis, whereas they believe the requirements of IFRS 17 are on cash basis and therefore provide less transparent information; and
- (d) a few TRG members suggested that IFRS 17 should be amended to bring premiums receivables into the scope of IFRS 9 instead of IFRS 17.

***Implementation challenges in identifying premiums received related to groups of insurance contracts***

- A13. TRG members stated that a significant implementation challenge results from the need to identify premiums received with each group of contracts. TRG members explained that the challenge is primarily due to a need for new systems or a significant change to existing systems because existing systems do not link the system that registers premiums received and the system that generates the information necessary to determine the liability for remaining coverage. The latter processes information based on the assumption that premiums were received or are received when due.
- A14. In addition, TRG members noted that, under existing practice, information is managed using systems based on different granularity levels that reflect the manner in which an entity operates its business. For example, some TRG members noted that the system that registers premiums received, which is focused on the collection of premiums receivable and the management of credit risk, generally aggregates contracts by distribution network (for example, contracts may be aggregated by a broker or an agent).
- A15. A few TRG members noted that insurers reconcile the receivables generated from the system that registers the premiums received with the information included in the general accounting systems as part of the overall control framework that insurers have developed around their working capital cycle and the close of the financial reporting. However, this is performed at a higher level of aggregation than a group of contracts.
- A16. Some TRG members suggested that the challenge of identifying premiums received relating to groups of contracts is equally relevant to life and non-life contracts. Other TRG members suggested that this challenge would be more relevant to non-life contracts mainly because:
- (a) for most life contracts the amounts identified as premiums due to be received are less significant than for non-life contracts. For non-life contracts the beginning of the coverage period and the premium due date are contractually defined independently from whether the premium has been paid (a few TRG members noted that this is also relevant to health and

protection business). Conversely, for most life insurance contracts with an investment component the contract only begins when the premium is paid.

- (b) it is expected that an immaterial number of groups of life contracts would switch between asset and liability positions due to the long-term coverage.

- A17. TRG members suggested that to integrate a system solution that would provide entities with the capabilities to identify premiums received with groups of insurance contracts is likely to be complex and costly. The demands come from a greater need for memory storage, computational capabilities and from the work necessary for this new/upgraded technology to be integrated with the legacy systems of insurers.
- A18. TRG members noted a concern that, in their view, the costs related to the implementation challenges would be higher than the benefit related to presenting information in the statement of financial position based on groups of insurance contracts.
- A19. A few TRG members observed that an alternative solution may be to apply an approximation approach for allocating premium receipts amongst the groups of insurance contracts, noting that paragraph 24 of IFRS 17 allows for reasonable approximations to allocate fulfilment cash flow components to groups of contracts. It was observed that challenges in achieving consistency, reacting to changes in policyholder payment behaviour and validation of the allocation method may arise.

***Implementation challenges in identifying the liability for incurred claims related to groups of insurance contracts***

- A20. TRG members stated that a significant implementation challenge results from the need to identify the liability for incurred claims for each group of insurance contracts. They regarded this basis as inconsistent with actuarial valuation principles and stated that it would result in significant implementation costs.
- A21. TRG members explained that claims are managed and administrated in separate, independent systems (claims administration systems) that are not linked to the system that generates the information necessary to determine the liability for remaining coverage. TRG members also noted that the information about the liability for incurred claims is managed at a granularity level that reflects the manner in which an

entity operates its business. For example, some TRG members observed that typically claims are actuarially managed on an accident year claim basis or underwriting year contract basis in order to most appropriately reflect specific characteristics and actuarial principles. TRG members explained that information based at this level of aggregation is a necessary basis for the calculation of the liability for incurred claims including IBNR.

- A22. A few TRG members noted that, applying IFRS 17, there are other expenses an insurance entity incurs to fulfil the insurance contract obligations that are a level higher than the group of insurance contracts—for example, insurance acquisition cash flows—and that an allocation to groups of insurance contracts would be required regardless of the presentation requirements of IFRS 17. Some of these members expected that the guidance in paragraph 24 of IFRS 17 would be used.
- A23. Some TRG members suggested that the challenge of identifying the liability for incurred claims with groups of contracts is equally relevant to life and to non-life contracts. Other TRG members suggested that this challenge would be more relevant to non-life contracts where contracts tend to have a long settlement period.

### ***Supporting materials***

- A24. Based on the responses received from the TRG members, the staff have identified a few areas that the staff believe would benefit from the development of additional supporting materials. The topics that are expected to form the base for these materials, including an illustrative example, are provided below and in the examples in Appendix A to this paper. These materials could be useful in facilitating a better understanding of the requirements of the Standard and may be helpful in mitigating some of the implementation concerns expressed by preparers. The topics are the following:
- (a) entities should consider the disclosure requirements included in paragraphs 121–132 of IFRS 17 to provide information about the entity’s exposure to insurance and financial risks arising from insurance contracts. In particular, the disclosures related to credit risk that arises from insurance contracts may be relevant in considering whether there is a loss of information that TRG members view as useful to users of financial statements.

- (b) the requirements in IFRS 17 specify the amounts to be reported, not the methodology to be used to determine those amounts.
- (c) paragraph 24 of IFRS 17 states that an entity may estimate the fulfilment cash flows at a higher level of aggregation than a group or portfolio, provided it is able to include the appropriate fulfilment cash flows in the measurement of the group by way of allocation. Paragraph 33(a) of IFRS 17 specifies that the estimates of future cash flows shall incorporate all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows. An allocation that incorporates all reasonable and supportable information without undue cost or effort may provide an alternative approach to identifying the premiums received and the liability for incurred claims for each group of insurance contracts.
- (d) in a few of the responses received, there may be a misunderstanding of the mechanics of the PAA. The staff have developed a few examples based on a fact pattern provided by a TRG member to illustrate the mechanics of the PAA approach together with the accounting under existing practice. The staff think it would be helpful to communicate these examples as supporting material (see examples below).

## Examples of the PAA mechanics (with comparison to the accounting under existing practice)

### *Fact pattern<sup>4</sup>*

- A25. A contract is issued with a period of insurance coverage 1 July 20X1–30 June 20X2. The contractually agreed premium is CU1,200. Insurance acquisition cash flows of CU180 are paid on 1 July 20X1.
- A26. The premium is paid at different timing in the three scenarios:
- (a) Scenario 1—Premium paid up front;
  - (b) Scenario 2—Premium paid at the end of the coverage period; and
  - (c) Scenario 3—Premium paid on a monthly basis.
- A27. The example illustrates the accounting for the contract applying the PAA at each interim reporting period. The example:
- (a) is simplified, however it illustrates that the timing of premium receipts do not directly affect the revenue recognition pattern applying IFRS 17;
  - (b) assumes, for simplicity, that no claims are incurred (the liability for incurred claims is part of the insurance contract liability or asset); and
  - (c) illustrates the presentation of items on the statement of financial position applying existing practice and applying IFRS 17.

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<sup>4</sup> The fact pattern and accounting under existing practice is based on examples provided by a TRG member.

### Scenario 1—Premium paid up front

Reporting date	01.07.X1	30.09.X1	31.12.X1	31.3.X2	30.6.X2
<b>Existing practice—insurance line items on the statement of financial position and revenue reported</b>					
Premium receivable	0	0	0	0	0
Unearned premium reserve (UPR)	(1200)	(900)	(600)	(300)	0
Deferred acquisition cost (DAC)	180	135	90	45	0
<b>Sum of insurance line items on the statement of financial position (overall liability position)</b>	<b>(1020)</b>	<b>(765)</b>	<b>(510)</b>	<b>(255)</b>	<b>0</b>
<b>Revenue for each period (change in UPR)</b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>IFRS 17 PAA—insurance contract asset / (liability) on the statement of financial position and revenue reported</b>					
Opening balance	0	(1020)	(765)	(510)	(255)
55(a)(i) Premium received on initial recognition	(1200)				
55(a)(ii) Insurance acquisition cash flows	180				
55(b)(i) Premiums received in the period		0	0	0	0
55(b)(iii) Amortisation of insurance acquisition cash flows		(45)	(45)	(45)	(45)
<b>55(b)(v) Insurance revenue applying B126<sup>5</sup></b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>Closing balance of insurance contract asset / (liability)</b>	<b>(1020)</b>	<b>(765)</b>	<b>(510)</b>	<b>(255)</b>	<b>0</b>

#### IFRS 17 PAA—journal entries

##### At initial recognition - 01.07.X1

<b>Receipt of premiums</b>	Dr	Cash	1200
		Cr	Insurance contract liability
			1200
<b>Insurance acquisition cash flows</b>	Dr	Insurance contract liability	180
		Cr	Cash
			180

##### At each reporting date (30.09.X1, 31.12.X1, 31.03.X1 and 30.06.X1)

<b>Amortisation of insurance acquisition cash flows</b>	Dr	Insurance service expenses	45
		Cr	Insurance contract liability
			45
<b>Insurance revenue</b>	Dr	Insurance contract liability	300
		Cr	Insurance revenue
			300

<sup>5</sup> Expected premium receipts allocated to coverage periods (CU1200 / 4 periods = CU300)

### Scenario 2—Premium paid at the end of the coverage period

Reporting date	01.07.X1	30.09.X1	31.12.X1	31.3.X2	30.6.X2
<b>Existing practice—insurance line items on the statement of financial position and revenue reported</b>					
Premium receivable	1200	1200	1200	1200	0
Unearned premium reserve (UPR)	(1200)	(900)	(600)	(300)	0
Deferred acquisition cost (DAC)	180	135	90	45	0
<b>Sum of insurance line items on the statement of financial position (overall asset position)</b>	<b>180</b>	<b>435</b>	<b>690</b>	<b>945</b>	<b>0</b>
<b>Revenue for each period (change in UPR)</b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>IFRS 17 PAA—insurance contract asset / (liability) on the statement of financial position and revenue reported</b>					
Opening balance	0	180	435	690	945
55(a)(i) Premium received on initial recognition	0				
55(a)(ii) Insurance acquisition cash flows	180				
55(b)(i) Premiums received in the period		0	0	0	(1200)
55(b)(iii) Amortisation of insurance acquisition cash flows		(45)	(45)	(45)	(45)
<b>55(b)(v) Insurance revenue applying B126<sup>2</sup></b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>Closing balance of insurance contract asset / (liability)</b>	<b>180</b>	<b>435</b>	<b>690</b>	<b>945</b>	<b>0</b>

#### IFRS 17 PAA—journal entries

##### At initial recognition - 01.07.X1

<b>Insurance acquisition</b>	Dr	Insurance contract asset	180
<b>cash flows</b>	Cr	Cash	180

##### At each reporting date (30.09.X1, 31.12.X1, 31.03.X1 and 30.06.X1)

<b>Amortisation of insurance acquisition cash flows</b>	Dr	Insurance service expenses	45
	Cr	Insurance contract asset	45
<b>Insurance revenue</b>	Dr	Insurance contract asset	300
	Cr	Insurance revenue	300

##### At the end of the coverage period (30.06.X1)

<b>Receipt of premium<sup>6</sup></b>	Dr	Cash	1200
	Cr	Insurance contract asset	1200

<sup>6</sup> Entities should consider the disclosure requirements included in paragraphs 121–132 of IFRS 17 to provide information about the entity’s exposure to credit risk that arises from insurance contracts.

### Scenario 3—Premium paid on a monthly basis

Reporting date	01.07.X1	30.09.X1	31.12.X1	31.3.X2	30.6.X2
<b>Existing practice—insurance line items on the statement of financial position and revenue reported</b>					
Premium receivable	1200	900	600	300	0
Unearned premium reserve (UPR)	(1200)	(900)	(600)	(300)	0
Deferred acquisition cost (DAC)	180	135	90	45	0
<b>Sum of insurance line items on the statement of financial position (overall asset position)</b>	<b>180</b>	<b>135</b>	<b>90</b>	<b>45</b>	<b>0</b>
<b>Revenue for each period (change in UPR)</b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>IFRS 17 PAA—insurance contract asset / (liability) on the statement of financial position and revenue reported</b>					
Opening balance	0	180	135	90	45
55(a)(i) Premium received on initial recognition	0				
55(a)(ii) Insurance acquisition cash flows	180				
55(b)(i) Premiums received in the period		(300)	(300)	(300)	(300)
55(b)(iii) Amortisation of insurance acquisition cash flows		(45)	(45)	(45)	(45)
<b>55(b)(v) Insurance revenue applying B126<sup>2</sup></b>		<b>300</b>	<b>300</b>	<b>300</b>	<b>300</b>
<b>Closing balance of insurance contract asset / (liability)</b>	<b>180</b>	<b>135</b>	<b>90</b>	<b>45</b>	<b>0</b>

#### IFRS 17 PAA—journal entries

##### At initial recognition - 01.07.X1

<b>Insurance acquisition</b>	Dr	Insurance contract asset	180
<b>cash flows</b>	Cr	Cash	180

##### At each reporting date (30.09.X1, 31.12.X1, 31.03.X1 and 30.06.X1)

<b>Receipt of premiums</b>	Dr	Cash	300
	Cr	Insurance contract asset	300
<b>Amortisation of insurance acquisition cash flows</b>	Dr	Insurance service expenses	45
	Cr	Insurance contract asset	45
<b>Insurance revenue</b>	Dr	Insurance contract asset	300
	Cr	Insurance revenue	300

## STAFF PAPER

December 2018

IASB<sup>®</sup> meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	Discount rates, risk adjustment and OCI option		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

**Purpose and structure of the paper**

1. This paper discusses the following topics:
  - (a) the use of locked-in discount rates to adjust the contractual service margin;
  - (b) the risk adjustment in a group of entities;
  - (c) the subjectivity in the determination of discount rates and risk adjustment; and
  - (d) the OCI option for insurance finance income or expenses.
2. For each topic, this paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendation and a question for Board members.
3. Appendix A to this paper includes an example illustrating the effect of using locked-in, rather than current, rates for measuring adjustments to the contractual service margin.

## Summary of staff recommendations

4. The staff recommend that the Board should not amend the requirements in IFRS 17 for the following topics:
  - (a) the use of locked-in discount rates to adjust the contractual service margin;
  - (b) the risk adjustment in a group of entities;
  - (c) the subjectivity in the determination of discount rates and risk adjustment; and
  - (d) the OCI option for insurance finance income or expenses.

## Use of locked-in discount rates to adjust the contractual service margin

### *IFRS 17 requirements*

5. IFRS 17 requires an entity to measure insurance contracts as the sum of the fulfilment cash flows and the contractual service margin. The fulfilment cash flows are a current measure of the estimates of the cash flows expected to arise under the contracts and the contractual service margin at initial recognition is the unearned profit in the contracts. The contractual service margin is not an estimate of a future cash flow, it is the difference between the estimates of discounted risk-adjusted inflows and discounted risk-adjusted outflows.
6. IFRS 17 requires an entity to adjust (ie unlock) the contractual service margin for changes in estimates of cash flows that relate to future service. When measuring the fulfilment cash flows, these changes in estimates are measured consistently with all other aspects of the fulfilment cash flows using a current discount rate. For insurance contracts without direct participation features the adjustment to the contractual service margin is determined using the discount rate that applies on initial recognition (ie the locked-in discount rate).<sup>1</sup>

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<sup>1</sup> For insurance contracts with direct participation features the contractual service margin at initial recognition is updated to reflect changes in the amount of the variable fee, including those related to changes in discount rates and other financial variables.

7. This leads to a difference between the change in the fulfilment cash flows and the adjustment to the contractual service margin—the difference between the change in the cash flows measured at a current rate and the change in the cash flows measured at the locked-in discount rate. That difference:
- (a) represents the cumulative effect of changes in financial variables on the underlying change in estimates between the date the insurance contracts were initially recognised and the date of the change in estimates; and
  - (b) gives rise to a gain or loss that is included in profit or loss or other comprehensive income (OCI), depending on the accounting policy choice an entity makes for the presentation of insurance finance income or expenses in the statement(s) of financial performance.

**Board’s rationale**

8. The Board introduced the requirement to adjust the contractual service margin when there are changes in estimates of cash flows in response to comments received on the 2010 Exposure Draft *Insurance Contracts*. The rationale for adjusting the contractual service margin when there are changes in estimates of cash flows is to increase consistency between estimates made at initial recognition and estimates made after initial recognition, as illustrated in the example in Appendix A to this paper. Accordingly, the Board decided that the adjustments to the contractual service margin for changes in estimates of cash flows should be measured at the rate that applied to the initial determination of the contractual service margin.
9. A change in estimates may be the consequence of either:
- (a) the inclusion of a cash flow that was not included in previous estimates—in this case no cumulative effect of changes in discount rates has been recognised before (because the cash flow was not included in previous estimates) and IFRS 17 requires an entity to perform a catch up and recognise the cumulative adjustment as insurance finance income or expenses; or
  - (b) the removal of an expected cash flow that was included in previous estimates—in this case the cumulative effect of changes in discount rates has

already been recognised as insurance finance income or expenses and IFRS 17 requires an entity to reverse it through insurance finance income or expenses for consistency.

10. The Board noted that making an adjustment to the contractual service margin measured at the current rate would mean that the contractual service margin would have no internal consistency and that changes in discount rates would affect the insurance service result (through the contractual service margin) rather than the insurance finance income or expenses. This is because the contractual service margin would reflect the difference between amounts determined using discount rates that applied when the contractual service margin was initially recognised, adjusted by amounts determined using current discount rates. The remaining balance of the contractual service margin would therefore reflect a mix of discount rates that applied at different times.
11. During the development of IFRS 17, and in particular in redeliberating the proposals in the 2013 Exposure Draft *Insurance Contracts*, the Board considered:<sup>2</sup>
  - (a) the concerns raised by some stakeholders who thought that tracking locked-in discount rates would be too burdensome, because doing so would require systems and processes to track discount rates from contract inception to completion which, for some insurance contracts, could be up to 60 years;
  - (b) the view expressed by those stakeholders that the operational burden could be reduced if an entity were to use current, rather than the locked-in, discount rates for measuring the adjustments to the contractual service margin;
  - (c) the view expressed by some stakeholders that a current discount rate should be used for measuring the adjustments to the contractual service margin, to be consistent with the current discount rate used to measure the fulfilment cash flows, and that such an approach would be conceptually correct; and

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<sup>2</sup> See Agenda Paper 2B for the July 2014 Board meeting.

- (d) the support of some stakeholders for the Board's view that it would be conceptually correct to use the locked-in discount rate for measuring the adjustments to the contractual service margin because it would:
    - (i) separate changes in estimates of cash flows that relate to future service between the insurance service result and the insurance finance income or expenses in a clear way (see the discussion in paragraphs 9–10 of this paper).
    - (ii) provide a faithful representation of the revenue earned as an entity provides service that would reflect the price charged for that service. If the contractual service margin were to be fully remeasured to reflect current discount rates, the revenue recognised would reflect the effect of current interest rates on the price that the entity would charge for the service at the reporting date. To the extent that the contractual service margin reflected current discount rates because of adjustments measured using current rates, the revenue recognised would reflect the effect of current interest rates on the prices that the entity would charge for the service at the date of the adjustments.
12. The Board noted that measuring the adjustments to the contractual service margin at a current rate would only be appropriate if the contractual service margin as a whole were to be remeasured to reflect current rates. This would mean that:
- (a) the rate implicit in the contractual service margin would be updated and the interest accreted on the contractual service margin would be at the current rate, as well as the adjustments to the contractual service margin being determined at the current rate; and
  - (b) the changes to the contractual service margin arising from interest, including the unwinding of and changes in discount rates, would be captured in the insurance finance income or expenses.
13. The Board considered such an approach and concluded that it would be appropriate only for insurance contracts with direct participation features (for which the variable fee approach applies). The Board also concluded it would not be appropriate to reflect

current discount rates only in the adjustment to the contractual service margin as it would create inconsistencies, as described in paragraph 10 of this paper, and make the depiction of the contractual service margin and the resulting revenue arbitrary and difficult to explain.

14. Therefore, the Board confirmed the proposals in the 2013 Exposure Draft that, for insurance contracts without direct participation features, an entity should use the locked-in discount rate for measuring the adjustments to the contractual service margin. The Board observed that:
- (a) both locked-in rates and current rates for measuring the adjustments to the contractual service margin have complexities.
  - (b) remeasuring the contractual service margin as a whole to reflect changes in discount rates would not be appropriate for insurance contracts accounted for applying the general model and would add substantial complexity.
  - (c) the use of locked-in discount rates does not introduce additional complexities for entities that track locked-in discount rates for the presentation of insurance finance income or expenses (ie entities that decide to use the OCI option for the presentation of insurance finance income or expenses in the statement(s) of financial performance). However, it imposes an additional burden on entities that decide to present changes in discount rates entirely in profit or loss.
15. In the editorial review of a draft of IFRS 17 that was conducted before the issuance of IFRS 17, some reviewers also disagreed with requiring the use of a locked-in discount rate for measuring adjustments to the contractual service margin, citing the concerns and views mentioned in paragraphs 11(a)–11(c) of this paper. The Board considered those concerns and views again and decided not to reconsider the alternative of applying a current discount rate for measuring adjustments to the contractual service margin, noting again its view that:
- (a) the balance of the contractual service margin is not a future cash flow; and

- (b) the adjustments represent a change to amounts previously determined in the contractual service margin at initial recognition and those amounts are not updated for changes in discount rates.<sup>3</sup>

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

- 16. Consistent with the feedback during the development of IFRS 17, some stakeholders would prefer to use current discount rates for measuring adjustments to the contractual service margin.
- 17. Some stakeholders state that the gain or loss arising from the difference between the change in the fulfilment cash flows and the adjustments to the contractual service margin described in paragraph 7 of this paper would significantly distort the performance results. This is because they think that it is difficult to explain the gain or loss in the statement(s) of financial performance if the entity chooses not to use the OCI option for the presentation of insurance finance income or expenses in the statement(s) of financial performance.
- 18. Other stakeholders would prefer the contractual service margin to be remeasured as a whole as discussed in paragraph 12 of this paper. Those stakeholders note that in some situations, an insurance contract would comprise fulfilment cash flows in a debit position and a contractual service margin in a credit position. Those stakeholders regard the application of different rates to the adjustments to the fulfilment cash flows and the contractual service margin as particularly anomalous in these situations because they regard the fulfilment cash flows as in an asset position and the contractual service as being a related liability. For example, those stakeholders stated that:
  - (a) the measurement of a regular premium contract with initial fulfilment cash flows in a debit position combined with a contractual service margin in a credit position typically results in a small overall balance; and

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<sup>3</sup> See Agenda Paper 2C for the February 2017 Board meeting.

- (b) the effect of the subsequent measurement of the fulfilment cash flows using current discount rates would not be offset by the effect of the subsequent measurement of the contractual service margin using locked-in discount rates—there would be an unexpectedly large effect in profit or loss or OCI from the subsequent measurement of a contract with a small overall balance.

### ***Staff analysis and recommendation***

19. The staff note that the arguments for the IFRS 17 requirements that use a locked-in discount rate for measuring adjustments to the contractual service margin when there is a change in estimates are still valid. Those arguments are described in paragraphs 8–15 of this paper. In summary, the use of a locked-in discount rate:
  - (a) is consistent with the rationale for unlocking the contractual service margin—ie to ensure there is consistency between the unearned profit that is determined on initial recognition of a group and the effect of changes in estimates on that profit. Thus, the contractual service margin does not reflect locked-in rates for cash flows expected at initial recognition and different rates for each change in estimates of cash flows.
  - (b) ensures that the effects of changes in discount rates on the difference in estimated cash flows are not included in the contractual service margin and therefore do not affect the insurance service result. This is consistent with the principle in IFRS 17 that the insurance service result is shown separately from the insurance finance income or expenses.
  - (c) ensures that the revenue recognised as an entity provides service reflects the price charged for that service, rather than being affected by an arbitrary amount arising from changes in discount rates at different dates.
  
20. The staff note that the Board has considered feedback consistent with the concerns and implementation challenges described in paragraphs 16–18 of this paper a number of times during the development of IFRS 17. Each time the Board has concluded that the use of a locked-in discount rate for measuring adjustments to the contractual service margin is consistent with what the Board intended the contractual service

margin to represent. The Board has also concluded that there are balancing considerations relating to the operational burden described by stakeholders.

21. The staff note in particular the stakeholder concerns that using a locked-in discount rate results in a gain or loss arising from the difference between a change in fulfilment cash flows and a change in the adjustment to the contractual service margin which some stakeholders regard as difficult to explain. The magnitude of this gain or loss has become clearer in recent discussions with stakeholders and this is consistent with the fact that small changes in discount rates can have a significant effect on the measurement of insurance contracts. However, the staff note that:
- (a) if the adjustments to the contractual service margin were determined using current rates, that effect of changes in discount rates on the change in cash flows would still exist, but it would be incorporated into the adjustments to the contractual service margin.
  - (b) an adjustment to the contractual service margin is substantially a catch-up adjustment. It is an over or under accretion of interest on the contractual service margin in previous periods which is shown as an adjustment in profit or loss or OCI in the current period. The adjustment ensures that the correct amount of accretion (at the locked-in rate) is applied to the current contractual service margin balance after adjustment.
  - (c) contrary to the view expressed by some stakeholders, the gain or loss included in either profit or loss or OCI provides useful information. That gain or loss reflects either the cumulative amount of insurance finance income or expenses that was previously recorded and should be reversed or the amount that should have been previously recorded and has not been caught up (see discussion in paragraph 9 of this paper).
  - (d) under the existing approach in IFRS 17:
    - (i) an entity can choose to present the effects of changes in discount rates disaggregated between profit or loss and OCI, leaving the information some stakeholders regard as relevant to the profit or loss unaffected by these requirements; and

- (ii) there are sufficient disclosure requirements about changes in estimates and the effects on the contractual service margin and the statement(s) of financial performance to enable preparers to explain to the users of their financial statements the implications of applying IFRS 17 requirements.

22. In addition, the staff observe that:

- (a) requiring the use of current discount rates for determining adjustments to the contractual service margin for changes in estimates of cash flows, rather than locked-in discount rates, would damage the consistency in separating the insurance service result from the financial result, which is one of the improvements introduced by IFRS 17. Thus, amending IFRS 17 in this way would reduce the usefulness of information that would arise from applying IFRS 17.
- (b) the analysis in paragraph 18 of this paper of an insurance contract comprising an asset component for the fulfilment cash flows and a liability component for the contractual service margin is not consistent with the approach required in IFRS 17 to depicting insurance contracts. As discussed in Agenda Paper 2A *Presentation of insurance contracts on the statement of financial position*, IFRS 17 treats the combination of rights and obligations arising from a group of insurance contracts as a single asset or liability. A debit balance for fulfilment cash flows and a credit balance for the contractual service margin does not affect the analysis in paragraph 22(a) of this paper.
- (c) the systems requirements for determining the contractual service margin are one of the most significant changes to existing insurance accounting practices. The difference between the systems required to store and manage locked-in discount rates for the measurement of the contractual service margin and other types of systems could be significant. Accordingly, amending IFRS 17 in this way could unduly disrupt implementation already under way because entities would need to revisit the work they have already done to develop systems and processes to store and manage locked-in discount rates. Such disruption could be minimised if the Board were to allow an optional approach for determining

the rate used to measure adjustments to the contractual service margin.

However, such optionality would impair the comparability which is a key benefit arising from IFRS 17.

23. Accordingly, the staff think it would not be possible to amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin in a way that would meet the criteria set by the Board at its October 2018 meeting and summarised in paragraph 5 of Agenda Paper 2.
24. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin.

**Question 1 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin?

**Risk adjustment in a group of entities**

***IFRS 17 requirements***

25. The measurement of a group of insurance contracts includes a risk adjustment for non-financial risk. IFRS 17 defines the risk adjustment for non-financial risk as ‘the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts’.
26. The risk adjustment for non-financial risk reflects the degree of diversification benefit an entity includes when determining the compensation it requires for bearing that risk.

27. An entity is required to:
- (a) remeasure the risk adjustment for non-financial risk at each reporting date; and
  - (b) recognise the reduction in the liability for remaining coverage related to the risk adjustment for non-financial risk as revenue over the coverage period.<sup>4</sup>

***Board's rationale***

28. The Board noted that the measurement of the risk adjustment for non-financial risk depends on the probability distribution of the underlying cash flows and that the shape of that distribution depends on the level at which an entity determines the risk adjustment for non-financial risk.
29. The 2010 Exposure Draft proposed to specify the level of aggregation to be used in determining the risk adjustment for non-financial risk: the risk adjustment for non-financial risk would be determined at the level of a portfolio of insurance contracts.
30. In redeliberating the proposals in the 2010 Exposure Draft, the Board:
- (a) considered the feedback on those proposals—many stakeholders indicated that the risk adjustment for non-financial risk should reflect the effect of diversification between portfolios and therefore that it should be determined at a higher level, rather than at a portfolio level.
  - (b) concluded that the objective of the risk adjustment for non-financial risk is to reflect the *entity's* perception of the economic burden of its non-financial risks and that it would be consistent with that objective to allow an entity to determine the risk adjustment for non-financial risk based on the extent to which it considered diversification benefits in its perception of the economic burden of its non-financial risks. Thus, specifying the level of aggregation at which to determine the risk adjustment for non-financial risk could contradict that objective.

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<sup>4</sup> The release of risk adjustment within the liability for incurred claims reduces expenses recognised for incurred claims rather than creating revenue.

***Concerns and implementation challenges expressed since IFRS 17 was issued***

31. Some existing insurance accounting practices already require an entity to reflect in the measurement of insurance contracts an explicit adjustment for risk, which may be different from the risk adjustment for non-financial risk in IFRS 17. Some stakeholders are concerned that, when determining the risk adjustment for non-financial risk for contracts issued by an entity in a group structure, the requirements in IFRS 17 could be read in different ways and, depending on the reading, might introduce significant changes to those existing insurance accounting practices.
32. Some stakeholders read IFRS 17 as requiring the risk adjustment for non-financial risk to be determined from the perspective of the entity issuing the contract, which does not change depending on whether the reporting entity is the issuing entity or a consolidated group that includes the issuing entity. Therefore, if a subsidiary issues an insurance contract, the risk adjustment for non-financial risk is determined by considering what compensation the subsidiary requires for the risk. The subsidiary might require compensation that reflects the diversification benefits available to it from the group and, therefore, the risk adjustment for non-financial risk might be different compared to if the subsidiary had been a standalone entity with no diversification benefits available to it from the group. On the other hand, some subsidiaries might set the compensation required for bearing non-financial risk without considering any diversification benefits available to it because it is part of a group. In both cases, the risk adjustment for non-financial risk is not different in the issuing entity's individual financial statements and in the parent's consolidated financial statements, even if the parent might require different compensation for risk for the contracts if it had issued them directly.
33. Other stakeholders read IFRS 17 as requiring or allowing different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity and the consolidated group would require different compensation for bearing non-financial risk.
34. At its May 2018 meeting, the Transition Resource Group for IFRS 17 (TRG) discussed the determination of the risk adjustment for non-financial risk in a group of entities. Some TRG members agreed with the reading in paragraph 32 of this paper,

whereas other TRG members agreed with the reading in paragraph 33 of this paper. TRG members observed that a group of entities must apply the requirements consistently across all groups of insurance contracts.

### ***Staff analysis and recommendation***

35. The staff note that the TRG discussions indicate that:
- (a) some entities already have systems in place to manage different risk adjustments for different reporting levels. For some of those entities, the reading in paragraph 32 of this paper would introduce more changes to the insurance accounting practices they currently apply than the reading in paragraph 33 of this paper would. This is because the reading in paragraph 32 would not permit an entity to continue to use different risk adjustments for different reporting levels for the same group of insurance contracts.
  - (b) the reading in paragraph 33 of this paper is nonetheless expected to be limited to insurance contracts accounted for applying the premium allocation approach. This is because:
    - (i) for insurance contracts accounted for applying the general model, the reading in paragraph 33 of this paper would potentially result in two different measurements of the risk adjustment for non-financial risk for each group of contracts issued by a subsidiary. This in turn would require the management of two different measurements of the contractual service margin, which would significantly increase the practical complexity of the general model in IFRS 17 and hence the reading in paragraph 33 of this paper is unlikely to be applied for general model contracts.
    - (ii) for insurance contracts accounted for applying the premium allocation approach the risk adjustment for non-financial risk is identified only for the liability for incurred claims. Therefore, applying the requirements in IFRS 17 as analysed in paragraph 32 of this paper would result in fewer practical complexities.

- (c) a group of entities must apply the requirements in IFRS 17 consistently across all group of insurance contracts it issues (based on the reading in either paragraph 32 or paragraph 33 of this paper), thus reducing the likelihood of diversity among contracts.
  - (d) applying the requirements in IFRS 17 as analysed in paragraph 32 of this paper would be more practical to implement, thus further reducing the likelihood of diversity in practice.
36. In summary, the TRG discussions indicate that the requirements in IFRS 17 might result in diversity in practice, but only in limited circumstances—most entities are expected to apply IFRS 17 as analysed in paragraph 32 of this paper.
37. The staff think that determining the risk adjustment for non-financial risk in IFRS 17 is a single decision that is made by the entity that is party to the contract (ie the issuer of the insurance contract) and would not change depending on whether the reporting entity is the issuing entity or the consolidated group (ie the staff think that the stakeholders’ reading discussed in paragraph 32 of this paper is what IFRS 17 requires). An amendment to clarify that only the issuing entity that is party to the contract determines the compensation the entity would require for bearing non-financial risk would:
- (a) further clarify the Board’s objective when setting the IFRS 17 requirements for the risk adjustment for non-financial risk; and
  - (b) help some entities to apply IFRS 17 in a slightly more consistent way and might, therefore, reduce possible diversity in practice.
38. However, as discussed in paragraphs 25–26 of this paper, the risk adjustment for non-financial risk reflects the compensation an entity requires to fulfil an insurance contract and is expected to vary entity by entity. Therefore, the staff think that such a clarification to the requirements in IFRS 17 would not help to address all the possible differences in the determination of the risk adjustment for non-financial risk among entities. Consistency of the risk adjustment for non-financial risk considering all aspects of its determination is something the Board can consider in a future post-implementation review of IFRS 17, once practice has developed.

39. The staff also note that, in the meantime, any potential lack of comparability will be alleviated by the required disclosures about the risk adjustment for non-financial risk—IFRS 17 requires an entity to disclose the approach used to determine the risk adjustment for non-financial risk (see the discussion about the subjectivity in the determination of the risk adjustment for non-financial risk in paragraphs 45–49 of this paper).
40. Accordingly, the staff think that there is no need to amend IFRS 17 at this time to clarify how to determine the risk adjustment for non-financial risk in a group of entities and recommend that the Board should not amend the requirements in IFRS 17 for the risk adjustment for non-financial risk.

**Question 2 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 for the risk adjustment for non-financial risk?

## **Subjectivity in the determination of discount rates and risk adjustment**

### ***IFRS 17 requirements***

41. As with other IFRS Standards, IFRS 17 is principle-based. IFRS 17 requires an entity to measure insurance contracts by:
- (a) discounting cash flows using current, market-consistent discount rates that reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts; and
  - (b) reflecting the risk adjustment for non-financial risk, as discussed in paragraphs 25–27 of this paper.

42. IFRS 17:
- (a) sets an objective for the discount rates and risk adjustment for non-financial risk included in the measurement of insurance contracts;
  - (b) permits an entity to determine discount rates and the risk adjustment for non-financial risk using different approaches and techniques, as long as they achieve the objectives set out in the Standard; and
  - (c) requires the entity to disclose, among other information:
    - (i) information about the approach used to determine discount rates and the risk adjustment for non-financial risk, including the methods and processes used and changes to methods and processes;
    - (ii) the yield curve (or range of yield curves) used to discount the cash flows that do not vary based on the returns on underlying items; and
    - (iii) the confidence level used to determine the risk adjustment for non-financial risk or, if the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, the technique used and the confidence level corresponding to the results of that technique.

***Board's rationale***

43. The Board decided to require a principle-based approach for determining discount rates and for measuring the risk adjustment for non-financial risk, rather than identifying specific rates or techniques. This is because this approach:
- (a) allows entities to develop the best approaches in their circumstances that meet the principles; and
  - (b) is consistent with the approach used by the Board in other IFRS Standards, such as the Board's approach on how to determine a similar risk adjustment in IFRS 13 *Fair Value Measurement*.

44. The principle-based approach that IFRS 17 uses for determining discount rates and the risk adjustment for non-financial risk could give rise to different amounts. Accordingly, the Board decided that an entity should disclose information to allow users of financial statements to understand how those amounts might differ from entity to entity.

*Risk adjustment for non-financial risk*

45. As noted in paragraph 25 of this paper, the objective of the risk adjustment for non-financial risk is to reflect the compensation an entity requires for bearing the uncertainty inherent in the cash flows that arise as the entity fulfils the insurance contract.
46. The Board noted that permitting a wide range of techniques to determine the risk adjustment for non-financial risk could lead to diversity in practice, which might reduce the relevance of the resulting measurement and might make it difficult for users of financial statements to compare risk adjustments for non-financial risk determined by different entities. Accordingly, the 2010 Exposure Draft proposed to limit the number of permitted techniques for determining the risk adjustment for non-financial risk.
47. However, when commenting on the proposals in the 2010 Exposure Draft many stakeholders supported a principle-based approach rather than limiting the number of techniques. Only a few stakeholders supported limiting the number of approaches to improve comparability between insurers.
48. The Board:
- (a) was persuaded that a more principle-based approach for measuring the risk adjustment for non-financial risk would be consistent with the Board's approach of not providing extensive guidance on how to determine a similar risk adjustment in IFRS 13; and
  - (b) noted that:
    - (i) it is not practicable for a Standard to specify in detail every situation in which particular techniques would be appropriate; and

- (ii) specifying particular techniques might prevent the use of new techniques that are more suitable.

49. Therefore, the Board concluded that IFRS 17 should specify the objective of the risk adjustment for non-financial risk rather than prescribing the techniques for and the level of the determination of the risk adjustment for non-financial risk. The Board decided to require an entity using a technique other than the confidence-level technique for determining the risk adjustment for non-financial risk to disclose a translation of the result of that technique into a confidence level. The Board concluded that this information is important to allow users of financial statements to see how the entity's own assessment of the compensation it requires for risk compares to that of other entities.

### *Discount rates*

50. Throughout the project, the Board has specified that the objective of the discount rate is to reflect the current value of the time value of money and that, therefore, the discount rates are current discount rates that reflect only the characteristics of the cash flows of the contracts and that do not consider an insurer's own credit risk. Some stakeholders have disagreed with this objective, but the Board did not change its view.
51. In commenting on the Board's proposals that preceded IFRS 17, some stakeholders expressed concerns about:
- (a) the difficulty of directly reflecting the inherent illiquidity of insurance contracts in the discount rates; and
  - (b) the lack of application guidance on how to determine discount rates when observable market rates for an instrument with the same characteristics of the cash flows of the insurance contract are not available.
52. The Board addressed those concerns by providing:
- (a) a simplification that can be used when an entity applies the top-down approach to determine discount rates—the entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts; and

- (b) a number of clarifications to the accompanying guidance to make its intentions clear and to reduce the risk of inconsistent application—for example, the application guidance in IFRS 17 specifies that when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the group of insurance contracts, an entity shall estimate the appropriate rates using an estimation technique.
53. However, the Board remains committed to provide principle-based guidance and notes that difficulties could arise if the guidance is too detailed.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

54. Some investors, analysts and regulators expressed concerns that the principle-based nature of IFRS 17 could limit comparability between insurance entities. This is because the accounting for insurance contracts relies on assumptions and IFRS 17 requires entities to use judgement to determine key factors for the measurement of insurance contracts, such as the discount rates and the risk adjustment for non-financial risk.

### ***Staff analysis and recommendation***

55. As discussed in paragraphs 45–53 of this paper, the Board set out the requirements in IFRS 17 for the determination of discount rates and the risk adjustment for non-financial risk considering the feedback during the development of IFRS 17, including the concerns about principle-based accounting versus rule-based accounting.
56. The staff note that insurance contracts have a variety of forms, terms and conditions. Requiring an entity to measure insurance contracts using a rule-based approach would result in outcomes that are appropriate only in some circumstances. The Board was concerned that, for example, prescribing the use of a particular observable market rate would result in appropriate measurement of the insurance contracts only if the cash flows of the insurance contracts are similar to the assumptions driving that particular

rate. In all other circumstances, requiring the use of that particular rate might reduce the relevance of the financial statements of entities issuing insurance contracts. In contrast, applying the principle-based approach in IFRS 17 entities:

- (a) determine the inputs that are most relevant to the circumstance thus providing the information that is most useful to their users of financial statements; and
- (b) provide information in the notes to the financial statements about the methods used and the judgements applied.

- 57. Importantly, entities applying IFRS 17 are all required to meet the same measurement objectives. IFRS 17 requirements provide comparability without imposing uniformity.
- 58. Discount rates and the risk adjustment for non-financial risk are fundamental components of the measurement model in IFRS 17. Any change to make more prescriptive the IFRS 17 requirements for determining those components would require entities that have already started implementation of IFRS 17 to revisit the work they have already done to implement IFRS 17.
- 59. The staff therefore recommend that the Board should not amend IFRS 17 to prescribe the discount rates used to measure insurance contracts or to limit the number of risk adjustment techniques that an entity can use.

**Question 3 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 to prescribe the discount rates used to measure insurance contracts or to limit the number of risk adjustment techniques that an entity can use?

**OCI option for insurance finance income or expenses**

***IFRS 17 requirements***

- 60. IFRS 17 permits an entity to choose to present insurance finance income or expenses either in profit or loss or disaggregated between profit or loss and OCI. This choice is made on a portfolio-by-portfolio basis.

### ***Board's rationale***

61. The Board decided that an entity should be permitted to choose to present insurance finance income or expenses either in profit or loss or disaggregated between profit or loss and OCI because it concluded that users of financial statements may find that, for some contracts, the presentation of insurance finance income or expenses based on a systematic allocation in profit or loss would be more useful than the presentation of total insurance finance income or expenses in profit or loss. This conclusion also led the Board to decide not to require all insurance finance income or expenses to be included in profit or loss with separate presentation of some or all such income or expenses.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

62. Most investors and analysts we spoke to expressed concerns that permitting, but not requiring, a presentation of the effect of some changes in financial assumptions in OCI could impair comparability between entities.
63. When developing IFRS 17 the Board was aware of this potential impediment to comparability and therefore sought to mitigate the effects. IFRS 17 requires:
- (a) an entity to make the amounts recognised in OCI in any period clearly identifiable; and
  - (b) an entity that chooses to disaggregate insurance finance income or expenses between profit or loss and OCI to disclose an explanation of the methods used to determine the amounts recognised in profit or loss.
64. Hence IFRS 17 provides users of financial statements with a basis to adjust information reported by entities to make them more comparable. However, some investors have expressed the view that the OCI option for insurance finance income or expenses adds unnecessary complexity to their analysis of the information reported by entities applying IFRS 17.

**Staff analysis and recommendation**

65. The Board developed the OCI option for insurance finance income or expenses considering the feedback during the development of IFRS 17.
66. The staff think that amending IFRS 17 to require, rather than permit, entities to present insurance finance income or expenses either entirely in profit or loss or partly in OCI would increase comparability between entities. However, the staff note that:
- (a) the Board already exposed for comments those alternative accounting treatments in the proposals that preceded IFRS 17 and overall feedback on those proposals was mixed. Such feedback is not surprising given the Board’s experience on the use of OCI across many projects and is likely to continue whatever the Board decides on this question.
  - (b) the reasons for which the Board decided to introduce the OCI option for insurance finance income or expenses discussed in paragraph 61 of this paper are still valid.
67. The staff note that the systems requirements for determining amounts recognised in profit or loss and OCI are complex. Accordingly, such an amendment to IFRS 17 would unduly disrupt implementation already under way. Entities may also need to revisit related considerations about the classification of financial assets held, considering that the OCI option allows an entity to align the accounting treatment of each portfolio of insurance contracts with the accounting treatment of the assets that back that portfolio and, therefore, helps the entity to reduce accounting mismatches.
68. The staff therefore recommend that the Board should not amend IFRS 17 to require, rather than permit, entities to present insurance finance income or expenses either entirely in profit or loss or partly in OCI.

**Question 4 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 about the presentation of insurance finance income or expenses?

**Appendix A—Example illustrating the effect of using locked-in, rather than current, rates for measuring adjustments to the contractual service margin<sup>5</sup>**

- A1. The example in this appendix illustrates the difference in an entity's financial statements when an entity uses:
- (a) the locked-in discount rate for measuring adjustments to the contractual service margin; compared to
  - (b) the current discount rate for measuring adjustments to the contractual service margin.
- A2. The example is based on the following assumptions:
- (a) the contract provides coverage for insurance risk over 5 years;
  - (b) the policyholder pays a premium of CU1,200 at the start of the coverage period;
  - (c) the entity expects to pay a claim of CU893 at the end of the coverage period;
  - (d) the insurance contract liability discount rate at inception equals 5%;
  - (e) the insurance contract liability discount rate changes to 2% at the end of Year 2; and
  - (f) the risk adjustment for non-financial risk equals zero for simplification.
- A3. The contractual service margin equals CU500 at inception (present value of expected premiums of CU1,200 minus present value of expected claims of CU700). The contractual service margin is allocated based on coverage units on a straight-line basis.
- A4. At the end of Year 3, the entity revises its expectations about the expected cash outflows so that the entity expects to pay CU1,100, rather than the CU893 that was expected at inception. The present value of the difference of CU207 adjusts the contractual service margin. That present value would be:

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<sup>5</sup> This example is extracted from Appendix A to Agenda Paper 2B for the July 2014 Board meeting.

- (a) CU188 if the change in cash flows is discounted using locked-in rate of 5%;  
and
- (b) CU199 if the change in cash flows is discounted using current rate of 2%.

### **Statement of financial position**

A5. The tables below illustrate the reconciliation of the contractual service margin from the opening to closing balance at the end of each period of the coverage period calculated using (i) locked-in; and (ii) current rates. The staff note that the calculation of the contractual service margin does not affect the amount of the fulfilment cash flows which are always measured using the current rate. Consequently, the difference between the contractual service margin at the end of each period would result in the equivalent difference between the insurance contract liabilities.

<b>Locked-in rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	44	23	500
Interest accreted	25	21	17	2	1	66
Release to P&L	(105)	(110)	(116)	(23)	(24)	(378)
Change in present value of expected cash flows	-	-	(188)	-	-	(188)
Closing balance	420	331	44	23	-	-

<b>Current rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	33	17	500
Interest accreted	25	21	17	2	1	66
Release to P&L	(105)	(110)	(116)	(18)	(18)	(367)
Change in present value of expected cash flows	-	-	(199)	-	-	(199)
Closing balance	420	331	33	17	-	-

<b>Difference in closing balance</b>	-	-	(11)	(6)	-	-
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A6. As illustrated above, the rate used to calculate the present value of cash flows that unlocks the contractual service margin affects the balance of the insurance contract liability at the end of each period after the change (Year 3).

**Statement(s) of financial performance**

A7. The tables below illustrate the amounts recognised in the statement(s) of financial performance using locked-in and current rates for calculating present value of expected cash flows that unlock the contractual service margin.

<b>Locked-in rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	105	110	116	23	24	378
Insurance finance expenses	(25)	(21)	(28)	(2)	(1)	(77)
<b>Total comprehensive income</b>	<b>80</b>	<b>89</b>	<b>88</b>	<b>21</b>	<b>23</b>	<b>301</b>

<b>Current rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	105	110	116	18	18	367
Insurance finance expenses	(25)	(21)	(17)	(2)	(1)	(66)
<b>Total comprehensive income</b>	<b>80</b>	<b>89</b>	<b>99</b>	<b>16</b>	<b>17</b>	<b>301</b>

<b>Comparison</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	-	-	-	5	6	11
Insurance finance expenses	-	-	(11)	-	-	(11)
<b>Total comprehensive income</b>	<b>-</b>	<b>-</b>	<b>(11)</b>	<b>5</b>	<b>6</b>	<b>-</b>

A8. As illustrated in the tables above, the choice of locked-in or current rates does not affect the accumulated total comprehensive income. However, in addition to the

effects on the measurement of the insurance contract liability (as explained in paragraph A6 of this paper), it affects:

- (a) the insurance service result and the insurance finance income or expenses in each reporting period and over the life of the contract; and
- (b) the total comprehensive income at the end of each period.

A9. When the entity unlocks the contractual service margin for the present value of cash flows calculated using the locked-in rate, the discount rate effect on changes in cash flows is recognised in the insurance finance income or expenses. Therefore, the insurance service result is not affected by the discount rate changes but only by the change in expected cash flows since inception. When the present value of cash flows that unlocks the contractual service margin is measured using the current rate, the discount rate effect on changes in those cash flows is reported in the insurance service result.

## STAFF PAPER

December 2018

IASB<sup>®</sup> meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	<b>Variable fee approach</b>		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

**Purpose and structure of the paper**

1. This paper discusses the following topics:
  - (a) the definition of an insurance contract with direct participation features (which sets the scope for the variable fee approach); and
  - (b) the limited applicability of the risk mitigation exception.
2. This paper does not discuss reinsurance contracts held. Questions about the scope of the variable fee approach and accounting to reflect risk mitigation in respect of reinsurance contracts held will be discussed in a paper at a future meeting of the International Accounting Standards Board (Board).
3. For each topic, this paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendation and questions for Board members.

## Summary of staff recommendations

4. The staff recommend that the Board should not amend the requirements in IFRS 17 for the following topics:
  - (a) the definition of an insurance contract with direct participation features; and
  - (b) the limited applicability of the risk mitigation exception.

## Definition of an insurance contract with direct participation features

### *IFRS 17 requirements and rationale*

5. IFRS 17 distinguishes between insurance contracts with and without direct participation features. The general model for insurance contracts without direct participation features is modified for insurance contracts with direct participation features—those contracts are measured applying modified requirements referred to as the ‘variable fee approach’.
6. The variable fee approach was developed as part of the Board’s thinking on how to account for insurance contracts with participation features. Many insurance contracts include participation features, whereby policyholders share in the returns of underlying items. The Board discussed the treatment of participation features extensively during the development of IFRS 17, resulting in the following requirements:
  - (a) the fulfilment cash flows of *all* insurance contracts with participation features include the effect of policyholders’ participation—the estimates of future cash flows include the expected effect of the returns on underlying items and the discount rate applied to the future cash flows reflects the variability of those returns;<sup>1</sup> and
  - (b) for insurance contracts with *direct* participation features, additional adjustments are made in the subsequent measurement of the contractual

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<sup>1</sup> Alternatively, the estimates of future cash flows are adjusted to reflect the variability of the returns and discounted at a risk-free rate.

service margin (the variable fee approach) compared to those made for insurance contracts without direct participation features (the general model).

7. The Board developed the variable fee approach for contracts with direct participation features in response to feedback that identified some insurance contracts as being substantially investment-related service contracts. In these contracts, the entity is promising an investment return based on underlying items, in effect providing an asset management service. The obligation to the policyholder can be regarded as a promise to return the underlying items to the policyholder, after deducting a variable fee.
8. The definition of insurance contracts with direct participation features identifies contracts with the characteristics described in paragraph 7 of this paper. They are insurance contracts for which, on inception:
  - (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
  - (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and
  - (c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.
9. For these contracts, the Board concluded that to provide a faithful representation of the variable fee, the subsequent measurement of the contractual service margin (and hence revenue) should, in addition to the adjustments required under the general model:
  - (a) include the entity's share of the changes in the fair value of the underlying items;
  - (b) include the change in the effect of the time value of money and financial risk not arising from the underlying items (for example, the effect of financial guarantees); and

- (c) be recognised in profit or loss as insurance *and investment-related services* are provided.<sup>2</sup>
10. In developing the variable fee approach, the Board acknowledged that treating insurance contracts with direct participation features differently from insurance contracts without direct participation features adds complexity for users and preparers of financial statements. The Board noted that the requirements for the measurement of the fulfilment cash flows and the initial recognition of the contractual service margin are the same for both types of contract, and the differences are limited to the subsequent measurement of the contractual service margin. The Board was persuaded by stakeholders that those differences are necessary to provide a faithful representation of the different nature of the types of contract.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

11. Some stakeholders are concerned that the scope of the variable fee approach is too narrow, resulting in economically similar contracts being accounted for differently. In their view some types of insurance contracts are economically similar to insurance contracts with direct participation features except that:
- (a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation; and
  - (b) the contractual terms do not specify a clearly identified pool of underlying items.
12. Those stakeholders expressed the view that specifying different accounting for insurance contracts with direct participation features and for insurance contracts without direct participation features results in unjustified differences in their accounting.

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<sup>2</sup> In June 2018, the Board tentatively decided to propose an extension to the period over which the contractual service margin should be recognised from the period in which insurance services are provided to the period in which either insurance services or investment-related services are provided.

### **Staff analysis and recommendation**

13. As discussed in paragraphs 5–10 of this paper, the Board developed the scope of the variable fee approach in response to feedback during the development of IFRS 17. The Board considered carefully both the circumstances in which it would be appropriate to have different accounting, and what that different accounting should be.
14. The variable fee approach is designed to give a faithful representation of contracts that meet the definition of insurance contracts with direct participation features. Consequently, the staff do not think it would be possible to amend the scope of the variable fee approach without also reconsidering the modifications to the general model that comprise the variable fee approach. Given the modifications are designed to fit the existing scope, the Board would need to consider whether:
  - (a) different modifications would be necessary for a different scope for the variable fee approach; or
  - (b) the variable fee scope and approach would be left unchanged and a new category of contract identified, with a separate scope and modifications.
15. Either approach is likely to add complexity to IFRS 17. The staff also observe that whatever the scope of any modifications to the general model, there would be differences between the accounting for contracts within the scope and those outside the scope.
16. Considering the specific features of contracts that stakeholders have argued should be allowed within the scope of the variable fee approach (see paragraph 11 of this paper), the staff observe:
  - (a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation—a fundamental aspect of the variable fee approach is that the entity’s share of the underlying items is regarded as a *variable fee*. The Board decided that for this to be the case, the

*contract* needs to specify the fee, ie the relationship between underlying items and the amounts payable to the policyholders;<sup>3</sup> and

- (b) the contractual terms do not specify a clearly identified pool of underlying items—such contracts cannot be regarded as in effect providing asset management services if there are no specified assets.

17. The staff think the definition of an insurance contract with direct participation features appropriately identifies those contracts for which the Board thought modifications to the general model were necessary because the contracts essentially provide asset management services in exchange for a fee that depends on the returns on the underlying items.
18. Accordingly, the staff recommend that the Board should not amend the requirements in IFRS 17 relating to the definition of an insurance contract with direct participation features. The staff observe that some of the concerns expressed about contracts that are not eligible for the variable fee approach relate to the recognition of the contractual service margin in profit or loss over only the period in which insurance coverage is provided, rather than a longer period in which other services might be provided. The staff will bring a paper to a future Board meeting discussing the period in which the contractual service margin is recognised in profit or loss under the general model.

**Question 1 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to the definition of an insurance contract with direct participation features?

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<sup>3</sup> Applying paragraph 2 of IFRS 17, contract terms include all terms in a contract, explicit or implied. Implied terms in a contract include those imposed by law or regulation.

## Limited applicability of the risk mitigation exception

### ***IFRS 17 requirements and rationale***

19. IFRS Standards treat insurance contracts and the financial assets an entity holds as separate items. IFRS 17 applies to insurance contracts and IFRS 9 *Financial Instruments* to financial assets.
  
20. During the development of IFRS 17, the Board considered whether to develop a bespoke solution for all hedging activities for insurance contracts. However, the Board observed that IFRS 9 includes some general hedge accounting options that entities can use to avoid accounting mismatches. Developing a bespoke solution for hedging activities for insurance contracts beyond what is already permitted applying IFRS 9 should form part of a broader project on accounting for risk management activities, and the issuance of IFRS 17 should not be delayed pending completion of that project.
  
21. Nonetheless, IFRS 17 does allow a choice in the treatment of the contractual service margin in the variable fee approach to address some risk mitigation activities, specifically if an entity mitigates the financial risks of insurance contracts with direct participation features using derivatives. Stakeholders had expressed concern that in such cases:
  - (a) the change in the fair value of the derivative would be recognised in profit or loss applying IFRS 9; but
  - (b) the change in the insurance contract, the risk of which was mitigated by the derivative, would adjust the contractual service margin applying IFRS 17.
  
22. In response to this feedback, the Board included in IFRS 17 an option for the entity in specified circumstances to recognise the effect of some changes in financial risk in the insurance contracts in profit or loss, instead of adjusting the contractual service margin.
  
23. The reason the Board decided to include this specific risk mitigation option in the variable fee approach is because the mismatch described in paragraph 21 of this paper is an accounting mismatch caused by the variable fee approach. For contracts under

the general model, the contractual service margin is not adjusted for the changes in fulfilment cash flows the derivatives are intended to mitigate. Hence, both the change in the carrying amount of fulfilment cash flows and the change in the value of the derivatives will be recognised in profit or loss,<sup>4</sup> so no accounting mismatch arises.

24. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that because the application of the approach is optional, entities could choose the risk mitigation relationships to which it would apply with the benefit of knowing at transition how that relationship had developed. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

25. Consistent with the feedback during the development of IFRS 17, some stakeholders are still concerned that the approach to risk mitigation activities in IFRS 17 is too narrow. Those stakeholders are concerned that the risk mitigation exception in IFRS 17 can be used:<sup>5</sup>
- (a) only for insurance contracts with direct participation features.
  - (b) only when the hedging instrument is a derivative—those stakeholders think that the risk mitigation option should be equally applied when other arrangements provide a similar economic hedging mechanism.
  - (c) prospectively although risk mitigation arrangements may have been in place before the date of initial application of IFRS 17.

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<sup>4</sup> As long as the entity does not use the OCI option.

<sup>5</sup> Stakeholders also expressed concern that the requirements in IFRS 17 for reinsurance contracts held do not adequately depict their role in risk mitigation. This paper does not discuss reinsurance contracts held. The treatment of reinsurance contracts held will be discussed in a paper at a future Board meeting.

**Staff analysis and recommendation**

26. The staff observe that—as discussed in paragraph 23 of this paper—the existing risk mitigation exception was intentionally designed to reduce accounting mismatches that would otherwise be introduced by the variable fee approach. It reduces such mismatches by allowing an entity to treat some changes in insurance contracts in the same way that they would be treated applying the general model. As such, the specific risk mitigation exception in IFRS 17 by definition cannot be applied to contracts accounted for applying the general model (ie insurance contracts without direct participation features).
27. The staff think that an amendment to IFRS 17 to extend a deliberately narrow exception to broader circumstances of other risk mitigation activities should be considered as part of a comprehensive review on providing information about risk mitigation activities. The Board is working on such a project. Any solution developed in the short term outside the Board’s other work on risk management activities would likely cause significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements by increasing complexity and by reducing comparability between entities. Such an amendment could also introduce inconsistencies with, and potentially override the requirements of, IFRS 9.
28. Accordingly, the staff recommend that the Board should not amend the non-transitional requirements in IFRS 17 relating to risk mitigation activities.

**Question 2 for Board members**

Do you agree that the Board should not amend the non-transitional requirements in IFRS 17 relating to risk mitigation activities?

29. The staff also think that an amendment to IFRS 17 to permit retrospective application of the risk mitigation option would cause significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements, by creating a further inconsistency with IFRS 9. In addition, it may enable entities to ‘cherry pick’ favourable outcomes for designation and retrospective application, because of its optional basis.

30. Accordingly, the staff recommend that the Board should not amend the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option.

**Question 3 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option?

## STAFF PAPER

December 2018

IASB<sup>®</sup> meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	<b>Business combinations</b>		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

**Purpose and structure of the paper**

1. This paper discusses the following topics:
  - (a) business combinations: classification of acquired contracts as insurance contracts; and
  - (b) business combinations: identification of insured event for acquired insurance contracts.
2. For each topic, this paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendation and a question for Board members.

## Summary of staff recommendations

3. The staff recommend that the Board should not amend the requirements in IFRS 17 or IFRS 3 *Business Combinations* for the following topics:
  - (a) business combinations: classification of acquired contracts as insurance contracts; and
  - (b) business combinations: identification of insured event for acquired insurance contracts.

## Business combinations: classification of acquired contracts as insurance contracts

### *IFRS 17 requirements*

4. IFRS 17 amended IFRS 3 so that the assessment of whether contracts acquired in a business combination are insurance contracts is made on the basis of terms and conditions at the acquisition date, rather than at the inception of the contract as previously required by IFRS 3. In June 2018, the Board tentatively decided to amend IFRS 3 so that the amendment introduced by IFRS 17 applies only to business combinations that occur when or after IFRS 17 is effective.<sup>1</sup>

### *Board's rationale*

5. IFRS 17 amended IFRS 3 by removing an exception to the general classification requirements in IFRS 3 that was introduced for insurance contracts accounted for applying IFRS 4 *Insurance Contracts*—an interim Standard. That exception required an entity to classify contracts as insurance contracts on the basis of the contractual terms and other factors at the inception of the contract, rather than at the date of acquisition. By removing that exception, IFRS 17 introduces consistent accounting for

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<sup>1</sup> See Agenda Paper 2A for the June 2018 Board meeting.

insurance contracts and other contracts acquired in a business combination. The removal of that exception thus aligns the accounting for insurance contracts with the usual approach to business combination accounting.

6. As noted in paragraph BC187 of the Basis for Conclusions on IFRS 3, the Board decided that providing a general principle for classifying contracts acquired in a business combination would facilitate consistent application of IFRS 3. It observed that application of the acquisition method results in the initial recognition in the acquirer's financial statements of the assets acquired and liabilities assumed in a business combination. Therefore, in principle, the acquirer should classify and designate all items acquired in a business combination at the acquisition date in the context of the contractual terms, economic conditions and other pertinent factors at that date. That classification principle for business combination accounting is one of the foundations of IFRS 3.
7. In redeliberating the proposals in the 2013 Exposure Draft *Insurance Contracts*, the Board:<sup>2</sup>
  - (a) considered the concerns about a lack of clarity about the requirements for insurance contracts acquired in a business combination discussed in paragraph 18 of this paper; and
  - (b) decided to clarify that such contracts should be accounted for as if they had been issued by the entity (the acquirer) at the date of the business combination.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

8. Some stakeholders are concerned that the requirement to assess the classification of contracts acquired on the basis of terms and conditions at the acquisition date instead of on the date of the contract inception adds complexity and costs and could result in different accounting for the same contract in different reporting levels in a group of

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<sup>2</sup> See Agenda Paper 2D for the May 2014 Board meeting.

entities. For example, a five-year contract with an investment component providing insurance coverage for the first two years:

- (a) might meet the definition of an insurance contract at its inception date (and so would be accounted for as an insurance contract throughout its life by an acquiree); and
  - (b) might not meet the definition of an insurance contract at an acquisition date occurring after the end of Year 2 (and so would not be accounted for as an insurance contract by an acquirer).
9. Some stakeholders suggest re-introducing an exception to the general classification requirements in IFRS 3 for insurance contracts and making the use of that exception optional for an entity. Other stakeholders do not support re-introducing an exception and note that the classification of insurance contracts based on terms and conditions at the acquisition date avoids operational complexity.

### ***Staff analysis and recommendation***

10. As discussed in paragraphs 5–7 of this paper, the Board decided on the requirements about insurance contracts acquired in a business combination considering the feedback during the development of IFRS 17.
11. The staff think that an amendment to IFRS 3 to re-introduce an exception for insurance contracts to the general classification requirements in IFRS 3 would not unduly disrupt implementation processes that are already under way because the consequential amendment to IFRS 3 applies only to business combinations that occur when or after IFRS 17 is effective.
12. However, the staff think that such an amendment would cause significant loss of useful information relative to that which would be provided by IFRS 3 as amended by IFRS 17, by increasing the complexity for users of financial statements because it will reduce comparability with the requirements for other transactions.

13. At the November 2016 Board meeting, the Board explicitly considered another difference in accounting for insurance contracts between an acquiree and an acquirer: an entity will need to calculate different contractual service margins for the consolidated financial statements and the separate financial statements of the subsidiary that issued the contract. This is because an entity is required to use the fair value at the date of the business combination to determine the contractual service margin for contracts in the consolidated financial statements. The Board noted that this difference reflects that the reporting entity in consolidated financial statements acquired the contracts on a different date from the inception of the contracts for the subsidiary. Hence, the Board confirmed that such differences were a normal consequence of acquisition accounting applying IFRS Standards.
14. Differences in accounting caused by a business combination are not unique to insurance contracts and are not unusual when applying IFRS Standards. Other IFRS Standards do not require exceptions to the classification principles in IFRS 3.<sup>3</sup> For example, a financial asset classified as measured at amortised cost by an acquiree will be assessed by an acquirer at the date of acquisition and may not be eligible for classification in that category in the acquirer's financial statements even if it is eligible in the financial statements of the acquiree. As discussed in the *Effects Analysis on IFRS 17*, applying commonly understood IFRS principles to many aspects of the accounting for insurance contracts is expected to make the insurance sector more attractive to investors, facilitating comparability between insurers and entities in other industries and improving capital allocation.
15. Accordingly, the staff think that amending the requirements in IFRS 17 and IFRS 3 relating to the classification of contracts acquired in a business combination as insurance contracts would result in a loss of comparability with the requirements for other transactions and therefore would cause a significant loss of useful information. Therefore, the staff recommend that the Board should not amend IFRS 17 or IFRS 3

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<sup>3</sup> The only exception in IFRS 3 for the classification of acquired assets and liabilities is for the classification of lease contracts in which the acquiree is a lessor. That exception was retained when IFRS 16 was issued because IFRS 16 did not change accounting by lessors.

relating to the classification of contracts acquired in a business combination as insurance contracts.

**Question 1 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 or IFRS 3 relating to the classification of contracts acquired in a business combination as insurance contracts?

**Business combinations: identification of insured event for acquired insurance contracts**

***IFRS 17 requirements***

16. Paragraph B93 of IFRS 17 requires an entity to identify groups of insurance contracts as if it had entered into the contracts on the acquisition date. Paragraph B5 of IFRS 17 states that for insurance contracts that cover events that have already occurred, the insured event is the determination of the ultimate cost of those claims. Hence an entity treats insurance contracts acquired in a business combination that cover events that have already happened as providing coverage for the adverse development of claims. This means that the entity recognises a liability for remaining coverage and recognises revenue for the insurance service provided and expenses for the claims incurred.

***Board's rationale***

17. As noted in paragraph 5 of this paper, the requirements in IFRS 17 for insurance contracts acquired in a business combination apply the general principles of business combinations in IFRS 3 to insurance contracts.
18. In redeliberating the proposals in the 2013 Exposure Draft, the Board:<sup>4</sup>
- (a) considered that a few respondents to the 2013 Exposure Draft sought clarification on how they should account for contracts acquired in a business

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<sup>4</sup> See Agenda Paper 2D for the May 2014 Board meeting.

combination when their coverage period has ended and the contracts are in the settlement period. Those respondents stated that the requirements in the 2013 Exposure Draft were unclear as to whether an insurance contract in its settlement period should be treated as:

- (i) the remainder of a pre-existing contract that is in its post-coverage period; or
  - (ii) a new insurance contract that is at the beginning of its coverage period.
- (b) decided to clarify that contracts acquired in a business combination should be recognised from the date of the business combination as new contracts (ie they should be accounted for as if they had been issued by the entity at the date of the business combination). When an entity acquires a contract in its settlement period in a business combination, the entity has written a new contract in which the insured event is the discovery of a loss or the adverse development of claims for past events. The insured event is not the event giving rise to the claims in the first place.

### ***Concerns and implementation challenges expressed since IFRS 17 was issued***

19. Consistent with the feedback during the development of IFRS 17, some stakeholders noted that applying IFRS 17 requirements to contracts acquired in a business combination reflects a significant change from existing practice and results in implementation challenges and costs.
20. For example, consider an entity that issues insurance contracts that have an insurance coverage period of one year and acquires similar contracts in their settlement period in a business combination. The settlement period for both sets of contracts is expected to be many years and there is substantial uncertainty over the ultimate amount that will be paid in claims. In such cases, entities would need to apply the general model to the acquired contracts, although they could choose to apply the premium allocation approach (PAA) for the contracts they issue. Hence some stakeholders state that entities may need to make systems changes to determine contractual service margins

in preparation for potential future acquisitions, even if all their existing contracts are eligible for the PAA and hence do not require determination of a contractual service margin.

21. In addition, some of those stakeholders expressed the view that users of financial statements could consider the information provided applying IFRS 17 requirements to be misleading or counterintuitive because similar contracts will be accounted for differently based on whether they have been issued by an entity or acquired by the entity during their settlement period—contracts acquired in their settlement period will be considered part of the liability for remaining coverage for the entity that acquired the contract and not part of the liability for incurred claims. Some stakeholders also expressed the view that the requirements of IFRS 17 result in revenue and expenses for the same contract being recognised twice, once by the acquiree in the original coverage period and subsequently by the acquirer in the period of coverage for adverse development of claims.
22. Some stakeholders observed that different treatments might be appropriate for different circumstances:
  - (a) for entities with a business model to acquire and run-off the settlement of claims, it might be more appropriate to treat the acquired liability as a liability for remaining coverage, giving rise to revenue and expenses; and
  - (b) for entities purchasing contracts in the expectation of getting future renewals of those contracts, it might be more appropriate to treat the acquired liability as a liability for incurred claims, thereby not creating revenue or expenses for claims incurred previously recognised by the acquiree.
23. These stakeholders think this issue is similar to an implementation question discussed at the September 2018 Transition Resource Group for IFRS 17 (TRG) meeting not related to business combinations—whether the entity’s obligation to pay amounts subject to insurance risk after an incurred claim should be treated as:
  - (a) a liability for incurred claims; or
  - (b) a liability for remaining coverage.

24. On this question, TRG members observed that the definitions of IFRS 17 allow an entity to use judgement when determining whether the obligation to pay amounts subject to insurance risk after an incurred claim is part of a liability for remaining coverage or a liability for incurred claims. Stakeholders argue that an acquirer of an insurance contract for which the claim has occurred should be allowed to exercise the same judgement.

**Staff analysis and recommendation**

25. As discussed in paragraph 18 of this paper, the Board decided on the requirements for insurance contracts acquired in a business combination considering the feedback during the development of IFRS 17.
26. As with the first topic discussed in this paper, application of the acquisition method results in the initial recognition in the acquirer's financial statements of the assets acquired and liabilities assumed in a business combination. The acquirer identifies the assets and liabilities acquired based on the contractual terms and economic conditions that exist at the acquisition date and applies the requirements of IFRS 17 accordingly. From the perspective of the acquirer, applying paragraph B5 of IFRS 17 (see paragraph 16 of this paper) it has received the fair value of the contract in return for providing coverage for adverse development of a claim. That is the case whatever the reason for the acquirer making the acquisition. Further, the acquirer of the contract is in a different position to the issuer of the contract in respect of the judgement discussed in paragraph 24 of this paper. From the perspective of the acquirer, the coverage for adverse development of a claim is *the only* insurance coverage provided under the contract. Given the contract is to be treated as an insurance contract, it must be regarded as providing insurance service for that coverage.
27. As noted in paragraph 14 of this paper, there are other assets and liabilities that are accounted for differently by the entity that holds the assets and liabilities and the acquiring entity after a business combination. In such cases, additional disclosures might be necessary to provide information that enables users of financial statements to

evaluate the nature and financial effect of a business combination according to paragraph 59 of IFRS 3. These disclosures, together with those required by IFRS 17, may mitigate some of the concerns raised above.

28. The staff note that all entities applying the general model will need to develop mechanisms to determine the contractual service margin. Therefore, additional implementation costs arise only for entities that expect all contracts they issue will be eligible for the PAA, other than those they acquired in a business combination.
29. The staff think that an amendment to introduce an exception to the general requirements for the determination of the insured event for insurance contracts acquired in a business combination as suggested by some stakeholders would cause significant loss of useful information relative to that which would be provided by IFRS 17. It would increase the complexity for users of financial statements because it would reduce comparability with the requirements for other transactions.
30. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to the determination of the insured event for insurance contracts acquired in a business combination.

**Question 2 for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to the determination of the insured event for insurance contracts acquired in a business combination?

## STAFF PAPER

December 2018

## IASB® meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	Future cash flows in the measurement of reinsurance contracts held		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

**Purpose and structure of the paper**

1. This paper discusses future cash flows in the measurement of reinsurance contracts held. Other aspects of the accounting for reinsurance contracts held will be discussed in a future meeting of the International Accounting Standards Board (Board).
2. This paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendation and a question for Board members.
3. Appendix A to this paper provides an example of measuring a reinsurance contract held and the underlying insurance contracts issued.

**Staff recommendation**

4. The staff recommend that the Board should not amend the requirements in IFRS 17 for future cash flows in the measurement of reinsurance contracts held.

## IFRS 17 requirements

5. Insurance contracts issued and reinsurance contracts held are measured applying the same measurement model. The measurement includes a probability-weighted average estimate of all future cash flows within the contract boundary and an explicit risk adjustment to reflect the uncertainty in the timing and amount of cash flows that arises from non-financial risk.
6. To reflect that reinsurance contracts held are not issued by the entity, paragraphs 60–70 of IFRS 17 modify the general requirements.<sup>1</sup> Paragraphs 7–9 of this paper summarise the requirements for determining the cash flows within the boundary of a contract.
7. An entity applies the contract boundary requirements in paragraph 34 of IFRS 17 to the insurance contracts it issues and the reinsurance contracts it holds. This means that:
  - (a) the cash flows within the boundary of an insurance contract issued arise from the entity’s substantive rights and substantive obligations as the issuer of that contract. These include the substantive right to receive amounts from the policyholder and the substantive obligation to provide services to the policyholder.
  - (b) the cash flows within the boundary of a reinsurance contract held arise from the entity’s substantive rights and substantive obligations as the holder of that contract. These include the substantive right to receive services from the reinsurer and the substantive obligation to pay amounts to the reinsurer.
8. A substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk or the reinsurer has a substantive right to terminate the coverage.<sup>2</sup>

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<sup>1</sup> The staff have published an *IFRS 17 Pocket Guide on reinsurance contracts held* which is a helpful reference tool on how IFRS 17 applies to reinsurance contracts held.

<sup>2</sup> This topic was discussed at the February 2018 Transition Resource Group for IFRS 17 (TRG) meeting. A summary of the observations made in that meeting can be found in the *Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 6 February 2018*.

9. Accordingly:
- (a) if the entity *has* a substantive right to receive services from the reinsurer relating to underlying contracts that are expected to be issued in the future, cash flows within the boundary of the reinsurance contract held will include cash flows relating to those future underlying contracts.
  - (b) if the entity *does not have* a substantive right to receive services from the reinsurer relating to underlying contracts that are expected to be issued in the future, the cash flows relating to those future underlying contracts will belong to a future reinsurance contract held (assuming the entity does not have a substantive obligation to pay amounts to the reinsurer).<sup>3</sup>

### **Board's rationale**

10. A fundamental aspect of measuring an insurance contract is determining which future cash flows should be included in the measurement, ie determining which cash flows are within the contract boundary. In most accounting models, the boundary of a contract is determined by the explicit contract terms. However, during the development of IFRS 17, the Board noted that a common feature of insurance contracts is that it can be difficult to determine where the boundaries of the contract lie because they often bind the entity issuing the contract more closely than the other party. For example, in many contracts the contract requires the entity to continue to accept premiums but permits the policyholder to stop paying premiums. The Board concluded that the contract boundary should be determined on the basis of the substantive rights and substantive obligations created by the contract for the entity.
11. The Board concluded that expected future cash flows for reinsurance contracts held and insurance contracts issued should be measured using a similar approach. This means that the reinsurance contract held is measured the same way as insurance

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<sup>3</sup> Generally, an entity can choose to stop paying premiums to the reinsurer, thus terminating coverage. However, in some reinsurance arrangements the entity is compelled to continue paying premiums. An example of such a reinsurance arrangement was discussed at the May 2018 TRG meeting. A summary of the observations made in that meeting can be found in the *Summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 2 May 2018*.

contracts issued, including reinsurance contracts issued. It also means that consistent assumptions are used to measure the reinsurance contract held and the underlying insurance contracts (for example, the assumptions about expected lapses).<sup>4</sup>

12. Hence, if the entity has a substantive right to receive services from the reinsurer in respect of underlying insurance contracts it issues that are covered by the reinsurance contract, the cash flows within the boundary of the reinsurance contract held include all the cash flows expected to arise from those underlying insurance contracts expected to be covered by the reinsurance contract. This includes a substantive right relating to underlying contracts expected to be issued in the future.

### **Concerns and implementation challenges expressed since IFRS 17 was issued**

13. Stakeholders have expressed three concerns with applying the contract boundary requirements to reinsurance contracts held. Those concerns are described in paragraphs 14–16 of this paper.
14. Firstly, stakeholders think the requirements are operationally complex. Applying existing practice for measuring reinsurance contracts held, entities do not typically estimate future cash flows relating to insurance contracts not yet issued. Instead, reinsurance contracts held are typically measured using a ‘mirroring approach’, essentially matching reinsurance contract revenue, costs, assets and liabilities to the underlying insurance contracts. Stakeholders are concerned that measuring future cash flows for the reinsurance contract that relate to future underlying contracts is operationally complex and will result in that measurement being uncertain and unreliable, given that cash flows relating to future underlying contracts are uncertain.
15. Secondly, stakeholders think that the requirements will create a mismatch between the insurance contract liability and the reinsurance contract asset because the reinsurance

---

<sup>4</sup> The Board concluded on this fundamental principle in an early stage of the insurance contracts project (see [Discussion Paper Preliminary Views on Insurance Contracts](#) May 2007). This principle has been reflected in the Board’s outreach and decisions throughout the project. Generally, feedback throughout the project was supportive of this fundamental principle. However, the Board noted at an early stage that some stakeholders interpret ‘consistent’ differently to the Board. Those stakeholders thought that to measure a reinsurance contract held consistently with insurance contracts issued should mean to apply ‘mirror’ accounting, similarly to existing accounting practice.

contract asset will be ‘grossed up’ with the cash flows for future underlying contracts that have not yet been issued.

16. Thirdly, stakeholders think that the requirements might result in the contractual service margin for the reinsurance contracts held being recognised in an inconsistent way to the recognition of the contractual service margin for the underlying insurance contracts.
17. Some stakeholders have proposed amendments to IFRS 17 that they think would address their concerns. The two amendments proposed are:
  - (a) amend the recognition requirements for reinsurance contracts held in paragraph 62(a) of IFRS 17 to require a group of reinsurance contracts held that provides proportionate coverage to be recognised at the later of:
    - (i) the beginning of the coverage period of the group of reinsurance contracts held; or
    - (ii) at the initial recognition of *the* underlying contracts (instead of at the initial recognition of *any* underlying contract, as stated in IFRS 17).
  - (b) modify the contract boundary requirements in paragraph 34 of IFRS 17 for reinsurance contracts held so that cash flows relating to underlying insurance contracts are included in the measurement of the reinsurance contract held only at the time that those underlying insurance contracts are recognised.

### **Staff analysis and recommendation**

18. The staff do not think that an amendment to IFRS 17 is justified because of stakeholder concerns about the uncertainty of future cash flows, described in paragraph 14 of this paper. The staff observe that cash flows of uncertain timing and amounts are included in the measurement of all insurance contracts. This is not unique

to reinsurance contracts held. For example, for all insurance contracts the entity is required to estimate the probability and amounts of claims that will be incurred.

19. The staff do not think that an amendment to IFRS 17 is justified because of stakeholder concerns about a ‘grossed up’ reinsurance contract, described in paragraph 15 of this paper. The staff observe that future underlying insurance contracts are reflected in the cash inflows, cash outflows, risk adjustment for non-financial risk and contractual service margin included in the measurement of the reinsurance contract held. Those amounts sum to nil up until the point that one of the following events occurs:
  - (a) the entity pays or receives amounts relating to the reinsurance on those future underlying contracts (for example, the entity pays reinsurance premiums); or
  - (b) those underlying contracts are issued and the entity starts receiving reinsurance services relating to those contracts.
  
20. When one of those events occurs, the amounts included in the measurement of the reinsurance contract held relating to those contracts will no longer sum to nil. For example, when the entity pays reinsurance premiums which relate to underlying insurance contracts, the entity reduces the cash asset by paying the premium and in turn increases the reinsurance asset to reflect the service it will receive as a result of paying those premiums. That reinsurance asset is then reduced as the contract is fulfilled.
  
21. The staff do not think that an amendment to IFRS 17 is justified because of stakeholder concerns about the pattern of recognition of the contractual service margin, described in paragraph 16 of this paper. The staff observe that the contractual service margin recognised in a reporting period is determined considering the services received in the current period and expected to be received in future periods under the reinsurance contract held. This is consistent with the requirements for insurance contracts issued. The staff observe that in circumstances that the service the entity receives from the reinsurer is proportionate to the service that the entity provides to the policyholder, the identification and allocation of coverage units for reinsurance

contracts held will result in a pattern of contractual service margin recognition which reflects that symmetry.

22. The staff have published an educational example to demonstrate that the requirements in IFRS 17 reflect an entity's rights and obligations under a reinsurance contract held, and do not result in the apparent mismatches that stakeholders are concerned about, as described in this paper. That educational example is included in Appendix A to this paper.
23. In summary, the staff think that modifying the contract boundary requirements in IFRS 17 for reinsurance contracts held is not justified. In particular, the staff think that modifying the IFRS 17 contract boundary requirements for reinsurance contracts held as proposed by stakeholders in paragraph 17(b) of this paper would result in a significant loss of useful information relative to that which would otherwise be provided by IFRS 17 for users of financial statements, for the following reasons:
  - (a) the measurement of reinsurance contracts held would not fully reflect the entity's substantive right to receive services from the reinsurer. This would reduce the relevance and faithful representation of information in the financial statements.
  - (b) the proposed amendment would go against the fundamental principle in IFRS 17 that all future cash flows within the contract boundary are reflected in the measurement of an insurance contract.
  - (c) the proposed amendment would add complexity to the contract boundary requirements.
24. The staff observe that the amendment proposed in paragraph 17(a), alone, would not address stakeholders' concerns in the way they expect because the requirement in paragraph 62(a) of IFRS 17 relates to the initial recognition of a group of reinsurance contracts held, and not the measurement. For that amendment to achieve what stakeholders expect, IFRS 17 would also need to be amended to require that a reinsurance contract held that covers multiple underlying insurance contracts be separated and treated as a number of separate reinsurance contracts (ie a reinsurance

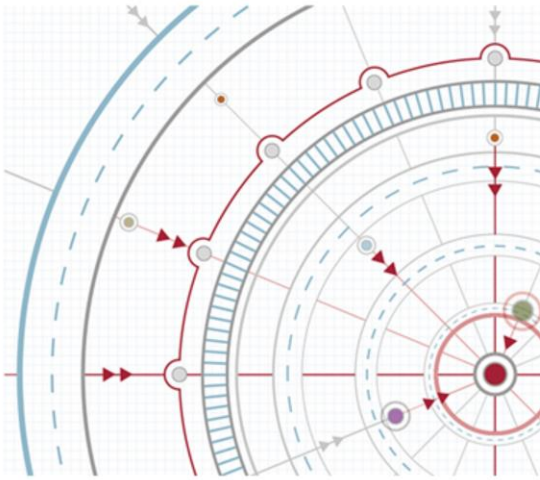
contract for each underlying insurance contract), and entities would need to group each of those contracts separately.

25. The staff also observe that the purpose of the amendment proposed in paragraph 17(a) is to achieve ‘mirror’ accounting between the reinsurance contract held and the underlying insurance contracts issued. This approach was considered and rejected by the Board during the development of IFRS 17 because such an approach is contradictory to the fundamental principle that a reinsurance contract held should be accounted for in the same manner as insurance contracts issued, including reinsurance contracts issued.
26. For those reasons, this paper does not consider further the amendment proposed in paragraph 17(a) of this paper.
27. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to future cash flows in the measurement of reinsurance contracts held.

**Question for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to future cash flows in the measurement of reinsurance contracts held?

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# Reinsurance contracts held: an example of proportionate reinsurance coverage

*IFRS 17 Insurance Contracts*

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not necessarily those of the International Accounting Standards Board (the Board) or  
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This example illustrates the requirements in IFRS 17 *Insurance Contracts*:

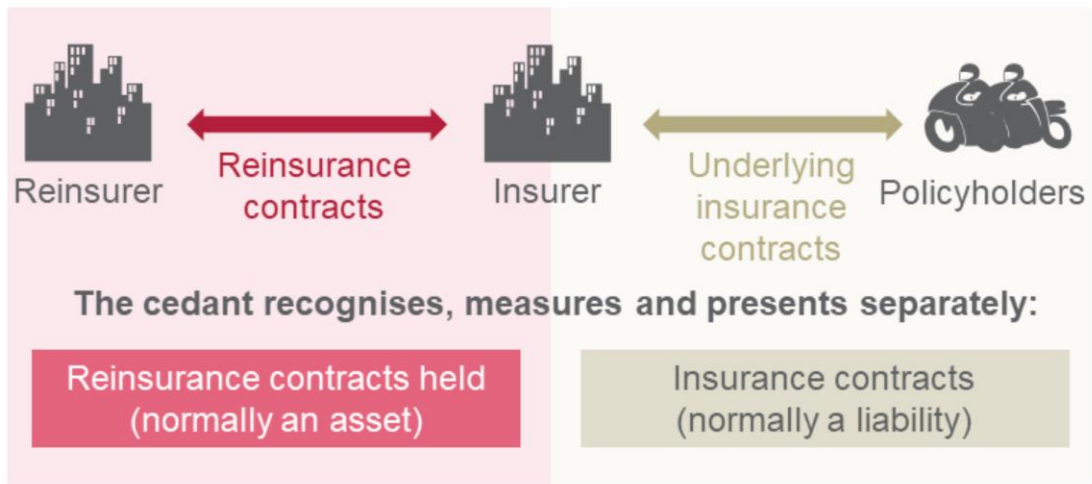
- a) applied to a group of underlying insurance contracts; and
- b) applied to a group of reinsurance contracts held that provides proportionate coverage for that group of underlying insurance contracts

This example demonstrates that:

- the measurement of a group of reinsurance contracts held is consistent with the measurement of any underlying insurance contracts
- the timing of cash flows do not directly affect the recognition of reinsurance income or expenses

# Reminder: IFRS 17 requirements

3



## **Further information**

Paragraphs 60-70 of IFRS 17 *Insurance Contracts*

Paragraphs BC296-BC315 of the Basis for Conclusions on IFRS 17 *Insurance Contracts*

Webcast *Reinsurance contracts held* available at: [go.ifrs.org/IFRS-17-implementation](http://go.ifrs.org/IFRS-17-implementation)

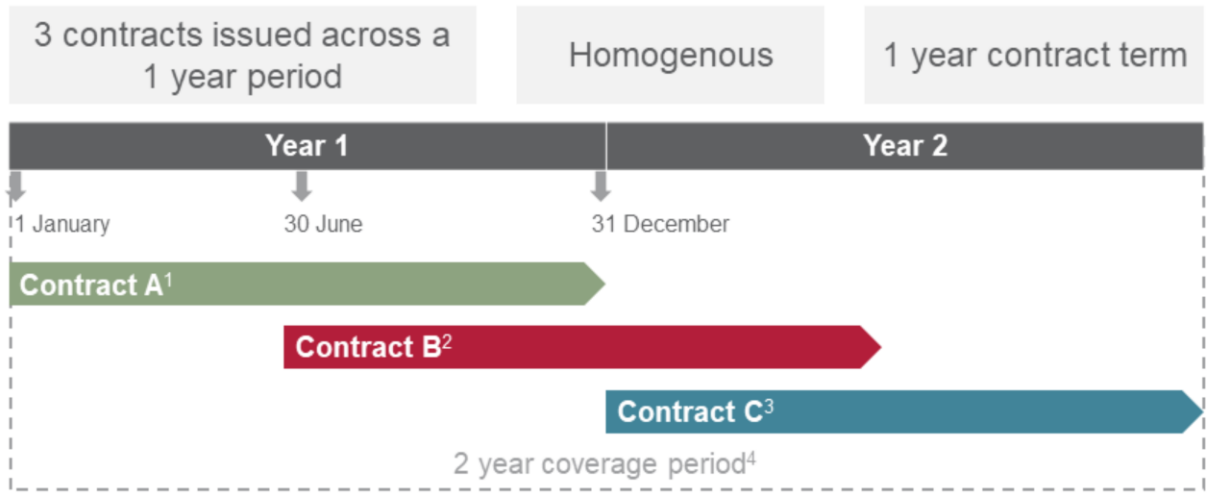
- IFRS 17 general model (not PAA)
- Risk adjustment for non-financial risk is nil
- Discount rate 0%
- Services are provided by the insurer evenly over the contract term for each contract
- All events occur as expected at initial recognition

**Further information**

The objective of this example is to demonstrate the mechanics of the IFRS 17 requirements for reinsurance contracts held. For simplicity, a number of assumptions have been made. This example is not intended to reflect a real fact pattern.

# Group of underlying insurance contracts

## A group of insurance contracts issued



**Further information**

<sup>1</sup> Contract A is issued on 1 January in year 1

<sup>2</sup> Contract B is issued on 30 June in year 1

<sup>3</sup> Contract C is issued on 31 December in year 1

<sup>4</sup> Initial recognition of the group of insurance contracts: 1 January in year 1 is the beginning of the coverage period of the group of insurance contracts (paragraph 25(a) of IFRS 17). The coverage period for the group of insurance contracts is from 1 January in year 1 to 30 December in year 2. For simplicity, in this example the coverage period is referred as 2 years.

# Cash flows

7

	Year 1			Year 2		Total
	1 Jan	30 June	31 Dec	30 June	31 Dec	
Premiums <sup>1</sup>	300	300	300	-	-	900
Claims <sup>2</sup>	-	(100)	(200)	(200)	(100)	(600)
<b>Net cash inflow</b>						<b>300</b>



## **Further information**

All events occur as expected at initial recognition.

<sup>1</sup> Premiums of 300 are expected on day 1 for each of the 3 underlying insurance contracts.

<sup>2</sup> Claims of 600 are expected for the group of insurance contracts. Claims are incurred equally by each of the 3 underlying insurance contracts. For each underlying insurance contract, claims occur evenly over the 1 year contract term as services are provided and are paid immediately after incurred. The claims cash flows at each reporting date can be analysed as:

- Year 1 30 June – Contract A 100
- Year 1 31 December – Contract A 100 + Contract B 100
- Year 2 30 June – Contract B 100 + Contract C 100
- Year 2 31 December – Contract C 100

# Statement of financial position

8

	Year 1			Year 2	
	1 Jan <sup>1</sup>	30 June <sup>2</sup>	31 Dec <sup>3</sup>	30 June <sup>4</sup>	31 Dec <sup>5</sup>
Fulfilment cash flows	(200)	(300)	(300)	(100)	-
Contractual service margin	(100)	(150)	(150)	(50)	-
<b>Insurance contract asset / (liability)</b>	<b>(300)</b>	<b>(450)</b>	<b>(450)</b>	<b>(150)</b>	<b>-</b>



## Further information

<sup>1</sup> At 1 January in year 1 the group is recognised and consists of the cash flows for Contract A only.

- FCF: premiums of 300 for Contract A are received on 1 January. The fulfilment cash flows at this date reflect expected claims of 200.
- CSM: the CSM of 100 at initial recognition is the amount that results in no income or expenses arising from the initial recognition of the fulfilment cash flows of 200 and the premiums received on that date of 300.

<sup>2</sup> At 30 June in year 1 the cash flows for Contract B are added to the group.

- FCF: premiums of 300 for Contract B are received on 30 June. The fulfilment cash flows reflect expected claims of 300 (opening balance of 200 plus 200 expected claims for Contract B minus 100 claims paid in the period).
- CSM: the balance of the CSM is 150 (opening balance of 100 plus 100 for Contract B minus 50 recognised as revenue in the period (see profit or loss slide 9)).

<sup>3</sup> At 31 December in year 1 the cash flows for Contract C are added to the group.

- FCF: premiums of 300 for Contract C are received on 31 December. The fulfilment cash flows reflect expected claims of 300 (opening balance of 300 plus 200 expected claims for Contract C minus 200 claims paid in the period).
- CSM: the balance of the CSM is 150 (opening balance of 150 plus 100 for Contract C minus 100 recognised as revenue in the period).

<sup>4</sup> At 30 June in year 2 no new cash flows are added to the group.

- FCF: the fulfilment cash flows reflect expected claims of 100 (opening balance of 300 minus 200 claims paid in the period).
- CSM: the balance of the CSM is 50 (opening balance of 150 minus 100 recognised as revenue in the period).

<sup>5</sup> At 31 December in year 2 the group is derecognised.

- FCF: the fulfilment cash flows reflect expected claims of 0 (opening balance of 100 minus 100 claims paid in the period).
- CSM: the balance of the CSM is 0 (opening balance of 50 minus 50 recognised as revenue in the period).

# Statement of profit or loss

9

	Year 1		Year 2	
	1Jan-30Jun	1Jul-31Dec	1Jan-30Jun	1Jul-31Dec
Expected claims incurred <sup>1</sup>	100	200	200	100
Contractual service margin	50 <sup>2</sup>	100	100	50
<b>Insurance revenue</b>	<b>150</b>	<b>300</b>	<b>300</b>	<b>150</b>
Actual claims incurred <sup>1</sup>	(100)	(200)	(200)	(100)
<b>Insurance service expenses</b>	<b>(100)</b>	<b>(200)</b>	<b>(200)</b>	<b>(100)</b>
<b>Insurance service result</b>	<b>50</b>	<b>100</b>	<b>100</b>	<b>50</b>



## Further information

<sup>1</sup> In this example, for each underlying insurance contract, claims are incurred evenly over the 1 year contract term as services are provided and are paid immediately when incurred. All events occur as expected. See cash flows slide 7.

<sup>2</sup> At 30 June in year 1, the CSM before recognising any amount in profit or loss is 200. The CSM recognised for the period of six months ending 30 June in year 1 is 50. 50 reflects the amount allocated to coverage provided in the period (contract 1 was in force for six months) while the remaining 150 reflects coverage expected to be provided in the future (contract 1 is expected to be in-force for six months and contract 2 expected to be in force for a year). The CSM recognised in the remaining periods is determined in the same way.

Reinsurance contract held:  
timing of cash flows match timing of  
cash flows for the underlying  
insurance contracts

## Facts

### Proportionate reinsurance contract held



#### Further information

<sup>1</sup> The reinsurance contract held is recognised on 1 January in year 1. In this example the reinsurance contract held, as a single contract, is identified as a group of insurance contracts. In this example, the group is referred to as the reinsurance contract held.

<sup>2</sup> Initial recognition of reinsurance contract held: 1 January in year 1 is the beginning of the coverage period for the reinsurance contract held and is also the initial recognition of the first underlying insurance contract added to the group (paragraph 62(a) of IFRS 17). The coverage period for the reinsurance contract held is equal to the coverage period for the group of underlying insurance contracts, from 1 January in year 1 to 30 December in year 2. For simplicity, in this example the coverage period is referred to as 2 years.

# Cash flows

12

	Year 1			Year 2		Total
	1 Jan	30 June	31 Dec	30 June	31 Dec	
Premiums <sup>1</sup>	(300)	(300)	(300)	-	-	(900)
Claims <sup>2</sup>	-	100	200	200	100	600
<b>Net cash outflow</b>						<b>(300)</b>



## **Further information**

<sup>1</sup> Premiums expected to be paid to the reinsurer are equal to the premiums received from the policyholder on the underlying insurance contracts. Premiums are expected to be paid to the reinsurer on the same day that premiums are received from the policyholder.

<sup>2</sup> Claims expected to be received from the reinsurer are equal to the claims expected to be paid to the policyholder on the underlying insurance contracts. Claims are expected to be received from the reinsurer on the same day that claims are paid to the policyholder.

See slide 7 for the cash flows arising from the group of underlying insurance contracts.

# Statement of financial position

13

	Year 1			Year 2	
	1 Jan <sup>3</sup>	30 June <sup>4</sup>	31 Dec <sup>5</sup>	30 June <sup>6</sup>	31 Dec <sup>7</sup>
Fulfilment cash flows <sup>1</sup>	0	200	300	100	-
Contractual service margin <sup>2</sup>	300	250	150	50	-
<b>Reinsurance contract asset / (liability)</b>	<b>300</b>	<b>450</b>	<b>450</b>	<b>150</b>	<b>-</b>



## Further information

<sup>1</sup>The fulfilment cash flows of the reinsurance contract held reflect all future cash flows expected to arise within the boundary of the reinsurance contract held. In this example, those cash flows relate to all underlying insurance contracts expected to be covered by the reinsurance contract including underlying insurance contracts that have not been issued yet.

<sup>2</sup>The CSM for the reinsurance contract held represents the net cost of purchasing reinsurance.

<sup>3</sup>At 1 January in year 1 the reinsurance contract held is recognised.

- FCF: the fulfilment cash flows are 0 (opening balance of 0 plus 900 expected premiums minus 600 expected claims minus 300 premiums paid relating to Contract A).
- CSM: the CSM of 300 at initial recognition is the amount that results in no income or expenses arising from the initial recognition of the fulfilment cash flows of 0 and the premiums paid on that date of 300.

<sup>4</sup>At 30 June in year 1:

- FCF: the fulfilment cash flows are 200 (opening balance of 0 minus 100 claims received plus 300 premiums paid relating to Contract B).
- CSM: the balance of the CSM is 250 (opening balance of 300 minus 50 recognised as reinsurance contract expenses in the period (see profit or loss slide 14)).

<sup>5</sup>At 31 December in year 1:

- FCF: the fulfilment cash flows are 300 (opening balance of 200 minus 200 claims received plus 300 premiums paid relating to Contract C).
- CSM: the balance of the CSM is 150 (opening balance of 250 minus 100 recognised as reinsurance contract expenses in the period).

<sup>6</sup>At 30 June in year 2:

- FCF: the fulfilment cash flows are 100 (opening balance of 300 minus 200 claims received)
- CSM: the balance of the CSM is 50 (opening balance of 150 minus 100 recognised as reinsurance contract expenses in the period).

<sup>7</sup>At 31 December in year 2 the reinsurance contract held is derecognised.

- FCF: the fulfilment cash flows are 0 (opening balance of 100 minus 100 claims received).
- CSM: the balance of the CSM is 0 (opening balance of 50 minus 50 recognised as reinsurance contract expenses in the period).

# Statement of profit or loss

14

	Year 1		Year 2	
	1Jan-30Jun	1Jul-31Dec	1Jan-30Jun	1Jul-31Dec
Reinsurance premiums <sup>1</sup> :				
Expected claims recovered <sup>2</sup>	(100)	(200)	(200)	(100)
Contractual service margin <sup>3</sup>	(50)	(100)	(100)	(50)
Amounts recovered from reinsurance <sup>2</sup>	100	200	200	100
<b>Net expense from reinsurance contracts</b>	<b>(50)</b>	<b>(100)</b>	<b>(100)</b>	<b>(50)</b>

## Further information

<sup>1</sup> The breakdown of the reinsurance premiums amount is given in the slide to explain the results in this example. Applying IFRS 17, revenue does not arise from reinsurance contracts held. Accordingly, the requirements for revenue, including the related disclosures, do not apply.

<sup>2</sup> In this example, claims received from the reinsurer are equal to the claims paid to the policyholder on the underlying insurance contracts. Claims are received from the reinsurer on the same day that those claims are paid to the policyholder. All events occur as expected. See expected cash flows - slide 12.

<sup>3</sup> To determine the amount of the contractual service margin to be recognised in profit or loss in the period for the reinsurance contract held, in this example, the insurer considers the relevant facts and circumstances related to the underlying insurance contracts and determines that the amount and timing of services received under the reinsurance contract held are consistent to the amount and timing of services provided under the underlying insurance contracts (see slide 9).

# Statement of financial position:

## *the whole picture*

15

	Year 1			Year 2	
	1 Jan	30 June	31 Dec	30 June	31 Dec
Fulfilment cash flows	(200)	(300)	(300)	(100)	-
Contractual service margin	(100)	(150)	(150)	(50)	-
<b>Insurance contract asset / (liability)</b>	<b>(300)</b>	<b>(450)</b>	<b>(450)</b>	<b>(150)</b>	<b>-</b>
Fulfilment cash flows	0	200	300	100	-
Contractual service margin	300	250	150	50	-
<b>Reinsurance contract asset / (liability)</b>	<b>300</b>	<b>450</b>	<b>450</b>	<b>150</b>	<b>-</b>



### **Further information**

FCF: in this example, the cash flows for the reinsurance contract held are equal to the cash flows for the group of underlying insurance contracts and they occur at the exact same time.

CSM: in this example, the insurer provides service equally over the contract term for each underlying insurance contract. In this example, the insurer determines that the amount and timing of services received under the reinsurance contract held are equal to the amount and timing of services provided under the underlying insurance contracts.

As a result of the above, the balance of the reinsurance contract asset is equal to the balance of the insurance contract liability.

# Statement of profit or loss

*the whole picture*

16

	Year 1		Year 2	
	1Jan-30Jun	1Jul-31Dec	1Jan-30Jun	1Jul-31Dec
Insurance revenue	150	300	300	150
Insurance service expenses	(100)	(200)	(200)	(100)
Net expense from reinsurance contracts	(50)	(100)	(100)	(50)
<b>Insurance service result</b>	-	-	-	-



### **Further information**

This is a simplified example of 100% proportionate reinsurance coverage. In this example, the services provided by the insurer under the underlying insurance contracts in each period are consistent with the services received from the reinsurer under the reinsurance contract held in each period. Also, the consideration to which the insurer expects to be entitled to in exchange for the services provided under the underlying insurance contracts is equal to the consideration the insurer expects to pay to the reinsurer in exchange for the services received under the reinsurance contract held.

As a result, there is a nil impact on the statement of profit or loss.

Reinsurance contract held:  
cash flows are settled net at  
the end of the coverage  
period

# Cash flows

18

Same fact pattern, expect that all reinsurance contract cash flows are settled net at the end of the coverage period

	Year 1			Year 2		Total
	1 Jan	30 June	31 Dec	30 June	31 Dec	
Premiums	-	-	-	-	(900)	(900)
Claims	-	-	-	-	600	600
<b>Net cash outflow</b>						<b>(300)</b>



## **Further information**

A net amount of 300 is expected to be paid to the reinsurer at the end of the coverage period (900 premiums minus 600 claims).

# Statement of financial position

19

	Year 1			Year 2	
	1 Jan	30 June	31 Dec	30 June	31 Dec
Fulfilment cash flows <sup>1</sup>	(300)	(300)	(300)	(300)	-
Contractual service margin <sup>2</sup>	300	250	150	50	-
<b>Reinsurance contract asset / (liability) <sup>3</sup></b>	<b>-</b>	<b>(50)</b>	<b>(150)</b>	<b>(250)</b>	<b>-</b>



## **Further information**

<sup>1</sup> The fulfilment cash flows at each reporting date is 300 until the end of the coverage period. This reflects that the insurer expects to make one payment of 300 to the reinsurer at the end of the coverage period.

<sup>2</sup> The contractual service margin is measured and recognised in the same way as in the previous example (see slides 13–14) because the services provided under the reinsurance contract held are the same. The only difference in this example is the timing of the cash flows.

<sup>3</sup> In this example, the balance is a reinsurance contract liability because the expected future cash flows are a net outflow.

# Statement of profit or loss

20

	Year 1		Year 2	
	1Jan-30Jun	1Jul-31Dec	1Jan-30Jun	1Jul-31Dec
Reinsurance premiums:				
Expected claims recovered	(100)	(200)	(200)	(100)
Contractual service margin	(50)	(100)	(100)	(50)
Amounts recovered from reinsurance	100	200	200	100
<b>Net reinsurance contract expenses</b>	<b>(50)</b>	<b>(100)</b>	<b>(100)</b>	<b>(50)</b>

## **Further information**

The statement of profit or loss in this example is the same as the statement of profit or loss in the previous example (see slides 13–14) because the services provided under the reinsurance contract held are the same. The only difference in this example is the timing of the cash flows. The timing of cash flows may impact insurance finance income or expenses however, for simplicity in this example, the discount rate is 0%.

# Statement of financial position: *the whole picture*

21

	Year 1			Year 2	
	1 Jan	30 June	31 Dec	30 June	31 Dec
Fulfilment cash flows	(200)	(300)	(300)	(100)	-
Contractual service margin	(100)	(150)	(150)	(50)	-
<b>Insurance contract asset / (liability)</b>	<b>(300)</b>	<b>(450)</b>	<b>(450)</b>	<b>(150)</b>	<b>-</b>
Fulfilment cash flows	(300)	(300)	(300)	(300)	-
Contractual service margin	300	250	150	50	-
<b>Reinsurance contract asset / (liability)</b>	<b>-</b>	<b>(50)</b>	<b>(150)</b>	<b>(250)</b>	<b>-</b>



### **Further information**

FCF: in this example, the cash flows for the reinsurance contract held are equal to the cash flows for the group of underlying insurance contracts, however the cash flows occur at different times.

CSM: as with the previous example, the insurer provides service equally over the contract term for each underlying insurance contract. Also in this example, the insurer determines that the amount and timing of services received under the reinsurance contract held are equal to the amount and timing of services provided under the underlying insurance contracts.

As a result of the above, the balance of the reinsurance contract liability is not equal to the balance of the insurance contract liability. This reflects the fact that, at each reporting period, the expected future cash flows under the reinsurance contract held are different to the expected future cash flows under the group of underlying insurance contracts.

# Statement of profit or loss

*the whole picture*

22

	Year 1		Year 2	
	1Jan-30Jun	1Jul-31Dec	1Jan-30Jun	1Jul-31Dec
Insurance revenue	150	300	300	150
Insurance service expenses	(100)	(200)	(200)	(100)
Net expense from reinsurance contracts	(50)	(100)	(100)	(50)
<b>Insurance service result</b>	-	-	-	-



**Further information**

See slide 16.

## In practice

- In practice it is likely that there will be differences between the cash flows arising from:
  - a) the rights and obligations of the underlying insurance contracts; and
  - b) the rights and obligations of the reinsurance contract held.
- These differences may exist, for example, because:
  - a) the timing of cash flows can vary, which can also impact insurance finance income or expenses; or
  - b) the reinsurer prices the reinsurance contract differently to the pricing of the underlying contracts.

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## STAFF PAPER

December 2018

## IASB® meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	The treatment of accounting estimates in interim financial statements		
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**Purpose and structure of the paper**

1. This paper discusses the treatment of accounting estimates in interim financial statements.
2. This paper provides:
  - (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
  - (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;
  - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
  - (d) the staff analysis, recommendation and a question for Board members.

**Staff recommendation**

3. The staff recommend that the Board should not amend the requirements in IFRS 17 for the treatment of accounting estimates in interim financial statements.

## IFRS 17 requirements

4. Notwithstanding the requirement in IAS 34 *Interim Financial Reporting* that the frequency of reporting shall not affect the measurement of the annual results, IFRS 17 requires entities not to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or in the annual financial statements.

## Board's rationale

5. Requiring the contractual service margin to be adjusted for changes in estimates of the fulfilment cash flows, but not for experience adjustments, has the consequence that the accounting depends on the timing of a reporting date. Applying the requirements of IAS 34 would have required the recalculation of amounts previously reported in interim financial statements for the annual financial statements, as demonstrated in the following example.
6. Consider an entity that prepares annual financial statements and also prepares quarterly interim financial statements applying IAS 34. At the beginning of the year, the entity includes in the measurement of the liability for remaining coverage an amount of CU10 expected to be incurred in the third quarter. In the second quarter, the entity changes its expectation and now expects an amount of CU15 to be incurred in the third quarter. In the third quarter, an amount of CU15 is actually incurred. Applying the requirements in IAS 34:
  - (a) in the quarterly interim financial statements, the difference of CU5 would be treated as a change in estimate of fulfilment cash flows that adjusts the contractual service margin in the second quarter. In the third quarter, the amount incurred is as expected and so there would be no amendment to the contractual service margin or experience adjustment recognised in profit or loss.
  - (b) in the annual financial statements, the difference of CU5 would be treated as an experience adjustment recognised in profit or loss.

7. The Board received feedback that applying existing accounting practices, some entities determine experience adjustments and changes in estimates annually. However, stakeholders noted that to continue to determine those amounts annually applying the requirements in IFRS 17 would result in a significant practical burden when an entity reports more frequently than annually, because of the need to recalculate the carrying amount of the contractual service margin and the amounts recognised in profit or loss. Stakeholders also said that this would greatly reduce the informational value of the interim financial statements, because they would become less indicative of the annual results.
8. The Board therefore decided that IFRS 17 should specifically prohibit 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 financial statements.

### **Concerns and implementation challenges expressed since IFRS 17 was issued**

9. Some stakeholders think that the requirement in paragraph B137 of IFRS 17 relating to interim financial reports as defined in IAS 34 should be extended to other types of interim reports that are not defined elsewhere in IFRS Standards. For example, monthly management reports or internal reports provided by subsidiaries to a parent.
10. Those stakeholders observe that applying the requirements in IFRS 17 raises practical difficulties because entities may need to maintain a separate set of reports for each type of interim report that does not meet the requirement in paragraph B137 of IFRS 17. For example, consider a subsidiary that does not prepare interim financial reports as defined by IAS 34, but does provide interim financial information to its parent to be included in the interim financial reports, as defined by IAS 34, for the consolidated group. For the purpose of preparing the individual financial statements of the subsidiary, paragraph B137 of IFRS 17 does not apply. For the purpose of preparing financial information to be included in the consolidated financial statements of the group, paragraph B137 of IFRS 17 does apply.

11. Other stakeholders think that the requirement in paragraph B137 of IFRS 17 should not be extended to other types of interim reports but should be amended so that its application is permitted but not required. Those stakeholders think that allowing for this option would facilitate increased comparability between entities with different interim reporting frequencies because an entity could decide whether to apply the option considering its reporting frequency compared to the reporting frequency of its competitors.

### **Staff analysis and recommendation**

12. The staff think that amending the requirement in IFRS 17 applicable to interim financial reports as defined in IAS 34 to extend them to any type of reporting that is not defined elsewhere in IFRS Standards would result in different entities developing different definitions of an interim report. This in turn would:
- (a) add complexity for both preparers and users of financial statements; and
  - (b) reduce comparability among entities.
13. The staff think that amending the requirement in IFRS 17 applicable to interim financial reports as defined by IAS 34 so that its application is permitted but not required would result in different entities treating accounting estimates made in previous interim financial statements differently. This in turn would:
- (a) add complexity for both preparers and users of financial statements.
  - (b) reduce comparability among entities. The staff observe that if applying the requirement in IFRS 17 was an option, an entity might decide whether or not to use the option considering:
    - (i) its reporting frequency compared to the reporting frequency of all or some of its competitors;
    - (ii) which option is less burdensome from a practical perspective;  
or
    - (iii) it might consider a combination of both of these factors.Different entities would have different priorities in this regard.

14. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to the treatment of accounting estimates in interim financial statements.

**Question for Board members**

Do you agree that the Board should not amend the requirements in IFRS 17 relating to the treatment of accounting estimates in interim financial statements?