

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Insurance risk consequent to an incurred claim		
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This paper has been prepared for discussion at a public meeting of the Transition Resource Group for IFRS 17 *Insurance Contracts* and does not represent the views of any individual member of the International Accounting Standards Board or staff. Comments on the application of IFRS[®] Standards do not purport to set out acceptable or unacceptable application of IFRS Standards.

Introduction

1. We have received a number of submissions on insurance contracts under which an incurred claim results in insurance risk for the issuer that would not exist if no claim were made.
2. An example described in the submissions is an insurance contract that provides coverage for a policyholder becoming disabled during a specified period. If a valid claim is made, the entity is required to make regular payments to the policyholder until the policyholder recovers, reaches a specified age or dies.
3. The objective of this paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

4. This paper includes the following information:
- (a) background information;
 - (b) implementation question; and
 - (c) review of accounting requirements.

Background information

5. Appendix A of IFRS 17 defines the coverage period as:
- The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.
6. Appendix A of IFRS 17 defines an insured event as:
- An uncertain future event covered by an insurance contract that creates insurance risk.
7. Appendix A of IFRS 17 defines a liability for remaining coverage as:
- An entity's obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (ie the obligation that relates to the unexpired portion of the coverage period).
8. Appendix A of IFRS 17 defines a liability for incurred claims as:
- An entity's obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not yet been reported, and other incurred insurance expenses.
9. Paragraph B5 of IFRS 17 states:
- Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance

contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Implementation question

10. The submissions discuss a situation in which an incurred claim under an insurance contract creates insurance risk for the entity that would not exist if no claim were made. In this paper, such insurance risk is referred to as consequential insurance risk.
11. The submissions ask whether the entity's obligation to pay amounts subsequent to an incurred claim that are subject to insurance risk should be treated as:
 - (a) a liability for incurred claims; or
 - (b) a liability for remaining coverage.
12. The classification of the obligation as a liability for incurred claims or a liability for remaining coverage does not affect the determination of the fulfilment cash flows. However, it does affect the determination of the coverage period. Consequently, it affects whether some changes in the fulfilment cash flows adjust the contractual service margin and the allocation of the contractual service margin.

Review of accounting requirements

13. This paper uses two examples to illustrate alternative applications of the relevant definitions in IFRS 17:
 - (a) insurance coverage for disability that provides an annuity for the period in which the policyholder is disabled; and

- (b) insurance coverage for fire that provides compensation for the cost of rebuilding a house after a fire.
14. Different interpretations of the definitions in IFRS 17 lead to different views on whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of a liability for remaining coverage or a liability for incurred claims.
15. Applying the definitions in support of the consequential insurance coverage being part of the liability for incurred claims:
- (a) disability insurance:
 - (i) the insured event is the uncertain event that a policyholder becomes disabled because of the occurrence of an accident/illness.
 - (ii) the coverage period is the period in which a policyholder can make a valid claim for becoming disabled due to an accident/illness.
 - (iii) the liability for remaining coverage is the entity's obligation to pay valid claims relating to accidents/illnesses that have not yet occurred causing disability.
 - (iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claim on becoming disabled. The amount of the claim (the total payments under the annuity) is uncertain and subject to insurance risk.¹ However, such features are clearly envisaged as potentially being part of the liability for incurred claims applying IFRS 17 by the

¹ The amount of the claim is subject to insurance risk because the risk of the policyholder being disabled for an uncertain period is transferred to the entity.

inclusion of a risk adjustment for non-financial risk in that liability.²

- (b) fire insurance:
 - (i) the insured event is the uncertain occurrence of a fire.
 - (ii) the coverage period is the period in which a fire can occur for which a policyholder can make a valid claim.
 - (iii) the liability for remaining coverage is the entity's obligation to pay claims relating to fire events that have not yet occurred.
 - (iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claim for a fire. The amount of the claim (the cost of rebuilding the house) is uncertain and subject to insurance risk (because house building costs may increase), but such features are clearly envisaged under IFRS 17 by the inclusion of a risk adjustment for non-financial risk in the liability for incurred claims.

16. Applying the definitions in support of the consequential insurance coverage being part of the liability for remaining coverage:

- (a) disability insurance:
 - (i) the insured events are the uncertain event of the policyholder becoming disabled following an accident/illness in the period specified in the contract and the uncertain event of the policyholder remaining disabled and eligible to claim.

² Paragraph 40(b) of IFRS 17 requires the fulfilment cash flows for the liability for incurred claims to be measured applying paragraphs 33–37 of IFRS 17. Paragraph 37 of IFRS 17 requires an entity to make an adjustment for non-financial risk.

- (ii) the coverage period is the period in which a policyholder may be eligible to make a claim for being disabled.
 - (iii) the liability for remaining coverage is the entity's obligation to pay claims for future periods of disability both for policyholders that are already disabled and for policyholders yet to become disabled. This treatment would be consistent with the treatment of such insurance contracts when they are acquired after the policyholder becomes disabled, applying paragraphs B5 and B93 of IFRS 17 (see paragraph 24 of this paper).
 - (iv) the liability for incurred claims is the entity's obligation to settle a claim already made by a policyholder for a period of disability. The amount of the claim is relatively certain, not subject to insurance risk and is expected to be small assuming annuities are paid monthly.
- (b) fire insurance:
- (i) the insured events are claims for the cost of rebuilding a house damaged by a fire that occurred in the period specified in the contract.
 - (ii) the coverage period is the period in which a fire can occur or in which the policyholder can make a claim for the cost of rebuilding a house damaged by a qualifying fire event.
 - (iii) the liability for remaining coverage is the entity's obligation to pay claims relating to fire events that have not yet occurred and to pay claims for the cost of building the house for buildings already damaged by qualifying fire events. This treatment would be consistent with the treatment of such insurance contracts when they are

acquired in the period after a fire event, applying paragraphs B5 and B93 of IFRS 17 (see paragraph 24 of this paper).

- (iv) the liability for incurred claims is the entity's obligation to pay for a policyholder's claims for the cost of rebuilding the house. The amount to settle the claims as they are made is relatively certain and not subject to insurance risk.

17. The staff think that the analyses in both paragraphs 15 and 16 of this paper are valid interpretations of IFRS 17 for both examples. The staff think it is a matter of judgement for the entity as to which interpretation provides the most useful information about the insurance service provided by the entity to the policyholder under the contract. The staff think that judgement will be influenced by:

- (a) the relative complexity of the two approaches. Treating payments caused by an initial claim as a liability for remaining coverage is more complex than treating them as a liability for incurred claim because:

- (i) the period in which adjustments are made to the contractual service margin is extended; and
- (ii) the determination of coverage units includes two types of insurance coverage.

- (b) comparability with other products available in the market. If the insurance coverage provided as a consequence of an initial claim is also commonly available as a standalone product, more useful information may be given by treating the consequential payments as a liability for remaining coverage, consistent with the treatment of the standalone products.

18. The staff observe that in some cases, the difference between the two approaches may not be significant. The number of contracts in a group that continue into the consequential insurance coverage period is likely to be a small proportion of the total number of contracts. In addition, if the expected coverage period of the

consequential insurance coverage is short compared to the initial coverage period, the amount of the contractual service margin recognised in the consequential coverage period may be small.

19. The staff also observe that the approach applied by an entity is an accounting policy as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.³ Applying IAS 8, an entity is required to:
- (a) select and apply accounting policies consistently for similar transactions, other events and conditions.
 - (b) change an accounting policy only if the change:
 - (i) is required by an IFRS Standard; or
 - (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.
 - (c) disclose the nature of a change in accounting policies and the reasons why applying the new accounting policy provides reliable and more relevant information.
20. Hence, an entity should apply an approach consistently for similar transactions and over time. For example, the same approach should be applied to all groups of contracts for the same product type or all groups of contracts with similar insurance service provided by the entity to the policyholder.
21. Given the factors discussed in paragraphs 17–20 of this paper, the staff think it is likely that for many products, different entities will adopt the same approaches. However, as practice develops, if evidence emerges of diversity that is widespread

³ IAS 8 defines accounting policies as 'the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.'

and has a material effect, the International Accounting Standards Board can consider whether to take any action.

22. The staff note that whichever approach an entity applies, IFRS 17 requires disclosure of significant judgements made in applying the Standard and substantial disclosures relating to the contractual service margin (for example, the reconciliation of the opening and closing balances and an explanation of when the entity expects to recognise the remaining balance in profit or loss), which will enable users to understand the effects of the approach applied.

Additional points

23. The submissions raise two additional questions:
- (a) whether the treatment of the payments consequent to an incurred claim depends on whether the contracts are reinsurance contracts relating to underlying contracts for which the insured event has already occurred (for example, reinsurance for adverse development of claims) or are insurance contracts that were transferred during the claims settlement period; and
 - (b) what effect law or regulation might have.
24. The staff observe that reinsurance contracts relating to underlying contracts for which the insured event has already occurred create a liability for remaining coverage, applying paragraph B5 of IFRS 17. IFRS 17 also specifies that insurance contracts acquired after the insured event has occurred create a liability for remaining coverage, applying paragraphs B5 and B93 of IFRS 17.⁴ The analysis in this paper does not affect those classifications.

⁴ Paragraph B93 of IFRS 17 states ‘When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.’

25. One submission asks about an example of coverage for personal or third party injury caused by a motor vehicle accident. The contract does not specify how claims will be settled. However, law or regulation might, in rare circumstances, impose a requirement for the entity to settle a claim by life-contingent annuity payments.
26. Paragraph 2 of IFRS 17 states:
- An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).
27. Hence an entity would need to consider the possibility of law or regulation imposing settlement by life-contingent annuity payments in its assessment of insurance risk created by the contract. The same analysis in paragraphs 15–20 of this paper then applies.

TRG discussion

Question to TRG members

What are your views on the implementation question presented above?

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Determining discount rates using a top-down approach		
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Introduction

1. We have received two submissions about how an entity applies a top-down approach to determine the discount rates for insurance contracts with cash flows that do not vary based on the returns on underlying items. The submissions question whether:
 - (a) an entity could:
 - (i) use the assets it holds as a reference portfolio of assets; and
 - (ii) ignore the liquidity characteristics of insurance contracts.
 - (b) changes in the assets the entity holds result in changes in the discount rates used to measure insurance contracts under specific circumstances.
2. The objective of this paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

3. This paper includes the following:
 - (a) background information;
 - (b) implementation question; and
 - (c) review of accounting requirements.

Background information

4. Paragraph 36 of IFRS 17 states:

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

- (a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
- (b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
- (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.

5. Paragraph B78 of IFRS 17 states:

Discount rates shall include only relevant factors, ie factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Such discount rates may not be directly observable in the market. Hence, when observable

market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the insurance contracts, an entity shall estimate the appropriate rates. IFRS 17 does not require a particular estimation technique for determining discount rates. In applying an estimation technique, an entity shall:

- (a) maximise the use of observable inputs (see paragraph B44) and reflect all reasonable and supportable information on non-market variables available without undue cost or effort, both external and internal (see paragraph B49). In particular, the discount rates used shall not contradict any available and relevant market data, and any non-market variables used shall not contradict observable market variables.
- (b) reflect current market conditions from the perspective of a market participant.
- (c) exercise judgement to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

6. Paragraph B79 of IFRS 17 states:

For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without

incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.

7. Paragraph B80 of IFRS 17 states:

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

8. Paragraph B81 of IFRS 17 states:

Alternatively, an entity may determine the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach). An entity shall adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.

9. Paragraph B82 of IFRS 17 states:

In estimating the yield curve described in paragraph B81:

- (a) if there are observable market prices in active markets for assets in the reference portfolio, an entity shall use those prices (consistent with paragraph 69 of IFRS 13).
- (b) if a market is not active, an entity shall adjust observable market prices for similar assets to make them comparable to market prices for the assets being measured (consistent with paragraph 83 of IFRS 13).

- (c) if there is no market for assets in the reference portfolio, an entity shall apply an estimation technique. For such assets (consistent with paragraph 89 of IFRS 13) an entity shall:
 - (i) develop unobservable inputs using the best information available in the circumstances. Such inputs might include the entity's own data and, in the context of IFRS 17, the entity might place more weight on long-term estimates than on short-term fluctuations; and
 - (ii) adjust those data to reflect all information about market participant assumptions that is reasonably available.

10. Paragraph B83 of IFRS 17 states:

In adjusting the yield curve, an entity shall adjust market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, and shall adjust observed market rates to reflect the degree of dissimilarity between the instrument being measured and the instrument for which transaction prices are observable. For cash flows of insurance contracts that do not vary based on the returns on the assets in the reference portfolio, such adjustments include:

- (a) adjusting for differences between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts; and
- (b) excluding market risk premiums for credit risk, which are relevant only to the assets included in the reference portfolio.

11. Paragraph B84 of IFRS 17 states:

In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in

practice the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach.

12. Paragraph B85 of IFRS 17 states:

IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph B81. However, fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics. For example, if the cash flows from the insurance contracts do not vary based on the returns on underlying items, fewer adjustments would be required if an entity used debt instruments as a starting point rather than equity instruments. For debt instruments, the objective would be to eliminate from the total bond yield the effect of credit risk and other factors that are not relevant to the insurance contracts. One way to estimate the effect of credit risk is to use the market price of a credit derivative as a reference point.

13. Paragraph BC196 of the Basis for Conclusions on IFRS 17 explains:

[...] in response to feedback suggesting that it may be difficult to determine a liquidity premium in isolation, the Board observed that in estimating liquidity adjustments, an entity could apply either of the following:

- (a) a 'bottom-up' approach based on highly liquid, high-quality bonds, adjusted to include a premium for the illiquidity.
- (b) a 'top-down' approach based on the expected returns of a reference portfolio, adjusted to eliminate factors that are not

relevant to the liability, for example market and credit risk. The Board expects a reference portfolio will typically have liquidity characteristics closer to the liquidity characteristics of the group of insurance contracts than highly liquid, high-quality bonds. Because of the difficulty in assessing liquidity premiums, the Board decided that in applying a top-down approach an entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts.

Implementation question

14. The submissions question whether, when using a top-down approach to determine the discount rates for cash flows that do not vary based on the returns on underlying items—ie when applying paragraph B81 of IFRS 17—an entity:
- (a) could use the assets it holds as a reference portfolio of assets;
 - (b) could ignore the liquidity characteristics of the group of insurance contracts being measured; and
 - (c) should reflect in the discount rates any changes occurring during the reporting period in the assets it holds when the entity:
 - (i) uses those assets as a reference portfolio of assets; and
 - (ii) does not to adjust the yield curve for differences in liquidity between the group of insurance contracts being measured and the reference portfolio of assets.
15. Regarding the question in paragraph 14(c) of this paper, one submission notes that a change in the assets held as a reference portfolio may occur when more illiquid assets become available in the market. When more illiquid assets become available entities may sell more liquid assets (yield reflects a lower return) and buy assets that are less liquid (yields reflecting a higher return). This would

increase the yield curve derived from the reference portfolio of assets used for determining the discount rates for the insurance contracts, without there being a change in the liquidity characteristics of the insurance contracts. This submission provides two alternative views:

- (a) View A—Changes in the entity’s assets used as a reference portfolio should not affect the discount rates used to measure insurance contracts. A reference portfolio is a benchmark composed of a consistent mix of well-defined asset types and classes, rather than the assets held by the entity. The characteristics of the cash flows of the insurance contracts do not vary following changes in the entity’s assets.
- (b) View B—Changes in the entity’s assets used as a reference portfolio may impact the discount rates used to measure insurance contracts. Paragraph B81 of IFRS 17 states that an entity is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio. Therefore, any changes in the liquidity characteristics of the reference portfolio impacting the yield curve would flow through the discount rates derived from the reference portfolio.

Review of accounting requirements

Reference portfolio of assets

- 16. Paragraph B81 of IFRS 17 permits an entity to determine the appropriate discount rates for a group of insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach).
- 17. As noted in paragraph B85 of IFRS 17, IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph B81 of IFRS 17.

Also, IFRS 17 does not define ‘a reference portfolio of assets’. Consequently, a portfolio of assets that an entity holds can be used as a reference portfolio of assets to determine the discount rates as stated in paragraph B81 of IFRS 17, as long as the discount rates achieve the objectives set out in paragraph 36 of IFRS 17 of:

- (a) reflecting the characteristics of the insurance contracts. This means that adjustments are necessary to eliminate any characteristics of the assets that are not present in the insurance contracts (subject to the discussion on liquidity set out in paragraph 20 of this paper). For example, if the top-down approach starts with the yield curve based on contractual cash flows of debt instruments, the entity needs to adjust for the expected credit losses on those instruments in determining the appropriate discount rates for the insurance contracts.
- (b) being consistent with observable current market prices. This means, for example, that if the top-down approach starts with the yield curve based on assets held by the entity, this yield curve needs to be derived from the current fair value of the assets held, even if the entity does not measure those assets at fair value for financial reporting purposes.

Liquidity of insurance contracts

- 18. Paragraph BC195 of the Basis for Conclusions on IFRS 17 explains the Board’s conclusion that it is not appropriate in a principle-based approach to ignore the liquidity characteristics of the item being measured. Several paragraphs of IFRS 17 require that the liquidity characteristics of insurance contracts are considered when determining the discount rates applied to the estimates of cash flows that do not vary based on the returns on underlying items.
- 19. As an overall principle, paragraph 36 of IFRS 17 requires that those discount rates reflect, among other factors, the liquidity characteristics of the insurance

contracts. Paragraphs B78–B79 of IFRS 17 further specify that those discount rates shall include only factors relevant to insurance contracts—such as liquidity—and shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts.

20. However, when using the top-down approach described in paragraph 16 of this paper, as a simplification, paragraph B81 of IFRS 17 permits an entity not to adjust the yield curve derived from a reference portfolio of assets for differences in liquidity characteristics of the insurance contracts and the reference portfolio. The difficulty in determining a liquidity premium in isolation is noted in paragraph BC196(b) of the Basis for Conclusions on IFRS 17. Paragraph BC196(b) of the Basis for Conclusions on IFRS 17 also notes that the Board expected a reference portfolio of assets typically to have liquidity characteristics closer to the liquidity characteristics of a group of insurance contracts than would be the case for highly liquid, high-quality bonds. In other words, the reference portfolio envisaged by the Board when providing the simplification would have required little adjustment for liquidity differences if such adjustment was made.

Changes in the reference portfolio of assets

21. In applying paragraph 36 of IFRS 17 to determine the appropriate discount rates for cash flows that do not vary based on the returns on underlying items, an entity shall ensure that at each reporting date those discount rates reflect the characteristics of the insurance contracts, even when the entity chooses to use a portfolio of assets that it holds to determine the discount rates.
22. As noted in paragraph 17(a) of this paper, the entity needs to eliminate any differences resulting from characteristics of that portfolio of assets that are not present in the insurance contracts, such as expected credit losses. In principle, the entity should also eliminate any differences in liquidity.

23. Both expected credit losses and liquidity of the assets in a reference portfolio may fluctuate over time because of:
- (a) market movements; and/or
 - (b) changes in the characteristics of the assets in the reference portfolio or in the composition of the reference portfolio.
24. Those fluctuations affect the yield of the reference portfolio of assets. The staff view is that to achieve the objectives in paragraph 36 of IFRS 17 an entity needs to make adjustments to the yield curve of the reference portfolio of assets at each reporting date to eliminate any effect on discount rates of:
- (a) credit risk. This is because credit risk is not a characteristic of the insurance contracts. Credit risk fluctuations, therefore, should not affect discount rates used to measure insurance contracts.
 - (b) differences in liquidity characteristics of the insurance contracts and the reference portfolio. If an entity eliminates these differences, liquidity fluctuations in the yield curve of the reference portfolio will affect the discount rates for the insurance contracts to the extent of changes in the market price for liquidity and/or changes in the liquidity characteristics of the insurance contracts. Changes in the yield curve of the reference portfolio caused by changes in the composition of the reference portfolio or the liquidity characteristics of the assets in the reference portfolio would not affect the discount rates for insurance contracts. However, the entity may use the simplification discussed in paragraph 20 of this paper. If the entity uses that simplification, fluctuations in the liquidity of the reference portfolio are mirrored in the changes in the discount rates used to measure the group of insurance contracts. Paragraphs 87–90 of IFRS 17 permit the entity to present the effect of changes in discount rates, including any liquidity fluctuations, either in profit or loss or in other comprehensive income if the entity has elected

to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income.

25. IFRS 17 requires an entity to disclose qualitative and quantitative information about the significant judgements, and changes in those judgements, made when applying IFRS 17. Paragraphs 117 and 120 of IFRS 17 require an entity to disclose:
- (a) the methods used to measure insurance contracts and the processes for estimating the inputs to those methods, including the approach used to determine the discount rates;
 - (b) any changes in the methods and processes for estimating inputs used to measure insurance contracts, the reason for the change, and the type of contracts affected; and
 - (c) the yield curve or range of yield curves used to discount cash flows that do not vary based on the returns on underlying items.
26. Paragraph BC198 of the Basis for Conclusions on IFRS 17 explains that the different approaches IFRS 17 allows for determining the discount rate could give rise to different rates. Accordingly, the Board decided that disclosure of the yield curves used to discount cash flows that do not vary based on the returns on underlying items is required to allow users of financial statements to understand how those yield curves might differ from entity to entity.
27. An entity is required by paragraph 94 of IFRS 17 to disclose any additional information to meet the objective set out in paragraph 93 of IFRS 17. That objective is to disclose information in the notes that, together with the information provided in the primary financial statements, gives a basis for users of financial statements to assess the effect that insurance contracts have on an entity's financial position, financial performance and cash flows.
28. Identifying a reference portfolio, adjusting the yield curve to determine the discount rates and using the simplification discussed in paragraph 20 of this paper

(whether the reference portfolio is held by the entity or not) are all methods and processes for estimating the inputs to those methods used to measure insurance contracts. Therefore, these methods and processes for estimating the inputs to those methods, and any changes in them, should be disclosed applying paragraph 117 of IFRS 17.

29. With reference to the question in paragraph 14(c) of this paper, and considering the disclosure objective in paragraph 93 of IFRS 17 and the specific disclosure requirements of paragraph 117 of IFRS 17, the staff think that an entity is required to provide information about the effect of a change in the composition of the assets in the reference portfolio on discount rates used to measure insurance contracts, if material.

TRG discussion

Question to TRG members

What are your views on the implementation question presented above?

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Commissions and reinstatement premiums in reinsurance contracts issued		
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Introduction

1. We have received a number of submissions about amounts exchanged between the issuer of a reinsurance contract (the reinsurer) and the holder of a reinsurance contract (the cedant). The submissions question how the following should be accounted for in the financial statements of the reinsurer:
 - (a) common types of commissions due to the cedant; and
 - (b) reinstatement premiums charged to the cedant following the occurrence of an insured event.
2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

3. This paper includes the following:
 - (a) background information (paragraphs 5–14).
 - (b) implementation question (paragraphs 15–17).
 - (c) review of accounting requirements:
 - (i) commissions that are not contingent on claims (paragraphs 18–35);
 - (ii) commissions that are contingent on claims (paragraphs 35–46); and
 - (iii) reinstatement premiums (paragraphs 47–58).
4. This paper includes two appendices:
 - (a) Appendix A—Flowchart; and
 - (b) Appendix B—Examples of commissions and other contract features contingent on claims.

Background information

5. Paragraph 42(a) of IFRS 17 requires an entity to recognise insurance service expenses for claims incurred in the period.
6. Paragraph 83 of IFRS 17 states:

An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs B120–B127 specify how an entity measures insurance revenue.

7. Paragraph 86 of IFRS 17 sets out the requirements for presenting income or expense from a group of reinsurance contracts held. It states:

An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid it shall:

- (a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held
- (b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and
- (c) not present the allocation of premiums paid as a reduction in revenue.

8. Paragraph B123 of IFRS 17 requires that insurance revenue for a period relating to the provision of services is determined based on the changes in the liability for remaining coverage excluding changes that do not relate to services expected to be covered by the consideration received by the entity. Changes that do not relate to services expected to be covered by the consideration received by the entity include changes that do not relate to services provided in the period, such as changes resulting from the receipt of cash for premiums and changes that relate to investment components in the period. Insurance revenue for a period relating to insurance acquisition cash flows is determined as set out in paragraph B125 of IFRS 17.
9. Paragraph B126 of IFRS 17 states that when an entity applies the premium allocation approach, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect

the time value of money and the effect of financial risk, if applicable) allocated to the period.

10. Appendix A of IFRS 17 defines insurance acquisition cash flows as:

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

11. Appendix A of IFRS 17 defines an investment component as:

The amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

12. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that the International Accounting Standards Board (Board) decided that an investment component should be defined as the amount that is paid to the policyholder in all circumstances, regardless of whether the insured event occurs. In the Board's view, the insurance benefit is the additional amount that the entity would be required to pay if an insured event occurs.

13. Paragraph BC299 of the Basis for Conclusions on IFRS 17 explains:

The amount an entity pays for reinsurance coverage consists of premiums the entity pays minus any amounts paid by the reinsurer to the entity to compensate the entity for expenses it incurs, such as underwriting or acquisition expenses (often referred to as 'ceding commissions'). [...]

14. Paragraph BC346 of the Basis for Conclusions on IFRS 17 provides explanation about the economic effect of the commissions describes in paragraph 86 of IFRS 17:

[...] IFRS 17 allows an entity to present income or expenses from reinsurance contracts held either as a single net amount or as separate amounts recovered from the reinsurer and an allocation of the premiums paid. If it presents separate amounts, IFRS 17 requires the entity to treat:

- (a) cash flows contingent on the claims or benefits in the underlying contracts, including ceding commissions, as part of the claims that are expected to be reimbursed under the reinsurance contract held, unless those cash flows need to be accounted for as investment components. In the Board's view, the economic effect of changes in those cash flows is equivalent to the effect of reimbursing a different amount of claims than expected.
- (b) ceding commissions that are not contingent on claims of the underlying contracts as a reduction of the premiums to be paid to the reinsurer. The economic effect of such ceding commissions is equivalent to the effect of charging a lower premium with no ceding commissions.

Implementation question

15. The submissions describe common types of commissions due from a reinsurer to a cedant and question how these should be accounted for in the financial statements of the reinsurer. The submissions describe both:
- (a) commissions that are not contingent on claims; and
 - (b) commissions that are contingent on claims.
16. The submissions ask:
- (a) for each type of commission, whether it is considered part of the premium or part of claims.
 - (b) whether all or some of the amounts related to these commissions meet the definition of:
 - (i) insurance acquisition cash flows; or
 - (ii) an investment component.
17. The submissions also describe reinstatement premiums charged to a cedant of a reinsurance contract following the occurrence of an insured event. The submissions question how these reinstatement premiums should be accounted for

in the financial statements of the reinsurer. One of the submissions distinguishes between mandatory and voluntary reinstatement premiums.

Review of accounting requirements

Commissions that are not contingent on claims

18. The commission is described in the submissions as an amount due from the reinsurer to the cedant with the following characteristics:¹
- (a) the amount of the commission due to the cedant is often settled net with the premium charged to the cedant (or otherwise paid upfront); and
 - (b) the amount of the commission due to the cedant is not dependent on claims or is otherwise fixed.
19. One of the submissions provides the following example:

Cash flow	Description	Amount
Reinsurance premium	60% of premium on underlying insurance contracts	6,000
Ceding commission	30% of reinsurance premium (6,000 x 30%)	1,800
Net amount	Amount received from the cedant (reinsurance premium minus ceding commission)	4,200

20. Exchanges between a reinsurer and a cedant need to be identified as either part of claims or part of premiums for the reinsurer that issues the contract to either recognise these amounts within claims incurred as insurance service expenses

¹ The submissions note that the existing practice for these types of commissions is to present the commission separately as an acquisition expense, ie it is not netted against the premium.

applying paragraph 42(a) of IFRS 17 or recognise these amounts as insurance revenue applying paragraph B123 or B126 of IFRS 17.

21. IFRS 17 does not provide specific requirements for determining whether exchanges between the entity and the policyholder are part of the premium or part of claims, except with respect to the presentation of income or expenses from reinsurance contracts held in paragraph 86 of IFRS 17.
22. The staff observe that the requirements for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant, and therefore the staff consider that an assessment of the economic effect of such exchanges would be appropriate to apply to reinsurance contracts issued as well.
23. The staff observe that the economic effect of ceding commissions that are not contingent on claims, such as in the example in paragraph 19 of this paper, is equivalent to the effect of charging a lower premium with no ceding commission. Therefore, the ceding commission is part of the premium and, applying paragraph B123 or B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 4,200 for the contract.
24. For the example in paragraph 19 of this paper, assume that the group of insurance contracts comprises a single reinsurance contract and that the group is recognised on the day that the premium (net of commission) is settled. The expected claims are 3,500. For simplicity, the risk adjustment for non-financial risk is nil and the discount rate is 0%. The entity determines the following:
 - (a) the liability for remaining coverage at initial recognition is 4,200 consisting of fulfilment cash flows of 3,500 and a contractual service margin of 700 (4,200 - 3,500). Applying paragraph B123 of IFRS 17, the change in the liability for remaining coverage during the coverage period is 4,200, reflecting the insurance revenue. If, alternatively the commission was expected to be paid after the day of initial recognition, the same revenue of 4,200 would be recognise because the total change in the liability for remaining coverage would be 6,000 and applying

paragraph B123(a) of IFRS 17 the change that relates to the commission of 1,800 would be considered related to premium and therefore would be eliminated from the total change to arrive at the insurance revenue.

- (b) alternatively, insurance revenue of 4,200 can be analysed applying paragraph B124 of IFRS 17 as consisting of the expected insurance service expenses of 3,500 and the contractual service margin recognised in profit or loss of 700.
- (c) applying paragraph B126 of IFRS 17, the amount of expected premium receipts allocated over the coverage period as revenue is 4,200.

25. The submission also considers whether the ceding commission in the example in paragraph 19 of this paper meets the definition of insurance acquisition cash flows.
26. Another submission notes that in some reinsurance contracts such ceding commissions are fixed, not adjusted subsequently and not repaid in any circumstances. This submission considers whether these ceding commissions meet the definition of insurance acquisition cash flows, noting that the commission would be paid even if no premium is ceded eventually, and therefore may not be considered as an adjustment to the premium for the contract.
27. Insurance acquisition cash flows are defined as cash flows arising from costs—the costs of selling, underwriting and starting a group of insurance contracts. The staff observe that unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, the ceding commission reflects a reduction in the transaction price, and not insurance acquisition cash flows of the reinsurer. The ceding commission may reflect compensation that the reinsurer provides the cedant for acquisition costs that the cedant incurs for underlying insurance contracts, but this does not make the commission an acquisition costs of the reinsurer. While the activities taken by the cedant to sell, underwrite and start a group of underlying insurance contracts may benefit the reinsurer, the cedant

undertakes these activities in its own right in order to sell insurance contracts to its policyholders, rather than to provide a distinct service to the reinsurer. If the cedant were to undertake activities and incur costs in order to provide a distinct service to the reinsurer, those costs may not meet the definition of insurance acquisition cash flows from the cedant's perspective.

28. The staff observe that unlike insurance acquisition costs that are usually paid, for example, to a third-party intermediary, ceding commissions are paid by the reinsurer to the cedant who is the customer buying the contract.
29. The staff observe that for circumstances in which ceding commissions are fixed, not adjusted subsequently, not repaid in any circumstances and the reinsurer expects that no premium would be ceded or that the expected premium is insufficient to recover the costs of fulfilling the contracts (including the commission), the reinsurance contract issued would be considered an onerous contract.
30. One of the submissions also considers whether the ceding commission in this example is an investment component. An investment component is an amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur and is excluded from the insurance service expenses and insurance revenue. The staff observe that ceding commissions may meet the definition of investment component if they are *repaid* to the cedant in *all circumstances*.
31. However, for the fact pattern provided, the staff view is that the ceding commission is not an investment component even if it is an amount due to the cedant in all circumstances. This is because it is settled net of premium charged to the cedant. In this example, no payment to the reinsurer or from the reinsurer after the premium is received includes amounts that the reinsurer is required to *repay* to the cedant in all circumstances. If, alternatively, the ceding commission was paid to the cedant at a later date than the premium is received, the ceding commission may meet the definition of an investment component. This is because in this case it would reflect a financial component within the insurance contract recognised,

similar to a deposit. The outcome, in terms of excluding the commission from the contract revenue would be the same, however in this case, additional disclosures related to investment components may be required applying paragraph 103(c) of IFRS 17.

32. One of the submissions questions whether ceding commissions that are fixed, not adjusted subsequently and not repaid in any circumstances can be considered a compensation for a distinct service that the cedant is providing to the reinsurer. The submission notes that the cedant may have promised the reinsurer to manage sales and underwriting, claims handling and other administrative matters related to the contract, and that judgement should be applied to consider whether a distinct service is provided to the reinsurer and an intangible asset may be recognised with respect to the commission.

33. Although the staff agree that entities should consider all relevant facts and circumstances and apply judgement to determine whether a separate service is being provided to the reinsurer within the reinsurance contract, the staff do not think a service is being provided in the specific fact pattern provided. While managing sales, underwriting and handling claims of the contract may benefit the reinsurer, it is not a service provided by the cedant to the reinsurer, rather it is an activity the cedant undertakes in its own right to fulfil the insurance contracts it has issued.

34. In summary, the staff observe that amounts exchanged between the issuer of an insurance contract and the policyholder that are not contingent on claims:
 - (a) are part of the premium and would therefore be recognised as part of the insurance revenue; and
 - (b) if paid after the premium is received, may meet the definition of an investment component, provided the amounts are repaid to the policyholder in all circumstances.

Commissions that are contingent on claims

35. Commissions that are contingent on claims are commissions that are adjusted according to the claims that are incurred. One of the submissions refers to contracts with such commissions and other contracts with similar features as retrospectively rated contracts, noting that those features are common in reinsurance contracts and commercial line insurance contracts. That submission notes that these types of commissions can be used when the reinsurer and the cedant cannot agree on a fixed price for the risk or when the cedant wants to participate in the benefits of controlling its claims.
36. The submissions provide a number of examples. The discussion in this paper uses a sliding scale commission as an example to facilitate the analysis. Additional examples are provided in Appendix B to this paper.
37. The submission describes the sliding scale commission as an amount due from the reinsurer to the cedant.² The terms of the sliding scale commission are as follows:
- (a) the commission amount is dependent on the loss experience of the contract, while a minimum amount is due to the cedant regardless of the loss experience of the contract;
 - (b) a provisional commission amount is settled net with the premium charged to the cedant; and
 - (c) the final commission amount is determined, and any adjustments to the provisional amount are settled several years after the coverage period, when all claims are fully paid.

² The submission notes that the existing practice for these types of commissions is to present the commission separately as expense, ie it is not netted against the premium.

38. The submission provides the following example:

Cash flow	Description	Amount
Reinsurance premium	60% of premium on underlying insurance contracts	6,000
Provisional commission	30% of reinsurance premium assuming a 65% loss ratio ³ (6,000 x 30%)	1,800
Net amount initially received	Amount received from the cedant (reinsurance premium minus provisional ceding commission)	4,200

The commission due to the cedant is between 20% and 40% of the reinsurance premium, contingent on the loss ratio of the contract. Adjustments to the provisional commission amount based on the ultimate loss ratio of the contract are determined and settled several years after the coverage period as follows:

Loss ratio	Commission as % of reinsurance premium	Amount
Above 75%	Minimum commission of 20%	1,200
55%–75%	Commission in the range of 20%–40%	Sliding scale
Below 55%	Maximum commission of 40%	2,400

³ Loss ratio is a measurement reflecting the loss experience of a contract.

39. Considering the economic effect of the ceding commission, the staff have analysed the ceding commission as containing two features:
- (a) a feature that is not contingent on claims—the minimum commission amount that is due to the cedant regardless of the loss experience of the contract. In this example it is the 20% minimum commission (1,200).
 - (b) a feature that is contingent on claims—an amount that varies based on the loss experience of the contract. In this example it is the additional amount of commission above the 1,200 minimum commission that is paid only when the loss ratio is below 75%.
40. Consistent with the analysis in paragraphs 22–23 of this paper, the staff view the economic effect of the feature that is not contingent on claims as equivalent to the effect of charging a lower premium. In other words, for this example, the economic effect of the 20% minimum commission amount is equivalent to the effect of charging a premium of 4,800 rather than 6,000. The analysis provided in paragraphs 22–23 of this paper for commissions that are not contingent on claims is therefore relevant to this feature.
41. The staff observe that the economic effect of the feature that is contingent on claims is equivalent to the effect of reimbursing a different amount of claims to the cedant. In other words, for this example, the economic effect of the claims contingent feature is equivalent to the effect of charging a premium of 4,800 for the reinsurance contract and paying the cedant a higher amount for claims as long as the loss ratio is below 75%.
42. Therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 4,800 for the contract. Any commission above 1,200 would be recognised as part of insurance service expenses when incurred.
43. The submission considers whether the ceding commission in this example is, or includes, an investment component. Consistent with the analysis in paragraphs 30–31 of this paper, the staff observe that the ceding commission is not an investment component in this example. In the fact pattern provided, the minimum

ceding commission (included within the provisional commission) is settled net of premium charged to the cedant. Any amounts to be paid in the future depend on the amount of claims. Therefore, no payment to the reinsurer or from the reinsurer after premium is received includes amounts that the reinsurer is required to repay to the cedant in all circumstances.

44. The staff have considered a possible scenario in which the provisional commission settled net of the reinsurance premium is lower than the minimum commission amount. For the example in paragraph 38 of this paper, this could be the case if the provisional commission is based on 10% of the reinsurance premium. In this scenario, the final commission payment may include an amount that the reinsurer is required to repay the cedant in all circumstances, which is the additional 10% to meet the 20% minimum commission. Therefore, in this scenario, the final commission payment may include an investment component. Treating the additional 10% commission that the reinsurer is required to repay to the cedant as an investment component reflects that the contract with the cedant includes a financial component, similar to a deposit.⁴
45. The staff observe that the ceding commission, or any part of it, is not an insurance acquisition cash flow as discussed in paragraphs 27–28 of this paper, nor does it reflect a distinct service provided by the cedant to the reinsurer as discussed in paragraph 33 of this paper.
46. In summary, the staff observe that amounts exchanged between the issuer of an insurance contract and a policyholder that are contingent on claims (ie the amounts excluding any minimum amounts that are, in effect, non-contingent) are part of claims and would therefore be recognised as part of insurance service expenses.

⁴ Similarly, if the reinsurance premium of 6,000 were prepaid with no provisional commission netted, the final commission payment may include an investment component of 1,200.

Reinstatement premiums

47. The reinstatement premium is described in the submissions as an amount charged to the cedant following an insured event occurring in order to continue coverage. One of the submissions distinguishes between mandatory and voluntary reinstatement premiums. The analysis in this paper is provided separately for each type of reinstatement premium.

Mandatory reinstatement premiums

48. One of the submissions provides a fact pattern of a mandatory reinstatement premium. The reinstatement premium is predetermined. This means that no additional underwriting or repricing can be done. It is assumed that the reinstatement premium is compulsory and it is assumed that the contract cannot be terminated before the end of its contractual term. The submission also provides the following information about the reinstatement premium:

- (a) the reinstatement premium amount is contingent on the claim amount;
- (b) if no insured event occurs, no reinstatement premium is charged to the cedant (ie there is no minimum reinstatement premium amount that is paid in all circumstances); and
- (c) the reinstatement premium is settled net with the claims paid to the cedant (reduces claims).

49. The submission provides the following example:⁵

Cash flow	Description	Amount
Reinsurance premium	Amount charged for coverage (see limit per claim and aggregate limit below)	250

⁵ The submission notes that the existing practice for this example is that the reinstatement premium is treated as a separate cash flow and presented separately to the premium for the contract. It is not netted against claims incurred.

Claim limit	Maximum amount that can be claimed per claim event	1,000
Aggregate claims limit	Maximum amount that can be claimed under the contract	2,000

The reinstatement premium is charged when a claim is incurred. The amount is based on a percentage of the premium charged and the amount of claims made.

The following are examples of possible scenarios under the contract:

Scenario	Reinstatement premium	Amount
No claims	The cedant will not be charged an additional reinstatement premium	0
Claim of 100	The reinstatement premium is determined as 250 reinsurance premium x 10% of claim limit used (100/1,000)	25
Claims of 1,500 (from two events)	Maximum reinstatement premium of 250 (using all of the claim limit of 1,000 would require 100% of additional premium to be paid).	250

50. The staff considered the economic effect of the reinstatement premium in this example to determine whether it reflects an additional premium or a reduction in the amount paid for claims.
51. The staff observe that the economic effect of the reinstatement premium is equivalent to the effect of reimbursing a different amount of claims to the cedant. In other words, for this example, the economic effect of a reinstatement premium is equivalent to the effect of charging a premium of 250 and paying 75% of the claims up to 1,000 and 100% of additional claims up to 2,000.

52. Therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 250 for the contract. Any reinstatement premium would be recognised as part of insurance service expenses when incurred.
53. One of the submissions considers whether mandatory reinstatement premiums represent a premium of a new reinsurance contract. The staff observe that cash flows related to claims are within the contract boundary of the reinsurance contract issued, as well as the reinstatement premiums that accompany them. Therefore, mandatory reinstatement premiums cannot be considered cash flows related to a future contract.

Voluntary reinstatement premiums

54. A voluntary reinstatement premium is an amount charged to the cedant, on predetermined terms, following an insured event occurring. However, in contrast to the mandatory reinstatement premium, the cedant can decide not to pay the reinstatement premium and in this case the contract terminates. This means that voluntary reinstatement premiums are not contingent on claims as the cedant may decide to avoid paying those premiums and terminate the coverage instead.
55. The reinsurer is required to accept reinstatement premiums and to provide the related coverage.
56. One of the submissions considers whether voluntary reinstatement premiums represent a premium of a new reinsurance contract.
57. The staff observe that the economic effect of a voluntary reinstatement premium is equivalent to the effect of charging a higher premium to extend the contract coverage to an additional period/higher level of exposure.
58. The staff observe that applying paragraph 34 of IFRS 17, the reinstatement premium and related cash flows are within the boundary of the initial reinsurance contract. In the fact pattern provided, the reinsurer has no right to exit the contract and has no right to reprice the contract (the reinstatement premium is at predetermined rates). Therefore the expected cash flows related to the

reinstatement premium are within the boundary of the initial reinsurance contract and voluntary reinstatement premiums cannot be considered cash flows related to a future contract.⁶

TRG Discussion

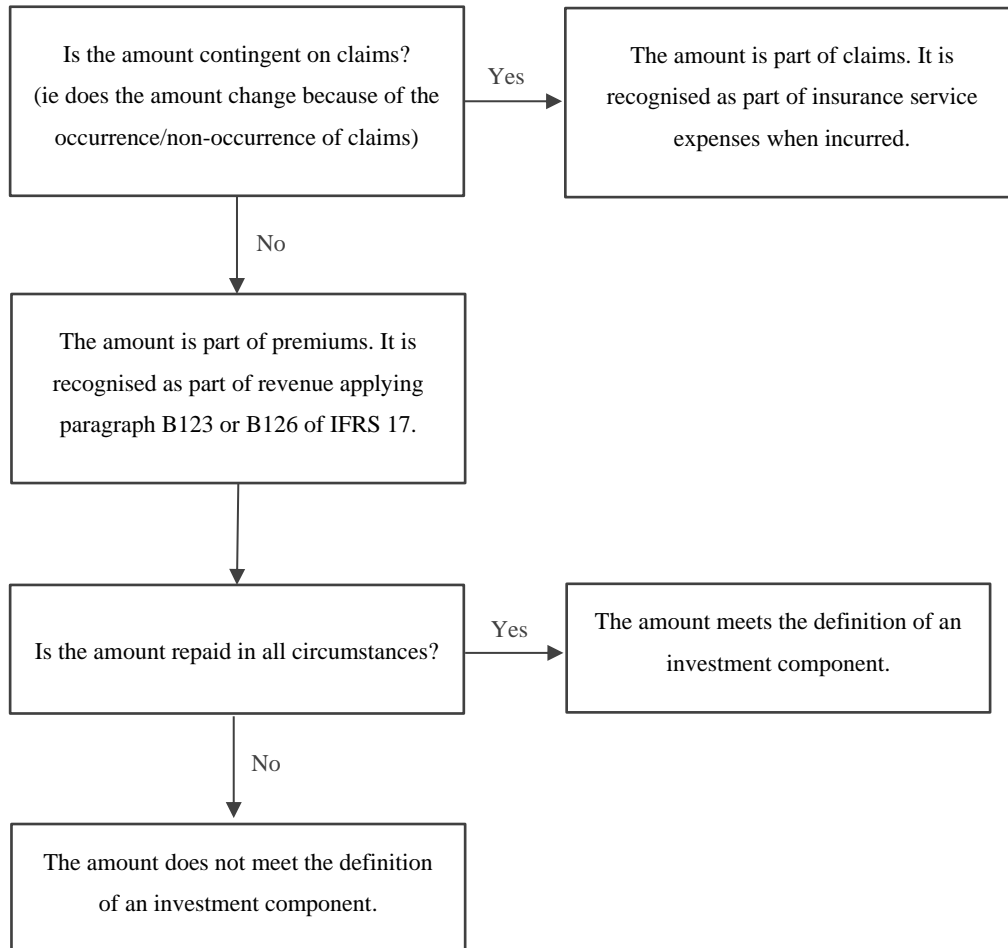
Question to TRG members

What are your views on the implementation question presented above?

⁶ Agenda paper 3 *Cash flows within the contract boundary* from May 2018 TRG meeting and Agenda paper 5 *Cash flows that are outside the contract boundary at initial recognition* of the September 2018 TRG meeting discuss the topic of the boundary of an insurance contract in more detail.

Appendix A—Flowchart

A1. The following flowchart may assist the assessment of how to account for exchanges between a reinsurer and a cedant.⁷



⁷ It is assumed that amounts due to the cedant are not compensation paid to it for a distinct service it provides to the reinsurer.

Appendix B—Examples of commissions and other contract features contingent on claims

Profit commission

B1. In the example, the profit commission is determined as 25% of the profit under the contract. The profit under the contract is the difference between the premiums and losses assumed by the reinsurer. The commission cannot be negative. The fact pattern is as follows:

Description	Amount
Reinsurance premium	1,000
Profit commission (profit = reinsurance premium minus claims incurred by the reinsurer under the contract)	25%

B2. The profit commission is contingent on the amount of losses assumed by the reinsurer under the contract, for example:

Claims	Calculation of commission	Profit commission	Total payment to cedant
0	$(1,000 - 0) \times 25\%$	250	250
100	$(1,000 - 100) \times 25\%$	225	325
500	$(1,000 - 500) \times 25\%$	125	625
1,500	$1,000 - 1,500 = 500$ loss	0	1,500

B3. Staff analysis applying IFRS 17:

- (a) in all circumstances, the reinsurer will pay to the cedant a minimum amount of 250. All other payments to the cedant are contingent on claims.
- (b) the staff observe that the economic effect of the minimum profit commission is equivalent to the effect of charging a lower premium to the same extent. In other words, for this example, the economic effect of the profit commission is equivalent to the effect of charging a premium of 750 and paying 75% of the claims up to 1,000 and 100% of claims above 1,000.
- (c) therefore, applying paragraph B123 of IFRS 17 or paragraph B126 of IFRS 17, insurance revenue for the reinsurer in this example should be 750 (1,000 - 250) for the contract. In the third scenario shown in which the claims are 500, the claims incurred applying IFRS 17 should be 375 (500 x 75%) for the contract and there would not be an additional/separate expense of 125 for the profit commission paid as this amount is part of the premium.
- (d) assuming the cedant paid the premium of 1,000 at the inception of the contract, an amount of 250 may meet the definition of investment component.

Adjustments to premiums in a retrospectively rated insurance contract**B4. One of the submissions provides two examples of retrospectively rated contracts:**

- (a) contract 1—a premium of 200 is paid at the beginning of the coverage period, however an additional premium of 80% of claims is charged to the policyholder, up to a maximum additional premium of 800.
- (b) contract 2—a premium of 1,000 is paid at the beginning of the coverage period, however the insurer will refund the policyholder 80% of any profit on the contract.

B5. Staff analysis applying IFRS 17:

- (a) contract 1—a premium of 200 paid at the beginning of the coverage period is the contract premium applying IFRS 17 as this amount is not contingent on claims. An additional premium up to a maximum of 800 is contingent on claims as it is charged to the policyholder only if claims incur under the contract. The additional premium therefore is part of the claims and shall be recognised as part of insurance service expenses.
- (b) contract 2—the premium of 1,000 paid at the beginning of the coverage period is the contract premium applying IFRS 17, however an amount of 800 may meet the definition of an investment component. An amount of 800 is not contingent on claims because it would be refunded to the policyholder if no claims occur (assuming 80% of the profit equals 80% of the premium in this simplified example) and it would be refunded to the policyholder if the maximum amount of claims occur (if the amount of claim is, for example, 1,500 – 800 of which is a premium refund). If an amount of 800 would be repaid to the policyholder in all circumstances it would meet the definition of investment component and therefore the insurance revenue for the contract would be 200.
- (c) the staff observe that both contracts seem economically similar and therefore the contract revenue for both is the same. However, if contract 2 contains an investment component, it has a financial component that contract 1 does not have, and this would impact the financial income or expenses of contract 2.
- (d) the staff observe that if under contract 2, the amount of 800 is not repaid to the policyholder in all circumstances (for example, if the contract is cancelled) this amount would not meet the definition of investment component and the contract premium of 1,000 would also be the insurance revenue of the contract. In the staff's view, if this would have been the case, contract 1 and contract 2 are not economically similar, and therefore it is reasonable that they would result in a different insurance revenue.

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Premium experience adjustments related to current or past service		
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This paper has been prepared for discussion at a public meeting of the Transition Resource Group for IFRS 17 *Insurance Contracts* and does not represent the views of any individual member of the International Accounting Standards Board or staff. Comments on the application of IFRS[®] Standards do not purport to set out acceptable or unacceptable application of IFRS Standards.

Introduction

1. We have received three submissions about how differences between expected premiums and actual premiums (ie premium experience adjustments) which relate to current or past service should be accounted for. Should those differences:
 - (a) adjust the contractual service margin; or
 - (b) be recognised in the statement of profit or loss immediately as part of either:
 - (i) insurance revenue; or
 - (ii) insurance service expenses.
2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

Structure of the paper

3. This paper includes the following:
 - (a) background information;
 - (b) implementation question; and
 - (c) review of accounting requirements.
4. Appendix A to this paper provides examples of accounting for premium experience adjustments related to current or past service.

Background information

Experience adjustments

5. Appendix A of IFRS 17 defines an experience adjustment as:

A difference between:

 - (a) for premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or
 - (b) for insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.
6. Paragraph B96 of IFRS 17 states that, among other changes in the fulfilment cash flows, the following changes relate to future service and therefore adjust the contractual service margin:

[...] (a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c); [...]

7. Paragraph B97 of IFRS 17 states that, among other changes in the fulfilment cash flows, the following changes do not relate to future service and therefore do not adjust the contractual service margin:

[...] (c) experience adjustments, except those described in paragraph B96(a).

8. Paragraph BC233 of the Basis for Conclusions on IFRS 17 explains:

The Board defined experience adjustments as (a) differences between the premium receipts (and related cash flows) that were expected to happen in the period and the actual cash flows or (b) differences between incurred claims and expenses that were expected to happen in the period and the actual amounts incurred. The Board decided that for the liability for remaining coverage, in general, it was reasonable to assume that experience adjustments relate to current or past service. In contrast, changes in estimates of future cash flows in general can be assumed to relate to future service. The Board noted that experience adjustments relating to premiums received for future coverage relate to future service and are an exception to this general rule.

Insurance revenue

9. Paragraph 83 of IFRS 17 states:

An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.

Paragraphs B120–B127 specify how an entity measures insurance revenue.

10. Paragraphs B120–B127 of IFRS 17 state:¹

B120 The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:

- (a) adjusted for a financing effect; and
- (b) excluding any investment components.

B121 Paragraph 83 requires the amount of insurance revenue recognised in a period to depict the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following amounts:

- (a) amounts related to the provision of services, comprising:
 - (i) insurance service expenses, excluding any amounts allocated to the loss component of the liability for remaining coverage;
 - (ii) the risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and
 - (iii) the contractual service margin.
- (b) amounts related to insurance acquisition cash flows.

B122 Insurance revenue for a period relating to the amounts described in paragraph B121(a) is determined as set out in paragraphs B123–B124.

[...]

¹ At the June 2018 International Accounting Standards Board (Board) meeting the Board tentatively decided to propose minor amendments to paragraphs 104, B121 and B124 of IFRS 17 to remove requirements that could result in double-counting of the risk adjustment for non-financial risk in the insurance contracts reconciliation disclosures and revenue analyses.

B123 Applying IFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying IFRS 17, when an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:

- (a) changes that do not relate to services provided in the period, for example:
 - (i) changes resulting from cash inflows from premiums received;
[...]

B124 Consequently, insurance revenue for the period can also be analysed as the total of the changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration. Those changes are:

- (a) insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:
 - (i) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(a);
 - (ii) repayments of investment components;
 - (iii) amounts that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph B65(i));
and
 - (iv) insurance acquisition expenses (see paragraph B125).
- (b) the change in the risk adjustment for non-financial risk, excluding:
 - (i) changes included in insurance finance income or expenses applying paragraph 87;
 - (ii) changes that adjust the contractual service margin because they relate to future service applying paragraphs 44(c) and 45(c); and

- (iii) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(b).
- (c) the amount of the contractual service margin recognised in profit or loss in the period, applying paragraphs 44(e) and 45(e).

B125 [...]

B126 When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:

- (a) on the basis of the passage of time; but
- (b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

B127 An entity shall change the basis of allocation between paragraphs B126(a) and B126(b) as necessary if facts and circumstances change.

Implementation question

11. The submissions ask how differences between expected premiums and actual premiums (ie premium experience adjustments²) which relate to current or past service should be accounted for. Should those differences:
- (a) adjust the contractual service margin; or

² This paper does not discuss differences between expected and actual premiums that occur because premiums are contingent on claims. Those differences are claims experience adjustments which are discussed in Agenda Paper 3 *Commissions and reinstatement premiums in reinsurance contracts issued of the September 2018 TRG meeting*.

- (b) be recognised in the statement of profit or loss immediately as part of either:
 - (i) insurance revenue; or
 - (ii) insurance service expenses.
- 12. One submission describes two examples of premium experience adjustments related to current or past service in which coverage in a prior period was based on an estimated risk exposure and is adjusted in the current period based on actual risk exposure. In these examples, the premium experience adjustment relating to the difference between expected and actual coverage in the prior period is received or refunded in the current period. The two examples are:
 - (a) workers' compensation—in which a premium rate is applied to estimated headcount and salaries and the total premium is then adjusted at a later date based on actual headcount and salaries; and
 - (b) reinsurance—in which coverage in a prior period was based on estimated risk exposure determined based on the expected amount of underlying insurance contracts covered and is adjusted in the current period based on actual risk exposure determined by the actual amount of underlying insurance contracts covered.
- 13. One submission asks how to determine whether premium experience adjustments relate to current and past service or future service.
- 14. One submission also asks whether the principles for accounting for premium experience adjustments related to current or past service are similar applying the general model and the premium allocation approach (PAA). The submission considers two opposing views. The first is that similar principles apply because the PAA is a simplification of the general model, and the treatment of premium experience adjustments relating to current or past service should be consistently applied. The second is that an entity can select an appropriate approach for premium experience adjustments applying the PAA and follow it consistently

because IFRS 17 does not provide any specific requirements on how to account for premium experience adjustments applying the PAA.

Review of accounting requirements

General model

15. The submissions consider whether premium experience adjustments related to current or past service adjust the contractual service margin. Paragraph B96(a) of IFRS 17 states that experience adjustments arising from premiums received in the period that relate to future service adjust the contractual service margin. Applying paragraph B97(c) of IFRS 17 all other experience adjustments do not relate to future service and therefore do not adjust the contractual service margin. Accordingly, premium experience adjustments that relate to current or past service are recognised immediately in the statement of profit or loss.
16. Paragraphs BC232–BC233 of the Basis for Conclusions on IFRS 17 explain that it is reasonable to assume that for the liability for remaining coverage, in general, experience adjustments relate to current or past service. Those paragraphs also explain that experience adjustments related to premiums received for future coverage are an exception to this general rule and relate to future service.
17. An example in which a premium experience adjustment relates to future service is when the actual premium received in the current period for coverage in a future period differs from the expected premium because lapses differ from those expected.
18. Experience adjustments that relate to current or past service are recognised immediately in the statement of profit or loss. Examples of premium experience adjustments that relate to current or past service are those that relate to services that have already been provided, such as the examples described in paragraph 12 of this paper. The submissions ask whether premium experience adjustments are recognised as part of:

- (a) insurance revenue; or
 - (b) insurance service expenses.
19. Paragraphs B120–B127 of IFRS 17 specify how an entity measures insurance revenue. Paragraph B120 of IFRS 17 states that total insurance revenue for a group of insurance contracts is the amount of premiums paid to the entity (adjusted for a financing effect and excluding any investment components). Paragraph B123 of IFRS 17 requires that when an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. Paragraph B123 of IFRS 17 specifies which changes in the liability for remaining coverage give rise to insurance revenue.
20. Applying the requirements in paragraphs B120 and B123 of IFRS 17, the staff observe that premium experience adjustments related to current or past service should be recognised in the statement of profit or loss immediately as part of insurance revenue because total insurance revenue is the total amount of premiums paid to the entity.
21. Appendix A to this paper includes examples (Example A and Example B) to demonstrate the mechanics of applying paragraph B123 of IFRS 17 to a group of insurance contracts with a premium experience adjustment related to current or past service. Applying paragraph B123(a)(i) of IFRS 17, the reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes that result from cash inflows of premiums received. Examples A and B demonstrate that applying paragraph B123(a)(i) of IFRS 17 to a group of insurance contracts with a premium experience adjustment results in total insurance revenue being equal to the total premium received.
22. The staff note that the analysis of insurance revenue in paragraph B124 of IFRS 17 does not specifically identify premium experience adjustments relating to current or past service. However, because the purpose of paragraph B124 of IFRS 17 is to demonstrate an alternative analysis of insurance revenue as determined by paragraph B123 of IFRS 17, applying the requirements in IFRS 17 should result

in premium experience adjustments relating to current and past service being included in insurance revenue.

Premium allocation approach

23. One submission asks whether the principles for accounting for premium experience adjustments related to current or past service are similar applying the general model and the PAA. Paragraphs B126–B127 of IFRS 17 specify the requirements for measuring insurance revenue applying the PAA.
24. The staff observe that the mechanics for recognising insurance revenue applying the PAA are different to the mechanics for recognising insurance revenue applying the general model. Applying paragraph B126(a) of IFRS 17, an entity allocates the expected premium receipts to each coverage period on the basis of the passage of time. Since premium experience adjustments are part of the expected premium receipts, they are allocated on the basis of passage of time as well. If the expected pattern of release of risk differs significantly from the passage of time, the expected premium receipts are allocated to each period of coverage on the basis of the expected timing of incurred insurance service expenses, applying paragraph B126(b) of IFRS 17. Since premium experience adjustments are part of the expected premium receipts they are allocated to each period of coverage on the basis of the expected timing of incurred insurance service expenses as well.
25. Appendix A to this paper includes an example (Example C) of contracts with a premium experience adjustment related to current service accounted for applying the PAA.

TRG Discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Examples of accounting for premium experience adjustments related to current or past service

- A1. This appendix includes three examples:
- (a) Example A—General model: premium experience adjustment that relates to current service;
 - (b) Example B—General model: premium experience adjustment that relates to past service; and
 - (c) Example C—PAA: premium experience adjustment that relates to current service.
- A2. For simplicity, the following assumptions are made in the examples:
- (a) discount rates are 0%; and
 - (b) all claims occur as expected and are paid immediately.

Example A—General model: premium experience adjustment that relates to current service

- A3. An entity issues an insurance contract for workers’ compensation coverage for a period of one year, 1 January 2021–31 December 2021. The premium is based on the number of employees covered by the contract over the duration of the coverage period. On 1 January 2021, the policyholder pays a premium of 2,500 based on an expected headcount of 100.
- A4. At initial recognition, the entity determines that the insurance contract is a group of insurance contracts applying the level of aggregation requirements in IFRS 17. The entity measures the group of insurance contracts as follows:

Fulfilment cash flows – expected cash outflows (CF)	1,800
Fulfilment cash flows – risk adjustment for non-financial risk (RA)	200
Contractual service margin (CSM) (2,500 – (1,800 + 200))	500

Insurance contract liability at 1 January 2021	2,500
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A5. Journal entries:

Dr	Cash	2,500
Cr	Insurance contract liability – liability for remaining coverage	2,500

A6. At 31 December 2021 this example assumes that, for simplicity, all claim events have occurred as expected and 1,800 has been paid. However, at that date the actual headcount for 2021 is determined to be 120 compared to the expected headcount of 100. The policyholder immediately pays the extra premium of 500 (2,500 x 20/100).

A7. The entity measures the insurance contract liability at 31 December 2021 as follows:

	CF	RA	CSM	Total
1 January 2021	1,800	200	500	2,500
Cash outflows	(1,800)	0	0	(1,800)
Changes related to current service	(500)	(200)	(500)	(1,200)
Cash inflows	500	0	0	500
31 December 2021	0	0	0	0

A8. The movement in the period can also be reconciled as follows, showing the split between the liability for remaining coverage (LRC) and liability for incurred claims (LIC):

	LRC	LIC	Total
1 January 2021	2,500	0	2,500
Insurance revenue	(3,000) ³	0	(3,000)
Insurance service expenses	0	1,800	1,800
Cash outflows	0	(1,800)	(1,800)
Cash inflows	500	0	500
31 December 2021	0	0	0

A9. Journal entries:

Claims incurred		
Dr	Insurance service expenses	1,800
Cr	Insurance contract liability – liability for incurred claims	1,800

³ The total reduction in the liability for remaining coverage is 2,500. Applying paragraph B123(a)(i) of IFRS 17, the reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes that result from cash inflows of premiums received. Therefore, the entity must exclude from the change of 2,500 the increase of 500 from the receipt of premiums. This means that the reduction in the liability for remaining coverage that gives rise to insurance revenue is 3,000 (2,500 – (-500) = 3,000).

Payment of claims incurred

Dr	Insurance contract liability – liability for incurred claims	1,800
Cr	Cash	1,800

Changes in the liability for remaining coverage because of cash inflows from premiums received (excluded from insurance revenue applying paragraph B123(a)(i) of IFRS 17)

Dr	Cash	500
Cr	Insurance contract liability – liability for remaining coverage	500

Other changes in the liability for remaining coverage (ie excluding change because of cash inflows from premiums received)

Dr	Insurance contract liability – liability for remaining coverage	3,000
Cr	Insurance revenue	3,000

Example B—General model: premium experience adjustment that relates to past service

- A10. The facts set out in paragraphs A3–A4 of this paper also apply for Example B.
- A11. Again, for simplicity, at 31 December 2021 it is assumed that all claim events have occurred as expected and 1,800 has been paid. However, in this example the actual headcount for the year has not yet been determined at 31 December 2021 and will be determined at a later date. As at 31 December 2021, the entity has not

changed its expectation of the headcount. Any payment/repayment of premiums will occur at a later date when the actual headcount is determined.

A12. The entity measures the insurance contract liability at 31 December 2021 as follows:

	CF	RA	CSM	Total
1 January 2021	1,800	200	500	2,500
Cash outflows	(1,800)	0	0	(1,800)
Changes related to current service	0	(200)	(500)	(700)
31 December 2021	0	0	0	0

A13. The movement in the period can also be reconciled as follows, showing the split between the liability for remaining coverage (LRC) and liability for incurred claims (LIC):

	LRC	LIC	Total
1 January 2021	2,500	0	2,500
Insurance revenue	(2,500)	0	(2,500)
Insurance service expenses	0	1,800	1,800
Cash outflows	0	(1,800)	(1,800)
31 December 2021	0	0	0

A14. Journal entries:

Claims incurred

Dr	Insurance service expenses	1,800
Cr	Insurance contract liability – liability for incurred claims	1,800

Payment of claims incurred

Dr	Insurance contract liability – liability for incurred claims	1,800
Cr	Cash	1,800

Insurance revenue

Dr	Insurance contract liability – liability for remaining coverage	2,500
Cr	Insurance revenue	2,500

A15. During 2022, the actual headcount for 2021 is determined to be 120 compared to the expected headcount of 100. The policyholder immediately pays the extra premium of 500 ($2,500 \times 20/100$).

A16. At 31 December 2022, the entity measures the change in the insurance contract liability as follows:

	CF	RA	CSM	Total
1 January 2022	0	0	0	0
Changes related to past service	(500)	0	0	(500)
Cash inflow	500	0	0	500
31 December 2022	0	0	0	0

A17. The movement in the period can also be reconciled as follows, showing the split between the liability for remaining coverage (LRC) and liability for incurred claims (LIC):

	LRC	LIC	Total
1 January 2022	0	0	0
Insurance revenue	(500) ⁴	0	(500)
Cash inflows	500	0	500
31 December 2022	0	0	0

⁴ The total reduction in the liability for remaining coverage is 0. Applying paragraph B123(a)(i) of IFRS 17, the reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes that result from cash inflows of premiums received. Therefore, the entity must exclude from the change of 0 the increase of 500 from the receipt of premiums. This means that the reduction in the liability for remaining coverage that gives rise to insurance revenue is 500 (0 – (-500) = 500).

A18. Journal entries:

Changes in the liability for remaining coverage because of cash inflows from premiums received (excluded from insurance revenue applying paragraph B123(a)(i) of IFRS 17)		
Dr	Cash	500
Cr	Insurance contract liability – liability for remaining coverage	500

Other changes in the liability for remaining coverage (ie excluding change because of cash inflows from premiums received)		
Dr	Insurance contract liability – liability for remaining coverage	500
Cr	Insurance revenue	500

Example C—PAA: premium experience adjustment that relates to current service

A19. The facts for Example C are the same as for Example A, however in this example the entity chooses to apply the PAA.

A20. At initial recognition the entity determines that the insurance contract is a group of insurance contracts applying the level of aggregation requirements in IFRS 17. The entity measures the group of insurance contracts as follows:

Premiums received at initial recognition	2,500
Insurance contract liability at 1 January 2021	2,500

A21. Journal entries:

Dr	Cash	2,500
Cr	Insurance contract liability – liability for remaining coverage	2,500

A22. The entity measures the insurance contract liability at 31 December 2021 as follows:

1 January 2021	2,500
Premiums received in the period	500
Insurance revenue	(3,000)
31 December 2021	0

A23. The movement in the period can also be reconciled as follows, showing the split between the liability for remaining coverage (LRC) and liability for incurred claims (LIC):

	LRC	LIC	Total
1 January 2021	2,500	0	2,500
Insurance revenue	(3,000) ⁵	0	(3,000)
Insurance service expenses	0	1,800	1,800
Cash outflows	0	(1,800)	(1,800)

⁵ Applying paragraph B126 of IFRS 17, total premium receipts for the contract of 3,000 are allocated to each coverage period based on the passage of time.

Cash inflows	500	0	500
31 December 2021	0	0	0

A24. Journal entries:

Claims incurred

Dr	Insurance service expenses	1,800
Cr	Cash	1,800

Premiums received in the period

Dr	Cash	500
Cr	Insurance contract liability – liability for remaining coverage	500

Insurance revenue

Dr	Insurance contract liability – liability for remaining coverage	3,000
Cr	Insurance revenue	3,000

STAFF PAPER

September 2018

Project	Transition Resource Group for IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Cash flows that are outside the contract boundary at initial recognition		
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This paper has been prepared for discussion at a public meeting of the Transition Resource Group for IFRS 17 *Insurance Contracts* and does not represent the views of any individual member of the International Accounting Standards Board or staff. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards.

Introduction

1. We have received a number of submissions about the accounting for cash flows that are outside the boundary of an insurance contract at initial recognition. The submissions relate to both insurance contracts issued and reinsurance contracts held. In particular, the submissions question the interrelation between the requirements in paragraph 35 of IFRS 17 *Insurance Contracts* (cash flows that are outside the boundary of an insurance contract) and the requirements in paragraph B64 of IFRS 17 (reassessment of the boundary of an insurance contract at each reporting date).
2. The objective of this paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 (TRG).

Structure of the paper

3. This paper includes the following:
 - (a) background information;
 - (b) implementation question; and
 - (c) review of accounting requirements.
4. Appendix A to this paper provides examples of subsequent accounting for cash flows that are outside the boundary of a contract at initial recognition.

Background information

Extract of requirements on contract boundary in IFRS 17

5. Paragraph 34 of IFRS 17 states:

Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71). A substantive obligation to provide services ends when:

- (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
- (b) both of the following criteria are satisfied:
 - (i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

- (ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

6. Paragraph 35 of IFRS 17 states:

An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

7. Paragraph B61 of IFRS 17 states:

Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract and no other cash flows. An entity shall apply paragraph 2 in determining the boundary of an existing contract.

8. Paragraph 2 of IFRS 17 states:

An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

9. Paragraph B62 of IFRS 17 states:

Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk shall reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. [...]

10. Paragraph B63 of IFRS 17 states:

When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

11. Paragraph B64 of IFRS 17 states:

Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has that practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage. In determining

the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

12. Paragraph B66 of IFRS 17 states:

The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

[...]

- (c) cash flows that may arise from future insurance contracts, ie cash flows outside the boundary of existing contracts (see paragraphs 34–35). [...]

13. Paragraph BC164 of the Basis for Conclusions on IFRS 17 explains:

Because the entity updates the measurement of the group of insurance contracts to which the individual contract belongs and, hence, the portfolio of contracts in each reporting period, the assessment of the contract boundary is made in each reporting period. For example, in one reporting period an entity may decide that a renewal premium for a portfolio of contracts is outside the contract boundary because the restriction on the entity's ability to reprice the contract has no commercial substance. However, if circumstances change so that the same restrictions on the entity's ability to reprice the portfolio take on commercial substance, the entity may conclude that future renewal premiums for that portfolio of contracts are within the boundary of the contract.

Observations from previous TRG meetings

14. At the February 2018 TRG meeting it was observed that, for some reinsurance contracts, the reinsurer can terminate the coverage at any time with a three month notice period. In these circumstances, the contract boundary would exclude cash flows related to premiums outside of that three month notice period.
15. At the May 2018 TRG meeting it was observed that:
 - (a) an option to add insurance coverage at a future date is a feature of the insurance contract.
 - (b) an entity should focus on substantive rights and obligations arising from that option to determine whether the cash flows related to the option are within or outside the contract boundary.
 - (c) unless the entity considers that an option to add coverage at a future date is a separate contract, the option is an insurance component that is not measured separately from the remainder of the insurance contract.
 - (d) if an option to add insurance coverage is not a separate contract and the terms are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary, depending on whether the entity has the practical ability to set a price that fully reflects the reassessed risks.
 - (e) for reinsurance contracts held, cash flows are within the contract boundary if they arise from substantive rights and obligations that exist during the reporting period in which the entity is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer. A right to terminate coverage that is triggered by the reinsurer's decision to reprice the reinsurance contract is not relevant when considering whether a substantive obligation to pay premiums exists. Such a right is not within the entity's control and

therefore the entity would continue to be compelled to pay premiums for the entire contractual term.

Implementation question

16. The submissions question how to account for cash flows of an insurance contract issued or of a reinsurance contract held that, at initial recognition, are outside the boundary of the contract when facts or circumstances change over time.
17. One submission provides the example of an insurance contract for which applying paragraph 34 of IFRS 17:
 - (a) at initial recognition, the entity concludes that the cash flows related to a renewal premium are outside the contract boundary because, at the renewal date, the entity has the practical ability to reprice the contract to reflect reassessed risks of the policyholder; and
 - (b) at a subsequent reporting date, the entity concludes that the cash flows related to the renewal premium are within the contract boundary because, at that time, the entity no longer has the practical ability to reprice the contract to reflect reassessed risks of the policyholder.
18. Another submission provides the example of a reinsurance contract held for which both the entity and the reinsurer have the unilateral right to terminate the coverage with respect to new business ceded at any time with a 90-day notice period to the other party. In the example provided in the submission:
 - (a) at initial recognition, the entity concludes that the cash flows related to premiums from underlying contracts to be issued and ceded after the 90-day notice period are outside the contract boundary (for example, for an annual contract starting on 1 January, cash flows related to underlying contracts expected to be issued after 31 March would be outside the contract boundary); and

- (b) as each subsequent day passes without termination notice being given, additional cash flows are included in the contract boundary (using the same example, after one day without termination notice, cash flows related to premiums from underlying contracts expected to be issued and ceded on 1 April would be within the contract boundary).
19. The submissions question whether and in what circumstances either of the following requirements should be applied:
- (a) paragraph 35 of IFRS 17—cash flows outside the boundary of the contract relate to future contracts. Applying this requirement, cash flows outside of the boundary of a contract at initial recognition are cash flows of a new contract that is recognised and measured separately from the initial contract.
- (b) paragraph B64 of IFRS 17—the boundary of the contract is reassessed at each reporting date and, therefore, may change over time (for example, it might be shortened or extended). Applying this requirement, cash flows that were outside the boundary of a contract at initial recognition can be reassessed as cash flows that are within the boundary at a later reporting date. Consequently, extending the boundary for cash flows that relate to future service adjusts the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.

Review of accounting requirements

20. As noted in paragraph BC159 of the Basis for Conclusions on IFRS 17, contract boundary requirements in IFRS 17 distinguish whether future premiums, and the resulting benefits and claims, arise from:

- (a) an existing insurance contract—if so, those future premiums and the resulting benefits and claims are included in the measurement of the group of insurance contracts to which the contract belongs; or
 - (b) future insurance contracts—if so, those future premiums and the resulting benefits and claims are not included in the measurement of the group of existing insurance contracts.
21. For future insurance contracts, no expected premiums or expected claims are recognised as assets or liabilities in applying paragraph 35 of IFRS 17—those expected premiums and claims are amounts outside the boundary of the existing insurance contract.
22. As noted in paragraphs B64 of IFRS 17 and BC164 of the Basis for Conclusions on IFRS 17, an entity updates the measurement of the group of insurance contracts to which a contract belongs in each reporting period. The entity reassesses the boundary of an insurance contract to include the effects of changes in circumstances on the entity's substantive rights and obligations.
23. The staff observe that the requirements in paragraphs 35 and B64 of IFRS 17 are different and address different circumstances. The requirement to reassess the contract boundary applying paragraph B64 of IFRS 17 should be read within the context of the whole paragraph. Paragraph B64 of IFRS 17 discusses the assessment of the practical ability of an entity to reprice a contract considering constraints that might limit that ability. Paragraph BC164 of the Basis for Conclusions on IFRS 17 explains that an example of a contract boundary reassessment may occur when in one reporting period repricing restrictions have no commercial substance but in the next reporting period they do have commercial substance. In this scenario, a reassessment is performed in determining the contract boundary at the subsequent reporting period. In this example, the assessment of whether a restriction has commercial substance has been applied initially to determine the contract boundary and is reassessed subsequently applying paragraph B64 of IFRS 17.

24. A reassessment of the contract boundary may result in:
- (a) cash flows that were outside the contract boundary at a previous reporting date being within the contract boundary at a subsequent reporting date; or
 - (b) cash flows that were within the contract boundary at a previous reporting date being outside the contract boundary at a subsequent reporting date.
25. The staff note that for subsequent changes in a contract boundary that either add or remove cash flows to/from the measurement of an existing group of insurance contracts:
- (a) the fulfilment cash flows are updated to reflect those changes in cash flows within the (revised) contract boundary; and
 - (b) such changes in estimates of the fulfilment cash flows relate to future service and therefore, are recognised by adjusting the carrying amount of the contractual service margin of the group of contracts to which the contract belongs (see paragraphs 44(c) and 45(c) of IFRS 17 for insurance contracts issued and paragraph 66(c) of IFRS 17 for reinsurance contracts held).
26. The staff think that the submissions discuss circumstances that are different to the circumstances to which paragraph B64 of IFRS 17 applies as explained above. The fact patterns provide examples of contracts in which cash flows related to future periods are outside the contract boundary applying paragraph 34 of IFRS 17, but occur at a later date because of an option to renew the contract being exercised or an option to terminate the contract not being exercised.
27. The staff observe that these circumstances are not considered to be a reassessment of the contract boundary of the existing contract, since the likelihood of the renewal/termination options being exercised was not assessed in determining the contract boundary on initial recognition. The additional cash flows do not reflect

cash flows arising from the substantive rights and obligations of the existing contract, but rather relate to rights and obligations of a future contract.

Paragraph 35 of IFRS 17 applies in these circumstances and these additional cash flows will be recognised as a new contract when the recognition criteria of the new group of insurance contracts are met.

28. The staff think that paragraph 35 of IFRS 17 should not be read as if cash flows outside the contract boundary could be within the existing contract boundary at a later reporting date, other than in the circumstances to which paragraph B64 of IFRS 17 applies. To apply the requirements in paragraph B64 of IFRS 17 in circumstances as described in paragraph 26 of this paper would not be appropriate and could turn any annual contract into a long-term contract for the purpose of applying IFRS 17.
29. The staff observe that the requirements in paragraphs 34 and 35 of IFRS 17:
 - (a) may be consistent with the legal form of an insurance contract in some circumstances. For example, when the contract is a yearly renewable contract with a boundary of one year. In this case, the renewed contract may be a separate contract in legal form which is consistent with the accounting.
 - (b) may not be consistent with the legal form of an insurance contract in some circumstances. For example, in a long-term contract when the entity has an option to reprice the contract annually and the boundary of the contract is one year. In this case, the extension of a contract with or without repricing is considered a new contract applying IFRS 17 while the legal form is of a single long-term contract.
30. The staff observe that the accounting for subsequent cash flows of contracts with the same boundary in accordance with IFRS 17 should be the same because the economic substance is similar, regardless of legal form of the contract (for example, if it is a long-term contract that has a boundary of one year because of

the nature of an annual repricing mechanism or an annual contract with a renewal option that is determined to have a boundary of one year).

31. Appendix A includes examples of how to apply these IFRS 17 requirements to specific fact patterns.

TRG discussion

Question to TRG members

What are your views on the implementation question presented above?

Appendix A—Examples of subsequent accounting for cash flows that are outside the boundary of a contract at initial recognition

A1. In this appendix the staff comment on how the accounting analysis provided in paragraphs 20–30 of this paper would apply to specific fact patterns. Example 1 and Example 2 below have been developed by the staff. Example 3 was provided in a submission.

Example 1—Five-year insurance contract with an annual repricing mechanism

A2. The insurance contract:

- (a) covers health risks of the policyholder for five years;
- (b) provides the entity a right to perform further underwriting of the individual policyholder's risks every year and annual repricing of premiums, while repricing is limited to a premium increase of 100% of the premium charged in the previous year; and
- (c) does not provide the entity with a right to compel the policyholder to pay premiums.

A3. At initial recognition at the beginning of Year 1, the entity issuing the contract determines that expected premiums for Years 2–5 and the related expected claims are outside the contract boundary because the entity considers restrictions on its ability to reprice the contract to have no commercial substance. For example, it expects changes in the health risk profile of policyholders to stay relatively stable over the coverage period, in a manner that it is highly unlikely that the repricing limit would restrict repricing. Therefore, when estimating the cash flows that will arise as the entity fulfils the contract the entity does not include cash flows related to premiums for Years 2–5.

A4. The entity's reporting date is the end of the year. At the end of Year 1, the entity determines that restrictions on its ability to reprice the contract now have

commercial substance. For example, due to significant increase in local currency costs of health care, an increase of 100% in the premium has commercial substance. Applying paragraph B64 of IFRS 17, the entity reassesses the contract boundary to include cash flows within five years of initial recognition of the contract. The expected premiums for Year 2–5 and the related expected claims are now within the contract boundary.

- A5. Applying paragraph 44(c) of IFRS 17, changes in fulfilment cash flows relating to the coverage to be provided in Years 2–5 adjust the carrying amount of the contractual service margin of the group of contracts to which the contract belongs.
- A6. Conversely, if at the end of Year 1 the entity determines that the restrictions on its ability to reprice the contract continue to have no commercial substance, the contract boundary of the existing contract continues to be one year. The expected cash flows for each following year relate to future contracts that would be recognised when the recognition criteria are met, regardless of whether the pricing for the contract has changed.

Example 2—One-year contract with a renewal option

- A7. The insurance contract:
- (a) covers health risks of the policyholder for one year; and
 - (b) provides the policyholder an option to extend the insurance coverage for a second year that the policyholder can exercise before or at the end of Year 1.
- A8. The entity:
- (a) has no right to compel the policyholder to pay premiums; and
 - (b) is obligated to provide additional coverage if the policyholder exercises the option.

- A9. At initial recognition at the beginning of Year 1, the entity issuing the contract determines that the option to add insurance coverage is not a separate contract (see paragraph 15(a)–(d) of this paper). Assume the following two scenarios:
- (a) Scenario A—The cash flows related to premiums after the option exercise date are outside the contract boundary because the entity has the practical ability to reprice the contract when the policyholder exercises the option to extend the coverage. Therefore, when estimating the cash flows that will arise as the entity fulfils the contract the entity does not include cash flows related to premiums for Year 2.
 - (b) Scenario B—The cash flows related to premiums after the option exercise date are within the contract boundary because the entity does not have the practical ability to reprice the contract when the policyholder exercises the option to extend the coverage. Therefore, when estimating the cash flows that will arise as the entity fulfils the contract the entity includes cash flows related to premiums for Year 2. Those cash flows are included in the measurement of the contract on initial recognition.
- A10. If the policyholder exercises the option to add coverage at the end of Year 1:
- (a) under Scenario A, the entity treats the renewal of the contract as a new contract applying paragraph 35 of IFRS 17; and
 - (b) under Scenario B, the entity treats any changes in expected cash flows as changes in estimates of fulfilment cash flows by applying paragraphs 40–52 of IFRS 17.
- A11. If the policyholder does not exercise the option to add coverage at the end of Year 1:
- (a) under Scenario A, no changes occur; and
 - (b) under Scenario B, the entity treats any changes in expected cash flows as changes in estimates of fulfilment cash flows by applying paragraphs

40–52 of IFRS 17. The entity derecognises the insurance contract by applying paragraphs 74–77 of IFRS 17 assuming the criteria are met.

Example 3—Proportional reinsurance contract held

- A12. The reinsurance contract held:
- (a) is issued and recognised on 1 January;
 - (b) covers a proportion of all risks arising from underlying insurance contracts issued in a 24-month period (ie the entity transfers to the reinsurer a proportion of the premiums from the underlying insurance contracts and the reinsurer reimburses to the entity the same proportion of claims arising from underlying insurance contracts); and
 - (c) provides the unilateral right to both the entity and the reinsurer to terminate the contract with a three month notice period to the other party with respect to new business ceded only.
- A13. At initial recognition, the entity buying the reinsurance contract concludes that cash flows within the reinsurance contract boundary are those arising from underlying contracts expected to be issued and ceded within a three month period. Since the reinsurer can terminate the coverage with respect to new business ceded with three months notice, the entity has no substantive right to receive services with respect to new business expected to be ceded after a three month period. Cash flows related to the underlying insurance contracts expected to be issued and ceded in the last 21 months of the reinsurance contract are outside the contract boundary and are therefore related to a future reinsurance contract(s).
- A14. The entity's reporting date is 31 March. At 31 March, neither the entity nor the reinsurer has given notice to terminate the reinsurance contract with respect to new business ceded.

- A15. Applying paragraph B64 of IFRS 17 would not cause a reassessment of the contract boundary since the contract boundary determination at initial recognition was not based on an assessment of the practical ability to set a price that fully reflected the risks in the contract. Applying paragraph 35 of IFRS 17, the cash flows related to underlying contracts that are expected to be issued and ceded in the next three month period are cash flows outside the existing contract boundary as at 31 March and relate to a future reinsurance contract(s) held. That (future) contract would be recognised applying paragraph 62 of IFRS 17 and the cash flows within the boundary of that contract would be determined on this date applying paragraph 34 of IFRS 17.
- A16. One submission raises a concern that applying this approach may result in daily reinsurance contracts being recognised for every day passing without either party exercising its termination rights with respect to new business ceded. However, the staff observe that reinsurance contracts held are recognised only when the recognition criteria in paragraph 62 of IFRS 17 are met. In the fact pattern provided, this is likely to be 1 April or later. The contract boundary is determined at the date of initial recognition, applying paragraphs 32–35 of IFRS 17. In this example, this will result in a new reinsurance contract held being recognised after the end of the first three month period with a contract boundary of cash flows arising from contracts expected to be ceded in the following three months—ie at 1 April the measurement of the first reinsurance contract held would reflect the coverage on the underlying contracts issued and ceded from 1 January to 31 March and the measurement of the second reinsurance contract held would reflect coverage on the underlying contracts expected to be issued and ceded in the period from 1 April until 30 June. Subject to paragraph 16 of IFRS 17, all of these reinsurance contracts held could belong to an annual group of contracts applying the level of aggregation criteria.
- A17. The submission includes an additional fact pattern in which there is (or there is not) a unilateral right for the reinsurer to amend the rate of the ceding commission

it pays, in addition to the unilateral termination rights. The submission notes a possible view that a contract extended with repricing might be accounted for differently if extended without repricing. The staff observe that in this fact pattern, the existence of the right to terminate the contract with a three month notice period determines the cash flows within the contract boundary regardless of the existence of a right to amend the rate of the ceding commission if the contract is not terminated. Therefore, the same accounting would be applied to the additional fact pattern provided.