Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*
Submission form for potential implementation question

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Stakeholder group	Industry Group

Potential implementation question

In measuring the insurance (reinsurance held) Liability/Asset for Remaining Coverage [L/AfRC] under the Premium Allocation Approach [PAA]:
{A} are contracted premiums receivable (payable), or only premiums received (paid), included in the PAA L/AfRC?
{B} if only insurance premiums received (reinsurance premiums paid) are included:
(i) how should an insurer's obligation to provide insurance service over the coverage period (for which premiums have not been received) be reflected?
(ii) is there scope for remediating the inconsistencies and accounting mismatches that would arise from measuring the L/AfRC using only premiums received?

Paragraph of IFRS 17 *Insurance Contracts*

Please see analysis

Analysis of the question

The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice.

Please see below

1. Measuring the Liability/Asset for Remaining Coverage (L/AfRC)

Possible bases on which to measure the PAA L/AfRC

1.1 In the context of direct insurance contracts (and reinsurance contracts held), there appear to be three potential bases on which to measure the L/AfRC under the Premium Allocation Approach (PAA).

(a) Narrow view – PAA L/AfRC includes only insurance premiums received (reinsurance premiums paid).

(b) Broader view – PAA L/AfRC includes premiums invoiced / billed – received (paid) or not.

(c) Unearned premium (UEP) view – PAA L/AfRC includes insurance premiums received (reinsurance premiums paid) and expected to be received (paid) within the contract boundary for the contractual coverage period.

Narrow view

1.2 IFRS 17.55 outlines the mechanics of the PAA – (emphasis added).

> 55 Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:
>
> (a) on initial recognition, the carrying amount of the liability is:
>
> (i) the **premiums**, if any, **received** at initial recognition;
>
> (ii) minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and
>
> (iii) plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.
>
> (b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:
>
> (i) plus the **premiums received** in the period;
>
> (ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

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> (iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);
>
> (iv) plus any adjustment to a financing component, applying paragraph 56;
>
> (v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and
>
> (vi) minus any investment component paid or transferred to the liability for incurred claims.
>
> 69 An entity may use the premium allocation approach set out in paragraphs 55–56 and 59 (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, …

1.3 The reference in IFRS 17.55(a)(i) to ‘premiums, if any, received’ implies the ‘**narrow view**’ is required.[1] In a commercial context, all insurance contracts would involve premiums being received or receivable by an insurer and ‘if any’ seems to contemplate that no premiums may be included in the measure of the initial L/AfRC in some cases.

Broader view

1.4 IFRS 17.25 is relevant to identifying when insurance contracts (but not necessarily revenues) are initially recognised (emphasis added).

> 25 An entity shall recognise a group of insurance contracts it issues from the earliest of the following:
>
> (a) the beginning of the coverage period of the group of contracts;
>
> (b) the date when the first **payment** from a policyholder in the group **becomes due**; and
>
> (c) for a group of onerous contracts, when the group becomes onerous

1.5 IFRS 17.25(b) could imply only premiums that have become due are included in measuring the L/AfRC, which would mean the ‘**broader view**’ is required. Therefore, any future premium instalments that have become due under the contract coverage would also be part of L/AfRC.

1.6 In addition, from the perspective of IFRS 9 *Financial Instruments*, premium receivables are akin to trade receivables and there’s an argument that they should be recognised as contractual rights to receive cash.

1.7 In discussing acquisition cash flows, IFRS 17.BC183 notes:

> BC183 … the Board wanted to avoid measuring liabilities and expenses at different amounts depending on how an entity structures its insurance acquisition activities, as described in paragraph BC182(a).[2]

1.8 Using only premiums received in measuring the PAA L/AfRC will mean that different acquisition structures will result in different liabilities. An example illustrates the point.

(a) One insurer acquires all of its insurance contracts providing one year of coverage from direct sales via the internet and telephone and receives annual premiums in advance directly from policyholders. The L/AfRC under the ‘narrow view’ would be measured based on premiums relating to all of its obligations to provide cover.

(b) Another insurer acquires all of its insurance contracts providing one year of coverage through brokers who notify the insurer of contracts sold on a weekly basis, but have 90 days to remit the annual premiums received in advance from policyholders. The L/AfRC under the ‘narrow view’ would be measured based only premiums received from brokers and would not reflect all of its obligations to provide cover.

1.9 IFRS 17.BC183 could imply that the IASB intended the ‘**broader view**’ to be applied to avoid the situation where different acquisition structures give rise to different L/AfRC outcomes.

UEP view

1.10 One of the basic aims of the IASB’s Phase II insurance project is reflected in IFRS 17.BC35.

> BC35 The Board noted the inherent challenges for some insurance contracts in identifying and measuring progress in satisfying the performance obligations during the period; for

[1] Example 10 at IFRS 17.IE113 to IE123 (Illustrative Examples) on applying the PAA does not help to determine the way the PAA is intended to apply because it involves all premiums being received up-front.

[2] IFRS 17.182(a) says: “In the Board’s view, differences in the structure of insurance acquisition activities would not necessarily reflect economic differences between insurance contracts issued by the entities.”

> example, for stop-loss contracts and for contracts that include financial guarantees. However, **the liability for remaining coverage represents the obligation to provide coverage for a future period and other services needed to fulfil the contract**. As a result, recognising insurance revenue to the extent of a reduction in the liability for remaining coverage, adjusted to eliminate changes that do not relate to the satisfaction of the performance obligation, would **faithfully represent** the entity's performance in providing services. The adjustments to the liability for remaining coverage exclude from total insurance revenue the part of the change in the liability for remaining coverage that does not relate to cash flows expected to generate revenue; for example, insurance finance income or expenses, and losses on groups of onerous contracts. These adjustments ensure that the total insurance revenue presented over the duration of the group of insurance contracts is the same as the premiums received for services, adjusted for a financing component.

1.11 The message in IFRS 17BC35 is consistent with the qualitative characteristic of 'faithful representation'. The IASB's *Conceptual Framework* notes that, "To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent".[3]

1.12 IFRS 17.BC35 and the conceptual framework imply the '**UEP view**' is relevant. This is because, for example, an insurance contract providing three years of coverage involves the insurer having an obligation for the whole three years, no matter when the policyholder pays premiums (three years in advance, annual, quarterly, etc.). In this example, only the '**UEP view**' provides a faithful representation of an insurer's obligations.

Conclusions on PAA L/AfRC

1.13 On balance, this analysis concludes that:

(a) the 'narrow view' is intended by IFRS 17, based on IFRS 17.55 (even though this is not consistent with the explanation in IFRS 17.BC35 about what the L/AfRC represents);

(b) based on the analysis later in this submission, assuming only the 'narrow view' is intended to apply, there is a need to address the potential for inconsistent interpretations that may arise in practice in applying the PAA. This is because the 'narrow view':

(i) is so far removed from prevailing industry practice; and

(ii) has the potential to measure the L/AfRC at an amount that does not represent an insurer's obligation to provide future coverage and to create accounting mismatches (discussed below);

potentially resulting in substantial scope for different interpretations to emerge.

2. Understanding the PAA L/AfRC 'narrow view'

Contracts issued

2.1 An example helps to illustrate the nature of the L/AfRC measured using the PAA. Assume the following facts for an insurer with a 31 December year end:

~ a portfolio of 100 contracts with annual coverage commencing on 15 November 20X1

~ each policyholder is contracted to pay premium(s) of $480 and can choose between annual up-front payment or quarterly payment

~ exposure to risk is expected to be even over the coverage period

~ no lapses are expected

~ there are expected to be 365 valid claims of $100 each

> one claim is incurred each day

> each claim is paid immediately, so the focus is on the L/AfRC (not the Liability for Incurred Claims).

2.2 When all premiums are paid annually up-front, the PAA L/AfRC as at 31 December 20X1 is:

[3] *Conceptual Framework for the Preparation and Presentation of Financial Statements*, paragraph QC12.

Example 1	*Calculation*	*L/AfRC*	*IFRS 17*
Premiums received	100 x $480	$48,000	55(a)(i)
Premium earned	100 x (46/365) x $480	($6,049)	55(b)(v)
Total		$41,951	

2.3 When 70% of premiums are paid at the beginning of each quarter, and 30% annually up-front, the PAA L/AfRC as at 31 December 20X1 is:

Example 2	*Calculation*	*L/AfRC*	*IFRS 17*
Annual premiums received	30 x $480	$14,400	55(a)(i)
Quarterly premiums received	70 x $120	$8,400	55(a)(i)
Premium earned	100 x (46/365) x $480	($6,049)	55(b)(v)
Total		$16,751	

2.4 For most general insurance contracts, policyholders can cancel before the coverage period ends and receive a refund of the 'unused' premium. In the above examples, as at 31 December, $41,951 (Example 1) and $16,751 (Example 2) is potentially refundable to policyholders.

2.5 It seems arbitrary that the PAA L/AfRC depends on choices made by policyholders about premium payment terms and will produce inconsistent measurements of L/AfRC in practice.

Reinsurance contracts held

2.6 Building on the above examples, assume the following facts:

~ the insurer enters into a contract reinsuring 100% of all claims on the portfolio of 100 direct contracts with annual coverage commencing 15 November 20X1

~ two half-yearly premium payments of $24,000 each are made on 15 November 20X1 and 15 May 20X2

~ claim recoveries paid quarterly on 15 February 20X2, 15 May 20X2, 15 August 20X2 and 15 November 20X2

Because the contract provides proportional coverage, it is recognised from the beginning of the coverage period – 15 November 20X1 [IFRS 17.62(a)].

2.7 The L/AfRC as at 31 December 20X1 is:

Example 3	*Calculation*	*Asset*	*IFRS 17*
Premiums paid	1 x $24,000	($24,000)	55(a)(i)
Reinsurance expense	1 x (46/365) x $48,000	$6,049	55(b)(v)
Total		($17,951)	

2.8 Even though the underlying direct insurance contracts are 100% reinsured, the following mismatches arise from applying the PAA as at December 20X1.

	Direct	*Reinsurance*	*Mismatch*
Example 1	$41,951	($17,951)	$24,000
Example 2	$16,751	($17,951)	($1,200)

2.9 In economic terms, there is no mismatch. The mismatches arise purely due to the way in which the PAA basis of measurement applies.

3. Reflecting insurer's obligations to provide coverage

3.1 The ICA understands that the PAA is designed to be a simplification of the general model [IFRS 17.BC291] and, as such, seeks to achieve a measure of the liability for remaining coverage that matches the general model's measure. However, in seeking to match the outcomes under the general model, the PAA adopts a cash receipts basis of accounting that does not lead to a faithful representation of an insurer's obligation to provide coverage.[4]

[4] Because the general model takes into account all future cash flows in respect of the coverage period, it is a faithful representation of an insurer's net obligations.

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3.2 Worldwide practice in the general insurance industry is the accrual basis of accounting – the UEP approach. When insurance premiums are to be received (reinsurance premiums paid) in arrears, an insurer recognises trade debtors (trade creditors) for contracted premiums. Corresponding entries are made to the L/AfRC. This results in consistency between:

~ the L/AfRC for different contracts; and

~ the L/AfRC for underlying (direct) insurance contract liabilities and corresponding reinsurance contract assets;

regardless of the timing of receipt (payment) of insurance (reinsurance) contract premiums.

3.3 Accordingly, relative to the IFRS 17 general model, current industry practice is a ‘gross approach’ to accounting for insurers’ assets and liabilities in relation to remaining coverage.

3.4 Under the PAA, an insurer writing insurance contracts that oblige it to provide (for example) insurance cover for a year and that will receive some or all premiums in arrears, would not be able to recognise a L/AfRC that reflects its full obligations. This would be potentially misleading to a wide range of financial statement users.

3.5 This outcome under IFRS 17 is completely inconsistent with the objective of general purpose financial reporting, which is to provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.[5]

4. Limitations of the PAA

PAA L/AfRC would not provide useful information

4.1 Summarising the above discussion, assuming the ‘narrow view’ of measuring the L/AfRC applies, the PAA has the following limitations.

(a) Information for users would be potentially misleading because the L/AfRC would show an insurer’s obligations to provide coverage in only some cases depending on when premiums are received, which is inconsistent with IFRS 17.B35.

(b) The way in which an insurer acquires its insurance contracts (for example, directly or through brokers) can give rise to a different L/AfRC, which is inconsistent with IFRS 17.B183.

(c) The mismatches created by there being different timing of premium receipts and payments for insurance contracts issued and reinsurance contracts held would provide a misleading impression of an insurer’s net exposures.

4.2 It is highly likely that insurers will need to continue to generate information based on the accounting that currently prevails worldwide to mitigate the potential loss of transparency associated with the PAA L/AfRC under the ‘narrow view’. For example:

(a) Investors and prudential regulators are highly likely to demand information that shows insurers’ full obligations to policyholders and the full extent of the reinsurance relating to those obligations.

(b) Insurers, as part of sound business practice, manage the credit risks associated with premium receivables and these systems for credit management typically rely on information gathered through the financial reporting system.

(c) Insurers, as part of sound business practice, usually manage their distribution channels on the basis of gross written premium.

4.3 This would entail insurers having to maintain two comprehensive information systems to generate (1) the additional information needed by users; and (2) the information needed for IFRS 17 accounting. This would result in more administration costs for insurers, which would inevitably be passed on to policyholders.

4.4 Because the general model is a net current value measure and involves taking into account all future expected cash flows, it does not exhibit all the limitations associated with the PAA. The general model does not depend on when premiums are received from policyholders (or via brokers) or when premiums are ceded to reinsurers, other than for discounting purposes.

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[5] *Framework for the Preparation and Presentation of Financial Statements*, paragraph OB2

However, universally adopting the general model would be an expensive option because, for most contracts, there is considerably more work (and cost) involved in applying it. Instead the PAA's limitations should be addressed.

5. ICA recommendations for addressing PAA limitations

5.1 The PAA needs to be changed to focus on ensuring an insurer's contractual obligations to provide coverage and its contractual rights to any offsetting cover under reinsurance contracts held are faithfully represented.

Suggested solution on amending the PAA

5.2 One solution for minimising the impact of the inconsistencies and mismatches that arise under the PAA would be to modify the PAA by:

~ recognising in the L/AfRC all of an insurer's existing contractual obligations to provide coverage for periods up until the next contractual renewal date, which would also mean recognising contractually-agreed trade debtors; and

~ recognising all of an insurer's existing contractual rights to recoveries from reinsurers up to the next contractual renewal date, which would also mean recognising contractually-agreed trade creditors.

5.3 The above suggested approach is based on contractual rights and obligations. It could be supported by analogy with 'financial assets' and 'financial liabilities' defined in IFRS 9 *Financial Instruments* and IAS 32 *Financial Instruments: Presentation*.

5.4 IAS 32.11 includes the 'financial asset' and 'financial liability' definitions (emphasis added).

> A **financial asset** is any asset that is:
> (a) cash;
> (b) an equity instrument of another entity;
> (c) **a contractual right**:
> (i) **to receive cash** or another financial asset **from another entity**; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
> (d) a contract that will or may be settled in the entity's own equity instruments and is: …
>
> A **financial liability** is any liability that is:
> (a) a **contractual obligation**:
> (i) **to deliver cash** or another financial asset **to another entity**; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
> (b) a contract that will or may be settled in the entity's own equity instruments. …

5.5 Under contracts in-force, an insurer has:

~ an obligation to pay valid claims relating to future service for the remaining contractual coverage period; and

~ a right to receive cash in exchange for those services to the extent the policyholder has not prepaid premiums.

5.6 Accordingly, insurance contracts can be regarded as giving rise to both financial liabilities and financial assets – even though they are specifically excluded from IFRS 9[6] to enable them to be addressed separately in IFRS 4 and IFRS 17. In addition, the ICA acknowledges that, under many general insurance contracts, there is the potential for policyholders to cancel contracts and therefore not pay the remaining premiums for unexpired coverage (and receive a refund of premiums already paid for remaining coverage). Therefore, literally, there is not a 'contractual right to receive cash' in respect of insurance contracts issued

5.7 However, the ICA considers there is a clear analogy with financial assets and liabilities that supports the ICA's suggested solution for amending the PAA and enabling insurers to show their existing contractual obligations to provide coverage and any compensating reinsurance cover.[7]

[6] IFRS 9.2.1(e)

[7] If IFRS 9 were applied, its impairment requirements might also apply. In that context, due to the nature of premium receivables, they would probably qualify for impairment to be accounted for using a practical expedient under

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5.8 Under the suggested solution, the following examples illustrate the impact of applying the suggested modifications to the PAA.

~ A general insurer with a construction risks policy providing three years of coverage would measure its L/AfRC based on three years of premiums received and receivable.

~ A life insurer with a 20-year life insurance contract that provides the policyholder with an annual opportunity to renew or discontinue their cover would not accrue premiums beyond the existing year of cover.[8]

Implications for the criteria for PAA eligibility

5.9 If the PAA were modified to include premiums receivable (payable), the criteria for applying it should also be modified or supplemented. Otherwise, fewer multi-year contracts may be eligible for the PAA based on the criterion in IFRS 17.53(a).[9] This is significant and needs to be avoided because, for most contracts, there is considerably more work (and cost) involved in applying the general model, particularly in accounting for the contractual service margin.

5.10 IFRS 17.53 sets out the criteria for PAA eligibility.

> 53 An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:
>
> (a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or
>
> (b) the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

5.11 The ICA suggests that either of the following solutions be adopted.

(a) Replace or supplement the existing IFRS 17.53 criteria as a basis for permitting a modified PAA to be applied with the following:

> The entity reasonably expects the PAA, **net of any trade receivables/payables**, would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the general model.

(b) Modify the general model of measurement to also accommodate trade receivables/payables.

~ end ~

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IFRS 17.B5.5.37. An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix.

[8] That is, there are 19 separate occasions on which policyholders need to decide whether they continue their cover or allow it to lapse. If they choose to keep paying premiums, they can continue their cover for the whole coverage period of 20 years.

[9] Although this submission does not present information establishing this is the case, it is based on a separate analysis of the outcomes of the general model and PAA for various patterns of premium payments/receipts for contacts providing one-year of coverage.