Australian Government
Australian Accounting Standards Board

XRB | Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

Staff Paper

Project	**Insurance Activities in the Public Sector**	**Meeting**	AASB (M183)/NZASB September 2021
Topic	Identifying and accounting for onerous contracts and related unit of account issues	**Agenda item**	AASB 11.2 NZASB 3.2
		Date	23 August 2021
Contacts	Angus Thomson athomson@aasb.gov.au Vanessa Sealy-Fisher vanessa.sealy-fisher@xrb.govt.nz Patricia Au pau@aasb.gov.au	**Project priority**	Medium
		Decision-making	High
		Project status	Board deliberation

Objective of this paper

1. The objective of this paper is for the AASB and the NZASB to decide whether public-sector-specific modifications or guidance is needed in AASB 17/PBE IFRS 17 *Insurance Contracts* in respect of identifying and accounting for onerous contracts.

Structure of this paper

2. This staff paper is set out in five sections:

- Section 1 sets out the basis for identifying and recognising onerous contracts under AASB 1023/PBE IFRS 4
- Section 2 sets out the basis for identifying and recognising onerous contracts under AASB 17/PBE IFRS 17
- Section 3 sets out possible approaches on onerous versus non-onerous groups of contracts
- Section 4 sets out possible approaches on annual groups of contracts
- Section 5 sets out possible approaches on initial recognition of insurance contracts.

Summary of staff recommendations

3. Staff are recommending a number of public sector modifications to AASB 17/PBE IFRS 17 relating to the grouping of contracts. Staff expect that the issues and reasoning in respect of these modifications will be included as part of a Basis for Conclusions to AASB 17/PBE IFRS 17.

Background

4. Under both AASB 1023 *General Insurance Contracts*/PBE IFRS 4 *Insurance Contracts* and AASB 17/PBE IFRS 17 *Insurance Contracts* , because the liability for incurred claims is measured using current estimates of cash flows, there is no need to separately consider whether the amount provided is adequate. That is, there is no need for an onerous contract testing and recognition process in respect of liability for incurred claims. Accordingly, the identification of

onerous contracts and the subsequent accounting is only relevant to liabilities for remaining coverage, and these are the focus of this paper.

Terminology

5. The equivalent of the AASB 17/PBE IFRS 17 term ‘liability for remaining coverage’ under AASB 1023/PBE IFRS 4 is ‘unearned premium liability’ – although the two liabilities are calculated differently (depending on the circumstances) as explained below.

6. Selected terms relating to contract recognition are outlined in Appendix A.

7. The language used in AASB 1023/PBE IFRS 4 differs from the language used in AASB 17/PBE IFRS 17 – for example an ‘unearned premium liability’ under AASB 1023/PBE IFRS 4 is effectively a ‘liability for remaining coverage’ under AASB 17/PBE IFRS 17. To simplify the discussion, this paper generally uses the AASB 17/PBE IFRS 17 term unless specified.

Section 1: Identifying and recognising onerous contracts under AASB 1023/PBE IFRS 4

8. Under AASB 1023/PBE IFRS 4, the liability for remaining coverage is measured as the amount of premium received and or receivable for the contract period that remains unearned. An insurer is required to apply a liability adequacy test (LAT) to the carrying amount of the liability for remaining coverage (UEP) when there is an indication that the liability may be inadequate [AASB 1023.9.1/PBE IFRS 4 (Appendix D.9.1)]. The LAT is applied at the **portfolio level**. **In the case of some public sector entities, there is only one portfolio of contracts**. For those entities, the LAT is effectively conducted at the **whole-of-entity** level.

9. The LAT involves comparing:

   (a) the balance of the liability for remaining coverage recognised on the balance sheet; with

   (b) current estimates of the present value of the expected future cash flows relating to future claims arising from existing insurance contracts, plus a risk margin that reflects the inherent uncertainty in the central estimate.

   There is a deficiency if (a) < (b). An additional ‘unexpired risk liability’ is recognised for the deficiency,[1] which is also recognised immediately as a loss.[2]

10. An indication that the liability for remaining coverage is inadequate and needs a LAT could include, for example, recent claims that are materially higher than expected when premiums were originally priced.

1 Because a deficiency is not represented by ‘unearned premium’ in the context of AASB 1023/PBE IFRS 4, the deficiency is separately recognised as an ‘unexpired risk liability’.

2 An entity with deferred acquisition costs and intangible assets related to insurance contracts would write those off before recognising any remaining deficiency [AASB 1023.9.1/PBE IFRS 4 (Appendix D.9.1)]; however, public sector entities do not ordinarily have material deferred acquisition costs or intangible assets.

Example		
A portfolio consists of 1,000 contracts each with a premium of $100 for a year's coverage, commencing on 1 April 20X1	Total premium	$100,000
At 30 June 20X1, 25% of premiums have been earned (i.e. 75% of unearned premium) (assumes a straight-line basis for earning)	Unearned premium liability at 30 June	$75,000
Estimated cost of claims incurred in the period 1 April to 30 June 20X1 is $30,000 and this experience is expected to continue for the remainder of the coverage period	Estimated **future** claims from existing contracts	$90,000
The unearned premium liability is inadequate [$75,000 less $90,000]	Unexpired risk liability	$15,000

11. In the private for-profit sector, the presumption is that insurers issue insurance contracts that are intended to be profitable. The profit component should act as a 'buffer' to any liability inadequacy. In practice, private for-profit sector insurers only occasionally need to test for liability inadequacy and few entities need to recognise an unexpired risk liability.

12. For most public sector insurers, the liability for remaining coverage calculated based on unearned premium is routinely inadequate because they price to break even after taking into account projected investment returns.[3] That is, on a stand-alone basis, levies/premiums charged are inadequate to meet expected claims. Accordingly, many public sector entities routinely recognise unexpired risk liabilities under AASB 1023/PBE IFRS 4. **This is a key distinguishing factor among public sector entities compared with private sector for-profit entities**.

13. There are no public sector specific modifications to AASB 1023/PBE IFRS 4 based on this key distinguishing factor – the routine recognition of unexpired risk liabilities, which are typically offset by investment income/gains, is an accepted practice. However, the more granular levels of disaggregation required for assessing and recognising onerous contracts under AASB 17/PBE IFRS 17 might complicate the accounting for some public sector entities and lead to them presenting less relevant information – these matters are considered below.

Section 2: Identifying and recognising onerous contracts under AASB 17/PBE IFRS 17

Premium allocation approach (PAA)

14. When liabilities for remaining coverage are measured using the PAA,[4] the onerous contract test in AASB 17/PBE IFRS 17.57 applies (based on the sub-groupings identified below). It is equivalent to the LAT in AASB 1023/PBE IFRS 4.9.1 in that it applies after initial recognition of contracts and involves comparing the PAA balance to an amount based on the present value of fulfilment cash flows when facts and circumstances indicate that a group of insurance contracts is onerous.

Sub-grouping at initial recognition – onerous versus non-onerous

15. One of the key differences between:

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3 The expected investment returns are ordinarily higher than the discount rates (for time value) applied to measure insurance liabilities

4 Refer to June 2021 AASB Agenda Paper 14.3 and NZASB Agenda Paper 8.3.

(a) existing insurance accounting practices in Australia and New Zealand (and most other jurisdictions); and

(b) IFRS 17 requirements;

is the need to sub-group contracts within a portfolio from initial recognition. In general, AASB 17/PBE IFRS 17 will result in contracts being recognised as onerous earlier and more often because AASB 17/PBE IFRS 17 applies a more granular unit of account for testing.

16. AASB 17/PBE IFRS 17.16 requires insurers to divide each portfolio of contracts into sub-groups:

(a) contracts that are onerous at initial recognition, if any; and

(b) other (non-onerous) contracts.[5]

<table>
<tr><th colspan="4">Example for illustrative purposes</th></tr>
<tr><td colspan="2">AASB 1023/PBE IFRS 4</td><td colspan="2">AASB 17/PBE IFRS 17</td></tr>
<tr><td rowspan="2">(a) Portfolio unearned premium</td><td rowspan="2">$1,000,000</td><td>(a1) Non-onerous sub-group PAA</td><td>$500,000</td></tr>
<tr><td>(a2) Onerous sub-group PAA</td><td>$500,000</td></tr>
<tr><td rowspan="2">(b) Portfolio PV of future claims on existing contracts</td><td rowspan="2">$950,000</td><td>(b1) Non-onerous sub-group PV of future claims on existing contracts</td><td>$350,000</td></tr>
<tr><td>(b2) Onerous sub-group PV of future claims on existing contracts</td><td>$600,000</td></tr>
<tr><td>Portfolio onerous contract loss [because (a) > (b)]</td><td>0</td><td>Onerous contract loss (a2) – (b2)</td><td>$100,000</td></tr>
</table>

17. The sub-groups under AASB 17/PBE IFRS 17.16 are established at initial recognition and are not subsequently changed, although new contracts would be added[6] to each group over an underwriting year. That is, the discovery that contracts initially thought to be non-onerous are actually onerous based on subsequent experience does not give rise to a new sub-grouping.

Sub-grouping at initial recognition – by issue date within one year period

18. AASB 17/PBE IFRS 17.22 requires insurers to divide each portfolio of contracts into sub-groups of contracts issued no more than a year apart. These sub-groups are a key unit of account used in applying AASB 17/PBE IFRS 17. This contrasts with AASB 1023/PBE IFRS 4 under which successive generations of contracts are included in a single portfolio, which is the key unit of account used in applying AASB 1023/PBE IFRS 4. This has an impact on the potential for early recognition of onerous contracts with multi-year coverage periods.

19. Under AASB 1023/PBE IFRS 4, a profitable annual cohort of contracts can offset a loss-making annual cohort of contracts; whereas the loss-making annual cohort would be accounted for on a stand-alone basis and regarded as onerous under AASB 17/PBE IFRS 17.

5 In practical terms, there are two sub-groups: (a) onerous; and (b) non-onerous. However, in theory, the actual requirement is more complex – there are three sub-groupings: (a) a group of contracts that is onerous at initial recognition; (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; (c) other contracts. However, early indications are that most insurers consider that (c) would rarely, if ever, arise; or insurers are unable to distinguish between (b) and (c).

6 Except in the cases of public sector entities with a single fixed contract period for all contracts – such as 1 July to 30 June each year.

Example for illustrative purposes			
AASB 1023/PBE IFRS 4		AASB 17/PBE IFRS 17	
(a) Portfolio (20X1 and 20X2 cohorts) unearned premium	$2,000,000	(a1) Non-onerous 20X1 cohort PAA	$1,100,000
		(a2) Onerous 20X2 cohort PAA	$900,000
(b) Portfolio (20X1 and 20X2 cohorts) PV of future claims on existing contracts	$1,900,000	(b1) Non-onerous 20X1 cohort PV of future claims on existing contracts	$950,000
		(b2) Onerous 20X2 cohort PV of future claims on existing contracts	$950,000
Portfolio (20X1 and 20X2 cohorts) onerous contract loss [because (a) > (b)]	0	Onerous 20X2 cohort contract loss [(a2) – (b2)]	$50,000

20. There is no impact on the long-run overall results from taking different approaches to onerous contract units of account. The main impact of AASB 17/PBE IFRS 17 (relative to AASB 1023/ PBE IFRS 4) will be to front-end losses that would otherwise have been recognised over the life of the contracts.

How might public sector entities be affected by AASB 17/PBE IFRS 17.16?

21. The impact of AASB 17/PBE IFRS 17.16 will depend on the nature of the contracts and how they have been priced. The following examples help to illustrate the impact in different circumstances.

(a) Worker's compensation insurance contracts are typically priced for the expected actual risks by employer and/or industry. At initial recognition, unless a deliberate decision has been taken to underprice for risk on some contracts and overprice others, ordinarily there would not be onerous and non-onerous sub-groups. Typically, as noted in paragraph 8(above), there will often be only one group of contracts and, as noted in paragraph 12, that will typically be an onerous group of contracts.

(b) Transport accident insurance contracts are typically priced for the expected actual risks over the whole portfolio. However, the public sector entity would typically have relatively granular information available about policyholders by risk profile. For example, it may be known that drivers living in particular geographic regions are likely, on average, to give rise to fewer claims and are largely profitable. In such a case there may be onerous and non-onerous groups of contracts based on geographic regions.

22. AASB 17/PBE IFRS 17.20 provides relief from sub-grouping under AASB 17/PBE IFRS 17.16 when contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics. Accordingly, in the transport accident insurance contract case, if the pricing constraints on the entity are the cause of overpricing for low-claim geographic regions, they need not be separately accounted for (as a non-onerous contract group).

23. As discussed by the Boards in June 2021 (in respect of PAA eligibility), the price/levy decision-making power may reside with the entity itself, or it might reside with the government (for example, the relevant Minister). At their June meetings, the Boards decided it should be clarified that assessing a public sector entity's practical ability to fully price for risks or benefits would include assessing the ability of its controlling government, and any relevant Minister(s),

to decide on pricing or benefits. This would be on the basis that, for the purposes of determining pricing and benefits, the controlling government, including any relevant Minister(s), are acting in their capacity as managers of the public sector entity.

24. There are two ways in which this decision about a controlling government, including any relevant Minister(s) might be interpreted for the purposes of AASB 17/PBE IFRS 17.20.

    (1) It would mean that a pricing constraint imposed on an entity by its controlling government (or any relevant Minister) would not provide the entity with access to relief from sub-grouping because it would be deemed to be self-imposed.

    (2) While a public sector entity's practical ability to fully price for risks or benefits would include assessing the ability of its controlling government, and any relevant Minister(s), to decide on pricing or benefits, this is only in respect of their capacity as managers of the public sector entity. The overall pricing constraints relevant to AASB 17/PBE IFRS 17.20 are in respect of government policy more broadly, which is possibly set out in legislation (rather than being within a government's or Minister's management capacity). This broader framework of constraints would mean the entity has access to relief from sub-grouping because it would be deemed to be an externally-imposed constraint.

How might public sector entities be affected by AASB 17/PBE IFRS 17.20 (annual cohorts)?

25. Many public sector entities would only issue contracts with one year of coverage and the above difference [paragraph 16] between the portfolio perspective versus sub-grouping by annual cohort would not arise. However, some public sector entities issue contracts that provide multi-year coverage – for example, in respect of domestic building risk coverage arrangements, which may result in a greater frequency of early onerous contract recognition.

Stakeholder feedback

26. NZASB ED 2018-7[7] proposed no changes to PBE IFRS 17 in respect of onerous contracts; however, it specifically sought feedback from stakeholders on the requirements in PBE IFRS 17.16.

27. The responses to NZASB ED 2018-7 generally concluded that a PBE modification is needed based on a view that the requirements in PBE IFRS 17.16 are not relevant to the circumstances of public sector insurers in New Zealand. The responses included the following.

    (a) Pricing decisions and the resulting onerous contracts will often be a consequence of broader policy decisions of government.

    (b) The level of aggregation should be the same as the level used for setting levies.

    (c) While for profit insurers use granular information to improve profitability and avoid adverse selection by policyholders – this is not relevant to PBEs, which typically deliberately cross-subsidise across communities.

    (d) PBEs do not choose their customers or seek to market their services to particular customers, and risks are usually community rated – accordingly, grouping by onerous/non-onerous arrangements is not relevant.

28. Some responses to NZASB ED 2018-7 also concluded that a PBE modification is needed because the requirement in PBE IFRS 17.22 is not relevant to the circumstances of some public sector insurers that take a long view on pricing. That is, grouping by annual cohort is irrelevant

7 NZASB Exposure Draft ED 2018-7 PBE IFRS 17 *Insurance Contracts* [ED 2018-7].

when the insured risk is for highly uncertain and infrequent events where the entity is a monopoly provider (and cannot exit the market).

29. The AASB DP (2017)[8] did not specifically flag this issue and there were no comments from respondents to the AASB DP on onerous contract groups. The issue was raised in interviews between Australian stakeholders and AASB and NZASB staff conducted in late 2020 and early 2021 and feedback included the following.

   (a) In any given year, all contracts in a portfolio are likely to be onerous at initial recognition because the entity relies on investment returns to break even. That is, on a stand-alone basis, levies/premiums charged are inadequate relative to expected claims and there will be a negative insurance service result (negative underwriting result). Accordingly, unless there is sound evidence of a non-onerous group of contracts there would be no disaggregation of the portfolio under AASB 17.16.

   (b) Given that some entities do not price differentially based on policyholder-specific risks, they do not monitor (and may not possess) the information necessary to differentiate between onerous versus non-onerous contracts at initial recognition. For example, some entities are not permitted to hold information on gender or age; however, if available, gender and/or age-related information would enable the entity to identify onerous versus non-onerous contracts.

   (c) Ordinarily, all of a public sector entity's onerous contracts and non-onerous contracts would be the result of regulatory impediments that are covered by the 'relief' in AASB 17.20.

   (d) The entity takes a long-term view to avoid volatility in premiums/levies – periodically, there may be profitable or onerous contracts that depend on whether, for example, there are deficits to be 'rectified' or surpluses to be 'used up'.

Section 3: Possible approaches on onerous versus non-onerous groups of contracts

30. The IASB decided on the requirements in AASB 17/PBE IFRS 17.16 to divide each portfolio of contracts into sub-groups because it regards information about onerous contracts to be useful information about an entity's decisions on pricing contracts and about future cash flows, and wants this information to be reported on a timely basis. The IASB does not want this information to be obscured by offsetting onerous contracts in one group with profitable contracts in another group [IFRS 17.BC119].[9]

8 AASB Discussion Paper *Australian-specific Insurance Issues – Regulatory Disclosures and Public Sector Entities* (2017) [AASB DP (2017)].

9 The IASB chose groups of contracts as a way of striking a compromise between accounting on an in individual contract basis (that would be particularly burdensome) and accounting at the portfolio level of aggregation [IFRS 17.BC123 & BC124].

31. In respect of AASB 17/PBE IFRS 17.16 and 20, the Table below outlines approaches available to the Boards. Other approaches or combinations of approaches might also be available.

Reasons for and against each approach to AASB 17/PBE IFRS 17.16 & 20			
Possible approach		**Arguments for**	**Arguments against**
A1	Exempt all public sector entities from AASB 17/PBE IFRS 17.16	[**1a**] The basis for these requirements is timely information on profitability, which is not relevant to most public sector entities [**1b**] Most public sector entities have portfolios of onerous contracts – sub-groups of onerous contracts are not relevant	[**2a**] Timely information on sub-groups of onerous contracts might be useful because it might help inform users about cross-subsidies between participants / policyholders
A2	As above, but only exempt not-for-profit public sector entities (which is the majority of the relevant entities)	[**1c**] Information on profitability remains relevant to for-profit public sector entities	[**2b**] For-profit public sector entities also have portfolios of onerous contracts[10] – sub-groups of onerous contracts are not relevant
B1	Exempt all public sector entities from AASB 17/PBE IFRS 17.16; however, require disclosure about the nature of the pricing process, including constraints under which an entity operates to cross-subsidise different policyholder cohorts, that can lead to some groups of contracts being onerous	As per [**1a**, **1b** & **2a**] [**3**] Provides additional relevant information about the impact of price constraints on each entity (the information could be provided by cross-reference)	[**4**] The additional disclosure would be a burden and may already be readily available from other sources (although the burden might be mitigated by permitting disclosure by cross-reference)
B2	As above, but only exempt not-for-profit public sector entities	As per [**1c**]	As per [**4**] As per [**2b**]
C	No amendments/guidance on applying the requirements in AASB 17/PBE IFRS 17.16 & 20 (That is, no exemption for public sector entities.)	[**5**] Public sector entities should be able to identify the constraints relevant to their pricing decisions	As per [**1a**, **1b**, **2a** & **2b**] [**6**] Public sector entities may struggle to identify constraints relevant to their pricing decisions, resulting in inconsistent reporting outcomes
D	Keep AASB 17/PBE IFRS 17.16 and provide guidance to the effect that the constraints identified in AASB 17/PBE IFRS 17.20 would be constraints imposed on the entity itself and its controlling government (Ministers) in their managerial capacities	As per [**6**] [**7**] Consistent with the Boards' decision on PAA eligibility	As per [**5**] [**8**] Despite the guidance, public sector entities may struggle to identify the relevant constraints, resulting in inconsistent reporting outcomes
E	Keep AASB 17/PBE IFRS 17.16 and provide guidance to the effect that the constraints identified in AASB 17/PBE IFRS 17.20 would be constraints imposed on the entity in respect of government policy broadly, which is possibly set out in legislation [and not in the controlling government's (Ministers') managerial capacities]	As per [**6**] [**9**] The context of price constraints for contract boundary purposes is different from the relief provided by AASB 17/PBE IFRS 17.20[11]	As per [**5 & 8**] [**10**] Might be viewed as inconsistent with the Boards' decision on PAA eligibility

10 The entity itself might aim to be 'profitable' after taking into account investment earnings, but the contracts themselves are typically onerous prior to taking into account the investment earnings.

11 Price constraints for contract boundary purposes [AASB 17/PBE IFRS 17.34] are constraints that operate between the insurer and policyholder(s) and affect coverage periods; whereas, the regulatory constraints for the purposes of AASB 17/PBE IFRS 17.20 are imposed on both the insurer and the policyholder(s) and affect aggregation/disaggregation.

Staff views

32. Staff consider that the Boards should exempt all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.16. That is, Approach A1 in the Table immediately above.

33. Staff consider the exemption for all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.16 is justified for the following reasons.

    (a) The IASB's thinking about why the requirements for information about onerous contracts is useful information about an entity's decisions on pricing contracts is not as relevant in the public sector context (relative to the private sector). This is particularly the case for not-for-profit entities. However, even the public sector entities that are identified as for-profit entities are typically not able to underwrite risks in the manner available to private sector insurers and, therefore, pricing decisions are not a useful basis for disaggregation.

    (b) Public sector entities' information systems are typically geared to identifying, at a broad level, high-risk groups of participants/policyholders for strategic and government policy decision-making (for example, to conduct safety campaigns), but not necessarily for identifying separate groups of contracts for accounting purposes. The managements of public sector entities (whether for-profit or not-for-profit) typically do not seek to financially remediate groups of onerous contracts or seek to attract more profitable customers in the same manner as private sector insurers. And, unlike private sector insurers, public sector entities do not ordinarily choose the customers to which they market their products. Accordingly, the costs for public sector entities of disaggregating onerous versus non-onerous groups of contracts would exceed any likely benefits.

    (c) If public sector entities are subject to AASB 17/PBE IFRS 17.16 it would be necessary to explain how AASB 17/PBE IFRS 17.20 would be applied in a public sector context. That would mean explaining whether the constraints identified in AASB 17/PBE IFRS 17.20 would be constraints imposed only on the entity itself or on the entity and its controlling government (Minister). However, it would be potentially confusing if the explanation was anything other than an explanation that is perceived as being consistent with the decision in respect of PAA eligibility. It might be feasible to argue a distinction between:

        (i) a public sector entity's practical ability to fully price for risks or benefits including the ability of its controlling government, and any relevant Minister(s), to decide on pricing or benefits in their capacity as managers of the public sector entity; versus

        (ii) overall pricing constraints relevant to AASB 17/PBE IFRS 17.20 in respect of government policy more broadly.

    However, any such distinction could be a source of confusion.

34. Staff also note that the differences (from the private sector) in the accountability/regulatory, governance and financial management frameworks in general among public sector insurers could justify an exemption for all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.16.[12]

12 In particular, paragraph 30(g) of the *AASB Not-for-Profit Entity Standard Setting Framework*; and, to some extent, paragraph 60 of the *New Zealand Accounting Standards Framework*.

35. Staff consider that additional disclosures about the nature of the pricing process, including constraints under which an entity operates that result in cross-subsidising different groups of policyholders, is not justified for the following reasons.

(a) (There is no equivalent disclosure in AASB 17/PBE IFRS 17.

(b) In general, accounting standards (on other topics) do not require disclosures around pricing decisions and whether they involve cross-subsidisation among customers.

(c) In practice, a wide variety of disclosures of varying usefulness might result from requiring this type of disclosure. Some entities might provide pages of explanation or multiple cross-references to a range of possible sources, while others may provide a 'boilerplate' disclosure. Staff consider that users who are interested in this aspect of an entity's activities would probably be able to obtain this type of information from other sources, which might (for example) include the entity's management commentary, actuarial reports, deliberations of supervisory bodies, budget papers, and enabling legislation.

Question for Board members

Q1 Do Board members agree with the staff view that it would be appropriate to:

(a) exempt all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.16; and

(b) not require any additional disclosure?

Section 4: Possible approaches on annual groups of contracts

36. The requirement in AASB 17/PBE IFRS 17.22 to identify separate groups of contracts by their year of issue is expected to result in insurers identifying their reporting period as the relevant period. The year of issue is often referred to as the 'underwriting year'. For example, an entity with a 1 July to 30 June financial year would be expected to regard all contracts issued between 1 July and 30 June as being within one group of contracts for the purposes of complying with AASB 17/PBE IFRS 17.22.

37. The IASB decided on the requirements in IFRS 17.22 because it considers annual grouping by the underwriting year to be important to ensure that trends in the profitability of a portfolio of contracts are reflected in the financial statements on a timely basis [IFRS 17.BC136].

Underwriting year versus accident year

38. The AASB 17/PBE IFRS 17.22 requirement to determine groups of contracts based on the underwriting year as the unit of account for the liability for remaining coverage could have flow-on systems consequences for the ways in which the liability for incurred claims would also be managed (unless insurers operate two parallel systems). This is because:

(a) claims are usually compared with premium/levies earned, and premium earning under AASB 17/PBE IFRS 17 would be based on the underwriting year groups used for the liability for remaining coverage under AASB 17/PBE IFRS 17.22; and

(b) many general insurers (including some public sector entities) tend to manage claims on an 'accident year' basis.[13] That is, all claims arising from incidents/accidents within a particular annual period are tracked over time and compared year-on-year with levies/premiums earned in that year for the related contracts, regardless of when those contracts were issued/underwritten.

39. For some public sector entities, the underwriting year and the accident year are the same.[14] However, for other public sector entities they are different. The following table is intended to help explain the approach implied by AASB 17/PBE IFRS 17.22 versus the accident year approach. The table is based on contracts that have a one-year coverage period.

	Underwriting year basis	***Accident year basis***
Basis of groups	Contracts issued between 1 July to 30 June 20X2 [AASB 17/PBE IFRS 17.22]	Accidents occurring between 1 July to 30 June 20X2 [existing practice]
Observations	Accidents related to these contracts could occur between 1 July 20X2 to 29 June 20X3	Contracts related to these accidents could have been issued from 2 July 20X1 to 30 June 20X2
	The focus is on tracking and reporting **underwriting performance** year-on-year	The focus is on tracking and reporting **claims** year-on-year

40. Given that there is less focus on profitability and underwriting performance for public sector entities (relative to their private sector for-profit counterparts) claims management plays a more prominent role for public sector entities. Liabilities for incurred claims are relative more significance to public sector entities versus liabilities for remaining coverage when compared with the private sector (as identified in the Boards' previous meeting papers on this project[15]).

Other factors – coverage for highly uncertain infrequent events

41. Some insurance risks relate to providing coverage for highly uncertain infrequent events. The coverage period for contracts for these risks are often only one year and:

(a) in years when there are no relevant events, the business is highly profitable; while

(b) in years when a relevant event occurs, the business results in large losses.

42. From the perspective of a private sector insurer that can choose to engage in these contracts or withdraw from the market, sub-grouping contracts by their year of issue (underwriting year) based on AASB 17/PBE IFRS 17.22 might help track this profit or loss volatility.

43. From the perspective of a public sector insurer that is a monopoly and cannot choose to withdraw from the market, sub-grouping contracts by their year of issue (underwriting year) based on AASB 17/PBE IFRS 17.22 seems much less relevant. For these entities, tracking sub-groups of contracts by the year in which the infrequent events occur (accident year) might be more relevant.

13 Lloyd's business is a major exception because the syndicates (whose members' relative interests in the syndicates may change over time) are based on underwriting years.

14 For example, Comcare and iCare's Workers' Compensation business (except for 'new' employers).

15 For example, June 2021 [Agenda Paper AASB 14.3/NZASB 8.3](#).

Staff views

44. Staff consider that the Boards should exempt all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.22. Staff consider the exemption for all public sector entities is justified for the following reasons.

(a) The focus of interest among some public sector entities is on claims experience rather than profitability or underwriting performance. Some of those entities would track and manage claims on an accident year basis (not an underwriting year). Others use an underwriting year basis. Some entities track claims on both bases. Managements are likely to continue their existing tracking focus (which they have found to be effective) even if the external reporting requirements changed to groups based on the date when contracts are issued. The costs for some entities of operating a parallel tracking system (based on the underwriting year) to facilitate external reporting would not justify any benefits that might arise from applying AASB 17/NZ IFRS 17.22.

(b) The IASB's reasoning behind the requirements (annual groupings by issue date are important to ensure that trends in the profitability of a portfolio of contracts are reflected in the financial statements on a timely basis) is generally less crucial (or unimportant) to public sector entities.

(c) The requirement in AASB 17/PBE IFRS 17.57 to compare the PAA liability for remaining coverage with the fulfilment cash flows that relate to remaining coverage when facts and circumstances indicate a group of insurance contracts is onerous could be applied at the portfolio level. [This is the level at which the LAT is currently applied under AASB 1023.9.1/PBE IFRS 4 (Appendix D.9.1).] Given that, for most public sector entities, the liability for remaining coverage is routinely inadequate because they price to break even after taking into account projected investment returns, exempting public sector entities from applying the requirements in AASB 17/PBE IFRS 17.22 would rarely (if ever) result in delayed recognition of onerous contracts.

(d) The differences (from the private sector) in the accountability/regulatory, governance and financial management frameworks in general among public sector insurers help justify an exemption for all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.16.[16]

Question for Board members
Q2 Do Board members agree with the staff view that it would be appropriate to exempt all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.22?

Section 5: Initial recognition of insurance contracts

45. In general, the following applies under AASB 1023/PBE IFRS 4.

(a) An insurance liability is recognised when premium is received or receivable, because the measurement model simply defers unearned premiums received or receivable on the balance sheet. Premiums might be received before coverage begins, on the day coverage begins or after coverage begins.

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16 In particular, paragraph 30(g) of the *AASB Not-for-Profit Entity Standard Setting Framework*; and, to some extent, paragraph 60 of the *New Zealand Accounting Standards Framework*.

(b) An unexpired risk liability (onerous contract loss) is recognised based on whether unearned premiums are adequate to meet expected future claims and other relevant costs. Accordingly, loss recognition is dependent on when unearned premiums are recognised on the balance sheet – see (a) above.

46. In contrast, AASB 17/PBE IFRS 17.25 says:

> 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.

47. IFRS 17.BC140 to BC144 indicate that, for the onerous contract trigger in AASB 17/PBE IFRS 17.25(c) to be the earliest date, the insurer would have already accepted the insured's risk before coverage commences and before premiums are due and there are facts and circumstances indicating a group of insurance contracts is onerous.[17] Staff interpret this to mean that there are onerous contracts which are 'bound but not incepted' (BBNI).[18]

48. Accordingly, there would need to be up-front loss recognition for any onerous contracts that have been entered into as at the balance date, even though the coverage period may only commence in the subsequent financial year.

Private sector versus public sector circumstances

Circumstances	***Private sector for-profit insurers***	***Public sector entities***
Prevalence of onerous contracts	An insurer would only by exception knowingly issue onerous contracts [see IASB's perspective in IFRS 17.BC135]. In practice, as at the reporting date, insurers will need to consider all of their BBNI contracts and identify those which are onerous based on facts and circumstances.	As noted in paragraph 12, most public sector entities routinely issue onerous contracts (because levies/premiums charged are inadequate to cover expected claims).
Prevalence of BBNI contracts	An insurer will typically have contracts commencing throughout their financial year and, therefore, only a relatively small portion of contracts would typically be within the BBNI category as at any given reporting date.	Some public sector entities have a large portion of their contracts covering periods that coincide with their financial year. Accordingly, for these entities, all or most of next year's contracts could be BBNI at financial year end.

17 The IASB reasoned that it would be too burdensome to require all contracts (rather than just onerous contract) to be recognised on the acceptance of risk due to the need to track each group of contracts prior to coverage commencing [IFRS 17.BC141]. However, an entity would need to know the population of those contracts in order to determine which are onerous.

18 'Bound But Not Incepted' (BBNI) or 'Written But Not Incepted' (WBNI) is a widely accepted notion in the general insurance industry. For example, in relation to capital adequacy, refer to: APRA Discussion Paper *Integrating AASB 17 into the capital and reporting frameworks for insurers and updates to the LAGIC framework* [page 43].

49. The differences in circumstances between private sector for-profit insurers versus many public sector entities with insurance arrangements mean that AASB 17/PBE IFRS 17.25(c) might have a much more significant impact in the public sector.

> ***Example public sector entity***
>
> Coverage for all contracts runs from 1 July to 30 June. All contracts are known to be onerous [refer paragraph 12]. As at balance date, all of the entity's policyholders/participants have entered into arrangements that commence on 1 July of the subsequent financial year (that is, they are all BBNI contracts). The losses (before investment earnings) for the next year's arrangements are estimated to be $50m. All of next year's arrangements would be initially recognised in this year's financial statements, including the $50m onerous contract loss.

50. The Table below shows a range of possible circumstances for an entity that is reporting for the year ending 30 June 20X1 and:

- coverage for all (existing) contracts expire on 30 June 20X1
- there is one (new) contract with a single premium of $100 for a coverage period from 1 July 20X1 to 30 June 20X2, which is arranged on 15 June 20X1 and premium is due and paid on 1 August 20X1.

The Table illustrates when the accounting under AASB 17/PBE IFRS 17.25(c) will be different from the accounting under AASB 1023/PBE IFRS 4.

Circumstances	***AASB 1023/PBE IFRS 4***	***AASB 17/PBE IFRS 17***	***Comment***
Premium due & paid: 15 June 20X1 Contract is not onerous	**20X1 balance sheet** Debit: Cash $100 Credit: UEP liability $100 **20X1 income statement** No impact	**20X1 balance sheet** Debit: Cash $100 Credit: PAA liability $100 **20X1 income statement** No impact	Same outcome
Premium due & paid: 1 August 20X1 Contract is not onerous	**20X1 balance sheet** No impact **20X1 income statement** No impact	**20X1 balance sheet** No impact **20X1 income statement** No impact	Same outcome
Premium due & paid: 15 June 20X1 Contract is **onerous** ($10)	**20X1 balance sheet** Debit: Cash $100 Credit: Liability $100 **20X1 income statement** No impact	**20X1 balance sheet** Debit: Cash $100 Credit: PAA liability $110 **20X1 income statement** Debit: Onerous contract loss $10	**Different outcome** ***AASB 17/PBE IFRS 17 requires loss recognition for BBNI while losses under AASB 1023/PBE IFRS 4 arise only once coverage has commenced***
Premium due & paid: 1 August 20X1 Contract is **onerous** ($10)	**20X1 balance sheet** No impact **20X1 income statement** No impact	**20X1 balance sheet** Credit: PAA liability $10 **20X1 income statement** Debit: Onerous contract loss $10	

IASB's deliberations

51. The IASB considered, but rejected, requiring all insurance contracts to be recognised from the time an insurer accepts risk, which is potentially before coverage begins. The IASB agreed with stakeholders who were concerned that this would require system changes whose high costs outweigh the benefits of doing so [IFRS 17.BC141]. However, as a compromise, the IASB decided to impose recognition from the time an insurer accepts risk for onerous contracts [IFRS 17.BC142]. This reflects the IASB's emphasis on the early recognition of onerous contract losses.

Staff views

52. Staff consider that the consequences of applying AASB 17/PBE IFRS 17.25(c) to some public sector insurers would:

    (a) be potentially burdensome from a practical systems viewpoint; and

    (b) lead to information that is not useful for users of the financial statements because, for some public sector entities on an ongoing basis, the results for the current period would include the onerous contract losses of the following year's contracts.

53. AASB 17/PBE IFRS 17.25(c) was conceived in the context of private sector for-profit insurers for which, in theory, onerous contracts would be the exception and BBNI contracts as at the reporting date would be a relatively small proportion of total contracts. Given that:

    (a) for most public sector insurers, onerous contracts are typical; and

    (b) for some public sector insurers, BBNI arrangements as at the reporting date would be all, or a relatively significant proportion of total arrangements;

    staff consider that public sector insurers should be exempted from applying AASB 17/PBE IFRS 17.25(c) to ensure that current period's result would not include losses of following year's onerous contracts.

54. In addition, staff note that the differences (from the private sector) in the accountability/regulatory, governance and financial management frameworks in general among public sector insurers could justify an exemption for all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.25(c).[19]

Question for Board members	
Q3	Do Board members agree with the staff view that it would be appropriate to exempt all public sector entities from applying the requirements in AASB 17/PBE IFRS 17.25(c) to ensure that current period's result would not include losses of following year's onerous contracts?

19 In particular, paragraph 30(g) of the *AASB Not-for-Profit Entity Standard Setting Framework*; and, to some extent, paragraph 60 of the *New Zealand Accounting Standards Framework*.

Appendix A – Selected terms relating to contract recognition

A1 For information – the following Table outlines the terminology used in the Standards.

Terminology	***AASB 1023/PBE IFRS 4***	***AASB 17/PBE IFRS 17***	***Comment***
Inception date	Occasionally used to indicate when a coverage period begins [AASB 1023/PBE IFRS 4.2, 3 & 27]	Appears to mean when contract terms are agreed, which could be prior to when coverage begins [IFRS 17.BC80 & BC135]	Different meanings attached to the same term
Attachment date	The date from which the insurer accepts risk from the insured under an insurance contract [AASB 1023/PBE IFRS 4.19.1]	Not used	Appears to mean the same as inception date under AASB 17/PBE IFRS 17
Initial recognition	Not used (in respect of insurance contract recognition)	Earlier of when coverage begins, first payment is due from insured, or the contract has incepted and is onerous [IFRS 17.25]	