IFRS

# STAFF PAPER

September 2018

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| **Project** | **Transition Resource Group for IFRS 17 *Insurance Contracts*** |
| Paper topic | Cash flows that are outside the contract boundary at initial recognition |


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## 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

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| **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.