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

Under the Premium Allocation Approach ("PAA") in IFRS 17 Insurance Contracts paragraphs 55(a)(i) and 55(b)(i), the Insurance Liability/Reinsurance Held Asset for Remaining Coverage ("L/AfRC") is required to include any premiums received. Paragraphs 55(a)(i) and 55(b)(i) appear to preclude the recognition of future premiums already invoiced but not yet paid and future premiums not yet invoiced.

This results in an inconsistency, because under normal accounting principles the receivable would be recognised as an asset. Under IFRS 9 Financial Instruments the future premium receivables represents contractual rights to receive cash and would be recognised as trade receivables assets. Under IFRS 15 Revenue from Contracts with Customers the right to receive the future premiums would be recognised as contract assets.

The question arises whether IFRS 17 paragraphs 55(a)(i) and 55(b)(i) precludes the recognition of such a receivable in all circumstances. It is generally accepted practice in all major global insurance markets to recognise trade receivables and liabilities for remaining coverage which insurers are contractually obliged to provide. Preparers are looking to interpret paragraph 55(b)(i) as permitting receivables for 2 reasons:

1) practical difficulties and significant costs in applying cash requirements at a group level; and
2) concerns that the resulting liability is shown on a "net" basis rather than a "gross" basis and is therefore less transparent.

Firstly, given the move to "group" reporting occurred late in the development of IFRS 17, preparers are just now fully understanding the extent of the practical issues and want to ensure the IASB is also cognisant of the impacts. The operational difficulties are driven by the fact that the existing systems are not capable of extracting cash balances at that granular a level. The granularity, and the uncertainly around the level of granularity required, will significantly increase the cost of infrastructure and compliance costs before the existing PAA can be applied.

The second reason is primarily one of presentation (net versus the current gross approach) and whether a net approach provides the user with sufficient and appropriate information regarding the financial position of the insurer. This includes an indication of future expected insurance contract revenue from incepted contracts, and whether the approach to net presentation is consistent with the principles in other standards (as discussed later in this paper). This is a significant change from existing practice and not aligned with reporting currently required by eg tax authorities and prudential regulators.

Notwithstanding that the PAA should have the same result as the general model, the ICA requests the IASB to enable the recognition of the receivable in paragraph 55. If the IASB decides not to enable this, then additional guidance/examples are requested to illustrate how this is going to work in practice.

The issue raised in this paper was discussed at length by the AASB TRG for Insurance Contracts and the TRG is supportive of presenting this issue to the IASB TRG for Insurance Contracts.

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. Introduction

1.1 IFRS 17 para 55(a)(i) states that the measurement of the Insurance Liability/ Reinsurance Held Asset for Remaining Coverage [L/AfRC] under the Premium Allocation Approach [PAA] includes **"premiums, if any, received"**. Interpreted literally, this would give the **"narrow view"** of the L/AfRC. Generally accepted accruals based accounting would suggest that this wording should be interpreted to mean **"premiums, if any, received and receivable"** - the **"broader view".** We anticipate differences in application as insurers may interpret this standard in different ways. The Insurance Council seeks clarification that the appropriate methodology is the "broader view". This paper sets out:

- The two potential views of the recognition of the L/AfRC for the PAA.
- The reasons why the "broader view" is necessary.
- The implications if the "narrow view" were adopted.

1.2 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. In seeking to match the outcomes under the general model, the PAA wording appears to adopt a cash receipts basis of accounting that does not lead to a faithful representation of an insurer's obligation to provide coverage or its right to receive premiums.

2. Alternative methods of measuring the Liability/Asset for Remaining Coverage (L/AfRC)

Narrow view

2.1 IFRS 17 paragraph 55 wording appears to adopt a "***narrow view***" of the measurement of the L/AfRC under the Premium Allocation Approach (PAA) by including only insurance premiums received (reinsurance premiums paid).

> 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);
> (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.
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> 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, …

2.2 This "narrow view" results in non-recognition of trade receivables and non-recognition of the LfRC for policies where payments are made in arrears at the contract inception.

Broader view

2.3 Currently, generally accepted insurance practice in major global markets adopts a "***broader view***" by recognising trade receivables (reinsurance payables) the insurer is expected to receive (pay) based on contracts which have incepted and the associated L/AfRC representing the obligation to provide cover. This "broader view" is considered to be a more faithful representation of the obligation an insurer has to provide coverage to policyholders.

2.4 The broader view is also more conceptually aligned to other IFRS Standards, allowing greater consistency and comparability, for example:

(a) premium receivables are akin to trade receivables under IFRS 9, and therefore they should be recognised as contractual rights to receive cash; and

(b) IFRS 15 recognises a contract asset representing the right to receive premiums [IFRS 15.105].

2.5 The ICA expects preparers would have a preference to apply the broader view in order to achieve the outcome of gross presentation and disclosure. This is likely to lead to differences in interpretation.

2.6 Supporting this "broader view", 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 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.

2.7 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".[1] This supports the "**broader view**".

2.8 Further supporting this "broader view", 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]

2.9 Using only premiums received in measuring the PAA L/AfRC would mean that different acquisition structures would result in different liabilities. For example, a direct insurer issues annual householder policies which have an option for the policyholder to pay premiums through different payment arrangements such as annually up front, in quarterly or in monthly instalments. The L/AfRC under the "narrow view" would only be recognised on day 1 for the annual up front premiums even though the obligation to provide cover is equivalent for all policyholders and the insurer has an equivalent obligation to all policyholders (for example an insurer may be permitted to deduct unpaid premium in the event of a claim). The difference in balance sheet outcome which emerges if this is applied to policyholders who opt for different payment plans is further illustrated with examples in Appendix A.

2.10 IFRS 17.BC183 may indicate 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.

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1 *Conceptual Framework for the Preparation and Presentation of Financial Statements*, paragraph QC12.

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."

3. "Broader view" required to reflect the insurer's obligations to provide coverage and related trade receivables in a manner that is transparent to users

3.1 Worldwide practice in the insurance industry supports the accrual basis of accounting – the "broader view". 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 payment plan the policyholder / reinsured selects. For example, the following are the journal entries for a policy providing coverage from 15 November 20X1 to 14 November 20X2 with two premiums of $60 due and payable on 15 February 20X2 and 15 August 20X2.

Date	Description	Debit	Credit
15 Nov 20X1	Trade debtor – premium receivable	$120	
	L/AfRC		$120
31 Dec 20X1	L/AfRC	$15	
	Premium revenue for year to 31 Dec		$15
15 Feb 20X2	Cash	$60	
	Trade debtor		$60
30 Jun 20X1	L/AfRC	$60	
	Premium revenue for half year to 30 Jun		$60
15 Aug 20X2	Cash	$60	
	Trade debtor		$60
14 Nov 20X2	L/AfRC	$45	
	Balance of premium revenue		$45

The following balances represent the differences at a reporting date of 31 December 20X1 that could occur between the different models.

"**Broader View**" Balances as at 31 December 20X1

Description	Asset	Liability	P/L
Trade debtor – premium receivable	$120	-	
L/AfRC	-	($105)	
Premium revenue for year to 31 Dec			($15)

"**Narrow View**" Balances as at 31 December 20X1

Description	Asset	Liability	P/L
L/AfRC	$15	-	

Premium revenue for year to 31 Dec			($15)

3.2 Under the PAA, if the "narrow view" applies, an insurer writing insurance contracts obliging it to provide insurance cover for a year (for example) and that will receive some or all premiums in arrears, for example on a monthly payment plan, 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.

3.3 This outcome under IFRS 17 would be 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.[3]

3.4 The "broader view" is supported by analogy with 'financial assets' and 'financial liabilities' defined in IFRS 9 *Financial Instruments* and IAS 32 *Financial Instruments: Presentation*.

3.5 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. …

3.6 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.

3.7 Accordingly, insurance contracts can be regarded as giving rise to both financial liabilities and financial assets.

3.8 The ICA considers there is a clear analogy with financial assets and liabilities that supports the ICA's suggested solution for clarifying the "broader view" of the PAA applies and enabling insurers to show their contractual obligations to provide coverage and any compensating reinsurance cover.[4]

4. Limitations of "narrow view" PAA and associated complexity and costs

4.1 In summary, the "narrow view" 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 the pattern of premium receipts, which is inconsistent with IFRS 17.B35.

(b) The way in which an insurer acquires its insurance contracts (for example, directly or through brokers) or payment methods selected by policyholders (e.g. monthly , quarterly or annual payment plans) can give rise to a different L/AfRC, which is inconsistent with IFRS 17.B183.

3 *Framework for the Preparation and Presentation of Financial Statements*, paragraph OB2

4 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 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.

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

4.2 In addition, there are significant operational costs associated with extracting data on premiums received as distinct from received and receivable particularly when consideration at the unit of measurement of a "group" of insurance contracts. Insurance systems deal with insurance contract data; retaining information on premiums, claims, commissions etc. These systems generally export data to specific cash management systems which focus on collection of premiums receivable and the need to manage credit risk. These credit control systems are usually separate from core policy administration systems and would not generally have connectivity back into core systems to differentiate between what is received vs receivable or indeed to identify "groups" of contracts.

4.3 It is also 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) Returns for tax authorities and prudential regulators are likely to be on an accrual basis of accounting requiring the full insurance exposure to be reflected.

(c) 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.

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

4.4 This would entail insurers having to maintain two comprehensive information systems to generate (1) the additional information needed by preparers and users; and (2) the information needed for IFRS 17 accounting. This would create significant and unnecessary costs for insurers, that would ultimately be borne by policyholders and the wider community.

4.5 Furthermore, 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, concerns about the PAA's potential limitations should be addressed.

5. ICA recommendations

5.1 The IASB should clarify how the contractual right to receive insurance premiums – the trade receivable – should be accounted for when applying IFRS 17.

5.2 The ICA recommends the IASB amends IFRS 17 to allow the recognition of premiums receivable when measuring the L/AfRC, to:

(a) remain consistent with the requirements of other IFRS Standards;

(b) maintain transparency for users of financial statements;

(c) relieve insurers of the significant costs associated with system changes; and

(d) avoid differences between the PAA and general model arising from possible diverging interpretations in practice.

5.3 If the IASB decides not to amend IFRS 17, then additional guidance and examples are requested to illustrate how this aspect of the Standard will work in practice.

Appendix A - Explanation of the consequences of the PAA L/AfRC "Narrow View"

Contracts issued

A.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 plans
- the insurer is obliged to provide cover for an annual period and 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).

A.2 When all premiums are paid annually up-front, the PAA L/AfRC as at 31 December 20X1 is:

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	

A.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	

A.4 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

A.5 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)].

A.6 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)	

A.7 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)

A.8 In economic terms, there is no mismatch. The mismatches arises in the balance sheet purely due to the way in which the “narrow view” PAA basis of measurement applies.