Australian Government
Australian Accounting Standards Board

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

In addition to the form, attachments (such as memos) may be included with the submission.

Any public discussion of issues submitted will be without the identification of the submitter's name. Although the submission forms will remain private, please do not include any confidential information in your submission.

Email a PDF of the completed (including any attachments) form to standards@aasb.gov.au.

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Stakeholder group	Auditor
Do you wish to present to the TRG?	Yes

Potential implementation question

How are three key components of discount (being the initial recognition of discount, the subsequent unwind of discount and any movements in discount rates) presented in the P&L/OCI?

Paragraph of IFRS 17 *Insurance Contracts*

Various, including: AASB 17 41 (c), 87, B123 (a), B124 (a), IASB IFRS 17 effects 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 attached three pages
Q1 Do you support View 1 or View 2?
Q2 Do you believe that IFRS 17 supports View 1, View 2 or both Views?

Is the question pervasive?
Explain whether the question is expected to be relevant to a wide group of stakeholders.

The issue affects most insurance industry stakeholders (both general and life).

Presentation of Discount – AASB TRG June 2020

Two different views have been identified for presenting the discount, and associated unwind, in the Profit and Loss Account. For the purposes of this paper the selection of presentation of discount in either, Profit and Loss account, or, Profit and Loss account and Other Comprehensive Income has not been considered; however, the principles in the paper would also be applied in a similar way where the latter method is adopted.

View 1 The initial recognition of the effects of the time value of money (i.e. initial discount) on fulfillment cash flows is included in the measurement of **insurance service expense**. Subsequent unwind of the initial discount and any movements in discount rates are included in **finance income and expenses.**

View 2 The initial recognition of the effects of the time value of money on fulfillment cash flows, subsequent unwind of these amounts and any movements in discount rates are all included in **finance income and expenses**.

Depending on the view adopted, the amounts recognised as **insurance service expense and finance income and expense** would differ and the related presentation and disclosures would differ. Overall Profit and Loss would not differ.

View 1 – initial discount is included in insurance service result

1.1 Initial discount calculation is recognised as part of the **insurance service result**, and only the subsequent unwind of discount and market value movement of the discount is included in **insurance finance income and expense**.

1.2 The impact is to reduce the insurance service expense (i.e. claims incurred) in the Profit and Loss and increase the insurance service result, assuming profitable business and a positive discount rate.

1.3 Under this view, premium, which is at today's monetary value, is determined in a consistent way to reported claims incurred (i.e. insurance service result under IFRS 17) and so in real terms these two components of the insurance service result are calculate on an equivalent basis.

1,4 **Insurance finance income and expense** is reported alongside **investment income** earned on the financial instruments held by the insurer. Assuming these financial instruments are held at Fair Value through Profit and Loss, which includes both realised and unrealised income, investment returns would correlate more closely with View 1 (i.e. the unwind of discount would offset investment income earned and market value movements of discount and investments would more likely offset each other)

1.5 Determining the amount of discount to be included in **insurance finance income and expense** would likely be more complicated under this View 1 as you would be required to track the components of the discount (being the initial recognition of discount, the subsequent unwind of discount and any movements in discount rates) and separate out these components for financial reporting presentation, rather than just looking at the difference between two balance sheets calculations of discount as required under View 2.

View 2 – no discount is included in the insurance service result

2.1 View 2 recognises all discount changes in **insurance finance income and expense**.

2.2 The amount reported in **insurance finance income and expense** is thus a mixture of an increase in discount (e.g. for new claims outstanding recognised, or changed values or timing of existing claims), the unwind of the discount previously recognised due to the passage of time and any movement in discount rates.

2.3 View 2 aligns to a balance sheet-based approach for calculating discount. For example, discount is calculated based on the outstanding claims liabilities at the balance sheet at discrete intervals (i.e. reporting dates) to determine the total discount required on the balance sheet at a point in time. This balance is posted to the balance sheet, with the total movement being recorded in **insurance finance income and expense.**

2.4 Over time, discount included for each group in **insurance finance income and expense** will be zero – it is zero before being recognised, it is set up, and then unwound to nil once claims are paid. Thus, the effect of the discount on a stable business will be nil each year (assuming discount rates don't change), as it will be on all business over time.

Simple Example

Assume a premium of £100 today, claims of £100 to be paid in a year's time.
Assume for simplicity we get investment income of 11% on the invested premium, but that the discount rate is 10%. Numbers are higher than today, but rounded for simplicity, but the concept is the same whatever the level of discount and investment return.

Under View 1, we would have an insurance profit of £10 (£100 premium less claims of £100 claims discounted by 10%) and investment income of £1 (£11 of earned income less £10 of discount unwind). This reflects the economic position whereby the claim is worth less in today's money because of the discount calculation.

Under View 2, we would have an insurance service income of nil (£100 premium less claims of £100) and investment income of £11 (being simply the earned investment income as the initial discount and unwind of discount net off to nil).

More Detailed Example

A different more complex example is given in the attached spreadsheet below.

Appendix: Relevant extracts from IFRS 17 and supporting material

In support of View 1 – IASB staff illustration

Example on page 122 / 123 of the Effects Analysis (see link below) appears to support view 1 (i.e. the impact of the discounting at inception is not included in the insurance finance expense.

https://cdn.ifrs.org/-/media/project/insurance-contracts/ifrs-standard/ifrs-17-effects-analysis.pdf

Illustration 3—Simplified approach

This illustration shows the effects of IFRS 17 on the balance sheet and the statement of comprehensive income for a group of contracts accounted for using the simplified approach (see Section 5.3—*Key cost reliefs*).

Illustration 3—background information

- The group of insurance contracts is composed of one-year contracts.
- All claims are incurred at the end of the coverage period. Cash outflows for those claims are paid in subsequent years. No changes in estimates occur after contract inception.
- The explicit risk adjustment, in applying IFRS 17, is calculated as 4 per cent of the outstanding undiscounted claims for each year to their expected settlement.
- The discount rate is 2 per cent a year.
- The premiums collected, net of expenses incurred, are invested in financial assets generating a return of 2.5 per cent a year. Financial assets are measured at fair value with gains and losses recognised in profit or loss.
- All investment income and insurance finance expenses are recognised in profit or loss (and not in other comprehensive income).
- When applying IFRS 17, no interest is accreted on the liability for remaining coverage as permitted by IFRS 17 for contracts with a coverage period of one year or less.
- When applying IFRS 4:
  (a) liabilities for incurred claims are not discounted; and
  (b) an implicit allowance for risk (risk margin) is made by increasing the best estimate of claims; this risk margin is calculated as 2 per cent of the undiscounted future claims for each year to their expected settlement.
- Expected and actual cash flows are summarised in the following table.

Expected and actual cash flows

	Year 1	Year 2	Year 3	Year 4	Year 5
Opening balance of cash	–	9,840	4,910	2,439	1,465
Insurance contract cash flows:					
Premiums	10,000	–	–	–	–
Claims	–	(5,000)	(2,500)	(1,000)	(500)
Commission expense	(400)	–	–	–	–
Other expenses	–	(50)	(30)	(10)	(5)
Financial asset cash flows:					
Investment income	240	120	59	36	24
Closing balance of cash	9,840	4,910	2,439	1,465	984

Illustration 3 assumes that all premiums and commission cash flows occur at the beginning of the year. All other claims and expense cash flows occur at the end of the year.

IFRS 4

Balance sheet—Illustration 3

	Year 1	Year 2	Year 3	Year 4	Year 5
Financial assets	9,840	4,910	2,439	1,465	984
Insurance contract liabilities	(9,395)	(4,165)	(1,555)	(515)	–
Equity	445	745	884	950	984

Statement of comprehensive income—Illustration 3

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Earned premiums	10,000	–	–	–	–	10,000
Claims and expenses	(9,395)	180	80	30	10	(9,095)
Acquisition costs	(400)	–	–	–	–	(400)
Investment income	240	120	59	36	24	479
Profit or loss	445	300	139	66	34	984
Other comprehensive income	–	–	–	–	–	–
Comprehensive income	445	300	139	66	34	984

IFRS 17

Balance sheet—Illustration 3

	Year 1	Year 2	Year 3	Year 4	Year 5
Financial assets	9,840	4,910	2,439	1,465	984
Insurance contract liabilities	(9,401)	(4,167)	(1,555)	(515)	–
- Present value of cash flows	(8,801)	(3,927)	(1,475)	(495)	–
- Risk adjustment	(600)	(240)	(80)	(20)	–
Equity	439	743	884	950	984

Statement of comprehensive income—Illustration 3

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance revenue	10,000	–	–	–	–	10,000
Incurred claims and other expenses	(9,401)	360	160	60	20	(8,801)
Acquisition expenses	(400)	–	–	–	–	(400)
Insurance service result	199	360	160	60	20	799
Investment income	240	120	59	36	24	479
Insurance finance expenses	–	(176)	(78)	(30)	(10)	(294)
Net financial result	240	(56)	(19)	6	14	185
Profit or loss	439	304	141	66	34	984
Other comprehensive income	–	–	–	–	–	–
Comprehensive income	439	304	141	66	34	984

Effects on the balance sheet

When applying IFRS 17, the liability for incurred claims is discounted and includes an explicit risk adjustment. When applying IFRS 4, the liability for incurred claims is not discounted, but it includes an implicit allowance for risk. In this illustration, the difference between the explicit risk adjustment in applying IFRS 17 and the implicit allowance for risk in applying IFRS 4 is similar to the effect of discounting the liability for incurred claims in applying IFRS 17.

Effects on the statement of comprehensive income

The patterns of profit recognition in this illustration are similar. If the effect of discounting was more significant than the effect of increasing the risk adjustment, the recognition of profits in applying IFRS 17 would be accelerated. If the effect of discounting was less significant than the effect of increasing the risk adjustment in applying IFRS 17, the recognition of profits would be deferred. The main effect of IFRS 17 is on the presentation of the effects of risk and discounting. The interest accreted on the discounted claims liabilities is presented as part of the net financial result, and not as part of the insurance service result.
In both presentations, claims and expenses recognised in Years 2–5 represent the reduction of the risk adjustment as the company is released from risk.

Effects Analysis | IFRS 17 Insurance Contracts | May 2017 | 123

Relevant extracts in support of View 2

41(c) and para 87, indicate that the effect of the time value of money must go through Insurance Finance income or expense and hence this element cannot also be included in the Insurance service result. [emphasis added].

> ***41 An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:***
>
> *(a) insurance revenue—for the reduction in the liability for remaining coverage because of insurance contract services provided in the period, measured applying paragraphs B120–B124;*
>
> *(b) insurance service expenses—for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52); and*
>
> ***(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87***
>
> ***87 Insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from**:*
>
> *(a**) the effect of the time value of money and changes in the time value of money; and***
>
> *(b) the effect of financial risk and changes in financial risk; . . .*

This view appears to be further supported by:

a) Paras B123 (a)(iv) makes it clear that changes in LRC that give rise to insurance revenue exclude insurance finance income and expenses (i.e. effect of time value of money as per para 87) [emphasis added];
b) B124 makes clear that the incurred insurance services expenses reflected in revenue are to be measured based on amounts expected as at the start of the period, including unwind of discount in this amount effectively means the expectation is being adjusted for time value to the end of the period [emphasis added].

> ***B123** Applying IFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying IFRS 17, when an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. **The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:***
>
> ***(a)** changes that do not relate to services provided in the period, for example:*
>
> *(i) changes resulting from cash inflows from premiums received;*
>
> *(ii) changes that relate to investment components in the period;*
>
> *(iia) changes resulting from cash flows from loans to policyholders;*
>
> *(iii) changes that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph B65(i));*
>
> ***(iv) insurance finance income or expenses;***
>
> ***B124** Consequently, **insurance revenue for the period can also be analysed as the total of the changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration. Those***
> ***changes are:***
>
> ***(a) insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), . . .***

DRAFT FOR DISCUSSION

Gross LIC estimate day 1	1000
Settlement	2 years
Revised estimate at the end of six month	1200
Change	200
Discount rate	1%

	Day	End of month																								Total	Comments
	1	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24		
Cash flow - day 1 assumption	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1000		
Additional cash outflow	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	200		
View 1																											
Balance Sheet LIC	788	795	803	811	820	828	836	844	853	861	870	879	887	896	905	914	923	933	942	951	961	971	980	990	1000		
Due to change in cash flow							167	169	171	172	174	176	177	179	181	183	185	187	188	190	192	194	196	198	200		
Total BS	**788**	**795**	**803**	**811**	**820**	**828**	**1003**	**1013**	**1023**	**1034**	**1044**	**1054**	**1065**	**1076**	**1086**	**1097**	**1108**	**1119**	**1130**	**1142**	**1153**	**1165**	**1176**	**1188**	**1200**		
ISE	-788						-167																			**-955**	
IFIE	0	-8	-8	-8	-8	-8	-8	-10	-10	-10	-10	-10	-11	-11	-11	-11	-11	-11	-11	-11	-11	-12	-12	-12	-12	**-245**	
Total P/L	**-788**	**-8**	**-8**	**-8**	**-8**	**-8**	**-175**	**-10**	**-10**	**-10**	**-10**	**-10**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-12**	**-12**	**-12**	**-12**		
View 2																											
Balance Sheet LIC	788	795	803	811	820	828	1003	1013	1023	1034	1044	1054	1065	1076	1086	1097	1108	1119	1130	1142	1153	1165	1176	1188	1200		
Total BS	**788**	**795**	**803**	**811**	**820**	**828**	**1003**	**1013**	**1023**	**1034**	**1044**	**1054**	**1065**	**1076**	**1086**	**1097**	**1108**	**1119**	**1130**	**1142**	**1153**	**1165**	**1176**	**1188**	**1200**		
ISE	-1000						-200																			**-1200**	
IFIE	212	-8	-8	-8	-8	-8	25	-10	-10	-10	-10	-10	-11	-11	-11	-11	-11	-11	-11	-11	-11	-12	-12	-12	-12	**0**	Zero total for IFIE
Total P/L	**-788**	**-8**	**-8**	**-8**	**-8**	**-8**	**-175**	**-10**	**-10**	**-10**	**-10**	**-10**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-11**	**-12**	**-12**	**-12**	**-12**		
Difference between the two in P/L in total	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**		
Difference between the two in P/L for IFIE	**-212**	**0**	**0**	**0**	**0**	**0**	**-33**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**-245**	
Difference between the two in P/L for ISE	212	0	0	0	0	0	33	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	**245**	