Australian Government
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AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Implementation question discussed by Variable Fee Approach (VFA) focus group – presentation of VFA revenue

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Implementation question discussed by VFA focus group

Should the insurance service result under the variable fee approach (VFA), include non-investment component experience, when the underlying items all vary with the fulfilment cash flows (FCF) and the contractual service margin (CSM)?

In these circumstances, the difference between actual and expected cash flows only impact the entity's share of the fair value of the underlying items via the change in CSM, which in turn is released as insurance revenue over time as insurance contract services are provided.

Hence, if experience is also included in the insurance service result, in addition to the CSM release, an offset adjustment is required in the insurance finance result, so that the overall result reflects just the change in CSM.

Paragraph of IFRS 17 *Insurance Contracts*

Various, including: AASB 17.41, 45, 83, 85, B104 and B101

Background

Under AASB 17 insurance revenue is determined based on expected future cash flows and a margin for profit known as the CSM. Insurance service expense is based on actual incurred amounts, which means the insurance service result will reflect any difference between the expected and actual experience, in addition to the CSM release for that period.

For contracts with participating features under VFA, the conditions for VFA eligibility in paragraph B101 ensure the entity is obliged to pay to the policyholder the net of:

- the fair value of the underlying items; and
- a variable fee (i.e. the amount of the entity's share of the fair value of the underlying items).

Consequently, any change in the entity's share of the fair value of the underlying items adjusts the CSM and the balance of any change to the underlying items adjust the FCF. Therefore, any underwriting experience impacting the underlying items is reflected in the entity's share of the fair value of the underlying items via the change in the CSM, which in turn is released as insurance revenue over time as insurance contract services are provided. As such, the movement in the liability for remaining coverage (LfRC) over the period will absorb all the experience, apart from that already incorporated into the CSM release.

Experience adjustments related to the investment component are excluded from insurance revenue and as a result, the changes in future cash flows adjusting the underlying items **which are not related to the investment component** will be included in the insurance result through insurance revenue and insurance expenses.

In order to appropriately reflect in the total insurance service result the profit that ultimately flows solely to the shareholder (i.e. the CSM release), an adjustment is required to reflect the difference in actual vs expected underwriting experience through the Insurance Finance Expense (IFE).

Discussions held with IASB staff in July 2020, confirmed the above treatment is in line with their current understanding of the intention of the Standard which is to show the impact of underwriting activity (in the insurance service result) separately from the participation (which they see as being included as part of the insurance finance income/expense).

In addition, adjusting the insurance finance expense with the experience is supported by the amendment in IFRS 17.B128(c), which states: "changes in the measurement of a group of insurance contracts caused by changes in the value of underlying items (excluding additions and withdrawals) are changes arising from the effect of the time value of money and financial risk and changes therein".

Is the question pervasive?

The issue affects most insurance industry stakeholders issuing contracts with direct participation features.

Insurance Result under VFA – AASB TRG September 2020

Appendix A

Consider the following example:

- All underlying items vary with the fulfilment cash flows, hence a difference between expected and actual cash flows (e.g. insurance claim variances related to underwriting performance) will impact the underlying items.
- Expected insurance claims at the beginning of the period are CU50, while actual claims are CU100, resulting in a claims variance of CU50 which affects the value of the underlying items at the end of the period by this amount before any CSM release.
- The profit share is 80:20, therefore the claims variance reduces future benefits payable to policyholders by CU40 and the variable fee (for current and future periods) by CU10.
- The CSM release for the period is CU19 which reflects the profit for the period after adjusting for the claims variance.
- Investment income is CU100.

The insurance service result of a loss of CU31 reflects the underwriting performance which adjusts the underlying items (i.e. the negative claims variance of CU50) plus the CSM release of CU19.

The movement in the LfRC over the period reflects not only the recognition of revenue for the period expected to cover insurance events (e.g. expected claims of CU50), but also the impact of the CU50 claims variance. As the latter results in a CU40 reduction in future policyholder benefits plus a CU10 reduction in CSM, which remains in LfRC to the extent it relates to the delivery of future service, with the balance coming through the change in CSM related to service delivered in the period (i.e. the CSM release). Thus, the total insurance service result is inconsistent with both the profit that ultimately flows solely to the shareholder (i.e. the CSM release of CU19) and the change in LfRC.

As such, the recognition of an adjustment of CU50 (reflecting the difference in actual vs expected underwriting experience) is required through the Insurance Finance Income and Expense (i.e. as part of the finance result), to ensure that the ultimate profit is equal to the CSM release of CU19 and consistent with the balance sheet movement (as shown below).

Income statement	
Expected Claims - Insurance	50.0
CSM Release	19.0
Insurance service revenue	**69.0**
Claims - Insurance (actuals)	(100.0)
Insurance service expense	**(100.0)**
Insurance service result	**(31.0)**
Investment income	100.0
Insurance finance expense	(50.0)
Finance result	**50.0**
Profit or loss	**19.0**

Cashflows	
Investment Earnings	100.0
Claims	(100.0)
Net Cash Flow	**0.0**

Balance Sheet	Opening	Closing
Insurance Contract Liabilities	2,000.0	1,981.0
Shareholder Net Equity	0	19.0
Total Liabilities	**2,000.0**	**2,000.0**
Assets	**(2,000.0)**	**(2,000.0)**

Note: Insurance finance expense includes expected adjustment of 100 Dr related to removal of investment income and 50 Cr related to underwriting experience

In summary, under the VFA where the underlying items all vary with the FCF and CSM, an entity:

- shows the full performance of the underwriting activity in the insurance service result, even though in these circumstances, the shareholders portion of the performance is already included in the CSM (balance sheet and P&L); and
- includes an equal and opposite offset adjustment for full performance of the underwriting activity within the Insurance Finance Income and Expense (reflecting IASB staff view that participation impacts on FCF and CSM are a financial risk).

This ensures the ultimate profit only reflects the CSM release for the period and is consistent with the balance sheet movement.