Paper 2—Submission Paper: Loss component

Potential implementation question

1. Accounting treatment for experience adjustments arising from premiums received in the period that relate to future service when the premiums are from an onerous group of insurance contracts and the consequential accounting for the reversal of the loss component from the same onerous group of insurance contracts.

2. This paper compiles arguments that were presented in other papers and notes on the same subject during the May, June and July 2018 IISG meetings and during the IASB IFRS 17 TRG meeting on 26-27 September 2018 (particularly agenda paper 4 "Premium experience adjustments related to current or past service"). Specifically, in the TRG discussion agenda paper 4 on 26-27 September 2018 (paragraph 22), IASB staff noted that when premium variance relates to current or past coverage periods the amount is taken to P&L and presented in insurance revenue.

3. This submission therefore seeks to establish the accounting sequence of reversing a loss component in a financial period given premium experience adjustments that relate to future service and a change in cash flows that is consequential to those adjustments. The submission discusses also the associated presentation and disclosures under IFRS 17. Three Views are presented below, View A, View B and View C.

Fact pattern

- A two year coverage contract is issued with premium of 100 to pay each year
- Death benefit is set at 220. No decrement in the first year and 100% mortality is assumed at end of 2nd year.
- At initial recognition, the contract is determined to be onerous, with PV outgo/ PV inflow/ BEL equal to 220/200/20 respectively and loss component being 20.
- At the end of year 1, there is a variance of -30 during year and also as a result, death benefit is reduced by 60
- There is no variance in decrement and no other cash flows variance in year 1 except the variance in premium
- For simplicity, assume no discounting, risk adjustment and CSM amortization (That is, no coverage service is provided).
- At the 2nd year a CSM is re-established.

Overview of the fact pattern

Description	CU	Description	CU
PV outgo @ initial recognition	220	Expected premium in year 1 @ initial recognition	100
PV inflow @ initial recognition	200	Actual premium in year 1	70
BEL @ initial recognition	20	Expected benefit payment in year 1 @ initial recognition	0
Loss component @ initial recognition	20	Actual benefit in year 1	0
Variance in Premium @ year 1	-30	Expected premium in year 2@ year 1	100
Change in BEL outflows @ year 1 due to premium variance	-60	Actual premium in year 2	100
		Expected benefit payment in year 2 @ year 1	160
		Actual benefit in year 2	160

Paragraphs of HKFRS/IFRS 17 *Insurance Contracts*

Refer to pages 5 to 8 of this paper.

Analysis of the question

4. To reach the correct analysis of the issue we need to analyse the nature of the loss component. IFRS 17 explains that a loss component is recognised when a group of insurance contracts is onerous and this condition means that the outflows plus risk adjustment are greater than the inflows of the group of contracts [Paragraph 47].

5. IFRS 17 is also clear that the loss component subsequent measurement are only reported in P&L so that they reverse promptly the loss previously recognised [paragraph 41(b) and 103(b)(iv)].

6. The liability for remaining coverage for a group that has a loss component will include all of the expected inflows as well as the expected outflows and risk adjustment up to the total inflows. It is from this liability that IFRS 17 requires the insurer to account for the insurance service revenue in line with B120 and subsequent paragraphs. The Loss Component would not generate any insurance service revenue. Instead, its subsequent measurement and derecognition would be reported in the insurance expense line

7. The fact pattern describes a situation when the expected inflows compare with a lower actual receipt of inflows in a given period, which is a negative premium experience variance for future coverage services. The accounting would need to take into account the nature of the loss component and of the liability for remaining coverage as well as the principles on insurance service revenue discussed above.

View A – P&L gross up

8. On receipt of premium:

	DR	CR
Cash (BS)	70	
Insurance service expenses (P&L)	30	
BEL – LRC excl. LC (BS)		100

The premium variance of -30 would decrease the liability for remaining coverage [paragraph B96(a)]:

	DR	CR
BEL – LRC excl. LC (BS)	30	
Loss component – BEL (BS)		30

9. The insurer adjusts the loss component due to the fact that the outflows not covered by inflows are now larger by 30. The total loss component is now 50 [paragraphs 48 & 49].

10. Under View A the expected premium included in the calculation of BEL is 100 while the actual premium received is 70. The difference of 30 needs to be recognised in P&L because the outflows not covered by inflows are now larger.

11. This appears to be contrary to the guidance in B96(a) which states that premium variances for future coverage are adjusted through CSM—thereby, they are not reported through P&L unless they relate to current or past coverage.

12. The financial statements at this point have the following balances (accounting signs are used rather than presentation signs to more easily link back to the fact pattern and the journals):

Assets		*Liabilities*			*Profit or Loss*	
Cash	70	BEL – LRC excl. LC	70		Insurance revenue	Nil
Negative equity	**50**	Loss component – BEL(1)	50		Insurance service expense (Note 1)	50
					Insurance service loss	**50**

Note 1: The insurance service expense amount includes the initial recognition charge to P&L for 20 and the subsequent charge of 30 reported when the premium variance has occurred.

Assuming a different fact pattern where there is coverage service provided during the year, and that the premium experience variance adjustment is related to current or past services, then the insurance result would be a loss of 50 (Insurance revenue of negative 30 and insurance service expense of 20) and the statement of financial position would not change at this point.

However, for the loss component accounting issue discussed in this paper, under View A the accounting for the loss component – BEL would continue to be for 50 and in this case it would account for both the onerous expense and the premium experience variance adjustment.

Change in fulfilment cash flows

13. The insurer then reassesses the future outflows in light of the lower premiums received and determines that there is a positive change for 60 which would allow the full reversal of the loss component to P&L

	DR	CR
Loss component – BEL (BS)	50	
Insurance service expenses (P&L)		50

The remaining changes in the expected outflows would relate to the liability for remaining coverage and they would create a CSM balance:

	DR	CR
BEL – LRC excl. LC (BS)	10	
LRC CSM (BS)		10

At this point the financial statements at the end of year 1 would show the following amounts:

Assets		*Liabilities*			*Profit or Loss*	
Cash	70	BEL – LRC excl. LC	60		Insurance revenue	Nil
Negative equity	**Nil**	CSM – LRC	10		Insurance service expense	Nil
		Loss component – BEL	Nil		**Insurance service loss**	**Nil**

14. Under View A the variance of premium and the changes in fulfilment cash flow that reverse the loss component are all presented in P&L in the insurance service expense line. Given the fact pattern indicated that no coverage service is provided, no insurance revenue is reported. In addition, the "test" in paragraph B120 of IFRS 17 on total insurance revenue to be recognised being equal to the total inflows of 170 (the total premiums paid to the entity) is satisfied when adding the LRC of 70 to the future remaining expected premium to be received of 100. That is, paragraph B120 requires that the total insurance revenue for a group of contracts is the consideration for the contracts (i.e. the amount of premiums paid to the entity).

View B – balance sheet approach

15. On receipt of premium

	DR	CR
Cash (BS)	70	
BEL – excl. LC (BS)		70
Loss component – BEL (BS)		30
BEL – excl. LC (BS)	30	

Premium variance is not recognised through P&L in compliance with B96(a). The loss component is increased through a balance sheet reduction of the "LRC excl. LC (BS)" balance.

The total revenue to be recognised under B120 is equal to the inflows of 170. The financial statements at this point would present the following amounts:

Assets		*Liabilities*			*Profit or Loss*	
Cash	70	BEL – LRC excl. LC	40		Insurance revenue	Nil
Negative equity	**20**	Loss component – BEL	50		Insurance service expense	20
					Insurance service loss	**20**

16. Under View B the change in the loss component does not get reported in P&L in compliance with B96(a) when premium experience variances relates to future coverage period leaving in P&L only the effect of the onerous loss reported at initial recognition date. Under View B though the total revenue from the LRC is lower than the total premium of 170 (BEL – LRC excl. LC of 40 and future inflows of 100). This would require the portion of the expected outflows from the loss component that did not get reported in P&L to be released in the insurance revenue line of the P&L to reconcile it with the requirements of paragraph B120. This appears to be in conflict with the requirement in paragraph 49.

Change in fulfilment cash flows

17. The insurer would then look at the change in assumptions for expected cash flows and concludes that there is a positive change of 60. This is sufficient to reverse the loss reported at initial recognition (20), report the amounts arising from premium variances without recognition through P&L (30) and then create the CSM for 10 [paragraph 50(b)].

	DR	CR
Loss component – BEL (BS)	50	
Insurance service expenses (P&L)		20
BEL – LRC excl. LC		30

Similar to view A, the remaining changes in the expected outflows would relate to the liability for remaining coverage and they would create a CSM balance:

	DR	CR
BEL – LRC excl. LC (BS)	10	
LRC CSM (BS)		10

At the end of year 1 the financial statements are as follows:

Assets		*Liabilities*			*Profit or Loss*	
Cash	70	BEL – LRC excl. LC	60		Insurance revenue	Nil
Negative equity	**Nil**	CSM – LRC	10		Insurance service expense	Nil
		Loss component – BEL	Nil		**Insurance service loss**	**Nil**

18. These are identical to View A. Similar to view A, and given the fact pattern indicated that no coverage service is provided, no insurance revenue is reported and the test in B120 on total insurance revenue to be recognised is passed being equal to the total inflows of 170.

19. The difference between the two views would be in the following disclosures:

IFRS 17 disclosure requirement	*View A*	*View B*
Paragraph 103(b) (iv) changes that relate to future service, ie losses on onerous groups of contracts and reversals of such losses.	The entity would need to disclose that initial onerous losses of 20 and that a subsequent premium experience variance related to future coverage (rather than a change in future cash flows related to future service) caused an additional onerous loss of 30. It would then need to disclose that a change in future cash flows that relate to future service of 50 has reversed such losses.	The entity would need to disclose that initial onerous losses of 20 and that a change that relate to future service of 20 reversed such losses
Paragraph 104(a) "(ii) changes in estimates that do not adjust the contractual service margin, ie losses on groups of onerous contracts and reversals of such losses;"	The disclosure of the reversal of losses on groups of onerous contracts is 50	The disclosure of the reversal of losses on groups of onerous contracts is 20

View C – policy choice

20. Both View A and View B are acceptable and they form part of an entity accounting policy setting in application of IFRS 17.

Paragraphs of HKFRS/IFRS 17 *Insurance Contracts*

47 An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

48 A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:

a) unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and
b) for a group of insurance contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items.

Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in profit or loss to the extent of that excess.

49 An entity shall establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised applying paragraphs 47–48. The loss

component determines the amounts that are presented in profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue.

50 After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:

(a) the subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:

(i) the loss component of the liability for remaining coverage; and

(ii) the liability for remaining coverage, excluding the loss component.

(b) any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity's share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

51 The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying paragraph 50(a) are:

(a) estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;

(b) changes in the risk adjustment for non-financial risk recognised in profit or loss because of the release from risk; and

(c) insurance finance income or expenses.

52 The systematic allocation required by paragraph 50(a) shall result in the total amounts allocated to the loss component in accordance with paragraphs 48–50 being equal to zero by the end of the coverage period of a group of contracts.

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 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.

103 An entity shall separately disclose in the reconciliations required in paragraph 100 each of the following amounts related to insurance services, if applicable:

(a) insurance revenue.

(b) insurance service expenses, showing separately:

  (i) incurred claims (excluding investment components) and other incurred insurance service expenses;

  (ii) amortisation of insurance acquisition cash flows;

  (iii) changes that relate to past service, i.e. changes in fulfilment cash flows relating to the liability for incurred claims; and

  (iv) changes that relate to future service, i.e. losses on onerous groups of contracts and reversals of such losses.

B96 For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c);

(b) changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);

(c) differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c); and
(d) changes in the risk adjustment for non-financial risk that relate to future service.

B120 The total insurance revenue for a group of insurance contracts is the consideration for the contracts, i.e. the amount of premiums paid to the entity:
(a) adjusted for a financing effect; and
(b) excluding any investment components.

B121 Paragraph 83 requires the amount of insurance revenue recognised in a period to depict the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following amounts:
(a) amounts related to the provision of services, comprising:
    (i) insurance service expenses, excluding any amounts allocated to the loss component of the liability for remaining coverage;
    (ii) the risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and
    (iii) the contractual service margin.
(b) amounts related to insurance acquisition cash flows.

B122 Insurance revenue for a period relating to the amounts described in paragraph B121(a) is determined as set out in paragraphs B123–B124. Insurance revenue for a period relating to the amounts described in paragraph B121(b) is determined as set out in paragraph B125.

B123 Applying HKFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying HKFRS 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;
    (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;
    (v) insurance acquisition cash flows (see paragraph B125); and
    (vi) derecognition of liabilities transferred to a third party.
(b) changes that relate to services, but for which the entity does not expect consideration, i.e. increases and decreases in the loss component of the liability for remaining coverage (see paragraphs 47–52).

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), excluding:
    (i) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(a);
    (ii) repayments of investment components;
    (iii) amounts 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)); and
    (iv) insurance acquisition expenses (see paragraph B125).

(b) the change in the risk adjustment for non-financial risk, excluding:
    (i) changes included in insurance finance income or expenses applying paragraph 87;
    (ii) changes that adjust the contractual service margin because they relate to future service applying paragraphs 44(c) and 45(c); and

   (iii) amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(b).

(c) the amount of the contractual service margin recognised in profit or loss in the period, applying paragraphs 44(e) and 45(e).

B125 An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.