Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Meeting Summary
Hong Kong Insurance Implementation Support Group (HKIISG)
07 May 2020

Attendance
HKICPA representatives
Ernest Lee, Financial Reporting Standards Committee (FRSC)
Michelle Fisher, Deputy Director, Standard Setting
Tiernan Ketchum, Associate Director, Standard Setting

HKIISG members
Erik Bleekrode, KPMG China
Dennis Chiu, (representing Sai-Cheong Foong), AIA Group Limited
Marcus Chung (representing Norman Yao), AXA China Region Insurance Company Limited
Joyce Lau, Target Insurance Company Limited
Sally Wang, Dajia Insurance Group
Kevin Wong, FWD Life Insurance Company (Bermuda) Limited
Alexander Wong, HSBC Life
Steven To (representing Tracey Polsgrove), Manulife Asia
Candy Ding, Ping An Insurance (Group)
Matsuta Ng (representing Nigel Knowles), Prudential Hong Kong Limited
Ronnie Ng, China Overseas Insurance Limited
Doru Pantea, EY Hong Kong
Francesco Nagari, Deloitte Hong Kong
Chris Hancorn, PwC Hong Kong

Guests
James Anderson, KPMG China
Ian Farrar, PwC Hong Kong

Apologies

Discussion objectives:
Readers are reminded that the objective of the HKIISG is not to form a group consensus or decision on how to apply the requirements of HKFRS/IFRS 17 *Insurance Contracts*. The purpose of HKIISG is to share views on questions raised by stakeholders on the implementation of HKFRS 17. Refer to HKIISG terms of reference.

The meeting summaries of HKIISG discussions are solely to provide a forum for stakeholders to follow the discussion of questions raised. Stakeholders may reference HKIISG member views when reconsidering their own implementation questions—but should note that the meeting summaries do not form any interpretation or guidance of HKFRS/IFRS 17.

1. Update since last meeting

HKICPA representatives provided the HKIISG members with a brief update since the last meeting (13 March 2020). This update noted that HKICPA staff had discussed key comments made and local submissions raised during the March 2020 HKIISG meeting with IASB staff. Those comments and local submissions are summarised in the March 2020 HKIISG meeting summary.

An HKIISG member observed that the IASB has tentatively elected to retain its existing educational guidance published on IFRS 17, but not to update that guidance for the amendments to IFRS 17. This member expressed the view that it would be more helpful, and would avoid confusion in practice, were that guidance to either be updated or retired. HKICPA representatives noted that the Institute will consider the need to update its own educational guidance and the effect of the amendments thereon.

2. Local submission: Accounting for premium received upfront

This summary should be read in conjunction with the local submission (Paper 2[1]). Please refer to the full submission for the detailed fact pattern and analysis.

This submission analyses the accounting for premium received upfront relating to an insurance contract that is a single contract for legal purposes, but which comprises several contracts in substance for accounting purposes. The single legal contract is viewed as comprising several contracts in substance because of a unilateral cancellation clause held by the issuer, which gives the issuer the practical ability to terminate its substantive obligations with 30 days' notice, in exchange for providing the policyholder a pro-rata refund of the premium received. As such, a 1 year legal contract is seen for accounting purposes as comprising 12 in-substance contracts. The submission presents two views:

- View A: Each of the 12 in-substance contracts should be recognised at the time the premium is received (day 1). As such, the liability for remaining coverage should be recognised at the same time for all 12 in-substance contracts, albeit with future start dates for their respective coverage periods.
- View B: The upfront premium relates entirely to the initial 30-day in-substance contract. The remaining 11 in-substance contracts would not be recognised until the first contract ends. As such, the liability for remaining coverage will include the expected claims for the current 30-day period, as well as an estimated refund of premium.

Paper 2's presenter noted that members previously discussed the effect of short-term termination clauses on contract boundaries during the 14 December 2018 HKIISG meeting[2]. At that meeting, members generally observed that when applying IFRS 17 requirements to these contracts, it is quite clear that the termination clauses will create a contract boundary.

Among HKIISG members who commented on Paper 2, it was noted:

- Among those who supported View A:
  - A member commented that View A appeared more appropriate and in line with the Standard. This member considered that was IFRS 17.25 to be applied under View B, this could lead to a scenario where the first 30-day contract was profitable while the remaining 11 contracts were onerous, which would not be an appropriate outcome.
  - The presenter of Paper 2 supported View A for the rationale presented in the paper.
  - View A was generally seen as being operationally easier to implement than View B.
- Among those who supported View B:
  - A few members were supportive of View B for the rationale set out

[1] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/hkfrs-17/2020-Agenda-papers-and-meeting-summaries/paper20507.pdf

[2] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/hkfrs-17/2018-Agenda-papers-and-meeting-summaries/msdec14.pdf

in Paper 2, to an extent. These members noted that the cancellation clause does create a contract boundary. As a result, the question arises of how to account for the portion of the premium related to the contracts arising after the first 30-day period. A potential argument is that in order to get the first 30 days of coverage, the policyholder is required to pay for the entire 12 months. As such, the rationale in View B holds that the annual premium relates entirely to the initial 30-day contract. One member similarly questioned why under View A it could be argued that one does not consider that the full amount of premium needs to be paid prior to getting the first 30 days of coverage.

    - The presenter explained that the legal and in-substance timing of the premium is negotiated between the contractual parties, who have agreed a bulk transaction with the premium paid up-front. IFRS 17.25-26 and the timing of the contract's issuance hence support View A.

  - Under View B, the premium related to the remaining contracts could be considered a prepayment and thereafter the question arises if that should be treated as a separate prepayment or a part of the liability for remaining coverage.
  - One member took a "modified" View B. This member generally agreed with the rationale and accounting for View B for non-onerous contracts; however, disagreed with the paper's proposed View B accounting for onerous contracts. The member argued that were the entity in question expecting a loss, it would exercise its cancellation right in order to avoid the loss. Hence, losses for the remaining months would not be taken into account.
  - One member noted that one could argue against View A in that an insurer may be considered not to have a substantive obligation until it has decided not to exercise its cancellation rights. As such, premium related to the forward starting contracts would be accounted for as a prepayment until that initial cancellation period had passed, at which point it would form part of the insurance contract liability.
    - The presenter argued in response that IFRS 17 requires for an entity's own behaviour to be taken into account in measuring insurance contracts. Given the contract has been issued, is forward starting, and that payment has been received, then the substantive obligation still exists and it should be measured against the entity's own behaviour with regards to the exercise of the cancellation right. Only if none of the conditions in IFRS 17.25-26 were met could there be a situation of non-recognition, which is not the case here. Furthermore, IFRS 17.2 indicates that obligations arise when the contract is entered into.

- One member questioned (1) whether the acquisition costs should be attributed to each in-substance contract, and (2) when trying to allocate the upfront premium across the 12 in-substance contracts, how would the pattern be determined.
  - In response, the presenter: (1) noted acquisition costs should not trigger onerous contract accounting under either View A or B. Under View A, a portion of the acquisition cost would be allocated to each of the in-substance contracts. Under View B, the liability should be able to absorb the total cost, either as a deduction from the excess of the coverage portion of the liability, or recognition as

a pre-coverage asset that would be rolled forward and taken down to zero over time; and (2) posited that risks for the respective in-substance periods need to be considered, as such, the liability for remaining coverage needs to be accounted for in view of the risk adjusted revenue principle of the Standard. A straight-line, "divide by 12 months" method would generally not be appropriate when the expected pattern of release of risk during each of the coverage periods differs significantly from the passage of time (IFRS 17.B126).

- A couple of members questioned the fact pattern, in particular whether the cancellation clause as described would be substantive. These members noted that such an outcome could obviously change the analysis, but for the purpose of the conversation they presumed that it was substantive.
- A couple of members expressed ambivalence towards the two views.
    - One member preferred View B under the present environment as insurance liabilities would be smaller at a point in time, however looking forward to a risk-based capital environment, View A could be preferable.
- One member questioned whether it could be argued that there is only one contract from an accounting perspective. This member referenced guidance in IFRS 17.B24, B61 and 35 as informing the interpretation of IFRS 17.2, and questioned whether an argument could be made that given the first 30-day contract is bounded at 30 days, the remaining 11 contracts can be ignored at inception.
    - The presenter did not think that such an argument could be made, and that the cancellation clause does create multiple in-substance contracts. For example, if an entity sold 12 legal contracts on day 1 which were all paid for upfront, and 11 started at a future date, all 12 should still be recognised.
    - A member commented that the only means by which it could be argued there is one contract would be if the cancellation clause was non-substantive.
- A member commented that as a practical matter, insurers need to consider their existing cancellation clauses and balance their legal and business needs with the effect that such clauses may have under IFRS 17.

3. Local submission: Accounting treatment for onerous contracts

This summary should be read in conjunction with the local submission (Paper 3[3]). Please refer to the full submission for the detailed fact pattern and analysis.

This submission asks:

- Question 1: What discount rates should be used to calculate the changes to be reported in profit or loss for changes in the estimates of future cash flows relating to future services that establish, increase or reverse a loss component (LC).
- Question 2: Should the measurement of the loss component for presentation in the statement of financial position use the same or a different discount rate as the rate determined in Question 1.
    - View A: The **locked-in rate** described in IFRS 17.B72(c) is used to

[3] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/hkfrs-17/2020-Agenda-papers-and-meeting-summaries/paper30507.pdf

calculate the changes to be reported in profit or loss. LC is measured in statement of financial position using the **current rate**.
    - View B: The **current rate** described in IFRS 17.B72(a) is used to calculate the changes to be reported in profit or loss. LC is measured in statement of financial position using the **current rate**.
    - View C: The **current rate** described in IFRS 17.B72(a) is used to calculate the changes to be reported in profit or loss. LC is measured in statement of financial position using the **current rate** (with modification to how the effect of time value of money is accounted for in other comprehensive income – see submission for details).
- Question 3: If the answer to Question 1 is the current rate for profit or loss (View B or C), then when the contractual service margin (CSM) is re-established following a loss reversal event, what is the locked-in discount rate to be used for CSM interest accretion and for measuring the unlocking of the CSM from that date?
    - View 1: Use interest rate determined for CSM at initial recognition.
    - View 2: Establish new locked-in rate (current rate as of the date the loss reversal occurred).

Among HKIISG members who commented on Paper 3, it was noted:
- A few members supported View A for Question 1-2. Those members generally agreed that the logic of the Standard as noted in Paper 3 leads to View A, with particular reference to IFRS 17.44(c) and B72(c).
    - A few members noted that under View A, the effect of a change in discount rates would not be reflected in the insurance service result figure in the statement of comprehensive income, given the use of a locked-in rate. This effect could be particularly pronounced given the recent interest rate environment, and could potentially be unintuitive to users of financial statements. Nevertheless, these members felt that the Standard requires View A, and this effect is as a result of the principles of the general measurement model (GMM).
- A member supported View B for Question 1-2. This member argued that IFRS 17 does not prescribe the LC to be measured at a locked-in rate. This member considered that View B would be the most logical conclusion and what the Standard intended, and would also result in more economically sensible accounting than View A.
    - This member also considered that View A could result in accounting that failed to represent the underlying economics in the statement of comprehensive income (for similar reasons as noted by View A's supporters).
- No members expressed support for View C.
- Among those who commented on Question 3:
    - A few members preferred View 1 on the basis that IFRS 17 requires the CSM to be measured applying the discount rate determined on initial recognition, and a re-establishment of a CSM due to a loss reversal is not an initial recognition event. Rather, it's a recreation of the same CSM, and as such, that CSM should be measured using the same rate as was determined at its initial recognition.
    - The presenter preferred View 2 on the basis that the CSM under the GMM comprises two sources of profit: (1) the undiscounted cash flow advantage, and (2) the time advantage. The GMM

requires the time advantage to be measured at one point of time – the initial recognition of the contract, after which the CSM crystallizes the time advantage via its locked-in rate. Hence, given that the LC should be measured at the current rate in the statement of financial position, if that LC is reversed, the CSM should be recreated in the same manner as it would be when it was initially established (i.e. with a new locked-in rate being the current rate at the time of loss reversal).

- A couple of members took an alternative view from those presented in Paper 3. These members commented that IFRS 17 is silent on how to perform the systematic allocation required when allocating subsequent changes in fulfilment cash flows between the loss component and remaining liability for remaining coverage. These members argued that entities should make a policy choice as to how they will elect to perform this allocation.
  - One of these members suggested that IFRS 17 does not require measurement of the LC at a current rate on the statement of financial position. Rather, only the total liability for remaining coverage is required to be measured at a current rate. This member noted that having the choice as to how to measure the LC, for instance symmetrically to the CSM, would also be easier to operationalize.
    - The presenter of Paper 3 however took the view that the LC must be measured at a current rate on the statement of financial position regardless of how it is accounted for in the statement of comprehensive income.

4. Educational guidance: Contractual service margin

HKIISG members were provided with draft educational guidance prepared by HKICPA representatives and certain HKIISG members. This draft guidance considers the recognition of the CSM in profit or loss for insurance contracts that provide multiple, heterogeneous services.

HKICPA representatives noted that this topic had been identified as an area involving technical complexity and judgement, particularly given the existence of such contracts in Hong Kong and Asia Pacific. Most recently, discussions around this topic were brought to the HKIISG in December 2019 (Paper 3). HKICPA representatives explained this guidance is designed to respond to this and assist implementation by summarizing the relevant requirements and providing illustrative examples of how those requirements could be implemented.

Among HKIISG members who commented on Paper 4, it was noted:

- Members were generally supportive of the HKICPA developing local educational guidance with the assistance of the HKIISG.
- A few members noted the importance of ensuring that this guidance does not interpret IFRS Standards or otherwise create unintended consequences, and that it drafted in such a format that it does not give the reader an incorrect impression as to its level of authority or as to the accounting options actually available to preparers. Some members also commented that the fact patterns and analyses should not be overly complex or detailed.
  - HKICPA representatives emphasised that such guidance would not be authoritative or prescriptive, but rather would be designed

to assist its readers to understand the relevant requirements and observe a potential application of those requirements in a simplified format. HKICPA representatives also noted that this guidance would go through the Institute's due process including review by the Financial Reporting Standards Committee, who will consider if any areas require discussion with the IASB staff.

Conclusion

Members generally supported the HKICPA continuing to develop and publish local educational guidance on the recognition of the CSM in profit or loss for contracts that provide multiple services.

Next steps

Institute staff will share the local submissions with the IASB project team.

Members will provide the HKICPA representatives with comments on the draft educational guidance by the start of June 2020. HKICPA representatives will continue working with members and other stakeholders to develop the guidance with the intention to bring it to the Financial Reporting Standards Committee in Q3 2020.