Should the change in credit risk on collectability of premiums be presented in insurance revenue or insurance finance income and expense? (Deloitte)

Background:

The purpose of this paper is to explore whether the change in credit risk (recoverability of insurance premium receivables) on premiums in relation to remaining service and past services should be reflected in 'insurance revenue' or 'insurance finance income and expense'.

Given the similarities in concepts between IFRS 15 and IFRS 17 of which IFRS 17 was built, comparison is made with IFRS 15. Under IFRS 15, an entity should only take a customer's credit risk into account when determining the discount rate used to adjust the promised consideration for a significant financing component, and not when determining the transaction price under the contract.

IFRS 15:47 specifies that the transaction price is the amount to which an entity expects to be entitled rather than the amount it expects to collect. The determination of the amount to which an entity expects to be entitled is not affected by the risk of customer default (i.e. the customer's credit risk). IFRS 15:BC260 and 261 explain that this approach was adopted to enable users of the financial statements to analyse 'gross' revenue (i.e. the amount to which the entity is entitled) separately from the effect of receivables management (or bad debts).

However, when the timing of payments due under the contract provides the customer with a significant benefit of financing, the transaction price is adjusted to reflect the time value of money. IFRS 15:BC239 indicates that, in such circumstances, an entity will consider a customer's credit risk in determining the appropriate discount rate to apply.

While under IFRS 17:B120 and B126, it seems to suggest the insurance revenue should be adjusted for the credit risk as the insurance revenue is the amount of premium received or the amount of premium expected to be received.

And under IFRS 17:106 a(iv) and B124(d), the insurance revenue should 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. The changes include experience adjustments for premium receipts other than those that relate to future service. Thus if the expected premiums to be received changes, the amount of insurance revenue should be adjusted.

Questions:

1. Should the change in credit risk of premiums in relation to *remaining service* be reflected in insurance revenue or insurance finance income and expense?

2. If we conclude that premiums due for past coverage form part of the liability for incurred claims, how do we reflect the non-collectability of premium: as an experience adjustment to insurance revenue for past service or insurance finance income and expense?

Alternative Views:

Question 1: Should the change in credit risk of premiums in relation to *remaining service* be reflected in insurance revenue or insurance finance income and expense?

View A: Insurance revenue

IFRS 17:B120 and B126 suggest the insurance revenue should be adjusted for the amount of premium received and the premium expect to be received. If the amount of premium received and expect to be received changes in the period, the amount of insurance revenue should be adjusted. The total insurance revenue in a group of contracts is equal to amount of premiums received by the insurer from that group, after excluding the investment component. In the premium allocation approach the insurance revenue is recognised only to the extent of cash receipts.

Supporters for this view also argue credit risk is non-financial (as IFRS Standards define financial risk in a way that would exclude the risk of non-payment of a specified debtor), so should not be included in insurance finance income or expense but should be included in insurance revenue. As such, the adjustment for changes in credit risk for the recoverability of insurance premium receivables should always go to insurance revenue line.

View B: Insurance finance income and expense

Insurance finance income and expense arise from the effect of financial risk and changes in financial risk. The change of the expected credit risk is one of the changes in financial risk, thus changes of premium credit risks related to remaining service should be reflected in insurance finance income and expense.

Supporters for view B also analogise with IFRS 15 on 'Effect of a customer's credit risk on the determination of the transaction price'. Under IFRS 15, the transaction price is the amount to which an entity expects to be entitled rather than the amount it expects to collect. The revenue line is normally not adjusted for customer credit risk unless there is a significant financing component. In IFRS 17 the adjustment for financing component is done through discounting with the effect reflected in insurance finance income or expense. Using this analogy, the change in policyholder credit risk in relation to remaining service should be reflected in insurance finance income and expense rather than in insurance revenue line.

IFRS 17 prohibits changes in expected credit losses adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service. Accordingly, any changes in expected credit losses are economic events that the Board decided should be reflected as gains and losses in profit or loss when they occur. This is consistent to the credit-impaired financial assets accounted for in accordance with IFRS 9. [IFRS 17:BC309]

View C: An entity should make an accounting policy choice as where to present the changes on credit risks in relation to premiums for remaining services, either in insurance revenue or in insurance finance income and expense.

Question 2: If we conclude that premiums due for *past coverage* form part of the liability for incurred claims, how do we reflect the non-collectability of premium: as an experience adjustment to insurance revenue for past service or insurance finance income and expense?

View A: The non-collectability of premium should be included in the insurance revenue line as an experience adjustment.

Under IFRS 17:106 a(iv) and B124(d), the insurance revenue should 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. The changes include experience adjustments for premium receipts other than those that relate to future service. Thus if the expected premiums to be received change for the past service, the amount of insurance revenue should be adjusted.

In addition, the credit risk for premium receivables is a non-financial risk (as IFRS Standards define financial risk in a way that would exclude the risk of non-payment of a specified debtor); thus it should not be included in the insurance finance income and expense but should be included in insurance revenue line.

View B: The non-collectability of premium should be adjusted under insurance finance income and expense as credit risk is a financial risk and should be reflected in insurance finance income and expense. The arguments for this view are similar as for View B for Question 1. Because the coverage has expired and all the service has been provided, resulting in premiums due being recorded in liability for incurred claims, supporters of this view draw further analogy with IFRS 15 and treatment of bad debts. Supporters of this view also regard the contractual term of premium being due after the provision of coverage (since had the premium was due earlier and remained unpaid, insurer would have cancelled the contract) as a type of financing for the policyholder with the resulting risk of collectability.

View C: An entity should make an accounting policy choice as where to present the changes on credit risks in relation to past services, either in insurance revenue or in insurance finance income and expense.

Technical References:

IFRS 17:106

For insurance contracts issued other than those to which the premium allocation approach described in paragraphs 53–59 has been applied, an entity shall disclose an analysis of the insurance revenue recognised in the period comprising:

(a) the amounts relating to the changes in the liability for remaining coverage as specified in paragraph B124, separately disclosing:
   i. the insurance service expenses incurred during the period as specified in paragraph B124(a);
   ii. the change in the risk adjustment for non-financial risk, as specified in paragraph B124(b); and
   iii. the amount of the contractual service margin recognised in profit or loss because of the transfer of insurance contract services in the period, as specified in paragraph B124(c); and.
   iv. other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service as specified in paragraph B124(d).

(b) the allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows (see paragraph B125).

IFRS 17:B120

The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:

(a) adjusted for a financing effect; and
(b) excluding any investment components.

IFRS 17: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
   ii. remaining coverage applying paragraph 51(a);
   iii. repayments of investment components;
   iv. 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));
   v. insurance acquisition expenses (see paragraph B125); and.
   vi. the amount related to the risk adjustment for non-financial risk (see (b)).

(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).

(d) other amounts, if any, for example, experience adjustments for premium receipts other than those that relate to future service (see paragraph B96(a)).

IFRS 17:B126

When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of insurance contract services coverage:

(a) on the basis of the passage of time; but
(b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

IFRS 17 BC309

IFRS 17 prohibits changes in expected credit losses adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service. Accordingly, any changes in expected credit losses are economic events that the Board decided should be reflected as gains and losses in profit or loss when they occur. This would result in consistent accounting for expected credit losses between reinsurance contracts held and purchased, and originated credit-impaired financial assets accounted for in accordance with IFRS 9.

IFRS 17 Appendix A – Defined terms

Financial risk

The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

IFRS 15:47

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.