Paper 5

## How to determine the currency denomination of an insurance contract with cash flows denominated in multiple currencies (Deloitte)

### Background

IFRS 17:30 states that *"an entity shall treat the group of contracts, including the contractual service margin, as a monetary item."* Any effect of changes in exchange rates of the currency of the CSM are reported in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*. IAS 21:8 states that *"Monetary items are units of currency held or assets and liabilities to be received or paid in a fixed or determinable number of units of currency."* IFRS 17 requires a group of insurance contact to be treated as a monetary items as a whole, even though its measurement is made up of the liability for remaining coverage and the liability for incurred claims. The CSM only relates to the former.

When all the cash flows for the contracts within a group are denominated in a single currency, it seems clear the insurance contract is denominated in that single currency and that IFRS 17 requires the currency for the CSM to be the same as the currency of the underlying cash inflows and outflows.

However, contracts may comprise cash flows in multiple currencies and it is useful to establish the guidance to determine in which currency to denominate an insurance contract before determining the currency for the CSM of the group of insurance contracts in which that contract belongs.

When fulfilment cash flows of a contract are denominated in multiple currencies, IFRS 17 does not provide guidance on the currency in which the insurance contract is denominated.

For example, insurance contracts may have premiums in one currency, claims in another, and expenses in yet a third different currency.

This paper considers the currency denomination of a single insurance contract with cash flows denominated in multiple currencies. Given the estimate of the present value of the future cash flows is the only element of an insurance contract that is calculated at that level, the currency of the CSM for a group of contracts and the currency of the risk adjustment will be discussed in a separate future paper.

### Question

In which currency is the estimate of future cash flows from an insurance contract denominated when its cash flows are denominated in different currencies and at which point is that determined? E.g. a contract has its premium in one currency, claims in another currency and expenses in a third currency, with all currencies different to the insurer's functional currency.

## Views

**View 1 – The insurance contract is denominated in the currency of the premium inflows, with such assessment done at initial recognition of the contract and not subsequently reassessed.**

An insurance contract is denominated in the currency of its premium because it is the dominant cash flow in all profitable contracts and its currency has the greatest impact on the overall currency of the contract. The currency denomination for the insurance contract is determined at the initial recognition of the insurance contract and is not reassessed subsequently.

Supporters of this view argue that this approach provides a direct connection to the issue of determining the currency of the impact of a contract's cash flows (and their changes) on the group CSM balance. The interaction between IFRS 17:30 (the principle that the whole carrying amount of a group of insurance contracts is a monetary item), IFRS 17:44(d) and 45(d) (the adjustment of the CSM for the effect of currency exchange differences) and IFRS 17:92 (the principle to present foreign exchange gains and losses in P&L/OCI) requires a close alignment of the CSM to the currency of the cash flows that produce its initial measurement and the determination of an associated number of currency units denominated in the resulting currency.

**View 2 – The insurance contract is denominated in the currency of the "predominant" cash flows, with such assessment done at initial recognition of the contract and not subsequently reassessed.**

Under this view, the insurance contract is denominated in the currency of the predominant cash flows. Similar to View 1, the currency denomination for the insurance contract is determined at the initial recognition of the insurance contracts and is not reassessed subsequently. This means that the currency in which the insurance contract is denominated, once determined at initial recognition, does not change even when the predominant currency of the fulfilment cash flows changes over the lifetime of the contract (e.g. following collection or disbursement of cash flows in a particular currency that were previously expected and dominant). Supporters of View 2 acknowledge that 'predominant' is not a defined term in IFRS, thus the application of View 2 requires judgment.

Supporters of this view argue that it aligns with the view set out in IFRS 17:BC277-BC278 whereby the IASB viewed the whole of the insurance contract as a monetary item because the measurement in IFRS 17 is largely based on estimates of future cash flows, resulting in the whole contract also being accounted for as a single monetary item (i.e. inclusive of its contribution to the CSM of the group of contracts in which the particular contract belongs).

Supporter of View 2 argue that View 1 is actually an application of View 2 when the predominant cash flows are the premiums. However, View 1 does not address cases in which the premium cash flows are not the predominant cash flows, such as for onerous contracts. At initial recognition IFRS 17 requires all onerous contracts to be in a group of contracts of their own.

**View 3 – The insurance contract is not denominated in any particular currency ("dual currency bonds issued" approach), with all foreign currency cash flows translated to the entity's functional currency.**

Supporters of View 3 analogize to the accounting for dual currency bonds issued in IFRS 9:B4.3.8(c) where a single contractual arrangement has multiple currencies with each foreign currency element being accounted for under IAS 21. Under View 3, an insurance contract with multiple currencies would require the insurer to isolate foreign currency cash flows and translate them into the functional currency as if they were a separate streams of cash flows.

In addition, supporters of View 3 would argue that all contracts that have their cash flows with the same mix of currencies have "similar risks" and belong to the same portfolio if all of the other risks are similar and they are "managed together".

Applying View 3, the resulting net inflow or net outflow at initial recognition of a contract with multi-currency cash flows contributes to the CSM balance of the group of contracts it belongs to, as determined by translating the foreign currency net inflow or net outflow into the functional currency of the insurer and then applying IFRS 17:38 for the group.

The CSM of insurance contracts with multiple currency cash flows will always be denominated in the functional currency of the entity. This is consistent with its nature of unearned profit. This accounting treatment is aligned with IAS 21:21 and offers an analogy to the treatment of a prepayment of future services under IFRS 15 Revenue from Contracts with Customers, as interpreted in IFRIC 22 Foreign Currency Transactions and Advance Consideration. Although the IFRS 15/IFRIC 22 analogy is to the accounting treatment of a non-monetary item, supporters of View 3 argue that this is admitted in IFRS 17:B277 as a characteristic of the CSM, which is a deferral of profit to be recognised as services are provided, thus making the analogy to IFRS 15/IFRIC 22 on the accounting for a prepayment of future services a pertinent analogy to interpret the interaction between IFRS 17 and IAS 21.

Finally, supporters of View 3 note that IFRS 17:44(d) and 45(d) require the CSM to include "the effect of any currency exchange differences on the contractual service margin" and that under View 3 these gains and losses would only arise when the CSM denominated in the insurer's functional currency is translated in a different presentation currency.

## Technical references

IFRS 17:30 When applying IAS 21 "The Effects of Changes in Foreign Exchange Rates" to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the contractual service margin, as a monetary item.

IFRS 17:38 The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides insurance contract services in the future. An entity shall measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that, unless paragraph 47 (on onerous contracts) or paragraph B123A (on insurance revenue relating to paragraph 38(c)(ii)) applies, results in no income or expenses arising from:

a) the initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;
b) any cash flows arising from the contracts in the group at that date;
c) the derecognition at the date of initial recognition of:
   i. any asset for insurance acquisition cash flows applying paragraph 28C; and
   ii. any other asset or liability previously recognised for cash flows related to the group of contracts as specified in paragraph B66A.

IFRS 17:44 For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

a) the effect of any new contracts added to the group (see paragraph 28);
b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);
c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:
   i. such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or
   ii. such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
d) the effect of any currency exchange differences on the contractual service margin; and
e) the amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting

period (before any allocation) over the current and remaining coverage period applying paragraph B119.

IFRS 17:45 For insurance contracts with direct participation features (see paragraphs B101–B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

a) the effect of any new contracts added to the group (see paragraph 28);
b) the change in the amount of the entity's share of the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:
   i. paragraph B115 (on risk mitigation) applies;
   ii. the decrease in the amount of the entity's share of the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or
   iii. the increase in the amount of the entity's share of the fair value of the underlying items reverses the amount in (ii).
c) the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:
   1. paragraph B115 (on risk mitigation) applies;
   2. such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or
   3. such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
d) the effect of any currency exchange differences arising on the contractual service margin; and
e) the amount recognised as insurance revenue because of the transfer of insurance contract services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

IFRS 17:92 Paragraph 30 requires an entity to treat an insurance contract as a monetary item under IAS 21 for the purpose of translating foreign exchange items into the entity's functional currency. An entity includes exchange differences on changes in the carrying amount of groups of insurance contracts in the statement of profit or loss, unless they relate to changes in the carrying amount of groups of insurance contracts included in other comprehensive income applying paragraph 90, in which case they shall be included in other comprehensive income.

IFRS 17:BC277 When applying IAS 21 *"The Effects of Changes in Foreign Exchange Rates"*, the fulfilment cash flows are clearly monetary items. However, the contractual service margin component might be classified as non-monetary because it is similar to prepayments for goods and services. The Board decided that it would be simpler to treat all components of the measurement of an insurance contract denominated in a single currency as either monetary or non-monetary. Because the measurement in IFRS 17 is largely based on estimates of future cash flows, the Board concluded that it is more appropriate to view an insurance contract as a whole as a monetary item.

IFRS 17:BC278 Accordingly, IFRS 17 requires an insurance contract to be treated as a monetary item for foreign currency translation in applying IAS 21. This applies for both the fulfilment cash flows and the contractual service margin. The Board's conclusion that the insurance contract is a monetary item does not change if an entity measures a group of insurance contracts using the simplified approach for the measurement of the liability for remaining coverage.

IAS 21:8 The following terms are used in this Standard with the meanings specified:

Closing rate is the spot exchange rate at the end of the reporting period.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.)

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

A group is a parent and all its subsidiaries.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

IAS 21:21 A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

IFRS 9:B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

[omitted text]

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IAS 21 The Effects of Changes in Foreign Exchange Rates requires foreign currency gains and losses on monetary items to be recognised in profit or loss.

IFRIC 22 Foreign Currency Transactions and Advance Consideration

References
The Conceptual Framework for Financial Reporting (footnote 1)
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
IAS 21 The Effects of Changes in Foreign Exchange Rates

Background

1. Paragraph 21 of IAS 21 The Effects of Changes in Foreign Exchange Rates requires an entity to record a foreign currency transaction, on initial recognition in its functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency (the exchange rate) at the date of the transaction. Paragraph 22 of IAS 21 states that the date of the transaction is the date on which the transaction first qualifies for recognition in accordance with IFRS Standards (Standards).
2. When an entity pays or receives consideration in advance in a foreign currency, it generally recognises a non-monetary asset or non-monetary liability (footnote 2) before the recognition of the related asset, expense or income. The related asset, expense or income (or part of it) is the amount recognised applying relevant Standards, which results in the derecognition of the non-monetary asset or non-monetary liability arising from the advance consideration.
3. The IFRS Interpretations Committee (the Interpretations Committee) initially received a question asking how to determine 'the date of the transaction' applying paragraphs 21–22 of IAS 21 when recognising revenue. The question specifically addressed circumstances in which an entity recognises a non-

monetary liability arising from the receipt of advance consideration before it recognises the related revenue. In discussing the issue, the Interpretations Committee noted that the receipt or payment of advance consideration in a foreign currency is not restricted to revenue transactions. Accordingly, the Interpretations Committee decided to clarify the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income when an entity has received or paid advance consideration in a foreign currency.

Scope

4. This Interpretation applies to a foreign currency transaction (or part of it) when an entity recognises a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration before the entity recognises the related asset, expense or income (or part of it).
5. This Interpretation does not apply when an entity measures the related asset, expense or income on initial recognition:
   a) at fair value; or
   b) at the fair value of the consideration paid or received at a date other than the date of initial recognition of the non-monetary asset or non-monetary liability arising from advance consideration (for example, the measurement of goodwill applying IFRS 3 Business Combinations).
6. An entity is not required to apply this Interpretation to:
   a) income taxes; or
   b) insurance contracts (including reinsurance contracts) that it issues or reinsurance contracts that it holds.

Issue

7. This Interpretation addresses how to determine the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration in a foreign currency.

Consensus

8. Applying paragraphs 21–22 of IAS 21, the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) is the date on which an entity initially recognises the non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration.
9. If there are multiple payments or receipts in advance, the entity shall determine a date of the transaction for each payment or receipt of advance consideration.

Footnotes

1 The reference is to the Conceptual Framework for Financial Reporting, issued in 2010 and in effect when the Interpretation was developed.

2 For example, paragraph 106 of IFRS 15 Revenue from Contracts with Customers requires that if a customer pays consideration, or an

entity has a right to an amount of consideration that is unconditional (ie a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).