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STAFF PAPER

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Project	Transition Resource Group for IFRS 17 *Insurance Contracts*		
Paper topic	Insurance acquisition cash flows paid on an initially written contract		

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Introduction

1. We have received a submission about how to account for insurance acquisition cash flows unconditionally paid when a contract is first written by the entity (an initially written contract). The entity:
   (a) expects renewals outside the contract boundary to occur; and
   (b) has written the new business with that expectation.
2. The objective of the paper is to provide background and an accounting analysis to support discussion at the Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG).

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Structure of the paper

3. This paper includes the following:

   (a) background information;

   (b) implementation question; and

   (c) review of accounting requirements.

Background information

4. The submission is seeking to apply the requirements of IFRS 17 to determine insurance acquisition cash flows in the measurement of a group of insurance contracts. Insurance acquisition cash flows are considered in the measurement of the liability for remaining coverage of a group of insurance contracts regardless of whether those cash flows occur before, on or after initial recognition of the group. For a group of contracts accounted for under:

   (a) the general requirements, insurance acquisition cash flows are included in the measurement of the contractual service margin (see paragraph 38 of IFRS 17).

   (b) the premium allocation approach, insurance acquisition cash flows reduce the liability for remaining coverage (see paragraph 55 of IFRS 17)[1].

[1] An entity can choose to expense incurred insurance acquisition cash flows when the coverage period of each contract in the group is no more than one year applying the premium allocation approach.

How to determine insurance acquisition cash flows to be included in the measurement of a group of contracts

5. IFRS 17 requires measurement of groups of insurance contracts. In determining the insurance acquisition cash flows to be included in the measurement of a group of contracts, the following IFRS 17 requirements are relevant:

   (a) the level of aggregation requirements to determine each group (see paragraphs 6–7 below); and

   (b) the contract boundary requirements (see paragraphs 8–9 below).

Level of aggregation

6. An entity identifies portfolios of insurance contracts. Portfolios comprise contracts that are subject to similar risks and managed together (paragraph 14 of IFRS 17). Then, an entity is required at initial recognition to divide a portfolio of contracts into a minimum of:

   (a) a group of contracts that are onerous, if any;

   (b) a group of contracts that have no significant possibility of becoming onerous subsequently, if any; and

   (c) a group of remaining contracts in the portfolio, if any (paragraph 16 of IFRS 17).

7. According to paragraph 24 of IFRS 17, to measure a group of insurance contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or the portfolio provided that the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts.

Contract boundary

8. After determining the groups of contracts, an entity shall include in the measurement of a group of insurance contracts all the future cash flows, which includes insurance acquisition cash flows, within the boundary of **each contract** in the group (see paragraphs 33–34 of IFRS 17).

9. An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of an insurance contract. Such amounts relate to future insurance contracts (see paragraph 35 of IFRS 17).

Implementation question

10. The submission raises the question of how to account for insurance acquisition cash flows unconditionally paid for each initially written contract. The entity:
    (a) expects renewals outside the contract boundary to occur; and
    (b) has written new business with that expectation.

11. The submission provides a specific fact pattern for the question raised.
    (a) A commission of CU200 is paid to an agent for each initially written insurance contract. The commission, once paid, is non–refundable.
    (b) The contract states that it has an unlimited coverage period. However, it is assumed that the boundary of the contract applying IFRS 17 is one year.
    (c) The commission is greater than the premiums in the initially written contract's boundary.
    (d) The entity expects a substantial number of renewals over a number of years. Those renewals are outside the initially written contract's boundary.
    (e) If a group comprises only the contracts initially written in the annual period, an onerous loss will be recognised immediately in profit or loss. The cash outflows, including the commission of CU200, are greater than the cash inflows, the premium charged. Even if the commission were the only cash outflow, an onerous loss would be recognised because the commission is greater than the premium charged.

(f) For the renewed contracts the cash inflows, ie the premiums charged, are significantly greater than the cash outflows. It is likely that, if the commission were allocated partly to the renewed contracts, the group to which the renewed contracts belong would not be loss–making.

12. There are three views provided in the submission on the treatment of such insurance acquisition cash flows.

View A

13. The acquisition cash flows are considered in the measurement of the group to which the initially written contract belongs. Those cash flows are not considered in the measurement of the future groups to which the renewed contracts will belong. Applying the IFRS 17 level of aggregation requirements, the staff understands that the contracts renewed in the same annual period as initially written contracts are in a different group than those contracts that are initially written.

14. The rationale provided for this view is that incorporating all available information by applying paragraph 33 of IFRS 17, the acquisition cash flows are triggered solely when the contract is initially written. Therefore, the acquisition cash flows are within the boundary of the initially written contracts.

15. Additionally, even if the entity contemplates that most contracts will be renewed, applying paragraph 35 of IFRS 17, an entity cannot recognise part of the acquisition cash flows as an asset for future groups that will be recognised when the contracts are renewed. The renewals are outside the boundary of the initially written contracts. Applying this view, the acquisition cash flows are considered only in the measurement of the group to which the initially written contract belongs.

16. Based on the fact pattern and under View A, a group comprises only the initially written contracts and the commission of CU200 per contract should be allocated fully only to that group. Accordingly, an onerous loss is recognised.

17. The submission raises concerns that this results in a mismatch between economic and accounting profit because an onerous loss has to be recognised, although the contract (including renewals) is expected to be in place for a longer period than the contract boundary and is, therefore, considered profitable as a whole.

View B

18. The acquisition cash flows are considered in the measurement of the group to which the initially written contract belongs and in the measurement of the future groups to which the renewed contracts will belong. Applying the IFRS 17 level of aggregation requirements, the staff understands that the contracts renewed in the same annual period are in a different group than those that are initially written.

19. The rationale provided for this view is that:

    (a) applying paragraph 27 of IFRS 17, those acquisition cash flows relate to the groups consisting of initially written contracts and of contracts that are renewed. Therefore, they should be allocated also to the measurement of those future groups and should be recognised as an asset until those groups are recognised;

    (b) the entity underwrites those initially written contracts in the expectation that most of those contracts will be renewed; and

    (c) the requirements in paragraphs 95 and 99 in IFRS 15 *Revenue from Contracts with Customers* (IFRS 15) can be applied by analogy to insurance contracts under the scope of IFRS 17. Those requirements are on the treatment of acquisition costs directly related to an anticipated contract that the entity can specifically identify within scope of IFRS 15.

20. Based on the fact pattern provided under View B, the commission of CU200 should be allocated to the group to which the initially written contracts belong and to all future groups to which the renewed contracts belong when those groups are recognised. The insurance acquisition cash flows allocated to future groups that

have yet to be recognised are an asset. A portion of that asset is derecognised when the relevant group is recognised. As a result, the group to which the initially written contract belongs and each group recognised on the renewal of the contract is unlikely to be loss making when each group is initially recognised.

View C

21. The acquisition cash flows are considered in the measurement of the group to which the initially written contract belongs. This is similar to View A except that in applying the IFRS 17 level of aggregation requirements—the contracts renewed in the same annual period as initially written contracts are in the same group as those that are initially written. The insurance acquisition cash flows are effectively allocated to newly issued contracts as well as renewed contracts within the same annual period.

22. The rationale behind this view is that applying paragraph B65(e), insurance acquisition cash flows directly attributable to the portfolio level comprise the acquisition cash flows relating to initially written and renewed contracts as being subject to similar risks and are managed together. Therefore, they are allocated to the group that includes both:

    (a) initially written contracts; and

    (b) renewed contracts in the same period.

23. Based on the fact pattern provided under View C, the group contains both contracts that are initially written and contracts that are renewed in the same annual period. The total commissions paid for all initially written contracts within the group is included in the measurement of the group that contains more than those contracts. This is likely to result in the group not being loss making.

Review of accounting requirements

24. The staff think View A outlined in paragraphs 13–17 above describes how the IFRS 17 requirements should be applied to the fact pattern provided in paragraph 11 because:

    (a) the specified insurance acquisition cash flows paid on the initially written contracts should be included in the measurement of the group of contracts to which those contracts belong. Those specified cash flows are directly attributable to those contracts because they are paid for each initially written contract (discussed further in paragraphs 26–32 below).

    (b) the specified insurance acquisition cash flows cannot be included in the measurement of any future group(s) to which the contract once renewed would belong. Those specified costs cannot be allocated to future groups recognised on renewal because the specified costs are paid unconditionally for each initially written contract (discussed further in paragraphs 33–35 below).

    (c) the specified initial contracts cannot be in the same group as the specified contracts that are renewed during the same annual period applying the level of aggregation requirements.

        (i) Initially written contracts are onerous contracts at initial recognition because the acquisition cash outflows are greater than the cash inflows included in the contract boundary.

        (ii) The renewed contracts belong to a different group because those contracts are not onerous at initial recognition (discussed further in paragraphs 36–39 below).

25. The requirements of paragraphs 95 and 99 of IFRS 15, on the treatment of acquisition costs directly related to an anticipated contract that the entity can specifically identify, cannot be applied by analogy because:

    (a) IFRS 17 has specific requirements (as discussed in paragraph 24 above); and

(b) the requirements in other IFRS Standards cannot be applied by analogy to override specific requirements of IFRS 17.

Insurance acquisition cash flows included in the measurement of a group of insurance contracts

26. Appendix A of IFRS 17 defines insurance acquisition cash flows as:

> Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

27. Acquisition costs are normally identified as those that are incremental at the contract level in IFRS Standards. However, the Board considered that the measurement of the insurance contract would be represented more faithfully by also including an allocation of costs that are directly attributable to the portfolio level in the measurement of a group of contracts (see paragraphs BC181–BC184 of the Basis for Conclusions on IFRS 17 reproduced in Appendix A below).

28. Accordingly, insurance acquisition cash flows directly attributable to the portfolio of contracts comprise of:

    (a) acquisition cash flows directly attributable to individual contracts or groups of insurance contracts within the portfolio (if any); and

    (b) acquisition cash flows not necessarily directly attributable to individual contracts or groups of insurance contracts within the portfolio but that are directly attributable to the portfolio (if any).

29. Identification of insurance acquisition cash flows under IFRS 17 discussed in paragraphs 26–28 above is required at the portfolio level. In deciding which acquisition cash flows should be included in the measurement of the group, the concepts in paragraphs 24 and 33 of IFRS 17 are applicable (emphasis in italics):

    (a) Paragraph 24 of IFRS 17 requires the entity to be able to include the *appropriate* fulfilment cash flows in the measurement of the group

when there are estimates that occur at a higher level of aggregation than the group.

(b) Paragraph 33 of IFRS 17 requires the entity to include in the measurement of a group of insurance contracts all estimates of future cash flows within the boundary of each contract within the group. Those estimates must incorporate, in an unbiased way, *all reasonable and supportable information available* without undue cost or effort about the amount, timing and uncertainty of those future cash flows.

30. Paragraphs 24 and 33 of IFRS 17 are applicable to fulfilment cash flows. Some insurance acquisition cash flows may not meet the definition of fulfilment cash flows solely because they occur in the past (or on the initial recognition date) and fulfilment cash flows by definition are only future cash flows. The staff think that the approach applicable to determining the insurance acquisition cash flows to be included in the fulfilment cash flows is relevant to determining the other insurance acquisition cash flows that are included in the measurement of a group—that is insurance acquisition cash flows that are paid in past period, or on the date of initial recognition. Staff notes that there is no difference in substance between those cash flows and the only difference is timing.

31. Accordingly, applying the concepts in paragraphs 24 and 33 of IFRS 17:

(a) acquisition cash flows that are directly attributable to individual contracts (or a group) (see paragraph 28(a) above) should be included only in the measurement of the group to which the individual contracts belong (or of that group) and not to other groups within the same portfolio; and

(b) insurance acquisition cash flows directly attributable to the portfolio, but not necessarily directly attributable to individual contracts (or a group), will need to be allocated in an appropriate manner to the groups within the portfolio. An entity shall use reasonable and supportable information to do so.

32. Applying those concepts to the fact pattern submitted (see paragraph 11 above), the commission of CU200 is an insurance acquisition cash flow directly attributable to the individual contract because the commission is paid for each initially written contract.

33. IFRS 17 has specific requirements on whether expected renewals should be included in the future cash flows within the boundary of each contract within a group (see paragraph 34 of IFRS 17). The fact pattern provided assumes that the expected renewals are not within the boundary of the initially written contract. Applying paragraph 35 of IFRS 17, the expected premiums and claims arising from the expected renewals relate to future insurance contracts and a group is not recognised until the renewal has taken place.

34. The staff think that because the specified commission is paid **unconditionally** on the initially written contract, that the commission:

    (a) does not relate to the future group(s) to which the future contract once renewed would belong; and

    (b) therefore, cannot be allocated to those future groups applying paragraph 27 of IFRS 17.

35. Accordingly, applying IFRS 17 the specified commission is included in the measurement of the group to which the initially issued contract belongs.

Can these initially written contracts be included in the same group as contracts renewed in the same annual period (eg View C)?

36. IFRS 17 does not prohibit initially written contracts from being in the same group with renewed contracts so long as the level of aggregation requirements in IFRS 17 are met.

37. However, based on the fact pattern provided, applying paragraphs 16–17 of IFRS 17, contracts consisting of both the initially written and renewed contracts that are issued in the same annual period would not be in the same group.

38. Because of the significant acquisition cash flows directly attributable only to the initially written contracts, the entity has reasonable and supportable information that the set of initially written contracts will be in a group of contracts that are onerous at initial recognition. The entity will need to measure the set of initially written contracts to determine if those contracts are onerous. Once, the entity establishes that set is onerous, it includes that set in the group of contracts that are onerous at initial recognition applying paragraph 16 of IFRS 17.

39. For the set of contracts renewed in the same annual period as the initially written contracts were issued, the entity will have to determine if it has reasonable and supportable information to conclude that the renewed contracts will all be in the same group applying paragraph 17 of IFRS 17. If it does,

    (a) the entity may measure the set that has all the renewed contracts.

    (b) based on the fact pattern, the set of renewed contracts is not onerous. Accordingly, applying paragraph 16 of IFRS 17, the entity is prohibited from including the set of the renewed contracts in the group of contracts that are onerous at initial recognition:

        (i) The initially written contracts issued in the same period is in the group of onerous contracts (see paragraph 38 above).

        (ii) The set of renewed contracts will be in a different group.

TRG Discussion

Question to TRG members
What are your views on the implementation question presented above?

Appendix A—IFRS 17 relevant paragraphs

Appendix A of IFRS 17 definition of insurance acquisition cash flows:

insurance acquisition cash flows	Cash flows arising from the costs of selling, underwriting and starting a **group of insurance contracts** that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **groups of insurance contracts** within the portfolio.

IFRS 17 treatment of insurance acquisition cash flows relevant paragraphs:

27 An entity shall recognise an asset or liability for any *insurance acquisition cash flows* relating to a group of issued insurance contracts that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

..

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 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) 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) the derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and

(c) any cash flows arising from the contracts in the group at that date.

…..

55 Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:

(a) on initial recognition, the carrying amount of the liability is:

(i) the premiums, if any, received at initial recognition;

(ii) minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

(iii) plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

(b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(i) plus the premiums received in the period;

(ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) …….

IFRS 17 Level of aggregation relevant paragraphs:

14 **An entity shall identify *portfolios of insurance contracts*. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.**

…

16 **An entity shall divide a portfolio of insurance contracts issued into a minimum of:**

(a) a group of contracts that are onerous at initial recognition, if any;

(b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

(c) a group of the remaining contracts in the portfolio, if any.

17 If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

…..

24 An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the *fulfilment cash flows* at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment

cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

IFRS 17 contract boundary relevant paragraphs:

33 **An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:**

(a) **incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs B37–B41). To do this, an entity shall estimate the expected value (ie the probability-weighted mean) of the full range of possible outcomes.**

(b) **…**

34 Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71). A substantive obligation to provide services ends when:

(a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

35 An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

…

B65 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) ……….

(e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) ………

IFRS 17 Basis for Conclusions relevant paragraphs:

BC181 The Board considered whether only insurance acquisition cash flows that are incremental at a contract level should be included in the measurement of an insurance contract. Those cash flows can be clearly identified as relating specifically to the contract. Including cash flows that relate to more than one contract requires a more subjective judgement to identify which cash flows to include.

BC182 However, the Board noted that:

(a) including only insurance acquisition cash flows that are incremental at a contract level would mean that entities would recognise different contractual service margins and expenses depending on the way they structure their acquisition activities. For example, there would be different liabilities reported if the entity had an internal sales department rather than outsourcing sales to external agents. In the Board’s view, differences in the structure of insurance acquisition activities would not necessarily reflect economic differences between insurance contracts issued by the entities.

(b) an entity typically prices insurance contracts to recover not only incremental costs, but also other direct costs and a proportion of indirect costs incurred in originating insurance contracts—such as costs of underwriting, medical tests and inspection, and issuing the policy. The entity measures and manages these costs for the portfolio, rather than for the individual contract. Accordingly, including insurance acquisition cash flows that are incremental at the portfolio level in the fulfilment cash flows of the insurance contracts would be consistent with identification of other cash flows that are included in the measurement of the contracts.

BC183 The Board also considered whether to restrict insurance acquisition cash flows to be included in the measurement of a group of insurance contracts to those cash flows related directly to the successful acquisition of new or renewed insurance contracts. The approach in IFRS 17 to the measurement of a group of insurance contracts is to estimate the profit expected to be generated over the duration of the group. In this context, excluding some insurance acquisition cash flows that relate to issuing a portfolio of contracts would result in an understatement of the fulfilment cash flows and an overstatement of the contractual service margins of groups in the portfolio. In addition, the Board wanted to avoid measuring liabilities and expenses at different amounts depending on how an entity structures its insurance acquisition activities, as described in paragraph BC182(a).

BC184 The Board also noted that the measurement approach in IFRS 17 automatically recognises as an immediate expense any insurance acquisition cash flows that cannot be recovered from the cash flows of the portfolio of contracts, because such cash flows reduce the contractual service margin below zero and must therefore be recognised as an expense. Hence, no amount can be recognised in the statement of financial position for insurance acquisition cash flows that are not recoverable.