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January 2020

Insurance Accounting Alert

IASB addresses five of the proposed amendments to IFRS 17

What you need to know

At its meeting on 30 January 2020, the IASB tentatively decided to:

1. Amend the requirements related to interim financial statements in IFRS 17 to require an entity to:
   - Make an accounting policy choice on whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or the annual reporting period
   - Apply this policy choice at reporting entity level
2. Retain the existing IFRS 17 requirements for insurance contracts acquired in their settlement period in a portfolio transfer or business combination in the scope of IFRS 3
3. Change the requirements relating to the expected recovery of insurance acquisition cash flows on transition to IFRS 17 and for contracts acquired in a portfolio transfer or business combination in the scope of IFRS 3 by amending:
   - IFRS 17 to require that an asset for insurance acquisition cash flows should be recognised at the transition date, and to specify requirements under the modified retrospective and fair value approaches
   - IFRS 3 and IFRS 17 to require recognition of a separate asset for insurance acquisition cash flows measured at fair value at acquisition date for contracts acquired in a portfolio transfer or business combination in the scope of IFRS 3
4. Retain the prohibition from applying the risk mitigation option retrospectively at transition
5. Confirm the proposed scope exclusion from IFRS 17 for certain credit card contracts and to introduce the following changes to the amendments proposed:
   - Require an entity that provides insurance coverage as part of the contractual terms of the credit card contract to:
     - Separate the insurance coverage component and apply IFRS 17 to it
     - Apply other applicable standards (such as IFRS 9) to the other components
   - Extend this amendment to other contracts that provide credit or payment arrangements similar to credit card contracts

The IASB expects to consider most of the remaining potential amendments to IFRS 17 at its February meeting, before reviewing the whole package of amendments and deciding on the effective date of IFRS 17 in March.

Overview

At its January 2020 Board meeting, the International Accounting Standards Board (IASB or the Board) continued its re-deliberations on the proposed amendments in the Exposure Draft *Amendments to IFRS 17 Insurance Contracts* (the ED), in line with the plan outlined in its November 2019 meeting.

The story so far

The IASB issued IFRS 17 in May 2017. Our publication, Applying IFRS 17: A closer look at the new insurance contracts standard, provides further details on the requirements: http://ey.com/Publication/vwLUAssets/ey-Applying-IFRS-17-Insurance-May-18/$FILE/ey-Applying-IFRS-17-Insurance-May-18.pdf

Having considered 25 concerns and implementation challenges arising since IFRS 17 Insurance Contracts (IFRS 17 or 'the standard') was issued, the IASB issued an ED in June 2019 proposing targeted amendments to the standard to respond to some, but not all, of those concerns and challenges: https://www.ifrs.org/projects/work-plan/amendments-to-ifrs-17/#published-documents

For further details of the IASB's exposure draft, and its subsequent discussions refer to our recent Insurance Accounting Alerts: https://ey.com/gl/en/issues/ifrs

1. Interim financial statements

Paragraph B137 of IFRS 17 prohibits an entity from changing the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or in the annual reporting period.

The IASB developed the requirement in B137 in response to stakeholder concerns about having to maintain separate contractual service margins (CSMs) for the purposes of annual and interim reporting. However, an effect of B137 is that entities with identical fulfillment cash flows operating in the same economic environment could report different CSMs and insurance service result in the same reporting period depending on the frequency of their external reporting.

Stakeholders expressed concern at this outcome, as they often prepare their interim financial statements and subsequent annual financial statements on a year-to-date basis. Paragraph B137 creates a practical burden in groups that publish consolidated interim financial statements, but, in which, insurance subsidiaries only produce annual financial statements.

The Board tentatively agreed with the staff's recommendation to amend IFRS 17 and require an entity to:

- Make an accounting policy choice on whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or annual reporting
- Apply its choice to all insurance contracts issued and reinsurance contracts held (i.e., an accounting policy choice at reporting entity level)

13 Board members agreed with the staff recommendations and one voted against.

Observations from the Board meeting

One board member noted that a problem still exists if a consolidated group prepares interim financial statements on a discrete period basis (consistent with paragraph B137), but its subsidiaries do not prepare interim financial statements. In this case, the group and solo entity CSMs for the same groups of contracts will need to be different. Another board member expressed concerns that an accounting policy choice would reduce comparability of the results of insurance companies.

2. Contracts acquired in their settlement period

The uncertain future event that transfers insurance risk in an insurance contract acquired during its settlement period, from the perspective of the acquirer, is the ultimate cost of settling the claims. Applying IFRS 17, the insurance contract liability is classified as a liability for remaining coverage even though the acquired entity will classify its obligation as a liability for incurred claims. This is a significant change to existing accounting practices. The IASB responded to concerns about the availability of information needed to apply this approach at transition by permitting an entity to classify a liability for contracts acquired in their settlement period prior to the transition date to IFRS 17 as a liability for incurred claims. Stakeholders welcomed this transition relief, but some suggested that IFRS 17 be amended to permit this in all circumstances (including after transition to IFRS 17).

Those in favour of such an amendment feel it would improve the usefulness of information provided by IFRS 17 while reducing complexity and costs. This would be the case, in particular, for entities that would be required to apply the general model, rather than the premium allocation approach, only as a result of treating the contracts acquired in their settlement period as part of the liability for remaining coverage.

The Board tentatively agreed with the staff's recommendations to retain unchanged the requirements in IFRS 17. The IASB considers that the requirements in IFRS 17 are consistent with the principles in IFRS 3 Business Combinations and believes that exempting insurance contracts acquired in their settlement period from the general requirements for determining the insured event would create complexity for users of financial statements and reduce comparability with other transactions, e.g., adverse development cover contracts.

All 14 Board members agreed with the staff recommendations.

Observations from the Board meeting

Board members agreed that the requirements were conceptually correct, but acknowledged the practical challenges. Some board members noted that one of the objectives of IFRS 17 is to bring insurance accounting into line with that of other industries and this would inevitably involve operational costs.

One board member remarked that insurers can provide additional information about acquired contracts if they think that is necessary for the understanding of future cash flows that are likely to arise from such a transaction.

3. Asset for insurance acquisition cash flows — transition and business combination requirements

At its December 2019 meeting, the Board tentatively decided to make amendments to IFRS 17 relating to the expected recovery of insurance acquisition cash flows. At this meeting, the Board tentatively decided to clarify how this will apply at the transition date, and at the date that contracts are acquired in a portfolio transfer or a business combination within the scope of IFRS 3.

Transition:

The Board tentatively agreed with the staff recommendation to amend IFRS 17 to require an entity to identify, recognise and measure at the transition date, an asset for insurance acquisition cash flows for a group of insurance contracts. Only where it is impracticable to apply this requirement retrospectively, an entity should use the modified retrospective approach (MRA) or fair value approach (FVA) to measure the asset.

Modified retrospective approach:

The Board tentatively decided to permit an entity to use the modification described below only if it does not have reasonable and supportable information to apply a retrospective approach.

The modification available in such cases is that an entity is required to:

a) Measure an asset for insurance acquisition cash flows using information available at transition date by identifying the amount of insurance acquisition cash flows paid before the transition date (excluding the amount relating to the contracts that ceased to exist before the transition date)

b) Allocate the identified amount using the systematic and rational allocation that the entity will apply going forward after the transition date to:

   i) Groups of insurance contracts that are recognised at the transition date

   ii) Groups of insurance contracts expected to be recognised after transition dates (to recognise an asset for insurance acquisition cash flows)

c) Adjust the measurement of the CSMs of the insurance contracts that are recognised at the transition date by deducting the amount of insurance acquisition cash flows determined by applying subparagraph (b)(i)

d) Recognise an asset for insurance acquisition cash flows for the insurance contracts expected to be recognised after the transition date at the amount determined applying subparagraph (b)(ii)

Where the entity applies the MRA, but does not have reasonable and supportable information necessary to apply this modification, it may apply the MRA by adjusting the CSM of groups of contracts recognised at the transition date by nil and recognise an asset for insurance acquisition cash flows to be recognised after the transition date as nil. (This modification is necessary to prevent an entity from having to use the FVA solely because of a lack of information about insurance acquisition cash flows).

Fair value approach

The Board tentatively decided that an entity should measure the asset for insurance acquisition cash flows under the FVA as the amount of insurance acquisition cash flows that the entity would incur at the transition date to obtain the rights to:

a) Recover insurance acquisition cash flows from premiums of insurance contracts originated before the transition date but not yet recognised at the transition date

b) Obtain future contracts after the transition date without paying again insurance acquisition cash flows the entity has already paid

c) Obtain future renewals of:

   i) Contracts recognised at the transition date

   ii) Contracts described in (a) and (b) above

Portfolio transfers and business combinations in the scope of IFRS 3

The Board tentatively agreed to amend IFRS 3 and IFRS 17 to require an entity to recognise a separate asset for insurance acquisition cash flows at the acquisition date for transfers of insurance contracts that do not form a business ('portfolio transfers') as well as business combinations in the scope of IFRS 3.

This asset represents the rights to:

- Obtain future contracts after the acquisition date without paying again insurance acquisition cash flows the entity has already paid
- Obtain future renewals of:
  - Contracts recognised at the acquisition date; and
  - Contracts described in (a).

Such an asset should be recognised separately from intangible assets recognised applying IFRS 3, and should be measured at fair value.

Impairment test

At transition date, entities will need to meet the recoverability assessment requirement in paragraph 28D of IFRS 17, discussed in the December 2019 IASB meeting, i.e., to carry out an impairment test if facts and circumstances indicate the asset for acquisition cash flows may be impaired.

The Board tentatively decided to clarify that for the assets for insurance acquisition cash flows recognised at the transition date, an entity is not required to apply the recoverability assessment requirement in paragraph 28D of the Exposure Draft retrospectively for the periods before the transition date. This is because the same effect will be achieved through applying the recoverability assessment at the transition date.

All 14 Board members agreed with the staff recommendations above.

Comments from the staff and observations from the Board meeting

Board members noted that the approach adopted to measure the asset for acquisition cash flows at transition (i.e., full retrospective, MRA or FVA), is not independent of the approach for measuring the liability for the groups of contracts to which the asset relates. The element of the asset that relates to contracts that have not yet joined a group that exists at the transition date will need to be measured on a basis consistent with that group. The staff mentioned it will clarify this matter through drafting.

4. Transition — prohibition from applying the risk mitigation option retrospectively

The risk mitigation option in IFRS 17 permits an entity to recognise immediately in profit or loss, some or all of the changes in the effect of financial risk on insurance contracts with direct participation features that would otherwise adjust the CSM, provided certain conditions are met, e.g., the entity uses derivatives or reinsurance contracts to mitigate financial risk arising from the contracts and it has previously documented its risk management objectives and strategy. However, this option can only be applied prospectively from the date of transition to IFRS 17.

The IASB had previously concluded that permitting retrospective application of the risk mitigation option would come at a significant cost. The risk of the use of hindsight would affect the credibility of information presented on transition to IFRS 17 and in the subsequent periods. Even if an entity applied the requirements retrospectively without using hindsight, it would be impossible for a user of financial statements to tell the difference between that entity and another which had used hindsight. The staff paper stated that the staff had not identified any new information for the IASB to consider regarding the significant risk that the potential use of hindsight would affect the credibility of information presented on transition to IFRS 17.

The Board tentatively decided to retain unchanged the prohibition from applying the risk mitigation option retrospectively on transition to IFRS 17.

13 Board members agreed with the staff recommendations.

Observations from the Board meeting

Some stakeholders expressed disappointment about the decision not to allow retrospective application of the risk mitigation option at transition. Some support a proposal that an entity should be allowed to retrospectively apply the effect of either all or none of the risk mitigation relationships it had in place prior to transition for which it has documentation. They feel that this 'all-or-nothing' approach with respect to pre-transition risk-mitigation relationships would remove the risk of hindsight or 'cherry picking'.

The Board thinks it would be extremely difficult to prove that all risk mitigation relationships in the past had been quantified and reflected in the CSM at transition. One board member referred to comments by audit firms that it would be difficult to prove whether historical risk management documentation was complete or not.

5. Scope exclusion for credit cards:

The Board tentatively decided to confirm the proposed requirement to exclude from the scope of IFRS 17, credit card contracts that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer.

The Board tentatively decided:

- To require an entity that provides the insurance coverage as part of the contractual terms of the credit card contract to:
  - Separate the insurance coverage component and apply IFRS 17 to it
  - Apply other applicable standards (such as IFRS 9) to the other components
- To extend this amendment to contracts that are similar to credit cards (providing credit or payment arrangements), if they meet the definition of an insurance contract and the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer

Banks and other stakeholders had expressed concerns about applying IFRS 9 to credit cards and similar contracts that they consider are primarily financial instruments, but which also meet the definition of an insurance contract. Contracts that provide insurance coverage by virtue of their contractual terms (as opposed to insurance provided due to law or regulation) would be likely to fail the solely payment of principal and interest (SPPI) test in IFRS 9 and would therefore be required to be measured at fair value through profit or loss (FVPL) under that standard. Stakeholders felt this would not provide useful information. The separation of insurance components and accounting for these in accordance with IFRS 17, rather than as part of a financial instrument subject to IFRS 9, avoids this issue. The IASB staff papers also acknowledge that IFRS 9 may not be well suited to dealing with insurance cash flows in the context of a contract that may be viewed as a combination of a financial asset and an undrawn loan commitment.

All 14 Board members agreed with the staff recommendation.

Observations from the Board meeting

Several board members noted that banks will need to develop insurance accounting systems to account for the separated insurance coverage component. Some suggested the cost of this could be disproportionate to the benefit. One board member wondered whether entities that made no other use of IFRS 17 could use IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to measure the insurance coverage obligation instead. Other board members felt that if banks voluntarily include insurance coverage within credit card and similar contracts, and accept significant insurance risk, then the most appropriate accounting standard is IFRS 17.

How we see it

- Allowing insurers an accounting policy choice on whether to 'lock in' accounting estimates made in previous interim financial statements allows them to determine how to best address the effort and complexity of maintaining multiple CSMs. An insurer can make an accounting policy choice on whether it applies a period-to-date measurement basis following paragraph B137 of IFRS 17 or a year-to-date measurement basis as specified by IAS 34 *Interim Financial Reporting*. However, it might still be necessary to have separate CSMs for the purposes of group and solo reporting because of other factors, for example, intercompany charges that are fulfillment cash flows in insurance contracts eliminated in consolidated financial statements. Furthermore, given the decision to 'lock in' accounting estimates is an accounting policy choice, preparers' system designs may have to allow for both approaches.
- Some insurers that acquire insurance contracts in their settlement period, particularly those that would not otherwise need to apply the general model to the insurance contracts they issue, will be disappointed by the IASB's decision not to change the IFRS 17 requirements for these contracts.
- Insurers that lack the necessary reasonable and supportable information to apply the modified retrospective approach to measure insurance acquisition cash flow assets at transition are not forced to apply the fair value approach, but can instead record the insurance acquisition cash flow asset at nil. Such a treatment would have a favourable impact on the transition CSM under the modified retrospective approach.
- Banks and other financial institutions will welcome the proposal to separate insurance coverage from the other components of credit card and similar contracts, thereby increasing the likelihood that components subject to IFRS 9 will meet the SPPI test.

Next steps

The IASB is due to redeliberate the remaining topics raised by stakeholders before it published the ED. The IASB staff has also committed to considering three new concerns and implementation questions that were raised in comment letters on the ED. The IASB staff indicated that most of these will be considered in the February meeting. The Board will review the whole package of amendments and consider the effective date during the March 2020 meeting. The staff expects the timetable will allow sufficient time for the Board to consider the remaining topics and finalize any resulting amendments in mid-2020.

Appendix: Summary of proposed amendments included in the Board's plans for re-deliberations and new items the staff plan to present to the Board.

	Topic (per Appendix A of January 2020 IASB agenda paper AP2)	Date of re-deliberation
1.	Scope exclusion for loans	December 2019
2.	Contractual service margin attributable to investment services – coverage units for insurance contracts with direct participation features	December 2019
3.	Presentation in the statement of financial position – portfolio instead of group level	December 2019
4.	Applicability of the risk mitigation option – reinsurance contracts held	December 2019
5.	Transition reliefs for business combinations	December 2019
6.	Transition reliefs for the risk mitigation option – application from the transition date and the option to apply the fair value approach	December 2019
7.	Scope exclusions for credit cards	January 2020
8.	Expected recovery of insurance acquisition cash flows	December 2019
9.	CSM attributable to investment services- coverage units for insurance contracts without direct participation features, disclosures and terminology	December 2019
10.	Reinsurance contracts held – recovery of losses	December 2019
11.	Applicability of the risk mitigation opinion – non-derivative financial instruments at fair value through profit or loss.	**Future meeting**
12.	Effective date of IFRS 17	**Future meeting** **Expected March 2020**
13.	Extension of the IFRS 9 temporary exemption in IFRS 4	**Future meeting** **Expected March 2020**
14.	Transition – the prohibition from applying the risk mitigation option retrospectively	January 2020
15.	Minor amendments	**Future meeting**
16.	Level of aggregation – annual cohorts for some specific insurance contracts	**Future meeting**
17.	Business combinations- contracts acquired in their settlement period	January 2020
18.	Interim financial statements	January 2020
19.	Additional specific transition modifications and reliefs (including transition requirements for insurance acquisition cash flows)	January 2020 (insurance acquisition cash flows) **Future meeting (other)**
	New items raised that the IASB staff plan to analyze and present to the Board to decide what, if any, action is required	
A.	Accounting treatment of policyholder taxes applying IFRS 17	**Future meeting**
B.	Application of paragraph B113b of IFRS 17 regarding changes in the effect of the time value of money and financial risks not arising from underlying items, such as the effect of financial guarantees, under the variable fee approach (VFA)	**Future meeting**
C.	Contracts that change nature over time (for example VFA contracts that become a pay-out annuity after exercise of an option).	**Future meeting**

Refer also to our June 2019 Insurance Accounting Alert for further details of the proposed amendments in the ED.

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