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IFRS 17: Implications for Onerous Contracts

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After a very long journey, the International Accounting Standards Board (IASB) issued IFRS 17. IFRS 17 replaces IFRS 4, which was issued in 2004. The overall objective of IFRS 17 is to provide a more useful and consistent accounting model for insurance contracts among entities issuing insurance contracts globally.

To increase the transparency of an entity's performance, the entity is required to group contracts in a way that reflects the profitability at initial recognition. IFRS 17 requires an entity to identify portfolios of insurance contracts (within the same financial reporting year) and to further divide the group of contracts that are onerous at initial recognition (if any) from the profitable group of contracts. The IASB determined that the onerous contracts should not be hidden and that the respective losses should be accounted for explicitly in the statement of comprehensive income (SCI) when it was known. This treatment is consistent with the recognition of losses for onerous contracts in accordance with IFRS 15 *Revenue from Contracts with Customers and IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.

An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows (FCF) allocated to the contract, any previously recognized insurance acquisition cash flows, and any cash flows arising from the contract at the date of initial recognition in total are a net outflow [IFRS 17.47].[1]

Reinsurance contracts held cannot be onerous [IFRS 17.68]. Instead of profitable or onerous contracts, IFRS 17 views them as the net cost or gain on purchasing the reinsurance contracts. Both positive and negative contractual service margin (CSM) are allowed for reinsurance contracts held (RCH), unless the reinsurance coverage relates to events that occurred before the purchase of the reinsurance (retroactive cover). In subsequent measurement, changes in the FCF that relate to future service are adjusted to RCH's CSM, unless they are stemming from changes that do not adjust the CSM of the related underlying contracts (UC).

Table 1
Summary of Profitable and Onerous Contracts Treatment for UCs and RCHs (updated for the June 2019 proposed amendments by IASB)—Under GMM

<table>
<tr><th>UC/ RCH and Profitability group</th><th>Linkage With RCHs or UCs</th><th>Initial CSM</th><th>Initial Recognition in SCI</th><th>Linkage Between UC and RCH in Subsequent Measurement</th></tr>
<tr><td>Profitable UC</td><td rowspan="2">Without RCH covered</td><td>Non-negative</td><td>No day 1 gain is recognized</td><td rowspan="2">N/A</td></tr>
<tr><td>Onerous UC</td><td>Zero</td><td>Recognize the loss immediately</td></tr>
<tr><td>Profitable UC</td><td>With RCH covered</td><td>Non-negative</td><td>No day 1 gain is recognized</td><td rowspan="6">Offset between UC and RCH if the UC becomes onerous or more onerous (on the portion covered by RCH)</td></tr>
<tr><td>Onerous UC</td><td>With nonproportionate RCH covered</td><td>Zero</td><td>Recognize the loss immediately</td></tr>
<tr><td>Onerous UC</td><td>With Proportionate RCH covered</td><td>Zero</td><td>Recognize the loss immediately, and with consideration of the RCH income offset</td></tr>
<tr><td>RCH</td><td>Related UCs are profitable at initial recognition</td><td rowspan="2">Positive or negative</td><td rowspan="2">No day 1 cost or gain is recognized (except for the net cost under retroactive cover)</td></tr>
<tr><td>Nonproportionate RCH</td><td>Related UCs are onerous at initial recognition</td></tr>
<tr><td>Proportionate RCH</td><td>Related UCs are onerous at initial recognition</td><td>Adjust RCH CSM with considerations of UC</td><td>Recognize RCH income to offset the UC loss (on the portion covered by RCH)</td></tr>
</table>

Under the June 2019 proposed amendments to IFRS 17, for onerous UCs that are covered by RCHs that provide proportionate coverage, an entity shall adjust, at initial recognition, the CSM of the RCH and recognize RCH income to offset the corresponding portion of UC loss. Table 1 summarizes the latest IASB proposals on the treatment of the profitable and onerous contracts for UCs and RCHs under the general measurement model (GMM).

This article discusses the key IFRS 17 requirements of the accounting for onerous contracts, with an illustrative example to demonstrate the systematic allocation requirement for the UCs.

HOW DOES IFRS 17 APPLY TO ONEROUS CONTRACTS?

What is the level of aggregation requirements to determine the profitability grouping of insurance contracts issued as of initial recognition?

To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts [IFRS 17.47].

An entity should apply the recognition and measurement model requirements of IFRS 17 to onerous contract testing. An entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts if an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group (i.e., there will be no offsetting effects of onerous and profitable contracts in the same group). If an entity does not have reasonable and supportable information, then it shall determine the group of onerous contracts by considering individual contracts. While there is no clear guidance on the "reasonable and supportable information," it is generally expected that the entity can leverage relevant information produced during the product development stage.

Can an entity reassess the onerous contract grouping in subsequent measurement?

An entity shall establish the groups at initial recognition and add contracts to the group applying paragraph 28. The entity shall not reassess the composition of the groups subsequently [IFRS 17.24] except when there is modification.

Are there any particular differences for onerous contract treatment under the GMM and variable fee approach (VFA)?

No. The distinctions between GMM and VFA are the same for profitable and onerous contracts.

What is the treatment for a group of contracts under the premium allocation approach (PAA) that is onerous?

The same principle of grouping applies to insurance contracts under PAA, but the standard wording is adapted to reflect its specific characteristics. The entity assumes all contracts are not

onerous at initial recognition unless facts and circumstances indicate otherwise. The entity also assesses whether the profitable contracts at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in relevant facts and circumstances.

If facts and circumstances indicate that a group of contracts is onerous during the coverage period, an entity shall calculate the difference between (i) the carrying amount of the liability for remaining coverage (LRC), excluding the loss component determined under PAA, and (ii) the FCF that relate to remaining coverage similar to what is needed under the GMM. The entity shall recognize this difference as a loss and increase the liability for remaining coverage.

What is a systematic allocation between (i) the loss component of the liability for remaining coverage and (ii) the liability for remaining coverage, excluding the loss component, under GMM?

The entity should track the remaining loss component (LC). If a group of contracts is onerous, there is no CSM. The entity shall allocate the subsequent changes in FCF of the LRC on a systematic basis between (i) the LC and (ii) the LRC, excluding the LC, with the following considerations:

- estimates of the present value of future cash flows for claims and expenses released from the LRC because of incurred insurance service expenses;
- changes in the risk adjustment (RA) for nonfinancial risk recognized in profit or loss because of the release from risk; and
- insurance finance income or expenses.

What is the treatment for contracts that become more or less onerous in subsequent measurement?

See Table 2 (pg. 32) for a summary of treatment for contracts that become more or less onerous in subsequent measurement.

Table 2
Summary of Treatments for Contracts That Become More or Less Onerous in Subsequent Measurement

Subsequent Measurement/ Measurement Model	GMM	VFA	Implications to SCI
Contract becomes onerous or more onerous	Unfavorable changes relating to future service in the FCF arising from changes in estimates of future cash flows and RA exceed the carrying amount of the CSM	Decrease in the amount of the entity's share of the fair value of the underlying items or increase in FCF relating to future service that exceed the carrying amount of the CSM	An entity shall recognize an LC (or additional LC) depicting the losses in SCI to the extent of the excess listed. Subsequently, this LC is then presented in SCI as reversal of losses on onerous groups and is consequently excluded from the determination of insurance revenue.
Onerous contract with favorable changes related to future service	Any subsequent decreases relating to future service in the FCF arising from changes in estimates of future cash flows and RA	Any subsequent increases in the amount of the entity's share of the fair value of the underlying items or decrease in FCF relating to future service	An entity shall allocate the changes solely to the LC until the LC is reduced to zero and subsequently allocate the remaining portion of changes (if any) to CSM after the LC is depleted

Table 3
Projected Best Estimate Cash Flows (BECFs) and Initial Measurement

BECFs/Year		Yr1	Yr2	Yr3
Premium income		70	80	90
Claims and expense outgo		10	10	250
Investment component (included in the outgo)		3	3	75
Initial Measurement				
Initial loss	20			
Initial loss ratio	7.8%			

Table 4
SCI

SCI/Year	Yr1	Yr2	Yr3
Insurance revenue	**6.5**	**6.5**	**161.3**
Insurance service expense			
Claims and expenses incurred	(7.0)	(7.0)	(175.0)
Losses on new onerous contracts	(20.0)		
Allocation of subsequent changes in FCF to LC	**0.5**	**0.5**	**13.7**
Insurance finance income and expenses (IFIE)			
IFIE allocated to LRC, excluding LC	(1.1)	(2.4)	(5.3)
IFIE allocated to LC	(0.3)	(0.3)	(0.5)
Total profit	(21.5)	(2.7)	(5.8)

ILLUSTRATIVE EXAMPLE FOR SYSTEMATIC ALLOCATION UNDER THE GMM

The IASB considered whether to require specific methods to track the LC but concluded that any such methods would be inherently arbitrary. It therefore decided to require an entity to make a systematic allocation as noted above.

A simple three-year endowment product is created to illustrate one possible way of the allocation of subsequent changes in FCF of the LRC on a systematic basis between (i) the LC and (ii) the LRC, excluding the LC.

Table 3 summarizes the key fact pattern. We assumed no RA, time value of options and guarantees, and investment income. With the discounting applied, FCF equals 20, which means that the expected outflow is larger than the expected inflow; it is an onerous contract with an initial loss of 20. The initial loss ratio is calculated as the initial loss divided by the present value of total outgo (some also suggested the total outgo should exclude the investment component, which is not illustrated here).

Table 4 summarizes the items to be shown in SCI in this simplified example:

- Insurance revenue equals *Insurance component of the outgo * (1- loss ratio)*

- For the insurance service expense, (i) the total outgo, excluding the investment component, is presented assuming everything goes as expected, (ii) the initial loss is recognized immediately in the SCI, and (iii) the allocation of subsequent changes in FCF to LC equals *Insurance component of the outgo * loss ratio*.

- For the insurance finance income and expenses, (i) IFIE allocated to LC equals *PV of total outgo*$_t$ * *discount rate*$_t$ * *loss ratio*, and (ii) IFIE allocated to LRC excluding LC equals *FCF unwinding minus Reversals of losses (IFE)*.

- Certain checking needs to be performed for the SCI: (i) The total insurance revenue is the amount of premiums paid to the entity, adjusted for a financing effect and excluding any investment components; (ii) the total reversal of loss plus the loss component part of investment component should equal the initial loss recognized in SCI; and (iii) total profit should tie with the net CFs (given no investment income is considered in this example).

CONCLUSION

While onerous contracts may not be a significant part of an entity's portfolio generally, the entity should consider its logic during system development to ensure the SCI and corresponding disclosures can be handled properly by the IFRS 17 reporting systems.

The illustrative example included in this article provides only one of the approaches that fulfill the standard requirements under GMM, and we expect there are other ways of performing the systematic allocation. Similar to experience with Solvency II, it is generally expected that certain market consensus will converge on the approaches. The related methodology and considerations should be properly documented and approved within the entity's governance structure, and agreed with the entity's auditor. It is also important for individual entities to understand both the financial and operational impacts of the onerous contracts at the beginning of the implementation journey.

The views reflected in this article are the views of the authors and do not necessarily reflect the views of the global EY organization or its member firms. ■

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ENDNOTE

1 The references quoted by [ ] represent text or extracts from "IFRS 17 *Insurance Contracts* incorporating amendments as proposed in Exposure Draft Amendments to IFRS 17" (released as of June 26, 2019, by the International Accounting Standards Board) and Basis for Conclusions.