

In depth

A look at current financial reporting issues

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IFRS 17 marks a new epoch for insurance contract accounting

At a glance

In May 2017, the International Accounting Standards Board (IASB) issued IFRS 17, 'Insurance Contracts', and thereby started a new epoch of accounting for insurers. Whereas the current standard, IFRS 4, allows insurers to use their local GAAP, IFRS 17 defines clear and consistent rules that will significantly increase the comparability of financial statements. For insurers, the transition to IFRS 17 will have an impact on financial statements and on key performance indicators.

Under IFRS 17, the *general model* requires entities to measure an insurance contract at initial recognition at the total of the fulfilment cash flows (comprising the estimated future cash flows, an adjustment to reflect the time value of money and an explicit risk adjustment for non-financial risk) and the contractual service margin. The fulfilment cash flows are remeasured on a current basis each reporting period. The unearned profit (contractual service margin) is recognised over the coverage period.

Aside from this general model, the standard provides, as a simplification, the premium allocation approach. This simplified approach is applicable for certain types of contract, including those with a coverage period of one year or less.

For insurance contracts with direct participation features, the variable fee approach applies. The variable fee approach is a variation on the general model. When applying the variable fee approach, the entity's share of the fair value changes of the underlying items is included in the contractual service margin. As a consequence, the fair value changes are not recognised in profit or loss in the period in which they occur but over the remaining life of the contract.

The new standard is applicable for annual periods beginning on or after 1 January 2021. Early application is permitted for entities that apply IFRS 9, 'Financial Instruments', and IFRS 15, 'Revenue from Contracts with Customers', at or before the date of initial application of IFRS 17. The standard can be applied retrospectively in accordance with IAS 8, but it also contains a 'modified retrospective approach' and a 'fair value approach' for transition depending on the availability of data.

Appendix C provides a table of content for this publication.

Scope

Insurance contracts

IFRS 17 applies to:

- **insurance contracts** that an entity *issues*;
- all **reinsurance contracts** (that is, those an entity *issues* and those an entity *holds*); and
- **investment contracts with discretionary participation features**, provided that an entity also issues insurance contracts.

Insurance contracts

Similar to the current guidance, IFRS 17 defines **insurance contracts** as contracts under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

The assessment of whether the insurance risk is 'significant' has changed slightly. Under IFRS 4, the entity should determine whether, for any scenario that has commercial substance, the amounts to be paid if the insured event occurs significantly differ from the amounts to be paid if the insured event does not occur. The new standard clarifies that this assessment should be made on a present value basis. The discount rate used to calculate the present value should reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contract. The same rate is also used for measurement purposes if the contract meets the definition of an insurance contract (see the section on '*Discount Rates*' below).

PwC observation: Time value of money for assessment of significant insurance risk

IFRS 4 was silent about whether the significance of the insurance risk is assessed on a discounted or on an undiscounted basis. In practice, many entities used discounted cash flows, and so this change will have no effect. For those entities that made the assessment based on undiscounted cash flows, the guidance in IFRS 17 might affect the number of contracts within the scope of the insurance standard.

An insurance risk is only significant if there is at least one scenario in which the insured event results both in significant additional payments and also in an overall loss for that particular contract. To assess whether this is the case, the insurer assesses a possibility of a loss on a present value basis. This requirement did not exist in IFRS 4.

The significance of the insurance risk is assessed on a contract-by-contract basis. Accordingly, the insurance risk can be significant, even if there is minimal probability of significant losses for a portfolio or a group of contracts. The exemption in IFRS 4 – to make the assessment based on a book of contracts if those contracts are relatively homogeneous and small – is no longer part of the standard.

Insurance contracts (other than reinsurance contracts) that an entity holds are not within the scope of IFRS 17. Instead, the holder applies IAS 8 to choose an appropriate accounting policy.

PwC observation: IFRS 17 is for insurance contracts, not only for entities that are regulated as insurers

The insurance standard is not only relevant for insurance companies. All entities that issue contracts that meet the definition of ‘insurance contracts’ in IFRS 17 are within the scope of the standard.

So, for example, manufacturers, dealers or retailers sometimes retain certain risks related to the product sold that go beyond the types of warranty or residual value guarantee that are explicitly outside the scope of the standard. Telecommunication companies might, for example, provide protection against theft, loss or damage for mobile devices that they have sold. These kinds of contracts are likely to meet the definition of an insurance contract and are accounted for applying IFRS 17, unless they meet the requirements for a fixed fee service contract and can be accounted for using either IFRS 17 or IFRS 15.

Reinsurance contracts

A reinsurance contract is defined as an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity. The requirements for the assessment of significant insurance risk in a reinsurance contract are the same as for an insurance contract. However, a reinsurance contract transfers significant insurance risk if it transfers substantially all of the insurance risk resulting from the insured portion of the underlying insurance contract, even if it does not expose the reinsurer to the possibility of a significant loss.

Investment contracts with discretionary participation features

The term ‘investment contracts with discretionary participation features’ describes contracts under which the investor receives an additional payment, the amount or timing of which is contractually at the discretion of the issuer. To meet the definition, it should be expected that the amount is a significant portion of the total contractual benefits, and it should be contractually based on either:

- the returns on a specified pool of contracts or a specified type of contract,
- realised and/or unrealised investment returns on a specified pool of assets held by the issuer, or
- the profit or loss of the entity or fund that issues the contract.

Under IFRS 17, investment contracts with discretionary participation features are only within the scope of the standard if the entity also issues insurance contracts. Otherwise, they are accounted for as compound instruments containing a financial liability component within the scope of IFRS 9 and an equity component, if applicable. This is a change compared to IFRS 4. Under the current guidance, all investment contracts with discretionary participation features are included in the scope of the insurance standard, regardless of whether the issuer also issues insurance contracts.

PwC observation: Investment contracts with discretionary participation features in consolidated financial statements and individual financial statements of a subsidiary

This change will not affect many insurers who issue investment contracts with discretionary participation features, because they often also issue insurance contracts.

However, the new guidance for investment contracts with discretionary participation features might result in different accounting in the consolidated and the separate financial statements, as set out in the example below.

Entity S is a subsidiary of entity P; it has issued investment contracts with discretionary participation features but no insurance contracts. Entity P issues insurance contracts.

The investment contracts are accounted for as liabilities or as compound instruments within the scope of IFRS 9/IAS 32 in the separate financial statements of entity S; but they are accounted for as investment contracts with discretionary participation features within the scope of IFRS 17 in the consolidated financial statements of the group.

Scope exemptions

IFRS 17 does **not apply** to:

- Warranties provided by a manufacturer, dealer or retailer in connection with the sale of a product (either a good or a service) to a customer.
- Employers' assets and liabilities that arise from employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans.
- Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item (for example, some licence fees, royalties, variable and other contingent lease payments and similar items).
- Residual value guarantees provided by a manufacturer, dealer or retailer.
- A lessee's residual value guarantee embedded in a lease.
- Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used the accounting guidance applicable to insurance contracts (see below).
- Contingent consideration payable or receivable in a business combination.

Financial guarantee contracts that require the issuer to make specified payments, to reimburse the holder for a loss that it incurs because a specified debtor fails to make a payment when due, meet the definition of an insurance contract. They are, however, outside the scope of IFRS 17, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used the accounting guidance applicable to insurance contracts. For such contracts, the issuer can choose to apply either IFRS 17 or the guidance in IAS 32, IFRS 7 and IFRS 9. The issuer can make the election on a contract-by-contract basis, but the election for each contract is irrevocable.

Assertions that the issuer regards contracts as insurance contracts can typically be found in business documentation, contracts, accounting policies, financial statements and communications with customers and regulators.

PwC observation: Changes in the list of contracts that are outside the scope of IFRS 17 compared to IFRS 4

The list of insurance contracts outside the scope of IFRS 17 is similar to the list in IFRS 4. The only item added is 'residual value guarantees provided by a manufacturer, dealer or retailer'; under IFRS 4, the accounting for insurance contracts was applied to them.

A service provider might enter into **fixed fee service contracts**. Under these contracts, the customer pays a fixed fee to receive certain services over a fixed period of time when needed. Examples are maintenance contracts under which the service provider is obliged to repair specified equipment after a malfunction, or car breakdown services in which the provider is obliged to provide roadside assistance or tow the car to a nearby garage. Because the level of service and thereby the obligation of the service provider depends on an uncertain future event, these kinds of contract might meet the definition of an insurance contract.

An entity can, however, make the irrevocable choice to apply IFRS 15 instead of IFRS 17 to these contracts if all of the following conditions are met:

- The price of the contract does not reflect an assessment of the risk with an individual customer.
- The contract compensates the customer by providing a service.
- The insurance risk arises primarily from the customer's use of services rather than from uncertainty over the cost of the service.

The choice can be made on a contract-by-contract basis.

Combination and Separation of Insurance Contracts

Combination of Insurance Contracts

An entity might enter into a series of insurance contracts with the same or a related counterparty to achieve an overall economic effect. In order to ensure that the accounting reflects the substance of these contracts, it might be necessary to combine the group or series of contracts and analyse them in their entirety. If, for example, an entity enters into two separate insurance contracts with the same counterparty at the same time with exactly opposite rights and obligations, it does not account for those contracts, because the combined effect is that no rights and obligations exist.

PwC observation: Combination requirements for fronting arrangements

The combination requirements for insurance contracts under IFRS 17 changed compared to IFRS 4. There are no specific requirements about the combination of insurance contracts in IFRS 4 where entities are using different accounting policies. This could affect insurers entering into fronting arrangements. An example of a situation where the accounting might change is set out below.

A policyholder transfers risks to a third party insurer, but all of the risks are then passed back to the same policyholder under a reinsurance arrangement. There might be situations where the same legal entity is both the policyholder and the reinsurer, or where the policyholder and the reinsurer are different legal entities but they are part of the same group. Accounting for contracts by the insurer could be affected by the new combination requirements.

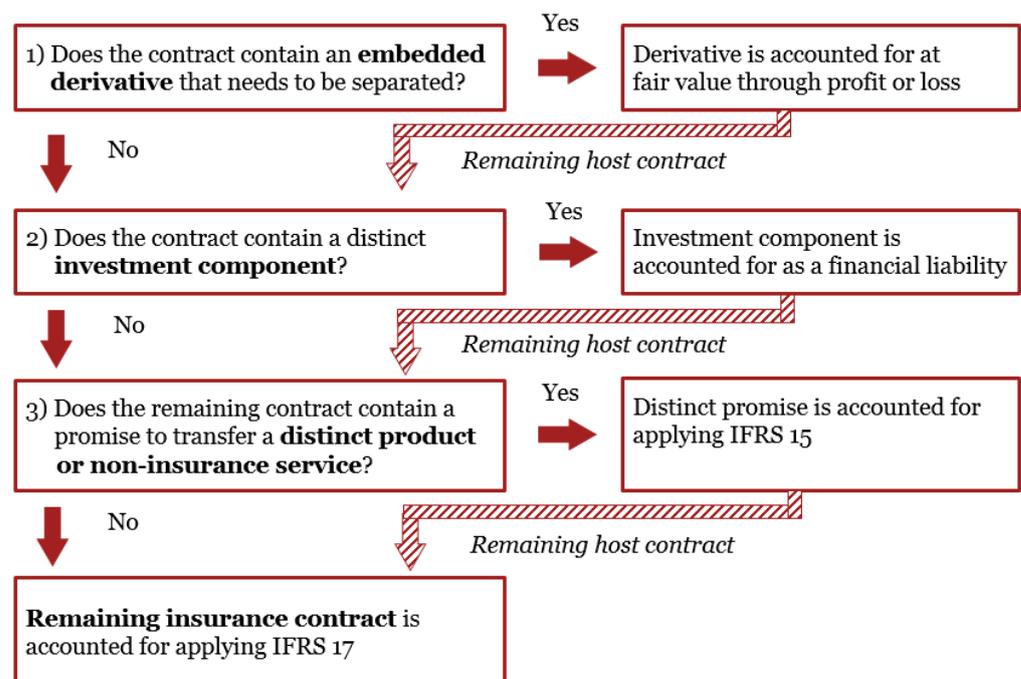
Entities should analyse the terms of each arrangement to conclude whether contracts should be combined under the new requirements in IFRS 17.

Separation of Insurance Contracts

Before the entity accounts for an insurance contract based on the guidance in IFRS 17, it should analyse whether the contract contains components that should be separated. IFRS 17 distinguishes between three different kinds of component that have to be accounted for separately if certain criteria are met:

- embedded derivatives;
- investment components; and
- promises to transfer distinct goods or distinct non-insurance services.

The sections below explain each of these items in more detail.



An entity applies IFRS 17 to all remaining components of the contract. Separation of other non-insurance components is prohibited.

PwC observation: Prohibition on voluntarily separating components of an insurance contract

We believe that under IFRS 17 separation of any components is prohibited unless it is explicitly required under the standard. This might have a significant effect on some entities. For example, a bank might issue loans that are waived if the borrower dies. Under IFRS 4, the bank could have voluntarily separated the contract into a loan accounted for at amortised cost, similar to other loans, and the insurance component accounted for under IFRS 4. Under the new standard, the loan element is unlikely to qualify as a distinct investment component (see below), and so the entire contract will be required to be accounted for as an insurance contract.

PwC observation: Contracts with riders

Insurers often issue contracts with riders. A rider is an add-on provision to a basic insurance policy that provides additional benefits to the policyholder at an additional cost. Riders can be either part of a contract at inception or added subsequently. Irrespective of when the riders are issued they can be priced at inception or subsequently in line with the prices at the date when the rider is issued. The accounting for riders depends on the terms of the contracts.

*Riders that are **separate** policies or insurance contracts*

If riders are issued and priced separately from the base insurance contracts, they should be viewed as separate insurance contracts for IFRS 17, unless required to be bundled together under the combination guidance.

*Riders that are issued together with the main insurance contract and form part of a **single** insurance contract*

If there is only one insurance contract with multiple provisions, and all of the riders are within the boundary of that contract, the contract will be viewed as one contract for IFRS 17. Separation of the insurance contract is prohibited.

Embedded derivatives

An entity applies the guidance in IFRS 9, 'Financial Instruments', to determine whether an embedded derivative should be separated. Under IFRS 9, an embedded derivative is separated if all of the following criteria are met:

- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host.
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- The hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss.

The guidance in IFRS 9 makes clear that the linkage of contractually required payments to an equity index or a debt index that reflects the credit risk of the underlying debt instruments issued by a third party is, in general, not closely related. For insurance contracts, IFRS 9 and IFRS 17 include two important exemptions. First, IFRS 9 explains that derivatives embedded in an insurance contract are closely related to the insurance contract and are not separated if the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately without considering the host contract. Second, IFRS 17 notes that the payment of an amount linked to a price index does not give rise to a non-closely related embedded derivative if the payment itself is triggered by an insured event and the transfer of insurance risk is significant.

PwC observation: Changes in requirements of IFRS 17 compared to IFRS 4

IFRS 4 requires insurers to follow the IFRS 9 guidance on separation of embedded derivatives, with an exception not to separate a policyholder's option to surrender an insurance contract for a fixed amount or for an amount based on a fixed amount and an interest rate. In addition, the implementation guidance to IFRS 4 has a few examples explaining when an embedded derivative should or should not be separated.

IFRS 17 requires entities to use the IFRS 9 guidance for the separation of embedded derivatives. The requirements and examples from IFRS 4 have not been carried forward to IFRS 17. Insurers should analyse derivatives embedded in the insurance contracts to conclude whether separation is required.

Investment components

In a second step, an entity separates any **investment component** that is **distinct**. An investment component is the amount that the insurer has to repay to the policyholder, even if the insured event does not occur.

The component is distinct if both of the following criteria are met:

- The investment component and the insurance component are not highly interrelated. The two components are highly interrelated if the value of one component varies with the value of the other component and hence the entity is unable to measure each component without considering the other. The components are also highly interrelated if the policyholder is unable to benefit from one component unless the other is also present. This is, for example, the case if the maturity or lapse of one component causes the maturity or lapse of the other component.
- A contract with terms equivalent to the investment component is sold, or could be sold, separately in the same market or same jurisdiction. An entity takes into account all reasonably available information when it makes this assessment, but it does not have to undertake an exhaustive search.

PwC observation: Distinct investment components

Often, for contracts with death benefits, other components of the contract are settled on the death of the policyholder or when the contract lapses. If investment components cease to exist on death or lapse of the contract, the investment components are non-distinct from the life insurance component. Thus, they are not separated. Similarly, some property and casualty contracts contain experience refunds or no claims bonuses that are investment components but would be non-distinct if termination of the insurance contract results in termination of those components.

An investment component that is separated from the insurance contract is accounted for as a financial instrument within the scope of IFRS 9. An investment component that is non-distinct and is not separated from an insurance contract for the purpose of measurement should nevertheless be excluded from both insurance revenue and insurance service expenses (see the section on '*Presentation*' below).

PwC observation: Policyholder loans

Some insurance companies provide loans to policyholders secured on insurance policies for an amount up to the maximum of the account value of the policy. Currently, these loans are often accounted for and presented as financial assets.

Under IFRS 17, the accounting depends on whether the policyholder loan is required to be repaid on maturity or lapse of the insurance contract. If the policyholder cannot benefit from the policyholder loan unless the insurance contract is in force, the policyholder loan is a non-distinct component of the insurance contract and should be accounted for together with the insurance contract. This means that payments of interest and principal are future cash flows from the insurance contract. They are measured on a current probability-weighted basis and discounted using the same discount rate as all other cash flows from the insurance contract.

It is not permitted to present policyholder loans as assets on the balance sheet separately from other cash flows from the same contract.

Promises to transfer distinct goods or non-insurance services

In a final step, after separating non-closely related embedded derivatives and distinct investment components, an entity should separate from the host insurance contract any **promise to transfer distinct goods or non-insurance services** to a policyholder.

A good or non-insurance service is **distinct** if the transferee can benefit from the good or service either on its own or together with other resources that are readily available. A resource is readily available if it is either sold separately or the transferee already owns it. A good or non-insurance service is not distinct if the cash flows and risks associated with that good or service are highly interrelated with those of the insurance component and the entity provides a significant service in integrating the good or service with the insurance component.

PwC observation: Assessment of distinct service components

The criteria in IFRS 17, to assess whether a promise to transfer goods or non-insurance services is distinct, are similar to the criteria in IFRS 15, 'Revenue from Contracts with Customers'. Under both standards, an entity should analyse whether the customer is able to benefit from the good or service either on its own or together with resources that are readily available and whether the transfer of good or service is interrelated with other components of the contract. Under certain circumstances, the additional guidance provided in IFRS 15 may therefore be helpful in interpreting the term 'distinct' in IFRS 17.

Activities that an insurer has to perform to fulfil the insurance contract, such as administrative tasks to set up the contract, are not separated. In general, processing the claims received is part of the activities that the insurer must undertake to fulfil the contract and is not a distinct service that should be separated. There are, however, exceptions, in particular if the insurance company provides the service to an entity that self-insures a part of its risks. Illustrative Example 5 to IFRS 17 demonstrates a contract with a distinct service component that should be separated.

Once the entity has concluded that a promise to transfer goods or non-insurance services is accounted for separately, it should **allocate** the cash flows to the insurance component and any promises to provide goods or non-insurance services accounted for separately.

A comprehensive example of how components are separated from an insurance contract is included in Illustrative Example 4 to IFRS 17.

Recognition

Level of Aggregation

Entities should aggregate contracts at inception in groups for recognition, measurement, presentation and disclosure. Groups should not be reconsidered after initial recognition.

An entity should initially identify portfolios of insurance contracts. A portfolio of insurance contracts is defined as insurance contracts subject to similar risks and managed together. It is generally expected that contracts in different product lines will have different risks. For example, single-premium fixed annuities and regular term life insurance contracts are expected to be in different portfolios, because they cover different insurance risks (longevity and mortality).

PwC observation: Applying the term ‘portfolio’

Applying the definition of a portfolio in practice might require judgement. Entities might define portfolios in different ways, as ‘managed together’ and ‘similar risks’ represent areas of judgement. This could affect how insurance contracts are measured. IFRS 17 uses the term ‘portfolio’ for a number of purposes, such as defining a group of insurance contracts and insurance acquisition cash flows. The way in which an entity defines portfolio should be applied consistently for all of these different purposes.

PwC observation: Aggregation of insurance contracts and investment contracts with discretionary participation features in one portfolio

Contracts are aggregated in portfolios if they are subject to similar risks and are managed together. Currently, under IFRS 4, many insurance contracts and investment contracts with discretionary participation features are measured together. Entities should exercise judgement to conclude whether insurance and investment contracts have similar risks and whether they can be aggregated and measured together.

Portfolios should be further disaggregated into groups of insurance contracts that are, on initial recognition:

1. onerous;
2. profitable, with no significant risk of becoming onerous; and
3. profitable, with significant possibility of becoming onerous (remaining contracts).

It is possible that, for an individual portfolio, there are no contracts in one or even two of the three groups. For example, if an entity expects that all insurance contracts in a portfolio are not onerous and have no significant risk of becoming onerous, only one out of three profitability-based groups will be required.

In some jurisdictions, laws and regulations might constrain an insurer's practical ability to set prices or level of benefits based on a specific characteristic (such as gender anti-discrimination laws). An entity should not allocate contracts to different groups based on different profitability resulting from such constraints. Other situations, such as general anti-discrimination laws that do not specifically relate to insurance premiums or benefits, self-regulatory practices or practices based on the law in other jurisdictions not applicable to the contract, will not qualify for the exemption.

It might not be necessary to assess the profitability of each insurance contract on initial recognition if an entity has reasonable and supportable information to conclude that each contract in a portfolio, a group or a set (being an aggregation of contracts that is neither a portfolio nor a group) has the same profitability. Profitability of insurance contracts should be assessed individually at inception if the entity does not have such information.

An entity should assess the significance of the risk of contracts becoming onerous based on the likely changes in assumptions affecting contract profitability using internal reporting that captures information about estimates.

In addition, a group can only include contracts that have been issued within one year of each other.

A group could consist of one contract.

PwC observation: Individual versus aggregated assessment of profitability of insurance contracts at inception for aggregation into groups

Often, entities will have information about the profitability of each insurance contract in a portfolio, a group or a set without assessing individually each insurance contract.

The assessment of profitability should be made based on the information available to an entity at inception. Throughout the coverage period, the information about the profitability of each insurance contract in a group will change and, ultimately, some contracts in the group will be profitable and some will be onerous. However, for a sufficiently homogeneous population of contracts, the expectation about the profitability of each contract at inception measured on an expected probability-weighted basis is likely to be similar.

An entity cannot use information about insurance contracts in a portfolio, a group or a set for contracts on an aggregate basis if the insurance contracts are not sufficiently homogeneous. For example, an entity might have reasonable and supportable information about a portfolio of motor insurance contracts that demonstrates that it is expected to be profitable at inception. However, at inception on a probability-weighted basis, policies issued to female drivers are expected to be profitable with no significant risk of becoming onerous, policies issued to male drivers of a specified age group are expected to be onerous, and policies issued to other male drivers will be profitable with significant possibility of becoming onerous. Aggregation of contracts based on profitability of the portfolio as a whole is not acceptable (in this example), because the entity cannot conclude that each contract in the portfolio has the same profitability at inception. However, it might be possible to use separate information about policies issued to female drivers, male drivers of a specified age group and other male drivers without assessment of each individual insurance contract in each of the indicated sets. The exception on regulatory pricing might also apply.

For some contracts, such as some bespoke (individually tailored) commercial contracts, there will be no information on an aggregated basis, and entities will be required to assess profitability of each contract at inception individually.

Timing of Initial Recognition

Groups of insurance contracts are initially recognised from the earliest of:

- when the coverage period starts;
- when the first payment from the policyholder is due, or actually received if there is no due date; and
- based on the facts and circumstances, when the entity determines that the group of contracts is onerous.

An entity should include individual contracts in an already existing group only when they are issued. The standard notes that an entity can issue more contracts in a group after the end of a reporting period. This could lead to a change in the discount rate from initial recognition of the group.

Measurement

Introduction

There are three measurement approaches under IFRS 17 for different types of insurance contract:

	<i>General model</i>	<i>Premium allocation approach</i>	<i>Variable fee approach</i>
<i>Why is it needed?</i>	Default model for all insurance contracts	Simplified measurement for short-term contracts with little pre-claim variability	Model for direct participating business
<i>Mandatory?</i>	Mandatory	Optional	Mandatory

General model should be applied to all insurance contracts, unless they have direct participation features or the contract is eligible for, and the entity elects to apply, the premium allocation approach.

Premium allocation approach is an optional simplification for measurement of liability for remaining coverage for insurance contracts with short-term coverage.

Variable fee approach should be applied to insurance contracts with direct participation features. This approach deals with participating business where payments to policyholders are contractually linked and substantially vary with the underlying items. This approach cannot be used for the measurement of reinsurance contracts.

Measurement of Non-participating Contracts

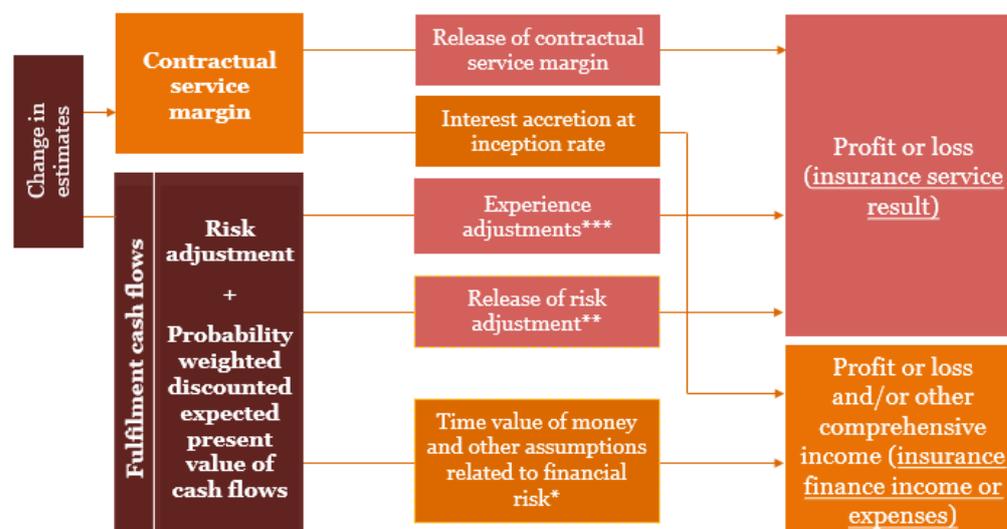
Participating contracts are insurance contracts or investment contracts with discretionary participation features where an insurer shares the performance of underlying items with policyholders. All other contracts are referred to as non-participating contracts.

General Model

The general model is based on the following building blocks:

- a current estimate of future cash flows expected (probability-weighted mean) to arise during the life of the contract;
- an adjustment to reflect the time value of money and other financial risks, such as liquidity and currency risks (discounting);
- an explicit risk adjustment for non-financial risks; and
- a contractual service margin representing the unearned profit from the contract.

The diagram below summarises the major building blocks in the general model and how the changes in the building blocks flow into the statement of comprehensive income. Measurement of each building block and its impact on the statement of comprehensive income are considered in more detail later in this publication.



* Accounting policy choice for future cash flows and risk adjustment: (1) recognise all in profit or loss; or (2) recognise insurance finance income or expenses by unwinding discount rate locked in at inception in profit or loss and changes in discount rate in other comprehensive income.

** Entity can choose whether to disaggregate change in risk adjustment for non-financial and financial risk. If it does not, the entire change is in the insurance service result.

*** Not all experience adjustments are recognised in profit or loss. Experience adjustments for premiums related to future services are treated as changes in estimates; that is, they adjust the contractual service margin and are not recognised in profit or loss immediately.

An entity should estimate each building block of the general model explicitly and separately, unless the most appropriate measurement technique combines some of the elements, as follows:

- cash flows should be estimated separately from the adjustment for the time value of money and other financial risks; and
- the risk adjustment for non-financial risks should be explicit and separate from the estimates of future cash flows and adjustment for time value of money and other financial risks.

An asset or a liability for a group of insurance contracts that generate cash flows in a foreign currency is a monetary item in accordance with IAS 21, 'The Effect of Changes in Foreign Exchange Rates'.

PwC observation: Assets and liabilities within the scope of IFRS 17 are monetary items

Currently, many insurers treat some elements of the non-life insurance liability, such as unearned premium reserve, as a non-monetary item under IAS 21 and use locked-in exchange rates for translation of such balances denominated in foreign currency. Insurers have found that this distorts some key performance indicators where the assets are monetary items and translated at current exchange rates.

IFRS 17 explicitly requires all assets and liabilities within the scope of IFRS 17 to be treated as monetary items under IAS 21. This will result in translation of the insurance assets and liabilities denominated in foreign currency in their entirety using closing exchange rates and will help insurers to reduce volatility from foreign exchange translation differences.

The fulfilment cash flows in the financial statements of the issuer should not reflect non-performance risk of that entity as defined in IFRS 13, 'Fair Value Measurement'.

Estimated Future Cash Flows

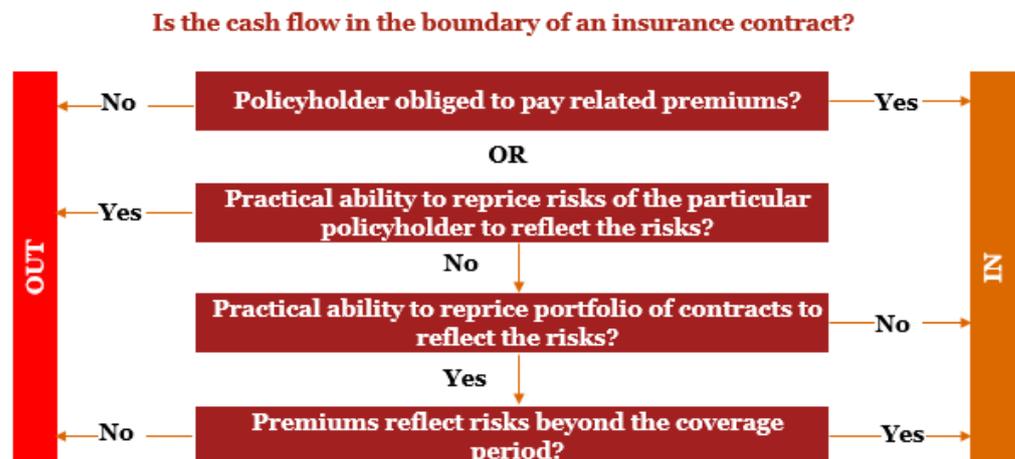
Contract Boundary

The concept of a contract boundary is used to determine which cash flows should be considered in the measurement of an insurance contract. Cash flows that are not in the boundary of an insurance contract relate to future insurance contracts.

Cash flows are within the boundary of an insurance contract if they arise from rights and obligations that exist during the period in which the policyholder is obliged to pay premiums or the entity has a substantive obligation to provide the policyholder with insurance coverage or other services. A substantive obligation ends when:

- (a) the entity has the practical ability to reprice risks of the particular policyholder or change the level of benefits so that the price fully reflects those risks; or
- (b) both of the following criteria are satisfied:
 - i. the entity has the practical ability to reprice the contract or a portfolio of contracts so that the price fully reflects the reassessed risk of that portfolio; and
 - ii. pricing of premiums related to coverage to the date when risks are reassessed do not reflect risks related to periods beyond the reassessment date.

The diagram below summarises the decision-making process to analyse what cash flows are included in the contract boundary:



PwC observation: Practical considerations for contract boundaries

The result of the contract boundary assessment depends on an entity's practical ability to reprice a portfolio of insurance contracts. Thus, contract boundaries could be affected by how an entity defines the portfolio. Applying the definition of a portfolio in practice might require judgement (see the section on '[Level of Aggregation](#)' above for more details about aggregation of contracts in a portfolio).

Health insurance products in some jurisdictions offer annual guaranteed renewal options. Entities are often not able to reassess risks fully for individual policyholders, because a policyholder does not have to go through health assessment procedures on renewal. However, entities can reset the price based on full reassessment of the risks for the portfolio of insurance contracts considering insurance risk up to the next renewal date. Such contracts will have an annual contract boundary if other criteria in the contract boundary assessment also indicate that this is a one-year contract.

Cash Flows within Contract Boundary

Cash flows within the contract boundary include the following types of cash flow related directly to the fulfilment of an insurance contract:

- premiums and related payments;
- claims and benefits, including reported but not settled claims, incurred but not reported claims, and future claims expected to be incurred within the contract boundary;
- discretionary payments and payments to policyholders that vary depending on returns from underlying items from existing contracts, regardless of whether those payments are expected to be made to current or future policyholders;
- payments resulting from embedded derivatives (such as options and guarantees) and non-distinct investment and service components that are not separated from the insurance contracts;
- insurance acquisition cash flows, if they are attributable to the portfolio to which the contract belongs;
- claim handling costs;
- costs of contractual benefits paid in kind;
- policy administration and maintenance costs, including recurring commissions paid to intermediaries;
- transaction-based taxes and levies (such as premium-based taxes) and payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder;
- recoveries on future and past claims, such as salvage and subrogation, to the extent that they are not recognised as separate assets;
- fixed and variable overheads; and
- other costs chargeable to the policyholder in accordance with the terms of the contract.

Insurance acquisition cash flows included within insurance contract boundary are defined as follows:

- costs arising from selling, underwriting and starting a group of insurance contracts; and
- costs that are directly attributable to the portfolio of insurance contracts to which the group belongs. There is no requirement for the cash flows to be directly attributed to an individual insurance contract or a group of contracts, provided that they are directly attributable to a portfolio. Cash flows that are not directly attributable to an individual insurance contract or a group of contracts are allocated on a reasonable and consistent basis to measure the group of insurance contracts.

Some acquisition costs, such as some product development and training costs, might not be directly attributable to a portfolio of insurance contracts. Such costs are recognised in profit or loss as incurred. Asset investment returns, cash flows from reinsurance contracts held, income taxes and cash flows related to components separated from insurance contracts are also excluded from the fulfilment cash flows of an insurance contract.

PwC observation: Income tax payments and receipts

Income tax payments and receipts that an entity does not pay or receive in a fiduciary capacity are recognised and measured under IAS 12, 'Income taxes', and are not included in the expected cash flows. In some territories, insurers pay tax on behalf of policyholders, but these taxes meet the definition of an income tax and so are not included in the measurement of the insurance contract. Measurement requirements under IAS 12 and IFRS 17 are different. For example, IAS 12 does not require discounting, leading to benefits being measured on a present value basis while related taxes are measured on undiscounted basis.

However, if taxes paid on behalf of policyholders are not measured under IAS 12 there will be within the scope of IFRS 17 and thus will reduce cash flows from the policyholder benefits when measuring insurance liabilities.

PwC observation: Insurance acquisition cash flows

Currently, under IFRS 4, many insurers recognise deferred acquisition cash flows separately as assets. Under IFRS 17, insurance acquisition cash flows decrease the contractual service margin and are thus implicitly deferred within the contractual service margin and are recognised as a decrease in revenue in future reporting periods as services are rendered. However, for presentation purposes qualifying acquisition costs are amortised as an insurance service expense in a systematic way with an equal amount recognised as insurance revenue.

The IASB decided not to distinguish between the following types of costs, all of which should be included in the measurement of insurance contracts, provided that they meet the definition of insurance acquisition cash flows:

(a) Successful and unsuccessful efforts

Costs of originating a portfolio of contracts include costs related to unsuccessful efforts to originate individual insurance contracts or a group of insurance contracts. The insurer usually attempts to originate numerous contracts, and some of those attempts are generally not successful. Therefore, the costs of all attempts are necessary to originate a portfolio of successful contracts.

It is generally expected that the types of costs qualifying as insurance acquisition cash flows and their impact on insurance liabilities will be comparable between entities, irrespective of the contracts acquisition models that an insurer uses, such as in-house sales department, working with third party intermediaries or direct response advertising.

(b) Direct costs and indirect costs that can be directly attributed to a portfolio of insurance contracts

Insurers generally consider some indirect costs when pricing premiums, so exclusion of such costs would lead to overstatement of the contractual service margin. Insurance acquisition cash flows that are directly attributable to a portfolio level are included in the boundary of an insurance contract.

PwC observation: Mutual insurers

Often, mutual insurers have no shareholders. Insurance contracts provide policyholders with a share in returns of the mutual insurer that issues the insurance contract. As a result, the residual interest of such mutual insurers is due to current and future policyholders. In certain situations, the fulfilment cash flows of a mutual insurer might include the rights of policyholders to the whole of any surplus of assets over liabilities. In this scenario, there might be no equity remaining and nil net comprehensive income reported in any accounting period.

Insurance contracts are measured using current estimates, except for accounting for the contractual service margin. Mutual insurers may elect to measure the majority of assets at fair value in accordance with other IFRSs, except for certain assets and liabilities, such as goodwill, deferred income tax and provisions. Accordingly, some accounting mismatches are likely between the value of assets and liabilities due to different measurement basis.

The result of the accounting mismatches (that is, the difference between total assets and insurance liabilities) will be recognised as either liability or equity depending on the legal form of the mutual insurer's organisation and terms of its insurance contracts.

Use of All Reasonable and Supportable Information Available without Undue Cost or Effort

The estimates of future cash flows should incorporate all reasonable and supportable information available without undue cost or effort about amount, timing and uncertainty of those future cash flows. To accomplish this, an entity should estimate the expected value of the full range of possible outcomes. Estimates and assumptions should be unbiased (that is, neither conservative nor optimistic).

The expected value represents a probability-weighted mean of a range of scenarios that reflect the full range of possible outcomes. For each scenario, the entity should identify the amount, timing and probability of that outcome. The approach to identify the most likely outcome or more-likely-than-not outcome does not comply with the requirements of IFRS 17. Scenarios include estimates of the catastrophic losses but do not include claims under possible future contracts.

The objective of considering the full range of all possible outcomes is to incorporate all reasonable and supportable information. An insurer is not required to identify every possible scenario. Explicit scenarios are not required if the result meets the objective. However, a single scenario based on the most likely outcome or the more-likely-than-not outcome would not meet the objective where there is a non-linear relationship between the different scenarios and the associated changes in measurement. Judgement is required to determine the appropriate number of scenarios that will capture material non-linearity. This will depend on facts and circumstances and should be periodically reassessed.

Example – Stochastic and deterministic modelling

The table below describes an insurance contract under a range of scenarios that reflect all possible outcomes. The table summarises information about net cash inflows and the probability of each scenario:

Scenario	Net cash inflows/ (outflows), CU	Probability	Probability- weighted outcome, CU
1	(10,000)	5%	(500)
2	–	15%	–
3	5,000	7%	350
4	15,000	73%	10,950
Total		100%	10,800

Currently, entities use either stochastic or deterministic modelling for measurement of insurance liabilities. Stochastic modelling requires considering various scenarios in determining the value of the insurance liabilities. Deterministic modelling usually identifies the most likely outcome or more-likely-than-not outcome and is not based on a range of all possible outcomes. For this example, the value of the insurance liability determined using stochastic modelling is CU10,800 (that is, probability-weighted outcome), while using deterministic modelling the value is CU15,000 (that is, most likely outcome).

Unlike many current accounting models that develop a single ‘best estimate’, under IFRS 17 all scenarios and their associated probabilities (even remote ones) should be considered and weighted. However, not all cases will require the development of explicit scenarios. In cases where there are complex underlying factors that behave in a non-linear fashion, sophisticated stochastic modelling might be needed. This could happen, for example, if the cash flows reflect a series of interrelated options. The objective is to incorporate all of the relevant information and not ignore any information that is difficult to obtain.

Stochastic modelling can be complicated, both to initially implement and to maintain. This may be an additional IFRS 17 implementation complexity for entities that do not use stochastic modelling currently under IFRS 4.

Reasonable and supportable information is defined as information reasonably available at the reporting date without undue cost or effort. Uncertainty and judgement associated with available information does not necessarily mean that information is not reasonable and supportable. Information available without undue cost and effort will include an entity’s own internal information, such as historical claims, benefits and lapse data and any forecasts of potential future claims, benefits and lapses, as well as externally available information such as economist forecasts and statistics (for example, mortality information) for a country where the entity operates.

The following are examples of possible sources of information about probabilities, amounts and timing of future payments:

- actual information available about policyholders, such as claims already reported;
- an entity’s own historical experience, such as claims previously reported for similar contracts;
- country or industry information about historical experience, such as country mortality rates;
- information about emerging trends or changes in economic, demographic and other conditions, such as development of a treatment for diseases that impact mortality rates; and
- changes in an entity’s own procedures that might affect the way in which information is gathered and presented, such as gathering sufficient statistically credible data for new products that enable an entity to measure liabilities using its own statistics while previously that was not possible.

Market and Non-market Variables

The estimates of future cash flows should reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables.

An entity is required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs, except for the following circumstances:

- alternative pricing methods are acceptable where an entity holds a large number of similar assets or liabilities, but the market price for each asset or liability is not readily accessible;
- market price does not represent fair value at the measurement date; or
- available market price should be adjusted where a significant adjustment is needed to reflect the characteristics of the asset or liability.

Unobservable inputs should be as close as possible to the observable inputs if observable inputs cannot be used without adjustment.

Market variables can be observed, or derived directly, from the market. For insurers, market estimates and assumptions can include interest rates, quoted prices of debt and equity securities for participating contracts, inflation rates and prices of embedded derivatives that are not separated, such as options and guarantees.

For some contracts, some cash flows from the liability will exactly match cash flows of a theoretical portfolio of assets in all scenarios (replicating portfolio). In this case, the value of the replicating portfolio of assets and cash flows arising from the liability would be identical. An entity can use the market value of the replicating assets portfolio as an observable input to measure cash flows from the liabilities. This is referred to as 'replicating portfolio technique'. If an entity chooses not to use a replicating portfolio technique, it must satisfy itself that its approach will not lead to a materially different measurement.

IFRS 17 does not require the use of any specific modelling techniques. Insurers should exercise judgement to identify the technique that best meets the objective of maximising the use of observable market inputs. In particular, the technique used should result in the measurement of any options and guarantees included in the insurance contracts being consistent with observable market prices for such options and guarantees.

Entities are not required to measure cash flows from insurance contracts separately (for example, separate measurement of cash flows related to participation features, options and guarantees, claims and expenses). Entities should use discount rates appropriate for a contract as a whole if cash flows are not measured separately based on their characteristics. This could be achieved by using stochastic modelling or risk-neutral measurement techniques.

PwC observation: Market consistent measurement of options and guarantees

IFRS 17 will require stochastic modelling of financial options and guarantees (such as a guaranteed maturity value), which might not be a common practice in certain territories, as discussed in 'Example – Stochastic and deterministic modelling' above. Options and guarantees should be recognised and measured on a current, market consistent basis. All cash flows, including fixed, guaranteed and cash flows variable with underlying items, should be measured on a probability-weighted basis using market variables, where relevant, and considering all possible scenarios. The measurement of options and guarantees will, in many cases, involve stochastic modelling or using a deterministic model, run multiple times, to reflect a range of scenarios because of the non-symmetric distribution of outcomes for those features. A single deterministic approach might, for example, omit valuing the scenarios where the expected investment return is less than a guaranteed return. For certain simple options and guarantees, a formula (such as 'Black Scholes') might exist which could be equivalent to stochastic modelling.

The most common methods for measuring financial options and guarantees on a market consistent, stochastic basis are the 'risk neutral' and 'real world/deflator' methods. In these methods, the financial options and guarantees are measured consistently with the cost of hedging the obligation (where observable) at the balance sheet date. This is achieved through the modelling of the interactions between cash flows that vary with underlying items and the discount rate for the contract as a whole. There are alternative 'real world' stochastic methods, used today in certain territories, where some asset classes (such as equity instruments and real estate) are assumed, based on historical market averages, to outperform fixed income asset classes. These 'real world' methods are not permitted under IFRS 17, because financial options and guarantees would not then be measured consistently with observable current market prices.

Non-market variables include all variables that cannot be observed, or derived directly, from the market. For insurers, non-market estimates and assumptions can include information about amounts, timing and uncertainty of incurred and future claims, lapse rates, mortality and morbidity rates, and expectations about how the insurer will exercise discretion in the future.

Entities can use both internal and external sources of non-market variables. Judgement is required to identify the most relevant information where both internal and external information is available. For example, mortality information is usually available both internally (from an entity's accumulated data about mortality experience) and externally (such as mortality statistics of the country where the entity operates). Mortality statistics of a country might be irrelevant if an entity issues policies only in one region of the country. On the other hand, if such a company decides to expand its business from a single region to the whole country, its internally accumulated mortality experience might be irrelevant for the new portfolio, and country statistics or other external sources of information might be more relevant.

In some cases, non-market variables might correlate with market variables. For example, for a participating contract with an embedded guarantee of minimum returns, the lapse rate might correlate with market interest rates. That is, the probability of lapse decreases with a decrease in market interest rates. In such cases, entities should ensure in relevant scenarios that probabilities associated with non-market variables are consistent with observable market information.

Market variables are often associated with financial risk, and non-market variables with non-financial risks, but this will not always be the case. For example, debt and equity instrument prices and interest rates always represent financial risk but they are not always observable in the market. Non-market variables should be as consistent as possible with available market information.

Current Estimates and Assumptions

The estimates of future cash flows should be current (that is, they should reflect conditions existing at the measurement date, including assumptions at that date about the future).

At each reporting date, an entity is expected to review estimates to ensure that estimates faithfully represent the conditions at the end of the reporting period. A range of estimates, rather than a point estimate, could be identified. Selecting a different point in a range compared to the previous reporting period, as an entity updates estimates at the end of the current reporting period, does not faithfully represent a change in conditions during the reporting period. Generally, no changes in estimates are expected if there are no changes in conditions.

The most recent actual experience might not be representative of estimates of future cash flows. An entity should consider the following questions to analyse what impact the most recent actual experience has on estimates of future cash flows:

- Is the change expected to last?
- Have the characteristics of the insured population changed?
- Does the most recent experience represent random fluctuation?
- Are there any other non-recurring causes affecting the most recent experience?

For non-market variables, an entity should analyse information about the past experience and expectations about future changes compared to the past experience. Future changes in legislation should not be considered until they are substantively enacted.

Discount Rates

The estimates of future cash flows should be adjusted to reflect the time value of money and other financial risks, such as currency and liquidity risk associated with those cash flows, unless the financial risks have been included in the estimates of cash flows. The discount rates should:

- (a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
- (b) be consistent with observable current market prices for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
- (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.

PwC observation: Restriction on using asset-based discount rates

Some insurers currently use discount rates based on the assets held by the insurer. IFRS 17 does not permit the use of an asset-based discount rate if the asset returns do not affect the cash flows of the insurance contracts. However, depending on the characteristics of the liabilities, the assets held by the insurer could be the starting point to determine a permissible discount rate.

PwC observation: Yield curve or single discount rate?

IFRS 17 does not specify whether an insurer should use a yield curve or a single discount rate. The terms ‘yield curve’ and ‘discount rate’ are used interchangeably in IFRS 17. For some measurements, such as discounting of future cash flows, entities might need to use a yield curve; for others, such as accretion of interest on the contractual service margin using locked-in discount rates, entities are likely to use single discount rate instead of a yield curve. Entities should ensure that the single discount rate or yield curve used for measurement fits the purpose of measurement and complies with the requirements of IFRS 17.

An entity is neither required to measure, nor prohibited from measuring, separately cash flows from an individual insurance contract with different characteristics. The discount rate applied to those cash flows should be relevant to the characteristics of the cash flows being measured. The discount rate should be blended to reflect the different characteristics of combined cash flows if an entity does not measure the cash flows separately and uses a single discount rate or a yield curve for the contract as a whole. Stochastic modelling or risk-neutral measurement techniques are examples of approaches that can be used where a single discount rate is applied to the whole insurance contract.

The following are examples of the required linkage between the discount rate and characteristics of the related cash flows:

- Cash flows that vary with returns on the underlying items are discounted using discount rates reflecting that variability. Alternatively, if the cash flows are adjusted to eliminate the variability, the discount rate applied should also be adjusted to exclude the variability from the underlying items (such as a risk-free rate).
- Cash flows that do not vary with the underlying items (such as fulfilment expenses, claims handling expenses and cash flows from options and guarantees) should be discounted using interest rates that do not reflect the characteristics of the underlying items.
- Cash flows that include the effect of inflation (nominal cash flows) should be discounted using interest rates not adjusted for inflation (nominal interest rates). Cash flows that exclude the effect of inflation (real cash flows) should be discounted using interest rates adjusted for inflation (real interest rates).

The discount rate can be determined using either:

Bottom-up approach*	Top-down approach
<p>An entity first determines a yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk and adjusts it to reflect the illiquidity of the insurance contract compared to the instrument for which market information is available.</p> <p>The illiquidity adjustment reflects the fact that policyholders often either cannot terminate insurance contracts at all or can terminate them only subject to surrender penalties. Thus, the discount under the bottom-up approach represents a risk-free rate plus an illiquidity premium.</p>	<p>An entity first determines a yield curve reflecting the current market rates of return for a reference portfolio of assets (which could be the assets supporting the liability) and adjusts it for characteristics that are irrelevant for insurance contracts, such as duration mismatches, expected credit losses and the market premiums for credit risks. There is no requirement to adjust differences in liquidity characteristics between the insurance contracts and the replicating portfolio. To determine the yield curve, an entity should maximise the use of relevant observable market inputs.</p>

* Only when cash flows do not vary with the underlying items.

Calculation of the discount rate using a top-down or bottom-up approach represents an estimate in accordance with IAS 8. In practice, a discount rate estimated using top-down and bottom-up approaches will often be different, due to inherent limitations on the way in which adjustments are calculated and the lack of liquidity adjustment for the top-down approach. An entity is required to use one of the two approaches and is not required either to calculate or to reconcile the result to the approach not used.

PwC observation: Using negative interest rates

In the current economic environment, the interest rates for instruments with characteristics similar to those of the insurance contract might be negative. Our view is that the entity should nevertheless use those rates, even if this results in the present value of the payments exceeding the nominal amount. The use of a zero per cent floor is not appropriate.

Sometimes, an entity will be required to use interest rates locked in at inception of the group of insurance contracts, such as accretion of interest on the contractual service margin in the general model. An entity could use weighted-average discount rates, over the period when contracts in the group are issued, to determine the discount rates at the date of initial recognition of a group of contracts.

Risk Adjustment for Non-financial Risk

The risk adjustment for non-financial risk is the compensation that an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils the insurance contract. An entity should adjust the present value of the future cash flows to reflect the risk adjustment for non-financial risk. Adjustments for financial risks are included either in the estimates of future cash flows or in the discount rate.

The risk adjustment for non-financial risks should be measured explicitly. An entity should avoid double counting when measuring the risk adjustment by having an explicit risk adjustment and not adjusting future cash flows or discount rate implicitly to reflect associated non-financial risks.

PwC observation: Explicit risk adjustment for non-financial risks

Incorporating an explicit risk adjustment into the measurement model is consistent with the pricing of insurance contracts, financial instruments and written options. It also reduces the amount of what would otherwise be a larger contractual service margin.

IFRS 17 does not require entities to use any specific technique to estimate the risk adjustment. Example of the techniques that insurers might use include confidence level, conditional tail expectation and cost of capital. The significance of the challenge for entities to reliably and consistently measure the risk adjustment will vary by territory, depending on the experience in that territory and whether risk adjustment techniques are used for capital management or solvency requirements.

The time value of money is independent from the estimate of future cash flows, so the risk of changes in discount rates is not part of the risk adjustment. For example, reinvestment rates for long-term bonds to determine an appropriate discount rate for liabilities will not affect the amount of the risk adjustment.

Example – Risk adjustment for non-financial risks

The table below describes an insurance contract under a range of scenarios that reflect all possible outcomes. The table summarises information about net cash inflows and the probability of each scenario:

Scenario	Net cash inflows/ (outflows), CU	Probability	Probability-weighted outcome, CU
1	10,000	84%	8,400
2	15,000	16%	2,400
Total		100%	10,800

The expected probability-weighted future cash flows for the insurance contract are CU10,800. Two outcomes are possible, due to uncertainty that comes from insurance, lapse, persistency, expense and other non-financial risks associated with the contract.

An entity will require compensation for the uncertainty if it has a choice between an insurance contract and a financial instrument (such as a deposit) that pays CU10,800 and has no uncertainty. The risk adjustment represents this compensation for non-financial risks arising from insurance contracts.

The expected probability-weighted outcome of this example and the **Example – stochastic and deterministic modelling** (above) is the same and amounts to CU10,800. However, in this example the risk adjustment will be lower, because less uncertainty is associated with this scenario – that is, the spread between the cash flows in the different outcomes is lower (CU10,000 and CU15,000), as opposed to (CU10,000), nil, CU5,000 and CU15,000 in the other example).

Because the risk adjustment represents compensation for uncertainty, it should also reflect the following:

- the degree of diversification benefit that the entity includes when determining the compensation that it requires for bearing that risk; and
- both favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion.

The risk adjustment should not reflect the risks that do not arise from the insurance contract, such as general operational risk.

An entity should follow the general principles for measurement of the risk adjustment; however, it can use different methods for measurement, provided that the method complies with the general principles. To reflect the compensation that the entity would require for bearing the non-financial risk, the risk adjustment for non-financial risk should have the following characteristics:

- (a) risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;
- (b) for similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;
- (c) risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;
- (d) the less known about the current estimate and its trend, the higher the risk adjustment for non-financial risk; and
- (e) to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease. and vice versa.

PwC observation: Impact of risk adjustment for non-financial risks on profit pattern

Expected changes in the measurement of the risk adjustment for non-financial risks related to the current reporting period are recognised as revenue, and they affect net profit reported during the period if an entity makes an accounting policy choice not to separate the effect of changes in discount rates from measurement of the risk adjustment. The pattern of revenue recognition and emergence of profit will differ depending on the risk adjustment measurement technique used, as well as the drivers influencing the risk adjustment. For example, the price of capital will affect the risk adjustment if a cost of capital technique is used.

Even though IFRS 17 does not specify the technique for measuring the risk adjustment, an entity will be required to disclose the confidence level to which the risk adjustment corresponds.

Contractual Service Margin

The contractual service margin is a component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned profit that the entity will recognise as it provides services under the insurance contracts in the group.

Initial Measurement of the Contractual Service Margin

An entity should measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that results in no income or expenses arising from:

- (a) the initial recognition of the fulfilment cash flows;
- (b) the derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows; and
- (c) cash flows arising from the contracts in the group at that date.

Before insurance contracts are recognised, an entity could pay acquisition costs to originate them. An entity should recognise prepayment assets for the amount of insurance acquisition cash flows paid before the related insurance contract is recognised. However, it is not allocated to any specific group until the related contracts are recognised. The asset should be allocated to a group of insurance contracts when the insurance contracts are subsequently recognised.

Example – initial recognition of an insurance contract

An entity issues an insurance contract which is the only contract in a group. The entity has paid acquisition costs of CU50 before the start of the coverage period, and the acquisition costs meet the definition of insurance acquisition cash flows. The total premiums are CU1,000 paid at the beginning of the coverage period. Total present value of expected cash outflows is CU545. The risk adjustment for non-financial risk on initial recognition equals CU90.

At the date when acquisition costs were paid, the entity should recognise prepaid acquisition costs of CU50.

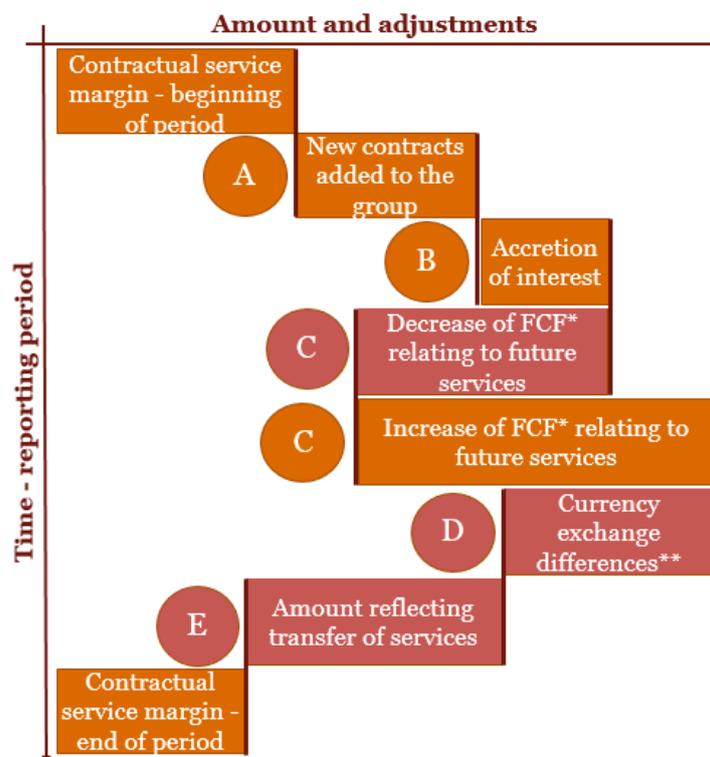
At the beginning of the coverage period (insurance contract inception date), the entity should recognise the insurance contract as follows (debits are presented as positive amounts and credits as negative):

Description	Amount, CU	Clarification
Cash – premiums received	1,000	Fulfilment cash inflows paid at the inception date
Acquisition costs paid before inception	(50)	Pre-coverage cash flows that qualify as insurance acquisition cash flows and written off when contract is initially recognised
Fulfilment cash flows: risk adjustment	(90)	To recognise risk adjustment for non-financial risks
Fulfilment cash flows: present value of expected future cash flows	(545)	To recognise present value of expected future cash flows
Contractual service margin	(315)	To recognise contractual service margin – balancing number
Insurance contract issued (that is, liability)	(950)	Total liability recognised on initial recognition of the contract

A group of insurance contracts is onerous if total fulfilment cash flows at the date of inception are a net outflow (negative contractual service margin). A loss from onerous insurance contracts is immediately recognised in profit or loss. Measurement requirements for onerous insurance contracts are discussed in the section on '*Onerous Insurance Contracts*' below.

Subsequent Measurement of the Contractual Service Margin

After initial recognition, the contractual service margin is measured as follows:



* FCF – fulfilment cash flows.

** Currency exchange differences can be positive.

An entity can recognise adjustments A, B, C and D to the contractual service margin in any order. Adjustment E – to recognise the contractual service margin in revenue to reflect the transfer of services during the reporting period – should be made last, after all other adjustments. The order of the adjustments could affect the amount of the contractual service margin recognised at the end of the reporting period.

PwC observation: Order of allocation of the contractual service margin

The specific requirements to allocate the contractual service margin to profit or loss for the period (Adjustment E above), after adjusting the brought-forward contractual service margin for changes in fulfilment cash flows, is likely to introduce complexity when designing modelling systems.

Adding new contracts to a group (Adjustment A)

An entity should include in the group only insurance contracts issued during the reporting period; future contracts should be added to the group when issued (limited to contracts issued within a year).

Accretion of interest (Adjustment B)

Accretion of interest on the contractual service margin is discussed in sections on '*Discount Rates*' above and '*Insurance finance income or expenses*' below.

Changes in fulfilment cash flows that relate to future periods and experience adjustments (Adjustment C)

Changes in the fulfilment cash flows that relate to future periods adjust the contractual service margin. The following changes relate to future services and adjust the contractual service margin:

- (a) Experience adjustments for premiums received and related cash flows (such as premium-based taxes and acquisition costs) that relate to future services; experience adjustments represent differences between the estimate at the beginning of the period of amounts expected in the period and actual payments during the period (for example, where fewer contracts lapse/surrender than expected).
- (b) Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (such as a change in the mortality assumption).
- (c) Changes related to the investment components that are not separated from insurance contracts.
- (d) Changes in the risk adjustment for non-financial risks that relate to future service.

The changes listed below do not relate to future services. They do not adjust the contractual service margin and are recognised in profit or loss for the reporting period:

- (a) changes related to the liability for incurred claims; and
- (b) experience adjustments related to insurance service expenses excluding insurance acquisition cash flows; experience adjustments represent differences between the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.

Changes related to discount rates are regarded as related to current and prior period services and are recognised in the statement of comprehensive income, as discussed in the section on '*Insurance finance income or expenses*' below.

Release of the contractual service margin to profit or loss (Adjustment E)

An entity should recognise the contractual service margin for a group of insurance contracts in profit or loss to reflect services transferred to policyholders during the period based on coverage units. The quantity of coverage units is determined by considering, for each contract, the quantity of the benefits provided under a contract and its expected coverage duration. The contractual service margin at the end of the period after all other adjustments is split equally between coverage units in the group and allocated between coverage units related to the current period and coverage units related to future periods. The amount of the contractual service margin related to the current period is recognised in revenue, and the balance related to future periods represents unearned profit for the in-force group of insurance contracts.

PwC observation: Release pattern and coverage units

In the Exposure Draft issued in 2013 the IASB suggested the straight line basis (passage of time) for release of the contractual service margin to profit or loss for individual contracts to reflect services provided during the reporting period. Ultimately, the IASB decided to change the unit of account from an individual contract to a group of contracts and, accordingly, suggested coverage units as the basis for the pattern of release of the contractual service margin for a group, because the passage of time would require calculating the release individually for each insurance contract.

Coverage units are based on the quantity of benefits and expected coverage duration. This pattern of release of the contractual service margin may be different from the straight line basis (passage of time) if coverage units are not the same in all periods and might require judgement, as discussed in the Illustrative Examples 2 and 6 to IFRS 17. Different approaches may be used to calculate release of the contractual service margin under the straight line basis (passage of time) which will result in different amounts of the release.

Example – Release pattern based on coverage units

This example illustrates one of the possible interpretations of the requirements related to treatment of coverage units. Other interpretations of the requirements might also be acceptable.

The contractual service margin at the end of the reporting period, after all adjustments other than release of the contractual service margin to revenue, is 1,000 currency units (CU). At the end of the period, there are two contracts in force in a group. Presented below is the information about benefits and remaining coverage periods for those contracts:

	Maximum amount payable to the policyholder if insured event occurs, CU	Number of coverage periods including reporting period (expected duration)
Contract 1	100,000	3
Contract 2	150,000	2

The number of coverage units and the allocation of the contractual service margin between current period and future periods could be calculated as follows:

	Current period	Future period 1	Future period 2	Total
Contract 1	100,000	100,000	100,000	300,000
Contract 2	150,000	150,000	–	300,000
Total, CU	250,000	350,000		600,000
Total, per cent	42%	58%		100%
Allocation of contractual service margin	CU420	CU580		CU1,000

Onerous Insurance Contracts

A group of insurance contracts is onerous at initial recognition if the total of insurance acquisition cash flows, cash flows occurring on initial recognition of the insurance contracts and fulfilment cash flows result in a net cash outflow. Such a net cash outflow is recognised in profit or loss immediately. On subsequent measurement, insurance contracts can become onerous when adjustments to the contractual service margin exceed the amount of the contractual service margin. Such excess is recognised immediately in profit or loss.

An entity should recognise all balances resulting from insurance contracts being onerous as a loss component of the liability for remaining coverage. An entity should

allocate, on a systematic basis, the components listed below between the loss component and the remaining component of liability for remaining coverage:

- expected incurred claims and expenses for the period;
- any change in the risk adjustment that relates to services rendered in the prior or current reporting period; and
- insurance finance expenses.

The allocation is made to reverse remaining loss component and exclude balances related to the loss components from revenue.

An entity should allocate any decrease in fulfilment cash flows in subsequent periods to the remaining loss component until it becomes zero before the entity can reinstate any contractual service margin.

PwC observation: Measurement of groups of onerous contracts

An entity should maintain accounting records for the loss component of the liability for remaining coverage. Throughout the coverage period, the entity should allocate changes in the liability for remaining coverage and insurance finance expenses between the loss component and liability for remaining coverage excluding the loss components on a systematic basis. Applying a proportion, calculated as the ratio of the loss component to the present value of expected future cash outflows, is an acceptable example of a systematic allocation basis. Insurers would be expected to apply a consistent allocation basis period-on-period. The amount of the change in the liability for remaining coverage allocated to the loss component represents a decrease in insurance service expenses during the period rather than insurance contract revenue.

An example of accounting for onerous contracts is presented in the Illustrative Example 8 to IFRS 17.

PwC observation: System implications from measurement of onerous contracts

The approach to the measurement of onerous contracts (notably, the level of granularity at which this is tracked) could be significantly different from the approach used currently under IFRS 4 in many jurisdictions. Entities are likely to need to develop operating systems to be able to track groups of onerous contracts and to account for the loss component of the liability for remaining coverage.

Premium Allocation Approach

	General model	Premium allocation approach	Premium allocation approach and undiscounted incurred claims
Liability for remaining coverage (unexpired risk)	Contractual service margin Risk adjustment Discounting Estimate of fulfilment cash flows	Premium (less acquisition costs) unearned	Premium (less acquisition costs) unearned
Liability for incurred claims (expired risk)	Risk adjustment Discounting Estimate of fulfilment cash flows	Risk adjustment Discounting Estimate of fulfilment cash flows	Risk adjustment Estimate of fulfilment cash flows

The premium allocation approach is a simplified method for measurement of the liability for remaining coverage for eligible groups of insurance contracts. Under this approach, the liability for incurred claims is still measured using the general model. A group is eligible for the premium allocation approach if:

- each contract in the group has a coverage period of one year or less; or
- measurement of the liability for remaining coverage for the group using the premium allocation approach is reasonably expected to produce a measurement of the liability for remaining coverage which is not materially different from using the general model or the variable fee approach.

The second criterion noted above is not met if, at the inception of the group, an entity expects significant variability in fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. The following are examples of situations where variability in the fulfilment cash flows increases:

- (i) there are embedded derivatives that have not been bifurcated and that impact the fulfilment cash flows of the contracts; and
- (ii) insurance contracts with longer coverage periods.

PwC observation: Which contracts are eligible for the premium allocation approach?

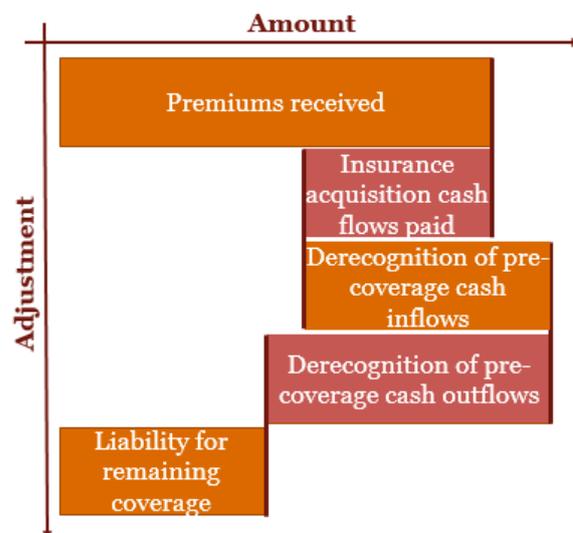
It is generally expected that general insurers will be attracted by the prospect of using the premium allocation approach to account for their liabilities for remaining coverage, because it avoids the need to calculate the contractual service margin and it is broadly similar to the current approach for unexpired risk (liabilities for remaining coverage) by recognising an unearned premium liability under many GAAPs.

Insurance contracts with a coverage period of one year or less are automatically eligible for the premium allocation approach. Many contracts with a coverage period of more than one year will not be eligible for the premium allocation approach. Entities should consider the following questions for the eligibility assessment at initial recognition of groups for using the premium allocation approach:

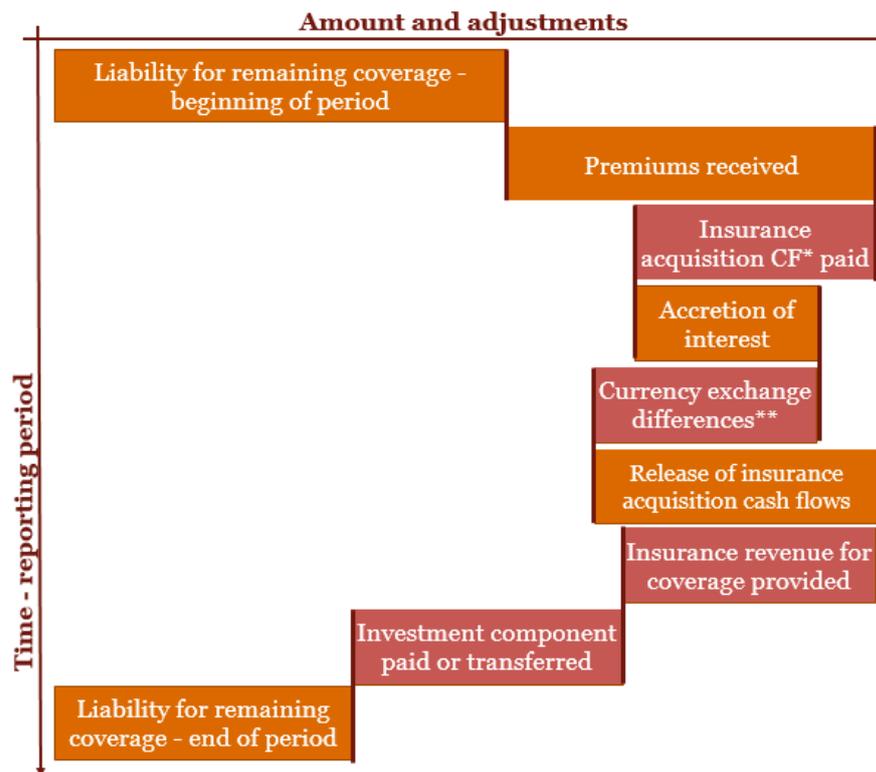
- Does the entity underwrite insurance contracts with the coverage period longer than one year?
- How should ‘would not materially differ’ be interpreted?
- How do differences in measurement, resulting from differences in the consideration of discounting for the liability for remaining coverage in the general model and in the premium allocation approach, affect eligibility?
- How do different patterns of release of the liability for the remaining coverage to revenue under the general model and the premium allocation approach affect eligibility?
- Which cash flows are considered for the general model and are not considered for the premium allocation approach, and how does this impact the eligibility?

The liability for the remaining coverage is measured using the premium allocation approach (unless the group of contracts is onerous).

The liability for the remaining coverage is initially recognised as follows:



The liability for the remaining coverage is subsequently measured as follows:



* CF – cash flows.

** Currency exchange differences can be positive.

An entity can choose to recognise insurance acquisition cash flows as an expense when incurred if each contract in a group has a coverage period of one year or less.

An entity should accrete interest on the liability for remaining coverage at the rate determined at inception of the group if, at the inception of the group, the entity expects that the time between provision of services and related premium due date is more than a year.

PwC observation: Voluntary accretion of interest for contracts with coverage period of one year or less

For contracts where the time between provision of services and related premium due date is less than a year, an entity can voluntarily choose to accrete interest at the rate determined at inception as an accounting policy choice, even though it is not required to do so under IFRS 17. Some entities might choose to discount all contracts to ensure consistent treatment. The accounting policy choice should be applied consistently to all similar transactions.

The amount recognised in profit or loss, to reflect the transfer of services during the period, represents revenue. An entity should allocate the expected premium (adjusted for any investment component and accretion of interest, if required) to profit or loss:

- on the basis of passage of time; or
- on the basis of the expected timing of incurred insurance service expenses, if the expected pattern of release of risk is significantly different from the passage of time.

Insurance service expense comprises incurred claims and other incurred insurance service expenses and the release of acquisition cash flows.

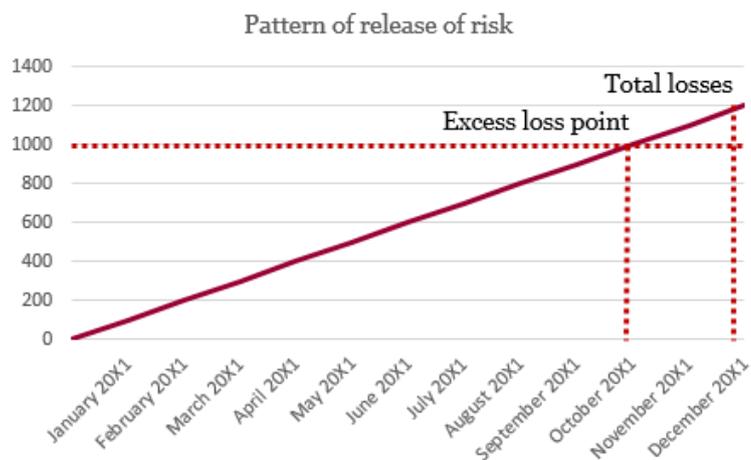
An entity should recognise insurance acquisition cash flows included in the liability for remaining coverage in a systematic way on the basis of passage of time as insurance revenue and insurance service expense.

PwC observation: Pattern of revenue recognition using the premium allocation approach for hurricane insurance

The expected pattern of release of risk is usually not linear for an annual policy with coverage against damages from hurricanes. The probability of damage caused by hurricanes is significantly higher during the hurricane season. The pattern of revenue recognition for such insurance coverage should reflect the fact that the risk of incurring a claim is significantly higher in the hurricane season and lower throughout the rest of the year. The difference in risk throughout the policy coverage period should be captured using the expected pattern of incurred claims as a proxy of the risk release pattern. However, insurance services expense from acquisition cash flows for these contracts will be recognised on the basis of passage of time if not expensed when incurred.

PwC observation: Pattern of revenue recognition using the premium allocation approach for an excess loss reinsurance contract

The following diagram demonstrates an example of the pattern of release of risk for an excess loss reinsurance contract issued by a reinsurer with a coverage period of one year where loss limits are triggered.



Generally, risks under such contracts are released throughout the year, even though claims reimbursements might be expected towards the end of the year when the excess loss point is reached. IFRS 17 requires the revenue recognition pattern to be based on the passage of time if the pattern of release of risk is not significantly different from the passage of time. Because, in this example, the pattern of release of risk from the underlying contract is not significantly different from the passage of time, the pattern of revenue recognition for such contract should also be based on passage of time.

A loss from onerous contracts should be recognised immediately in profit or loss if facts and circumstances indicate that a group of contracts measured using the premium allocation approach is onerous. The loss is measured as the difference between fulfilment cash flows related to the remaining coverage of the group using the general model and liability for the remaining coverage using the premium allocation approach.

PwC observation: Using the general model instead of the premium allocation approach to measure liability for the remaining coverage for onerous insurance contracts

Requirements for the measurement of the liability of the remaining coverage for onerous contracts under the premium allocation approach are similar to the requirements for the general model. For example, entities are required to calculate fulfilment cash flows using the general model if insurance contracts are onerous.

Entities applying the premium allocation approach and not having onerous contracts do not have to measure the liability for remaining coverage using the general model. However, they should ensure that their accounting systems are ready to use the general model if a group of contracts is or becomes onerous.

An entity is not required to adjust the liability for incurred claims for the time value of money and other financial risks under the premium allocation approach if claims are paid within one year after they are incurred. An entity should not adjust the fulfilment cash flows for the time value of money and other financial risks to measure the loss component of onerous contracts if an entity does not adjust liability for the incurred claims for time value of money and other financial risks.

The difference between the current rate and locked-in (historical) discount rate at initial recognition of the related liability for incurred claims applied to the fulfilment cash flows is recognised in other comprehensive income if an entity exercises the accounting policy choice to recognise the effect from changes in discount rates in other comprehensive income.

Measurement of Participating Contracts

Participating contracts are insurance contracts or investment contracts with discretionary participation features where an insurer shares the performance of underlying items with policyholders. The general model or the premium allocation approach are used for measurement of participating contracts without direct participation features. The requirements for the measurement of the contractual service margin for contracts with direct participation features are different from other contracts. In addition, cash flows of some participating contracts might affect, or be affected by, cash flows from other contracts (also known as contracts with mutualisation). This section discusses:

- the definition of contracts with direct participation features and the measurement of the contractual service margin for such contracts;
- application of the general model for participating contracts without direct participation features; and
- specific requirements for the measurement of contracts with mutualisation.

Contracts with Direct Participation Features

An insurance contract with direct participation features is defined as an insurance contract which, at inception, meets all of the following:

- (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and
- (c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

Contracts meeting the above criteria are accounted for under what is referred to as the 'variable fee approach'.

'Contractual terms' in criterion (a) include all substantive rights and obligations that are enforceable by contract, law or regulation. Contracts with similar contractual terms might be treated differently in different jurisdictions because of different regulation and legal practice. For criterion (a), it is not necessary for an entity to hold the underlying items, provided that the items are clearly defined in the contract. Underlying items can include financial and non-financial items, a reference portfolios of assets, other insurance and reinsurance contracts, and all or part of an entity's net assets. Criterion (a) is not met where:

- an entity can change the underlying items retrospectively; or
- there are no underlying items identified.

Criteria (b) and (c) are assessed at inception, based on the present value of probability-weighted average result of expected scenarios. The initial assessment should not be reconsidered subsequently.

PwC observation: Treatment of 'contractual'

As discussed in paragraph BC 69 of the Basis for Conclusions for IFRS 17, the standard explains that contracts can be written, oral or implied by an entity's business practices. An entity is also required to consider all substantive rights and obligations, whether they arise from contract, law or regulation (paragraph 2 of IFRS 17). Thus, when referring to contractual terms, the effects of law and regulation are also considered.

In many cases, there might be no legal practices related to an entity's obligations. In such situations, the entity may need to exercise significant judgement to conclude whether an insurance contract has direct participation features.

PwC observation: Treatment of 'a share of a clearly identified pool of underlying items'

A direct participating contract should clearly identify a pool of underlying items and how returns are shared between the entity and the policyholder. The following terms to share returns between policyholder and shareholder are generally expected to meet the requirement for 'a share' in criterion (a):

- Policyholder shares only in gains but not in losses from the underlying items; otherwise, the entity has full discretion over the amount of gains that it shares with the policyholder.
- Amount of benefits cannot reduce the amount of invested premiums; otherwise, the entity has full discretion over the amount of gains that it shares with the policyholder.
- Participation share is defined in regulation and not directly in the contract.

In addition to the assessment of criterion (a), entities should also ensure that criteria (b) and (c) are met. That is, in the examples presented above for assessment of criterion (a) where entities have significant contractual discretion over the future payments, entities should also assess whether a substantial share of the fair value returns on the underlying items is expected to be paid and whether a substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items.

PwC observation: Measurement model for common types of insurance contract

The features of participating contracts differ significantly between regions and insurers. All groups of contracts should be separately analysed to conclude whether they are eligible for the variable fee approach. However, as illustrated through the IASB Board deliberations, the following contracts are generally expected to qualify for the variable fee approach:

- unit-linked contracts, US variable annuities and certain equity index-linked contracts;
- continental European 90/10 contracts; and
- UK with-profits contracts.

The following contracts are expected not to qualify for the variable fee approach and will be measured using the general model:

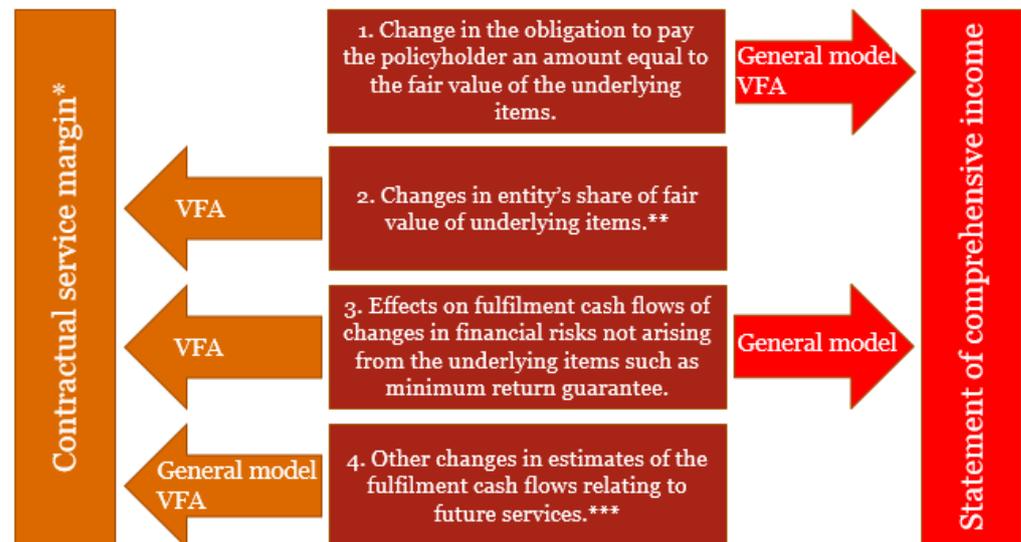
- term life and whole life insurance, protection business;
- inflation-linked annuity contracts;
- fixed immediate annuities-in-payment;
- certain general insurance contracts; and
- US-style universal life.

An entity's obligation to the policyholder under contracts with direct participation features is the net of:

- the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and
- a variable fee for future services.

The variable fee for future services equals an entity's share of the fair value of the underlying items less fulfilment cash flows that do not vary based on the returns on underlying items.

The general model requirements for measurement of non-participating contracts apply to the measurement of contracts with direct participation features, except for the measurement of the contractual service margin after initial recognition. The diagram below summarises the differences between the measurement of the contractual service margin using the general model and the requirements for contracts with direct participation features:



* No explicit adjustment is required for each component; there might be just one adjustment for all components to the contractual service margin.

** No effect on measurement of assets/ liabilities from insurance contracts in general model.

*** Under the variable fee approach (VFA), adjustments to the contractual service margin use current discount rates; under the general model, they use discount rates locked in at inception of a group of insurance contracts.

The contractual service margin for contracts with direct participation features is not explicitly adjusted for the accretion of interest, in contrast to the general model. Adjustment of the contractual service margin for the changes in an entity's share of the fair value of underlying items already incorporates an adjustment for financial risks and represents an implicit adjustment using current rates of the contractual service margin for the time value of money and other financial risks.

PwC observation: Measurement of underlying items at fair value

Insurance liabilities under the variable fee approach should be measured based on the change in the fair value of the underlying items. Often, underlying items will represent financial instruments and indices for which fair value measurement is generally widely used. However, insurance contracts and other non-financial items such as provisions, deferred tax and non-participating investment contracts could be included in the underlying items. This might be the case where an entity's net assets performance is shared with policyholders. The insurance liability relating to such underlying items should also be measured based on changes in their fair value.

In practice, fair value measurement of underlying items at each reporting date will require insurers to develop systems and processes which they might not currently have in place. In addition, this could result in accounting mismatches, because contracts with direct participation features will be measured on a current basis, based on the fair value of the underlying assets and liabilities, while those assets and liabilities will not be measured at fair value.

As an exception to the requirement to adjust the contractual service margin for the changes in an entity's share of the fair value of underlying items, an entity could choose to recognise the effect of changes in financial risk from an entity's share of underlying items, or from changes in financial risks not arising from the underlying items, such as a minimum return guarantee (as indicated in items 2 and 3 in the diagram above), in profit or loss rather than in the contractual service margin if:

- (a) the entity uses derivatives to mitigate financial risk from insurance contracts;
- (b) there is an economic offset between the derivative and the related group of insurance contracts; and
- (c) credit risk does not dominate the economic offset.

To be eligible for this exception, an entity should have documented the risk management objective and strategy to mitigate financial risk from the group of insurance contracts by using derivatives.

The entity should recognise all subsequent changes in financial risks in the contractual service margin if the economic offset ceases to exist. There should be no adjustment for changes already recognised in profit or loss.

Example – Credit risk dominating the economic offset

This example demonstrates criterion (c) above for using an exception to the general requirements of the variable fee approach.

An entity manages the risk of changes in interest rates (financial risk) for a portfolio of contracts with direct participation features with a derivative instrument. The parties do not provide any collateral to secure payment for the derivative instrument transaction. If there is a significant increase in credit risk of the counterparty to that derivative in the future, the effect of the changes in the counterparty's credit risk might outweigh the effect of other changes in financial risk on the fair value of the derivative, whereas changes in the value of the portfolio of contracts with direct participation features depend on these other changes in financial risk. In such a situation, there might be little to no offset of gains and losses from the derivative and the portfolio of contracts with direct participation features. The exception to the general requirements for accounting for the contractual service margin of contracts with direct participation features cannot be used.

PwC observation: Presentation of economic hedging and risk mitigation in the financial statements

Entities using economic hedging and risk mitigation techniques usually want to present information about this in the financial statements in a way that reflects management practices. IFRS currently has two solutions to achieve this: the risk mitigation exception in IFRS 17 for insurance liabilities, as described above; or hedge accounting in IFRS 9 or IAS 39. However, it is likely that insurers might not be able to reflect all economic risk mitigation in the financial statements in line with the risk management practices. An example of such a situation is the macroeconomic management of economic risks. Measurement exceptions under IFRS 17 apply only to contracts measured under the variable fee approach and do not apply to the contracts to which the general model applies. Insurers might choose to use non-GAAP measures in such situations to explain risk management practices to the users of the financial statements in common with entities in other industries.

Contracts without Direct Participation Features

The general model should be used for contracts without direct participation features, as discussed in the section on '*General Model*' above.

Some participating contracts without direct participation features provide policyholders with the right to receive discretionary payments. Changes in the commitment (estimates of cash outflows that arise as a consequence of changes in financial variables, such as changes in interest rates and asset gains or losses, and the corresponding change in discount rates) should be recognised in the statement of comprehensive income. In contrast, changes in estimates that arise as a result of changes in the application of discretion, such as changes in the participation percentage for policyholder crediting, affect the consideration that the entity will receive from the contract and adjust the contractual service margin.

There might be a number of acceptable ways to define commitment and thus to distinguish changes in financial variables related to the commitment from discretionary changes. An entity should define, at the inception of a contract, how it defines discretion, and it should apply that definition consistently throughout the life of the contract. Example 6 of the Illustrative Examples to IFRS 17 explains how discretion could be defined and how that affects the amounts recognised in the contractual service margin and in the statement of comprehensive income.

If an entity cannot define what it regards as its commitment and what it regards as discretionary, it should regard its commitment as the return implicit in the estimate of the fulfilment cash flows at inception of the contract.

Participating Contracts with Mutualisation

Some contracts have terms requiring that cash flows of a participating contract affect or are affected by cash flows from other contracts (including future contracts). These terms may be referred to as 'mutualisation'.

An entity should consider the impact of mutualisation when it estimates fulfilment cash flows. Mutualisation does not impact any aspect of measurement other than fulfilment cash flows. For example, the requirements for the level of aggregation for contracts with mutualisation are the same as for all other insurance contracts.

The fulfilment cash flows of contracts with mutualisation terms might include expected payments to current or future policyholders in other groups, even when the coverage of all contracts in a group ends. An entity is not required to allocate such fulfilment cash flows to specific groups, but can instead recognise a liability for such fulfilment cash flows arising from all groups.

Example – Mutualisation

An insurer issues participating contracts to two policyholders that share in the same pool of underlying items. The terms of the contracts are the same, except for the minimum return guarantee which is 5% for Policyholder 1 and 2% for Policyholder 2. The actual return from the underlying items is 4%. For Policyholder 1, the actual return from the underlying items of 4% is below the minimum return guarantee of 5%. For Policyholder 2, the actual return from the underlying items of 4% is above the minimum return guarantee of 2%. Based on the contractual terms for both policyholders, Policyholder 1 receives 5% (minimum return guarantee), and Policyholder 2 receives the residual return of 3% (4% less 1% additional return paid to Policyholder 1). The insurer pays only the returns from the underlying items of 4% to both policyholders and does not pay the difference between the actual returns from the underlying items and the minimum return guarantee to Policyholder 1.

Example – Mutualisation (continued)

The insurer would have to contribute its own funds to make payments to the policyholders only if returns from the assets are not sufficient to pay the minimum return guarantee to both policyholders. For example, when the actual returns from the underlying items are 2%, the insurer will have to make payments to Policyholder 1 for the difference between the minimum return guarantee of 5% and the actual return from the underlying items of 2%. Policyholder 2 in this case cannot absorb additional losses, because his minimum return guarantee is the same as the actual returns from the underlying items.

PwC observation: Level of aggregation for contracts with mutualisation

As discussed in paragraph BC 138 of the Basis for Conclusions for IFRS 17, there are no exceptions to the level of aggregation requirements for contracts with mutualisation. Such contracts should be disaggregated in different groups, so that there are no contracts issued more than one year apart in one group (annual cohorts). However, insurers can avoid disaggregation of portfolios into annual cohorts if there is no difference in the measurement of insurance contracts when they are disaggregated into annual cohorts and when they are not disaggregated.

It is expected that, in many circumstances, disaggregation of portfolios into annual cohorts will result in different measurement outcomes; however, there could be circumstances where there will be no difference.

Measurement of Investment Contracts with Discretionary Participation Features

Investment contracts with discretionary participation features are measured in the same way as insurance contracts, with the following exceptions:

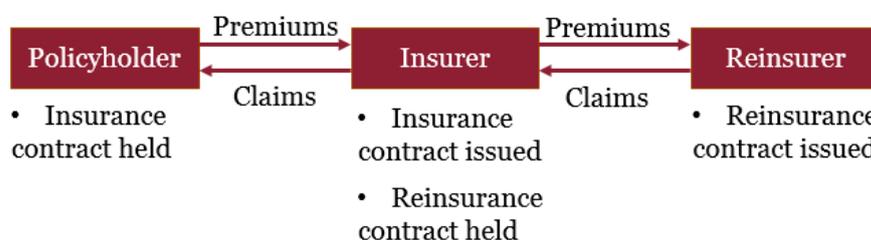
- (a) Contract is initially recognised when an entity becomes a party to the contract.
- (b) In assessing the contract boundary, the substantive obligation ends when the entity can reprice the contract so that the new price fully reflects the promise to deliver cash in the future and the related risks.
- (c) The contractual service margin is recognised in profit or loss over the duration of a group of contracts in a systematic way that best reflects the transfer of investment management services under the contract.

PwC observation: Transfer of investment management services

The most common basis of transfer of investment management services would be a straight-line pattern. It is unlikely that a pattern based on profits or fund management charges will meet the requirements of the new standard, because it does not reflect the services provided to the customer. A pattern based on funds invested might be appropriate if it reflects the transfer of the services to the customer and is not dependent on changes in market variables.

Measurement of Reinsurance Contracts

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity. The diagram below describes contractual relations between a reinsurer, insurer and policyholder, and the contracts that each party holds as a result of those contractual relationships:



Reinsurance contracts issued are similar to direct insurance contracts issued, and they should be accounted for by the reinsurer using either the general model or the premium allocation approach. Modifications to the general model for contracts with direct participation features (the variable fee approach) do not apply to reinsurance contracts held.

The requirements for **reinsurance contracts held** are modified as set out below.

Date of Initial Recognition of Reinsurance Contracts Held

Reinsurance contracts held are divided into those that provide proportionate coverage and those that provide other coverage. Under contracts that provide proportionate coverage cash flows of the reinsurance contract can be directly traced to individual underlying insurance contracts. Under contracts that provide coverage on another basis, such as excess of loss coverage, cash flows of the reinsurance contract cannot be traced to individual underlying contracts, because premiums and reimbursement are based on performance of a set of underlying contracts.

A group of reinsurance contracts held that provides proportionate coverage should be initially recognised from the later of:

- the beginning of the coverage period of the group of reinsurance contracts; and
- the initial recognition of any underlying contract.

A group of reinsurance contracts held that provide other coverage should be recognised from the beginning of the coverage period of the group of reinsurance contracts held.

Measurement of Reinsurance Contracts Held

The requirements for measurement of reinsurance contracts held are different from the requirements for insurance and reinsurance contracts issued. These differences impact the statement of financial position and financial performance. Summarised below are the measurement requirements specific to reinsurance contracts held:

- For insurance and reinsurance contracts issued, day 1 gains are not recognised and are fully absorbed by the contractual service margin, while day 1 losses are recognised in profit or loss immediately. For reinsurance contracts held, both day 1 gains (net gain) and day 1 losses (net cost) are initially recognised in the statement of financial position as a contractual service margin, and they are subsequently recognised in profit or loss as the reinsurer renders services. However, part of the day 1 cost should be recognised in profit or loss if it relates to events that occurred before the initial recognition of the reinsurance contract held. Reinsurance contracts held cannot be onerous.
- The assumptions used for measurement of reinsurance contracts held should be consistent with the assumptions used for measurement of the underlying insurance contracts.

- Non-performance risk of the reinsurer should be included in the measurement of the fulfilment cash flows. Changes in the non-performance risk should be recognised immediately in profit or loss.
- The risk adjustment for non-financial risks reflects the amount of risk transferred from the insurer to the reinsurer.
- Changes in fulfilment cash flows adjust the contractual service margin of a group of reinsurance contracts held if they relate to future coverage and other future services. However, changes in the fulfilment cash flows are recognised in profit or loss if related changes in the underlying contracts are also recognised in profit or loss, even if they relate to future services (that is, when underlying contracts are onerous).

An entity will be able to use the premium allocation approach for reinsurance contracts held if they meet eligibility criteria, as discussed in the section on '*Premium Allocation Approach*' above.

PwC observation: Coverage period of reinsurance contracts

Some reinsurance contracts cover underlying direct business that begins during a one-year coverage period of the reinsurance contract (risk-attaching reinsurance contracts). Because of this feature, the coverage period of these reinsurance contracts can effectively be more than one year.

For example, a reinsurance contract covers risks from all underlying direct motor insurance contracts signed during a calendar year. The coverage period of each underlying direct motor insurance contract is one year. However, coverage provided by the reinsurance contract could then be up to two years. The coverage period of the reinsurance contract ends when the coverage periods of all underlying contracts are expected to end.

Example – Initial recognition date, measurement of the contractual service margin at initial recognition and coverage period of reinsurance contracts held

Excess loss reinsurance contract held

This example assumes that the reinsurance contract held is accounted for using the general model rather than the premium allocation approach.

An insurer cedes losses from a motor insurance portfolio to a reinsurer in accordance with an excess loss reinsurance contract held. The reinsurance contract represents a single contract in the group. Reinsurance coverage is provided for claims arising from policies that are underwritten during the period to which the reinsurance relates, starting from 1 January 20X1 and ending on 31 December 20X1. There is coverage during the whole period of the underlying insurance contract, even if claims are only discovered after the expiration date of the reinsurance contract held. Direct insurance contracts that are underwritten before inception (1 January 20X1) or after expiry of the reinsurance contract are not covered, even if claims occur during the period of the reinsurance contract held (risk-attaching basis). There are no pre-coverage cash flows and no cash flows at the date when the reinsurance contract held is initially recognised. The premium paid for the reinsurance contract held on 1 January 20X1 is CU1,000. The excess point is CU3,500 loss from the underlying portfolio. The risk adjustment for non-financial risks and discounting component is assumed to be nil for this example.

Example – Initial recognition date, measurement of the contractual service margin at initial recognition and coverage period of reinsurance contracts held (continued)

The expectations for the ceded direct insurance contracts at inception are presented in the table below:

	Coverage period		Claims expected from direct insurance contracts, CU
	Start date	End date	
1.	23 January 20X1	22 January 20X2	900
2.	31 January 20X1	30 January 20X2	750
3.	16 March 20X1	15 March 20X2	1,600
4.	18 July 20X1	17 July 20X2	280
5.	11 October 20X1	10 October 20X2	925
Total			4,455

Question 1: What is the date of initial recognition of the reinsurance contract held?

A group of reinsurance contracts held that provide excess loss coverage should be initially recognised on the date when reinsurance coverage of any reinsurance contract in the group starts. The date when the coverage of the reinsurance contract held starts is 1 January 20X1, so this is the date of initial recognition of the reinsurance contract held.

Question 2: What is the contractual service margin of the reinsurance contract held at the date of initial recognition?

Premiums paid on the date of initial recognition of the reinsurance contract held on 1 January 20X1 are CU1,000. Expected claims are CU955, calculated as expected claims from the underlying portfolio of CU4,455 less excess point of CU3,500. Total fulfilment cash flows on 1 January 20X1 are CU45. Similar to the initial recognition of the contractual service margin for insurance contracts issued, the contractual service margin for reinsurance contracts held at inception is the amount of the fulfilment cash flows less cash flows paid at the date when coverage starts. So, the contractual service margin is CU45 (debits are presented as negative amounts and credits as positive):

Description	Amount, CU	Clarification
Cash – premiums paid	1,000	Fulfilment cash outflows paid at the inception date
Fulfilment cash flows	(955)	To recognise present value of expected future cash flows and risk adjustment
Contractual service margin	(45)	To recognise contractual service margin – balancing number
Reinsurance contract purchased that is asset	(1,000)	Total asset recognised on initial recognition of the reinsurance contract

Question 3: What is the coverage period of the reinsurance contract held?

The coverage period for risk-attaching contracts starts with the initial recognition of the reinsurance contract held and ends when the coverage period of the last underlying insurance contract ends. The coverage period represents the period when the reinsurer has the contractual obligation to reimburse losses to the insurer if they incur during this period. The coverage period of the reinsurance contract held is from 1 January 20X1 to 10 October 20X2. The end of the coverage period represents the entity's expectation at inception. The contractual service margin of CU45 for the reinsurance contract held should be released to expenses over that period, based on coverage units, if the general model is used.

PwC observation: Mismatches between measurement of underlying insurance contracts and reinsurance contracts held

Currently, under many accounting practices, the measurement of underlying insurance contracts and reinsurance contracts held is broadly aligned so that gains or losses from reinsurance contracts held match gains or losses from the underlying insurance contracts in the statement of comprehensive income.

The IASB regard reinsurance contracts held as being separate from the underlying insurance contracts for recognition, measurement, presentation and disclosure. Under IFRS 17, the matching of gains and losses from underlying insurance contracts and reinsurance contracts held will not always be possible. The following requirements for reinsurance contracts held could cause mismatches in the income statement:

- Reinsurance contracts held cannot meet the definition of an insurance contract with direct participation features, so they are measured using either the general model or the premium allocation approach, while the underlying insurance contracts with direct participation features are measured using the variable fee approach.
- Some reinsurance contracts might not be eligible for the premium allocation approach, while the underlying contracts might be eligible due to the different coverage periods.
- Day 1 gains and costs are deferred for reinsurance contracts held (unless the coverage relates to past events), while only day 1 gains are deferred for the underlying insurance contracts and day 1 losses are recognised immediately in profit or loss.
- The period for release of the contractual service margin for underlying insurance contracts, and of the negative or positive contractual service margin relating to the day 1 costs or gain for reinsurance contracts held, might be different due to the different coverage periods.

As a consequence, insurers might consider redesigning reinsurance arrangements to optimise the accounting and so reduce mismatches in the income statement.

PwC observation: Risk adjustment for reinsurance contracts held

There are no specific requirements in IFRS 17 regarding the approaches that should be used to determine the amount of risk being transferred by the holder to the issuer of a reinsurance contract. It is possible to directly calculate the risk inherent in the portion of the risk that is ceded, similar to how a reinsurer would calculate its risk adjustment for the business assumed (also known as ‘gross less ceded equals net’), or as the difference between the risk adjustment on the gross underlying contracts and the risk adjustment for the net risk retained after considering the reinsurance (also known as ‘gross less net equals ceded’). The IASB acknowledged at a public meeting that they do not intend to require any specific approaches for the calculation of the risk adjustment for non-financial risks for reinsurance contracts held, even though the results of the different approaches might be different in practice.

Example – Subsequent measurement of the contractual service margin for reinsurance contracts held

An insurer purchases a facultative proportional reinsurance contract to cede 50% of risks from an underlying property insurance contract covering losses from an office building in exchange for ceding 50% of the premiums. The direct underlying insurance contract is onerous at inception. The reinsurance consideration reflects a ceding commission which takes into account the fact that the direct contract is onerous such that the reinsurance contract is profitable to the reinsurer. Both the reinsurance and insurance contracts are the only contracts in the respective groups. Set out below is information about the reinsurance contract and the underlying insurance contract at initial recognition of the reinsurance contract held:

	Underlying insurance contract, CU	Reinsurance contract held, CU
Fulfilment cash flows	1,000 (liabilities)	500 (asset)
Contractual service margin/ day 1 gain or loss	–	100 (asset)

At inception the underlying insurance contract is onerous, so no contractual service margin is recognised. No gain or loss should be recognised for a reinsurance contract held in the statement of comprehensive income at inception of the reinsurance contract; and, therefore, the excess of fulfilment outflows over inflows from the reinsurance contract held of CU100 is recognised in the statement of financial position as an asset.

At the end of the reporting period, fulfilment cash flows related to the underlying insurance contract change to CU1,080. The change relates to future coverage; however, because the contract is onerous, it is recognised as an increase of the loss component of the liability for remaining coverage in profit or loss.

The fulfilment cash flows for the reinsurance contract held also change to CU540 due to the change related to the underlying insurance contract. The change of CU 40 relating to the reinsurance contract held is recognised immediately in profit or loss rather than increasing the contractual service margin, because it occurred subsequent to reinsurance contract inception and it results from a change in the underlying insurance contract that is also recognised in profit or loss. The contractual service margin for the reinsurance contract held (CU100) continues to be allocated to profit or loss based on the coverage units.

Derecognition and Modification

Modification

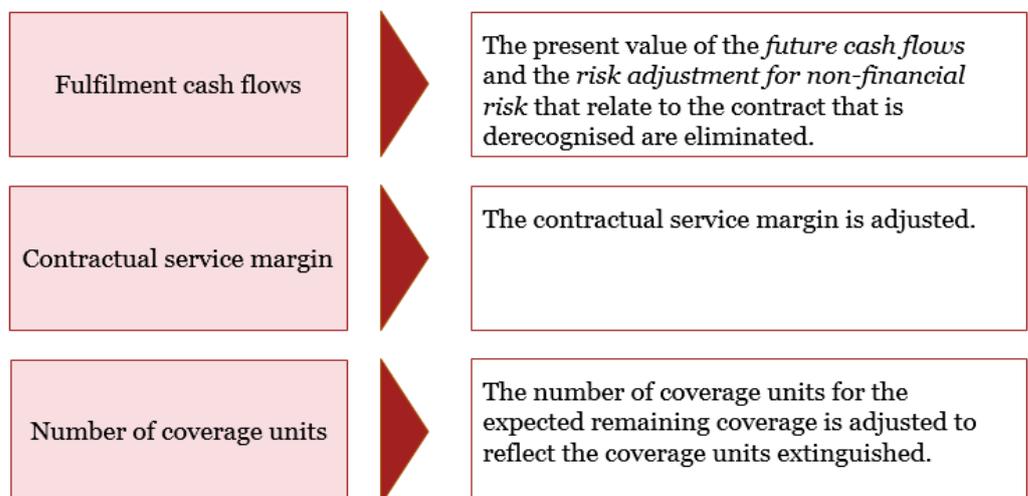
If the terms of an insurance contract are modified, an entity should assess whether this change qualifies for derecognition. A modification can be triggered by an additional agreement between the parties to the contract or by a change in regulation. The exercise of a right that was part of the original terms of the contract does not result in a modification. A change in terms results in a derecognition if one of the criteria below is met:

- The modified contract would have been excluded from the scope of IFRS 17 if the modified terms had already been included at inception of the contract.
- The entity would have separated different components from the host insurance contract if the modified terms had already been included at inception of the contract.
- The modified contract would have had a substantially different contract boundary if the modified terms had already been included at inception of the contract.
- The modified contract would have been included in a different group of contracts if the modified terms had already been included at inception of the contract.
- The modified contract no longer meets the definition of an insurance contract with direct participation features, whereas the original contract did (or vice versa).
- The entity applied the premium allocation approach to the original contract, but the criteria for the premium allocation approach are no longer met for the modified contract.

Modification that Results in Derecognition of the Original Contract

A modification for which one of the criteria above is met is accounted for as derecognition of the original contract and recognition of a new contract.

The derecognition of the **original contract** results in a number of adjustments:



The contractual service margin of the group from which the contract is derecognised is adjusted as follows (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage):



When recognising the **new contract**, the insurer assumes that it had actually received the ‘hypothetical’ premium that was used to calculate the adjustment of the contractual service margin for the original contract that was derecognised.

Modification that does not Result in Derecognition of the Original Contract

The modification of a contract that does not result in a derecognition is accounted for as a change in estimates – that is, the insurer treats any changes in cash flows as changes in estimates of the fulfilment cash flows (see further guidance in the section on ‘*Changes in fulfilment cash flows that relate to future periods and experience adjustments (Adjustment C)*’ above).

PwC observation: Modification – change from current practices

IFRS 4 has no requirements for modification of insurance contracts and, under local GAAPs, many different practices can be currently applied. IFRS 17 introduces specific requirements for modifications, and this could be a significant change for insurers who modify insurance contracts after inception.

Derecognition

There are two scenarios in which an insurance contract is derecognised:

- (1) The contract is **extinguished**. A contract is extinguished when the obligation specified in the contract expires or is discharged or cancelled. The mere fact that the entity has mitigated the risks resulting from the insurance contract (for example, by buying a reinsurance contract) does not result in a derecognition of the underlying insurance contract.
- (2) The contract is **modified and certain additional criteria** are met (see above).

The adjustments that have to be made if an insurance contract (or a part of it) is derecognised from a group of contracts have already been described above. The only difference relates to the adjustment of the contractual service margin. The adjustment of the contractual service margin depends on why the insurance contract is derecognised:

- (1) **Extinguishment:** The contractual service margin is adjusted by the same amount by which the fulfilment cash flows are adjusted (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage).
- (2) **Transfer:** The contractual service margin is adjusted by the difference between the amount by which the fulfilment cash flows are adjusted and the premium charged by the third party to which the contract has been transferred (unless the decrease in fulfilment cash flows is allocated to the loss component of the liability for remaining coverage).
- (3) **Modification:** See the section on '*Modification*' above.

Acquisition of Insurance Contracts

An insurer might acquire insurance contracts issued or reinsurance contracts held either in a transfer or in a business combination. These contracts are accounted for in the same way as all other insurance contracts. For additional requirements on transition, see the section on '*Transition*' below.

Transfer of Groups of Insurance Contracts

An entity accounts for insurance contracts acquired in a transfer as if it had entered into the contracts at the date of the transaction. When calculating the contractual service margin, the consideration received or paid is regarded as an approximation of the premium received. For onerous contracts, the entity recognises the excess of the fulfilment cash flows over the consideration paid or received as a loss in profit or loss.

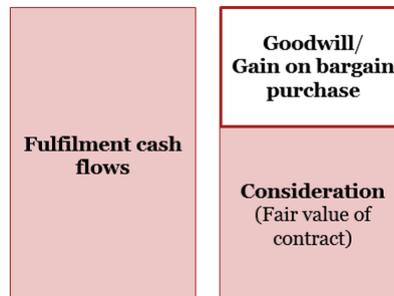
In a transaction that includes other provisions besides the transfer of insurance contracts, the part of the consideration that relates to other assets and/or liabilities is not part of the calculation.

Business Combinations

The accounting for a group of insurance contracts acquired in a business combination is similar to the accounting for insurance contracts acquired in a transfer. The consideration received or paid (and hence the amount of premium received that is taken into account when determining the contractual service margin) is the fair value of the contracts at the date of acquisition. For contracts with a demand feature, IFRS 13 explains that fair value is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid. However, this part of IFRS 13 is not applied when measuring the insurance contract.

For onerous contracts, the entity recognises the excess of the fulfilment cash flows over the consideration paid or received as part of the goodwill or as a gain on a bargain purchase. For all other contracts, the difference will result in a contractual service margin.

Onerous contracts



PwC observation: Insurance contracts acquired in a business combination

For insurance contracts acquired in a business combination, the insurer should recalculate the contractual service margin and reset the relevant assumptions for recognition and measurement (for example, regarding the discount rate) to the date of acquisition. Furthermore, from the acquiring group's perspective, the coverage period will start at the acquisition date, and hence it will be shorter than for the acquired subsidiary holding the contracts. For some general insurance contracts, the coverage period (from the acquiring group's perspective) is likely to be equal to the claim settlement period, and so some short-term contracts with a long settlement period, that might have been eligible for the premium allocation approach in the subsidiary, should be accounted for under the general model in the consolidated group financial statements.

As a consequence of these requirements, the carrying amount of the insurance contract, as well as its impact on the statement of comprehensive income, will differ between the separate financial statements of the acquired subsidiary that has issued the contract and the financial statements of the acquiring group. The insurer should prepare two sets of information: one based on the date when the contract was issued (to be presented in the subsidiary's separate financial statements); and a second set based on the date of acquisition (to be presented in the group's financial statements).

Transition requirements related to the acquired portfolios and subsidiaries are discussed in the section on '*Transition*' below.

Presentation

Statement of Financial Position

On the face of the statement of financial position, an insurer presents separately the carrying amount of:

- groups of insurance contracts issued that are assets;
- groups of insurance contracts issued that are liabilities;
- groups of reinsurance contracts held that are assets; and
- groups of reinsurance contracts held that are liabilities.

Assets or liabilities for insurance acquisition cash flows are not presented separately as assets or liabilities, but they are included in the carrying amount of the related insurance contracts.

PwC observation: Presentation of various rights and obligations from a group of insurance contracts in the financial statements

Under many current GAAPs, various rights and obligations from insurance contracts are presented separately in the financial statements, such as insurance liabilities, policyholder loans, insurance premiums receivable, deferred acquisition costs and insurance intangible assets. IFRS 17 requires all rights and obligations from a group of insurance contracts to be presented net in one line in the statement of financial position, unless the components of the insurance contract are separated (that is, embedded derivatives and distinct investment and service components). For many insurers, this will be a significant change.

Statement(s) of Financial Performance

In the statement of financial performance, an insurer presents separately:

- **insurance service result**, containing insurance revenue and insurance service expenses; and
- **insurance finance income or expenses**.

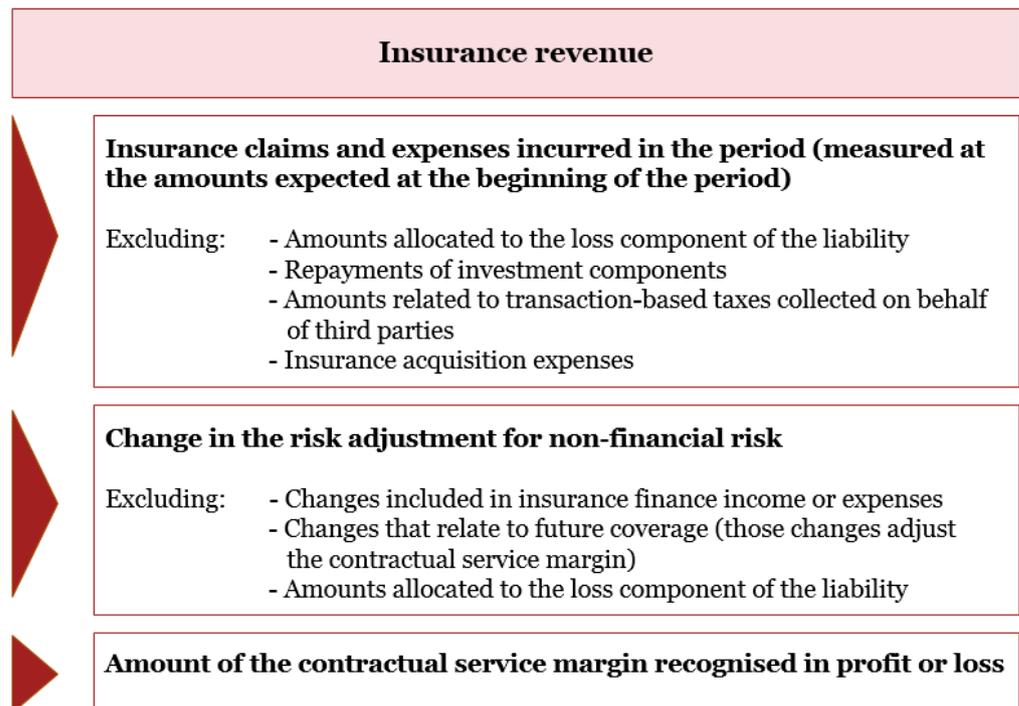
‘Income or expenses from insurance contracts issued’ is presented separately from ‘income or expenses from reinsurance contracts held’.

Insurance Service Result

Insurance revenue reflects the consideration to which the insurer expects to be entitled in exchange for the provision of coverage and other services.

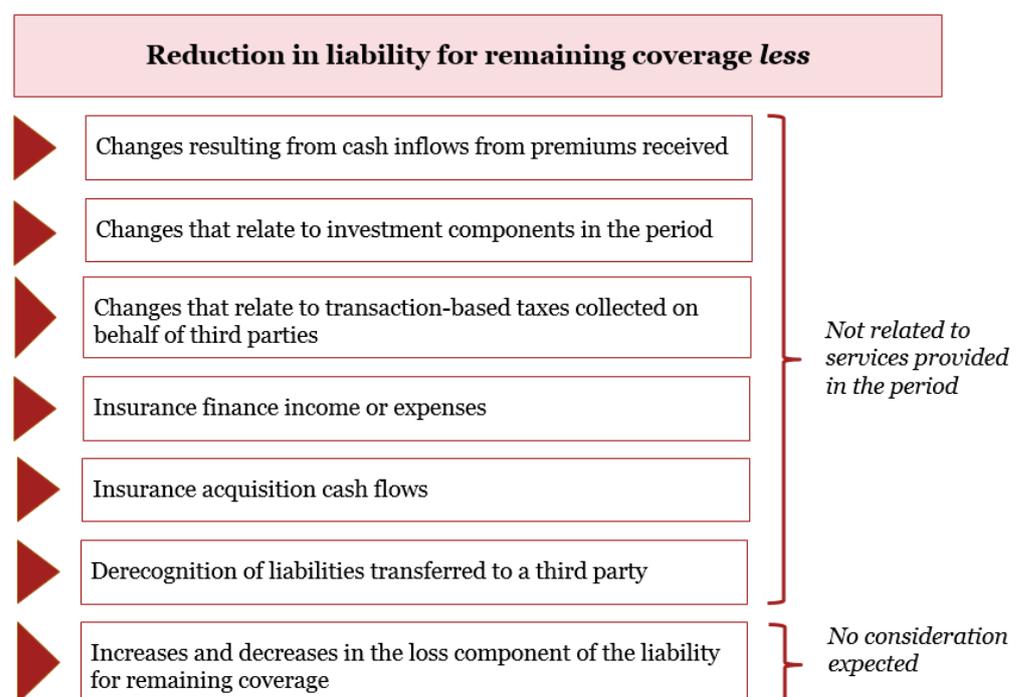
Under the general model and the variable fee approach, insurance contract revenue can be calculated in two different ways that both result in the same outcome; in both methods set out below, investment components do not affect revenue:

Method A – Sum of the changes in the liability for remaining coverage in the period that relate to services for which the entity expects to receive consideration.



Method B – Reduction in the liability for remaining coverage *less* changes that do not relate to services expected to be covered by the consideration received by the entity.

This method starts with the total amount of changes in the liability for remaining coverage and deducts any changes that either do not relate to services provided in the period or for which the entity does not expect consideration.



Under both methods, **insurance acquisition cash flows** are allocated in a systematic way on the basis of the passage of time. The amount allocated to each period is included in insurance revenue and insurance service expenses.

PwC observation: Revenue for life insurers might change

As described above, revenue under IFRS 17 will no longer be equal to the premium received in the period. IFRS 17 makes it clear that an insurer should not present premium information in profit or loss if that information is not in line with the definition of insurance revenue, as set out above. Many life insurers currently account for premiums received on a cash basis, rather than as services are provided. Because this kind of cash accounting is no longer permitted under IFRS 17, revenue will now be recognised in different periods.

Furthermore, the exclusion of the investment component will result in an amount of revenue that is, in aggregate, lower than under IFRS 4.

An insurer is not required to include the entire change in the **risk adjustment for non-financial risk** in the insurance service result. Instead, it can choose to split the amount between the insurance service result and insurance finance income or expenses.

PwC observation: Treatment of risk adjustment in revenue

Depending on the technique that the entity has chosen to determine the risk adjustment for non-financial risk, it might not be possible to identify the effect of a change in the discount rate on the risk adjustment. We therefore expect that, in practice, some entities will decide to show the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

Insurers using the premium allocation approach will determine revenue based on the passage of time or the expected timing of incurred insurance service expenses, as discussed in the section on '*Premium Allocation Approach*' above.

The **insurance service expenses** will comprise:

- incurred claims;
- other incurred insurance service expenses;
- amortisation of insurance acquisition cash flows;
- changes relating to past services (changes in fulfilment cash flows relating to liabilities for incurred claims); and
- changes relating to future services (losses/reversals on onerous groups of contracts).

Payments relating to investment components are excluded.

Example – Calculation of insurance revenue and insurance service expenses

An entity issues an insurance contract with a coverage period of three years. The coverage period starts when the insurance contract is issued; it is assumed that the contract will not lapse before the end of the coverage period.

The premium of CU900 is expected to be paid immediately after initial recognition, and so the expected present value of cash flows is also CU900. The entity estimates the annual expected cash outflows (to be paid immediately when expenses are incurred) as follows:

Expected annual cash outflows (end of year)	CU200 (total CU600)
Risk adjustment for non-financial risk	CU120

Using a discount rate of 5%, the expected present value of annual cash outflows is CU545. This results in the present value of expected cash flows of CU545 – CU900 = (CU355) and a contractual service margin of CU900 – CU545 – CU120 = CU235.

At the end of the year, the amounts are as follows:

	PV expected cash inflows/ (outflows)	Risk adjustment non-financial risk	Contractual service margin	Total liability
Opening balance	(CU355)	CU120	CU235	–
Cash inflows/premium received	CU900			CU900
Insurance finance expenses	CU27		CU12	CU39
Release for the year		(CU40)	(CU82)	(CU122)
Cash outflows	(CU200)			(CU200)
Closing balance	CU372	CU80	CU165	CU617

The insurance finance expenses are calculated as the interest based on the opening balance adjusted for the cash flows paid on day 1 of CU900 using the locked-in discount rate of 5%.

As explained above, **insurance revenue** for the period can be calculated in two different ways:

Method A

Insurance claims and expenses expected to be incurred in the period	CU200
Change in the risk adjustment for non-financial risk	CU40
Amount of the contractual service margin recognised in profit or loss	CU82
Insurance revenue	CU322

Method B

Total expected changes in liability for remaining coverage	(CU617)
- Changes resulting from cash inflows from premiums	CU900
- Insurance finance income or expenses	CU39
Insurance revenue	CU322

Insurance service expenses are equal to the amount of incurred claims (that is, CU200). In this example, there are no acquisition costs that qualify as fulfilment cash flows. If there were, they would be amortised and recorded as an expense, with an equivalent amount of revenue recorded.

PwC observation: Insurance revenue does not include experience adjustments

Insurance revenue is based on the expected insurance claims and expenses at the beginning of the reporting period and will not include experience adjustments that arise during the year, except indirectly through the subsequent release of the contractual service margin.

For a group of **reinsurance contracts** held, IFRS 17 allows two different ways to present income and expenses (other than insurance finance income or expenses). Either the insurer can present separately the amounts recovered from the reinsurer (as income) and an allocation of the premiums paid (as expense), or it can present one single net amount.

If the insurer decides to show the amounts recovered from the reinsurer and an allocation of the premiums paid separately, it should make a distinction between:

- *Reinsurance cash flows that are contingent on claims on the underlying contracts:* Part of the claims that are expected to be reimbursed under the reinsurance contract held.
- *Reinsurance cash flows that the entity expects to receive that are not contingent on claims on the underlying contracts:* Reduction in the premiums to be paid to the reinsurer.

The allocation of premiums paid cannot be presented as a reduction in revenue.

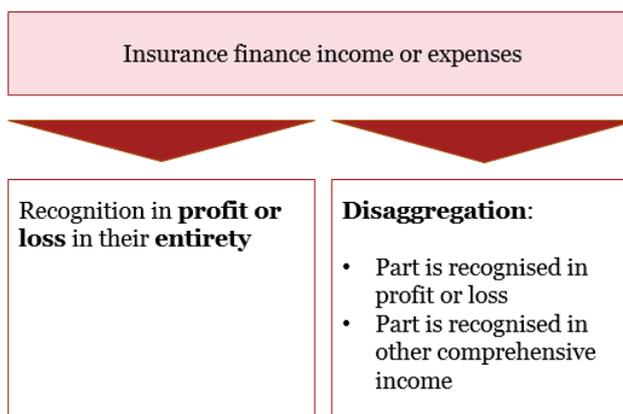
Insurance Finance Income or Expenses

Insurance finance income or expenses reflect the changes in the carrying amount of the group of insurance contracts that relate to financial risks. They comprise the effect of the **time value of money** (that is, the accretion of interest on all of the fulfilment cash flows, the risk adjustment for non-financial risk and the contractual service margin) as well as the effect of **financial risk** and changes in financial risks. Insurance finance income or expenses resulting from the risk adjustment for non-financial risk can also be presented as part of the insurance service result (see above).

For groups of insurance contracts with direct participation features, losses might arise if the entity's share of a decrease in the fair value of the underlying items or an increase in fulfilment cash flows relating to future services exceeds the carrying amount of the contractual service margin (for more information, see the section on '*Contracts with Direct Participation Features*' above). These changes are part of the insurance service expenses, even if they arise from time value of money or financial risks.

A financial risk is 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. A non-financial variable can also give rise to a financial risk if the variable is not specific to a party to the contract. Assumptions about inflation are only considered if they are based on an index of prices or rates or on prices of assets with inflation-linked returns. If they are based solely on an entity's expectations, they do not relate to a financial risk.

An insurer has an **accounting policy choice** either to present the entire amount of insurance finance income or expenses for the period in profit or loss, or to split it into one part that is included in profit or loss and one part that is included in other comprehensive income.



The accounting policy choice is applied on a portfolio basis.

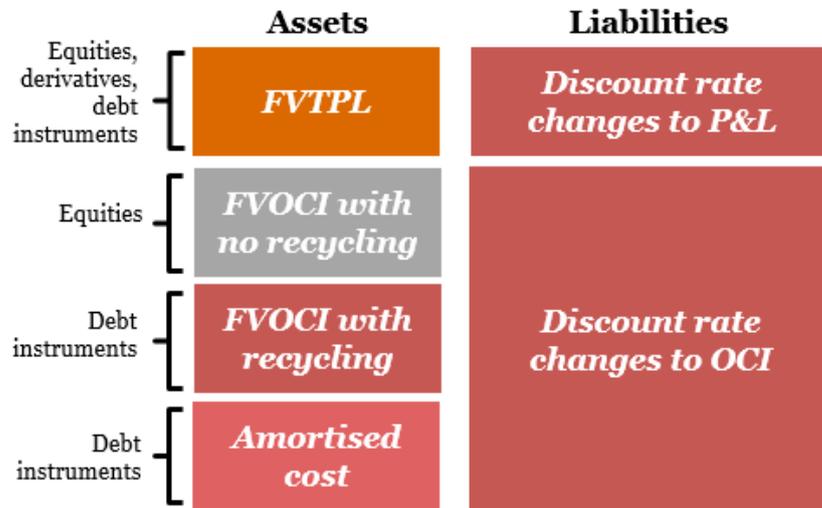
PwC observation: Different accounting policies for different entities in a group

In practice, the question will arise whether different legal entities can apply a different accounting policy in respect of insurance finance expense and whether consistency within one legal entity should be maintained. IFRS 17 explicitly requires entities to apply the accounting policy choice to portfolios of insurance contracts. A 'portfolio' is defined as insurance contracts with similar risks that are managed together. Groups can manage contracts differently, and thus the conclusion of the level of portfolios for a similar business could be different between different entities within a group and between different groups.

The way in which insurance finance income or expenses are disaggregated depends on the method that the insurer applies to account for the insurance contract. Furthermore, there is specific guidance for insurance contracts with direct participation features for which the entity holds the underlying items (Approach B described below).

PwC observation: Matching of financial results from assets and liabilities

How the accounting policy choice will be applied depends, to a certain extent, on how the related assets are measured under IFRS 9. In practice, we expect insurers to choose an approach that minimises overall volatility in profit or loss, as shown in the diagram below:



It will not be possible to completely eliminate mismatches between assets and liabilities, even if an entity decides to recognise changes in the discount rate for insurance liabilities in other comprehensive income. Listed below are some of the common situations that will result in mismatches between investment income and insurance finance income or expenses in the income statement:

- Regular premiums rather than a single premium are paid under the terms of the insurance contract. The discount rate for the insurance contract will be locked in at the inception of the contract, and the discount rate for the related assets will be locked in when premiums are received and invested in assets.
- Balances recognised in other comprehensive income for insurance contracts are recycled to profit or loss during the life of the contract, while other comprehensive income for related equity instruments is never recycled to profit or loss.
- It might be challenging to select an accounting policy for changes in discount rates for insurance liabilities to achieve better matching if related assets are classified in various categories.

Approach A – General model/Variable fee approach for insurance contracts with direct participation features for which the entity does *not* hold the underlying items

An insurer that:

- applies the general model; or
- applies the variable fee approach for insurance contracts with direct participation features for which it does *not* hold the underlying items,

defines a pattern by which the expected total insurance finance income or expenses over the duration of the group of contracts will be allocated systematically to each period. The difference between the amount allocated to each period based on this systematic allocation and the total insurance finance income or expenses of the period is recognised in other comprehensive income.

When choosing a **systematic allocation**, the entity should meet a number of requirements:

- The allocation should be **based solely on characteristics of the contract**. The allocation of the finance income or expenses should, for example, not be based on expected recognised returns on assets if those expected recognised returns do not affect the contract cash flows.
- The **total amount recognised in other comprehensive income** over the life of the contract should be **zero**.

Aside from these general principles, the standard provides more specific guidance depending on whether changes in **assumptions relating to financial risks** have a substantial effect on the amount paid to the policyholder.

The requirements below apply to all insurance contracts other those which are measured using the variable fee approach and for which an entity holds underlying items as assets.

- In scenarios where changes in assumptions relating to **financial risks do not have a substantial effect** on the amount paid to the policyholder, the allocation is made using the discount rate by which estimated future cash flows have been discounted on initial recognition.

Example – Measurement of the effect of changes in discount rates to be recognised in other comprehensive income

In the example included in the section on '*Statement(s) of financial performance*' above, financial risks do not have a substantial effect on the amount paid to the policyholder. An insurer that chooses to split the total insurance finance expenses would therefore recognise an interest charge of 5% each year in profit or loss.

Assume that, in the second year, market interest rate decreases to 2%.

	PV expected cash inflows/ (outflows)	Risk adjustment non-financial risk	Contractual service margin	Total
Opening balance (t = 0)	(CU355)	CU120	CU235	nil
Cash inflows/premium received	CU900			CU900
Insurance finance expenses	CU27		CU12	CU39
Release for the year		(CU40)	(CU82)	(CU122)
Cash outflows	(CU200)			(CU200)
Closing balance (t = 1)	CU372	CU80	CU165	CU617

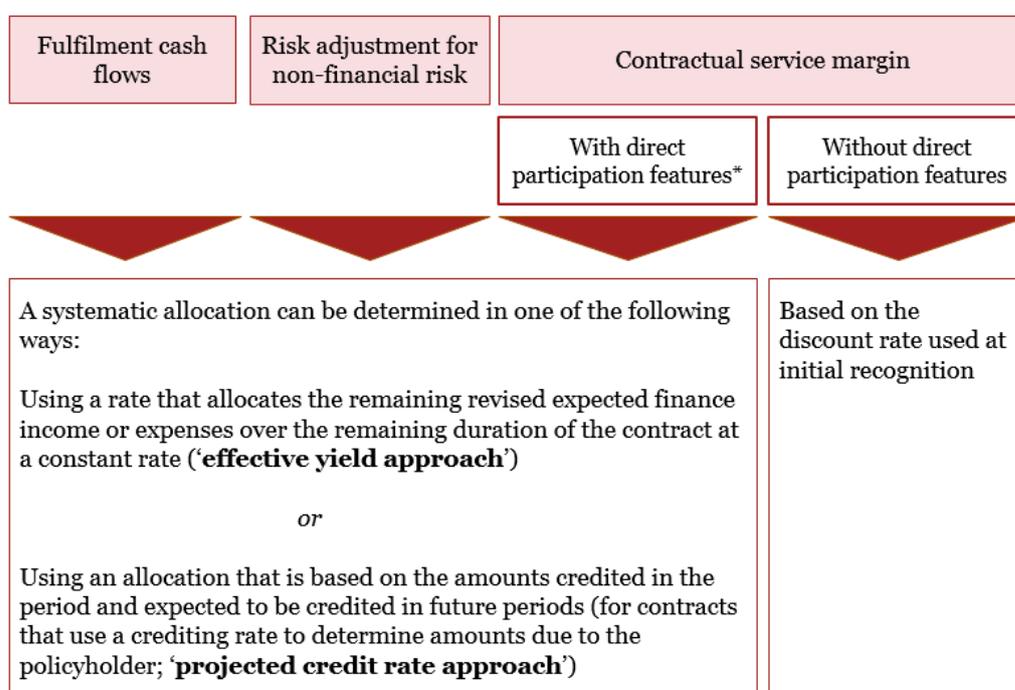
Example – Measurement of the effect of changes in discount rates to be recognised in other comprehensive income (continued)

	PV expected cash inflows/ (outflows)	Risk adjustment non-financial risk	Contractual service margin	Total
Release for the year		(CU40)	(CU87)	(CU127)
Cash outflows	(CU200)			(CU200)
<i>Change assumptions regarding financial risk</i>	CU5			CU5
Closing balance (t = 2)	CU196	CU40	CU86	CU322

The total insurance finance expenses of the second period (CU32) are split into:

- an amount of CU27, calculated based on the interest rate of 5% used at initial recognition, recognised in profit or loss; and
- a remaining amount of CU5 (CU32 – CU27) recognised in other comprehensive income.

- In scenarios in which changes in assumptions relating to **financial risks have a substantial effect** on the amount paid to the policyholder, a further distinction is made. The reason for having a substantial effect can be that there are participation features. But, even if the insurance contract does not qualify as an insurance contract with direct participation features (for example, because there are no clearly identified underlying items), financial risks might have a substantial effect on the payments to the policyholder.



* Applies to the insurance contracts with direct participation features when insurer does not hold underlying items as assets.

Example 15 in Illustrative Examples to IFRS 17 illustrates some of the acceptable interpretations of how the effective yield approach and the projected credit rate approach work.

PwC observation: Operational complexity from tracking different discount rates

In practice, the use of different discount rates that have to be calculated and tracked will be a significant operational effort that many insurers might find challenging.

Approach B – Variable fee approach for insurance contracts with direct participation features for which the entity holds the underlying items

The objective of the disaggregation for insurance contracts with direct participation features for which the entity holds the underlying items is to eliminate accounting mismatches with income or expenses included in profit or loss arising on the underlying items held. To achieve this objective, an entity includes in profit or loss income or expenses that exactly match the income or expenses included in profit or loss for the underlying items. As a result, the net of the two items separately presented is nil.

If an entity no longer holds the underlying items, it stops applying Approach B and moves to Approach A, as discussed above. The treatment of the accumulated amounts included in other comprehensive income follows the principle outlined above.

If a group of insurance contracts is transferred or derecognised, any remaining amount previously recognised in other comprehensive income is not reclassified to profit or loss.

PwC observation: Rejection of ‘mirroring approach’

The previous exposure draft introduced a ‘mirroring approach’ to avoid mismatches in profit or loss. The ‘mirroring approach’ was proposed for certain variable cash flows that depend on the development of underlying items (provided that the contracts require the entity to hold these underlying items and specify a link to returns on those underlying items). If applicable, this approach aligned the presentation and measurement of the variable cash flows resulting from the insurance contract with those from the underlying items. The IASB decided against this approach for participating contracts.

The insurance industry proposed using a contract book yield for all participating insurance contracts where the change in the carrying amount of assets would be shown as the insurance finance expense. The IASB rejected this approach and only allowed the matching approach where the underlying assets are held.

Changes between Approach A and Approach B

Sometimes an entity that has issued an insurance contract with direct participation features holds the underlying items only in some periods. If an insurer formerly did not hold the underlying items but subsequently starts to hold them, it stops applying Approach A and uses Approach B prospectively. At this point, the accumulated amount previously included in other comprehensive income is not recalculated as if the new disaggregation had always been applied. Instead, the entity includes in profit or loss the accumulated amount as it is before the change, as if it were continuing Approach A based on the assumptions that applied immediately prior to the change. Prior period comparative information is not adjusted.

Transfer/derecognition of a group of insurance contracts

In the case of a transfer or a derecognition of a group of insurance contracts, any remaining amount previously recognised in other comprehensive income is reclassified to profit or loss as a reclassification adjustment.

Approach C – Premium allocation approach

An entity that applies the premium allocation approach and chooses, or is required, to discount the liability for incurred claims can also decide to disaggregate insurance finance income or expenses instead of including the entire amount in profit or loss. If it decides to split the amount, the interest expense in profit or loss is determined using the discount rate at the date of initial recognition of the liability for incurred claims.

Foreign currency exchange differences

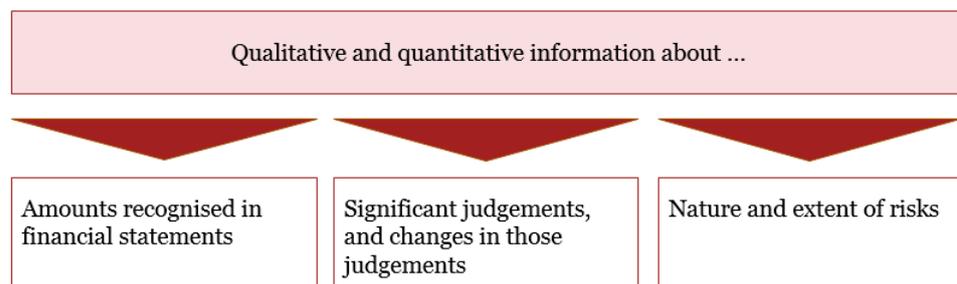
An insurance contract is a monetary item that could give rise to exchange differences when it is translated into the functional currency of the entity. The recognition of these changes in either profit or loss or other comprehensive income depends on the changes in the insurance contract to which it relates: exchange differences that relate to changes in the insurance contract recognised in other comprehensive income are also recognised in other comprehensive income; and all other changes are recognised in profit or loss.

Disclosures

The disclosures required in IFRS 17 should allow users of financial statements to assess the effect that contracts within the scope of the standard have on the entity's financial position, financial performance and cash flows. Information can be aggregated if that results in more useful information. The standard includes examples of aggregations that might be appropriate, as follows:

- type of contract (for example, major product lines);
- geographical area (for example, country or region); or
- reportable segment, as defined in IFRS 8, 'Operating Segments'.

There are three different kinds of disclosure required:



PwC observation: Additional disclosures will be required under IFRS 17 compared to IFRS 4

IFRS 17 requires a number of additional quantitative disclosures that have not been required under IFRS 4. In practice, providing these numbers and collecting all of the necessary information might be an operational challenge and should be considered when designing the system architecture.

This will be the case, in particular, for the requirements:

- to provide detailed reconciliations;
- to disclose the confidence level used to determine the risk adjustment for non-financial risks; and
- to disclose the yield curve (or range of yield curves) used to discount cash flows.

Explanation of Recognised Amounts – Statement of Financial Position

General Model/Variable Fee Approach

An entity must provide **reconciliations** showing how the net carrying amounts of contracts changed during the period as a result of cash flows and income and expenses recognised in the statement(s) of financial performance. It discloses reconciliations for:

- net liabilities (or assets) for the remaining coverage component, excluding any loss component;
- any loss component;
- liabilities for incurred claims;
- estimates of the present value of the future cash flows;
- risk adjustment for non-financial risk; and
- contractual service margin.

The reconciliations are given separately for insurance contracts issued and reinsurance contracts held. They are further disaggregated into a total for groups of contracts in an asset position and a total for groups of contracts in a liability position.

Example – Disclosure of reconciliations of the liability for remaining coverage and the liability for incurred claims

This example is based on the example of disclosure presented in Effects Analysis for IFRS 17, 'Insurance Contracts', issued by IFRS Foundation.

This example illustrates one of the possible ways to disclose the reconciliations required under IFRS 17. There are a number of simplifications in this disclosure example, including no comparative information and no reinsurance contracts held.

The table below summarises information about the components of the net insurance liabilities:

	31 December 20X1			
	Liability for remaining coverage excluding loss component	Loss component	Liability for incurred claims	Total
Present value of future cash flows	183,759	6,379	1,042	191,180
Risk adjustment	4,679	1,677	148	6,504
Contractual service margin	–	8,040	–	8,040
Total	188,438	16,096	1,190	205,724

Presented in the statement of financial position:

	31 December 20X1
Assets: Insurance contracts issued	(56,795)
Liabilities: Insurance contracts issued	262,519
Total	205,724

Example – Disclosure of reconciliations of the liability for remaining coverage and the liability for incurred claims (continued)

A reconciliation of the liability for remaining coverage and liability for incurred claims for 20X1 is presented below:

	20X1			
	Liability for remaining coverage excluding loss component	Loss component	Liability for incurred claims	Total
Opening balance	161,938	15,859	1,021	178,818
Insurance revenue	(9,856)	–	–	(9,856)
Insurance service expenses:	1,259	(623)	7,985	8,621
Incurred claims and other expenses	–	(840)	7,945	7,105
Acquisition expenses	1,259	–	–	1,259
Change that relate to future service: losses on onerous contracts and reversals of those losses	–	217	–	217
Change that relate to past service: changes for liabilities for incurred claims	–	–	40	40
Investment components	(6,465)	–	6,465	–
Insurance service result	(15,062)	(623)	14,450	(1,235)
Insurance finance expenses	8,393	860	55	9,308
Total changes in the statement of comprehensive income	(6,669)	237	14,505	8,073
Cash flows:				
Premiums received	33,570	–	–	33,570
Incurred claims and other expenses paid	–	–	(14,336)	(14,336)
Insurance acquisition cash flows paid	(401)	–	–	(401)
Total cash flows	33,169	–	(14,336)	18,833
Closing balance	188,438	16,096	1,190	205,724

Example – Disclosure of reconciliations of the liability for remaining coverage and the liability for incurred claims (continued)

A reconciliation of the present value of future cash flows, the risk adjustment and the contractual service margin for 20X1 is presented below:

	20X1			
	Present value of future cash flows	Risk adjustment	Contractual service margin (CSM)	Total
Opening balance	163,962	5,998	8,858	178,818
Changes that relate to future services:	(784)	1,117	(116)	217
Contracts initially recognised in the period	(2,329)	1,077	1,375	123
Changes in estimates reflected in the CSM	1,452	39	(1,491)	–
Changes in estimates that result in onerous contract losses	93	1	–	94
Changes that relate to current services:	35	(604)	(923)	(1,492)
CSM recognised in profit or loss	–	–	(923)	(923)
Changes in the risk adjustment (expected)	–	(604)	–	(604)
Experience adjustments	35	–	–	35
Changes that relate to past services:	47	(7)	–	40
Adjustments to liabilities for incurred claims	47	(7)	–	40
Insurance service result	(702)	506	(1,039)	(1,235)
Insurance finance expenses	9,087	–	221	9,308
Total changes in the statement of comprehensive income	8,385	506	(818)	8,073
Cash flows	18,833	–	–	18,833
Closing balance	191,180	6,504	8,040	205,724

For **insurance contracts** that are **initially recognised** in the period, an entity shows separately, for insurance contracts issued and reinsurance contracts held, the effect on:

- the estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows;
- the estimates of the present value of future cash inflows;
- risk adjustment for non-financial risk; and
- contractual service margin.

The effects of contracts acquired from other entities in transfers or business combinations and from groups of contracts that are onerous are shown separately from other contracts initially recognised in the period.

The entity explains when it expects to recognise the **contractual service margin** remaining at the end of the reporting period in profit or loss. This information can be provided either quantitatively or qualitatively. It should be provided separately for insurance contracts issued and reinsurance contracts held.

PwC observation: Disclosures will provide more information for users

Disclosures prepared in accordance with IFRS 17 will be more transparent and will provide more granular information to the users of financial statements than many GAAPs provide today. In particular, reconciliation of the contractual service margin for the reporting period will provide additional information to users on the drivers of profit.

Premium Allocation Approach

For entities adopting the premium allocation approach, **reconciliations** are provided of the net liabilities (or assets) for the remaining coverage component (excluding any loss component), any loss component and liabilities for incurred claims that include the information described above.

An entity also discloses the **reason why it was eligible** to apply the premium allocation approach and:

- whether it chose to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk (provided that the criteria are met); and
- which method it chose to recognise any insurance acquisition cash flows.

Explanation of Recognised Amounts – Statement(s) of Financial Performance

Insurance Revenue

An entity provides an analysis of insurance revenue recognised in the period. The analysis contains:

- The insurance service expenses incurred during the period.
- The change in the risk adjustment for non-financial risk.
- The amount of the contractual service margin released to profit or loss because of services transferred in the period.
- The allocation of the portion of the premiums that relates to the recovery of insurance acquisition cash flows.

This requirement does not apply to contracts that are accounted for using the premium allocation approach.

Insurance Finance Income or Expenses

An insurer should disclose and explain the relationship between insurance finance income or expenses and the investment return on the related assets that the entity holds. For insurance contracts with direct participation features, the following additional disclosures are required:

- The composition of the underlying assets and their fair value.
- The effect of the decision not to adjust the contractual service margin for changes in the effect of financial risk on the entity's share of the underlying assets when holding derivatives for risk mitigation purposes.
- Additional explanations if the insurer changes the split of finance income or expenses shown in profit or loss and in other comprehensive income because it either no longer holds the underlying items or starts to hold them.

Significant Judgements

An insurer discloses the methods used to measure insurance contracts and the processes for estimating the inputs to those methods, as well as changes in methods and processes. It provides quantitative information about the inputs, unless it is impracticable to do so.

Methods/processes include for example:
Approach used to distinguish changes in estimates of future cash flows arising from the exercise of discretion from other changes in estimates of future cash flows, for contracts without direct participation features
Approach used to determine risk adjustment for non-financial risk
Approach used to determine discount rates
Approach used to determine investment components
Methods to calculate the insurance finance income or expenses recognised in profit or loss (if the insurer disaggregates the total amount and recognises part of it in other comprehensive income)
Any changes in the methods and processes for estimating inputs used for measurement, the reason for such changes and the type of contracts affected

An insurer should disclose the confidence level both when it uses the confidence level approach and when it uses a different method for determining the risk adjustment for non-financial risks. The yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns from underlying items should also be disclosed.

PwC observation: Disclosing the confidence level

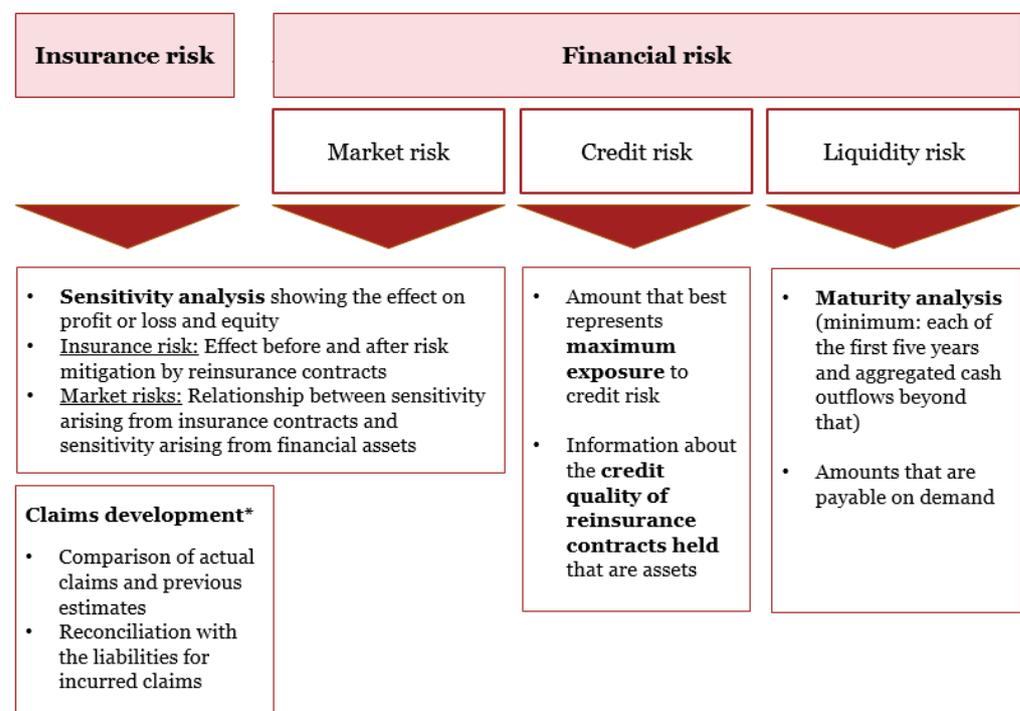
From an operational perspective, the requirement to disclose the confidence level might be challenging if the risk adjustment is not calculated on this basis.

Nature and Extent of Risks that Arise from Contracts within the Scope of IFRS 17

An entity discloses information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows from contracts within the scope of IFRS 17. Risks typically arise from insurance risk and financial risks (market risk, credit risk, and liquidity risk).

For each type of risk, the entity discloses its exposure, how the exposure arises, the entity's objectives, policies and processes for managing the risk, and the methods that are used to measure the risk. Furthermore, any changes in risks or risk management compared to the previous period have to be disclosed.

An entity should provide summary quantitative information about its exposure to each of the risks. At a minimum, the entity should make the disclosures outlined below:



* The disclosures are not needed if claims are settled within one year.

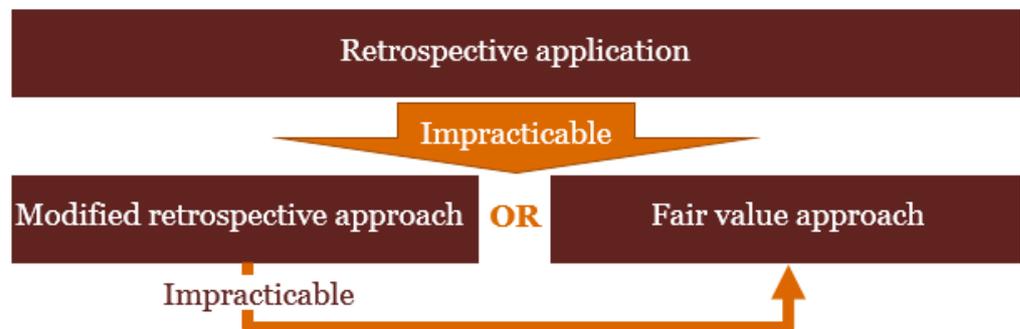
An entity should provide information about the **concentration of risk**. An entity could, for example, provide interest rate guarantees that come into effect at the same level for a material number of contracts, or it could provide product liability protection to pharmaceutical companies in which it also holds investments.

The **regulatory framework** in which the entity operates might also give rise to risks (for example, due to minimum capital requirements or required interest rate guarantees). These restrictions have to be explained in the notes. If legal or regulatory constraints on pricing affect how the entity groups contracts (see details in the section on '*Level of Aggregation*' above), this fact should also be disclosed.

Transition

IFRS 17 should be applied for annual reporting periods beginning on or after 1 January 2021. Early adoption is permitted if the entity applies IFRS 9 and IFRS 15 not later than on the date of initial application of IFRS 17. 1 January 2021 is the date of initial application of IFRS 17 unless an entity early adopts IFRS 17. The transition date is the beginning of the reporting period immediately preceding the date of initial application. Therefore, if an entity adopts on 1 January 2021, the transition date is 1 January 2020.

On transition, an entity should apply IFRS 17 retrospectively unless it is impracticable to do so. An entity should apply a modified retrospective approach or fair value approach if it is impracticable to apply IFRS 17 retrospectively for a group of insurance contracts. An entity should use the fair value approach if the modified retrospective approach is impracticable. The diagram below summarises the selection of approaches on transition:



An entity might consider that it would be impracticable to apply retrospective approach where:

- the effects of the retrospective application or retrospective restatement are not determinable;
- the retrospective application or restatement requires assumptions about what management's intent would have been in that period; or
- the retrospective application or restatement requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that:
 - i. provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
 - ii. would have been available, when the financial statements for that prior period were authorised for issue, from other information.

PwC observation: Result of measurement from applying different approaches

The result of measurement of the same group of contracts from applying the three transition approaches will be different. The measurement using the full retrospective approach and the modified retrospective approach might be relatively close, compared to the fair value approach, depending on the availability of information and simplifications used. The fair value approach might provide a very different measurement compared to the two retrospective approaches. For example, there might be no contractual service margin when applying the full retrospective approach or the modified retrospective approach if the contracts are onerous, while it is generally expected that there will be a contractual service margin when the fair value approach is applied, because IFRS 13 indicates that the fair value includes the profit margin that a market participant would require to accept obligations under insurance contracts.

The IASB acknowledge that the optionality available on transition will result in less comparable financial statements until the contracts written before the transition date are derecognised. However, the IASB concluded that the costs associated with the full retrospective approach or modified retrospective approach might exceed the benefits if there is little information available on the transition date. Thus, the fair value approach is permitted as an accounting policy choice in accordance with IAS 8 if a full retrospective approach is impracticable.

PwC observation: Measurement of contracts acquired in business combinations on transition

As discussed in the section on ‘*Business combinations*’ above, the coverage period, contractual service margin and locked-in assumptions might be different in the financial statements of an acquired subsidiary and in the consolidated financial statements of the group because the contract inception date is:

- the date when the contracts were written (see the section on ‘*Timing of Initial Recognition*’ above), in the financial statements of a subsidiary; and
- the date when contracts are purchased, in the consolidated financial statements of a group.

Measurement on transition in the financial statements of an acquired subsidiary and in the consolidated financial statements will be different, depending on the transition approaches that are used.

Measurement will be different, both on transition and after transition, if the full retrospective or modified retrospective approaches are used. The dates of initial measurement of contracts and the amount used to calculate the contractual service margin will be different for the acquired subsidiary and the group, resulting in different retrospective measurement. Coverage periods for the acquired subsidiary might be shorter than coverage periods for the acquiring entity, and this will result in different measurement of the contractual service margin after transition.

There will be no differences in measurement of insurance contracts on transition if the fair value approach is used, because the fair value is expected to be the same whether viewed from a subsidiary or from a group perspective. However, after transition the measurement might be different, because the coverage periods might still be different, resulting in different measurement of the contractual service margin.

PwC observation: First-time adoption of IFRS 17 after 2021

The IASB decided to provide the same options for entities adopting IFRS 17 for the first time after 2021 as they provided for transition to IFRS 17. Relevant amendments were made to IFRS 1 to allow the modified retrospective approach and the fair value approach.

Retrospective Application

Applying IFRS 17 retrospectively:

- An entity need not disclose the following information as required by IAS 8:
 - adjustment for each financial statement line affected; and
 - adjustment of the basic and diluted earnings per share.
- An entity should apply an exception related to risk mitigation for contracts with direct participation features not earlier than the date of initial application.
- An entity should, at the transition date, recognise and measure each group of insurance contracts in force at that date and derecognise any existing balances that would not exist as if IFRS 17 had always applied.
- An entity should, at the transition date, recognise in equity on a net basis any differences between amounts recognised under IFRS 4 and IFRS 17.

PwC observation: Applying the retrospective approach on transition for long-term contracts

IAS 8 generally requires retrospective application of new accounting policies, unless it is impracticable to do so. This is also the starting point for initial application of IFRS 17.

Insurers might issue long-term contracts, especially in the life insurance business. Gathering information for contracts issued many years before transition could be either very costly or not possible. Setting out assumptions and estimates for such contracts at the contract inception date might not be possible without the use of hindsight. So, the IASB offers insurers additional alternatives for transition where full retrospective application is impracticable.

The IASB wants to achieve a transition amount that is as close to the retrospective application as possible where only some information is missing. In such a situation, insurers could use the modified retrospective approach that provides a few simplifications compared to the full retrospective approach.

At the same time, the IASB acknowledged that there might be very little information available on transition. Application of the modified retrospective approach in such cases could be costly and might have little or no benefit. So, the IASB suggested a fair value approach as an accounting policy choice to reduce the implementation costs.

Modified Retrospective Approach

Applying the modified retrospective approach, an entity should achieve the closest possible outcome to the retrospective application using reasonable and supportable information without undue cost or effort. An entity should maximise the use of information required for the retrospective application, and it is permitted to use each modification only if there is no reasonable and supportable information available, without undue cost or effort, to apply a retrospective approach.

Applying the modified retrospective approach, the simplifications listed below are available; an entity should use simplifications only where it does not have reasonable and supportable information, without undue cost or effort, as required by the full retrospective approach:

- (a) assessments at the date of initial recognition of groups of insurance contracts;
- (b) contractual service margin for insurance contracts without direct participation features;
- (c) contractual service margin for insurance contracts with direct participation features; and
- (d) insurance finance income or expenses.

Each simplification is considered in detail below.

Assessments at the Date of Initial Recognition of Groups of Insurance Contracts

An entity is permitted to aggregate, together in a group, contracts that have been issued more than one year apart if there is no reasonable and supportable information available without undue cost or effort.

PwC observation: No ‘annual cohorts’ requirement on transition

In many cases, it will be impracticable for entities to group contracts in force on transition according to the year when they were written, because information might not be available at that level of detail. Entities can aggregate contracts issued more than one year apart in one group in such circumstances. This simplification is expected to streamline the aggregation of contracts on transition and reduce implementation costs.

An entity should apply the requirements listed below at the transition date, instead of applying them at the date of initial recognition of a group of insurance contracts:

- (a) identification of groups of insurance contracts;
- (b) assessment of whether an insurance contract has direct participation features; and
- (c) definition of discretion for contracts without direct participation features.

Contractual Service Margin for Insurance Contracts without Direct Participation Features

The contractual service margin for insurance contracts without direct participation features at initial recognition is determined in line with the requirements of the general model described in the section on ‘*Initial measurement of the contractual service margin*’ above. Under the modified retrospective approach, an entity can use the following simplifications for calculation of components of the fulfilment cash flows if there is no reasonable and supportable information available without undue cost or effort:

- Future cash flows at the date of initial recognition of a group of insurance contracts can equal the future cash flows at the transition date (or earlier date, if determinable), adjusted by the actual cash flows that have occurred between the transition (or earlier) date and the date of initial recognition. Actual cash flows include cash flows from contracts derecognised before the transition date.

- The discount rate to be applied at the date of initial recognition can be determined:
 - a. by using an observable yield curve that, for at least three years immediately before the transition date, approximates to the yield curve required by IFRS 17, if such an observable yield curve exists; and
 - b. if an observable yield curve does not exist, by calculating the average spread between an observable yield curve and the yield curve required by IFRS 17 for at least three years before the transition date, and applying that spread to that observable yield curve.
- The risk adjustment is determined as the risk adjustment at the transition date adjusted for the expected release of risk before the transition date. The expected release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the transition date.

The contractual service margin recognised in profit or loss, as a result of the transfer of services before the transition date, is determined by comparing the remaining coverage units at the transition date to the coverage units provided under the group of contracts before the transition date.

Contractual Service Margin for Insurance Contracts with Direct Participation Features

If there is no reasonable and supportable information available without undue cost or effort, the contractual service margin for insurance contracts with direct participation features at the transition date equals:

- a) the total fair value of the underlying items at the transition date; minus
- b) the fulfilment cash flows at the transition date, adjusted for:
 - i. amounts charged by the entity to the policyholder before that date;
 - ii. amounts paid to the policyholder before that date; and
 - iii. release of the risk adjustment for non-financial risk before transition date.

The resulting contractual service margin is a proxy for the contractual service margin before any amounts have been recycled in profit or loss. This amount is reduced for allocation to services provided before the transition date, based on the coverage units.

If the calculated contractual service margin results in a loss component, the resulting loss component is reduced to nil by transfer of the amount to the liability for remaining coverage excluding the loss component.

Insurance Finance Income or Expenses

Under the modified retrospective approach, an entity is allowed to use the following simplifications if there is no reasonable and supportable information available without undue cost or effort:

	For a group that has insurance contracts issued more than one year apart	For a group that has no insurance contracts issued more than one year apart
Locked-in discount rate at the date of initial recognition of a group or when a claim incurred for the premium allocation approach	Apply discount rate locked in at transition date	Use simplification for discount rate for estimation of the contractual service margin, as discussed in the section on <i>'Contractual service margin for insurance contracts without direct participation features'</i> above

	For a group that has insurance contracts issued more than one year apart	For a group that has no insurance contracts issued more than one year apart
Determine the cumulative amount recognised in other comprehensive income before the transition date, as described below, if an entity chooses to recognise an eligible portion of insurance finance income and expenses in other comprehensive income:		
For insurance contracts with direct participation features where an entity holds underlying items as assets	As equal to the cumulative amount for the underlying items recognised in other comprehensive income	
For insurance contracts without direct participation features for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder	As nil	Using the discount rates that applied at the date of initial recognition, determined as described in the section on <i>'Contractual service margin for insurance contracts without direct participation features'</i> above
For insurance contracts without direct participation features for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder		As nil
For insurance contracts measured using the premium allocation approach		Using the discount rates that applied at the date of incurred claim, determined as described in the section on <i>'Contractual service margin for insurance contracts without direct participation features'</i> above

Fair Value Approach

An entity can elect to use the fair value approach if the full retrospective approach is impracticable, and it should use the fair value approach if the modified retrospective approach is impracticable. Applying the fair value approach:

- The contractual service margin is determined as the difference between the fair value of a group of insurance contracts, measured in accordance with IFRS 13, 'Fair Value Measurement', and its fulfilment cash flows at the transition date. However, it should not increase the fair value to the amount that would be payable on demand as IFRS 13 requires.
- An entity can choose to determine the following, either retrospectively (if reasonable and supportable data exists without use of hindsight) or at the transition date:
 - aggregation of insurance contracts into groups;
 - whether an insurance contract meets the definition of an insurance contract with direct participation features; and
 - definition of discretion for contracts without direct participation features.
- An entity can choose to include in a group contracts issued more than one year apart.
- An entity can choose to determine the cumulative amount recognised in other comprehensive income before the transition date, as described below, if it chooses to recognise an eligible portion of insurance finance income and expenses in other comprehensive income:
 - retrospectively, if there is reasonable and supportable information available;
 - for insurance contracts with direct participation features where an entity holds underlying items as assets, as equal to the cumulative amount for the underlying items recognised in other comprehensive income; or
 - as nil, in any other circumstances.

PwC observation: Determining fair value of a group of contracts under IFRS 13

IFRS 13 requires a fair value measurement of a liability to be a value that a market participant would require in return for assuming all of the obligations related to that liability. Entities are already using IFRS 13 for measurement of insurance contracts at fair value where they have business combinations accounted for in accordance with IFRS 3 or portfolio transfers. For business combinations and portfolio transfers, insurers generally have a market price, which is the transaction price. On transition to IFRS 17, there will be few or no observable market prices for many insurance contracts. This will require additional judgement compared to the use of IFRS 13 for business combinations or portfolio transfers today.

Discount rate

Cash flows and discount rates should reflect the assumptions that market participants would use when pricing the asset or liability. To avoid double-counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows.

In contrast to the measurement requirements under IFRS 17:

- Own credit risk related to the liability should be considered in a fair value measurement.
- An asset-based discount rate could be used if such approaches are used by market participants in pricing liabilities in actual transactions.

PwC observation: Determining fair value of a group of contracts under IFRS 13 (continued)

Profit margin

Irrespective of the approach used for measurement of the fair value, entities should compare the results to any actual market transactions, and they should adjust the measurement to consider the actual market transactions or quotes for similar groups of contracts. In particular, an acquirer of a group of insurance contracts is likely to require a profit margin (above the probability-weighted, risk-adjusted discounted cash flows), even if the contract would have no unearned profit if a full retrospective approach had been applied on transition.

Application of the fair value approach might be expected to result in the fair value of a group of insurance contracts being higher than its fulfilment cash flows. This is because IFRS 13 considers the fair value of insurance contracts from the perspective of a market participant, and a market participant would generally require a profit margin on top of the fulfilment cash flows to accept a liability. This will be different to the full retrospective measurement or modified retrospective approach, where it is generally expected that onerous insurance contracts will have no contractual service margin, because losses will be immediately recognised in profit or loss.

PwC observation: Leveraging embedded value or economic-based regulatory measures when applying the fair value approach

Historically, many insurers issuing long-term contracts applied Market Consistent Embedded Value (MCEV) or European Embedded Value (EEV) Principles, issued by the European Insurance CFO Forum, to measure insurance contracts for supplementary reporting purposes. Where still produced, entities will be able to use these measurements or other economic-based regulatory measures (such as Solvency II in Europe) as a starting point for the fair value approach on transition to IFRS 17. However, entities should ensure that such measurement is consistent with the IFRS 13 requirements, and they should adjust it for any differences.

PwC observation: Practical implications of IFRS 17 transition choices

The choice between the modified retrospective approach and the fair value approach on transition will impact shareholders' equity on transition and the release of profit from the insurance contracts in force after transition. It is also likely to affect operational complexity and the cost of IFRS 17 implementation. In addition, some profits from insurance contracts might not be recognised at all in profit or loss (that is, they would not have been recognised in profit or loss under IFRS 4 and will be recognised as an adjustment to equity on transition to IFRS 17), while other profits might be recognised in profit or loss twice (that is, they would have been recognised in profit or loss under IFRS 4 and will be recognised in the contractual service margin and then in profit or loss after transition to IFRS 17). This is an unavoidable result of differences between measurement approaches used under IFRS 4 and on transition to IFRS 17.

Equity on transition and release of profit from insurance contracts after transition

The contractual service margin on transition represents the profit from insurance contracts in force that insurers will earn after transition. On transition, the higher the contractual service margin is, the lower is the accumulated profit from insurance contracts recognised in shareholders' equity and the more profit insurers will recognise in future periods until the end of the coverage of insurance contracts in force on transition.

PwC observation: Practical implications of IFRS 17 transition choices (continued)

This might impact the ability to pay future dividends, solvency capital or taxation, depending on local legal and regulatory requirements. This might also impact the way in which investors assess the performance of the entity on transition and at future dates until the end of the coverage period of the contracts in force on transition. Additional disclosures will be required, as explained in the section on 'Disclosure on transition' below.

Operational complexity and cost of IFRS 17 implementation

The complexity of application of the different transition approaches and the cost of transition to IFRS 17 might be different, depending on the availability of information. Generally, for insurance contracts issued a long time before the transition date, the full retrospective approach and the modified retrospective approach will be more expensive to apply. For short-term contracts and contracts issued close to the transition date, more information is likely to be available, and the fair value approach might be more complex and more expensive compared to the alternatives.

Comparative Information

An entity is required to present restated comparative information in accordance with the requirements of IAS 1. That means that, as a minimum, the following information should be presented in the financial statements when an entity first applies IFRS 17:

- three statements of financial position,
- two statements of profit or loss and other comprehensive income,
- two separate statements of profit or loss (if presented),
- two statements of cash flows,
- two statements of changes in equity, and
- related notes.

An entity is permitted, but not required, to present additional comparative information. The disclosure requirements are not required for voluntarily presented additional comparative periods, if any.

PwC observation: Relief from full retrospective application for all periods presented for entities filing with certain regulatory bodies

Some regulatory bodies require the presentation of comparative information for more comparative periods than is required under IFRS.

The IFRS 17 transition date is the beginning of the annual reporting period immediately preceding the date of initial application. This provides some relief from full retrospective application for all periods presented for entities filing with certain regulatory bodies, such as the US Securities and Exchange Commission, which require presentation of financial statements and financial information for periods greater than two years. An entity should clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis. Alternatively, an entity can present adjusted comparative information applying IFRS 17 for any earlier periods presented, but it is not required to do so.

Disclosure on Transition

On transition, insurance contracts will be measured differently from the measurement going forward, unless the full retrospective approach is applied. This will impact the measurement of insurance contracts in the statement of financial position and in the income statement after transition until the insurance contracts in force on transition are derecognised. The following disclosures are required for all periods where simplifications on transition affect the measurement in the financial statements:

- Reconciliation of the contractual services margin and revenue presenting separately contracts measured using the modified retrospective approach, contracts measured using the fair value approach and other contracts, together with an explanation for the measurement on transition using the modified and fair value approaches.
- For entities that use simplifications on transition to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, reconciliation of accumulated other comprehensive income for the reporting period for financial assets measured at fair value through other comprehensive income related to the groups of insurance contracts to which the disaggregation applies.

Applying IFRS 9 before IFRS 17

IFRS 17 allows an entity that has previously adopted IFRS 9 to revisit the following classifications for financial assets associated with insurance:

- designate assets at fair value through profit or loss or revoke previous designations at fair value through profit or loss;
- reassess the business model; or
- designate an equity instrument at fair value through other comprehensive income or revoke a previous designation.

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Appendix A – Comparison between Solvency II and IFRS 17 Measurement of Contract Liabilities

This appendix sets out a summary comparison of the main differences in the recognition and measurement of contract liabilities between Solvency II and IFRS 17. For many insurers in Europe, systems and processes developed for Solvency II are likely to be the starting point for implementing IFRS 17. Look out for our more detailed comparison publication on the topic.

The coding provides a guide to the significance of the differences for each topic when considered for a typical insurer across technical, financial and operational considerations.

Topic	IFRS 17	Solvency II	Observations
High significance			
Profit recognition <i>(implications of contractual service margin (CSM) component of contract liabilities)</i>	CSM eliminates day 1 gain and defers profit over the coverage period. Day 1 losses are recognised immediately. CSM is subsequently updated for certain changes since day 1. It cannot become negative (that is, an asset), but can be reinstated once eliminated.	Day 1 gains or losses are recognised for all contracts, including reinsurance. Changes (for example, experience variances and assumptions) are fully recognised in the period.	Solvency II is not designed as a performance reporting metric and there is no concept of the CSM. The CSM is a key driver in the timing of profit recognition under IFRS and the reason for more granular tracking of liabilities' movements over time in IFRS.
Contracts with participation features	Market consistent measurement principle. Cash flows from the participation features are included in the liability, including where these relate to future policyholders.	Market consistent measurement principle. Cash flows from the participation features are included in the liability, except for 'approved surplus funds'.	The IFRS treatment of residual participating fund assets and the allocation between liability and equity will depend on the specific nature of the contracts and national law. In Solvency II, national law defines 'surplus funds'. Other differences between Solvency II and IFRS, as set out in this comparison, will also apply for contracts with participation features.

Topic	IFRS 17	Solvency II	Observations
Reinsurance contracts	All components are presented gross of reinsurance, with a separate reinsurance asset. Specific requirements (as set out earlier) apply to reinsurance contracts held compared to underlying direct contracts.	Presented gross of reinsurance, with a separate reinsurance asset (except for the risk margin, which is net of reinsurance). Reinsurance often mirrors the direct contract (for example, contract boundary).	Unlike Solvency II, reinsurance under IFRS might not mirror the underlying direct contracts in IFRS. Presentation of the allowance for risk is different between IFRS (gross and reinsured) and Solvency II (net).
Acquisition costs in the cash flows	Attributable at portfolio level and included in measurement of liability.	Expensed as incurred.	Unlike in IFRS, there is no (implicit) deferral of acquisition costs under Solvency II.
Transition	Relief on initial application primarily in relation to the CSM on existing business.	Where approved, transitional measures can smooth the impact on initial adoption at 1 January 2016 for up to 16 years.	Different transitional arrangements in IFRS and Solvency II.

Medium significance

Definition and scope	Insurance (and participating investment, but only for companies that also issue insurance contracts). Certain contracts that are not regulated as insurance might be captured. Only applicable to IFRS reporters.	All contracts regulated as insurance. Insurers in specific jurisdictions only. Regulatory regimes that are deemed 'equivalent' to Solvency II recognise and measure contract liabilities according to these regimes.	The measurement of non-participating investment contracts in IFRS will be significantly different from Solvency II. These contracts are (in most cases) assessed under IFRS 9 and IFRS 15. Regimes equivalent to Solvency II might result in further differences to IFRS. Such regimes are not covered in this analysis.
Separating components	Distinct investment components, certain embedded derivatives and certain goods and services are separated.	No separation of components.	Where components are separated in IFRS, the measurement can be different from Solvency II (for example, fair value of certain embedded derivatives in IFRS).

Topic	IFRS 17	Solvency II	Observations
Recognition	<p>Earlier of date when coverage begins or date when first payment due for a 'group' of contracts (or earlier for a group of onerous contracts).</p> <p>Except for investment contracts with discretionary participation features, where date when party to contract.</p>	<p>Earlier of date when coverage begins or date when party to contract.</p>	<p>There is the potential for different recognition due to the 'first payment' (IFRS) versus 'party to' (Solvency II) condition; and the level of grouping and onerous contract test in IFRS.</p>
Granularity / Grouping of contracts	<p>Potential for three groups (based on profitability) per portfolio per annual cohort.</p>	<p>Prescribed grouping by type of contract.</p>	<p>This might result in a significantly more granular tracking of liabilities' movements over time in IFRS than Solvency II.</p>
Contract boundary	<p>Insurer no longer has substantive rights to receive premiums or obligations to provide services, because the risks of the policyholder or portfolio in setting the price or level of benefit can be reassessed.</p>	<p>Insurer no longer required to provide coverage, or can amend terms to 'fully reflect risk' at portfolio level (unless individual life underwriting took place).</p> <p>No projection of premiums for pure savings contracts.</p> <p>Contracts separated into components, where the boundary differs between components.</p>	<p>The contract boundary definition could be different between Solvency II and IFRS.</p>
Cash flows (excluding acquisition costs)	<p>Cash flows related directly to the fulfilment of the contracts.</p>	<p>All cash inflows and outflows required to settle the obligations over the lifetime.</p>	<p>There are differences in the cash flows included in the two frameworks (for example, the treatment of certain overhead expenses and participating contract cash flows – see earlier in this table).</p>

Topic	IFRS 17	Solvency II	Observations
Discount rate	<p>‘Top down’ or ‘bottom up’, reflecting the characteristics of the liability.</p> <p>(Current and ‘day 1’ rates for OCI and CSM accretion purposes, where applicable.)</p>	<p>Prescribed, based on swaps less credit risk (plus matching or volatility adjustment in certain circumstances).</p> <p>(Current rates only.)</p>	<p>Conceptually, a top-down approach in IFRS is similar to Solvency II with the application of a matching adjustment (given the close cash flow matching of assets to liabilities).</p> <p>The Solvency II volatility adjustment is not a feature of the liabilities and is therefore unlikely to be permissible in IFRS.</p>
Risk allowance	<p>No prescribed method.</p> <p>Companies’ own view of the compensation required for uncertainty arising for non-financial risks (only).</p> <p>Gross of reinsurance.</p>	<p>Prescribed 6% cost of capital method.</p> <p>Set at the reference undertaking (entity) level with defined risks, level of diversification benefit and other components.</p> <p>Net of reinsurance.</p>	<p>The Solvency II risk margin is prescribed, while the IFRS risk adjustment is principle-based. It is likely that there will be differences in the two approaches.</p> <p>Unlike in Solvency II, there is no transitional measure relief relating to the risk allowance in IFRS (which exists in certain European countries).</p>
‘Simplified method’ for certain non-life and other short-duration contracts	<p>‘Unearned premium’ model (known as ‘premium allocation approach’) for certain pre-claims liability, while cash flow projection required for the claims liability.</p>	<p>No separate model.</p>	<p>In IFRS, the ‘unearned premium’ model is optional. A cash flow approach can be adopted, as in Solvency II.</p> <p>Depending on the nature of the contracts, there could be a difference between Solvency II and IFRS.</p>
Business combinations and transfers	<p>Additional recognition and measurement principles apply at the point of combination or transfer (as set out earlier in this table).</p>	<p>Recognised and measured as if written by the reporting entity from inception.</p>	<p>Additional IFRS differences contrast with Solvency II, where there is no difference between organic and acquired business.</p>

<i>Topic</i>	<i>IFRS 17</i>	<i>Solvency II</i>	<i>Observations</i>
<i>Low significance</i>			
Derecognition	Where obligations are extinguished or on substantial modification of the contract.	Where obligations are extinguished, discharged or cancelled, or expire.	Likely to be similar, although there is no concept of modification in Solvency II.



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Appendix B – Comparison of IFRS 17 to 2013 IASB Exposure Draft (ED)

Topic	IFRS 17	2013 IASB ED
Key changes		
<i>Insurance contracts with direct participation features</i>	<ul style="list-style-type: none"> • Contracts where, at inception, policyholder participates in a share of clearly identified pool of underlying items, expects to pay to the policyholder a substantial share of fair value returns on those items, and expects a substantial proportion of any change in amounts paid to policyholder to vary with fair value changes of underlying items • Contract viewed as substantially an investment-related service contract, where obligation is the net of: <ul style="list-style-type: none"> (a) obligation to pay policyholder the fair value of underlying items, and (b) variable fee based on entity's share of fair value of underlying items less other fulfilment cash outflows that do not vary based on returns of underlying items (for example, death benefits and interest rate guarantees) • Changes in entity's share of fair value of underlying items and financial guarantees adjust contractual service margin (CSM), unless entity uses derivatives to mitigate its risk and chooses to record these changes in statement of profit or loss to offset the derivative changes • Changes in other fulfilment cash flows treated similarly to other cash flows in general model • If entity holds underlying items, amount in profit or loss for finance income or expenses matches the finance income or expenses on underlying items • Entity not required to hold underlying items 	<ul style="list-style-type: none"> • Separate accounting for contracts where contracts specified a link between payments to policyholder and returns on underlying items • Measurement was split between: <ul style="list-style-type: none"> (a) cash flows expected to vary directly with underlying items – apply 'mirroring approach'; and (b) other fulfilment cash flows – apply general building block model • Entity needed to hold underlying items
<i>Level of aggregation for presentation and measurement</i>	<ul style="list-style-type: none"> • At initial recognition, disaggregate a portfolio (that is, insurance contracts subject to similar risks and managed together) into up to three groups of contracts: onerous, profitable with no significant possibility of becoming onerous, and other profitable contracts • Contracts issued more than one year apart cannot be in same group • Release CSM to profit or loss in each period to reflect services provided for each group using coverage units • Coverage units for a group consider, for each contract in the group, quantity of benefits provided and expected coverage duration; re-estimated prospectively each period • Narrow exemption from normal grouping for the effects of law or regulatory constraints on pricing 	<ul style="list-style-type: none"> • Implied measurement at contract level • Portfolio definition also required contracts to be 'priced similarly'

Topic	IFRS 17	2013 IASB ED
<i>Transition</i>	<ul style="list-style-type: none"> Apply standard retrospectively to groups of insurance contracts, unless impracticable If impracticable, choice between modified retrospective approach and fair value approach on a group-by-group basis. Simplifications for classification, grouping, discount rates, and determination of risk adjustment and CSM Transition date: beginning of annual reporting period immediately preceding date of initial application, and only one restated comparative period required If entity previously applied IFRS 9, on adoption of IFRS 17 it can reassess the business model for eligible financial assets based on circumstances at that date 	<ul style="list-style-type: none"> Fully retrospective, with a modified retrospective approach, but with fewer available simplifications Transition date: beginning of earliest period presented
Other changes – Subsequent measurement		
<i>Onerous contracts</i>	<ul style="list-style-type: none"> Favourable changes in estimates relating to future coverage or other services that arise after previously recognised losses are recognised immediately in profit or loss, to the extent that they reverse those prior losses 	<ul style="list-style-type: none"> Favourable changes after loss recognition recorded as positive adjustments to CSM
<i>Risk adjustment</i>	<ul style="list-style-type: none"> CSM is adjusted for changes in risk adjustment relating to future coverage and other services Entities have choice to disaggregate changes in risk adjustment into insurance service and insurance finance components 	<ul style="list-style-type: none"> All changes in risk adjustment recorded in profit or loss immediately
<i>CSM ordering</i>	<ul style="list-style-type: none"> CSM should be amortised last, after all other adjustments to CSM have been made and after revised number of remaining coverage units has been determined 	<ul style="list-style-type: none"> No explicit guidance
Other changes – Discount rate		
<i>Impact of changes in discount rates</i>	<ul style="list-style-type: none"> Policy choice to recognise impact of changes in discount rates in profit or loss or in other comprehensive income (OCI) by portfolio 	<ul style="list-style-type: none"> Recognise impact of changes in discount rates in OCI
<i>Participating contracts not meeting definition of a contract with direct participation features (such as some universal-life contracts)</i>	<ul style="list-style-type: none"> If choice made to disaggregate finance income or expenses between profit or loss and OCI, amount included in profit or loss in each period is determined by a ‘systematic allocation’ For contracts with variable/discretionary crediting rates, ‘systematic allocation’ would include an allocation using a constant rate, or an allocation based on amounts credited in the period and expected to be credited in future periods 	<ul style="list-style-type: none"> Limited guidance
<i>Premium allocation approach (PAA)</i>	<ul style="list-style-type: none"> If choice made to disaggregate finance income or expenses between profit or loss and OCI, amount included in profit or loss in each period is determined using discount rate at date of incurred claim 	<ul style="list-style-type: none"> Discount rate at date of initial recognition of contract

Topic	IFRS 17	2013 IASB ED
Other changes – Premium allocation approach (PAA)		
<i>Eligibility</i>	<ul style="list-style-type: none"> Eligibility for PAA is based on a comparison of expected balance of liability for remaining coverage under PAA versus expected balance of liability for remaining coverage under general model; threshold is whether the two balances are reasonably expected not to differ materially 	<ul style="list-style-type: none"> Unclear which balances under PAA needed to be compared to general model
<i>Allocation of revenue</i>	<ul style="list-style-type: none"> Allocate revenue to each period of coverage based on passage of time, unless expected pattern of release of risk during coverage period differs significantly from passage of time; in which case, use expected timing of incurred insurance service expenses as basis 'Expected premium receipts' to be allocated to revenue exclude any investment component and are adjusted to reflect discounting, if applicable 	<ul style="list-style-type: none"> Allocated in a 'systematic way' that best reflected the transfer of services provided Revenue in each period was 'the amount of the expected premium receipts allocated for the period'
Other changes – Reinsurance		
<i>Recognition – reinsurance contracts held</i>	<ul style="list-style-type: none"> If a group of reinsurance contracts <i>held</i> provides proportionate coverage, cedant should recognise the reinsurance contracts at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is later In all other cases, cedant should recognise them from the beginning of the coverage period of the group of reinsurance contracts held 	<ul style="list-style-type: none"> Recognised at beginning of coverage period for 'aggregate' covers In all other cases, cedant would have recognised as each underlying contract was recognised
<i>Changes in fulfilment cash flows</i>	<ul style="list-style-type: none"> If changes in fulfilment cash flows on underlying insurance contracts relating to future service are taken immediately to profit or loss (that is, recording or reversing onerous contract entries), the corresponding change in the ceded reinsurance cash flows will also be recorded in profit or loss rather than as an adjustment to CSM 	<ul style="list-style-type: none"> All changes in cash flows relating to future service were recorded as adjustment to CSM



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