PAPER 04

**Update on Paper 05C of the 20 March HKIISG meeting—
Disaggregation of insurance finance income and expense**

Questions

If an entity elects the disaggregation option for insurance finance income or expenses, and the amount of insurance finance income or expenses included in profit or loss (P&L) is determined by a weighted-average discount rate over the period that contracts in the group are issued (not exceeding one year)[1]:

1. What discount rate (current or weighted-average) should be used at initial recognition of a group of contracts?
2. There is a difference between the locked-in discount rate for changes and interest accretion of the Contractual Service Margin (CSM) and the discount rate for fulfilment cashflows (FCF)—where is this difference recognized?
3. Is the weighted-average discount rate only used for the calculation of insurance finance income or expense (IFIE) for the whole group?

These questions apply to contracts with no direct participating features. Refer to HKIISG submission on 20 March (paper 5C).

HKICPA Staff analysis (for contracts with no direct participating features)

Question 1: What discount rate should be used at initial recognition?

Initial recognition of a group of contracts

- On initial recognition, an entity shall measure a group of insurance contracts at the total of FCF and CSM (para 32);
- Current discount rates should be applied in arriving at the FCF upon initial recognition (para 36);
- The CSM equals the FCF at initial recognition; and
- No income or expense should arise (assuming no onerous contracts) upon initial recognition of a group of contracts (para 38).

Conclusion:

As the CSM has to equal the FCF at initial recognition with no income or expense arising (assuming no onerous contracts), then the discount rate at initial recognition should be a current rate, regardless of whether an entity elects the disaggregation option.

IASB staff have also confirmed that the current discount rate applies at initial recognition.

Question 2: There is a difference between the locked-in discount rate for changes and interest accretion of the CSM; and the discount rate for FCF—where is this difference recognized?

Measurement of a group of contracts

Paragraph B72 prescribe how the FCF and CSM should be measured.

Liability component	**Discount rate to be applied**	**Reference to standard**
FCF	Current discount rate	B72(a)
CSM: - interest accretion - changes	Discount rate determined on initial recognition	 B72(b) B72(c)

1 Relevant paragraphs include 88(b), B130, B131, B72(e)(i) and B73

The discount rate for interest accretion of the CSM is locked-in to that at initial recognition for the following reasons[2]:

- CSM can be viewed as an allocation of part of the transaction price, which is the consideration paid or payable by the policyholder;
- CSM does not represent future cash flows, it represents the unearned profit in the contract;
- calculating interest on the CSM is consistent with IFRS 15 *Revenue from Contracts with Customers*, which requires an entity to adjust the promised consideration to reflect the time value of money;
- as CSM is measured at initial recognition, the interest rate used to accrete interest should be locked in at initial recognition and not adjusted subsequently because changes in the effects of the time value of money and financial risk do not affect the amount of unearned profit; and
- the underwriting result is regarded as the difference between the amount of premiums the entity charges (less any investment component) and the payments the entity makes because of the occurrence of the insured event.

The discount rate for changes in CSM is also locked-in at initial recognition for the following reasons[3]:

- the CSM must be adjusted for changes in estimates of future cash flows that related to future service;
- to make the CSM internally consistent, these adjustments are measured at the discount rate that applied on initial recognition;
- the IASB acknowledges that this will lead to a difference between the change in the FCF measured at a current rate and the change in the CSM measured at a locked-in rate;
- the IASB notes that this difference will be included in the P&L or other comprehensive income (OCI), depending on the accounting policy choice an entity makes for the presentation of insurance finance income and expenses.

Conclusion

As CSM is unearned profit recognized on day one, it should reflect the time value of money on initial recognition, similar to IFRS 15. As FCF represents the liability for remaining coverage and incurred claims, it is valued at current rates. This creates a difference.

Paragraph BC275 notes that difference between the locked-in discount rate for changes and interest accretion of the CSM and the discount rate applied for FCF will be included in the P&L or OCI—depending on the accounting policy choice an entity makes for the presentation of insurance finance income and expenses

Question 3: Is the weighted-average discount rate only used for the calculation of insurance finance income or expense (IFIE) for the whole group?

Disaggregation of insurance finance income and expense

Paragraph B129 states that it is an accounting policy choice, at the portfolio level, as to whether to disaggregate IFIE for the period.

The amount allocated to the P&L is calculated for a group of contracts per paragraph B131. Paragraph B73 allows a weighted-average discount rate to be used instead of the discount rate at initial recognition prescribed in paragraph B131 and B72(e)(i).

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2 Relevant paragraphs include BC272 to BC274, and BC228 to BC231

3 Relevant paragraph BC275

The following paragraphs are also relevant:

- a policy choice to disaggregate IFIE between P&L and OCI was allowed by the IASB to balance the sometimes competing demands of understandability and comparability (para BC43);
- the accounting policy choice is at the portfolio level because a key factor in making the choice will be what assets the entity regards as backing the insurance contracts (para BC44);
- accordingly, an option applied to portfolios of insurance contracts would allow entities to reduce accounting mismatches, because: an entity might hold financial assets measured at fair value through other comprehensive income for one portfolio, and for another portfolio, hold financial assets measured at fair value through profit or loss (para BC44).

Conclusion:
The choice to disaggregate IFIE between P&L and OCI is conducted at the portfolio level per paragraph B129. Therefore, by analogy, if the disaggregation is by a weighted-average rate, then it is for each group under that portfolio.

APPENDIX

Extracts of the HKFRS 17 *Insurance Contracts*:

32 On initial recognition, an entity shall measure a group of insurance contracts at the total of:

a) the fulfilment cash flows, which comprise:
   (i) estimates of future cash flows (paragraphs 33–35);
   (ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and
   (iii) a risk adjustment for non-financial risk (paragraph 37).

b) the contractual service margin, measured applying paragraphs 38–39.

36 An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

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 (if any) 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.

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

a) the initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;
b) the derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and
c) any cash flows arising from the contracts in the group at that date.

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

a) the effect of any new contracts added to the group (see paragraph 28);
b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);
c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:
   (iv) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or
   (v) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
d) the effect of any currency exchange differences on the contractual service margin; and
e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

87 Insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:

a) the effect of the time value of money and changes in the time value of money; and
b) the effect of financial risk and changes in financial risk; but
c) excluding any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin but do not do so when applying paragraphs 45(b)(ii), 45(b)(iii), 45(c)(ii) or 45(c)(iii). These are included in insurance service expenses.

88 Unless paragraph 89 applies, an entity shall make an accounting policy choice between:

a) including insurance finance income or expenses for the period in profit or loss; or
b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts, applying paragraphs B130–B133.

89 For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between:

a) including insurance finance income or expenses for the period in profit or loss; or
b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held, applying paragraphs B134–B136.

90 If an entity chooses the accounting policy set out in paragraph 88(b) or in paragraph 89(b), it shall include in other comprehensive income the difference between the insurance finance income or expenses measured on the basis set out in those paragraphs and the total insurance finance income or expenses for the period.

B72 An entity shall use the following discount rates in applying HKFRS 17:

a) to measure the fulfilment cash flows—current discount rates applying paragraph 36;
b) to determine the interest to accrete on the contractual service margin applying paragraph 44(b) for insurance contracts without direct participation features—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;
c) to measure the changes to the contractual service margin applying paragraph B96(a)–B96(c) for insurance contracts without direct participation features—discount rates applying paragraph 36 determined on initial recognition;
d) for groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage applying paragraph 56—discount rates applying paragraph 36 determined on initial recognition;
e) if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (see paragraph 88), to determine the amount of the insurance finance income or expenses included in profit or loss:
    (i) for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders, applying paragraph B131—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;
    (ii) for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, applying paragraph B132(a)(i)—discount rates that allocate the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; and
    (iii) for groups of contracts applying the premium allocation approach applying paragraphs 59(b) and B133—discount rates determined at the date of the incurred claim, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items.

B73 To determine the discount rates at the date of initial recognition of a group of contracts described in paragraphs B72(b)–B72(e), an entity may use weighted-average discount rates over the period that contracts in the group are issued, which applying paragraph 22 cannot exceed one year.

B129 Paragraphs 88–89 require an entity to make an accounting policy choice as to whether to disaggregate insurance finance income or expenses for the period between profit or loss and other comprehensive income. An entity shall apply its choice of accounting policy to portfolios of insurance contracts. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying paragraph 13 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the entity shall consider for each portfolio the assets that the entity holds and how it accounts for those assets.

B130 If paragraph 88(b) applies, an entity shall include in profit or loss an amount determined by a systematic allocation of the expected total finance income or expenses over the duration of the group of insurance contracts. In this context, a systematic allocation is an allocation of the total expected finance income or expenses of a group of insurance contracts over the duration of the group that:

a) is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts. For example, the allocation of the finance income or expenses shall not be based on expected recognised returns on assets if those expected recognised returns do not affect the cash flows of the contracts in the group;
b) results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling zero. The cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would

be measured at when applying the systematic allocation.

B131 For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rates specified in paragraph B72(e)(i).

B132 For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders:

a) a systematic allocation for the finance income or expenses arising from the estimates of future cash flows can be determined in one of the following ways:
   (i) using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; or
   (ii) for contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.
b) a systematic allocation for the finance income or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk applying paragraph 81, is determined using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.
c) a systematic allocation for the finance income or expenses arising from the contractual service margin is determined:
   (i) for insurance contracts that do not have direct participation features, using the discount rates specified in paragraph B72(b); and
   (ii) for insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.

B137 Notwithstanding the requirement in HKAS 34 *Interim Financial Reporting* that the frequency of an entity's reporting shall not affect the measurement of its annual results, an entity shall not change the treatment of accounting estimates made in previous interim financial statements when applying HKFRS 17 in subsequent interim financial statements or in the annual reporting period.

BC43 The Board decided to allow entities to choose an accounting policy for the presentation of insurance finance income or expenses to balance the sometimes competing demands of understandability and comparability. By allowing an accounting policy choice, the Board:

a) acknowledges that it could be appropriate for an entity to disaggregate the effect of changes in assumptions that relate to financial risks between profit or loss and other comprehensive income by presenting the insurance finance income or expenses in profit or loss using a systematic allocation based on the characteristics of the insurance contract;
b) but also:
   (i) acknowledges that an inherent feature of such a systematic allocation in profit or loss is that accounting mismatches are likely to arise; hence, an accounting policy choice allows entities to avoid such mismatches by permitting them to present the insurance finance income or expenses using a current measurement basis; and
   (ii) allows entities to avoid the costs and complexity of using other comprehensive income when the benefits of doing so do not outweigh those costs (because permitting entities to present the total insurance finance income or expenses in a period in profit or loss allows entities to avoid additional calculations to derive separate amounts to be presented in profit or loss and other comprehensive income).

BC44 The Board noted that, in selecting an accounting policy, entities would need to apply judgement regarding the policy's relative benefits and costs. The Board decided to require entities to make the accounting policy choice for each portfolio because a key factor in making the choice will be what assets the entity regards as backing the insurance contracts. The Board received feedback that many entities regard the choice of strategies for assets backing insurance contracts to be driven by the differences between portfolios of insurance contracts. Hence, an entity might hold financial assets measured at fair value through other comprehensive income for one portfolio, and for another portfolio, hold financial assets measured at fair value through profit or loss. Accordingly, an option applied to portfolios of insurance contracts would allow entities to reduce accounting mismatches. The Board concluded that even if it were to allow an accounting policy choice, entities within the same jurisdiction are likely to remain comparable because they are likely to issue similar products and adopt similar asset strategies for those products. Thus, the entities are likely to make similar accounting policy choices.

BC228 For insurance contracts without direct participation features, the Board concluded that changes in the effects of the time value of money and financial risk do not affect the amount of unearned profit. This is the case

even if the payments to policyholders vary with returns on underlying items through a participation mechanism, for the reasons set out in paragraphs BC229–BC231. Accordingly, the entity does not adjust the contractual service margin to reflect the effects of changes in these assumptions.

BC229 For insurance contracts without direct participation features, the underwriting result is regarded as the difference between the amount of premiums the entity charges (less any investment component) and the payments the entity makes because of the occurrence of the insured event. The insurance finance result reflects the interest arising on the group of insurance contracts because of the passage of time and the effect of changes in assumptions relating to financial risk. The statement(s) of financial performance also reflect gains and losses from the investments in which the premiums are invested. Such gains and losses would be recognised in profit or loss according to other applicable IFRS Standards.

BC230 Thus, for insurance contracts without direct participation features, the entity's profit from financing activities arises from the difference between:

a) the gains (or losses) from the investments; and
b) the change in the insurance contract liability depicted by the insurance finance income or expenses including the gains (or losses) the entity passes to the policyholder through any indirect participation mechanism.

BC231 This approach to determining profit from financing activities reflects the separate accounting for the investment portfolio and the group of insurance contracts, regardless of any participation mechanism in the insurance contracts, consistent with the following:

a) the entity controls the cash flows of the investments, even when the entity is required to act in a fiduciary capacity for the policyholder.
b) in most cases, an entity would be unlikely to have a legally enforceable right to set off the insurance contract liability with the investment portfolio, even if the investment portfolio were to be invested in assets that exactly match the entity's obligation, because the entity retains the obligation to pay the policyholders the amounts that are determined on the basis of the investments in the portfolio, irrespective of the entity's investment strategy.

BC272 For insurance contracts without direct participation features, IFRS 17 requires an entity to calculate interest on the contractual service margin. In the Board's view, on initial recognition the contractual service margin can be viewed as an allocation of part of the transaction price, which is the consideration paid or payable by the policyholder. Calculating interest on the contractual service margin is consistent with IFRS 15, which requires an entity to adjust the promised consideration to reflect the time value of money if the contract has a significant financing component. As a result of that adjustment, the transaction price would reflect the amount the customer would pay in cash for the promised good or service when they receive the good or service. Consequently, an entity would recognise revenue at an amount that corresponds to the cash selling price of the good or service, with the effects of the financing presented separately from revenue (as interest expense or interest income).

BC273 Because the contractual service margin is measured at initial recognition of the group of insurance contracts, the Board decided that the interest rate used to accrete interest on the contractual service margin for insurance contracts without direct participation features should be locked in at initial recognition and not adjusted subsequently. The Board also decided, for the sake of simplicity, that the rate should be a rate applicable to nominal cash flows that do not vary based on asset returns. Locking in the rate is consistent with the determination of the contractual service margin on initial recognition and making no adjustments for changes in assumptions relating to financial risk.

BC274 Some stakeholders argued that interest should be accreted at a current rate on the grounds that the current rate would be consistent with the measurement of the fulfilment cash flows. Also, a locked-in rate requires information about historical rates that would not otherwise be needed for entities not using the option to include insurance finance income or expenses in profit or loss using a systematic allocation (see paragraphs BC42–BC44). However, the Board noted that accreting interest on the contractual service margin for an accounting period at a current rate differs from measuring cash flows at a current rate. The contractual service margin does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts. For insurance contracts without direct participation features, the contractual service margin is not adjusted (remeasured) for changes in interest rates for the reasons set out in paragraphs BC228–BC231. Accreting interest for a period at a current rate without also remeasuring the contractual service margin at the start of the period would create an internally inconsistent measurement of the contractual service margin.