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Cancellation rights, payment terms and coverage obligations – How to handle IFRS 17 complexity efficiently

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Contents

Cancellation rights, payment terms and coverage obligations

Overview

Understanding the time dimensions of rights and obligations from an insurance contract is essential to design and implement systems that produce materially accurate financial information under IFRS 17.

The rigorous application of the "substance over form" overarching IFRS principle can bring complexity when an entity presumes that legal form is equal to economic substance.

In this webcast, we cover the interplay of three substantive rights and obligations and where IFRS 17 mandates the override of legal form to reflect the economic substance in the financial statements:

- Cancellation rights – when in the hands of the issuer they can create a contract boundary and break a legal contract into smaller "in substance" accounting contracts;
- Payment terms – when the application of the contract boundary principle overrides the form of a contract, different payment terms would trigger different accounting; and
- Coverage obligations – they do not always start with issue date or the coverage period does not necessarily equate with the contract boundary period.

Accounting would differ based on the combination of cancellation rights, payment terms and the nature of the stand ready obligation.

Contract boundary

IFRS 17 Requirements

Cash flows are within the boundary if they arise from substantive rights and obligations that exist during the period in which the entity can compel the policyholder to pay premiums or the entity has a substantive obligation to provide the policyholder with insurance contract services ...

The contract boundary is set to the further point in time when the insurer has the right to compel a policyholder to pay the premiums or when the insurer has the substantive obligation to provide the policyholder with insurance contract services.

Insurance contract liabilities

Contract boundary

The longer boundary of:

- The substantive right; or
- The substantive obligation of the insurer under the insurance contract

The entity's substantive obligation to provide services under a contract ends at the point that the entity can terminate or fully reprice the contract.

Payment terms

IFRS 17 Requirements

An entity shall recognise a group of insurance contracts it issues from the earliest of the following:

a) the beginning of the coverage period of the group of contracts;
b) the date when the first payment from a policyholder in the group becomes due; and
c) for a group of onerous contracts, when the group becomes onerous.

If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received.

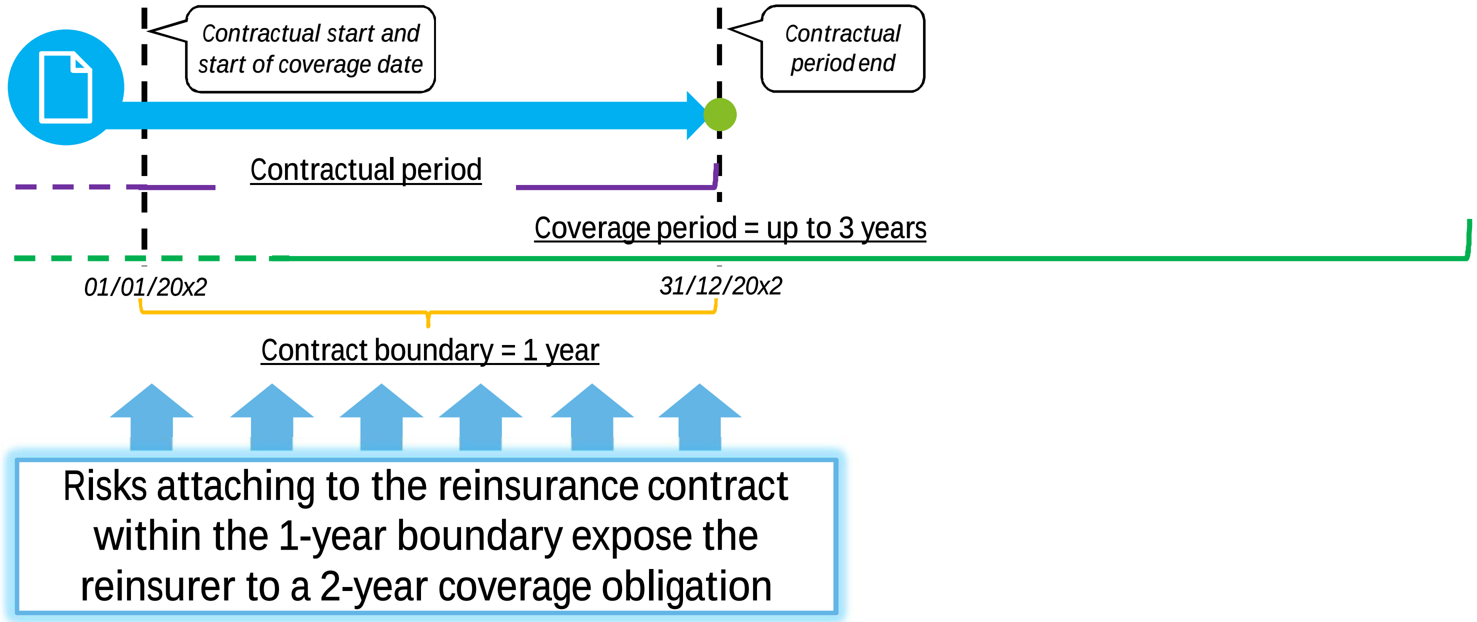
Before the recognition of a group of insurance contracts, an entity might be required to recognise an asset or liability for cash flows related to the group of insurance contracts […] either because of the occurrence of the cash flows or because of the requirements of another IFRS Standard. Cash flows are related to the group of insurance contracts if those cash flows would have been included in the fulfilment cash flows at the date of initial recognition of the group had they been paid or received after that date.

Coverage obligations

IFRS 17 Requirements

Coverage period is the period during which policyholders can be required to pay premiums and the insurer is obliged to provide coverage and other services.

In some reinsurance contracts the “risk attaching basis” causes the contract boundary and the coverage period to differ



Illustrative example

Fact pattern

The accounting treatment discussed in this webcast applies to the specific fact pattern being analysed. Any change in the fact pattern may result in a different accounting treatment to be applied.

Entity X issues an annual insurance contract (assessed to be profitable) on 1 July 20x1 with the following contractual terms:

- a single annual premium is payable upfront;
- insurance coverage starts at the same time as the date the contract is issued;
- a cancellation clause that provides Entity X and the policyholder the right to unilaterally cancel the contract by giving a 30-day notice:
  - if Entity X cancels the contract, the policyholder is entitled to a premium refund calculated on a pro rata basis;
  - if the policyholder cancels the contract, there is no refund of any premium; and
- claims/benefits are payable to the policyholder/beneficiaries if the insured event occurs or in the event that the policyholder dies.

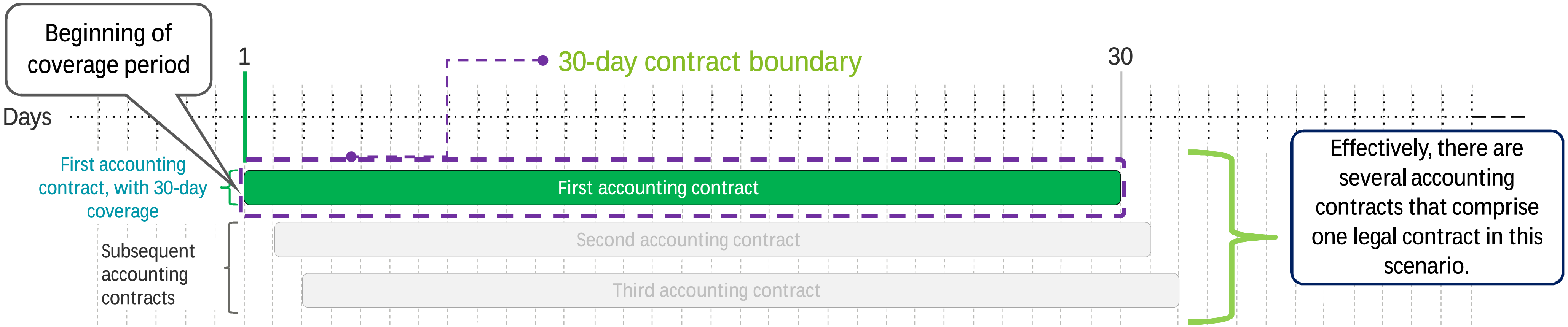
Accounting issue:

How should an insurer account for insurance contracts that provides the insurer with the right to unilaterally cancel the contract but subject to a notice period?

Illustrative example

Initial recognition

Day 1

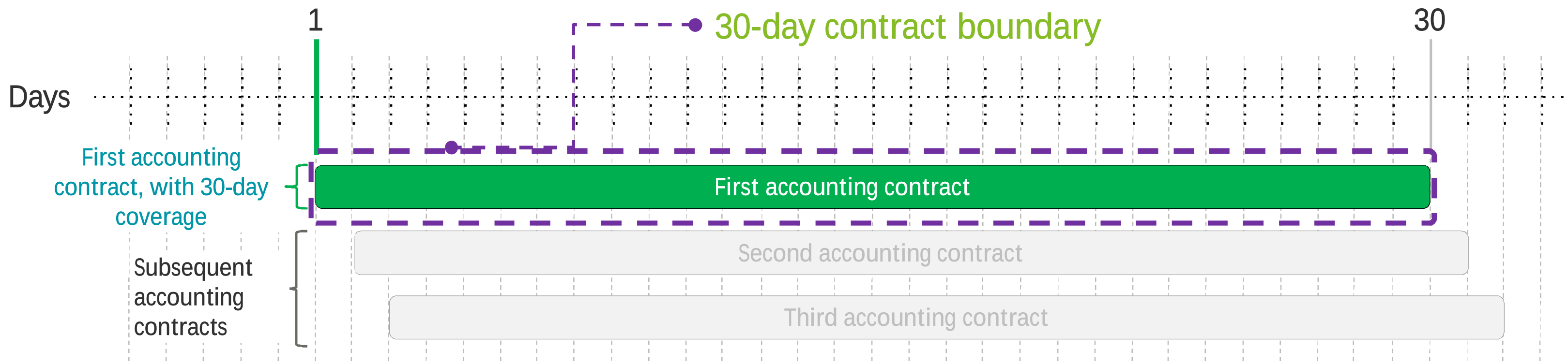


- On day 1, only the first accounting contract meets the recognition criteria set out in IFRS 17:25 (beginning of coverage period vs date when the first premium is due)
- The subsequent accounting contracts are not yet recognised, as no associated insurance risk has been accepted at this date.
- A pre-coverage liability is recognised for the portion of the premium already received relating to subsequent accounting contracts.

Illustrative example

Initial recognition

Day 1



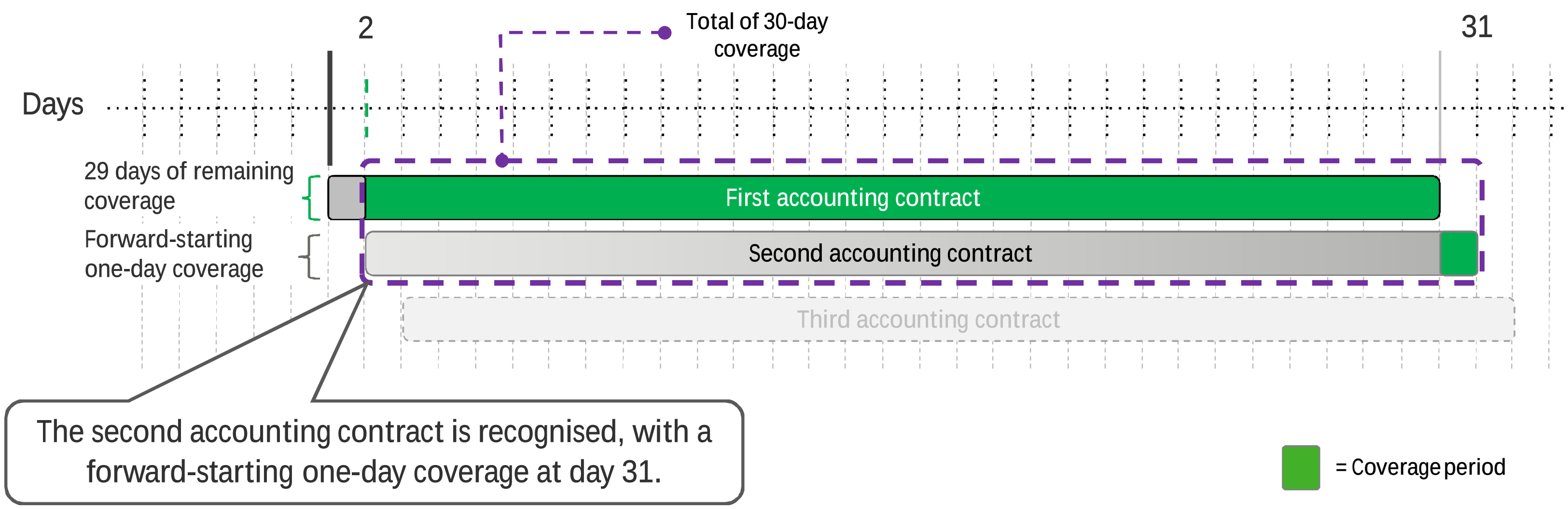
What if the insurance contract is onerous?

- Only the first accounting contract can be recognised as onerous.
- The initial recognition of the subsequent accounting contracts cannot be triggered at the date the first accounting contract is initially recognised applying IFRS 17:25(c) because Entity X can still avoid taking on the insurance risk from the future accounting contracts by serving notice to the policyholder.

Illustrative example

Initial recognition

Day 2



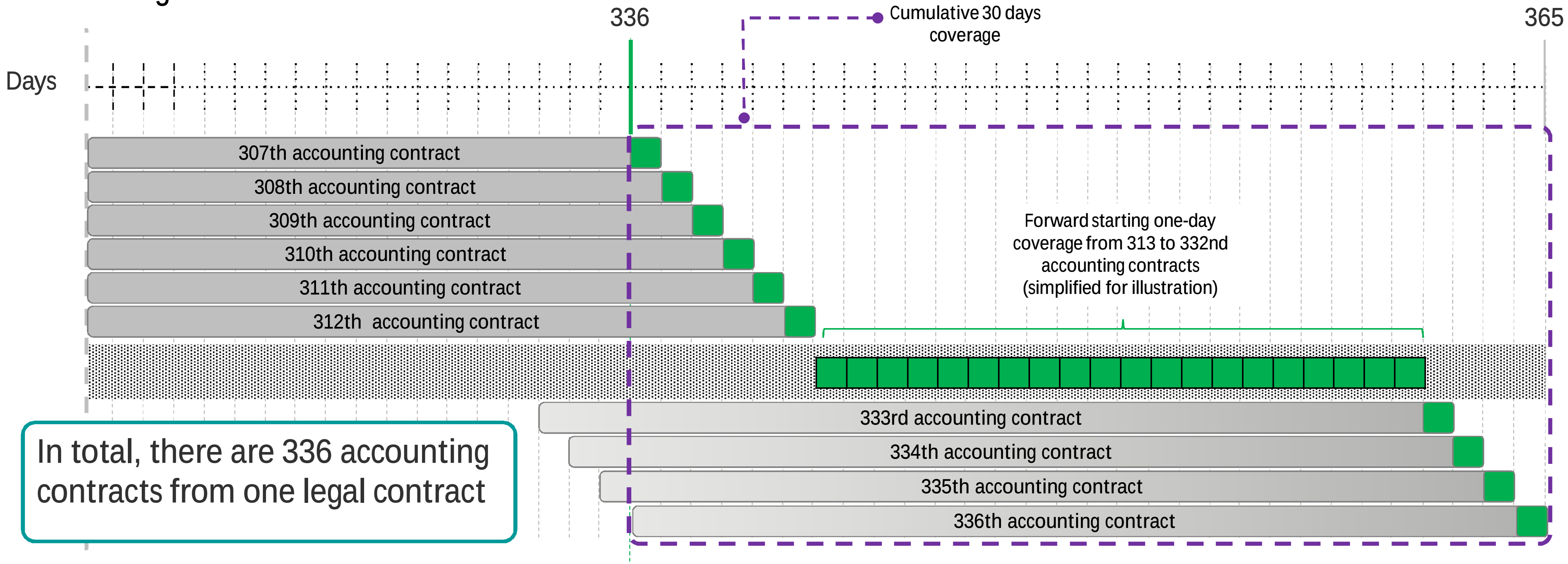
At day 2, the first accounting contract and the second accounting contract provides the policyholder with a combined 30-day coverage

Illustrative example

Initial recognition

Day 336

Once the first accounting contract is derecognised, the subsequent 30-day coverage will be provided by a combination of 30 accounting contracts:

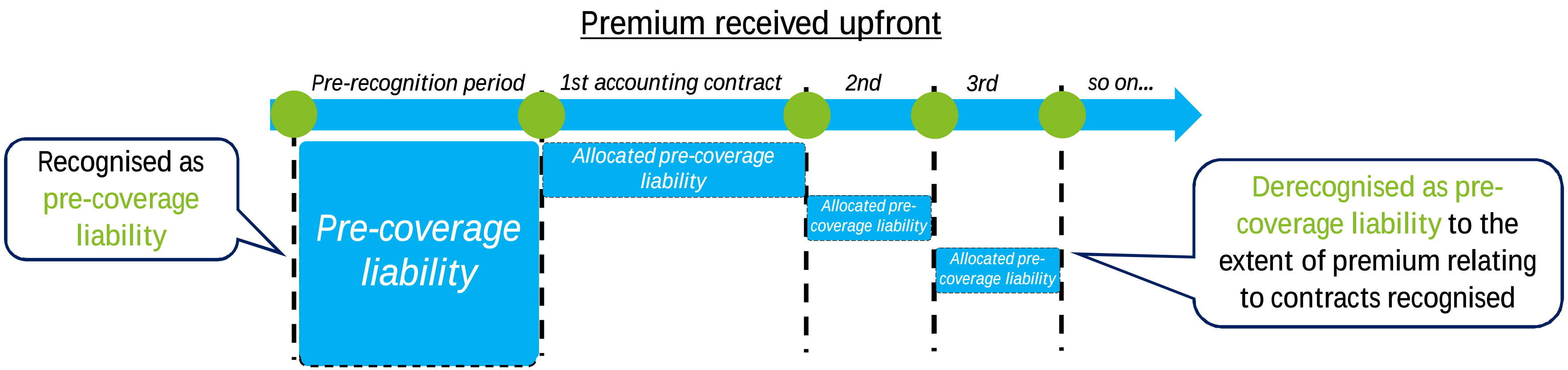


In total, there are 336 accounting contracts from one legal contract

Illustrative example

Pre-coverage liability

Accounting for the portion of the premium received upfront relating to the future accounting contracts:



In case of cancellation...

By the insurer, where there is premium refund (pro-rata basis):

- The remaining balance is reclassified to liability for incurred claims;
- Difference between the pre-coverage liability remaining balance and the amount of premium refund should be recognised in profit or loss.

— VS —

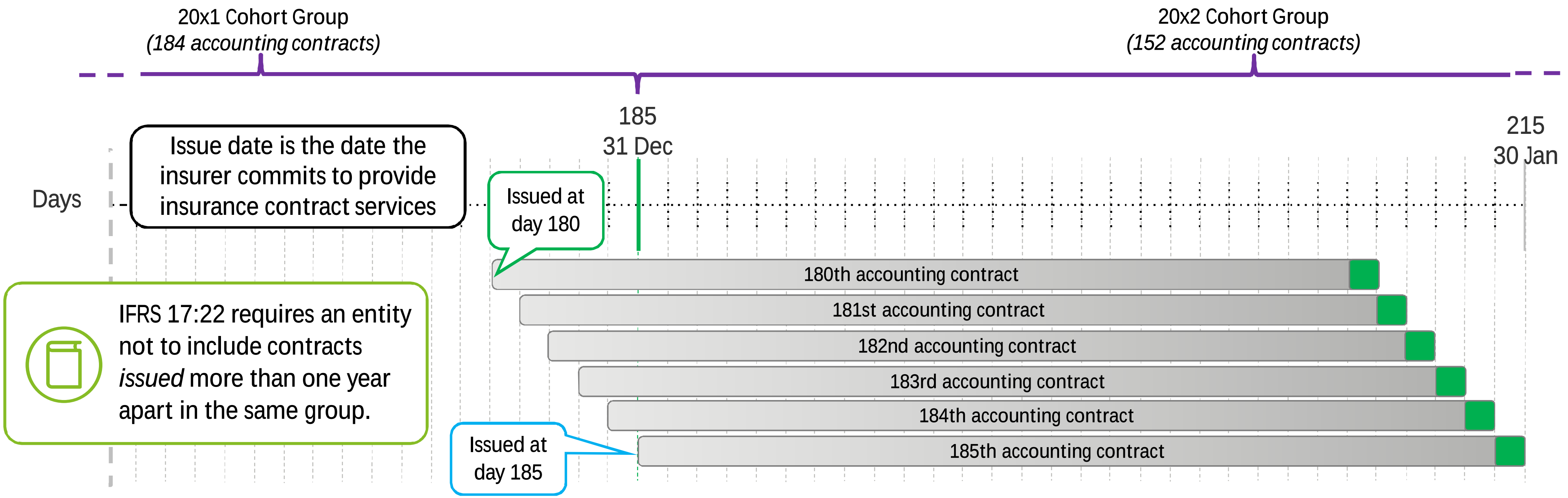
By the policyholder, where no refund of premium:

- The pre-coverage liability remaining balance is derecognised and an equal amount is recognised in profit or loss.

Illustrative example

Grouping of contracts

Assuming that the financial year coincides with the calendar year and a cohort group comprise all contracts issued within the financial year, the 336 accounting contracts will belong to different cohort groups:



Practical considerations

Some practical considerations when implementing these requirements of IFRS 17:

- Get the basic contract data right: substance over form is a non-negotiable requirement in IFRS 17 and systems need to be calibrated to convert existing contractual data into potentially new configurations needed to feed IFRS 17 calculations and postings
- “Daily accounting contracts” can be managed in a cost efficient system configuration – smartly accumulating common seriatim daily calculations, based on the recurring characteristics of the “in-substance” contracts derived from IFRS 17, would manage the computational and bookkeeping efforts within a reasonable effort
- Effective cut-off controls are needed to ensure appropriate allocation of the “in-substance” contracts to the correct group of contracts
- Actuarial models need to increase their granularity to align assumption setting processes and the cash flow projections to the relevant group of contracts. This is equally applicable for groups of contracts under the PAA when there are conditions that trigger onerous testing

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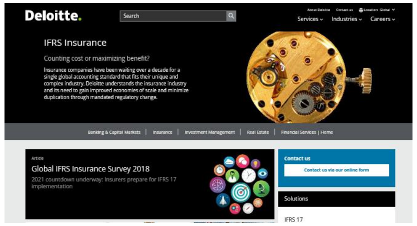

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