

Financial accounting module 23: Premium allocation approach

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Focus on the accounting policy choices regarding (i) present values of the liability for remaining coverage and the liability for incurred claims and (ii) the recognition of insurance acquisition expenses. The final exam does not test the premium allocation approach, since it tests the GAAP rules for short duration contracts, which are similar.

CONTRACT DURATION AND MEASUREMENT MODELS

The IFRS 17 general measurement model is designed for long duration insurance contracts with

- ! present values of cash flows that may differ greatly from the nominal values
- ! expected benefits in any year that are not matched to the premium received in that year
- ! policyholder benefits that may depend on the expected returns from specified pools of assets

Whole life insurance contracts with level premiums, increasing mortality rates, long durations, and crediting rates on policyholder account balances that track the returns on a specified pool of assets have the attributes listed above. These contracts are priced by valuing the present values of cash inflows and cash outflows over the lifetime of the insurance contracts. The IFRS 17 values these contracts by discounted cash flow methods similar to the actuarial techniques used to price these contracts.

This IFRS 17 model differs from the measurement of insurance contracts in other accounting systems and the measurement of contracts with consumers in IFRS 15. Traditional measurement of insurance contracts recognizes premium as revenue, either when the premium is due or when insurance services are provided, and recognizes claims and other benefits as expenses when they occur. Cash outflows are discounted for long duration contracts, where the adjustment is large, but not necessarily for short duration contracts, where the adjustment may be small. Acquisition cash flows are amortized over the coverage period for long duration contracts but may be reported as expenses when they occur for some short duration contracts.¹

For some contracts, the greater precision of the IFRS 17 general measurement model may not be worth the added complexity imposed on insurers. IFRS 17 allows a simpler measurement of these contracts, referred to as the premium allocation approach.²

Short duration insurance contracts

Short duration insurance contracts, such as motor insurance or personal property insurance, are priced using average costs over large portfolios, based on the attributes (such as age or location) of the insureds.

- ! Expected benefits in any year are matched to the premium received in that year.
- ! Claim costs depend on the insured losses, not on the expected returns from specified pools of assets.
- ! For some of these contracts, present values of cash flows do not differ greatly from the nominal values.

Insurers do not estimate the future cash flows of individual contracts until a claim occurs. These contracts are priced by actuarial methods similar to the procedures in IFRS 15, "Revenue from Contracts with Customers." Accounting requirements should not be more complex than the pricing systems.

The premium allocation approach is an optional alternative simpler than the general measurement approach and similar to the IFRS 15 accounting for other contracts with consumers.³ Insurers may use the premium allocation approach if (a) the insurance contract liability if the premium allocation approach does not differ materially from that of the general measurement approach or (b) if the coverage period is one year or less.⁴

Long duration insurance contracts, such as whole life insurance and guaranteed renewable health insurance, have contract periods longer than one year and use the IFRS 17 general measurement model. The premium received in any year is not matched to the expected policyholder benefits from the insurance services of that year and the effect of the time value of money over the long duration of the contracts is great, so the insurance contract liability from the premium allocation approach differs materially from the insurance contract liability in the general measurement model.

General insurance (property and liability) contracts generally have terms of one year or shorter and may be measured by the premium allocation approach. Some general insurance contracts have long claim settlement lags, and even for the premium allocation approach, their claims costs are discounted to present values.

Insurance contracts with high variability in their cash flows may not use the premium allocation approach.⁵ Long duration insurance contracts and contracts with embedded derivatives have high variability, so⁶

- ! Contracts with embedded derivatives (such as policyholder account balances with guaranteed minimums) may not use the premium allocation approach. Embedded derivatives cause the liability for remaining coverage in the general measurement model to vary with the fair values of market variables, such as common shares and other equities. The liability for remaining coverage in the premium allocation approach is a percentage of the premium, which does not vary with the fair values of market variables.
- ! Contracts with long policy terms (such as whole life insurance contracts issued to young policyholders) may not use the premium allocation approach. Mortality rates may vary significantly over long periods, so the liability for remaining coverage under the general measurement model may vary as well.⁷

For non-onerous contracts, the premium allocation approach

- ! is similar to the IFRS 17 general measurement model in that
 - " Cash flows are measured at present values if the difference between nominal value and present value is significant. If the time (a) from receipt of the premium to provision of insurance services or (b) from occurrence of a claim to the payment date is one year or less, the difference between nominal value and present value is deemed not to be significant and no discounting is required.
 - " The risk adjustment for non-financial risk is explicitly measured, not implicitly reported as a provision for adverse deviation.
 - " Except for discounting of short term claims, the liability for incurred claims in the premium allocation approach is the same as in the general measurement model.
- ! is similar to the customer consideration approach (in IFRS 15) in that

- " Insurance revenue is the premium allocated over the coverage period as insurance services are provided. For most insurance contracts, the allocation is based on the passage of time, since claim frequency and claim severity do not differ much over the contract period. For contracts with seasonal variation in claim costs, such as reinsurance treaties covering natural catastrophes, the recognition of insurance revenue is based on the expected timing of incurred claims.⁸
- " The liability for remaining coverage needed not be adjusted for the accretion of interest (the time value of money) if the adjustment is not significant or the accretion time is one year or less.
- " Cash flows need not be adjusted to present values if the discount period is one year or less.

Insurers may use the premium allocation approach when it gives similar results as the general measurement model. If the coverage period of the insurance contract is one year or less, the premium allocation approach is automatically permitted.⁹ If the coverage period is more than one year, the insurer must evaluate how the insurance contract liability in the premium allocation approach compares with that of the general measurement model. The insurer need not measure the insurance contracts by the general measurement model if it can reasonably assume that the premium allocation approach would give a similar insurance contract liability.

Illustration: An insurer issues three-year property insurance contracts with annual premiums fixed at initial recognition and expected claim frequencies that are the same each year. The insurer may use the premium allocation approach, since the annual premiums are matched to the expected claim costs.

Illustration: An insurer issues three-year term life insurance contracts to young policyholder, so the mortality rates are low and about the same each year. It may use the premium allocation approach, since the premiums are matched to the expected claim costs. If the insurer issues ten-year term life insurance contracts to retired persons, the mortality rates are high and increasing, and the coverage units differ each year, so the premium allocation approach would not be permitted.

Premium allocation approach simplifications

The premium allocation approach simplifies the measurement of insurance contracts several ways:

Interest expense must be accreted on the liability for remaining coverage only if the insurance contracts have a "a significant financing component": that is, if the present value of the liability for remaining coverage differs significantly from its nominal value. If the time between the date the premium is due and the date the coverage is provided is one year or less, the insurance contract does not have a significant financing component, and no accretion of interest is required.¹⁰

For the general measurement model, insurers assess whether each contract at initial recognition is onerous and group the contracts in one of (at least) three groups: onerous, no significant chance of becoming onerous, and all other contracts. For the premium allocation approach, insurers need not assess whether insurance contracts (or sets of contracts) are onerous at initial recognition. Insurers do not estimate the fulfilment cash flows at initial recognition for the premium allocation approach, and assessing whether insurance contracts are onerous requires insurers to estimate the fulfilment cash flows. Insurers must assess whether groups of insurance contracts are onerous only if other information ("facts and circumstances") indicate that a group of insurance contracts has become onerous. For example, if early claim reports suggest that loss costs are higher than expected, insurers compute the fulfilment cash flows to test if the group of contracts is onerous.¹¹

If the fulfilment cash flows using the general measurement model exceed the liability for remaining coverage using the premium allocation approach, the difference

- ! is recognized as a loss in the statement of profit or loss
- ! increases the liability for remaining coverage in the premium allocation approach

If the group of insurance contracts is onerous, or if the group becomes onerous during the coverage period, the insurer must compute the liability for remaining coverage and recognize the onerous contract loss in the

statement of profit or loss as though it used the general measurement model.¹² If the insurer does not adjust the premium allocation approach liability for incurred claims for the time value of money, it may not adjust the fulfilment cash flows mentioned above (as determined by the general measurement model) for the time value of money.¹³

Amortizing and allocating acquisition cash flows affects insurance revenue and insurance service expense for long duration insurance contracts, since the cash flows do not occur in the same pattern as the insurance services are provided. For whole life insurance contracts, acquisition cash flows occur in the early contract years, but claim cash flows occur later. For short duration insurance contracts with coverage periods of one year or less, the acquisition cash flows are paid the same year at the claims occur or in the preceding year. Insurance revenue in the premium allocation approach is based on the premium received, not on the pattern of incurred claims and other expenses. To reduce the accounting work for the premium allocation approach, insurers may charge acquisition cash flows to expense when the cash flows occur if the insurance contracts have coverage periods of one year or less.¹⁴

The general measurement model re-estimates the fulfilment cash flows at each valuation date using current discount rates. Insurance revenue in the premium allocation approach is the expected premium allocated over the coverage period, and the fulfilment cash flows for the liability for remaining coverage are not later re-estimated unless the group of contracts becomes onerous. If the insurer accretes interest on the liability for remaining coverage in the premium allocation approach, it uses the discount rate determined at initial recognition, not the current discount rate.¹⁵

The duration of the insurance contract depends on the length of the coverage period, not the time until claims are paid. Fire insurance and property insurance contracts have short claim settlement lags; commercial liability and professional liability insurance contracts have long claim settlement lags; motor insurance has a mix of short and long claim settlement lags. Incurred claims for the premium allocation approach must be discounted only if they are expected to be paid more than one year after they occur.¹⁶

- ! If the time from the accident date to the payment date is one year or less, discounting is not required.
- ! If the time from the accident date to the payment date is more than one year, discounting is required in the same manner as for the IFRS 17 general measurement model.¹⁷

The premium allocation approach applies to both primary insurance contracts and reinsurance contracts held. The (i) criteria for using the premium allocation approach and (ii) the measurement procedures in the premium allocation approach are the same for primary insurance contracts and reinsurance contracts held, though

- ! the insurance revenue for primary insurance contracts (the premium received) is an expense for reinsurance contracts held
- ! the expenses for primary insurance contracts (the expected incurred claims) are revenue for reinsurance contracts held.¹⁸

Premium allocation approach and GAAP for short duration contracts

The premium allocation approach is similar to U.S. GAAP for short duration contracts during the coverage period: insurance revenue is the premium earned, which is the full premium times the portion of the coverage period elapsed, and insurance expense is the expected claims incurred. The major differences are that

- ! U.S. GAAP matches acquisition costs to earned premium and sets up a deferred policy acquisition cost (DPAC) asset for the unamortized portion of these costs. IFRS 17 allows insurers to charge all acquisition cash flows to expense when they occur or to pro-rate the net premium (the gross premium minus the acquisition costs) over the coverage period to determine insurance revenue. In either case, IFRS 17 has no DPAC asset.
- ! U.S. GAAP does not discount claims on short duration insurance contracts, even if the claims are paid more than one year after they occur. IFRS 17 requires insurers to discount claims that are expected to

be paid more than one year after they occur. The liability for incurred claims in the premium allocation approach for claims expected to be paid more than one year after they occur is like the liability for incurred claims in the general measurement model.

Illustration: A motor insurance contract issued on October 1, 20X1, with a coverage period of one year has a premium of 100 and acquisition costs of 20. U.S. GAAP shows

- a liability for unearned premium reserves of 100
- a deferred policy acquisition cost asset of 20
- = a net liability of 80

By December 31, 20X1, three months (of twelve) have elapsed, so these values become

- a liability for unearned premium reserves of $100 \times (1 - 3/12) = 75$
- a deferred policy acquisition cost asset of $20 \times (1 - 3/12) = 15$
- = a net liability of 60

The IFRS 17 premium allocation approach to acquisition expenses differs two ways.

- ! Acquisition costs may be charged to expenses at initial recognition or amortized over the coverage period (if the coverage period is one year or shorter).¹⁹
- ! If acquisition costs are amortized over the coverage period, the unearned portion of the premium minus the unamortized policy acquisition costs is the liability for remaining coverage.

For the illustration above:

- ! If acquisition costs are charged to expense at initial recognition, the liability for remaining coverage is 100 on October 1 and $100 \times (1 - 3/12) = 75$ on December 31.
 - " The profit or loss for the year is 75 minus the incurred claims.
- ! If acquisition costs are amortized over the coverage period, the liability for remaining coverage is 80 on October 1 and $80 \times (1 - 3/12) = 60$ on December 31.
 - " The profit or loss for the year is 60 minus the incurred claims.

If the premium is received more than a year before the coverage is provided, the insurer must adjust for the time value of money (unless the financing component is not significant). For insurance contracts with annual terms and premium due during the contract period, no adjustment is needed for the time value of money.²⁰ But even for insurance contracts that do not require this adjustment, the insurer may choose to accrete interest at the discount rate determined at initial recognition. For the illustration above, if the discount rate is 6% *per annum* and the insurer accretes interest on the liability for remaining coverage, the carrying value of the liability on December 31 is

- ! If acquisition costs are charged to expense at initial recognition: $100 \times (1 - 3/12) \times 1.06^{0.25} = 76.10$.
- ! If acquisition costs are amortized over the coverage period: $80 \times (1 - 3/12) \times 1.06^{0.25} = 60.88$.

Onerous contracts in the premium allocation approach

If an insurer uses the general measurement model, it computes the present value of future cash flows at initial recognition, and it knows whether contracts are onerous. The insurer groups the contracts by type: onerous, not onerous with no significant possibility of becoming onerous, and not onerous with a significant possibility of becoming onerous.

If the insurer uses the premium allocation approach, it does not compute the present value of future cash flows at initial recognition, and it may not know if contracts are onerous. Emerging experience on the group of contracts, such as early claims, may indicate that the insurance contracts are onerous. If these facts and

circumstances suggest that the group of contracts is onerous, the insurer must assess the fulfilment cash flows relating to remaining coverage using the general measurement model: the present value of future cash flows plus the risk adjustment for non-financial risk. If the fulfilment cash flows using the general measurement model exceed the liability for remaining coverage using the premium allocation approach, the excess is added to the liability for remaining coverage in the premium allocation approach and is recognized as a loss in the statement of profit or loss.²¹ If the insurer does not adjust the liability for incurred claims in the premium allocation approach for the time value of money, it may not adjust the excess mentioned above for the time value of money.²²

For general insurance contracts with one-year coverage periods and premium received at initial recognition, the average accretion of interest on the liability for remaining coverage is half a year. Risk-free interest rates are now (in 2019) about 2% *per annum* in many western countries. In practice, insurers would rarely adjust the liability for remaining coverage in the premium allocation approach for the time value of money, but liability insurers must adjust the premium allocation approach liability for incurred claims for the time value of money if the claim payment lag is more than one year.

The first illustration below shows the IFRS 17 accounting entries if the insurer chooses not to adjust the liability for remaining coverage in the premium allocation approach for the time value of money.

Illustration: Premium allocation approach basics

On October 1, 20X1, an insurer writes a motor insurance contract with a term of one year, collects premium of 100, pays acquisition cash flows (directly attributable to the portfolio of insurance contracts) of 20, and uses the premium allocation approach. The discount rate is 6% *per annum*. We show

- A. The liability for remaining coverage at initial recognition
- B. The insurance revenue in 20X1
- C. The liability for remaining coverage at December 31, 20X1

Part A: The liability for remaining coverage depends on how the insurer treats directly attributable acquisition cash flows:

- ! If the insurer elects to charge the directly attributable acquisition cash flows to expenses when they occur, the liability for remaining coverage is 100.
- ! If the insurer elects to amortize the directly attributable acquisition cash flows over the coverage period, the liability for remaining coverage is $100 - 20 = 80$.

Part B: The contract period is one year, of which three months are in 20X1, so the insurance revenue in 20X1 is $3/12 \times$ (the premium received – the acquisition cash flows not reported as expenses when they occur) + the amortized acquisition expenses.

- ! If the insurer spreads the acquisition cash flows over the coverage period but does not accrete interest on the liability for remaining coverage,
 - " the acquisition expense for 20X1 is $3/12 \times 20 = 5$
 - " the insurance revenue is $3/12 \times (100 - 20) + 3/12 \times 20 = 25$
 - " the profit or loss for 20X1 is $25 - 5 -$ the incurred claims for 20X1
- ! If the insurer reports the acquisition cash flows as expenses when they occur,
 - " the acquisition expense for 20X1 is 20
 - " the insurance revenue is $3/12 \times 100 = 25$
 - " the profit or loss for 20X1 is $25 - 5 -$ the incurred claims for 20X1

Part C: The liability for remaining coverage at December 31, 20X1, depends on how the insurer treats the acquisition cash flows.

- ! If the insurer charges the acquisition cash flows to expenses when they occur, the liability for remaining coverage at December 31, 20X1, is $100 - 25 = 75$.
- ! If the insurer amortizes the acquisition cash flows over the coverage period, 25% of these acquisition cash flows, or $25\% \times 20 = 5$, are amortized in 20X1. The liability for remaining coverage at December 31, 20X1, is $100 - 20 - 25 + 5 = 60$.

PREMIUM ALLOCATION APPROACH WITHOUT INSURANCE FINANCE EXPENSE

On October 1, 20X1, an insurer writes a motor insurance contract with a term of one year, collects premium of 100, and pays acquisition cash flows directly attributable to the portfolio of insurance contracts of 20. The insurer incurs a claim for 40 on November 15, 20X1, and a claim for 30 on August 15, 20X2. Claims are paid half a year after they occur. The November 15 claim is paid for 40, and the August 15 claim is paid for 25. The risk adjustment for non-financial risk is 6% of the claim cost for each claim. The insurer measures insurance revenue, expenses, and the insurance contract liability by the premium allocation approach.

For simplicity, this illustration assumes the insurer does not adjust the liability for remaining coverage for the time value of money and does not discount the incurred claims. The subsequent illustrations add insurance finance expense to both the liability for remaining coverage and the liability for incurred claims. We show

- A. The liability for remaining coverage at initial recognition
- B. The insurance revenue in 20X1
- C. The liability for remaining coverage at December 31, 20X1
- D. The liability for incurred claims at December 31, 20X1
- E. The insurance service expense in 20X1
- F. The profit or loss for 20X1
- G. The insurance revenue in 20X2
- H. The liability for remaining coverage at December 31, 20X2
- I. The liability for incurred claims at December 31, 20X2
- J. The insurance service expense in 20X2
- K. The profit or loss for 20X2
- L. The profit or loss for 20X3

Part A: The liability for remaining coverage depends on how the insurer treats directly attributable acquisition cash flows:

- ! If the insurer elects to charge the directly attributable acquisition cash flows to expenses when they occur, the liability for remaining coverage is 100.
- ! If the insurer elects to amortize the directly attributable acquisition cash flows over the coverage period, the liability for remaining coverage is $100 - 20 = 80$.

Part B: The contract period is one year, of which three months are in 20X1, so the insurance revenue in 20X1 is $3/12 \times$ (the premium received – the acquisition cash flows not reported as expenses when they occur) + the amortized acquisition expenses.²³

The insurance revenue in 20X1 depends on whether the insurer accretes interest on the liability for remaining coverage and how it treats acquisition cash flows. For simplicity, this illustration assumes the insurer does not accrete interest on the liability for remaining coverage, so

- ! If the insurer spreads the acquisition cash flows over the coverage period,
 - " the acquisition expense for 20X1 is $3/12 \times 20 = 5$
 - " the insurance revenue is $3/12 \times (100 - 20) + 3/12 \times 20 = 25$
- ! If the insurer reports the acquisition cash flows as expenses when they occur,
 - " the acquisition expense for 20X1 is 20
 - " the insurance revenue is $3/12 \times 100 = 25$

The next illustrations add accretion of interest on the liability for remaining coverage.

Part C: The liability for remaining coverage at December 31, 20X1, depends on how the insurer treats directly attributable acquisition cash flows.

- ! If the insurer charges the acquisition cash flows to expenses when they occur, the liability for remaining coverage at December 31, 20X1, is $100 - 25 = 75$.
- ! If the insurer amortizes the acquisition cash flows over the coverage period, 25% of these acquisition cash flows, or $25\% \times 20 = 5$, are amortized in 20X1. The liability for remaining coverage at December 31, 20X1, is $100 - 20 - 25 + 5 = 60$. We can also compute this as $(1 - 3/12) \times (100 - 20) = 60$.

Part D: The liability for incurred claims is the fulfilment cash flows related to past service and equals the future cash flows for incurred claims plus the risk adjustment for non-financial risk:

$$\begin{aligned} & 40 \text{ for the incurred claim on November 15, 20X1} \\ + & 40 \times 6\% = 2.40 \text{ is the risk adjustment for non-financial risk} \\ = & 42.40. \end{aligned}$$

The liability for incurred claims in the premium allocation approach is the same as in the general measurement approach (the building block approach), except that the insurer "is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred."²⁴

Part E: The insurance service expense for claims is the change in the liability for incurred claims because of occurrence and re-estimates of claims. If the insurer does not discount the claims for the time value of money, the change in the liability for incurred claims is the nominal value of the claims occurring in the period plus the risk adjustment for non-financial risk = $40 + 2.40 = 42.40$ in 20X1.²⁵

The insurer recognizes incurred claims in 20X1 and 20X2 and reports an experience adjustment in 20X3.

Profit or loss

Part F: The profit or loss has the following pieces:

- ! the insurance revenue for the earning of the gross premium
- ! the insurance service expense for the incurred claims and the risk adjustment for non-financial risk
- ! the insurance acquisition cash flows charged to expenses when incurred
- ! the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period (not charged to expenses when incurred)
- ! the adjustment of the liability for remaining coverage if the insurer chooses to accrete interest or if the coverage period is more than one year and the adjustment is substantial
- ! the insurance finance expense for incurred claims, if they are discounted for the time value of money

The insurance revenue for the general measurement model is the sum of four pieces:

- ! the incurred claims and other expenses for which the insurer expects to receive consideration (that is, not including onerous contract losses)
- ! the release of the risk adjustment for non-financial risk
- ! the allocation of the contractual service margin to profit or loss
- ! the allocated acquisition expenses

For all years combined, the insurance revenue equals the premium accumulated for the time value of money. The accumulation is done separately for each of the pieces, as insurance finance expense on the fulfilment cash flows and as accretion of interest on the contractual service margin and the acquisition expenses.

The premium allocation approach gives insurers an accounting policy choice whether or not to accrete interest on the liability for remaining coverage. The insurance revenue is the expected premium allocated over the coverage period on the basis of the passage of time or the pattern of incurred claims, either with or without the accretion of interest.

For 20X1, the profit or loss depends on the recognition of the acquisition cash flows of 20:

- ! if the insurer recognizes acquisition cash flows when they occur: $+25 - 40.24 - 20 = -35.24$
- ! if the insurer amortizes acquisition expenses over the contract period: $+25 - 40.24 - 5 = -20.24$

The liability for remaining coverage uses the percentage of the contract period, not the fulfilment cash flows.

- ! The insurer must adjust the liability for remaining coverage for the time value of money if the insurance contracts have a significant financing component. If the time from the receipt of premium to the provision of coverage is more than one year and the interest rate is high, the insurer must adjust the liability for remaining coverage for the time value of money.
- ! If the time between providing each part of the coverage and the related premium due date is no more than a year (as is true for this motor insurance contract), the insurer need not adjust the liability for remaining coverage for the time value of money.

The liability for incurred claims uses fulfilment cash flows, but the insurer "is not required to adjust future cash flows for the time value of money ... if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred."²⁶ This illustration assumes the insurer does not adjust these two liabilities for the time value of money.

Part G: The contract period is one year, of which nine months are in 20X2, so the insurance revenue in 20X2 is $9/12 \times$ (the premium received – the acquisition cash flows not reported as expenses when they occur) + the amortized acquisition expenses.

- ! If the insurer spreads the acquisition cash flows over the coverage period:
 - " the acquisition expense for 20X2 is $9/12 \times 20 = 15$
 - " the insurance revenue is $9/12 \times (100 - 20) + 9/12 \times 20 = 75$
- ! If the insurer reports the acquisition cash flows as expenses when they occur:
 - " the acquisition expense for 20X2 is zero
 - " the insurance revenue is $9/12 \times 100 = 75$

Part H: The insurance contracts do not extend past 20X2, so the liability for remaining coverage at December 31, 20X2, is zero.

Part I: The November 15, 20X1, claim is paid six months later (May 15, 20X2), so it is no longer in the liability for incurred claims on December 31, 20X2. The August 15, 20X2, claim is paid in February 20X3. It remains in the liability for incurred claims on December 31, 20X2:

$$30 \text{ for future cash flows} + 30 \times 6\% \text{ for the risk adjustment for non-financial risk} = 30 + 1.80 = 31.80.$$

Part J: We examine the contributions of the two claims – both future cash flows and risk adjustment for non-financial risk – to the insurance service expense in 20X2:

The November 15, 20X1, claim is paid six months later (May 15, 20X2) for its estimated value of 40. On the statement of financial position, cash is credited (reduced) 40 and the liability for incurred claims is debited

(reduced) 40, with no change to profit or loss. (A decrease in an asset is a credit and a decrease in a liability is a debit.)

When the claim is paid on May 15, 20X2, the risk adjustment for non-financial risk is removed. In IFRS 17, the release of the risk adjustment for non-financial risk applies to the liability for remaining coverage when the claim occurs and is part of insurance revenue. The removal of the risk adjustment for non-financial risk when the claim is paid is not part of insurance revenue. To avoid confusion, we use the term “removed” instead of “released” in the paragraph below.

The risk adjustment for non-financial risk for the November 20X1 claim is removed on May 15, 20X2, and no asset is reduced. The removal of the risk adjustment is recognized in profit or loss as profit of $6\% \times 40 = 2.40$.

- ! For the general measurement model, the removal of the risk adjustment for non-financial risk is included in insurance revenue, just as the occurrence of the claim is included in insurance revenue.
- ! For the premium allocation approach, insurance revenue is the allocation of the premium received based on the passage of time. The removal of the risk adjustment for non-financial risk (like the payment of a claim for less than its expected value) is an offset to insurance service expense.

In practice, we say the risk adjustment for non-financial risk is released when an outstanding claim is paid. The terms used above (removal and removed) are to stress that this removal is not insurance revenue.

The August 15, 20X2, claim is recognized but not yet paid in 20X2, and a 6% risk adjustment for non-financial risk is recognized as well. The insurance service expense is $30 + 6\% \times 30 = 31.80$.

Part K: Profit or loss for 20X2 is

- insurance service revenue of $75\% \times 100 = 75$
 - amortization of directly attributable acquisition cash flows (if they are not recognized when they occur) of $75\% \times 20 = 15$.
 - + removal of the risk adjustment for non-financial risk for the November 15, 20X1, claim of 2.40.
 - insurance service expense for the occurrence of claims (and their associated risk adjustment for non-financial risk) of 31.80.
- ! $= 75 - 15 + 2.40 - 31.80 = 30.60$ (if the insurer amortizes directly attributable acquisition cash flows)
- ! $= 75 + 2.40 - 31.80 = 45.60$ (if the insurer charges directly attributable acquisition cash flows to expense when they occur)

Part L: Profit or loss in 20X3 stems from the payment of the August 15, 20X2, claim in February 20X3. We view the claim payment in three parts: re-estimate, payment, removal.

- ! *Re-estimate:* the August 15, 20X2, claim is re-estimated from 30 to 25 right before it is paid on February 15, 20X3, for insurance service expense of -5 (a contra-expense).
- ! *Payment:* the insurer pays 25 on February 15, 20X3, reducing its cash and its liability for incurred claims, but not causing an entry in the statement of profit or loss.
- ! *Removal:* the risk adjustment for non-financial risk of 1.80 is removed on February 15, 20X3, for a profit of 1.80.

The net profit $-(-5) + 0 + 1.80 = 6.80$.

IFRS 17 refers to the first two bullet points above as an experience adjustment: the payment of a claim for more or less than the expected value.²⁷

If the lag from occurrence to payment of claims exceeds one year, as is the case for many liability insurance claims, the liability for incurred claims in the premium allocation approach is computed the same way as for the general measurement approach, using risk-free discount rates (for claim cash flows that do not vary based on the returns on any underlying items) matched to the maturity, liquidity, and currency of the claims. When using the premium allocation approach:

- ! the liability for remaining coverage (if the lag from the premium due date to the date the insurance services are provided is more than a year) uses the discount rate determined at initial recognition [fn: See IFRS 17 paragraph B72(d).]
- ! the liability for incurred claims uses the current discount rate [fn: See IFRS 17 paragraph B72(a).]

If the insurer adjusts the liability for incurred claims for the time value of money and it elects to dis-aggregate the insurance finance expense between profit or loss and other comprehensive income, the discount rate used for the portion included in profit or loss is the discount rate at the date the claim occurs, not the discount rate determined at initial recognition of the insurance contracts.²⁸ We explain the dis-aggregation of the insurance finance expense for the premium allocation approach further below.

ACQUISITION EXPENSES AND FINANCIAL ADJUSTMENTS FOR THE PREMIUM ALLOCATION APPROACH

An insurer issues an insurance contract on July 1, 20X1, with a one year coverage period, which it measures by the premium allocation approach.

- ! Premium of 100 is received and acquisition cash flows of 20 are paid on July 1, 20X1.
- ! Claims are expected to occur evenly over the coverage period.
- ! The discount rate is 6% *per annum*.
- ! For simplicity, the risk adjustment for non-financial risk is zero.

At initial recognition, the insurer need not estimate future claims for the premium allocation approach. Unless facts and circumstances indicate otherwise, the insurer may assume that the contracts are not onerous.

- ! On December 31, 20X1, the insurer estimates that the claims that have occurred from July 1, 20X1, through December 31, 20X1, will be paid for 45 on December 31, 20X4.
- ! On June 30, 20X2, the insurer estimates that the claims that have occurred from January 1, 20X2, through June 30, 20X2, will be paid for 45 on December 31, 20X4.

For simplicity, all the claims are expected to be paid on December 31, 20X4, in this illustration. In practice, each claim has its own expected payment date. Insurers generally project claim payment patterns for groups of insurance contracts measured by the premium allocation approach, either as discrete percentages or as mathematical functions. Examples of the two methods are

- ! discrete percentages: 40% paid in the first year after the claim occurs, and 30%, 20%, and 10% paid in the next three years
- ! mathematical function: 40% of outstanding claims paid in the next year

The insurer has two accounting policy choices:

- ! whether to recognize the acquisition cash flows as expenses when they occur or to spread them over the coverage period
- ! whether to adjust the liability for remaining coverage for the time value of money

The claims are expected to be paid more than a year after they occur, so the insurer must report the liability for incurred claims at its present value.

We show four scenarios for the insurer's accounting policy choices:

<i>Scenario</i>	<i>Acquisition Expenses</i>	<i>Liability for Remaining Coverage</i>
1	recognize when they occur	does not accrete interest
2	spread over coverage period	does not accrete interest
3	recognize when they occur	accretes interest
4	spread over coverage period	accretes interest

Recognize expense when occurs; no accretion of interest

Scenario #1: acquisition cash flows are recognized as expenses when they occur and the liability for remaining coverage does not accrete interest

At initial recognition, the liability for remaining coverage is the premium received of 100 and the liability for incurred claims is zero.²⁹ The insurer has additional assets equal to the premium net of acquisition cash flows ($100 - 20 = 80$), and the acquisition expenses at initial recognition are 20. The change in the shareholders' equity can be measured two ways:

- ! change in assets – change in liabilities = $80 - 100 = -20$
- ! revenue – expenses = $0 - 20 = -20$

If shareholders' equity is Z before the insurance contract is issued, it is $Z - 20$ after the contract is issued.

At December 31, 20X1, the liability for remaining coverage decreases by the premium allocated over the first half of the policy year, or $50\% \times 100 = 50$. Claims of 45 are assumed to have occurred and will be paid in three years, so the liability for incurred claims is $45 / 1.06^3 = 37.78$.³⁰

The insurance revenue is the change in the liability for remaining coverage = $50 - 100 = -50$; the insurance revenue is the percentage of the premium for the expired portion of the insurance contract = $-\frac{1}{2} \times 100 = -50$.

The insurance service expense is the increase in the liability for incurred claims of 37.78. The change in shareholders' equity is

- ! change in assets – change in liabilities = $0 - (37.78 - 50) = 12.22$
- ! revenue – expenses = $50 - 37.78 = 12.22$

The change in shareholders' equity by December 31, 20X1 (not including investment income on the financial assets bought with the premium), is $-20 + 12.22 = -7.78$. In practice, the insurer earns investment income on its financial assets of 80, but this investment income is not shown on the IFRS 17 reconciliation exhibits.

Spread expenses; no accretion of interest

Scenario #2: acquisition expense is spread over the coverage period and the liability for remaining coverage does not accrete interest

At initial recognition, the liability for remaining coverage is the premium received minus the acquisition cash flows paid = $100 - 20 = 80$, and the liability for incurred claims is zero. The insurer has additional assets equal to the premium net of acquisition cash flows ($100 - 20 = 80$), and the acquisition expenses at initial recognition are zero. The change in shareholders' equity is

- ! change in assets – change in liabilities = $80 - 80 = 0$
- ! revenue – expenses = $0 - 0 = 0$

The present value of the acquisition cash flows is allocated by the passage of time to the two halves of the policy year, or $\frac{1}{2} \times 20 = 10$ to each half year. The acquisition expenses are not amortized to the valuation date because the liability for remaining coverage does not accrete interest.³¹

At December 31, 20X1, the liability for remaining coverage decreases by the premium allocated over the first half of the policy year, or $50\% \times 100 = 50$, and it increases by the acquisition costs allocated to the first half of the policy year, or $50\% \times 20 = 10$, so it becomes $80 - 50 + 10 = 40$. The liability for incurred claims is $45 / 1.06^3 = 37.78$.

The insurance revenue is the change in the liability for remaining coverage minus the allocated acquisition expenses = $40 - 80 - 10 = -50$. The insurance revenue is also the net premium for the part of the insurance contract that has expired plus the allocated acquisition expenses: $-(\frac{1}{2} \times (100 - 20) + 10) = -50$. The insurance service expense is the increase in the liability for incurred claims of 37.78. The change in shareholders' equity is

! change in assets – change in liabilities = $0 - (37.78 - 40) = 2.22$
 ! revenue – expenses = $50 - 37.78 - 10 = 2.22$

The change in shareholders' equity at December 31, 20X1 (not including investment income on the financial assets), is $0 + 2.22 = 2.22$.

Recognize expense when occurs; accretion of interest

Scenario #3: acquisition cash flows are recognized as expenses when they occur and the liability for remaining coverage accretes interest

Scenario #3 is like scenario #1 except that the liability for remaining coverage increases by insurance finance expense (accretion of interest) for the time value of money.

At initial recognition, the liability for remaining coverage is the premium received of 100 and the liability for incurred claims is zero. The insurer has additional assets equal to the premium net of acquisition cash flows ($100 - 20 = 80$), and the acquisition expenses at initial recognition are 20. The change in shareholders' equity is

! change in assets – change in liabilities = $80 - 100 = -20$
 ! revenue – expenses = $0 - 20 = -20$

At December 31, 20X1, the liability for remaining coverage increases by the insurance finance expense to $100 \times 1.06^{0.5} = 102.96$ and it decreases by the accumulated premium allocated over the first half of the policy year, or $50\% \times 100 \times 1.06^{0.5} = 51.48$. The insurance finance expense on the liability for remaining coverage in the premium allocation approach uses the discount rate determined at initial recognition, not the current discount rate.³² The discount rate here remains 6% *per annum* through the coverage period. If the discount rate changes, the insurance finance expense in the general measurement model includes the effect of the change, but the insurance finance expense in the premium allocation approach does not include the effect of the change. The liability for incurred claims is $45 / 1.06^3 = 37.78$.

The insurance revenue is determined as the change in the liability for remaining coverage minus the insurance finance expense = $51.48 - 100 - 2.96 = -51.48$. The insurance revenue is the premium for the expired portion of the insurance contract: $-\frac{1}{2} \times 100 \times 1.06^{0.5} = -51.48$. The insurance service expense is the increase in the liability for incurred claims of 37.78. The change in shareholders' equity is

! change in assets – change in liabilities = $0 - (37.78 + 51.48 - 100) = 10.74$
 ! revenue – expenses = $51.48 - 37.78 - 2.96 = 10.74$

The change in shareholders' equity at December 31, 20X1 (not including investment income on the financial assets), is $-20 + 10.74 = -9.26$.

Shareholders' equity is lower in Scenario #3 than in Scenario #1 by $10.74 - 9.26 = 1.48$ because the liability for remaining coverage increases by 1.48 from

- ! the accretion of interest of 2.96
- ! minus the additional allocation of the accumulated premium of 1.48.

Spread expenses; accretion of interest

Scenario #4: acquisition expense is spread over the coverage period and the liability for remaining coverage accretes interest

Scenario #4 is like scenario #2 except that the liability for remaining coverage increases by insurance finance expense (accretion of interest) for the time value of money.

At initial recognition, the liability for remaining coverage is the premium received minus the acquisition cash flows paid = $100 - 20 = 80$, and the liability for incurred claims is zero. The insurer has assets equal to the premium net of acquisition cash flows ($100 - 20 = 80$), and the acquisition expenses at initial recognition are zero. The change in shareholders' equity is

- ! change in assets – change in liabilities = $80 - 80 = 0$
- ! revenue – expenses = $0 - 0 = 0$

The present value of the acquisition cash flows is allocated by the passage of time to the two halves of the policy year, or $\frac{1}{2} \times 20 = 10$ to each half year. The acquisition expenses are amortized to the valuation date of December 31, 20X1, or $10 \times 1.06^{0.5} = 10.30$ for the first half year and $10 \times 1.06^{1.0} = 10.60$ for the second half year.

At December 31, 20X1, the liability for remaining coverage increases by the insurance finance expense to $80 \times 1.06^{0.5} = 82.3650$ and it decreases by the accumulated premium allocated over the first half of the policy year, or $50\% \times 80 \times 1.06^{0.5} = 41.18$. The liability for incurred claims is $45 / 1.06^3 = 37.78$.

The insurance revenue is the change in the liability for remaining coverage minus the sum of the insurance finance expense and the amortized acquisition expenses = $41.18 - 80 - (2.365 + 10.30) = -51.485$. The insurance revenue is also the net premium for the expired portion of the insurance contract plus the allocated acquisition expenses: $-(\frac{1}{2} \times 80 \times 1.06^{0.5} + 10 \times 1.06^{0.5}) = -51.48$. The insurance service expense is the increase in the liability for incurred claims of 37.78. The change in shareholders' equity is

- ! change in assets – change in liabilities = $0 - (37.78 + 41.18 - 80) = 1.04$
- ! revenue – expenses = $51.485 - 37.78 - 10.30 - 2.365 = 1.040$

The change in shareholders' equity at December 31, 20X1 (not including investment income on the financial assets), is $0 + 1.04 = 1.04$. In practice, the insurer earns investment income on its financial assets of 80, but this investment income is not shown on the IFRS 17 reconciliation exhibits.

Shareholders' equity is lower in Scenario #4 than in Scenario #2 by $2.22 - 1.04 = 1.18$ because the liability for remaining coverage increases by the accretion of interest of 2.365 minus the higher allocation of the accumulated premium of 1.18.

All four scenarios compute the liability for incurred claims as the present value of future cash flows, since the lag from the occurrence of the claims to the payment of the claims is more than one year. At June 30, 20X2, the coverage period ends, the liability for remaining coverage is zero, and the financial assets are the same

in all scenarios (since they depend on cash flows, not accounting entries), so the shareholders' equity is the same for all scenarios.

DISCOUNT RATES FOR PREMIUM ALLOCATION APPROACH

An insurer issues an insurance contract on July 1, 20X1, with a one year coverage period, which it measures by the premium allocation approach.

- ! Premium of 100 is received and acquisition cash flows of 20 are paid on July 1, 20X1.
- ! Claims are expected to occur evenly over the coverage period. The claims are expected to be paid on December 31, 20X4, for 90.
- ! For simplicity, the risk adjustment for non-financial risk is zero.

The current discount rate *per annum* at each valuation date is

- ! July 1, 20X1: 6%
- ! December 31, 20X1: 7%
- ! July 1, 20X2: 8%
- ! December 31, 20X2: 9%
- ! December 31, 20X3: 8%
- ! December 31, 20X4: 5%

The risk adjustment for non-financial risk is the same for the premium allocation approach as for the general measurement model. This illustration focuses on the discount rate for the present value of future cash flows and the dis-aggregation of the insurance finance expense between profit or loss and other comprehensive income. We show

- A. The liability for remaining coverage at December 31, 20X1, 20X2, 20X3, and 20X4.
- B. The liability for incurred claims at December 31, 20X1.
- C. The insurance service expense in 20X1.
- D. The insurance finance expense in 20X1.
- E. The dis-aggregation of insurance finance expense in 20X1 between profit or loss vs other comprehensive income.
- F. The insurance service expense in 20X2.
- G. The insurance finance expense in 20X2.
- H. The dis-aggregation of insurance finance expense in 20X2 between profit or loss vs other comprehensive income.
- I. The insurance service expense in 20X3.
- J. The insurance finance expense in 20X3.
- K. The dis-aggregation of insurance finance expense in 20X3 between profit or loss vs other comprehensive income.
- L. The insurance service expense in 20X4.
- M. The insurance finance expense in 20X4.
- N. The dis-aggregation of insurance finance expense in 20X4 between profit or loss vs other comprehensive income.

Part A: We show the liability for remaining coverage at December 31, 20X1, in four scenarios:

Scenario	Acquisition Expenses	Liability for Remaining Coverage
1	recognize when they occur	does not accrete interest
2	spread over coverage period	does not accrete interest
3	recognize when they occur	accretes interest
4	spread over coverage period	accretes interest

The liability for remaining coverage at December 31, 20X1, is

- the allocation percentage for the period × (the premium received minus the acquisition cash flows not reported as expenses when they occur) × an adjustment for the accretion of interest if applicable
- + the amortized acquisition expenses for the period, which are the allocation percentage for the period × the acquisition cash flows not reported as expenses when they occur × an adjustment for the accretion of interest if applicable

In this Illustration:

- ! The allocation percentage for 20X1 is 50% (half the policy term).
- ! The premium received is 100 and the acquisition cash flows are 20.
- ! The adjustment for the accretion of interest in the premium allocation approach uses the discount rate determined at initial recognition of the insurance contracts = $1.06^{0.5}$ (6% for half a year)

We compute the liability for remaining coverage at December 31, 20X1, for each scenario:

- ! Scenario #1: $50\% \times 100 = 50$
- ! Scenario #2: $50\% \times (100 - 20) + 50\% \times 20 = 50$
- ! Scenario #3: $50\% \times 100 \times 1.06^{0.5} = 51.48$
- ! Scenario #4: $50\% \times (100 - 20) \times 1.06^{0.5} + 50\% \times 20 \times 1.06^{0.5} = 51.48$

Insurance revenue depends on the timing of the acquisition expenses.

The coverage period ends on June 30, 20X2, so the liability for remaining coverage at December 31, 20X2, 20X3, and 20X4 is zero.

Part B: We use the current discount rate for the present value of future cash flows, so the liability for incurred claims at December 31, 20X1, is $45 / 1.07^3 = 36.73$.

Part C: Claims of 90 occur evenly over the coverage period and will be paid on December 31, 20X4, so claims of 45 occur from July 1, 20X1, through December 31, 20X1, with an average occurrence date of October 1, 20X1. The discount rate is 6% at July 1, 20X1, and 7% at December 31, 20X1, so we estimate the average discount rate as $\frac{1}{2} \times (6\% + 7\%) = 6.5\%$.

The total claim expense in 20X1 is the change in the liability for incurred claims = $36.73 - 0 = 36.73$. We divide this expense into the insurance service expense in 20X1 and the insurance finance expense in 20X1.

The insurance service expense is the present value of the incurred claims = $45 / 1.065^{3.25} = 36.67$, using the average discount rate at the dates the claims occur.

Part D: The discount rate changes from October 1, 20X1, to December 31, 20X1, so we use the discount rate at each valuation date to compute the insurance finance expense for 20X1: $45 \times (1.070^{-3} - 1.065^{-3.25}) = 0.06$.

The insurance finance expense comprises the time value of money and the change in financial assumptions:

- ! The time value of money gives insurance finance expense of $45 \times (1.065^{-3} - 1.065^{-3.25}) = 0.58$.
- ! The change in financial assumptions gives insurance finance expense of $45 \times (1.070^{-3} - 1.065^{-3}) = -0.52$.

The sum of the two parts is $0.58 + -0.52 = 0.06$.

The liability for incurred claims at December 31, 20X1, is the insurance service expense in 20X1 plus the insurance finance expense in 20X1 = $36.67 + 0.06 = 36.73$.

Some insurers assume that all claims in the accounting period occur at the valuation date, so the insurance service expense for 20X1 is $45 / 1.07^3 = 36.73$ and the insurance finance expense for 20X1 is zero. IFRS 17 requires proper timing of claims, but using the valuation date instead of the claim occurrence date is common.

Dis-aggregating insurance finance expense

Part E: To dis-aggregate insurance finance expense between profit or loss and other comprehensive income, the insurer uses the discount rate at the date the claim occurs for the insurance finance expense reported in profit or loss. The entries for 20X1 are

- ! 20X1 profit or loss: 0.58
- ! 20X1 other comprehensive income: $0.06 - 0.58 = -0.52$

Part F: Claims of 90 occur evenly over the coverage period and will be paid on December 31, 20X4, so claims of 45 occur from January 1, 20X1, through June 30, 20X2, with an average occurrence date of April 1, 20X2.

The discount rate is 7% at December 31, 20X1, and 8% at June 30, 20X2, so we estimate the average discount rate as $\frac{1}{2} \times (7\% + 8\%) = 7.5\%$.

The insurance service expense is the present value of the incurred claims = $45 / 1.075^{2.75} = 36.88$.

Part G: We compute the 20X2 insurance finance expense separately for the claims occurring in 20X1 and the claims occurring in 20X2.

- ! Claims occurring in 20X1: The discount rate changes from January 1, 20X2, to December 31, 20X2, so we use the discount rate at each valuation date to compute the insurance finance expense for 20X2:

$$45 \times (1.090^{-2} - 1.07^{-3}) = 1.14$$

- ! Claims occurring in 20X2: The discount rate changes from April 1, 20X2, to December 31, 20X2, so we use the discount rate at each valuation date to compute the insurance finance expense for 20X2:

$$45 \times (1.090^{-2} - 1.075^{-2.75}) = 0.99$$

The total insurance finance expense for 20X2 is $1.14 + 0.99 = 2.13$.

Part H: To dis-aggregate insurance finance expense between profit or loss and other comprehensive income, the insurer uses the discount rate at the date the claim occurs for the insurance finance expense reported in profit or loss. The entries for 20X2 are computed separately for the claims occurring in 20X1 and the claims occurring in 20X2. The 20X2 accounting entries are

- ! claims occurring in 20X1: profit or loss = $45 \times (1.065^{-2} - 1.065^{-3}) = 2.42$
- ! claims occurring in 20X1: other comprehensive income = $1.14 - 2.42 = -1.28$

- ! claims occurring in 20X2: profit or loss = $45 \times (1.075^{-2} - 1.075^{-2.75}) = 2.06$
- ! claims occurring in 20X2: other comprehensive income = $0.99 - 2.06 = -1.07$

The totals for all claims are

- ! profit or loss: $2.42 + 2.06 = 4.48$
- ! other comprehensive income: $2.13 - 4.48 = -2.35$

We can also compute the 20X2 other comprehensive income as $-1.28 + -1.07 = -2.35$

To dis-aggregate insurance finance expense between profit or loss and other comprehensive income, the discount rate for the part reported in profit or loss differs between the IFRS 17 general measurement model and the premium allocation approach:

- ! general measurement model: discount rate determined at initial recognition of the insurance contracts
- ! premium allocation approach: discount rate at the date the claim occurs³³

Part I: No claims occur in 20X3 (the coverage period ends at June 30, 20X2), no claim estimates are revised in 20X3, and no experience adjustments occur in 20X3, so the insurance service expense for 20X3 is zero.

Part J: We compute the 20X3 insurance finance expense using the discount rates at the beginning and end of the year:

$$90 \times (1.080^{-1} - 1.09^{-2}) = 7.58$$

Half the claims occur in 20X1 and half the claims occur in 20X2, so the insurance finance expense for each set of claims is $\frac{1}{2} \times 7.58 = 3.79$.

Part K: To dis-aggregate insurance finance expense between profit or loss and other comprehensive income, the insurer uses the discount rate at the date the claim occurs for the insurance finance expense reported in profit or loss. The entries for 20X3 are computed separately for the claims occurring in 20X1 and the claims occurring in 20X2. The 20X3 accounting entries are

- ! claims occurring in 20X1: profit or loss = $45 \times (1.065^{-1} - 1.065^{-2}) = 2.58$
- ! claims occurring in 20X1: other comprehensive income = $3.79 - 2.58 = 1.21$
- ! claims occurring in 20X2: profit or loss = $45 \times (1.075^{-1} - 1.075^{-2}) = 2.92$
- ! claims occurring in 20X2: other comprehensive income = $3.79 - 2.92 = 0.87$

The totals for all claims are

- ! profit or loss: $2.58 + 2.92 = 5.50$
- ! other comprehensive income: $1.21 + 0.87 = 2.08$

We verify the total insurance finance expense as $5.50 + 2.08 = 7.58$.

Part L: No claims occur in 20X4 (the coverage period ends at June 30, 20X2), no claim estimates are revised in 20X4, and no experience adjustments occur in 20X4, so the insurance service expense for 20X4 is zero.

Part M: We compute the 20X4 insurance finance expense using the discount rates at the beginning and end of the year:

$$90 \times (1.050^0 - 1.08^{-1}) = 6.667$$

Half the claims occur in 20X1 and half the claims occur in 20X2, so the insurance finance expense for each set of claims is $\frac{1}{2} \times 6.667 = 3.334$.

Part N: To dis-aggregate insurance finance expense between profit or loss and other comprehensive income, the insurer uses the discount rate at the date the claim occurs for the insurance finance expense reported in profit or loss. The entries for 20X4 are computed separately for the claims occurring in 20X1 and the claims occurring in 20X2. The 20X4 accounting entries are

! claims occurring in 20X1: profit or loss = $45 \times (1.065^0 - 1.065^{-1}) = 2.75$
 ! claims occurring in 20X1: other comprehensive income = $3.33 - 2.75 = 0.58$

! claims occurring in 20X2: profit or loss = $45 \times (1.075^0 - 1.075^{-1}) = 3.14$
 ! claims occurring in 20X2: other comprehensive income = $3.33 - 3.14 = 0.19$

The totals for all claims are

! profit or loss: $2.75 + 3.14 = 5.89$
 ! other comprehensive income: $0.58 + 0.19 = 0.77$

We verify the total insurance finance expense for 20X4 as $5.89 + 0.77 = 6.66$.

We verify that the other comprehensive income for all years combined is zero:

! 20X1 other comprehensive income: $0.06 - 0.58 = -0.52$
 ! 20X2 other comprehensive income: $-1.28 + -1.07 = -2.35$
 ! 20X3 other comprehensive income: $1.21 + 0.87 = 2.08$
 ! 20X4 other comprehensive income: $0.58 + 0.19 = 0.77$

Total other comprehensive income = $-0.52 + -2.35 + 2.08 + 0.77 = -0.02$. The -0.02 discrepancy is a rounding error from using only two decimal places.

Intuition: We show that the total insurance finance expense for all years combined equals the insurance finance expense reported in profit or loss for all years combined. For simplicity, we assume the claim occurs at time $t=0$ and is paid at time $t=n$, and the intervening valuation dates are at times time $t=1, 2, \dots, n-1$. The integral times for $t = \{0, 1, 2, \dots, n-1, n\}$ simplify the expressions but do not affect the logic.

Let C be the nominal value of the claim payment, and let d_t be “one plus the discount rate” at time $t = j$, where $j = \{0, 1, 2, \dots, n-1, n\}$.

The total insurance finance expense for all years combined, using the current discount rates, is

$$C \times ((d_{1-(n-1)} - d_{0-n}) + (d_{2-(n-2)} - d_{1-(n-1)}) + \dots + (d_{n-1-(1)} - d_{n-2-(2)}) + (d_{n-0} - d_{n-1-(1)}) = C \times (d_{n-0} - d_{0-n})$$

The insurance finance expense reported in profit or loss for all years combined, using the discount rate at the date the claim occurs, is

$$C \times ((d_{0-(n-1)} - d_{0-n}) + (d_{0-(n-2)} - d_{0-(n-1)}) + \dots + (d_{0-(1)} - d_{0-(2)}) + (d_{0-0} - d_{0-(1)}) = C \times (d_{0-0} - d_{0-n})$$

$d_{n-0} = d_{0-0} = 1$ (any real number raised to the power of zero is one), so both the total insurance finance expense and the insurance finance expense reported in profit or loss for all years combined = $(1 - d_{0-n})$.

Insurance revenue: change in liability vs allocation of premium

Insurance revenue for the premium allocation approach is determined either as the change in the liability for remaining coverage excluding the loss component (adjusted for the insurance finance expense, if needed) or as the allocation of the net premium over the coverage period. We show the two methods below.

The carrying value of the liability for remaining coverage at quarterly points is

- ! Policy inception: $(100 - 20) \times 100\% = 80$
- ! After 1 quarter: $(100 - 20) \times 75\% = 60$
- ! After 2 quarters: $(100 - 20) \times 50\% = 40$
- ! After 3 quarters: $(100 - 20) \times 25\% = 20$
- ! After 4 quarters: $(100 - 20) \times 0\% = 0$

The insurance revenue each quarter is the change in the carrying value of the liability for remaining coverage:

- ! 1 Quarter: $(100 - 20) \times (75\% - 100\%) = -20$
- ! 2 Quarter: $(100 - 20) \times (50\% - 75\%) = -20$
- ! 3 Quarter: $(100 - 20) \times (25\% - 50\%) = -20$
- ! 4 Quarter: $(100 - 20) \times (0\% - 25\%) = -20$

The time between providing each part of the coverage and the related premium due date is not more than a year in this illustration, so the insurer is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money.

If the time between providing each part of the coverage and the related premium due date is more than a year, or if the insurer chooses adjust the carrying amount of the liability for remaining coverage to reflect the time value of money (even though it is not required to do so), the carrying value of the liability for remaining coverage at the quarterly dates would use the discount rate at initial recognition of the insurance contracts:

- ! Policy inception: $(100 - 20) \times 100\% \times 1.06^0 = 80$
- ! After one quarter: $(100 - 20) \times 75\% \times 1.06^{0.25} = 60.88$
- ! After two quarters: $(100 - 20) \times 50\% \times 1.06^{0.50} = 41.18$
- ! After three quarters: $(100 - 20) \times 25\% \times 1.06^{0.75} = 20.89$
- ! After four quarters: $(100 - 20) \times 0\% \times 1.06^{1.00} = 0.00$

The change in the carrying value of the liability for remaining coverage is

- ! 1 Quarter: $(100 - 20) \times (75\% \times 1.06^{0.25} - 100\% \times 1.06^0) = -19.12$
- ! 2 Quarter: $(100 - 20) \times (50\% \times 1.06^{0.50} - 75\% \times 1.06^{0.25}) = -19.70$
- ! 3 Quarter: $(100 - 20) \times (25\% \times 1.06^{0.75} - 50\% \times 1.06^{0.50}) = -20.29$
- ! 4 Quarter: $(100 - 20) \times (0\% \times 1.06^{1.00} - 25\% \times 1.06^{0.75}) = -20.89$

The insurance finance expense by quarter is

- ! 1 Quarter: $(100 - 20) \times (1.06^{0.25} - 1) = 1.17$
- ! 2 Quarter: $(100 - 40) \times (1.06^{0.50} - 1.06^{0.25}) = 0.89$
- ! 3 Quarter: $(100 - 60) \times (1.06^{0.750} - 1.06^{0.50}) = 0.60$
- ! 4 Quarter: $(100 - 80) \times (1.06^{1.00} - 1.06^{0.75}) = 0.31$

The insurance revenue each quarter is the change in the carrying value of the liability for remaining coverage minus the insurance finance expenses:

- ! 1 Quarter: $-19.12 - 1.17 = -20.29$
- ! 2 Quarter: $-19.70 - 0.89 = -20.59$
- ! 3 Quarter: $-20.29 - 0.60 = -20.89$
- ! 4 Quarter: $-20.89 - 0.31 = -21.20$

The insurance revenue may also be computed as the premium allocated to the quarter and accumulated for the time value of money. The net premium of $100 - 20 = 80$ is allocated 20 to each quarter.³⁴

- ! 1 Quarter: $-20 \times 1.06^{0.25} = -20.29$
- ! 2 Quarter: $-20 \times 1.06^{0.50} = -20.59$
- ! 3 Quarter: $-20 \times 1.06^{0.75} = -20.89$
- ! 4 Quarter: $-20 \times 1.06^{1.00} = -21.20$

The insurance finance expense on the liability for remaining coverage (when it applies) uses the discount rate determined at initial recognition of the insurance contracts, not the current discount rate. In this illustration, even if the current discount rate changed to 6.5% after one quarter, the insurance finance expense uses the 6% discount rate determined at initial recognition.³⁵

Liability for incurred claims

The claims are expected to be paid more than one year from the date they occur, so the insurer is required to adjust the carrying amount of the liability for incurred claims to reflect the time value of money.³⁶

The discount rate for the fulfilment cash flows related to incurred claims is the current discount rate, not the discount rate determined at initial recognition.³⁷ The previous parts of this illustration show the exact formulas, with the claims occurring in 20X1 assumed to occur on September 30, 20X1, and the claims occurring in 20X2 assumed to occur on March 30, 20X2. For simplicity, we assume below that all claims occur on December 31, 20X1, so that we can focus on the dis-aggregation of the insurance finance expense between profit or loss and other comprehensive income without the complexity of specific claim dates. In practice, insurers should use the accident date of each claim.

The fulfilment cash flows for the incurred claims (assuming all occur on December 31, 20X1) are

- ! December 31, 20X1: $90 \times 1.07^{-3} = 73.47$
- ! December 31, 20X2: $90 \times 1.09^{-2} = 75.75$
- ! December 31, 20X3: $90 \times 1.08^{-1} = 83.33$
- ! December 31, 20X4: $90 \times 1.05^{-0} = 90.00$

The insurance finance expense for 20X2, 20X3, and 20X4 is

- ! 20X2: $90 \times (1.09^{-2} - 1.07^{-3}) = 2.28$
- ! 20X3: $90 \times (1.08^{-1} - 1.09^{-2}) = 7.58$
- ! 20X4: $90 \times (1.05^0 - 1.08^{-1}) = 6.67$

The total insurance finance expense for the three years is $2.28 + 7.58 + 6.67 = 16.53$.

The insurer makes an accounting policy choice on a portfolio by portfolio basis whether to report all insurance finance expense in profit or loss or to dis-aggregate the insurance finance expense between profit or loss and other comprehensive income. If the insurer dis-aggregates the insurance finance expense, the amount reported as profit or loss uses the discount rate determined at the date the claim occurs (not the date of initial recognition of the insurance contracts).³⁸

The discount rate determined when the claim occurs is 7% *per annum*, so the insurance finance expense that is recognized in profit or loss for 20X2, 20X3, and 20X4 is

- ! 20X2: $90 \times (1.07^{-2} - 1.07^{-3}) = 5.14$
- ! 20X3: $90 \times (1.07^{-1} - 1.07^{-2}) = 5.50$
- ! 20X4: $90 \times (1.07^0 - 1.07^{-1}) = 5.89$

The total insurance finance expense that is recognized in profit or loss for the three years is $5.14 + 5.50 + 5.89 = 16.53$.

The insurance finance expense reported as other comprehensive income for 20X2, 20X3, and 20X4 is

- ! 20X2: $2.28 - 5.14 = -2.86$
- ! 20X3: $7.58 - 5.50 = 2.08$
- ! 20X4: $6.67 - 5.89 = 0.78$

The total insurance finance expense reported as other comprehensive income for the three years is $-2.86 + 2.08 + 0.78 = 0.00$.

Claims paid under liability insurance contracts often depend on price levels at the date the claim is paid, not the date the claim occurs. The price level depends on the inflation rate, which may be correlated with interest rates, but changes in the price level are changes in the estimated value of the claim, not insurance finance expense.

Illustration: A claim occurs on December 31, 20X1, that is expected to be paid for 100 on December 31, 20X4.

- ! The risk-free interest rate (and the IFRS 17 discount rate) is 6% *per annum* on December 31, 20X1, and the loss cost trend is 7% *per annum*.
- ! On December 31, 20X2, the risk-free rate changes to 8% *per annum* and the loss cost trend changes to 9% *per annum*.

On December 31, 20X2, the estimated claim payment changes to $100 \times 1.09^2 / 1.07^2 = 103.77$.

The present value of the increase in the estimated claim payment, using the current discount rate, is $3.77 \times 1.08^{-2} = 3.23$, which is reported as insurance service expense for 20X2 and recognized as a loss in the 20X2 statement of profit or loss. The claim has already occurred, so changes in the fulfilment cash flows for this claim are recognized immediately in profit or loss.

The insurance finance expense is $100 \times (1.08^{-2} - 1.06^{-3}) = 1.77$, which is also recognized as a loss in the 20X2 statement of profit or loss. The insurance finance expense is the effect of the time value of money and the change in financial assumptions (the change in the current discount rate) on the value of the claim estimated at the beginning of the year, before the change in the estimate of the claim.

The total loss in the 20X2 statement of profit or loss is the insurance service expense plus the insurance finance expense = $3.23 + 1.77 = 5.00$.

The fulfilment cash flows at the beginning and end of 20X2 are

- ! January 1, 20X2: $100 \times 1.06^{-3} = 83.96$
- ! December 31, 20X2: $103.77 \times 1.08^{-2} = 88.97$

The change in the fulfilment cash flows is $103.77 \times 1.08^{-2} - 100 \times 1.06^{-3} = 5.00$.

End-notes:

¹ Pre-IFRS accounting systems for insurance contracts vary by country; the statements in the text do not apply to all pre-IFRS systems.

² See IFRS 17 *Basis for Conclusions* paragraph BC288: "IFRS 17 allows an entity to simplify the measurement of some groups of insurance contracts by applying a premium allocation approach."

³ See IFRS 17 *Basis for Conclusions* paragraph BC289: "The premium allocation approach permitted in IFRS 17 is similar to the customer consideration approach in IFRS 15. In the premium allocation approach, the initial measurement of the liability equals the premium received, and unless the group of insurance

contracts is onerous, the entity does not identify explicitly the components otherwise used in IFRS 17 to build the measurement of the insurance contract, ie the estimate of future cash flows, the time value of money and the effects of risk,” and IFRS 17 *Basis for Conclusions* paragraph BC96: “... the premium allocation approach ... would result in accounting similar to that which would result from applying IFRS 15.”

⁴ IFRS 17 paragraph 53 says that an insurer “(a) may use the premium allocation approach ... if it produces a measurement of the liability for remaining coverage ... that does not differ materially from the one ... produced [by the general measurement model] or (b) the coverage period of each contract ... is one year or less.” IFRS 17 *Basis for Conclusions* paragraph BC291 explains that “an entity [is] permitted, but not required, to apply the premium allocation approach when that approach provides a reasonable approximation to the general requirements of IFRS 17. ... the premium allocation approach [is] a simplification of those general requirements. ... an entity could assume, without further investigation, that the approach provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less.”

⁵ IFRS 17 says that the insurer may *not* reasonably expect that the liability for remaining coverage produced by the premium allocation approach would not differ materially from the liability for remaining coverage produced by the general measurement model if it expects “significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage ... before a claim is incurred.”

⁶ IFRS 17 paragraph 54 says that the premium allocation approach may not be used if the insurer “expects significant variability in the fulfilment cash flows ... before a claim is incurred. Variability ... increases with ... derivatives embedded in the contracts and the length of the coverage period ...”

⁷ Some general insurance contracts have coverage periods slightly longer than one year, such as a 13 month insurance contract issued on December 1 so that the renewal date is January 1. These contracts are not long duration.

⁸ To be precise, IFRS 17 compares the pattern of release of the risk adjustment for non-financial risk (not the variation in claim costs) to the passage of time. See IFRS 17 paragraph B126: “... insurance revenue for the period is the amount of expected premium receipts ... allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage: (a) on the basis of the passage of time; but (b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.” See also IFRS 17 *Basis for Conclusions* paragraph BC290: “... the liability for remaining coverage is recognised over the coverage period on the basis of the passage of time unless the expected pattern of release from risk differs significantly from the passage of time, in which case it is recognised based on the expected timing of incurred claims and benefits.”

⁹ See IFRS 17 paragraph 53: “An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach ... if, and only if, at the inception of the group (a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the [general measurement model] ... or (b) the coverage period of each contract in the group ... is one year or less.” Paragraph 15(a) is the basic requirement for using the premium allocation approach; paragraph 15(b) adds that contracts with coverage periods of one year or less meet the requirement and need not be further tested. See IFRS 17 *Basis for Conclusions* paragraph BC291: “an entity should be permitted, but not required, to apply the premium allocation approach when that approach provides a reasonable approximation to the general requirements of IFRS 17. The Board views the premium allocation approach as a simplification of those general requirements. To simplify its application, the Board also decided to provide guidance that an entity could assume, without further investigation, that the approach provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less.”

¹⁰ See IFRS 17 *Basis for Conclusions* paragraph BC292(a): "... entities should accrete interest on the liability for remaining coverage only for groups of insurance contracts that have a significant financing component. When the period between premiums being due and the provision of coverage is one year or less, the group is deemed not to have a significant financing component."

¹¹ See IFRS 17 *Basis for Conclusions* paragraph BC202(b): "... entities ... need to assess whether groups of insurance contracts are onerous only when facts and circumstances indicate that a group of insurance contracts has become onerous."

¹² See IFRS 17 paragraph 57: "If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between (a) the carrying amount of the liability for remaining coverage determined [by the premium allocation approach] and (b) the fulfilment cash flows that relate to remaining coverage [determined by the general measurement model]," and IFRS 17 paragraph 58: "To the extent that the fulfilment cash flows that relate to remaining coverage [determined by the general measurement model] exceed the carrying amount [of the liability for remaining coverage determined by the premium allocation approach] the entity shall recognise a loss in profit or loss and increase the liability for remaining coverage."

¹³ See IFRS 17 paragraph 57: "If ... the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment." In practice, insurers may not adjust the premium allocation approach liability for remaining coverage for the time value of money if the coverage period is one year or less, but they may adjust the premium allocation approach liability for incurred claims for the time value of money if the loss payment lag is more than one year.

¹⁴ See IFRS 17 *Basis for Conclusions* paragraph BC292(c): "... entities ... are permitted to recognise all insurance acquisition cash flows as an expense when incurred for groups of insurance contracts each with a coverage period of one year or less."

¹⁵ See IFRS 17 *Basis for Conclusions* paragraph BC293: "The premium allocation approach measures the group of insurance contracts using estimates made at initial recognition and does not update those estimates in the measurement of the liability for remaining coverage unless the group is or becomes onerous. Accordingly, IFRS 17 requires that entities, when accreting interest on the liability for remaining coverage, set the discount rate when the group is initially recognised."

¹⁶ See IFRS 17 *Basis for Conclusions* paragraph BC294: "IFRS 17 also allows a simplification for the measurement of the liability for incurred claims – an entity need not discount claims that are expected to be paid within one year."

¹⁷ If the claim settlement lag is more than one year, the only difference between the liability for incurred claims in the two measurement models is that the dis-aggregation between profit or loss and other comprehensive income for the premium allocation approach uses the discount rate determined when the claim occurs, not the discount rate determined at initial recognition (as discussed below in the text).

¹⁸ See IFRS 17 paragraph 69: "An entity may use the premium allocation approach (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held ..."

¹⁹ See IFRS 17 paragraph 59(a): "in applying the premium allocation approach, an entity may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year."

²⁰ See IFRS 17 paragraph 56: “If insurance contracts ... have a significant financing component, an entity shall adjust ... the liability for remaining coverage to reflect the time value of money ... the entity is not required to adjust ... the liability for remaining coverage to reflect the time value of money ... if the time between providing ... the coverage and the related premium due date is no more than a year.” Long duration contracts (such as whole life insurance) may not generally use the premium allocation approach.

²¹ See IFRS 17 paragraph 57: “if ... facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between (a) the carrying amount of the liability for remaining coverage and (b) the fulfilment cash flows that relate to remaining coverage of the group,” and IFRS 17 paragraph 58: “if the fulfilment cash flows exceed the [liability for remaining coverage] ... the entity shall recognise a loss in profit or loss and increase the liability for remaining coverage.”

²² See IFRS 17 paragraph 57(b): “If ... the entity does not adjust the liability for incurred claims [in the premium allocation approach] for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment.”

²³ See IFRS 17 paragraph 55: “Using the premium allocation approach, an entity shall measure the liability for remaining coverage ... on initial recognition [as] the premiums ... received at initial recognition ... minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense ...”

²⁴ See IFRS 17 paragraph 59(b).

²⁵ See IFRS 17 paragraph 42: “An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for incurred claims:

- (a) insurance service expenses – for the increase in the liability because of claims and expenses incurred in the period ... [that is, current service]
- (b) insurance service expenses—for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses ...[that is, past service].”

²⁶ See IFRS 17 paragraph 59(b).

²⁷ See IFRS 17 Appendix A (Defined terms): “experience adjustment [is] a difference between ... (b) for insurance service expenses (excluding insurance acquisition expenses) – 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.”

²⁸ The premium allocation approach reduces measurement complexity. Most general insurers track incurred claims separately from the policies giving rise to the claims. They keep the accident date of the claim, not the policy effective date of the insurance contract giving rise to the claim. Accretion of interest on these claims is simpler using the discount rate from the accident date.

²⁹ See IFRS 17 paragraph 55: “Using the premium allocation approach, an entity shall measure the liability for remaining coverage ... on initial recognition [as] the premiums ... received at initial recognition ... minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense ...” In this scenario, the acquisition cash flows are recognized as an expense at initial recognition, so the liability for remaining coverage is the premium received.

³⁰ See IFRS 17 paragraph 55: “Using the premium allocation approach, ... at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period: (i) plus the premiums received in the period; (ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense ... (iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense ... (iv) plus any adjustment to a financing

component ... (v) minus the amount recognised as insurance revenue for coverage provided in that period ...” In this scenario, the acquisition cash flows are recognized as an expense at initial recognition and the liability for remaining coverage is not adjusted for the time value of money (financing component), so the liability for remaining coverage is reduced by the insurance revenue for the coverage provided, or the premium for half a year. Since the date the premium is due is one year or less than the dates the insurance services are provided, the insurer need not accrete interest on the liability for remaining coverage. See IFRS 17 paragraph 56: “If insurance contracts in the group have a significant financing component, an entity shall adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using the discount rates ... as determined on initial recognition. The entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year.”

³¹ If the unamortized acquisition expenses are included in the liability for remaining coverage, the acquisition expenses accrete interest only if the liability for remaining coverage accretes interest.

³² See IFRS 17 paragraph 56: “... adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using the discount rates ... determined on initial recognition.” See also IFRS 17 paragraph B72(d): “An entity shall use the following discount rates in applying IFRS 17 ... 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 ... discount rates determined on initial recognition.”

³³ The IASB initially intended to use the discount rate determined at initial recognition of the insurance contracts for the premium allocation approach as well, but several insurers told the IASB that the discount rate at the date the claim occurs simplifies the accounting. IFRS 17 *Basis for Conclusions* paragraph BC295 explains: “In the 2013 Exposure Draft, the Board proposed using the discount rate at initial recognition to achieve consistency with the measurement of the liability for remaining coverage. However, both preparers and users of financial statements expressed the view that using the discount rate at the date the claim was incurred would be less complex than using the rate at the inception of the contract. The liability for incurred claims is zero when the group of insurance contracts is initially recognised and the entity may not have determined a discount rate at that time. The Board concluded that the premium allocation approach, which was developed as a simplification, should not burden entities by creating high costs and operational complexity. Consequently, IFRS 17 requires that entities measure the interest expense for the liability for incurred claims using the rate that applied when the liability for incurred claims was initially recognised, rather than when the group of insurance contracts was initially recognised.” The interest expense in the paragraph above (IFRS 17 *Basis for Conclusions* paragraph BC295) refers to the interest expense in IFRS 17 *Basis for Conclusions* paragraph BC294, which is the interest expense shown in the statement of profit or loss: “... in considering how to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income ... the Board considered requiring the interest expense for the liability for incurred claims to be measured using either: (a) the discount rate at initial recognition of the contract; or (b) the discount rate at the date the claims included in the liability for incurred claims occur.”

³⁴ See IFRS 17 paragraph B126: “When an entity applies the premium allocation approach ... insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable ... allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage ... on the basis of the passage of time”

³⁵ See IFRS 17 paragraph B72(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 ... discount rates ... determined on initial recognition; See also IFRS 17 *Basis for Conclusions* paragraph BC293: “The premium allocation approach measures the group of insurance contracts using estimates made at initial recognition and does not update those estimates in the measurement of the liability for remaining

coverage unless the group is or becomes onerous. Accordingly, IFRS 17 requires that entities, when accreting interest on the liability for remaining coverage, set the discount rate when the group is initially recognised.”

³⁶ IFRS 17 paragraph 59(b) says that the insurer ... “shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims ... the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.” This paragraph implies that the insurer may elect to discount the claims that will be paid more than one year from the date they occur and not to discount the claims that will be paid within one year. The illustration here assumes the insurer discounts all the claims, discounting only some of the claims adds more complexity.

³⁷ IFRS 17 paragraphs 56 and B72(d), which specify the discount rate determined at initial recognition for the premium allocation approach, apply to the liability for remaining coverage, not to the liability for incurred claims.

³⁸ See IFRS 17 paragraph B72(e)(iii): “... if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income ... to determine the amount of the insurance finance income or expenses included in profit or loss ... 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.” Paragraphs 59(b) and B133 refer to the liability for incurred claims in the premium allocation approach, not to the liability for remaining coverage. See also IFRS 17 paragraph B133: “In applying the premium allocation approach ... an entity may be required, or may choose, to discount the liability for incurred claims. In such cases, it may choose to disaggregate the insurance finance income or expenses ... If the entity makes this choice, it shall determine the insurance finance income or expenses in profit or loss using the discount rate specified in paragraph B72(e)(iii).”