

**IFRS 17 Accounting Policy Paper: Insurance acquisition cash flows**

|                               |   |
|-------------------------------|---|
| <b>Date:</b>                  | November 10, 2021                       |
| <b>Approvers / Reviewers:</b> | Approved by:<br>FA Accounting Committee |
| <b>Subject:</b>               | Insurance Acquisition Cash flows        |

**Disclaimer:**

This accounting policy paper, which is the responsibility of the Facility Association's (FA) management, is prepared solely for the FA as administrator of certain insurance pools, namely the Facility Association Residual Market (FARM) and each of the Risk Sharing Pools (RSPs). It is intended solely for the use of the FA to document management's accounting policy determinations under IFRS 17 as part of management's internal financial reporting and governance processes as applicable to the FARM and each of the RSPs.

This accounting policy paper is being made available through the FA website to member insurance companies for general information purposes only and does not constitute advice from the Facility Association. Member insurance companies are responsible for their own assessment of IFRS 17 as applicable to their financial reporting. We disclaim any responsibility to any member insurance company who may rely on this document.

## Content

|   |    |
|---|----|
| Purpose .....   | 3  |
| Executive Summary .....   | 4  |
| Question 1: Which expenses are considered “directly attributable”?.....                               | 5  |
| Question 2: Which directly attributable expenses are considered “insurance acquisition cash flows”? . | 8  |
| Question 3: Will the insurance acquisition cash flows be expensed or deferred?.....                   | 12 |

## **Purpose**

This paper summarizes Facility Association's interpretation of the requirements of IFRS 17 relating to directly attributable insurance acquisition cash flows and the application of those requirements to contracts issued via the Facility Association Residual Market ("FARM") and contracts assumed through the Risk Sharing Pools ("RSPs"). This includes determining which expenses incurred are "directly attributable", which of those expenses are considered "insurance acquisition cash flows" and how these will be recorded and measured, including accounting policy choices and conclusions reached on key judgments.

## **Entities:**

Facility Association (FA) administers three types of mechanisms on behalf of its membership. This paper covers only the two mechanisms in the scope of IFRS 17, namely:

- Facility Association Residual Market ("FARM")
- Risk Sharing Pools ("RSPs")\*

\* Outside the scope of this paper are requirements relating to the direct business issued by the individual members prior to transferring the business to the RSPs. Only business assumed via the RSPs will be addressed in this memo.

## **Topics Covered**

The topics covered in this paper are as follows:

1. Which expenses are considered "directly attributable"?
2. Which directly attributable expenses are considered "insurance acquisition cash flows"?
3. Will the insurance acquisition cash flows be expensed or deferred?

## **Dependencies and Relationships**

The technical positions developed in this paper affect (i.e., have downstream dependency on) or are affected by the conclusions of the following papers:

1. Scope
2. Level of aggregation
3. Initial recognition and contract boundary
4. Initial and subsequent measurement
5. Risk adjustment
6. Discount rate
7. Transition
8. Modification and extinguishment of insurance contract

## Executive Summary

FA reached the following conclusions regarding the requirements of IFRS 17 relating to directly attributable insurance acquisition cash flows and the application of those requirements to contracts issued via the FARM and contracts assumed through the RSPs:

- 1- Which expenses are considered “directly attributable”?
  - a. FARM:
    - i. 100% of all expenses incurred by (or attributed to) the FARM are directly attributable to the fulfilment of contracts.
  - b. RSPs:
    - i. 100% of all expenses incurred by (or attributed to) the RSPs are directly attributable to the fulfilment of contracts.
- 2- Which directly attributable expenses are considered “insurance acquisition cash flows”?
  - a. FARM:
    - i. Agent/broker commission and driver record abstracts would be considered insurance acquisition cash flows.
  - b. RSPs:
    - i. There are no directly attributable insurance acquisition cash flows relating to the RSPs.
- 3- Will the insurance acquisition cash flows be expensed or deferred?
  - a. FARM:
    - i. Insurance acquisition cash flows will be deferred and will be amortized on the same basis as insurance revenue (based on the passage of time).
  - b. RSPs:
    - i. Not applicable since no insurance acquisition cash flows have been identified.

**Question 1: Which expenses are considered “directly attributable”?**

*Technical References and Guidance*

**IFRS 17 Standard**

- B65 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:
- (a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.
  - (b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (i.e. reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).
  - (c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.
  - (d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).
  - (e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.
  - (f) claim handling costs (i.e. the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).
  - (g) costs the entity will incur in providing contractual benefits paid in kind.
  - (h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.
  - (i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.
  - (j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.
  - (k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.
  - (ka) costs the entity will incur:
    - (i) performing investment activity, to the extent the entity performs that activity to enhance benefits from insurance coverage for policyholders. Investment activities enhance benefits from insurance coverage if the entity performs those activities expecting to generate an investment return from which policyholders will benefit if an insured event occurs.

- (ii) providing investment-return service to policyholders of insurance contracts without direct participation features (see paragraph B119B).
- (iii) providing investment-related service to policyholders of insurance contracts with direct participation features.
- (l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.
- (m) any other costs specifically chargeable to the policyholder under the terms of the contract.

**B66** The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

- (a) investment returns. Investments are recognised, measured and presented separately.
- (b) cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately.
- (c) cash flows that may arise from future insurance contracts, ie cash flows outside the boundary of existing contracts (see paragraphs 34–35).
- (d) cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred.
- (e) cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in profit or loss when incurred.
- (f) income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity or that are not specifically chargeable to the policyholder under the terms of the contract. Such payments and receipts are recognised, measured and presented separately applying IAS 12 Income Taxes.
- (g) cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders.
- (h) cash flows arising from components separated from the insurance contract and accounted for using other applicable Standards (see paragraphs 10–13).

The concept of “directly attributable” is not defined in IFRS 17, and therefore its definition is open to interpretation. Such expenses generally relate to the cost of acquiring and maintaining groups of insurance contracts. As illustrated above, B65 explains that cash flows are within the boundary of the insurance contract if they relate directly to the fulfillment of insurance contract and B66 defines clearly which cash flows shall not be included when estimating the cash flows. However, between the expenses that are and are not clearly directly attributable, there can be a grey area in the classification of costs which requires judgement from the part of management.

### **FARM:**

The members' participation report includes several expense categories as follows:

1. Claim service fees;
2. Operating and service fees;
3. Agent/broker commissions;
4. Administration expenses; and
5. Driver record abstracts

As the sole purpose of the FARM is to ensure the availability of a residual automobile insurance market for owners and operators of motor vehicles required by law to have insurance who may otherwise have difficulty obtaining such insurance, all expenses incurred by the mechanism is related to this objective. As such, 100% of the expenses currently reported within the financial statements of the FARM are directly attributable.

**100% of the expenses incurred by the Collective through the FARM are directly attributable expenses under IFRS 17**

### **RSP:**

The members' operational report includes several expense categories as follows:

1. Expense allowance
2. Claims related expenses
3. Administration expenses

As the sole purpose of the RSPs is to facilitate the sharing of the risks for Canadian insurers, 100% of all expenses incurred by (or attributed to) the RSPs are assumed to be directly attributable to the fulfilment of insurance contracts. Only the expenses relating to this objective are allocated to the pools with no general expenses included.

**100% of the expenses incurred by the Collective through the RSPs are directly attributable expenses under IFRS 17**

### **Technical Position**

| <b>Mechanism</b> | <b>Technical Position</b>                      |
|------------------|--|
| FARM             | 100% of the expenses are directly attributable |
| RSPs             | 100% of the expenses are directly attributable |

**Question 2: Which directly attributable expenses are considered “insurance acquisition cash flows”?**

*Technical References and Guidance*

**IFRS 17 Standard**

**App A - Insurance acquisition cash flows:**

Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts (issued or expected to be issued) that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

BC182 However, the Board noted that:

- (a) including only insurance acquisition cash flows that are incremental at a contract level would mean that entities would recognise different contractual service margins and expenses depending on the way they structure their acquisition activities. For example, there would be different liabilities reported if the entity had an internal sales department rather than outsourcing sales to external agents. In the Board’s view, differences in the structure of insurance acquisition activities would not necessarily reflect economic differences between insurance contracts issued by the entities.
- (b) an entity typically prices insurance contracts to recover not only incremental costs, but also other direct costs and a proportion of indirect costs incurred in originating insurance contracts—such as costs of underwriting, medical tests and inspection, and issuing the policy. The entity measures and manages these costs for the portfolio, rather than for the individual contract. Accordingly, including insurance acquisition cash flows that are incremental.

As defined above, insurance acquisition cash flows are cash flows arising from the cost of selling, underwriting and starting a group of insurance contracts that are both directly and indirectly attributable to the portfolio of insurance contracts to which the group belongs.



**FARM:**

As noted under question 1, FARM financial statements include various types of expenses. The members' participation report includes the following expenses:

| Type of expense             | Description  | Conclusion  |
|-----------------------------|--|---|
| Claim service fees:         | These include servicing carrier costs associated with settling claims (calculated as a percentage of earned premiums) as well as legal and claims related professional fees  | These would <u>not</u> be considered insurance acquisition cash flows   |
| Operating and service fees: | These are servicing carrier costs associated with administering policies (calculated as a percentage of premiums written)  | These would <u>not</u> be considered to be insurance acquisition cash flows.  |
| Agent/broker commissions:   | These represents the commission paid the agents/brokers entering into a contract with the policyholders.   | These <u>would be</u> considered to be insurance acquisition cash flows as these are costs incurred to sell, underwrite and start a group of contracts.   |
| Administration expenses:    | These comprise of all FA operational and administration costs charged to FARM based on a set percentage. These are categorized:<br>i. Head office & operating (i.e., payroll, lease costs, etc.);<br>ii. Professional fees (i.e., audit, legal fees, etc.); and<br>iii. Data & processing (i.e., service fees, system maintenance, etc.) | These would <u>not</u> be considered insurance acquisition cash flows as costs incurred to "sell, underwrite or start a group of contracts" would be incurred by the Servicing Carriers and included within Agent/broker commissions (above). |
| Driver record abstracts     | These are the costs associated with obtaining driving record abstracts (documents outlining one's driving history) for insureds  | These <u>would be</u> considered to be insurance acquisition cash flows as these are costs incurred to sell, underwrite and start a group of contracts.   |

**Agent/broker commissions and driver record abstracts would be considered insurance acquisition cash flows.**

**RSPs:**

IFRS 17 defines “insurance acquisition cash flows” as per above.

Article 11 (section 1-5) of the FA Plan of Operations on Risk Sharing Pools provides basis for expense allowance paid to members by the RSPs on acquiring insurance risks. It states *“the member shall be entitled as a result of the transfer of premium to an expense allowance in an amount equal to a percentage of the written premium applicable to the transferred coverages, such percentage for use during a calendar year to be calculated on the basis set out in the Accounting and Statistical Manual using the base information employed to calculate the expense factor included in the member’s rate filing with respect to private passenger vehicle coverage last approved by the applicable rate approving body for the jurisdiction in which the Ontario Pool is operating prior to August 31<sup>st</sup> of the year immediately prior to the calendar year in which the transfer is made. The Board shall from time to time establish a maximum percentage of premiums for such expense allowance and if the calculation of the member’s expense allowance percentage is higher than such percentage, then the percentage established by the Board as a maximum shall be used”*.

The expense allowance exists to compensate members (i.e., the individual member who wrote the initial policy) for the costs incurred acquiring, underwriting and starting the insurance contract which was ultimately ceded to the RSP. However, expense allowance paid to members is not an insurance acquisition cash flow.

IFRS 17 TRG meeting in September 2018<sup>1</sup> clarified that unlike insurance acquisition costs that are usually paid, for example, to a third-party intermediary, ceding commissions are paid by the reinsurer to the cedant who is the customer buying the contract. Insurance acquisition cash flows are defined as cash flows arising from costs – the costs of selling, underwriting and starting a group of insurance contracts. The TRG paper states that unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, the ceding commission reflects a reduction in the transaction price, and not insurance acquisition cash flows to the reinsurer.

The ceding commission may reflect compensation that the reinsurer provides the cedant for acquisition costs that the cedant incurs for underlying insurance contracts, but this does not make the commission an acquisition cost of the reinsurer.

As such, as detailed by the TRG extract above, since the RSPs are considered to be reinsurance for the collective of members assuming the contracts through the RSPs, the expense allowance retained by cedants should be netted against premiums. Therefore, there is no directly attributable insurance acquisition cash flows for RSP.

---

<sup>1</sup> APR3 : Commissions and reinstatement premiums in reinsurance contracts issued (reposted on September 12, 2018) ifrs.com

| Type of expense         | Description   | Conclusion   |
|-------------------------|---|--|
| Expense allowance       | See description above from the Plan of Operations, the expense allowance exists to compensate members for costs incurred.   | These would not be considered insurance acquisition cash flows (“all costs incurred to “sell, underwrite or start a group of contracts” would be incurred by the insurers who transferred contracts into the pool and implicit within the expense allowance (which is net of premium)) |
| Claims incurred         | These include costs associated with settling claims.  | These would not be considered insurance acquisition cash flows   |
| Administration expenses | These comprise of all FA operational and administration costs charged to RSP based on a set percentage. These are categorized:<br>i. Head office & operating (i.e., payroll, lease costs, etc.);<br>ii. Professional fees (i.e., audit, legal fees, etc.); and<br>iii. Data & processing (i.e., service fees, system maintenance, etc.) | These would not be considered insurance acquisition cash flows   |

**There are no directly attributable insurance acquisition cash flows relating to the RSP**

### Technical Position

| Mechanism | Technical Position   |
|-----------|--|
| FARM      | Agent/broker commissions and driver record abstracts would be considered insurance acquisition cash flows. |
| RSPs      | There are no directly attributable insurance acquisition cash flows relating to the RSPs                   |

### Question 3: Will the insurance acquisition cash flows be expensed or deferred?

#### *Technical References and Guidance*

##### **IFRS 17 Standard**

- 24 An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition and add contracts to the groups applying paragraph 28, and the entity shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.
- 28A An entity shall allocate insurance acquisition cash flows to groups of insurance contracts using a systematic and rational method applying paragraphs B35A–B35B, unless it chooses to recognise them as expenses applying paragraph 59(a).
- 28B An entity not applying paragraph 59(a) shall recognise as an asset insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised applying another IFRS Standard) before the related group of insurance contracts is recognised. An entity shall recognise such an asset for each related group of insurance contracts.
- 28C An entity shall derecognise an asset for insurance acquisition cash flows when the insurance acquisition cash flows are included in the measurement of the related group of insurance contracts applying paragraph 38(c)(i) or paragraph 55(a)(iii).
- 28D If paragraph 28 applies, an entity shall apply paragraphs 28B–28C in accordance with paragraph B35C.
- 28E At the end of each reporting period, an entity shall assess the recoverability of an asset for insurance acquisition cash flows if facts and circumstances indicate the asset may be impaired (see paragraph B35D). If an entity identifies an impairment loss, the entity shall adjust the carrying amount of the asset and recognise the impairment loss in profit or loss.
- 28F An entity shall recognise in profit or loss a reversal of some or all of an impairment loss previously recognised applying paragraph 28E and increase the carrying amount of the asset, to the extent that the impairment conditions no longer exist or have improved.
- 59 In applying the premium allocation approach, an entity:
- (a) 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.
  - (b) shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and B36–B92. However, 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.

## FARM

As stated in IFRS 17.59 (a), under the PAA (see Initial and subsequent measurement accounting policy memo for PAA assessment of FARM) an entity may choose to recognize 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.

This option is available to FARM as the coverage period of each contract (individual policy) is 12 months. However, FA has decided to defer the insurance acquisition cash flows and to amortize them in a pattern consistent with insurance revenue – being in accordance with the passage of time.

**Insurance acquisition cash flows will be deferred and amortised in a pattern consistent with insurance revenue (in accordance with the passage of time)**

## RSP

No analysis required as there is no insurance acquisition cash flows.

**No analysis required; no insurance acquisition cash flows**

### Technical Position

| Mechanism | Technical Position  |
|-----------|---|
| FARM      | Insurance acquisition cash flows will be deferred and amortised in a pattern consistent with insurance revenue (in accordance with the passage of time) |
| RSP       | No analysis required; no insurance acquisition cash flows   |