IFRS 17: Matters for Non-insurance Entities

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Non-insurance entities can issue insurance contracts. If an entity issues a contract that meets the definition of an insurance contract, it needs to apply IFRS 17 *Insurance Contracts* unless a specific scope exemption is met. This is the case for all entities, whether or not the entity is a regulated insurance company or financial institution.

The definition of an insurance contract in IFRS 17 has not changed significantly from that in IFRS 4 *Insurance Contracts.* However, the accounting under IFRS 17 can be significantly more complex than under IFRS 4. For example, while IFRS 4 permitted entities to unbundle the insurance element of contracts and apply IFRS 4 to those insurance elements, IFRS 17 applies to the whole contract, with limited exceptions, and has detailed measurement requirements.

IFRS 17 is mandatorily applicable for annual reporting periods beginning on or after January 1, 2023, with restatement of comparative periods. Therefore, entities that are not insurance companies should assess whether they have issued contracts which fall within the scope of IFRS 17.

The Group discussed the following issues pertaining to the application of IFRS 17 to non-insurance entities.

Issue 1: What is an insurance contract?

Analysis

Appendix A of IFRS 17 defines an insurance contract as, "A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Insurance risk is a non-financial risk transferred from the holder of the contract to the issuer. Examples of non-financial risk include the risk from damage to property or the risk of failure of a product or service that the entity sells to be fit for purpose. Non-financial risk becomes insurance risk when one party accepts this risk from another party.

Insurance risk is considered significant if a scenario has commercial substance in which the insurer could possibly suffer a loss on a present value basis and pay significant additional amounts beyond what would be payable if the insured event had not occurred. To have commercial substance, a scenario must have a discernible effect on the economics of the transaction.

The significance of insurance risk is assessed on a contract-by-contract basis. As a result, even if there is a minimal probability of significant losses on a portfolio or group of contracts, insurance risk can be significant for an individual contract. Paragraph BC67 of IFRS 17 clarifies that the assessment of significant insurance risk is made on a "present value" basis. This was not clearly specified in IFRS 4.

For a specified uncertain future event to exist, at least one of the following must be uncertain at the inception of the contract:

(a) the probability of an insured event occurring;

(b) when the insured event will occur; or

(c) how much the insurer will need to pay if the insured event occurs.

To meet the definition of an insurance contract, the issuer must be required to compensate the policyholder if the specified uncertain event occurs. That compensation may be in the form of cash or payments in-kind, such as repair services.

The following are arrangements that are likely to be accounted for as insurance contracts by the provider (issuer):

(a) warranties issued on products or services not sold by the entity;

(b) performance bonds;

(c) indemnity issued by a vendor in a sale of its business;

(d) guarantees of minimum profit; and

(e) contracts that guarantee a minimum level of output (e.g., electricity generated by a solar plant).

The Group's Discussion

Several Group members indicated that this discussion should help raise awareness of the approaching effective date of IFRS 17. They noted it should encourage non-insurance entities that have not yet evaluated their contracts under IFRS 17 to do so and assess any impact of the new standard on their financial statements. One Group member commented that some contracts that were not in scope of IFRS 4 will be in scope of IFRS 17. Most Group members agreed this analysis provides a good reference for non-insurance entities to evaluate whether any of their contracts are in scope of the new standard.

Some Group members described examples of contracts in practice that might be considered insurance contracts. For example, some maintenance contracts that do not meet the fixed-fee service contracts scope exemption (discussed below) might be in scope. One Group member pointed out that some parent entities provide guarantees on behalf of a subsidiary. In such cases, the guarantee might be considered an insurance contract from the perspective of the parent's separate financial statements, but not for the consolidated group. An entity would consider the scope exemption for financial guarantee contracts in paragraph 7(e) of IFRS 17. Another Group member pointed out that entities in the public sector might consider whether certain laws and regulations create a substantive obligation that might be relevant when assessing whether an insurance contract within the scope of IFRS 17 exists.

Issue 2: Scope exemptions from IFRS 17

Analysis

The scope of IFRS 17 excludes various items that may meet the definition of an insurance contract, such as product warranties, financial guarantee contracts, fixed-fee service contracts, and credit

card contracts. IFRS 17 does not apply to these contracts, provided certain conditions are met. Several of these scope exemptions are discussed in more detail below.

Warranties

Per paragraph 7(a) of IFRS 17, "an entity shall not apply IFRS 17 to warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer."

This scope exemption applies if the entity that manufactures or supplies the good or service is the same entity that provides the warranty. For example, a company manufactures printers and sells them directly to customers. At the time of sale, it gives customers a free one-year warranty to cover repairs due to manufacturing defects. In addition, at the time of sale, the customer can choose to purchase a two-year extended warranty to cover repairs for a fixed price.

In the above example the scope exemption would apply to both the basic and extended warranty because they are both offered by the manufacturer in connection with the sale of its goods.

Entities should be alert to circumstances where the legal entity, which is the manufacturer, dealer or retailer of the goods or services, is different from the legal entity that offers the warranty. For example, consider a variation of the above example where the extended warranty contract and related repairs is provided by a subsidiary. The scope exemption would be met in the group's consolidated financial statements because the group both sells the products and provides warranties on the products. However, from the perspective of the subsidiary's stand-alone financial statements, the scope exemption for warranties would not appear to be met because the subsidiary which provides the extended warranty is not the manufacturer, retailer or dealer of the products. The subsidiary may consider whether the extended warranty contract meets the fixed-fee service scope exemption (discussed below).

Fixed-fee service contracts

Per paragraph 8 of IFRS 17, an entity may choose to apply IFRS 15 *Revenue from Contracts with Customers* instead of IFRS 17 to insurance contracts that have, as their primary purpose, the provision of services for a fixed fee. The entity may make that choice on a contract-by-contract basis, but the choice for each contract is irrevocable. This election is only available if the following conditions are met:

(a) the entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

(b) the contract compensates the customer by providing services, rather than by making cash payments to the customer; and

(c) the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

Entities need to apply judgment to determine whether the above conditions are met and, therefore, whether the contract would need to be accounted for under IFRS 17 or the choice of applying IFRS 17 and IFRS 15 is available. For example, if the contract is for vehicle repair and the pricing takes into account the nature of the vehicle (e.g., age, make, model) and/or the customer's history of repairs, this might reflect that the pricing for the contract is based on the individual risk assessment for that customer. Such a contract would likely not meet the first condition and would

need to be accounted for under IFRS 17 because there are indicators of an individual risk assessment that reflects the nature of an insurance contract rather than a service contract.

Credit card contracts

Paragraph 7(h) of IFRS 17 says that "an entity shall not apply IFRS 17 to credit card contracts, or similar contracts that provide credit or payment arrangements, that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the *insurance risk* associated with an individual customer in setting the price of the contract with that customer (see IFRS 9 and other applicable IFRS Standards). However, if, and only if, IFRS 9 requires an entity to separate an insurance coverage component (see paragraph 2.1(e)(iv) of IFRS 9) that is embedded in such a contract, the entity shall apply IFRS 17 to that component."

If the insurance component of the credit card contract is a contractual term, rather than required by local legislation, IFRS 9 *Financial Instruments* requires an entity to separate and apply IFRS 17 to that insurance component. Credit card issuers will need to apply judgment to evaluate whether the insurance coverage component is a contractual term of the credit card contract, considering the specific terms of the contract and local legislation governing credit card protection.

The Group's Discussion

One Group member indicated that the analysis of the fixed-fee service contracts exemption as it relates to vehicle service contracts requires clarification. This Group member noted that it is common for entities providing vehicle service contracts to set pricing based on a standard risk matrix that considers a variety of factors, including the vehicle's make, model and year. Therefore, it needs to be considered whether this type of pricing structure reflects an assessment of the risk associated with an individual customer. This Group member also commented that this type of pricing structure does not reflect an assessment of the risk associated with an individual customer because the same standard risk assessment is applied to all customers. Therefore, an entity using this type of pricing structure should be permitted to apply the fixed-fee service contract scope exemption.

Entities are also encouraged to consider whether the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services. Many fixed-fee service contracts which are currently accounted for under IFRS 15 are expected to qualify for the exemption.

Fact Pattern for Issue 3

- Entity A owns three retail properties and has decided to outsource their maintenance to Entity B for a five-year term for a fixed fee.
- Under the terms of the contract, Entity B is required to provide repairs and maintenance services to maintain the properties to an agreed upon standard, based on their condition at the inception of the contract. Repairs required as a result of external events, such as fires, are covered by Entity A's property insurance.
- The fixed fee, which was set at the inception of the contract, is based on Entity B's inspection of each of the properties.
- Assume that the scope exemption for fixed-fee service contracts is not met.

Issue 3: Identifying whether a contract qualifies as an insurance contract

Analysis

Determining whether a contract qualifies as an insurance contract, as defined in IFRS 17, will likely depend on understanding the nature of a company's business, the industry in which it operates and the specific terms of the contract. When evaluating contracts, it will be important for entities to consider the substance of the arrangements.

When evaluating whether a contract qualifies as an insurance contract, entities might consider asking themselves:

(a) Does the contract require the issuer to compensate the holder if a specified future uncertain event occurs?

(b) Does the specified uncertain future event adversely affect the policyholder?

(c) Has there been a transfer of significant insurance risk?

Note the following with regard to the Fact Pattern:

(a) There is a specified uncertain future event because it is uncertain whether any particular repair will be required, when it will be required and how much any particular repair will cost. Compensation would be in the form of repair services provided to Entity A.

(b) The need for a repair would adversely affect the policyholder as it would have to be remediated.

(c) By fixing the fee, Entity A has transferred risk to Entity B regarding the expenses of maintaining the properties. The risk of future repairs is a non-financial risk that has been transferred to Entity B. Therefore, this is an insurance risk.

At contract inception, Entity B would need to assess:

- if the insurance risk is significant by considering all scenarios, with commercial substance; and
- if there is a scenario that has commercial substance in which the issuer has the possibility of loss on a present value basis. Insurance risk is significant if an insured event could cause the issuer to pay significant additional amounts in any scenario with commercial substance, even if that scenario is extremely unlikely. Judgment will need to be applied in making this determination.

Entity B would need to assess the significance of insurance risk on a contract-by-contract basis. Therefore, insurance risk could be significant, even if there is a minimal probability of loss arising across all of Entity B's property management contracts. A significant loss could arise on any one contract, including the one with Entity A.

If the insurance risk is significant, this contract qualifies as an insurance contract in the scope of IFRS 17.

The Group's Discussion

The Group agreed with the analysis.

Some Group members noted that the contract in the example does not meet the scope exemption for fixed-fee service contracts due to the uncertainty surrounding the costs of services provided. The cost of building materials and labour has fluctuated significantly since the start of the pandemic. If this trend continues, it could be difficult for Entity B to determine the cost of any maintenance work required.

Issue 4: Next steps

Analysis

It is recommended that non-insurance entities identify contracts that may qualify as insurance contracts well in advance of the effective date of the standard to ensure a smooth implementation.

When evaluating whether contracts are in scope of IFRS 17, entities should consider the following:

(a) What are the non-financial/insurance risks that the entity has accepted in its contracts?

(b) Are such contracts specifically excluded from the scope of IFRS 17?

(c) Does the acceptance of these risks result in an insurance contract as defined in Appendix A of IFRS 17?

If a contract qualifies as an insurance contract, within the scope of IFRS 17, the entity will need to apply the requirements of IFRS 17. This includes grouping contracts that share similar risk characteristics and are managed together into portfolios then disaggregating them into groups for measurement purposes.

There are three ways to measure groups of insurance contracts: the general model, the premium allocation approach and the variable fee approach. The three models have similar objectives: they provide a mechanism to release the premium received as insurance revenue over the coverage period, resulting in a liability representing the compensation for promising to fulfill future claims and service costs and earn a profit margin. In addition, all three models require entities to separately recognize and provide for claims when incurred. Each model can be complex and has its own detailed measurement and disclosure requirements. Therefore, entities that have issued insurance contracts will need to carefully consider these detailed requirements, as well as whether new systems, processes and controls are necessary to accurately perform these calculations and provide the required disclosures.

The Group's Discussion

The Group agreed with the analysis.

One Group member commented that determining whether a contract falls within the scope of IFRS 17 can be a significant judgment for some entities. If this is the case, the entity should consider whether financial statement disclosure about such judgments is required. Another Group member commented that if a contract is an insurance contract within the scope of IFRS 17, it is possible that the pattern of income recognition may be similar to that in IFRS 15, but the disclosure requirements in IFRS 17 would be different.

Overall, the Group's discussion raised awareness of the impact of IFRS 17 on non-insurance entities. Given the new standard becomes effective from January 1, 2023, the Group recommended that the AcSB consider issuing material that steers preparers to existing publications from the IASB and the global accounting networks to help non-insurance entities understand the standard's requirements.

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