Canadian Institute of Actuaries
Institut canadien des actuaires

Explanatory Report

IFRS 17 Expenses

Committee on Life Insurance Financial Reporting
and
Committee on Property and Casualty Insurance Financial Reporting

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Canadian Institute of Actuaries / Institut canadien des actuaires

MEMORANDUM

To: Members in the life and health and property and casualty practice areas

From: Steven W. Easson, Chair Actuarial Guidance Council

Steve Bocking, Chair and Marie-Andrée Boucher, Immediate Past Chair
Committee on Life Insurance Financial Reporting

Sarah Ashley Chevalier, Chair
Committee on Property and Casualty Insurance Financial Reporting

Date: June 30, 2022

Subject: **Explanatory Report: IFRS 17 Expenses**

The Committee on Life Insurance Financial Reporting (CLIFR) and the Committee on Property and Casualty Insurance Financial Reporting (PCFRC) have prepared this report to provide information concerning expenses in accordance with IFRS 17 requirements.

The explanatory report is structured into six sections. Section 1 introduces the content presented in this explanatory report. The second section highlights the differences between IFRS 4 and IFRS 17 with regards to expenses. Section 3 constitutes the main section of the report, and presents considerations related to expenses under IFRS 17 with a focus on the concept of directly attributable expenses. The fourth section presents specific examples and considerations related to potential grey areas regarding classification of expenses as directly versus non-directly attributable, while Section 5 discusses other miscellaneous topics. The sixth and final section recommends disclosures that could be included in the Appointed Actuary's report to enable regulators to assess the range of practice regarding directly attributable expense classification in Canada. Appendix 1 provides an illustration of the LRC at initial and subsequent measurement under PAA including the treatment of deferred acquisition costs. Appendix 2 provides further detail on some expense types such as expenses included within liability for incurred claims (LIC) cash flows, expenses payable to the purchaser of the insurance or reinsurance contracts and expenses payable to intermediaries.

A preliminary version of the draft of this explanatory report was shared with the following committees:

- Committee on Risk Management and Capital Requirements (CRMCR)
- Appointed Actuary (AA) Committee
- International Insurance Accounting Committee (IIAC)
- Worker's Compensation Committee.

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A preliminary version of the draft of this explanatory report was also shared with the staff of the Accounting Standards Board (AcSB) to broaden consultations with the accounting community. Given that this report provides actuarial guidance rather than accounting guidance, the AcSB staff review was limited to citations of and any inconsistencies with IFRS 17. CIA reports do not go through the AcSB's due process and therefore, are not endorsed by the AcSB.

The draft of this explanatory report was also presented several times at the Actuarial Guidance Council (AGC) in the months preceding this request for approval. CLIFR and PCFRC are satisfied it has sufficiently addressed the comments received on the draft of this explanatory report and it was published in April 2021.

The following highlights the changes between this explanatory report and the draft published version:

- Updates on references and wording to the final version of the *Application of IFRS 17 Insurance Contracts* educational note (published in August 2021)
- Addition of Appendix 2 that provides further detail on some expense types such as expenses included within LIC cash flows, expenses payable to the purchaser of the insurance or reinsurance contracts and expenses payable to intermediaries
- Minor updates to wording

Given that the changes made to the final version of this explanatory report relative to the draft published version were not substantial, the final version of this explanatory report was only subject to a limited review by the CIA committees.

The creation of this memorandum and explanatory report has followed the AGC's protocol for the adoption of educational notes and other material. In accordance with the Institute's *Policy on Due Process for the Approval of Guidance Material other than Standards of Practice and Research Documents*, this report has been prepared by CLIFR and PCFRC and has received approval for distribution from the AGC on May 10, 2022.

CLIFR and PCFRC would like to acknowledge the contribution of its subcommittee that assisted in the development of this report: Wilson Ho (chair), Andrew Ryan, Boyang Liu, Claudette Cantin, Curtis Chim, David Howard, Denise Cheung, Dylan Lee, Faran Bahri, Harry Li, Louis-Philippe Morin-Lessard, Marie-Andrée Boucher, Mario St-Hilaire, Nicolas Sirois, Ping Xu, Simon Girard, and Veronika Molnar.

Questions or comments regarding this educational note may be directed to the Chairs of CLIFR and PCFRC and this subcommittee (noted above) at guidance.feedback@cia-ica.ca.

SWE, SB, MAB, SAC

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1. Introduction

IFRS 17 (or the Standard) establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the Standard. This explanatory report provides considerations relating to expenses under IFRS 17, and presents different views related to directly attributable expenses and other expense topics. While there is currently no consensus amongst the industry and accounting firms on some of the expense topics, CLIFR and PCFRC felt that a discussion of different perspectives and considerations will help Canadian actuaries to apply professional judgment in the application of the Standard. This explanatory report implicitly assumes that the actuary is accountable for determining expenses projected for groups of insurance contracts under IFRS 17, and should be read within that context. Given that actuaries will not have full accountability for the measurement of expenses in the valuation within many Canadian entities, combined with the lack of clear consensus on some key expense topics, CLIFR and PCFRC agreed to publish this paper as an explanatory report rather than as an educational note. This explanatory report may still provide helpful support when the actuary is not directly responsible for determining the expenses but must rely on that work in his/her valuation and opinion on the policy liabilities.

References to specific paragraphs of IFRS 17 are denoted by IFRS 17.XX, where XX represents the relevant paragraph number.

The guiding principles that the joint CLIFR/PCFRC subcommittee followed in writing this explanatory report were:

- consider Canadian-specific perspectives, rather than simply repeating international actuarial material;
- provide application options that are consistent with the IFRS 17 standard and applicable Canadian actuarial standards of practice and educational notes, without unnecessarily narrowing the choices available in the IFRS 17 standard; and
- consider practical implications associated with the implementation of potential methods; in particular, ensure that due consideration is given to options that do not require undue cost and effort to implement.

As a general statement, IFRS 17 valuation includes cash flows that relate directly to the fulfilment of an insurance contract. Refer to the CLIFR educational note *IFRS 17 Estimates of Future Cash Flows* for further guidance and the PCFRC educational note *IFRS 17 – Actuarial Considerations Related to Liability for Remaining Coverage in P&C Insurance Contracts*.

Expenses, like other cash flows, are allocated to *groups* of contracts under IFRS 17. Expense cash flows would include expenses related to particular contracts within the group. There would also be an allocation of other expenses directly attributable to the larger portfolio to which the group belongs. The latter requires more judgment than the former, and as such is the primary focus in this explanatory report.

Expense cash flows allocated to a group include costs of acquiring insurance contracts (acquisition expenses), and costs of fulfilling the obligations under insurance contracts (maintenance expenses). The distinction between acquisition and maintenance expenses is important for presentation and disclosure purposes.

- IFRS 17.B65 provides examples of cash flows that would be included in insurance contract valuation, including expense cash flows. Expenses specifically addressed in IFRS 17.B65 include claim handling costs, policy administration and maintenance costs, costs of paying benefits, allocations of acquisition costs, and allocations of overhead directly attributable to fulfilling insurance contracts. Transaction based taxes[1] and levies would also be included in insurance contract valuation.
- IFRS 17.B65(m) indicates that any other costs specifically chargeable to the policyholder under the terms of the contract would also be included in the estimates of future cash flows. This could be relevant for example for participating insurance contracts. More details are provided in section 5.2.5 of the *IFRS 17 Measurement and Presentation of Canadian Participating Insurance Contracts* educational note.

Expenses related to non-insurance business (such as the costs of issuing investment contracts or service contracts, and an associated share of overhead to these contracts), and expenses that do not relate directly to the acquisition or fulfilment of insurance contracts are referred to in this explanatory report as non-directly attributable expenses, and they are excluded from the measurement of insurance contracts under IFRS 17.

- IFRS 17.B66 provides examples of the types of cash flows that would not be included in the insurance contract valuation of direct contracts. Specific exclusions addressed in IFRS 17.B66 are expenses outside of the contract boundary, expenses not directly attributable to the fulfilment of insurance contracts, expenses from abnormal amounts of wasted labour, income tax payments (unless paid in a fiduciary capacity or specifically chargeable to the policyholder under the terms of the contract) and cash flows that arise under reinsurance contracts held.

Questions 2.20 to 2.29 of the *Application of IFRS 17 Insurance Contracts* educational note provides further guidance on expenses. This educational note, published in October 2021, is an adoption of the International Actuarial Note (IAN) 100, which is accompanied by a preamble. The preamble outlines a number of additional clarifications on the topics discussed in the final version of the IAN 100 that CIA members should be aware of.

2. Comparison between IFRS 4 and IFRS 17

2.1. Current practice: Life and health

Prior to the effective date of IFRS 17, insurance contract liabilities are subject to IFRS 4, which for life and health insurance contracts in Canada was the Canadian Asset Liability Method (CALM) as guided by CIA *Standards of Practice* and educational notes. Under IFRS 4, future policy-related maintenance expense cash flows are included in the valuation of the liabilities. Acquisition expenses would only be included if they are expected to be incurred after the valuation date.

[1] Canadian sales tax charged on insurance premiums (e.g., provincial sales tax or retail tax) would be included in the fulfilment cash flows, but may not need to be explicitly modeled as the ins and outs of the sales tax would usually net to zero. An exception could be segregated funds where explicit modeling of the sales tax would influence the account value projection and any corresponding guarantee cost. Furthermore, sales tax would be excluded from the measurement of both insurance revenue and insurance service expense per IFRS 17.B124(a)(iii).

2.2. Current practice: Property and casualty

Under IFRS 4, the P&C insurance contract liabilities are comprised of premium and claims liabilities valued in accordance with accepted actuarial practice in Canada including the selection of appropriate assumptions and methods.

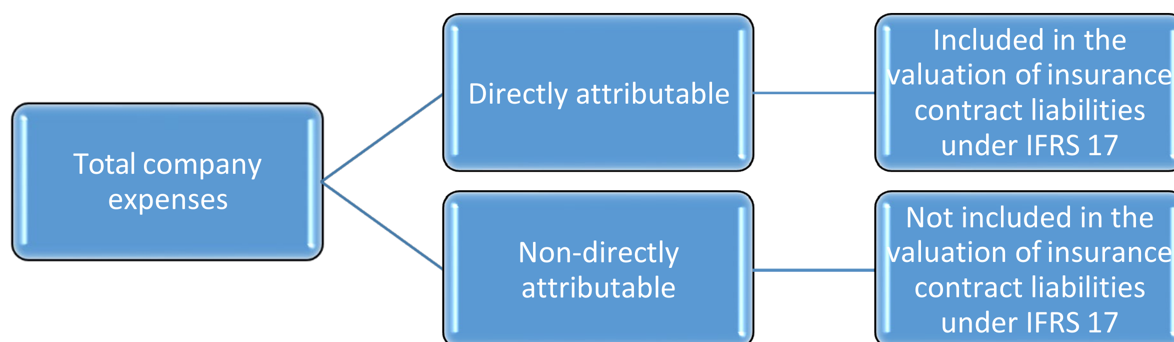
Claim liabilities include "the portion of insurance contract liabilities in respect of claims incurred on or before the calculation date." Claim liabilities comprise unpaid claims and claims-related expenses (including allocated and unallocated loss adjustment expenses), but do not include general maintenance or other unpaid expenses.

The premium liabilities are the net obligations of an insurer with respect to its insurance contracts other than claim liabilities. For the estimation of premium liabilities, acquisition and future general and claims-related expenses are taken into consideration. The premium liabilities are calculated as the sum of the expected losses, loss adjustment expenses, maintenance expenses, and other costs (e.g., profit commission, reinsurance) related to the policies in force at the valuation date. While premium liabilities are part of the Appointed Actuary's (AA) expression of opinion, they are not explicitly shown the financial statements[2].

For financial statement presentation, acquisition costs are either recognized as expenses when incurred, or are deferred as an asset and recognized over the coverage period. Other expenses associated with insurance operations, such as general and claims related expenses, are recognized as expenses when incurred.

2.3. Comparison between IFRS 17 and IFRS 4

IFRS 17 introduces the concept of "directly attributable expenses". The following chart illustrates how insurance contract expenses would be separated according to the Standard.



There could be several differences in expense treatment between IFRS 17 and IFRS 4, such as the following:

- The maintenance expenses in the scope of the valuation could differ, as IFRS 17 defines the expenses included in the fulfilment cash flows (FCF) as those that are "directly attributable" to insurance contracts. The concept of "directly attributable" is not defined

[2] The term "premium liabilities" in this context refers to an adequacy test of the unearned premium that is performed by P&C actuaries. These liabilities are included within the sum of the unearned premium, premium deficiency, and deferred policy acquisition costs (standard commission and premium taxes) which are presented on the balance sheet.

in the Standard, and therefore its definition is open to interpretation (see discussion in Section 3.1). For life and health insurance, directly attributable expenses will likely be a subset of the expenses included under IFRS 4. For P&C insurance, the range of practice is relatively wide (with respect to general expenses and loss adjustment expenses) under IFRS 4, and the maintenance expenses associated with the liability for remaining coverage (LRC) and liability for incurred claims (LIC) could therefore be higher or lower under IFRS 17.

- For life and health, acquisition expenses incurred following the contract issuance affected the IFRS 4 valuation. For P&C, policy acquisition expenses could either be recognized as incurred or deferred under the IFRS 4 valuation. Under IFRS 17, except as noted below, all acquisition expense cash flows – whether pre or post contract issuance - are included in the initial measurement of the group of insurance contract valuations, primarily to facilitate the determination of the initial FCF, and for presentation of financial results. The following exception applies:
    - Under the premium allocation approach (PAA), there is an option to recognize insurance acquisition cash flows as expenses when incurred if the coverage period of all contracts in the groups is one year or less (as per IFRS 17.59(a)). If this option is elected, acquisition costs have no impact on the measurement of the LRC. If the entity does not choose to recognize insurance acquisition cash flows as expenses when incurred, acquisition costs incurred will impact the LRC.

  For each group, as per IFRS 17.28B, the entity shall recognize as an asset insurance acquisition cash flows paid before the related group of insurance contracts is recognized unless the entity chooses to apply IFRS 17.59(a).

  Under IFRS 4, for life and health, maintenance expenses may have been allocated to direct contracts only, given the primary focus is on the appropriateness of the net liabilities. However, under IFRS 17, it is necessary to allocate some expenses to groups of reinsurance contracts held (i.e., those expenses that are directly attributable to portfolios of reinsurance contracts held, such as reinsurance administration costs). See Section 5.1 for further discussion of the IFRS 17 treatment of such expenses.

  Under IFRS 17, the investment expenses included in the projection of FCF are described under IFRS 17.B65(ka). Some investment expenses currently included in the IFRS 4 valuation may be out of scope under IFRS 17. Refer to Section 4 for further discussion of the IFRS 17 treatment of investment expenses.

The IFRS 17 treatment of expenses is explored further in the following sections. In addition, Appendix 1 provides an illustration of the LRC at initial and subsequent measurement under PAA including the treatment of deferred acquisition costs. Appendix 2 provides further detail on some expense types such as expenses included within LIC cash flows, expenses payable to the purchaser of the insurance or reinsurance contracts and expenses payable to intermediaries.

3. General considerations

3.1. Directly attributable expenses

IFRS 17 introduces the concept of directly attributable expenses, but the term “directly attributable” is not formally defined in the Standard. Directly attributable expenses are included

in the IFRS 17 measurement of insurance contract liabilities, whereas non-directly attributable expenses are not. The interpretation of "directly attributable" is therefore critical to the IFRS 17 valuation.

The key IFRS 17 application guidance regarding the inclusion of expenses in the measurement of insurance contract liabilities is found in IFRS 17.B65 and B66, and within the definition of insurance acquisition cash flows in Appendix A of the Standard. According to IFRS 17.B65, the following cash flows would be within the contract boundary and therefore be included in the measurement of insurance contract liabilities:

- IFRS 17.B65(e): an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.
    - Appendix A: "Insurance acquisition cash flows" are defined as "Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are **directly attributable (emphasis added)** 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."
- IFRS 17.B65(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 (emphasis added)** to fulfilling insurance contracts".

Expenses that are not directly attributable would be excluded from the measurement of insurance contract liabilities – i.e., recognized in profit and loss as incurred per IFRS 17.B66(d).

- IFRS 17.B66(d): cash flows relating to costs that **cannot be directly attributed (emphasis added)** 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.

Some expenses would clearly be directly attributable, and be included in the estimates of future cash flows within the IFRS 17 contract boundary, such as:

- claim handling costs, per IFRS 17.B65(f);
- policy administration and maintenance costs, per IFRS 17.B65(h); and
- cost specifically chargeable to the policyholder under the terms of the contract, per IFRS 17.B65(m).

Expenses attributable to non-insurance business (such as the costs of issuing investment contracts or service contracts, and an associated share of overhead allocated to these contracts) would clearly not be directly attributable to insurance contracts.

However, between the expenses that are and are not clearly directly attributable, there can be a grey area in the classification of costs. For example, expenses for investment management, asset liability management and risk management would be incurred by an entity that issues and maintains insurance contracts, but would those expenses qualify as <u>directly</u> attributable to issuing contracts or fulfilling contractual obligations? Inclusion or exclusion of some expenses from the IFRS 17 valuation requires an interpretation of the meaning of "directly attributable."

- One potential view is that an expense would only be considered directly attributable if it is incurred for the clear purpose of either issuing insurance contracts or fulfilling obligations under insurance contracts. From this perspective, expenses such as investment management, asset liability management and risk management would *not* be considered directly attributable. While these expenses are incurred to support the profitable operation of an entity, the primary purpose of these functions is one or two steps removed from acquiring insurance contracts or fulfilling obligations under insurance contracts.
- The counter argument to the view above is that an entity could not plausibly fulfil its obligations under its insurance contracts without expenses such as investment management, asset liability management, and risk management. Furthermore, while the primary purpose of incurring these costs may not be acquisition of insurance contracts or fulfilling obligations under insurance contracts, neither is the primary purpose of overhead expenses such as rent and HR costs, but these overhead costs are considered directly attributable under IFRS 17.B65(l). From this perspective, a wider interpretation of the scope of "directly attributable" could potentially be adopted. This interpretation may or may not align with the view of some audit firms, so each entity is advised to consult with its auditor before finalizing the entity's own views.

Section 4 of this explanatory report provides specific examples and considerations related to the potential grey areas regarding classification of expenses as directly versus non-directly attributable. Grey areas in the interpretation of the meaning of "directly attributable" along with an entity's specific facts and circumstances, have the potential to lead to a wide range of practice, which could diminish one of the primary objectives of IFRS 17 – the comparability of financial results between entities. Therefore, Section 6 of this explanatory report makes some recommendations for disclosures in the Appointed Actuary's Report, to provide regulators the data to assess the degree to which a wide range of practice actually emerges from different interpretations of the meaning of directly attributable.

Treatment of directly attributable expenses would depend on the measurement model, as discussed in the following sections. Non-directly attributable expenses related to the direct insurance contracts would generally be recognized as incurred, regardless of the classification (acquisition or maintenance) or the measurement model.

3.1.1. General measurement approach and variable fee approach

Under the general measurement approach (GMA) and the variable fee approach (VFA), directly attributable acquisition and maintenance expenses would be included in the FCF.

Directly attributable maintenance costs are generally incurred at a higher level of aggregation than the group of contracts; these costs would need to be allocated to groups of contracts in a systematic and rational manner. Expected future allocations within the boundary of the contract would be included in the FCF.

Directly attributable acquisition costs, known or anticipated at recognition of the group, regardless of when they are incurred (pre-recognition, concurrent to recognition or post-recognition), are included in the initial measurement of insurance contract liabilities. The Standard requires allocations of all directly attributable acquisition costs in a portfolio to groups

in that portfolio, and of any acquisition costs directly attributable to any future renewals of contracts (outside the boundary of the new contracts) to future groups using a systematic, consistent, and rational basis as per IFRS 17.28A and IFRS 17.B35A-B35B.

Insurance acquisition cash flows incurred before the recognition of their related insurance contracts are held as an asset per IFRS 17.28B (where incurred in this context means either an amount paid or a payable amount for which an accounting liability has been established). This asset will be referred to as the asset for insurance acquisition cash flows. CLIFR and PCFRC published an explanatory report on the topic of the asset for insurance acquisition cash flows and its recoverability. The following is an overview of the requirements:

- The asset for insurance acquisition cash flows (or a portion of it) is derecognized when the insurance acquisition cash flows are allocated to the group of insurance contracts at the group's initial recognition per IFRS 17.28C. To the extent that additional contracts are expected to be added to the group in future accounting periods, the entity would continue to recognize the portion of the asset related to those future contracts per IFRS 17.B35C.
- Two recoverability tests are required per IFRS 17.28E and B35D. As a result of these recoverability tests, the asset would be adjusted to reflect the loss of recoverability if the insurance acquisition cash flows are no longer expected to be recovered by future cash flows. That loss of recoverability is reflected in insurance results in the period that determination is made.
- Once the asset is adjusted down, the impairment can be reversed if a future assessment indicates that the cost is then recoverable, per IFRS 17.28F.

3.1.2. Premium allocation approach

If an insurance contract is measured using the PAA, the calculation of FCF is not required for the LRC unless the insurance contract is onerous. However, FCF calculations may be required for the calculation of the LIC; directly attributable expense classifications would be required in these calculations. More detail on expense cash flows associated with LIC can be found in Appendix 2. Furthermore, a split between directly attributable and non-directly attributable expenses would be required for presentation purposes – directly attributable expenses are part of the insurance service result, whereas non-directly attributable expenses are not. Non-directly attributable expenses are presented outside the insurance service result as "Other expenses" in the statement of financial performance.

For groups of contracts with a coverage period of one year or less, the insurer may elect to recognize the acquisition cash flows as expenses when they are incurred, as per IFRS 17.59(a). The LRC calculated on non-onerous contracts at initial and subsequent measurement would be impacted by this choice as per IFRS 17.55 (a) and (b). Appendix 1 includes a simple example that illustrates the impact of the application of IFRS 17.59(a) on the LRC at initial and subsequent measurement. Directly attributable maintenance expenses associated with the remaining coverage will be recognized as incurred.

3.1.3. Liabilities for incurred claims

The treatment of expenses for the measurement of the LIC is the same between the GMA, VFA and PAA; future maintenance expenses associated with the LIC, such as future claims related

expenses associated with incurred claims and overheads, would be included in the measurement.

3.2. Measurement and presentation

3.2.1. Contracts measured using the GMA

Initial measurement

Expected directly attributable acquisition and maintenance expenses are both included in the FCF at initial recognition, and therefore impact the amount of the contractual service margin (CSM) or loss component. As a result, the more expenses that are included in the FCF at initial recognition, the lower the CSM will be for the group; furthermore, the probability increases for contracts in the group to be classified as onerous.

Acquisition expenses incurred *prior* to the initial recognition of a group of insurance contracts are deferred and recognized as an asset for insurance acquisition cash flows. CLIFR and PCFRC published an explanatory report on the topic of the asset for insurance acquisition cash flows and its recoverability.

Non-directly attributable expenses are excluded from the measurement of the group of insurance contracts.

Subsequent measurement

As per IFRS 17.B96a, “experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows” are not recognized in profit/loss immediately, but instead adjust the CSM (if available).
Therefore, actual versus expected differences in directly attributable acquisition expenses will be reflected in profit/loss in subsequent periods through the amortization of the CSM.

Directly attributable maintenance expenses are typically incurred throughout the contract boundary and continue to be part of the FCF at subsequent measurement. Differences between actual versus expected directly attributable maintenance expenses in the current period relate to current service, and therefore will be recognized in profit or loss each period as actual expenses are incurred (as the difference between insurance revenue and insurance service expense described further below).

Presentation of profit or loss

Insurance revenue will include the expected directly attributable maintenance expenses and an amount for the amortization of directly attributable insurance acquisition expenses. Since insurance contracts are priced to recover these costs effectively, the portion of the premium that covers these expenses is recognized as revenue each period.

Actual directly attributable maintenance expenses are recognized as incurred in insurance service expenses. An amount equal to the amortization of directly attributable insurance acquisition expenses included in revenue is also included in insurance service expenses. This effectively recognizes the amount for the amortization of the directly attributable acquisition expenses over the coverage period rather than when the cash flows occur.

Therefore, the difference between actual and expected directly attributable maintenance expenses affects the current period insurance service result. Conversely, the amortization of

directly attributable acquisition expenses does not impact profit/loss because an equal amount is reported in insurance revenue and insurance service expense.

The presentation of expenses in insurance revenue and insurance service expenses is illustrated below:

Insurance Revenue	
Expected claims and other expenses (excluding investment components and amounts allocated to loss component)	← **Expected directly attributable maintenance expenses**
Release of the risk adjustment (excluding amounts allocated to loss component)	
CSM recognized for services provided	
Amortization of insurance acquisition cash flows	← **Equal to amount below in expenses**
Premium experience adjustments	
Total Insurance Revenue	
Insurance Service Expenses	
Incurred claims (excluding investment components) and other incurred insurance service expenses	← **Actual directly attributable maintenance expenses**
Amortization of insurance acquisition cash flows	← **Equal to amount above in revenue**
Changes related to future service (losses on onerous groups and reversals of such losses)	
Changes related to past service (changes in FCF related to incurred claims liability)	
Total Insurance Service Expenses	
Insurance Service Result	
Other Expenses	← **Non directly attributable expenses**
Profits / Losses	

Non-directly attributable expenses are recognized as incurred outside of the insurance service result. As per IFRS 17 illustrative example IE 79, non-directly attributable expenses would show under “Other expenses” and impact profits and losses. Although these expenses are excluded from the FCF, premium loads included in the FCF would generally be designed to recover these costs. The CSM that is created for non-onerous groups of contracts would therefore include the premium loads. This disconnect will create a timing mismatch, as non-directly attributable expenses are recognized as incurred while the associated premium loads are recognized in insurance revenue as the CSM is released. A presentation mismatch will also be created as the revenue is recognized in the insurance service result while the expense is recognized outside of the insurance service result in “Other expenses.”

Example

The following example illustrates how directly attributable expenses impact the measurement of insurance contracts and are presented in the statement of financial performance: A group of insurance contracts are issued with a coverage period of three years. The following are details of the expected future cash flows:

Description	**Total amount**	**Additional information**
Premiums	$900	Received at inception
Claims	$450	$150 per year
Directly attributable acquisition expenses	$90	Incurred at or prior to initial recognition
Directly attributable maintenance expenses	$150	$50 per year
Non-directly attributable acquisition expenses	$30	Incurred at inception
Non-directly attributable maintenance expenses	$75	$25 per year
For simplicity, assume the following: • No risk adjustment or discounting, • CSM is run-off on a straight-line basis • Insurance acquisition cash flows are amortized evenly over the three years.		

Calculation of CSM at initial recognition (positive numbers are inflows, negative numbers are outflows)**:**

Premiums:	$ 900
Claims:	($450)
Directly attributable acquisition expenses:	($90)
Directly attributable maintenance expenses:	($150)
Net inflow = CSM:	$ 210

Scenario A: Assume all events occur as expected. The insurance service result for **Year 1** would be as follows:

Insurance Revenue		
Expected claims and other expenses (excluding investment components and amounts allocated to loss component)	200	**$150 claims plus $50 maintenance expenses**
CSM recognized for services provided	70	**$210 over 3 years**
Amortization of insurance acquisition cash flows	30	**$90 over 3 years**
Total Insurance Revenue	***300***	
Insurance Service Expenses		
Incurred claims (excluding investment components) and other incurred insurance service expenses	200	**$150 claims plus $50 maintenance expenses**
Amortization of insurance acquisition cash flows	30	**equals amount in revenue**
Total Insurance Service Expenses	***230***	
Insurance Service Result	***70***	
Other Expenses	***55***	**$30 acquisition and $25 maintenance non directly attributable expenses**
Profits / Losses	***15***	

For this scenario (where all events occur as expected), the insurance service result is equal to the amortization of the CSM.

Non-directly attributable expenses of $55 ($30 of acquisition and $25 of maintenance) would be recognized as expenses outside of the insurance service result. Total profit would be $15 ($70 insurance service result less $55 of non-directly attributable expenses).

Scenario B: Assume actual directly attributable maintenance expenses incurred in Year 1 are $75 instead of the expected $50. The insurance service result for **Year 1** would be as follows:

Insurance Revenue		
Expected claims and other expenses (excluding investment components and amounts allocated to loss component)	200	**$150 claims plus $50 maintenance expenses**
CSM recognized for services provided	70	**$210 over 3 years**
Amortization of insurance acquisition cash flows	30	**$90 over 3 years**
Total Insurance Revenue	***300***	
Insurance Service Expenses		
Incurred claims (excluding investment components) and other incurred insurance service expenses	225	**$150 claims plus $75 maintenance expenses**
Amortization of insurance acquisition cash flows	30	**equals amount in revenue**
Total Insurance Service Expenses	***255***	
Insurance Service Result	***45***	
Other Expenses	***55***	**$30 acquisition and $25 maintenance non directly attributable expenses**
Profits / Losses	***(10)***	

Insurance revenue is the same as in Scenario A since revenue includes the expected amount of expenses. Insurance service expenses are higher by $25 since insurance service expenses represent the actual amounts incurred. As a result, insurance service result is lower by $25.

Non-directly attributable expenses of $55 ($30 of acquisition and $25 of maintenance) would be recognized as expenses outside of the insurance service result. Total profit would be a loss of $10 ($45 insurance service result less $55 of non-directly attributable expenses).

Scenario C: Assume actual directly attributable acquisition expenses incurred at initial recognition are $105 instead of $90. As noted previously, differences between expected and actual directly attributable acquisition expenses adjust the CSM.

The CSM at initial recognition would be adjusted as follows:

Premiums – cash inflow:	$ 900
Claims (cash outflow):	($450)
Directly attributable acquisition expenses (cash outflow):	**($105)**
Directly attributable maintenance expenses (cash outflow):	($150)
Net inflow = CSM:	**$ 195**

Insurance Revenue		
Expected claims and other expenses (excluding investment components and amounts allocated to loss component)	200	**$150 claims plus $50 maintenance expenses**
CSM recognized for services provided	65	**$195 over 3 years**
Amortization of insurance acquisition cash flows	35	**$105 over 3 years**
Total Insurance Revenue	***300***	
Insurance Service Expenses		
Incurred claims (excluding investment components) and other incurred insurance service expenses	200	**$150 claims plus $50 maintenance expenses**
Amortization of insurance acquisition cash flows	35	**equals amount in revenue**
Total Insurance Service Expenses	***235***	
Insurance Service Result	***65***	
Other Expenses	***55***	**$30 acquisition and $25 maintenance non directly attributable expenses**
Profits / Losses	***10***	

For this scenario, the insurance service result is equal to the amortization of the CSM. The amortization of the CSM is less than Scenario A due to the higher amount of acquisition expenses incurred, which reduces the expected profit from the group of insurance contracts.

Non-directly attributable expenses of $55 ($30 of acquisition and $25 of maintenance) would be recognized as expenses outside of the insurance service result. Total profit would be $10 ($65 insurance service result less $55 of non-directly attributable expenses).

3.2.2. Contracts measured using the PAA

Expenses are classified as acquisition expenses or maintenance expenses, similar to under the GMA. However, the measurement of the LRC is based on premiums received and recognition of revenue through expected premium receipts rather than a projection of future cash flows.

Directly attributable acquisition expenses can be deferred and amortized, or can be recognized as incurred when the coverage period is one year or less as per IFRS 17.59(a). Under the 59(a) election, acquisition expenses incurred prior to or at the measurement date of a contract would be excluded from the assessment of whether the contract is onerous. The 59(a) election therefore reduces the likelihood of onerous contract classifications; however, it does result in the immediate recognition in P&L of those expenses, which would be similar to the front-ended recognition of losses under onerous contracts. For non-onerous contracts, the 59(a) election accelerates the recognition of acquisition expenses which would otherwise be amortized over the remainder of the contract.

Maintenance expenses are recognized as incurred. Both directly attributable acquisition expenses (amount incurred or amortized, depending on the policy elected) and directly attributable maintenance expenses incurred are reported as insurance service expenses and impact the insurance service result. Revenue is the expected premium receipts (adjusted for time value of money and investment components, if required) recognized over the coverage period. Similar to the GMA, non-directly attributable expenses are recognized as “Other expenses” outside of the insurance service result.

If facts and circumstances indicate that a contract may be onerous, a projection of FCF is

required. Therefore, classification of expenses as directly attributable (or not), and the 59(a) election, can affect whether contracts are considered onerous.

Example

A group of insurance contracts are issued with a coverage period of two years and is eligible for the PAA. The following are details of the cash flows:

Description	Total amount	Additional information
Expected premiums	$1,000	Received at inception
Directly attributable acquisition expenses	$200	Incurred at inception
Directly attributable maintenance expenses	$50	Incurred in year 1
Non-directly attributable acquisition expenses	$30	Incurred at initial recognition
Non-directly attributable maintenance expenses	$50	$25 per year

Also assume the following:

- No claims are incurred in Year 1
- Expected premium receipts are allocated on the basis of the passage of time
- Acquisition costs are deferred and amortized over the two-year coverage period
- There is no discounting

Insurance service result for **Year 1**:

Insurance Revenue		
Revenue recognized under the premium allocation approach	500	**$1,000 expected premiums over 2 years**
Total Insurance Revenue	***500***	
Insurance Service Expenses		
Incurred claims (excluding investment components) and other incurred insurance service expenses	50	**$50 maintenance expenses**
Amortization of insurance acquisition cash flows	100	**$200 amortized over 2 years**
Total Insurance Service Expenses	***150***	
Insurance Service Result	***350***	
Other Expenses	***55***	**$30 acquisition and $25 maintenance non directly attributable expenses**
Profits / Losses	***295***	

4. Expense classification considerations – directly vs. non-directly attributable expenses

This section provides some examples of expenses that would generally be considered directly attributable for insurance contracts issued, and expenses that would be considered grey areas. These examples are reviewed from the perspectives of the two views of interpretation of the meaning of "directly attributable" expenses articulated in Section 3.1. These examples are not meant to be an exhaustive list of every possible expense, the nature/terminology of expenses could be different across companies and the actuary would apply professional judgment in the setting of principles and classification of directly attributable expenses. In practice, some of the

expense breakdown may not be available at a very granular level and materiality would be considered in the classification of such expenses.

4.1. Examples of expenses that would generally be considered directly attributable

Regardless of which of the two views an actuary takes, the following expenses would generally be considered directly attributable based on the principles outlined in Section 3.1. The first set of bullets would generally be considered acquisition expenses, while the second set would generally be considered maintenance expenses.

- Expenses incurred with the primary purpose being issuance or renewal of insurance contracts, such as:
  - costs related to pricing activities[3];
  - costs related to underwriting activities;
  - costs associated with policy issuance or renewal;
  - costs related to sales and distribution, including salaries, commissions, bonuses and agency costs;
  - contingent profit commissions[4] (except if qualify as non-distinct investment component), transfer/overwrite commissions (associated with procurement of new insurance contracts) (P&C only);
  - training and/or HR costs directly related to any of the above functions[5]; and
  - overhead attributed to issuance or renewal of insurance contracts.
- Expenses incurred with the primary purpose being fulfilment of obligations under insurance contracts, such as:
  - policy maintenance costs, including salaries of administration personnel, systems maintenance costs, and customer service costs;
  - claims settlement costs;
  - recurring commissions (e.g., related to recurring premiums);
  - sliding scale and other profitability-based commissions[6] (except if qualify as non- distinct investment component);
  - training and/or HR costs directly related to any of the above functions; and
  - overhead attributed to maintenance of insurance contracts.

[3] These expenses may need to be reviewed on a case-by-case basis as some pricing costs such as generic market research costs could be considered non-directly attributable.
[4] These expenses may need to be reviewed on a case-by-case basis and could be recognized as either insurance acquisition cash flow or as maintenance expense cash flow under IFRS 17.B65 (h). More detail on contingent commission and similar expenses payable to the purchaser of insurance contract can be found in Appendix 2.
[5] Caution would be applied when classifying training and HR costs. For example, training costs incurred in areas with significant employee turnover may not be considered directly attributable.
[6] These expenses may need to be reviewed on a case-by-case basis and could be recognized as either insurance acquisition cash flow or as maintenance expense cash flow under IFRS 17.B65 (h)

Premium taxes would be considered within the boundary of the insurance contract and would therefore be included in FCF. Further discussion on this topic is provided in Section 5.

4.2. Examples of grey areas that could be considered either directly or not directly attributable expenses

The following expenses may or may not be considered directly attributable, depending upon which of the two views is taken:

- Investment expenses
- Asset liability management (ALM) expenses
- Corporate governance expenses
- Regulatory and statutory reporting expenses
- Shareholder related expenses
- Generic marketing, sales conference, and events

4.2.1. Investment expenses

The term "investment expenses" refers to costs that are incurred in order to perform activities related to the management of assets/investments. Investment expenses include costs associated with the purchase and sale of assets (including personnel costs associated with an internal investment department, or fees paid to external parties), reporting and analysis of investment holdings, hedging activities, etc. ALM expenses could be viewed as an extension of investment expenses.

The classification of investment expenses as directly attributable or not directly attributable can have a very significant impact on IFRS 17 measurement, especially for entities with a long investment horizon for assets supporting long duration liabilities. As such, consistency of practice within Canada would be the preferred goal, to facilitate comparison between entities; however, the potential for different interpretations does exist, as outlined in the subsections below.

It should also be noted that some investment expenses might be accounted for under IFRS 9. Expenses that are accounted for under IFRS 9 *Financial Instruments* are out of scope of this report, but the actuary would need to be aware of the IFRS 9 treatment to avoid double counting or omission of expense cash flows in the IFRS 17 valuation.

4.2.1.1. Investment expenses for products that include the management of a clear pool of underlying assets

IFRS 17.B65(ka) specifies that costs related to investment activities to enhance benefits from insurance coverage for policyholders, and investment-return service/investment-related service provided to policyholders of insurance contracts with/without direct participation features are included in the FCF.

Products that fall under these categories include the following:

- Contracts with direct participation features that provide an investment-related service, generally measured under the VFA, such as segregated funds and some participating contracts. These products include the management of assets in a clearly defined pool of

underlying items, and the investment expenses associated with the underlying item would be considered directly attributable.

- Management of underlying assets that support account values for contracts not generally measured under the VFA, such as universal life products. These products would generally provide investment-return services, with the objective of managing underlying assets to enhance benefits of insurance coverage for the policyholders. The investment expenses associated with the underlying assets (e.g., universal life fund value) would be considered directly attributable.

4.2.1.2. Investment expenses for products that relate to the management of assets that are not part of the underlying item

The Standard is less clear on whether these expenses would be considered directly attributable or not, hence potential exists for the two views noted in Section 3.1 of this explanatory report. The key consideration is whether or not the investment activities enhance benefits payable to policyholders, per IFRS 17.B65(ka)(i).

- The intent of the IASB appears to be exclusion of investment expenses related to management of assets that are not part of an underlying item, as B65(ka)(i) describes enhancing benefits as generating "an investment return from which the policyholder will benefit if an insured event occurs." Normally investment returns on non-underlying assets accrue to the entity, not the policyholder, hence the associated expenses would not be directly attributable.
- An alternative would be that investment activities do enhance policyholder benefits (e.g., larger amount of coverage offered to the policyholders for the same premium when investments are considered), in which case investment expenses could be considered directly attributable expenses. This interpretation may or may not align with the view of some audit firms, so each entity is advised to consult with its auditor before finalizing the entity's own views.

The actuary would be mindful of the interdependency between including certain types of investment expenses in the FCF and the identification of investment-return services in insurance contracts. As per IFRS 17.B65(ka)(ii), costs incurred by the entity providing investment-return services would be included in the contract boundary. For example, if a life insurance product that has a cash surrender value component is considered to provide investment-return service, the investment expenses related to the assets supporting the cash surrender value may be considered as directly attributable.

4.2.2. Corporate governance, regulatory/statutory reporting and shareholder-related expense

The corporate governance and shareholder-related expenses are essential expenses for insurance companies (listed companies for the shareholder-related expense), these expenses are generally related to improving the overall performance of the entities and not directly related to issuance or fulfilment of insurance contracts. As such, these expenses would generally be considered non-directly attributable expenses as articulated in the first view in Section 3.1. However, given that these expenses are essential for insurance companies (listed companies for the shareholder-related expenses), there could be a rationale for classifying them as directly attributable expenses as articulated in the second view in Section 3.1.

Regulatory and statutory reporting are generally designed to protect policyholders' interests and are mandatory expenses and therefore directly related to the issuance or fulfilment of insurance contracts. As such, these expenses may be considered directly attributable expenses. However, given that these expenses are one or two steps removed from acquiring or fulfilling insurance contracts, there could be a rationale for classifying them as non-directly attributable expenses as articulated in the first view in section 3.1.

4.2.3. Generic marketing, sales conference, and events

For generic marketing expenses, the ultimate purpose of these costs is issuance of insurance contracts, hence these expenses could be classified as directly attributable as articulated in the second view in Section 3.1. However, that purpose is generally one or two steps removed from directly selling or enabling acquisition of specific new contracts or portfolios of contracts, and therefore these expenses could be classified as non-directly attributable expenses unless there is stronger direct linkage to the issuance of insurance contracts, as articulated in the first view presented in Section 3.1.

Similarly for sales conference and events expenses, the classification of these expenses into directly attributable expenses could be dependent on their nature. For example, if the conference is focused on specific product(s), it could be considered as directly related to issuance of insurance contracts and would therefore be part of the directly attributable expenses. On the other hand, conferences on general strategy would be considered non-directly attributable expenses as the purpose is one or two steps removed from issuance of insurance contracts. Judgment would be applied if the level of granularity required to assess the nature of these expenses is not available.

5. Other expense related topics

5.1. Reinsurance contract held expenses

As per paragraph IFRS 17.82 and paragraphs IFRS 17.BC345-346 of the Basis for Conclusions on IFRS 17, an entity is prohibited from offsetting reinsurance contract assets held against related underlying insurance contract liabilities in the statement of financial position. Consistently with such principle, income and expenses from reinsurance contracts held are presented separately from expenses or income incurred from insurance contract issued.

Companies would need to identify and track expenses incurred from reinsurance contracts held separately. Reinsurance contract held expenses include expenses incurred by the ceding company on the reinsurance contracts held as well as an allocation of applicable overheads. These expenses would not be included in the valuation of the insurance contracts issued per IFRS 17.B66 (b), but rather would be attributable to groups of reinsurance contracts held.

Examples of reinsurance-related expenses include:

- reinsurance administration system costs; and
- employee costs for individuals negotiating/pricing treaties, and performing administration tasks related to reinsurance contract management, as well as overhead expenses allocated to these individuals.

5.2. Productivity and economies of scale

Question 2.20 in the *Application of IFRS 17 Insurance Contracts* educational note states “It may also be appropriate to allow for expected future economies (or diseconomies) of scale, consistent with the likelihood of these scenarios and unbiased mean. Future costs will also consider whether the entity is being measured as a going concern. If so, costs may need to reflect a reasonable development of future new business, if appropriate, in deriving an unbiased estimate of the mean, representing any expected economies of scale.”

When estimating the FCF for a group of contracts, the actuary would consider how directly attributable expense allocations to that group are expected to change over the boundary of the contract. The two primary factors affecting directly attributable expense projections would be the following:

- The entity’s expected overall expense growth: expense growth would be influenced by general inflation and by the entity’s cost management strategy. It may be reasonable to assume that the entity’s fixed cost base would increase over time at the expected rate of general inflation, unless the entity has a credible cost containment (or expansion) strategy.
- The entity’s expected policy growth strategy: a growing aggregate policy base over time could result in lower fixed expense allocations to the group, as the entity’s fixed costs would be spread over a broader base of contracts. Variable costs would grow proportionally to the growth in the policy base, perhaps adjusted for general inflation.

In a growing entity, it may be possible that unit cost allocations would decrease over time if the entity’s policy growth exceeds its fixed expense growth. Conversely, in an entity that is not growing (runoff of inforce exceeds new business), unit cost allocations would likely increase at a faster rate than the entity’s expense growth. For these reasons, reasonable new business and inforce run off projections, and an understanding of the fixed/variable nature of the entity’s expenses, are likely to be fundamental inputs into the projection of expenses in the FCF.

5.3. Abnormal costs used to fulfil the contracts

According to IFRS 17.B66(e), any abnormal amount of wasted labor or other resources that are used to fulfil the contracts would not be classified as directly attributable expenses. They would therefore be excluded from the FCF.

5.4. Systematic and rational allocations of expenses

IFRS 17.28A states that “an entity shall allocate insurance acquisition cash flows to groups of insurance contracts using a systematic and rational method…”. The same concept would apply to maintenance expenses. The International Accounting Standards Board® Basis of Conclusions BC113 suggested other IFRS requirements such as IFRS 15 and IAS 2 – Inventories as reference when performing systematic allocations.

According to IAS 2,

- “The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities”.
- “Normal capacity is the production expected to be achieved on average over a number

of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance".

- "The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant."

As a practical example of how an overly simple allocation methodology could result in an allocation that is not rational, consider an entity with relatively fixed acquisition costs (e.g., flat cost of underwriters' salaries) but fluctuating sales volumes. Allocation of flat costs to a varying volume base could result in an over-allocation of expenses to groups of contracts when the volume is low, and an under-allocation of expenses to groups of contracts when the volume is high. Such over or under-allocations could affect the IFRS 17.16 classification of the group of contracts at initial recognition. One way to achieve a more reasonable allocation would be to base per contract directly attributable expense allocations on normal capacity expectations.

If the actuary chooses to take a seriatim contract grouping approach at initial recognition to satisfy IFRS 17.16, then a more sophisticated mechanism may be needed to allocate expenses to the contract level, or alternatively to unitize costs at a finer level of granularity such that the expected profitability of the contract is reasonably assessed. For example, if policy size and/or issue age significantly affect the level of acquisition and maintenance expenses for a contract, failure to recognize those dimensions in the allocation (or unitization) process could result in systematic misclassification of profitability for some contracts.

5.5. Frequency to review directly vs. non directly attributable expense

Once the expense classification principles of directly versus non-directly attributable expenses and expense allocation methodologies are determined, those principles and methodologies would not be expected to be modified frequently. The actual dollar expense allocation between directly versus non directly attributable expenses could vary periodically and it would be reviewed as part of the entity's internal expense review process.

Some situations may trigger updating of the expense classifications and/or allocation methodologies. For example, a major restructuring within a company, and/or a fundamental change to the company's internal expense study, could lead to substantial differences in the tracking and/or classification of expenses that could trigger a review of the expense allocation or classification methodologies. The launch of a new line of products could shift some of the cost base or allocations of expenses, but may not change the allocation methodology itself.

5.6. Premium taxes

Premium taxes are part of the FCF. There are two views on the presentation of premium taxes under IFRS 17. The first view excludes premium taxes from both insurance service expense and insurance revenue, while the second view includes premium tax in both insurance service expense and insurance revenue.

Under the first view, premium tax cash flows would be excluded from insurance service expenses and insurance revenue per IFRS 17.B124(a)(iii) and IFRS 17.B124(d). According to

this paragraph, “amounts that relate to transaction-based taxes collected on behalf of third parties” are excluded from insurance service expenses and insurance revenue. Premium taxes are specifically listed as an example. Per IFRS 17.B96(a), experience adjustments arising from cash flows related to premiums received in the period that relate to future service such as premium- based taxes adjust the CSM and are not recognized as insurance service expenses and insurance revenue. The premium tax would qualify as a premium-based tax. Also, IFRS 17.B96 (a) refers to premium-based taxes separately from insurance acquisition cash flows, which may imply they are not insurance acquisition cash flows.

The second view is based on premium tax as a component cost cash flow of the insurance contract and is factored in the determination of the policy premium. Under this view, the insurer would be a principal with respect to the premium tax and incurs the tax liability at the time of sale, which is then payable to the tax authorities periodically as required. Under this view, premium taxes would not be considered as “transaction-based taxes collected on behalf of third parties” per IFRS 17.B124(a)(iii), and they would meet the IFRS 17 definition of insurance acquisition cash flows as the sale of the contract will trigger the tax liability payable by the insurer; and the tax is an underwriting component of the policy premium charged. The expected premium tax would therefore be presented in the insurance revenue and the actual premium tax incurred would be presented in the insurance service expense.

6. Suggested disclosures in the Appointed Actuary’s Report

Directly attributable expenses are key components of the estimates of future cash flows impacting many aspects of the financial statements. The decisions to include or exclude expenses from the definition of “directly attributable” will affect both the level of the FCF and the CSM; the greater the exclusions, the lower the FCF and the higher the CSM. These amounts impact the Life Insurance Capital Adequacy Test and Capital Adequacy Requirements Guideline capital ratios for life and health. Under the PAA the decisions to include or exclude expenses from the definition of “directly attributable” will affect the LIC and the onerous assessment. For P&C practitioners the Minimum Capital Test could be impacted by the “directly attributable” expense included in the LIC and in the unexpired coverage calculations. As a result, it is recommended that the actuary include information in the Appointed Actuary’s report (AAR) pertaining to expenses under IFRS 17. The final AAR disclosure requirements will be specified by OSFI/AMF and supersede this suggested expense disclosure in this report to the extent that OSFI/AMF’s requirements are more comprehensive than the ones described in this report.

The following suggested disclosures would be included in the AAR:

1. Total company expenses (annual expenses in the current year) as shown in the annual statement.
2. Annual expenses in the current year related to IFRS 9 *Investment Contracts*, IFRS 15 *Service Contracts*, and other IFRS standards (expenses that are not within the scope of IFRS 17).
3. Remaining expenses = 1 – 2. These expenses are potentially within the scope of IFRS 17, if they are considered directly attributable to insurance contracts.
4. Expenses that are directly attributable to insurance contracts under IFRS 17.
5. Percentage of directly attributable expenses = 4 / 3.

Here is an example that illustrates the suggested disclosures in the AAR:

		Year 20XX
1.	Total company expenses (annual expenses in the current year) as shown in the annual statement	150
2.	Annual expenses in the current year related to IFRS 9 Investment Contracts, IFRS 15 Service Contracts and other IFRS standards	50
3	Total company expenses excluding expenses related to IFRS 9, IFRS 15 etc. (expenses that are potentially within the scope of IFRS 17)	100
4	Directly attributable expenses under IFRS 17	80
5	Percentage of directly attributable expenses = 4 / 3	80%

The AAR disclosure would also include qualitative comments on whether the grey area expense items discussed in Section 4 of this report (and other company specific grey areas that are material) are considered as directly attributable expenses or not. Moreover, actuaries would be expected to outline the rationale for categorizing these expenses as directly or non-directly attributable expenses.

Appendix 1 – Liability for remaining coverage at initial and subsequent measurement under the premium allocation approach

The following simple examples illustrate the impact on the LRC at initial and subsequent measurement of the application of IFRS 17.59(a). The following examples assume one year of coverage period (with two intervals within one year) and no discounting.

	Entity does not apply paragraph 59a **Example 1** **Cash flows at beginning of period**				Entity applies paragraph 59a **Example 2** **Cash flows at beginning of period**			
	t	0	1	2	t	0	1	2
	Premium	100			Premium	100		
	Claims		40	40	Claims		40	40
	Acq exp	10			Acq exp	10		
LRC at inception and at the end of period - GMA	t	0	1	2	t	0	1	2
	GMA				GMA			
	FCF	-10	40	0	FCF	-10	40	0
	CSM	10	5	0	CSM	10	5	0
	GMA LRC	**0**	**45**	**0**	**GMA LRC**	**0**	**45**	**0**

LRC at initial recognition - PAA

	Example 1	Example 2
55(a)(i) - Premiums received at initial recognition	100	100
55(a)(ii) - minus Insurance acq CF at that date unless the entity chooses to recognize the payments as an expense as per 59a	-10	0
55(a)(iii) - any amount arising from the derecognition of an asset or liability at that date	0	0
LRC under the PAA	**90**	**100**

LRC at the end of each subsequent reporting period

	Example 1 (1)	Example 1 (2)	Example 2 (1)	Example 2 (2)
LRC at the start of the reporting period	90	45	100	50
55(b)(i) - plus the premiums received in the period	0	0	0	0
55(b)(ii) - minus the insurance acquisition cash flows unless the entity chooses to recognize the payments as an expense applying 59a	0	0	0	0
55(b)(iii) - plus any amounts relating to the amortisation of insurance acquisiton cash flows recognised as an expense in the reporting period unless the entity chooses to recognize insurance acquisition cash flows as an expense	5	5	0	0
55(b)(iv) - plus any adjustment to a financing component	0	0	0	0
55(b)(v) - minus the amount recognised as insurance revenue for services provided in the period	-50	-50	-50	-50
55(b)(vi) - minus any investment component paid or transferred to the LIC	0	0	0	0
LRC under the PAA	**45**	**0**	**50**	**0**

	Example 1 (1)	Example 1 (2)	Example 2 (1)	Example 2 (2)
Insurance Revenue	50	50	50	50
Insurance Service Expense	45	45	50	40
Insurance Service Result	5	5	0	10

Appendix 2 – Other expense types

Directly attributable expenses are treated the same way between P&C and Life & Health in general, however the types of expenses may be different between the two practices. This appendix discusses some expense types that are predominantly associated with P&C insurance contracts.

1. Future directly attributable maintenance expense cash flows associated with LIC

Most P&C insurance contracts are expected to be eligible for PAA and would not require fulfilment cash flow calculations for the LRC[7]. However, fulfilment cash flow calculations would still be required for LIC. Many P&C insurance contracts may have significant LIC with settlement periods of several years or even decades and the fulfilment cash flows within the LIC would include *directly attributable maintenance expenses*[8].

1.1. Comparison between IFRS 4 and IFRS 17

Under IFRS 4, reserves were established for allocated and unallocated loss adjustment expenses to account for future expenses associated with incurred claims. These loss adjustment reserves may seem similar in concept to the future directly attributable maintenance expense cash flows under IFRS 17, however there could be material differences between the two for some entities. Under IFRS 4 there was a wide the range of practice to establish reserves for unallocated loss adjustment expenses (ULAE).

The directly attributable maintenance expenses within LIC could be narrower or broader compared to the loss adjustment expenses for which reserves were established under IFRS 4. Under IFRS 17 only directly attributable expenses are included, while under IFRS 4 ULAE could have included expenses that would not have met this criterion, if the expense policy of the entity allowed for it. On the other hand, there may be directly attributable future maintenance expenses associated with current or past service other than loss adjustment expenses; for example, under IFRS 4 contingent profit commissions (CPC) were accounted for outside of claim liabilities, however under IFRS 17 a portion of these expenses would be associated with LIC if they are paid based on the performance of the expired portion of underlying contracts.

1.2. General Considerations

To help identify which future directly attributable maintenance expense cash flows are associated with LIC, the expense cash flows could be divided into expenses that are associated with past service, current service and future service; where past and current service expenses would be associated with the LIC, if they are expected to be settled in the future. Per IFRS 17.103b insurance service expense for past service comprises of "changes in fulfilment cash flows relating to liability for incurred claims", current service includes incurred amounts for claims (excluding investment component) and other insurance service expenses and future service comprises of changes in losses on onerous groups of contracts and reversals of such losses.

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[7] Unless facts and circumstances indicate that the group of contracts may be onerous, in which case fulfilment cash flows associated with the remaining coverage would also be needed.

[8] In this report directly attributable expenses consist of maintenance expenses (costs of fulfilling the obligations under insurance contracts) and acquisition expenses (costs of acquiring insurance contracts). Under IFRS 4 maintenance expenses included expenses associated with insurance operations other than acquisitions costs and loss adjustment expenses.

To establish which directly attributable maintenance expenses need to be included in the estimation of future cash flows within LIC all three of the following considerations would need to be met:

i. Does it meet the definition of directly attributable expense under IFRS 17?
ii. Is it associated with current or past service?
iii. Is it expected to be settled in the future?

Examples of directly attributable expenses that would form part of future cash flows within LIC are claim handling costs expected to be paid in the future but that pertain to current or past services (i.e., that pertain to current and past claims). Other examples of expenses that may be included in the future cash flows within LIC are a portion of directly attributable fixed and variable overhead costs (related to current and past claims) and some claims related projects costs if they are directly attributable to a portfolio of insurance contracts (these expenses may only be associated with a portion of future cash flows).

As previously noted in this report, the actuary would need to discuss the entity's expense policy under IFRS 17 with his/her accounting counterparts and the selected methodology is expected to be applied consistently over reporting periods.

2. Expenses payable to the purchaser of an insurance contract

Some expenses[9] related to insurance or reinsurance contract issued are paid directly to purchaser of the insurance contract (purchaser). While these expense features may be more prevalent in reinsurance contracts; they could be found on commercial insurance contracts as well. In this section the "purchaser" refers to the policyholder of the insurance or reinsurance contract issued.

Expenses paid directly to the purchaser may include a fixed component, a variable component that is contingent on the claims experience or both (e.g., CPC, sliding scale commission, experience-based commission), these expenses would be divided into the components that reflect the economic impact of the total expense:

- The non-contingent component of the expense payable to purchaser (i.e., the implied amount due assuming a loss ratio of zero). This component produces the economic impact of a lower premium and is treated as a reduction in premiums within insurance service revenue. The treatment of the non-contingent portion may need to be evaluated on a case-by-case basis.
    - Note that if the amount is settled net of premiums (as an offset against the amount of premium due), it would be treated as part of premiums. In the example of a ceding commission being treated as an offset against the premium due, this would have an equivalent effect to charging a lower premium with no ceding commission.

[9] Examples of these expenses include sliding scale commission, swing-rated contract features, profit commissions, experience-rated contracts, retrospectively rated contracts, contingency fees, no-claims bonuses, premium rebate or refund, stabilization funds, and other expense features that are directly paid to the purchaser (other than indemnity).

- On the other hand, if it is settled at a later date (after premium is due), it is considered a (non-distinct) investment component[10], provided that it would be paid in all circumstances (either as expense or claims), even if there are no claims, or if the policy was cancelled. Similar to above, this portion of the expense payable to purchaser is excluded from the premium revenue. However, in this case, additional disclosures related to investment components may be required applying paragraph IFRS 17.103(c).

The expense structure may have provisional amounts embedded in the non-contingent component of the transaction (interim commission payable to the purchaser). The treatment of provisional amounts would reflect the economic impact of the total expense as outlined above. These are usually settled net of premium and would therefore be an offset against premium due. The difference between the non-contingent amount and provisional amount may be treated as non-distinct investment component if it is settled at a later date and would be repaid in all circumstances[11].

For more detail on (non-distinct) investment component and provisional amounts refer to the draft educational note on *Actuarial Considerations Related to P&C Reinsurance Contracts Issued and Held*.

- The contingent component of the expense payable to the purchaser that is contingent on claims experience; this component of the expenses produces the economic impact equivalent to paying a lower amount of claims[12] and is treated as part of incurred claims within insurance service expenses.

Commissions to brokers or bonuses to internal/external resources that are contingent on claims would not qualify for these treatments and would be reflected in insurance service expense. For more detail on these refer to Section 3 below.

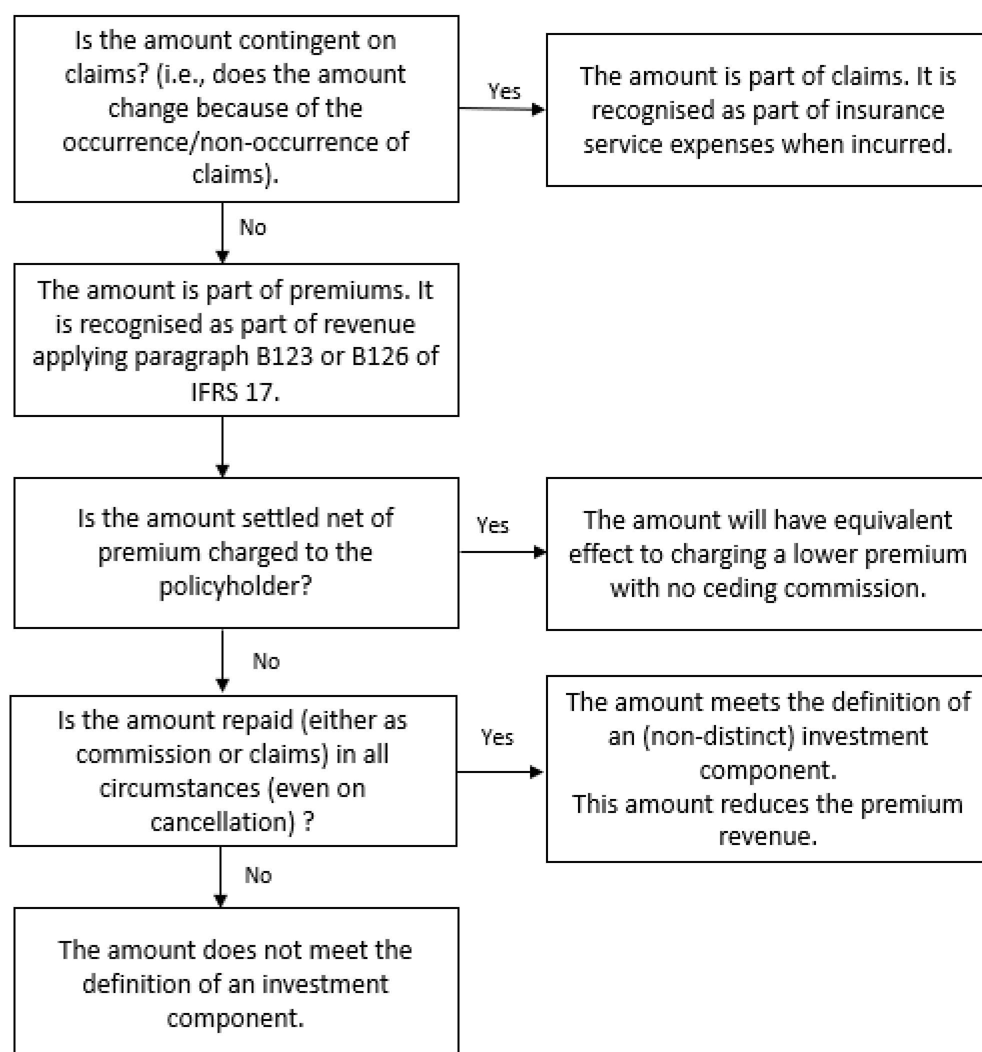
For each agreement where expenses are payable to purchasers, the following decision tree[13] can help with the assessment of how to account for exchanges between a (re)insurer and a purchaser:

[10]Canadian Institute of Actuaries Educational Note: *Application of IFRS 17 Insurance Contracts* discusses investment component in question 9.23 as "the profit participation feature may include elements that meet the attributes of an investment component (i.e., an amount that is repaid to the purchaser in all circumstances) in which case the amounts that have the attributes of an investment component should be shown as an investment component and excluded from both reinsurance premiums paid and reinsurance recoveries".

[11] If the non-contingent amount is not paid in all circumstances, for example in the event of the cancellation of the insurance contract, then there would not be an investment component.

[12] The claim paid amount would not change but are then adjusted by the impact of the contingent component within the insurance service expense.

[13] A similar decision tree can be found in the Transition Resource Group for IFRS 17 Insurance Contracts staff paper on Commissions and reinstatement premiums in reinsurance contracts issued by IASB.



The presentation of expenses payable to purchasers is illustrated below under PAA measurement. These illustrations show simplified examples of how CPC would be accounted for, the conclusions would be similar for other types of expenses payable to purchasers. In these examples sub-categories within Insurance Revenue and Insurance Service Expense were included for the purpose of illustration only; there are no requirements to show these sub-categories in the financial statements.

In Example 1 and Example 2, a group of reinsurance contracts are issued and settled within the same year. The following are details of the expense structure and impact on the S*tatement of financial performance* using PAA measurement. Examples of *Roll-forward of liability for insurance contracts issued* is also included for further detail:

Example 1

Cash Flows	Additional information	Total amount
Premium recognized		$1,000
Provisional Commission	Amount settled net of premium	30%

Loss Ratio	Commission as % of premium	Total amount
above 70%	20%	$200
between 50-70%	In the range of 20-40%	Sliding scale
below 50%	40%	$400
Also assume the following: - **Ultimate Loss Ratio of 45%**		

Calculation of non-contingent amount:

Claims	Commission	Total payment to purchaser
$0	$400	**$400**
$450	$400	$850
$600	$300	$900
$700	$200	$900
$900	$200	$1,100
The minimum amount due to purchaser is $400: - this amount has the same economic impact as charging lower premiums, and - this amount is due even if no claims have occurred; all other payments to the purchaser are contingent on claims.		

Notes:

Premium initially due (and received) from the purchaser is $700:

- this amount is calculated as the difference between premium recognized less provisional commission, which is settled net of premium.

There is a (non-distinct) investment component of $100:

- this amount is the difference between amount due to purchaser under all circumstances ($400) and provisional commission ($300)
- this amount would be refunded to the purchaser under all circumstances, and
- this is the amount by which premium collected exceeds insurance revenue.

Insurance service result:

Insurance Revenue	
Premium recognized	*1000*
Non-contingent component	*(400)*
Total Insurance Revenue	**600**
Insurance Service Expenses	
Incurred claims	*450*
Commission adjustment within incurred claims	*0*
Total Insurance Service Expenses	**450**
Insurance Service Result	**150**

Notes:

Total commission paid to the purchaser is $400.

Total amount paid to the purchaser is $850.

Example 1: Roll-forward of liability for insurance contracts issued

	Jan. 1 - June 30, 20XX				
	Liability for remaining coverage		Liability for incurred claims		Total
	Excluding loss component	Loss component	Estimates of the present value of future cash flows	Risk adjustment	
Insurance contract liabilities as at 01/01	-	-	-	-	-
Insurance revenue	(300)	-	-	-	**(300)**
Insurance service expenses	-	-	225	-	**225**
Incurred claims and other expenses	-	-	-	-	**225**
Amortization of insurance acquisition cash flows	-	-	-	-	-
Losses on onerous contracts and reversal of those losses	-	-	-	-	-
Changes to liabilities for incurred claims	-	-	-	-	-
Investment component*	(50)	-	50	-	-
Insurance service results	**(350)**	-	**275**	-	**(75)**
Insurance finance expenses	-	-	-	-	-
Effect of movement in exchange rates	-	-	-	-	-
Total changes in the statement of comprehensive income	**(350)**	-	**275**	-	**(75)**
Cash flows	-	-	-	-	-
Premium received**	700	-	-	-	**700**
Claims and other expenses paid***	-	-	(225)	-	**(225)**
Insurance acquisition cash flows	-	-	-	-	-
Total cash flows	**700**	-	**(225)**	-	**475**
Other movements	-	-	-	-	-
Insurance contract liabilities as at period end	**350**	-	**50**	-	**400**

	Jan. 1 - Dec. 31, 20XX				
	Liability for remaining coverage		Liability for incurred claims		Total
	Excluding loss component	Loss component	Estimates of present value of future cash flows	Risk adjustment	
Insurance contract liabilities as at 01/01	-	-	-	-	-
Insurance revenue	(600)	-	-	-	**(600)**
Insurance service expenses	-	-	450	-	**450**
Incurred claims and other expenses	-	-	-	-	**450**
Amortization of insurance acquisition cash flows	-	-	-	-	-
Losses on onerous contracts and reversal of those losses	-	-	-	-	-
Changes to liabilities for incurred claims	-	-	-	-	-
Investment component*	(100)	-	100	-	-
Insurance service results	**(700)**	-	**550**	-	**(150)**
Insurance finance expenses	-	-	-	-	-
Effect of movement in exchange rates	-	-	-	-	-
Total changes in the statement of comprehensive income	**(700)**	-	**550**	-	**(150)**
Cash flows	-	-	-	-	-
Premium received**	700	-	-	-	**700**
Claims and other expenses paid***	-	-	(550)	-	**(550)**
Insurance acquisition cash flows	-	-	-	-	-
Total cash flows	**700**	-	**(550)**	-	**150**
Other movements	-	-	-	-	-
Insurance contract liabilities as at period end	-	-	-	-	-

Notes:

*The investment component is initially recognized as LRC then released to the LIC as coverage is earned.

**Premium received is presented net of provisional commission, consistent with the IFRS 17 accounting context.

***Claims are paid as incurred. The investment component can be released either with claims or as part of commission adjustments. In this example the investment component is settled as part of commission adjustment.

Example 2 is the same as Example 1, however the ultimate loss ratio is 90%

Insurance service result:	
Insurance Revenue	
Premium recognized	*1000*
Non-contingent component	*(400)*
Total Insurance Revenue	**600**
Insurance Service Expenses	
Incurred claims	*900*
Commission adjustment within incurred claims	*(200)*
Total Insurance Service Expenses	**700**
Insurance Service Result	**(100)**

Notes:
Total commission paid to the purchaser is $200.
Total amount paid to the purchaser is $1,100.

The *Roll-forward of liability for insurance contracts issued* for Example 2 is similar to Example 1.

The (non-distinct) investment component can ultimately be paid in the form of claims, commission, or a combination of the two.

Any balance sheet amounts for these expenses payable to purchaser would be included in the LIC/ LRC (or AIC/ ARC) in the same way as premiums (for the non-contingent component) and claims (for the remainder). The (non-distinct) investment component recorded in the statement of financial position represents any amounts collected from the purchaser that will be returned in all circumstances. This is independent of the insurance revenue or insurance service expenses recognized in the statement of financial performance. The (non-distinct) investment component is contingent on amounts collected from the purchaser only, rather than actual insurance revenue and insurance service expenses which includes accruals. At initial recognition, the (non-distinct) investment component will be recorded as part of the LRC. Thereafter, as the service gets recognized, this provision will gradually shift to the LIC, until it has been returned to the purchasers.

It may be necessary to assess the expenses payable to purchaser of each (re)insurance contract issued on a case-by-case basis to determine the non-contingent component, the contingent component and whether any part of the non-contingent component meets the definition of an investment component.

For more information on expenses payable to the purchaser of a reinsurance contracts issued and investment component, refer to the *draft educational note on Actuarial Considerations Related to P&C Reinsurance Contracts Issued and Held*[14].

3. Variable commissions payable to brokers and agents

Besides regular commission, intermediaries, such as brokers, may receive a contingent commission to ensure alignment of interest. The intermediaries do not retain risk, but these commissions reward them for maintaining a persistent portfolio of profitable insurance

[14] Canadian Institute of Actuaries *Draft educational Note: Actuarial Considerations Related to P&C Reinsurance Contracts Issued and Held* (2020).

contracts. Agents and brokers could also be offered incentives for volume targets, or both volume and profitability targets. These costs could be viewed as directly attributable to acquiring additional insurance contracts but resemble a policy maintenance expense. The treatment of these contingent commissions, such as CPC, may need to be reviewed on a case-by-case basis and could be recognized as either insurance acquisition cash flow or as maintenance expense cash flow under IFRS 17.B65 (h).

The contingent commission payments to intermediaries are usually results dependent but will be accounted for as insurance service expense. The accounting for a CPC agreement would follow the specific facts and circumstances of the agreement. Contingent commission related to current and past service, such as commissions driven by profitability considerations would be recognized as LRC then move to LIC while contingent commissions related to future service, such as commissions driven purely by volume would be recognized as LRC. The contingent commissions may be dependent on several years of results and payable in future years.

Contingent commissions payable to intermediaries would be included in future cashflows, as they are directly attributable expenses. For contracts measured under the PAA, estimates for contingent commissions would be included the fulfilment cash flow calculations for onerous assessment.

Contingent commissions payable to third parties would not be treated as (non-distinct) investment component as they are not payable to the underlying insured, they are expensed as insurance service expenses.

4. Other insurance service expenses payable to intermediaries

Intermediaries may provide procurement, underwriting and/or claim handling services related to (re)insurance contracts issued. IFRS 17 applies to insurance contracts only, and while a contract between an intermediary (providing insurance support services) and an insurer does not constitute an insurance contract it is important to understand the treatment of the related expenses. Examples of such intermediaries providing insurance support services are managing general agents (MGA) and managing general underwriters (MGU) that has been delegated underwriting authority on behalf of the insurer (select risks, determine the price and set out terms and conditions for the coverage), third party claim adjusters (TPA) are managing, and handling claims on behalf of the insurer and brokers may provide any of these services or a combination of them.

4.1. Acquisition costs

Intermediaries with underwriting authority, such as MGAs, MGUs or brokers, receive a commission expressed as a percentage of premium written in considerations for all services provided i.e., underwriting costs or costs associated with selling policies. These commissions would be treated as regular commissions within acquisitions costs and expensed as insurance service expense, as discussed in Section 3.1 of this report.

4.2. Claim handling costs

An insurer may delegate authorities to MGAs, MGUs, TPAs or brokers to manage and handle claims. Depending on the agreement between the insurer and the intermediary, all costs and expenses incurred by the intermediary acting on behalf of the insurer in the handling of claims

may be charged to the applicable claim and paid by the insurer to the intermediary in a manner agreed upon. These expenses would be considered claim handling costs and would be part of fulfillment cash flows. The treatment of these claim handling costs would be similar to the insurer's own claims adjustment costs.

4.3. Variable Commission

For variable commission payable to intermediaries (other than brokers or agents) are treated the same as variable commissions payable to brokers and agents refer to "Variable commissions payable to brokers and agents" section above.