Explanatory Report

IFRS 17 Assets for Acquisition Cash Flows

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

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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 Assets for Acquisition Cash Flows**

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

The explanatory report is structured into five sections. Section 1 introduces the content presented in this report. Section 2 highlights the key similarities and differences between IFRS 4 and IFRS 17 with regards to acquisition cash flows. Section 3 constitutes the main section of the report, and presents considerations related to establishment of an asset for insurance acquisition cash flows and subsequent recoverability testing under IFRS 17, with a focus on both the general measurement approach (GMA) and premium allocation approach (PAA) for direct contracts. Section 4 presents some variations to the content of Section 3 such as reinsurance contracts, premium allocation approach, and other miscellaneous topics. Section 5 is an appendix that presents a number of illustrative examples, supported by an Excel attachment.

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

- Committee on Risk Management and Capital Requirements
- Appointed Actuary Committee
- International Insurance Accounting Committee
- Worker's Compensation Committee.

A preliminary version of the explanatory report was also shared with the staff of the Accounting Standards Board (AcSB) to broaden consultations with the accounting community. Given that this explanatory 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 endorser by the AcSB.

The explanatory report was also presented to the Actuarial Guidance Council (AGC) in the months preceding this request for approval. The subcommittee feels that it has addressed the material comments received by the various 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 explanatory 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 explanatory report: Simon Séguin (co-chair), Andrew Ryan (co-chair), Adam Peleshok, André Gauthier, Christopher McRae, Cynthia Potts, Donal Boissonneault, Denise Cheung, and Nicholas Caramagno.

Questions or comments regarding this explanatory report may be directed to guidance.feedback@cia-ica.ca.

SWE, SB, MAB, SAC

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1 Introduction

IFRS 17® Insurance Contracts (IFRS 17 or the Standard) establishes principles for the recognition, measurement, presentation, and disclosure of insurance contracts. This explanatory report provides considerations relating to insurance acquisition cash flows under IFRS 17.

While there is currently no consensus amongst the industry and accounting firms on some 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. Given that actuaries might use the work of others for the recognition or measurement of expenses in the valuation in some 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 using the work of others for expenses in the valuation.

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;
- Consider practical implications associated with implementation of potential methods; in particular, ensure that due consideration is given to options that do not require undue cost and effort to implement.

The main objective of this explanatory report is to provide background information and considerations for actuaries in applying IFRS 17.28A to IFRS 17.28F, with a focus on the recognition and derecognition of assets for insurance acquisition cash flows, and calculations required to perform the related recoverability tests.

An asset for insurance acquisition cash flows (AACF) is a concept that is relevant for all entities that write insurance contracts; it arises whenever acquisition cash flows are incurred in a reporting period prior to the recognition of the insurance contracts to which they are allocated. An AACF might be required even if no acquisition cash flows are allocated to future renewals.

It is important to note that entities that choose to use the premium allocation approach (PAA) and also to apply IFRS 17.59(a), for groups of insurance contracts with coverage periods that are no longer than one year, will not have any AACF. All insurance acquisition cash flows will be recognized as incurred under IFRS 17.59(a). This means that most of the considerations

discussed in this explanatory report are not applicable when the IFRS 17.59(a) election is made[1].

Under IFRS 17.28A, when the IFRS 17.59(a) election is not made, insurance acquisition cash flows are allocated to groups of insurance contracts. Application guidance in IFRS 17.B35A distinguishes between cash flows directly attributable to groups of insurance contracts and cash flows directly attributable to portfolios of insurance contracts; both sets of allocations can create an AACF, but the distinction is relevant for recoverability testing of the AACF. IFRS 17.B35A(a) also distinguishes between directly attributable cash flows allocated to a group, versus groups of contracts that will arise from future renewals of contracts in that group.

In this explanatory report, the terminology "short duration contracts" and "long duration contracts" are used to distinguish between the types of contracts that may or may not lead to cash flow allocations to future renewals. This is a simplification of a whole spectrum of duration of contracts and varieties of contracts, but that simplification is useful to distinguish between contracts for which cash flows could be allocated to future renewals. In practice, it would be rare (but not impossible) for acquisition cash flows to be allocated to future renewals of long duration contracts, such as most Individual Life & Health (L&H) contracts. On the other hand, short duration contracts, such as most Property and Casualty (P&C) and Group L&H contracts, may be priced assuming that acquisition expenses are recovered via one or more renewals of the initial contract; therefore, it could be reasonable to allocate some portion of those acquisition cash flows to future renewals of short duration contracts.

Topics considered in this draft explanatory report include the following:

- Comments on IFRS 4 practices related to deferred acquisition expenses (Section 2);
- Considerations related to deferral of cash flows incurred prior to initial recognition, falling into two distinct categories: (a) long duration contracts, and (b) short duration contracts (Section 3.1).
- Examples of acquisition cash flows that may be deferred to future renewals (Section 3.3);
- When and how to allocate deferred acquisition cash flows to groups including future groups, as well as considerations regarding the number of years in the future to which acquisition cash flows may be deferred (Section 3.3);
- Facts and circumstances that could suggest that recoverability tests would need to be performed (Section 3.4.1);
- Methodologies and elements to consider in performing the two recoverability tests of the AACF (by group and for future renewals) (Section 3.4.2);
- Disclosure requirements related to the recoverability of acquisition cash flows, for both impairment loss and reversal of an impairment loss (Section 3.5);

[1] As an example, entities using PAA and electing paragraph IFRS 17.59(a) could still use «other asset or liability» as specified in IFRS 17.B66A and discussed in section 4.2 of this explanatory report.

- Specific considerations for groups using the PAA, including groups for which an entity chooses to recognize acquisition cash flows as expenses when incurred under IFRS 17.59(a) (Section 4.4);
- Specific considerations for reinsurance contracts held (Section 4.2);
- Comments on the measurement of AACFs at transition from IFRS 4 to IFRS 17 (Section 4.6).

The following are referenced in the commentary that follows and may serve as additional useful guidance to actuaries:

- CLIFR and PCFRC Explanatory Report: *IFRS 17 Expenses*;
- CLIFR and PCFRC Draft Explanatory Report: IFRS 17 Financial Statement Disclosures;
- CLIFR Educational Note: *Fair Value of Insurance Contracts*.

2 Comparison between IFRS 4 and IFRS 17

There is a range of practice under IFRS 4 with respect of the types of expenses identified as acquisition cash flows, as expenses are generally allocated based on entity-specific models and studies. Under IFRS 17, entities will continue to identify, allocate and measure acquisition cash flows, but would review their internal models for identifying and measuring acquisition cash flows to ensure that they meet the IFRS 17 requirements.

Life & Health: Under IFRS 4, L&H insurance contracts in Canada were valued using the Canadian asset liability method (CALM) in accordance with CIA Standards of Practice and educational notes. Acquisition cash flows would only be included in the CALM valuation if they are expected to be incurred after the valuation date. Inclusion of acquisition cash flows in the IFRS 17 valuation is therefore a significant change from IFRS 4.

Under the IFRS 17 general measurement approach (GMA) and variable fee approach (VFA) acquisition cash flows are included in fulfilment cash flows used to determine the contractual service margin (CSM) at initial recognition; to the extent that insurance acquisition expenses are incurred in a reporting period prior to initial recognition of the associated contracts in the group, an AACF is established when the cash flows are incurred, and the AACF is derecognized on initial recognition of the associated group of contracts, thereby including the insurance acquisition cash flows in the initial measurement of the liability for remaining coverage (LRC). Similarly, under the IFRS17 PAA, the LRC at initial recognition is the premiums received less acquisition cash flows including derecognition of any AACF allocated to the group of contracts per IFRS 17.55(a), unless the entity chooses to recognize acquisition cash flows as incurred under IFRS 17.59(a).

Property and Casualty: Under IFRS 4, the premium liabilities of P&C insurers are not shown explicitly in their financial statements. The net premium liabilities are equal to the discounted losses and loss adjustment expenses (LAE) with provisions for adverse deviations (PfADs) plus maintenance expenses, contingent commissions and future reinsurance costs. The asset for deferred policy acquisition expenses recorded in the financial statements is subject to a test of recoverability based on consideration of the actuary's estimate of premium liabilities derived in

accordance with accepted actuarial practice in Canada. Under IFRS 4, it is common for actuaries to perform a single test of recoverability at the entity level. Also the deferred policy acquisition expenses are generally deferred no more than one year (due to the length of the coverage period). As discussed in Section 3.4, IFRS 17 requires recoverability to be tested at the group of contracts level or at the sub-group[2] level instead of the entity level and the deferral of acquisition cash flows could be longer than one year and allocated to multiple future renewals.

3 General considerations

This section addresses the key considerations under the GMA for insurance contracts issued. Additional considerations related to reinsurance contracts held are discussed in Section 4.2, while considerations related to PAA are discussed in Section 4.4.

Insurance acquisition cash flows are defined in Appendix A of IFRS 17 as follows:

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

Considerations related to the identification and classification of directly attributable acquisition cash flows are covered in the CLIFR and PCFRC *Explanatory Report: IFRS 17 Expenses*. The remainder of this section discusses considerations primarily related to the *timing* of recognition of directly attributable insurance acquisition cash flows in an IFRS 17 valuation.

Some of the costs of acquiring insurance contracts (or group of insurance contracts) may be incurred prior to the initial recognition of the contracts in the group. Examples of such directly attributable acquisition cash flows include the following:

- Some pricing, sales prospecting, including unsuccessful quotes, and underwriting activities;
- Launch of a new line of business, incurring a significant amount of underwriting, product development (excluding product development considered non-attributable expenses) and marketing cost directly attributable to a specific portfolio;
- Significant investment in IT development directly attributable to a specific portfolio with to the objective at acquiring business (that are not otherwise capitalized or amortized using other IFRS); and
- When commissions for the initial contract are significantly higher as a proportion of premium compared to future renewals[3].

These cash flows may be directly attributable to either groups of insurance contracts [IFRS 17.B35A(a)] or portfolios [IFRS 17.B35A(b)]. For the latter, a further allocation to groups of

[2] The recoverability Test 2 [IFRS 17.B35D(b)] is done a level that is different than a group or portfolio.
[3] Those higher commissions may or may not be dependent or contingent on the renewal of the contract. In both cases, some costs could be considered supporting future renewals and be allocated to renewals.

contracts within the portfolio is required. Although cash flows ultimately are allocated to the group level under both IFRS 17.B35A(a) and IFRS 17.B35A(b), the distinction is relevant to recoverability testing (as discussed in Section 3.4 of this explanatory report).

For these costs, IFRS 17.28B indicates that the entity would establish an AACF (for each group) equal to the dollar amount of the cost incurred, and subsequently derecognize the asset when the contracts for which the cash flows were incurred are recognized per IFRS 17.28C. This treatment defers the profit and loss (P&L) recognition of the cash flows until the fulfilment cash flows of the associated contracts are recognized, to avoid a timing mismatch.

- IFRS 17.28B: An entity not applying paragraph 59(a) shall recognise as an asset insurance acquisition cash flows paid (or insurance acquisition cash flows for which a liability has been recognised applying another IFRS Standard) before the related group of insurance contracts is recognised. An entity shall recognise such an asset for each related group of insurance contracts.
- IFRS 17.28C: An entity shall derecognise an asset for insurance acquisition cash flows when the insurance acquisition cash flows are included in the measurement of the related group of insurance contracts applying paragraph 38(c)(i) or paragraph 55(a)(iii).

As explained in IFRS 17.B35C, the derecognition of AACF is done at the same time as the related contracts are recognized. Not all of the AACF would necessarily be derecognized at the time of the initial recognition of a group of insurance contracts – rather, as contracts in a group are recognized, an appropriate portion of the AACF is derecognized and included in the initial measurement of these contracts. Once all the contracts in a group have been recognized, the entire AACF will have been derecognized and included in the initial measurement of the contracts in the group.

Not all acquisition cash flows will create an AACF. If the acquisition cash flows relate to insurance contracts that have been recognized, those cash flows will be included in the calculation of the LRC for those contracts. Only the cash flows relating to insurance contracts not yet recognized (renewals or not) can generate AACF.

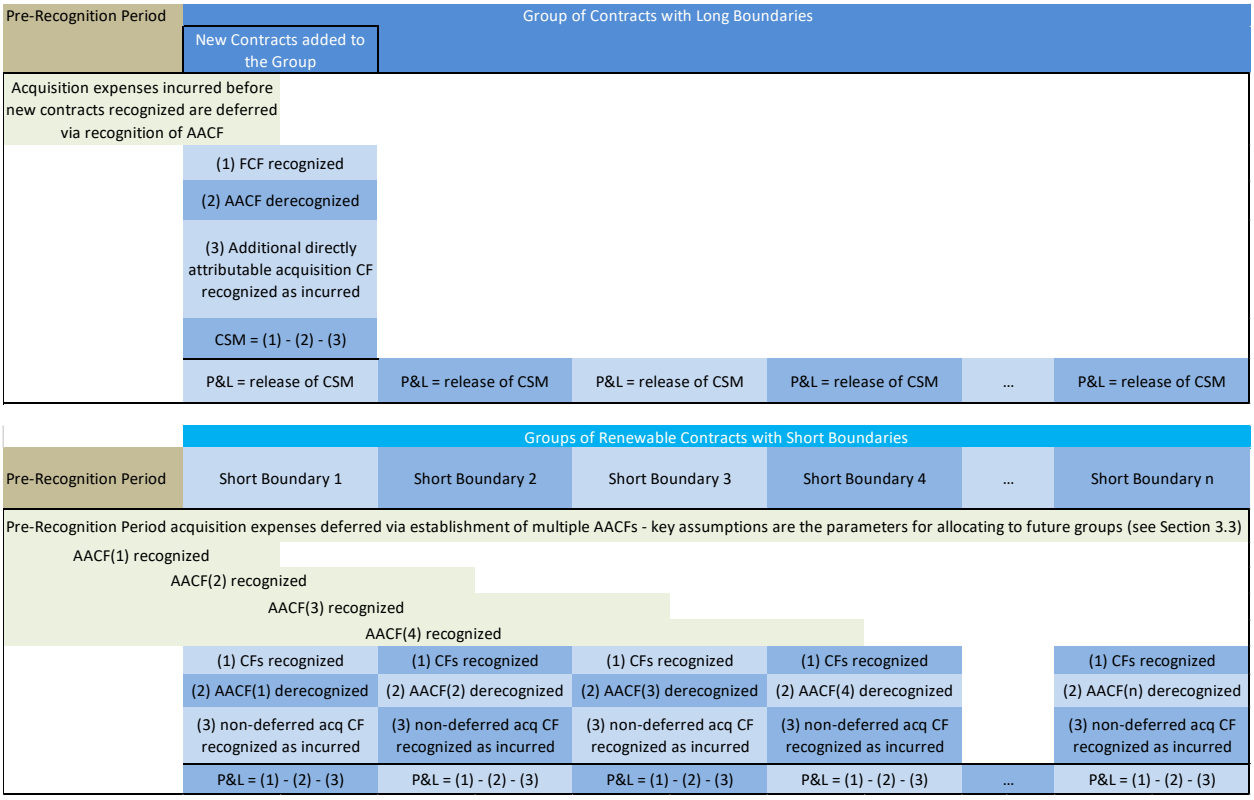
3.1 Groups of long duration contracts vs. groups of short duration contracts

A key area of judgment is the allocation of acquisition cash flows to groups of contracts, as eventual derecognition of the associated AACF of the group will result in recognition of expenses in that group. IFRS 17.B35A indicates that the entity would allocate insurance acquisition cash flows directly attributable to a group of contracts to (i) that group, and (ii) to future groups that are expected to arise from renewals of the contracts in that group. Accordingly, the discussion in this explanatory report of the deferral of acquisition cash flows is divided into two parts:

- For acquisition cash flows related to groups of long duration insurance contracts, which would include most groups of individual L&H contracts, it would be reasonable to fully recognize the directly attributable acquisition cash flows as part of the fulfilment cash flows as contracts are added to the group. Future renewals of long duration contracts, if any, would likely be out of scope for acquisition cash flow allocations.

- For acquisition cash flows related to short duration insurance contracts, which would include most P&C and Group L&H contracts, it may be reasonable to allocate some portion of the cash flows to future renewals of the contracts, under either IFRS 17.B35A(a) or IFRS 17.B35A(b).

The following picture illustrates some of the differences between acquisition cash flow deferral and recognition between long and short duration contracts. For short duration contracts, a key decision is the number of future groups over which the cash flows would be allocated, and the pattern of the allocation (linear, declining, etc.). This is discussed further in Section 3.3.



In the picture above, for both contracts with long boundaries and contracts with short boundaries (long duration contracts and short duration contracts):

- Acquisition cash flows incurred before the recognition of a group create an AACF (pre-recognition period);
- An AACF can be generated for acquisition cash flows incurred in a reporting period before the recognition of individual insurance contracts, even if the group to which these contracts are added has already been recognized.

In the picture above, it can also be seen what is different for the short boundary contracts (short duration contracts):

- Acquisition cash flows incurred in the pre-recognition period or in previous years can create an AACF for future groups.

- The diagram illustrates PAA for simplicity (with no CSM), but the profit emergence would be similar under GMA (with CSM recognized at the beginning of the year and fully released by the end of the year for each annual cohort).
- To simplify the illustration, it is assumed that the inflows and outflows related to each contract boundary are contained within the same time period.

Simple numerical examples of the concepts illustrated in the picture can be found in Section 5.1 of this explanatory report. For further clarity, the picture above implies the following:

- There will be zero P&L impact from insurance acquisition cash flows before the associated contracts are recognized; the timing of the recognition of a non-zero P&L impact is deferred via the establishment of an offsetting AACF.
- At initial recognition of the associated contracts, the AACF is de-recognized at the same time as recognition of all of the other expected cash flows in the initial LRC.
- For accounting presentation purposes, acquisition expenses are disclosed as part of revenue and expense over the life of the contracts in the group.

If at the end of a reporting period, facts and circumstances indicate that an AACF is impaired, the recoverability of the asset would be tested, and any non-recoverable portion of the asset would be derecognized. This would result in recognition (in insurance service expenses) of those cash flows in the period in which the AACF became impaired.

Two recoverability tests would be required for AACFs related to cash flows allocated to future renewals under IFRS 17.B35A(a); but only one test would be required when no cash flows are allocated to future renewals under IFRS17.B35A(a). Note that AACFs may also be allocated to future renewals under IFRS 17.B35A(b), however these AACFs would not be subject to the second recoverability test.

The following sections contain a more detailed discussion regarding considerations for establishment and derecognition of the AACF, for each of the two distinct types of contracts (long and short duration). Recoverability testing for the AACF is discussed in Section 3.4.

3.2 AACF for groups of long duration contracts

As noted in the previous section, the term “long duration contracts” is used in this explanatory report to refer to the types of contracts that are unlikely to have acquisition cash flows attributed to future renewals. Therefore, the scope of this subsection excludes considerations related to allocation of cash flows to groups comprised of future renewals.

Even when future renewals are excluded from consideration, some of the costs of acquiring insurance contracts (or group of insurance contracts) may be incurred in reporting periods prior to the initial recognition of the contracts in the group, which would generate an AACF. In practice, it may be difficult to differentiate cash flows to be deferred (i.e., expenses related to contracts to be recognized in future periods for which an AACF would be established) from cash flows related to contracts that are recognized in the current period.

When establishing a systematic and rational acquisition cash flow allocation methodology, a fundamental consideration is how to identify and measure acquisition cash flows that would be

allocated to contracts not yet recognized. This is true even if the cash flows would not be allocated to future renewals. There are numerous ways this could be achieved, including:

- ***Allocate cash flows incurred to current groups:*** There is no AACF in this approach, nor any attempt to strictly match cash flows to the contracts for which they were incurred. This approach ignores the fact that some cash flows incurred in the current period may be associated with contracts yet to be recognized. Instead, it implicitly relies upon a simplified assumption of a relatively steady state of expense incurrals and level of sales, such that cash flows that technically should be deferred and recognized in a future period are assumed to be not significantly different than cash flows that would have been incurred in a prior period and recognized in the current period. It is important to note, this approach would not be fully compliant with IFRS 17.28B. However, if it can be demonstrated that the timing mismatch between cash flow incurral and initial recognition of the associated contracts does not have a significant impact on the measurement of any particular group of contracts, it could be acceptable in some cases even if not fully compliant with IFRS 17. This approach is an approximation to a more fulsome allocation methodology, and it would be important to ensure that the entity's auditor continues to be supportive of such an approximation.
- ***Allocation based on functional time studies***: This approach would use functional time studies to estimate how acquisition cash flows incurred in the current period are expected to be distributed between contracts recognized in current and future periods. An AACF is recognized for expenses attributable to contracts yet to be recognized. Functional time studies may examine the historical lag between when certain types of cash flows (e.g., underwriting, sales prospecting, pricing activity) are incurred and when the associated contracts are initially recognized. This approach could meet the requirements of IFRS17.28B-C, but the process could be complicated to maintain, and relies upon the assumption that time lags are consistent.
- ***Unit-cost based allocation***: In this approach, unit costs are periodically calibrated to cover the entity's expected directly attributable costs based on its expected level of sales. Residual incurred cash flows (under-allocations or over-allocations relative to total incurred expense) in any given reporting period would adjust the AACF, which would be fully derecognized and included in the initial measurement of contracts by the time all contracts are added to the group.

See Section 5.2 for numerical illustrative examples of the potential workings of these allocation methodologies. The examples in Section 5.2.1 illustrate a baseline case where insurance acquisition cash flows and sales volumes are stable, and experience emerges in line with expectations. In this simple scenario, the three allocation methodologies above will yield similar results. In real-world situations, it is unlikely that acquisition cash flows and sales will be either perfectly stable or exactly in line with expectations. The examples in Section 5.2.2 illustrate how the IFRS 17 financial results can begin to diverge between allocation methodologies as experience variances emerge, and highlights some of the reasons for those differences, which would provide some indications if an allocation method is reasonable or not in a specific context. These illustrations are not meant to be exhaustive. Other variances such as the level of

acquisition cash flows in the period could emerge in practice, and allocation methods other than those illustrated could be used.

Judgment would be exercised (including discussions with the entity's auditor) in developing an allocation method that is systematic and rational based on the facts and circumstances specific to the entity.

3.3 AACF for groups of short duration contracts

As noted in the Introduction, the term "short duration contracts" is used in this explanatory report to refer to the types of contracts that might have acquisition expenses incurred that support both the initial contract and future renewals of the initial contract. In these circumstances, it is required to allocate a portion of the acquisition expenses incurred in the current period to future groups that include future renewals of existing and new contracts. However, there could be circumstances where short duration contracts would not have expenses incurred that support future renewals or where there would be no material expenses incurred that support future renewals. In such circumstances, a systematic and rational approach may be to allocate no insurance acquisition cash flows to future renewals.

Note that for short duration contracts, some portion of cash flows may be allocated to future renewals, but the remainder would be allocated to current groups that may or may not yet be fully formed. The considerations in Section 3.2 would apply to those allocations to current groups. The rest of this section focuses only on allocations to future renewals.

There is an important distinction that needs to be made between expenses that are directly attributable to a group (IFRS 17.B35A(a)) versus to a portfolio (IFRS 17.B35A(b)). Those expenses would need to be tracked separately, because the treatment would be different in the recoverability tests.

When costs of acquiring new contracts are significantly higher than costs of renewing contracts, consideration could be given to deferring some of the excess costs to future renewals.

Examples of such excess costs include:

- High first year commissions;
- Cost of unsuccessful quotes that are higher in the first year than renewals;
- Underwriting, inspections, marketing and other expenses that are larger in the first year of the policy compared to future renewals.

Some of those cost could be group specific (IFRS 17.B35A(a)) or portfolio specific (IFRS 17.B35A(b)) and a systematic and rational allocation should be done to separate those two segments of expenses.

Under IFRS 17, a portion of the general overhead expenses could be considered acquisition expenses. Those expenses are not specific to a single contract, but rational and systematic allocation methods can be used to allocate them to new business or renewal contracts. Those should generally be considered portfolio specific ((IFRS 17.B35A(b)).

There could also be significant investments at different points in time that could benefit both future new business and future renewals. Examples of such expenses include:

- Significant investment to support the development of a new product, from underwriting to system implementation;
- Significant investment to make changes to existing product and underwriting processes.

These two examples might generally be considered portfolio specific (IFRS 17.B35A(b)).

Once the acquisition cash flows are identified, the actuary would evaluate the number of renewals, the pattern over which the acquisition expenses may be deferred, and to which groups of contracts they might be allocated.

For acquisition cash flows that are higher in the first year than in the renewal years, the selected number of renewals and the selected pattern would be adapted to the context of the entity and to the line of business being analysed.

Different metrics may be used to evaluate the number of renewals and pattern over which the additional cost could be deferred. Some examples include:

- Average number of years with continuous insurance relationship;
- Number of years to reach a certain overall retention since originating year;
- Re-underwriting cycle or the number of years before a significant re-underwriting[4] of the contracts is performed;
- Average time before a significant change in profile that would render the renewals contract too different than original contract (as examples, cars are being replaced, people move, etc.);
- Payback period used internally to approve business initiatives or projects.

For acquisition expenses related to significant investments, the allocation could be to both future new businesses and future renewals for a certain number of years. Again, similar metrics as those mentioned above could be used; the objective would be to look for a reasonable number of years over which those large initial expenses would be partially attributable to future groups.

Section 5.3 contains illustrative examples.

3.4 Recoverability Tests

According to IFRS 17.28E, at the end of each reporting period the entity would assess the recoverability of an AACF if facts and circumstances suggest that the asset may be impaired.

Quantitative testing is only required when “facts and circumstances” indicate an AACF may be impaired as indicated in IFRS17.28E. If an impairment is identified, the impairment loss would

[4] Many insurance companies have simplified or less extensive underwriting processes for renewal business than for new business. Even so, there may be more thorough re-underwriting after a few renewal periods.

be recognized in the statement of financial performance (aka profit & loss statement) and the carrying amount of the related AACF would be reduced in the statement of financial position.

3.4.1 Facts and circumstances

The actuary would consider qualitative and quantitative sources of information that might be indicative of a potential impairment of the AACF. The following is a non-exhaustive list of activities or situations that might be considered relevant "facts and circumstances" in the context of the recoverability tests for the AACF:

- Significant experience variances or other events that trigger an adverse change in expected future cash flows relative to previous expectations;
- Pricing analysis and/or ratemaking committee decisions or analysis that might provide insight on current and prospective profitability;
- Relevant results from budget and financial planning;
- Large variations in the CSM or identification of new onerous groups;
- Decrease in number of sales or renewals expected or decrease in persistency rate.

3.4.2 Two recoverability tests

When facts and circumstances indicate potential impairment of an AACF, IFRS 17.B35D specifies two distinct quantitative tests that would be performed to assess recoverability.

- The first test would be performed regardless of the type of insurance contract for which an AACF is established. Recoverability is tested by group, and includes cash flows from all contracts expected to be part of the given group, including new business and renewals, if any.
- The second test would be performed only for acquisition expenses allocated to future renewals under IFRS 17.B35A(a). Recoverability is tested on subsets of groups, reflecting only the cash flows from renewals of existing contracts (i.e., excluding future new business). As previously mentioned, AACFs may also be allocated to future renewals under IFRS 17.B35A(b), however these would not be subject to the second recoverability test.

Recoverability test 1 [IFRS 17.B35D(a)]

The first recoverability test is done for each group to which acquisition expenses have been allocated and an AACF established. The test compares the amount of the AACF to the expected net[5] cash flows from all contracts expected to be part the group, including cash flows from expected future new business and renewals of existing and future new business. If the AACF exceeds the expected net cash flows from the group, the recoverability test would be failed. Future acquisition expenses not yet incurred would be part of the outflows and those future

[5] The term net cash flows refers to the netting of inflows and outflows and is not related to reinsurance; an expected net cash inflow position [inflows are higher than outflows] is a necessary condition for recoverability.

outflows would be allocated to future groups with a similar systematic method used to establish the AACF.

To illustrate the first test, let's assume the following simplified assumptions:

- New line of business started in 2020 and that line of business is in a separate portfolio;
- All contracts are one year or less;
- Contracts are grouped by issue year;
- Issue date and the effective date of the contracts are the same;
- All acquisition cash flows are incurred on the issue date;
- As acquisition cash flows are assumed to be much higher in the first year than for renewal years, a portion of the acquisition cash flows incurred at issue are allocated to the next five renewals;
- There is no large investment to allocate;
- Recoverability testing must be performed at the end of calendar year 2022.

Test 1 compares the AACF attributable to a particular IFRS 17 group of contracts to all expected cash flows from the given group; in this illustration, there would be five distinct tests, one for each group to which an AACF would be allocated. Table 1 shows the allocation of the AACF per original issue year and by IFRS 17 group. The original issue year can be interpreted as the IFRS 17 group of the original contracts. Table 2 shows the five distinct tests to be performed.

Table 1: AACF per groups

Original issue	AACF per IFRS 17 Group								
year	2020	2021	2022	2023	2024	2025	2026	2027	2028
2020				AACF	AACF	AACF			
2021				AACF	AACF	AACF	AACF		
2022				AACF	AACF	AACF	AACF	AACF	
2023									
2024									
2025									
2026									
2027									

In Table 1, the bold (blue) line represents the moment at which the test is being performed, which in this example is at the end of calendar year 2022. There is no AACF left for groups 2022 and prior, since all contracts in those groups have been issued and recognized as of the testing date. There is also no AACF for original years 2023 or after, since no acquisition cash flows have been incurred yet.

Table 2: Grouping for Test 1 (IFRS 17 B35Da)

Original issue year	IFRS 17 Group									
	2020	2021	2022	2023	2024	2025	2026	2027	2028	
2020	NB	REN	REN	REN	REN	REN	REN	REN	REN	Future renewals
2021		NB	REN	REN	REN	REN	REN	REN	REN	of existing contracts
2022			NB	REN	REN	REN	REN	REN	REN	
2023				NB	REN	REN	REN	REN	REN	
2024	Recognized IFRS groups				NB	REN	REN	REN	REN	Future new businesses
2025						NB	REN	REN	REN	and future renewals
2026							NB	REN	REN	of future new businesses
2027								NB	REN	

In Table 2, the five purple boxes correspond to the five tests to perform (for IFRS groups 2023 to 2027). For each IFRS 17 group (each box), the net cash flows of each group must be compared to the AACF for the corresponding group. The red dotted cells are future new businesses and their future renewals. At the end of calendar year 2022, there is no AACF associated with those contracts, but their expected cash flows are included in the recoverability test of the AACF for their group, including their (future) acquisition cash flows. Consistent allocation method between new business and renewals will be used to calculate future acquisitions cash flows for the red dotted cells. Finally, the black cells with white background are the renewals of existing contracts. Not all renewals of existing contracts will have an AACF associated with them: Table 1 shows which renewals have AACF in this example. All (black) cells with white background that are in the purple boxes would be included in the calculation of the first recoverability test even if there is no AACF associated with them.

Recoverability test 2 [IFRS 17.B35D(b)]

The second recoverability test is a test done only on those acquisition cash flows allocated to future renewals under IFRS 17.B35A(a). The test compares the amount allocated to future renewals under IFRS 17.B35A(a) to the expected net cash flow from the future renewals to which the cash flows were allocated. Note that cash flows from future new business are not included in recoverability test 2. If the acquisition cash flows allocated to future renewals under IFRS 17.B35A(a) exceed expected net cash flows from those renewals, the recoverability test would fail. The AACF allocated to those renewals based on IFRS 17.B35A(b) would be included in the net cash flows for the purpose of the recoverability test 2 and would reduce the net cash flows from those renewals.

The general consensus is that a separate test is required for each original issue year, i.e., each row. The original issue year is seen as the original IFRS 17 group that generated the allocations to future years. The portion of the AACF for cash flows allocated under IFRS 17.B35A(a) in a particular year would be compared against expected net cash flows from renewals of contracts originally issued that year, as illustrated in Table 3, including only the net cash flows associated with contracts (renewals) to which the AACF cash flows were allocated. This illustration is consistent with the numerical example presented in the December 2019 IASB Staff Paper "Expected recovery of insurance acquisition cash flows".

Table 3: Grouping for Test 2

Original issue year	IFRS 17 Group								
	2020	2021	2022	2023	2024	2025	2026	2027	2028
2020	NB	REN	REN	REN	REN	REN	REN	REN	REN
2021		NB	REN	REN	REN	REN	REN	REN	REN
2022			NB	REN	REN	REN	REN	REN	REN
2023				NB	REN	REN	REN	REN	REN
2024					NB	REN	REN	REN	REN
2025						NB	REN	REN	REN
2026							NB	REN	REN
2027								NB	REN

Other interpretations of the requirements of the second recoverability test are possible, but should be discussed with the entity's auditor before deviating from the above illustration.

3.4.3 Consequences of failure of recoverability test

If a recoverability test fails, the amount by which it fails would be recognized as a loss in the current period, and the related AACF(s) would be reduced such that the test is passed.

As per IFRS 17.B35D(b)(ii), test 1 should be performed before test 2. Any impairment losses recognized in test 1 allocated to renewals of existing contracts could reduce the amount of the AACFs when applying test 2. This means that the actuary could have to allocate the test 1 impairment losses by each combination of original issue year/IFRS 17 group in some circumstances.

Also, when impairment losses are recognized, this will reduce the acquisition expenses that will eventually be included in the initial recognition of the future contracts (and groups).

3.4.4 Reversal of previously recognized impaired losses

According to IFRS 17.28F, impairment losses previously recognized would be reversed by increasing the carrying amount of the AACF, if the conditions that led to the impairment no longer exist or have improved.

Consequently, when an entity had reduced the AACF because of an impairment, that entity can reverse (totally or partially) that loss at a subsequent reporting date if the net cash flows are greater than the AACF being tested. The reversal of previously impaired AACF must occur before the AACF has been derecognized and considered as part of the LRC.

No examples of reversals are provided in this explanatory report, but in the appendices, the various examples show the excess of the cash flows compared to the AACFs that could be used to reverse a previously impaired AACF.

3.5 Disclosure requirements

According to IFRS 17.105A-B, the entity would provide a reconciliation from the opening to the closing balance of AACFs, showing separately any recognition of impairment losses and reversals of impairment losses. The reconciliation would also present the carrying amounts at the beginning and at the end of the period separated into totals for those portfolios of contracts that are assets and those portfolios that are liabilities. Furthermore, the

reconciliations would be consistent with the insurance contract reconciliations as specified in IFRS 17.98.

In addition, IFRS 17.109A requires an entity to disclose quantitatively, in appropriate time bands, the expected derecognition of AACFs when the insurance acquisition cash flows are included in the measurement of the related groups of insurance contracts. The following table provides an example of AACF distributed in time bands than could be included in the financial statements notes as per IFRS 17.109A:

Balance at December 31, 2023	AACF
Less than or equal to one year	1 548
One to two years	1 022
Two to three years	613
Three to four years	337
Four to five years	173
Five to ten years	147
More than ten years	0
	3 840

Separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held. For reinsurance contract held, the requirements of paragraphs IFRS17.105A-B should be adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued.

The example disclosures below illustrate one way to address the requirements of IFRS17.105A-B:

Balance at December 31, 2022	3,718
Amounts incurred during the year	3,022
Amounts derecognized and included in the measurement of insurance contracts	(2,924)
Impairment losses and reversals	(13)
Effects of movement of exchange rates	37
Balance at December 31, 2023	3,840

Balance at December 31, 2022	
Presented in insurance contract assets	3,718
Presented in insurance contract liabilities	0
	3,718

Balance at December 31, 2023	
Presented in insurance contract assets	3,840
Presented in insurance contract liabilities	0
	3,840

In the example above, the deferred acquisition cash flows are all in the insurance contract portfolios in an asset position, but acquisition cash flows can also be associated with portfolios of insurance contracts that are in a liability position.

In the example above, if there were AACFs associated with portfolios of insurance contracts that are in a liability position, the numbers will be positive in that disclosure note. However, on the balance sheet, those AACFs would reduce the insurance contract liabilities of those portfolios.

As per IFRS 17.78 and IFRS 17.79, in the balance sheet, the AACFs will not be separate assets, but rather included in the insurance contract assets or insurance contract liabilities of the related portfolios. In the infrequent situation where the related portfolio has not been created yet, the AACF could be the first amount accounted for in a new portfolio which would result in that portfolio being in asset position.

Notwithstanding the level of granularity illustrated above, the optimal presentation would consider the requirements of the Standard in conjunction with the facts and circumstances of the entity.

Finally, in some regulatory balance sheets, the AACF could be required to be listed separately from the insurance contract assets or insurance contract liabilities. This is expected to be the case for the Office of the Superintendent of Financial Institutions' (OSFI) P&C return.

4 Other insurance acquisition cash flow related topics

4.1 Re-allocations to different groups of contracts

As noted earlier, acquisition cash flows that are directly attributable at the portfolio level must ultimately be allocated to the group level, as per IFRS 17.B35A(b). However, the allocation to the group level may not be straightforward for acquisition cash flows incurred prior to initial recognition of the associated contracts, because by definition these cash flows are incurred before there is any certainty regarding the number and profitability of contracts that will ultimately be recognized. IFRS 17.28A specifies that the entity should use a "systematic and rational" allocation method in applying paragraph IFRS17.B35A.

IFRS 17.B35B allows for changes in assumptions that determine the inputs to the method of allocation before all contracts have been added to a group. IFRS 17.B35B indicates that the entity shall revise the allocations made at the end of each reporting period to reflect any changes in assumptions that determine the inputs to the allocation, but allocations would not be changed after all contracts have been added to a group.

In some circumstances, the changes in allocation assumptions could also affect the allocation of AACF to future renewals. In those circumstances, it is important to note that the revision of the allocation assumptions between groups should be done before doing the impairment tests.

For example, assume that an entity has two distinct groups of contracts, and incurs $100 in underwriting expenses, expecting to sell an equal volume in each group in a future accounting period. The entity's underwriting operation is a shared service between the two groups, and its expense accounting methodology allocates expenses pro-rata based on sales volumes. This

would result in a $50 cash flow allocation to each group based on expected sales volumes, and establishment of a $50 AACF in each group, resulting in zero income recognition in the accounting period before the associated contracts are recognized, as illustrated in the following table.

	Expected Sales	Incurred Acq Exp	Allocated Acq Exp	AACF	Income Recognized
Group A	5		$50	$50	$0
Group B	5		$50	$50	$0
Total	10	$100	$100	$100	$0

If in a subsequent accounting period actual sales arose with a 60%/40% split (group A/B), it could be reasonable to revise the cash flow allocations to $60/$40. In this example, assume that the entity changes its assumptions and reallocates its cash flows, per IFRS 17.B35B, based on the actual level of sales relative to the expected level. The financial impact in the period the contracts are written is summarized in the following table[6].

	Re-Allocated Acq Exp	AACF Derecognition	Acq Exp Recognized
Group A	$10	$50	$60
Group B	($10)	$50	$40
Total	$0	$100	$100

The revised cash flow allocation would affect the measurement of the LRC for the two groups, presumably contributing a more faithful representation of the CSM for each group than the initial allocation that was estimated before any contracts had been recognized.

4.2 Reinsurance contracts

There is no concept of an asset for acquisition cash flows for reinsurance contracts held under IFRS17. This interpretation is based on the definition of insurance acquisitions cash flows that only refers to insurance contracts issued or expected to be issued, which is not the case for reinsurance held. Furthermore, IFRS 17.79 states that AACF should be included in the carrying amounts only for insurance contracts issued in asset position or liability position. Finally and perhaps most importantly, IFRS 17 does not require immediate recognition of expected losses under a reinsurance contract held, so it would seem contradictory to apply any recoverability testing to a "reinsurance held AACF".

However, applying IFRS 17.B66A, some cash flows attributable to reinsurance contracts held, paid prior to the recognition of the reinsurance contracts held, could generate an asset or a liability (other than an AACF). For example, cash flows associated with the pricing and negotiation of a reinsurance held contract would be incurred prior to initial recognition of the contract, and therefore could generate an asset. Additionally, if a reinsurer paid an allowance to the ceding company prior to the recognition of the reinsurance contract, the payment could

[6] Step 1: reallocate $10 from Group B to Group A. Step 2: derecognize the AACF for each group. Step 3: total expenses recognized for each portfolio are the adjusted allocation from step 1, plus the derecognition of the AACF from step 2.

lead to the establishment of an acquisition liability for the ceding company. IFRS 17 does not require a recoverability test for such asset or liability.

The requirements for reinsurance contracts issued with respect to acquisition cash flows are similar to those for direct contracts.

4.3 Interest accretion

IFRS 17 does not require interest accretion on an AACF, as noted in IFRS 17.BC184H(b). Should an entity choose to accrete its AACFs with interest, the recoverability testing would be more difficult to pass; this, combined with the operational complexity of accreting interest, makes it unlikely that entities will choose to accrete interest on AACF.

4.4 Premium allocation approach

The requirements to recognize an AACF are relevant when the PAA is applied, except for those eligible groups for which the entity has chosen to expense the insurance acquisition cash flows as they are incurred, in accordance with IFRS 17.59(a).

The recoverability tests under PAA are the same as for the GMA.

The allocation of the AACF to current groups and future groups is part of the facts and circumstances to consider in evaluating if a group of contracts may be onerous. A sudden increase in the AACF could mean lower expected profitability, perhaps to a point where the net cash flows of a group turn from inflows to outflows. In this situation, the order of operations (contract profitability grouping vs recoverability testing) can have different consequences for contracts that are issued but not yet effective[7].

- Contract classification before recoverability testing: If the AACF makes a group onerous, it could generate an initial recognition before the first contract of the group becomes effective, as per IFRS17.25(c) as long as a contract has been issued. [If the contracts are not issued, there are impairment losses and the AACF will be reduced before contract recognition and classification.]
- Recoverability testing before contract classification: Another way to manage the situation is to assume that the impairments to AACF are done before the evaluation of whether a group is onerous, which could avoid classifying a group as onerous due to the inclusion of the impaired portion of an AACF.

IFRS 17 does not prescribe an order of application between creating a new onerous group or reducing the AACF because of an impairment. The approach selected should however be applied consistently.

[7] It is common practice for short-duration contracts to be issued before their effective date, for example renewal offers for P&C home and auto contracts or Group L&H contracts would often be sent out 30-90 days before the effective date of the contract renewal.

4.5 Insurance contracts acquired

Per IFRS 17.B95E and BC327I, when an entity acquires insurance contracts in a transfer of contracts or a business combination, at the date of acquisition it recognizes an AACF at fair value for the rights to obtain:

- renewals of contracts recognized at the date of acquisition; and
- other future contracts after the date of acquisition without paying again insurance acquisition cash flows that the acquiree has already paid that are directly attributable to the related portfolio.

The last point means that some acquisition cash flows incurred prior to the transfer of contracts or the business combination would be included in the initial measurement of future contracts.

4.6 Transition

Discussion of the transition approach (full retrospective, modified retrospective, or fair value) is beyond the scope of this explanatory report, but the measurement of AACF at transition requires a separate decision of whether to use retrospective, modified retrospective, or fair value approach compared to the valuation of the insurance contracts. Nonetheless, regardless of approach, IFRS 17.C4(aa) requires recognition and measurement of any AACFs at the time of transition, as if IFRS 17 had always applied. There is no need to perform recoverability tests prior to the transition date.

Application guidance for the measurement of the AACF at transition under the modified retrospective approach can be found in IFRS 17.C8, IFRS 17.C14B-C14D, and IFRS 17.C17A). Application guidance for the measurement of the AACF at transition under the fair value approach can be found in IFRS 17.C24A-C24B.

Since modifications to the retrospective approach can be very specific to each entity, no example or additional details are provided in this explanatory report. Concerning the fair value approach, actuaries can refer to the CLIFR educational note: *Fair Value of Insurance Contracts*.

5 Appendix: Illustrative examples

The examples in this section are intended to supplement the content in Section 3.

5.1 Overview example

In this example, an insurer is choosing whether to sell short or long duration contracts through a broker. The parameters of the example have been designed such that the economic value of selling either short or long duration contracts is the same. The discount rate is zero for illustrative simplicity. The purpose of the example is to illustrate the potentially different accounting results depending upon cash flow allocation choices.

The insurer agrees to pay a flat fee of $400 on Sept 1, 2020 to the broker to sell its policies in 2021, plus a per policy commission at the time of sale. The options under consideration are the following:

- The expected market for 5-year term insurance (“long duration”) is 100 contracts. Expected net cash flows (premium less claims) are expected to be $3 per contract in

each of the five years of the contract (i.e., $1,500 FCF). The insurer will pay the broker $5 per contract as each new contract is sold. The insurer will use GMA with level coverage units over the five-year contract boundary, as expected lapses are zero.

- The expected market for one-year renewable insurance ("short duration") is 20 contracts. Renewal persistency is expected to be 100% for five years, with all contracts lapsing at the end of five years. Expected net cash flows (premium less claims) are expected to be $15 per contract for both new contracts and renewals (i.e., $300 inflow per year). The insurer will pay the broker $5 per contract as each contract is sold and renewed. The insurer will use PAA.

The following table shows that the long duration contract strategy will lead to CSM recognition of $600 in year 1, with insurance service income (P&L) equal to $120 per year as the CSM is released linearly.

Timeline	2021	2022	2023	2024	2025
Pre-Recognition Period	Group of Contracts with Long Boundaries				
	New Contracts added to the Group				
$400 AACF Recognized					
	$1500 FCF recognized $400 AACF derecognized				
	$500 acquisition cost				
	CSM = $600 (ie. $1500 - $400 - $500)				
	P&L = $600/5 = $120	P&L = $120	P&L = $120	P&L = $120	P&L = $120

The P&L impact of the short contract strategy is dependent upon how the actuary chooses to allocate the $400 up-front flat fee. Two scenarios are shown: in scenario 1, the entire $400 is allocated to 2021, the first policy year; in the second scenario, the actuary decides to allocate the $400 equally amongst the five policy years, resulting in establishment of five different AACFs of $80 each in 2020. The scenarios are economically equivalent, as both produce $600 income over the five-year period, but accounting differences emerge as illustrated in the following table. Note that the second scenario exactly replicates the P&L of the long duration strategy, but the first scenario recognizes losses up front in the P&L, as the cash flows in 2021 are not sufficient to offset the entire up-front $400 fee.

Timeline	2021	2022	2023	2024	2025
	Groups of Renewable Contracts with Short Boundaries				
Pre-Recognition Period	Short Boundary 1	Short Boundary 2	Short Boundary 3	Short Boundary 4	Short Boundary 5
Scenario 1: insurer chooses not to defer the $400 pre-recogntion expense to future renewals					
AACF(2021) = $400					
	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized
	$400 AACF(1) derecognized				
	$100 acq cost	$100 acq cost	$100 acq cost	$100 acq cost	$100 acq cost
	P&L = ($200)	P&L = $200	P&L = $200	P&L = $200	P&L = $200
Scenario 2: insurer chooses to defer the $400 equally amongst the five IFRS17 groups					
AACF(2021-25) = $80					
	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized	$300 CFs recognized
	$80 AACF(2021) derecognized	$80 AACF(2022) derecognized	$80 AACF(2023) derecognized	$80 AACF(2024) derecognized	$80 AACF(2025) derecognized
	$100 acq cost	$100 acq cost	$100 acq cost	$100 acq cost	$100 acq cost
	P&L = $120	P&L = $120	P&L = $120	P&L = $120	P&L = $120

It must be noted that IFRS 17 requires allocation to future renewals if the acquisition cashflows are judged to support future renewals. The two scenarios above are intended solely to illustrate the impact of that judgment on P&L emergence.

While allocation to future renewals is required if acquisition cash flows are judged to support future renewals, the pattern of such allocation is not prescribed by the Standard. A five-year linear allocation is illustrated here for simplicity, but this does not imply that the allocation must be linear, nor does it imply that five years is an optimal allocation period. Significant judgment will be required, and the actuary would tailor the allocation parameters to the facts and circumstances of the situation.

5.2 Examples of allocation methodologies for long duration contracts

This subsection is intended to supplement the discussion of the three allocation methodologies discussed in Section 3.2 with numerical examples. As a reminder, allocation to future renewals is out of scope for the long duration contracts in these examples.

The purpose of these illustrations is to inform the actuary of some of the underlying assumptions implicit in various allocation methodologies, and to present practical ideas that could be expanded upon in the construction of a systematic and rational allocation methodology. Judgment will be exercised regarding the complexity of the design of the allocation methodology based on entity-specific facts and circumstances, and discussions with the entity's auditor. Nothing in this explanatory report is intended to imply that any one methodology should be preferred over another.

5.2.1 Example 5.2.1: Flat acquisition cash flows and sales volumes

When expectations about the level of acquisition cash flows and new business volume are flat, and actual experience emerges in line with expectations, each of the three approaches mentioned in Section 3.2 would lead to the same result.

This equivalence can be illustrated with the following simple example. Assume that there is one portfolio with constant expected sales of 10 contracts in each accounting period, and a flat underwriting expense of $100 per period. Each new contract is expected to generate $12 of net cash inflows, before allocating the underwriting expenses.

The entity reports quarterly and establishes groups of contracts using annual cohorts to meet the requirements of IFRS 17.22. The portfolio in this example is in a steady state, with contracts being issued before, during and after the current calendar year. In this example, contracts issued in the current year are part of Group B, contracts issued in the prior year are part of Group A, and contracts issued in the following year are part of Group C. The example focuses on the accounting in the current year as Group B is recognized.

The parameters of this example are summarized in the following table. The problem to be solved is how to allocate acquisition cash flows incurred in the period to groups within the portfolio. Note that the "FCF Recognized" column in the table excludes acquisition cash flow allocation; CSM is the FCF less the acquisition cash flow allocation.

	(1)	(2)			(3) = (1) - (2)			(4)			(5) = (2) + (4)			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			Deferred - AACF Recognized			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100													10		
Period 1	$100		?			?			?			?		10	$120	?
Period 2	$100		?			?			?			?		10	$120	?
Period 3	$100		?			?			?			?		10	$120	?
Period 4	$100		?			?			?			?		10	$120	?
Period 5	$100													10		

- **Method 1: Allocate cash flows incurred to current groups**

To apply the first allocation method described in Section 3.2 to this example, the actuary could make a steady state assumption and simply ignore both recognition and derecognition of the AACF, allocating all current period expenses to contracts recognized in the current period. In each accounting period there is $100 of incurred acquisition cash flow, none of which would be deferred to the following period. The results would look like the following:

(i)	(1)	(2)			(3) = (1) - (2)			(4)			(5) = (2) + (4)			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			AACF Recognized			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$100									$100			10		
Period 1	$100		$100									$100		10	$120	$20
Period 2	$100		$100									$100		10	$120	$20
Period 3	$100		$100									$100		10	$120	$20
Period 4	$100		$100									$100		10	$120	$20
Period 5	$100			$100									$100	10		
													Period 1-4 Total		$480	$80

Where the steady state assumptions are achieved, as in this simple example, the results (in terms of acquisition cash flow allocation to Groups and CSM establishment) are identical to the other methods that follow. Clearly, the obvious advantage is that these results are achieved without the need for the complexity of establishment and derecognition of an AACF.

The actuary would need to assess whether this simple allocation method is compliant with IFRS 17 and meets the requirements of "systematic and rational" by considering how it would perform if the underlying steady state assumptions were not achieved. An extended example is presented in Section 5.2.2.

- **Method 2: Allocation based on functional time study**

To apply the second allocation methodology from Section 3.2, the actuary performs a historical study, and determines that 30% of the underwriting expenses have been attributable to contracts recognized in the same accounting period in which the underwriting occurs, and 70% have been attributable to the following accounting period. The expense allocation is based on this study.

In each accounting period there are $100 of incurred acquisition cash flows, $30 of which would be allocated to new contracts recognized in the current period, and $70 of which would be allocated to contracts expected to be recognized in the following period. Those expenses are

deferred to the following period via establishment of an AACF. The results of this allocation are summarized in the following table:

(ii)	(1)	(2)			(3) = (1) - (2)			(4)			(5) = (2) + (4)			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			Deferred via AACF Recognition			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$30				$70								10		
Period 1	$100		$30			$70			$70			$100	$0	10	$120	$20
Period 2	$100		$30			$70			$70			$100	$0	10	$120	$20
Period 3	$100		$30			$70			$70			$100	$0	10	$120	$20
Period 4	$100		$30				$70		$70			$100	$0	10	$120	$20
Period 5	$100			$30			$70			$70		$0	$100	10		
														Period 1-4 Total	$480	$80

- Recognition as incurred: 30% of acquisition cash flows incurred in an accounting period would be allocated to contracts initially recognized in the same period.
- Deferral (AACF Recognition): 70% of acquisition cash flows incurred in an accounting period would be allocated to contracts recognized in the following period. In the first three quarters of the year, $70 of incurred expenses would be allocated to contracts recognized in the following quarter, which would part of Group B (the AACF would be attributable to contracts not yet recognized in the group currently open to new contracts applying IFRS 17.B35C). The $70 AACF recognized in the fourth quarter would be attributable to a group of contracts not yet open (Group B for expenses incurred in period 0, and Group C for expenses incurred in period 4).
- AACF Derecognition: The $70 AACF established in any given quarter would be derecognized in the following period when the new contracts are recognized.
- Acquisition cash flows attributed to a group in an accounting period would be the total cash flows recognized as incurred (first bullet above) plus the AACF derecognition in the period (third bullet above).
- CSM established for new contracts in the period is the initial recognition of the FCF ($120, comprised of 10 new contracts each with expected net flows of $12) less the allocation of acquisition cash flows.

This method, while respecting the letter of the Standard, could require very complicated time studies and allocation engines as real-world situations could be far more complex than this simple example.

- **Method 3: Unit-cost based allocation methodology**

To apply the third allocation method described in Section 3.2, the actuary could allocate acquisition cash flows based on calibrated expected unit costs and expected sales. The AACF would be used as a mechanism to adjust for any temporary residual differences between incurred cash flows and expected cash flows. In this example, the actuary would calculate a $10 expected acquisition unit cost per contract ($100 of expected acquisition cash flows in each period, divided by 10 contracts expected to be recognized in each period).

In this example, $100 would be allocated to contracts recognized in the same period (10 new contracts multiplied by $10 unit cost). As a result of actual being equal to expected, there is no need for handling of residual expenses via an AACF. The results would look like the following (identical to the first two methodologies above, but derived differently):

(iii)	(1)	(2) = min[(1),(5)]			(3) = (1) - (2)			(4) = (5) - (2)			(5) = (6) * $10			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			AACF Recognized			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$100									$100			10		
Period 1	$100		$100									$100		10	$120	$20
Period 2	$100		$100									$100		10	$120	$20
Period 3	$100		$100									$100		10	$120	$20
Period 4	$100		$100									$100		10	$120	$20
Period 5	$100			$100									$100	10		
													Period 1-4 Total		$480	$80

If incurred cash flows differed from allocated cash flows, the actuary would adjust the AACF. This is explored further with a more complicated example in the next section. The purpose of this section was simply to illustrate the equivalence of three very different allocation methodologies under a steady state where actual is equal to expected.

5.2.2 Example 5.2.2: Fluctuating sales volumes

When actual experience does not emerge exactly in line with expectations, the results of the three methods mentioned above would begin to diverge. This section uses examples to illustrate the drivers of the divergence and discusses some of the implicit assumptions underlying each of the methodologies.

In the previous subsection, it was assumed that there is one portfolio with constant expected sales of 10 contracts in each accounting period, and a flat underwriting expense of $100 per period. Each new contract is expected to generate $12 of CSM, before allocating the underwriting expenses. In this subsection, the example is extended to illustrate the impact of actual sales differing from expected as shown in the following table. All other experience is equal to expected.

New Contract Recognition		
	Expected Contracts	Actual Contracts
Period 0	10	10
Period 1	10	8
Period 2	10	11
Period 3	10	8
Period 4	10	13
Period 5	10	10

- **Method 1: Allocate cash flows incurred to current groups**

In each accounting period there is $100 of incurred acquisition cash flow, none of which would be deferred to the following period despite the fluctuating sales volumes. The results[8] would look like the following:

(i)	(1)	(2)			(3) = (1) - (2)			(4)			(5) = (2) + (4)			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			AACF Recognized			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$100									100			10		
Period 1	$100		$100									$100		8	$96	($4)
Period 2	$100		$100									$100		11	$132	$32
Period 3	$100		$100									$100		8	$96	($4)
Period 4	$100		$100									$100		13	$156	$56
Period 5	$100			$100									$100	10		
													Period 1-4 Total		$480	$80

One conclusion that could be drawn from the results in the table above is that contracts recognized in periods 1 and 3 are onerous, because the aggregate CSM for the contracts added to that group in the period are negative (before flooring at zero and establishing a loss component). Entities applying the set of contracts approach in IFRS17.17 may not come to this conclusion, but entities doing a seriatim test for onerousness at initial recognition might put these contracts in a separate onerous group per IFRS 17.16. This illustrates a potential practical reality of contract classification that would need to be addressed, as in theory the seriatim and set of contracts approaches should yield similar results per the requirements of the Standard.

As noted in Section 3.2, this method is an approximation to the requirements of IFRS 17. The actuary would have to assess whether this method would be compliant with the requirements of the Standard when actual experience begins to diverge from the underlying steady state assumptions. That assessment is outside the scope of this explanatory report.

- **Method 2: Allocation based on functional time study**

The 30%/70% expense allocation introduced in Section 5.2.1 would continue to be used irrespective of sales volumes, hence the acquisition cash flow allocations from method 2 in Section 5.2.1 would not change. The only difference from the example presented in Section 5.2.1 would be the amount of CSM recognized in any given period, as the fulfilment cash flow recognition pattern would change when actual sales differs from expected. This is illustrated in the following table.

(ii)	(1)	(2)			(3) = (1) - (2)			(4)			(5) = (2) + (4)			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			Deferred via AACF Recognition			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$30				$70								10		
Period 1	$100		$30			$70			$70			$100	$0	8	$96	($4)
Period 2	$100		$30			$70			$70			$100	$0	11	$132	$32
Period 3	$100		$30			$70			$70			$100	$0	8	$96	($4)
Period 4	$100		$30				$70		$70			$100	$0	13	$156	$56
Period 5	$100			$30			$70			$70		$0	$100	10		
													Period 1-4 Total		$480	$80

[8] In the table, a negative CSM represents a loss component.

These results highlight an implicit assumption underlying this methodology that the expected time lag between acquisition cash flow incurral and contract recognition is constant. In fact, the time lag may be an average, and failure to adjust for fluctuations in the time lag could lead to inconsistent measurement of the CSM. As shown in the table above, fluctuations in the timing of recognition of new business could lead to over-allocations of acquisition cash flows to periods with lower than expected sales, and under-allocations to periods with higher than expected sales. The actuary would assess whether or not the likelihood of such over or under allocations should be accounted for via a more robust allocation methodology. That assessment would depend upon facts and circumstances relevant to the particular entity, and is beyond the scope of this explanatory report.

- **Method 3: Unit-cost based allocation methodology**

To apply this method, the actuary would allocate acquisition cash flows to a group based on the actual number of new contracts recognized in the period, multiplied by the $10 per contract unit cost allocation factor developed in the corresponding example in Section 5.2.1. The resulting allocations are shown in the "Acq CF allocated" column in the following table.

(iii)	(1)	(2) = min[(1),(5)]			(3) = (1) - (2)			(4) = (5) - (2)			(5) = (6) * $10			(6)	(7)=(6)*$12	(8) = (7)-(5)
	Incurred Acq CF	Recognized as Incurred			AACF Recognized			AACF Derecognized			Acq CF Allocated			Contracts Recognized	FCF Recognized	CSM Established
		A	B	C	A	B	C	A	B	C	A	B	C		B	B
Period 0	$100	$100									100			10		
Period 1	$100		$80			$20						$80		8	$96	$16
Period 2	$100		$100						$10			$110		11	$132	$22
Period 3	$100		$80			$20						$80		8	$96	$16
Period 4	$100		$100						$30			$130		13	$156	$26
Period 5	$100			$100									$100	10		
													Period 1-4 Total		$480	$80

The AACF is used as a balancing item to reconcile the acquisition cash flows incurred in the period to the cash flows allocated in the period. In general, when actual sales are less than expected, some portion of acquisition cash flows incurred in the period are deferred via recognition of an AACF, whereas when actual sales exceed expectations, additional cash flows are recognized via derecognition of an AACF. The following bullets explain the "recognized as incurred", "AACF recognition", and "AACF derecognition" columns in the above table:

- Period 1 & 3: Acquisition cash flow allocation is $80 (eight contracts multiplied by $10 unit cost factor). The remaining $20 of the $100 incurred acquisition cash flows in the period is deferred via AACF recognition.
- Period 2: Acquisition cash flow allocation is $110 (11 contracts multiplied by $10 unit cost factor). The full $100 acquisition cash flow in the current period is recognized as incurred. Recognition of an additional $10 acquisition cash flow is achieved by derecognizing $10 from the AACF.
- Period 4: Acquisition cash flow allocation is $130 (13 contracts multiplied by $10 unit cost factor). The full $100 acquisition cash flow in the current period is recognized as incurred. Recognition of an additional $30 acquisition cash flow is achieved by derecognizing $30 from the AACF.

The resulting CSM emergence from this methodology would be more intuitive than the other methods as the matching of acquisition cash flows with the associated contract recognition could be interpreted as more reflective of actual experience, but the actuary would assess whether the benefit of the more intuitive results outweighs the costs of the complexity of the method.

In this simple example, the AACF at the end of period 4 is zero. Had there been a non-zero AACF balance at the end of period 4, the actuary would consider whether the balance could be re-allocated to Group C per the discussion in Section 4.1, or fully derecognized at the end of period 4. If re-allocating a substantial amount to a future group, recoverability tests may be required based on the facts and circumstances (e.g., are FCF from Group C expected to be sufficient to support the AACF?).

5.3 Examples of allocation methodologies for short duration contracts

This subsection is intended to supplement the discussion in Section 3.3 with numerical examples. Acquisition cash flow allocation to future renewals is a key consideration for short duration contracts.

To illustrate the recoverability tests to be performed in various situations, an Excel workbook with six scenarios has been created. These scenarios are based on simplifying assumptions to illustrate the recoverability tests and the various steps more easily. The Excel workbook is purely illustrative, and is not intended to be used for actual IFRS 17 calculations.

The Excel workbook illustrates one scenario at time. The user can select the scenario in the sheet "0 – Inputs and Results" in cell D6. The other sheets will be updated based on the scenario selected.

5.3.1 Core assumptions in the illustrative examples

In this simple example, the following is assumed:

- PAA method is used;
- The contracts are in a new line of business with no existing contracts;
- One-year contracts are issued, with January 1st effective dates; the issue date may or may not precede the effective date depending upon the scenario;
- Premiums are paid at the effective date, whereas losses are incurred and paid mid-year;
- For simplicity, there is no risk adjustment nor any expenses other than acquisition costs for new businesses; furthermore, there are no additional acquisition costs associated with renewals;
- The entity allocates acquisition costs equally over a three-year period, with the exception of the treatment of a large initial investment that has its own scenario-specific hypothesis for allocation;
- A defined proportion of acquisition costs are directly attributed to groups and are then subject to the second recoverability test (IFRS 17.B35D(b));

- The large initial investment is considered to be related to the portfolio and not subject to the second recoverability test;
- The assumptions stay the same over the projection period, with scenario-specific exceptions of future changes in assumptions on claims loss ratio and/or persistency rates.

The illustrative examples do not show all the impacts on the accounting of the contracts. The purpose of the examples is only to illustrate the required calculations to calculate the AACFs at different points in time, to perform the recoverability tests and to verify if a group is onerous if contracts have been issued. Some examples of calculations or results not shown in the illustrative example are:

- Impacts on income statement;
- Impacts on the balance sheet;
- Disclosures about AACFs with the level of detail explained in Section 3.5.

Assumptions are made about the ways impairments will be allocated to the various AACFs. When there are impairments, those impairments are attributed first to the portion of AACFs generated by "regular" acquisition costs. The portion of an AACF generated by the assumed large initial investment is reduced only once the portion of the AACF generated by regular acquisition costs is insufficient to cover the impairment. This is not a requirement in IFRS 17, but it is one possible way to manage expenses that are directly attributable to a group compared to expenses directly attributable to a portfolio.

Otherwise, when applicable, impairments are allocated proportionately between original issue years (for test 1) or IFRS 17 groups (test 2).

An entity could use attribution and allocation methods different than those presented in the illustrative examples.

Finally, the examples first test whether groups have become onerous before testing for impairment of the AACFs at the end of the calendar year. IFRS 17 does not prescribe an order if the onerous groups need to be tested before or after verifying if AACFs could be impaired. In the illustrative example, the assumption that onerous groups could have been tested earlier than the end of year is taken, such as closer to the issue date of the contracts which would have resulted in practise to test for onerous group before testing for the impairments of the AACFs, the latter being only done at the end of the reporting period.

5.3.2 Description of the six scenarios

Various scenarios were selected to illustrate different circumstances that could affect the recoverability tests. The choice of scenarios is not exhaustive.

New contracts are effective on January 1, and subject to renewal on January 1 thereafter. The scenarios begin with contracts effective on January 1, 2020. Since some contracts may be issued prior to their effective date, there may or may not be AACFs at December 31, 2019 depending upon the fact pattern in the given scenario. For each scenario set, the spreadsheet

examines the AACF and its recoverability at two points in time: December 31, 2019 and December 31, 2020.

Scenario 1: This scenario is very basic with no discounting and no initial investment. The issue date that is the same as the effective date of each contract. There is no onerous group and no future change in assumptions.

- December 31, 2019: No AACFs exist at that time, since no contracts issued prior to Jan 1, 2020. Therefore no recoverability tests are required.
- December 31, 2020: In this scenario, all recoverability tests are passed.

Scenario 2: This scenario is very similar to the first one, except contracts are issued two months before the effective date and some acquisition costs are incurred at the issue date.

- December 31, 2019: AACFs exist because deferrable acquisition costs have been incurred in 2019. Recoverability testing is required, and all tests are passed.
- December 31, 2020: In this scenario, all recoverability tests are passed.

Scenario 3: This scenario is very similar to the first one, except there is a large initial investment that creates AACFs before the issuance of the contracts.

- December 31, 2019: AACFs exist due to the large initial investment. The recoverability test is failed in this scenario, and a portion of the AACFs needs to be derecognized.
- December 31, 2020: It is important to note that assumptions are not changed between December 2019 and December 2020. The insurer believes that business will profitable during 2020, such that there is no expectation of any onerous groups or that any AACFs would be impaired before the end of the year 2020. At the end of 2020, the second recoverability test fails. The second test fails at the end of 2020 despite no assumption changes during 2020, because it is the first time that the second test is actually performed: at the end of 2019, there were only AACFs allocated at the portfolio level and therefore only the first test was required.

Scenario 4: This scenario is a combination of scenarios 2 and 3: there is a large initial investment and some contracts are issued before the effective date.

- December 31, 2019: In this scenario, AACFs exist in 2019 due to both the large initial investment and the incurral of acquisition costs before the January 1, 2020 effective date. The IFRS 17 Group 2020 is expected to be onerous due to allocations to the group of a portion of the large initial investment. The 2020 group must therefore be recognized in 2019 at the issue date and the AACFs associated with that group are derecognized at that time. Additional AACFs for future groups (2021 and beyond) due to the allocations to those groups of portions of the large initial investment. Recoverability testing of those AACFs is required.
- December 31, 2020: In this scenario, the first recoverability test is passed, and the second test is failed. The first test can be partially subsidized by assumed net cash

inflows from future new business, whereas the second test does not benefit from this subsidization.

Scenario 5: Scenario 5 is similar to scenario 4, but the assumptions are changed (for the worse) at the end of 2020.

- December 31, 2019: Same as scenario 4.
- December 31, 2020: This scenario illustrates the steps when both first and second recoverability tests are failed at the same time.

Scenario 6: This scenario is similar to scenario 3, but adds the complexity related to discounting.

- The discounting reduces the amount of impairment in the first year, and also changes the level of impairment between first test and second test at the end of 2020.