Financial services knowledge series on IFRS 17: The new horizon

February 2023

Volume 1

Our outlook

Historically, International Accounting Standards (IAS), which prevailed between 1973 and 2001, were issued by International Accounting Standards Committee (IASC). In 2001, the International Accounting Standards Board (IASB) an independent non-profit organisation based in London, was formed to replace the IASC. The IASB was developed to work on a set of global accounting standards known as International Financial Reporting Standards (IFRS). At that time, there was no standard on insurance contracts, and therefore IASB published *IFRS 4, Insurance Contracts,* on 31 March 2004. The main aim of publishing IFRS 4 was to improve disclosures for insurance contracts and improve recognition and measurement practices. IFRS 4 was meant to be an interim standard, and several amendments have been made to it to make it better and more reliable.

Recently, IFRS 17, *Insurance Contracts*, came into existence to create a common accounting language for insurance companies across the globe that could be understood and used by all relevant stakeholders. The implementation of the standard will impart much-needed transparency and improve the comparability of financial statements by bringing parity in the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the standard. The implementation of a new accounting standard has its advantages and challenges.

We aim to start a knowledge series on IFRS 17 to help readers gain a much deeper understanding of the standard, its requirements and its implementation. This document is the first in the IFRS 17 knowledge series, and it aims at exploring the need for insurance contract accounting and its standardisation into IFRS.

Evolution of insurance contracts' accounting standard

Brief timeline highlighting key amendments and new standards

31 March 2004 – IAS issued IFRS 4, which was effective for annual periods beginning on or after 1 January 2005.

18 August 2005 – IASB issued Financial Guarantee Contracts (amendments to IFRS 4), which was effective for annual periods beginning on or after 1 January 2006.

30 July 2010 – IASB proposed improvements to insurance accounting.
A press release was issued on 30 July 2010.

9 December 2015 – A press release announced amendments to address the temporary consequences of the different effective dates for IFRS 9 and the new insurance contracts standard that will replace IFRS 4.

12 September 2016 – A press release announced amendments to IFRS4.
Amendments addressed concerns surrounding the implementation of IFRS 9. They were applicable when IFRS 9 was first applied (overlay approach) or for annual periods beginning on or after 1 January 2018 (deferral approach).

18 May 2017 – IASB issued IFRS 17, which replaced IFRS 4.

25 June 2020 – IASB issued an extension of the temporary exemption from applying IFRS 9 (amendments to IFRS 4).
The amendments aimed to address the temporary accounting consequences of the different effective dates of IFRS 9 and the forthcoming IFRS 17 on insurance contracts.

27 August 2020 – IASB issued Interest Rate Benchmark Reform Phase 2 – amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16.
It was effective for annual periods beginning on or after 1 January 2021.

5 January 2021 – The Interest Rate Benchmark Reform Phase 2 – amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16, was adopted for use in the UK and was effective for annual periods beginning on or after 1 January 2021.

1 January 2023 – IFRS 4 was withdrawn and replaced by IFRS 17.

The IASB has issued various standards and amendments over time to ensure effective governance and strengthen the insurance industry.

Introduction

The IASB issued IFRS 17, *Insurance Contract*, on 18 May 2017 and is effective from 1 January 2023. It replaced IFRS 4, Insurance Contracts, an interim standard that was issued in 2004.

It is the first comprehensive international accounting standard for insurance contracts issued by an entity, including reinsurance contracts. IFRS 17 will augment the comparability and transparency of financial statements and enhance the quality of financial information.

It establishes principles for the recognition, measurement, presentation and disclosure of insurance and reinsurance contracts issued and held by entities.

The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

Contracts under IFRS 17

- Insurance contracts issued
- Reinsurance contracts held
- Investment contracts with discretionary participating features issued

Key principles of IFRS 17

- Identifies as insurance contracts those contracts under which the entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder
- Separates specified embedded derivatives, distinct investment components and distinct performance obligations from the insurance contracts
- Divides the contracts into groups that it will recognise and measure
- Recognises and measures groups of insurance contracts at:
  - A risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all the available information about the fulfilment cash flows in a way that is consistent with observable market information, plus (if this value is a liability) or minus (if this value is an asset)
  - An amount representing the unearned profit in the group of contracts (the contractual service margin)
- Recognises the profit from a group of insurance contracts over the period the entity provides insurance contract services and as the entity is released from risk. If a group of contracts is/or becomes loss-making, an entity recognises the loss immediately
- Separately presents insurance revenue (that excludes the receipt of any investment component), insurance service expenses (that excludes the repayment of any investment components) and insurance finance income or expenses
- Discloses information to enable users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of an entity

IFRS 4 and IFRS 17

IFRS 4 and IFRS 17

Issues with IFRS 4

IFRS 4 was introduced in 2004 and was meant to be an interim standard. The key differences between IFRS 4 and IFRS 17 and issues with existing IFRS 4 are as follows:

- Under IFRS 4, varying accounting practices are followed depending on the national and regulatory requirements, which leads to a lack of comparability of financial statements between insurance companies across countries. On the other hand, under IFRS 17, standard accounting practices are followed by entities across the globe. Therefore, IFRS 17 improves the comparability of financial statements between insurance companies across countries.
- Under IFRS 4, the estimates are not updated to calculate future cash flows. However, under IFRS 17, the estimates to calculate the cash flows are updated at each reporting date. This leads to a more accurate calculation of liabilities and provides a more reliable indication of the profitability of insurance contracts.
- Under IFRS 17, the sources of revenue from insurance services and investment performance are presented separately. This makes it more transparent to identify underwriting and investment profits. However, this is not the case under IFRS 4.
- IFRS 17 results in better comparability of financial statements between insurance and non-insurance companies as compared to IFRS 4.

Switch from IFRS 4

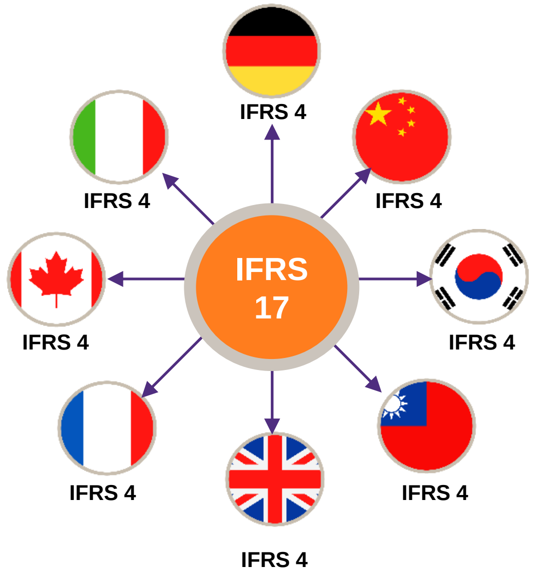
IFRS 17 eliminates the use of non-standard accounting policies and practices for similar types of insurance contracts within the industry. This provides a basis for users of financial statements to assess the impact of insurance contracts on the entity's financial position, performance and cash flows.

Benefits of IFRS 17

- The introduction of IFRS 17 will bring high-quality and consistent accounting standards for insurance contracts around the world, reducing much of the existing diversity in reporting.

  This will, in turn, bring **transparency** (by enhancing the international comparability and quality of financial information), **accountability** (by reducing the information gap between the providers of capital and the people to whom they have entrusted their money) and **efficiency** (by helping investors to identify opportunities and risks across the world) to financial markets across the globe.
- IFRS 17 measures and recognises the profit when the insurer delivers the insurance service. This is the standard practice followed across industries; for example, retailers make profits when they deliver the goods. This will provide a true reflection of profits and improve the transparency of the insurance company's financial statements with other industries.
- IFRS 17 requires entities to use current estimates and assumptions based on the most up-to-date information, which reflects the timing of the cash flows (discount rate) and uncertainty of insurance contracts (provision of risk). This leads to more reliable and accurate calculations of liabilities.

Moving to a consistent standard



IFRS 17

Challenges in IFRS 17

Granular data requirement

The data needed to implement IFRS 17 needs to be collected at a granular level. This will cause a change in the internal processes and reporting of companies, which will require substantial investment in capital and human resources.

Principle-based approach

IFRS 17 follows a principle-based approach. Although the principles remain the same across insurance companies, there is still some room for judgement as to how insurance contracts are measured. This impedes exact comparison between insurance companies.

Cost-benefit balance

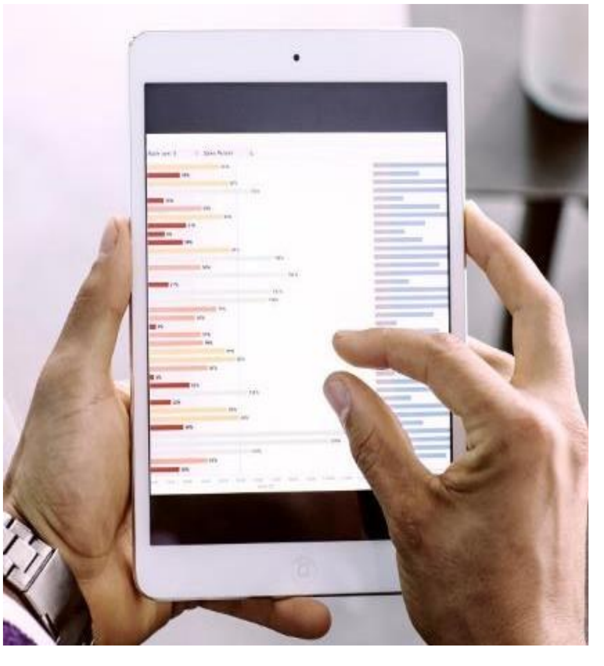
For most companies, implementation of IFRS 17 will require significant financial resources for IT systems and human resources to plug the capacity and technical gaps. The standard is therefore perceived as a high-cost standard. Insurers might go through extensive cost overruns in case of any mismanagement in the implementation, and as a result, a far-reaching strategy should be designed to ensure the delivery of strong financial performance.

Measurement models

IFRS 17 provides three measurement approaches for the accounting of insurance contracts:

- General Measurement Model (GMM) or Building Block Approach (BBA)
- Premium Allocation Approach (PAA) or simplified approach
- Variable Fee Approach (VFA)

Under GMM, insurance contract liabilities consist of some components, namely, probability-weighted mean present value (PV) of future cash flows (expected PV of cash flows), risk adjustment (RA) and contractual service margin (CSM). PAA is an option for certain short-term contracts, and VFA is applied to contracts with participating features that meet certain eligibility criteria.



Measurement models overview

Overview of measurement models

	Criteria	Examples
General Measurement Model (GMM)	• Cash flows are independent of the underlying investment strategy	• Conventional non-profit annuities • Protection businesses
Premium Allocation Approach (PAA)	• Short duration (12 months or less) • No embedded options/guarantees • Measurement is a good approximation to the GMM	• Reinsurance contracts held • General insurance contracts • Group protection contracts
Variable Fee Approach (VFA)	• Clear pool of underlying items • Policyholders receive a substantial share of the returns • Substantial portion of the amount paid to policyholders varies with the underlying item	• Conventional and unitised with-profit contracts • Unit-linked contracts

Accounting perspective

Accounting outlook

Fundamental accounting

Changes – IFRS 17

The IFRS 17 Module includes complex fundamental changes to accounting in two major factors as follows:

- **Liability measurement**

  An insurance contract may also consist of market-based linked plans. In IFRS 17, the major factor is to split the actual insurance portion and the market-linked (unit-linked) portion separately to evaluate the insurance portion liability for the remaining coverage period, along with the liability for incurred claims (including the future claims estimates).

- **Profitability recognition**

  The profit of contracts is recognised as the contractual service margin (CSM). At the start of the contract, the expected unearned profit of the contract must be amortised till the policy period and not in that year, and after the completion of each year, the profit/loss of that year will be recognised as an adjustment in the CSM and considered in the profit and loss (P&L) account. Once the insurance service is delivered, then that part of the CSM will go through the P&L, resulting in a profit.

  Insurance contracts are measured by the aforementioned three models (GMM, VFA and PAA) to calculate the liability and profitability based on their contract types.

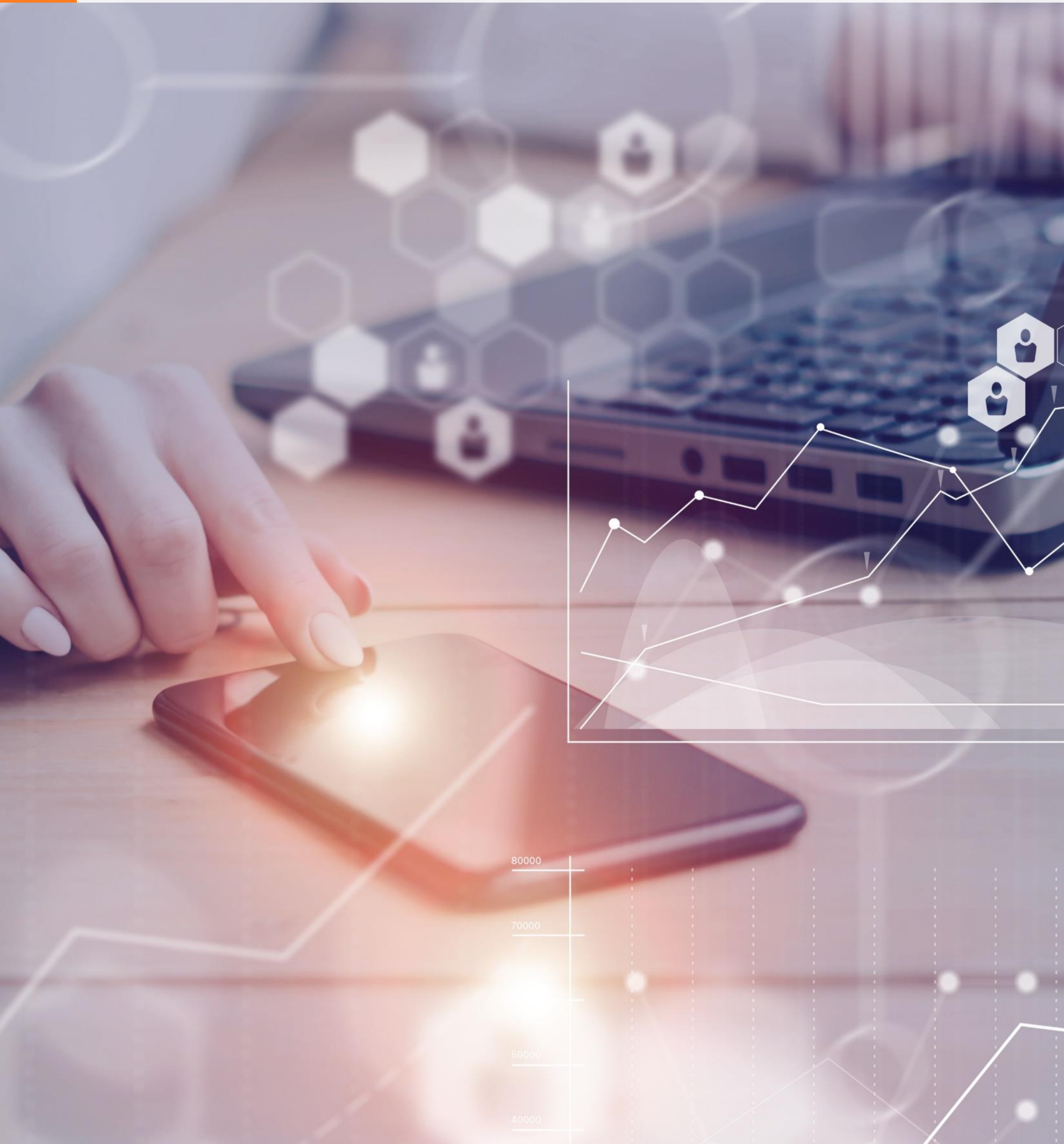
  IFRS 17 also results in consistency in P&L comparison with industries other than insurance. Moreover, the factors considered to create a balance sheet are quite simplified for many logical reasons.

  IFRS 17 introduces greater volatility in P&L, which requires more advanced forecasting and simulation capabilities to make financial forecasts.

IFRS grouping

Insurers need to disclose information based on a group of contracts. A group is a managed group (often a product) of contracts that were all profitable, onerous or may become onerous (decided at inception) within a certain inception year. IFRS 17 insisted on this grouping in order to have more transparency, as insurance companies cannot offset the result of one group to another.

Appendix



Upcoming releases, references and glossary

Upcoming releases

We will be releasing a list of documents in our knowledge series based on our thoughts on IFRS 17, with the following titles:

- **IFRS 17 Volume II: General Measurement Model (GMM) Unwrapped!**

The General Measurement Model is the standard approach to calculate liabilities for insurance contracts under IFRS 17. The General Measurement Model is applicable to contracts with longer terms. This document will aim at exploring the principles and concepts of the General Measurement Model under IFRS 17 in detail.

- **IFRS 17 Volume III: Premium Allocation Approach (PAA) – Let's make it simple!**

The Premium Allocation Approach is a simpler approach to calculate liabilities for an insurance contract under IFRS 17. It is used for short-term contracts (duration less than a year) in pre-claim liability. In this document, we will be exploring the principles and concepts of the Premium Allocation Approach in detail.

- **IFRS 17 Volume IV: Exploring Variable Fee Approach (VFA)**

The Variable Fee Approach is another variant of GMM to calculate liabilities for an insurance contract under IFRS 17. It is used for investment-related service contracts. This document will focus on the Variable Fee Approach for a better understanding of the user.

- **IFRS 17 Volume V: Reinsurance and Transition**

This document will focus on the modifications in requirements of the standard for reinsurance contracts held and also cover information on the effective date of IFRS 17 as well as the general requirements and challenges for transition.

References

- IFRS Foundation. (2020). 08 Level of aggregation: slides – IFRS.pdf
- IFRS Foundation. (2018). IFRS 17 pocket guide on reinsurance contracts held.pdf
- IFRS Foundation. Insurance Contracts IFRS 17.pdf

Glossary

- **CSM:** Contractual service margin is one of the elements in the General Measurement Model, which represents the unearned profit the entity will recognise as it provides services in the future.
- **IASB:** International Accounting Standards Board (IASB) is an accounting board developed to work on a set of global accounting standards known as IFRS.
- **P&L:** The profit and loss statement details a business's income and expenses over a defined period of time.

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