

IFRS 17 Insurance Contracts: “Party is over - there’s a New Sheriff in Town...”

After escaping from the long arm of the IFRS's market value accounting for more than a decade, it seems that the party is (nearly) over for the insurance industry. The newly issued IFRS 17 Insurance Contracts is presumably the biggest game changer in the history of insurers' accounting.

The long awaited Standard is a result of a project which started 20 years ago. The current Standard, IFRS 4, was issued in 2004 as an interim solution in order to accommodate the adoption of IFRS in the EU. IFRS 4 focuses on enhanced disclosure and doesn't prescribe the measurement of insurance contracts. It permits continuation of a wide variety of practices, and consequently results in a lack of comparison between insurance companies.

Although IFRS 17 has some similarities with the European Solvency II framework, there are also material differences between the two frameworks. Insurers are exempted from applying IFRS 9 to their financial investments until 2021 provided they meet the necessary qualification criteria.

Who are likely to be most affected?

Almost all insurers are likely to be affected by IFRS 17. However, the CFO's of the following insurers will have the most challenges:

- ▶ Issuers of long-duration insurance contracts, especially when these are measured using historical rather than current assumptions;
- ▶ Insurers that do not fully consider options and guarantees in their insurance contracts;
- ▶ Issuers of contracts with unit-linked and profit sharing features;
- ▶ Insurers that currently use expected investment returns on assets for discounting the insurance liabilities;
- ▶ Insurers that currently don't reflect the time value of money in long duration contracts;
- ▶ Insurers that currently report underwriting revenue and expenses on a cash basis or when the revenue includes deposits;
- ▶ Insurers that currently provide limited disclosure about their insurance contracts and insurance risk;
- ▶ Multinational insurance groups whose subsidiaries use different accounting policies; and
- ▶ Reinsurers.

Main features of IFRS 17

Definition	Similar to IFRS 4, there must be significant insurance risk.	Short-duration contracts	For some short-duration contracts, the Premium Allocation Approach (PAA) may be used. This is a simplified approach which is based on the unearned premium reserve approach.
Identification	Some non-insurance components should be separated and accounted for using other IFRSs.	Derecognition	When the obligations are extinguished or upon some contract modifications.
Recognition	An insurance contract is initially recognised when the coverage periods begins or when the company concludes that the contract is onerous.	Presentation	<i>Statement of Financial Position</i> - Insurance contracts are presented as insurance contract liabilities or as insurance contract assets. <i>Income Statement</i> - Insurance revenue less incurred claim expense equals the 'insurance service result', as the gross profit. Investment income less insurance finance expenses equals 'net financial result'. The effect of changes in discount rates on the insurance contract may be presented in Other Comprehensive Income (OCI) rather than in the income statement.
Contract Boundaries	When the insurer no longer has substantive rights to receive premiums or obligations to provide services.	Disclosure	Extensive disclosures requirements.
Initial measurement	<p>The general approach is the Building Block Approach (BBA). BBA is based on the building blocks of:</p> <ol style="list-style-type: none"> 1 <i>Future cash flows</i>: a current, unbiased estimate of the cash flows expected to fulfil the insurance contract (expected cash flows from premiums, claims and benefits); 2 <i>Discounting</i>: an adjustment for the time value of money (converting the future cash flows into current amounts consistent with market observable information); 3 <i>Risk adjustment</i>: an adjustment for the effects of risk and uncertainty (an entity specific measure to reflect the uncertainty about the amount and timing of the cash flows); and 4 <i>Contractual Service Margin (CSM)</i>: the positive (net inflow) difference between the risk-adjusted present value of expected inflows and outflows at initial recognition. If CSM is negative it is recognised in profit or loss (onerous contract) <p>The measurement must incorporate all available information about the expected cash flows related to fulfilling the insurance contract and must be consistent with observable market information.</p> <p>Options and guarantees must be reflected in the measurement of the insurance contracts.</p>		
Subsequent measurement	The insurer should remeasure the contracts using updated assumptions about cash flows, discount rate and risk. The effect of changes in estimates relating to future service is recognised in the periods in which the service is actually provided.		<h3 style="color: red;">Material differences with current practice</h3> <ul style="list-style-type: none"> ▶ <i>Comparability</i>: currently, there are significant differences in the accounting for insurance contracts across jurisdictions and even amongst entities in the same consolidated group financial statements. IFRS 17 is expected to result in a more consistent accounting treatment and presentation, making it easier for investors and analysts to compare and evaluate the insurer's financial position and performance. It will also result in synchronisation of the accounting policies of multi-national insurer groups. ▶ <i>Revenue recognition</i>: IFRS 17 will bring the insurer's revenue more in line with other industries. Deposits may not be reported as revenue. Revenue must be recognised as the insurance coverage is provided. The different profit components should be disclosed. ▶ <i>Use of current assumptions</i>: use of historical assumptions is not allowed. IFRS 17 requires updating the assumptions about cash flows, discount rate and risk adjustment at each reporting date. ▶ <i>Discount rate</i>: the discount rate will have to reflect the characteristics of the insurance liabilities. The practice of using the rate of return on the assets is not permitted. ▶ <i>Claims incurred</i>: the estimated future cash flows to settle claims incurred should be discounted. ▶ <i>Risk margin</i>: IFRS 17 requires the calculation and disclosure of an explicit risk adjustment.

- ▶ *Premium Allocation Approach*: for short duration contracts for which the PAA is applied, no significant change is expected. However, the insurer still needs to consider discounting and apply a risk adjustment for incurred claims.
- ▶ *Presentation (Statement of Financial Position)*: insurance contract assets and liabilities should not be netted. Furthermore, premiums receivable, unearned premiums and claims payable may no longer be presented separately from other insurance assets and liabilities. Rather, they will all be included in the measurement of the insurance liabilities and the reinsurance assets.
- ▶ *Presentation (Statement of Comprehensive Income)*: 'insurance revenue' will replace the current reporting of 'written premiums' and 'earned premiums'. Deposits should no longer be presented as revenue.
- ▶ *Disclosure*: insurers must provide information about the reported amounts (including detailed reconciliations of opening and closing balances of insurance liabilities/assets), the judgements used and the risks that arise from insurance contracts.

How can BDO help you?

IFRS 17 brings with it many accounting and operational challenges, but also many opportunities. Our professional advisors can help you to achieve a successful implementation of IFRS 17, which will see significant changes for the insurance industry.

We will:

- 1 guide you through the maze of IFRS 17, will support you in developing guidance and interpretations of the new requirements and in the preparation of a new accounting manual;
- 2 assist you in making the right accounting policy where there is a policy choice available under IFRS 17;
- 3 help you to decide on the appropriate transition approach;
- 4 advise you on the interaction of IFRS 17 with IFRS 9 *Financial Instruments* and on the pros and cons of early adoption;
- 5 help you to conduct an impact analysis and evaluate possible changes to your business model;
- 6 review the lessons learned from implementation of Solvency II in your organisation and consider how much you can leverage from the work done and the data which you already have 'in house'; and
- 7 assist you in developing training material and with educating internal staff as well as external stakeholders.