

## 4 IFRS 17, Insurance Contracts



### Section overview

- IFRS 17 was published in May 2017. It introduces a comprehensive financial reporting framework for insurance contracts which aims to achieve greater comparability and consistency in financial reporting by insurers.
- Adoption of IFRS 17 is mandatory for reporting periods beginning on or after 1 January 2021. Early adoption is permitted. In addition insurance companies are permitted to delay initial adoption of IFRS 9 until IFRS 17 is applied.
- The scope of IFRS 17 is similar to IFRS 4 and encompasses insurance contracts issued, reinsurance contracts both issued and held, and investment contracts with discretionary participation features if issued by insurers.
- A simplified measurement model referred to as the premium allocation approach can be used for short term insurance contracts. This is similar to the use of an unearned premium reserve under IFRS 4.
- The general measurement method is more complex and will be generally be applied to long-term insurance contracts, of greater than 12 months' expected coverage. It uses a building block approach to establish the value of insurance contracts on initial recognition.
- This general measurement method discounts future cash flows related to the contract and adjusts for non-financial risk to arrive at the amount of the fulfilment cashflows. To these is added an equal and opposite amount representing the unearned profit over the contract life, referred to as contractual service margin.
- Insurance contracts are remeasured at each subsequent year end and a proportion of contractual service margin is released to profit or loss as part of the insurance service result.
- Contracts for which the fulfilment cash flows are negative (liability) are referred to as onerous contracts. This amount is not mirrored in the creation of a contractual service margin, but rather is recognised immediately in profit or loss.
- In practice the measurement models of IFRS 17 will generally be applied to groups of contracts with similar characteristics aggregated together rather than on an individual contract basis.
- The measurement of reinsurance contracts follows the same measurement principles and mirrors that of the primary insurance contract(s) to which it is related.
- The implementation of such a significant change to the financial reporting of insurance contract is likely to represent a significant systems challenge to insurers, and auditors will need to perform additional work in relation to these systems and the internal controls related thereto.

### 4.1 Background

Insurance is a very significant part of the global economy with insurance companies, according to the IASB, globally accounting for **\$13 trillion of asset**. This makes it a priority to have effective and consistent financial reporting for this sector. However, insurance accounting has been a difficult subject for all interested parties that prepare and use insurance accounts to agree upon. Most users agreed that there has been a lack of transparency, comparability and consistency. The main difficulty was in achieving consensus on how to measure insurance liabilities.

The Discussion Paper *Preliminary Views on Insurance Contracts* was published by the IASB in May 2007 and focused on a '**current exit value**' measurement approach for insurance contracts on the basis that it was a proxy for fair value. This approach was not carried forward to the Exposure Draft (ED) issued in July 2010 by the IASB. After a joint effort with the FASB, it issued a revised Exposure Draft, *Insurance Contracts*, which was open for public comment until 30 November 2010.

These EDs proposed a new '**margin approach**' more closely linked to a new underlying measurement model and actual cash flow experience of the business written than the traditional premium less benefits approach to insurance accounting.

The final Standard, **IFRS 17, Insurance Contracts**, was published in **May 2017** using the approach of the previous EDs. Its publication is the culmination of a long IASB project to produce a comprehensive financial reporting standard covering insurance contracts.

## 4.2 The need for IFRS 17

IFRS 4 was introduced as an interim **stop-gap measure** allowing insurers to continue predominantly reporting using pre-existing national practices. As a result IFRS 4 is a very permissive standard due to the need to encompass divergent pre-existing financial reporting treatments of different jurisdictions. Reporting under IFRS 4 could give rise to the following issues for investors and other users of an insurer's financial statements:

- **Lack of comparability between different insurers**, particularly when comparing the insurers from different jurisdictions due to the range of permitted financial reporting treatments within the Standard.
- **Divergence** between the manner in which **short-term** and **long-term** insurance contracts are valued and profits reported.
- **Lack of comparability** when comparing performance of insurers to that of companies from **other industries** due to inconsistencies with other IFRS in areas such as the valuation of contracts and recognition of revenue and profit.
- Significant **inconsistency** between the solvency portrayed in the **statement of financial position** and that calculated for prudential regulation purposes under **Solvency II**.
- **Measurement** of insurance contracts based on **historical information**, not reflecting current information and estimates.

In order to address these issues, IFRS 17 introduces a more rigorous financial reporting framework for insurance contracts that is consistent with the principles used in other IFRSs. Its adoption by insurers should lead to greater comparability and transparency in their financial statements.

## 4.3 Implementation

Adoption of **IFRS 17 is mandatory** for reporting periods beginning **on or after 1 January 2021**. Early adoption is permitted prior to this date provided **IFRS 9, Financial Instruments** and **IFRS 15, Revenue from Contracts with Customers** are also both applied.

Adoption of **IFRS 9** is generally mandatory for reporting periods beginning **on or after 1 January 2018**. However, due to the interaction between IFRS 9 and IFRS 17 insurance companies are permitted to **delay initial adoption of IFRS 9 until IFRS 17 is applied** in order to avoid the creation of accounting mismatches.

As we will see IFRS 17 is a relatively complex standard with measurement of insurance contracts based on current information and estimates. This will require a considerable amount of additional information that would not have been necessary under IFRS 4, particularly in the case of long-term insurance contracts. As a result insurers are likely to have to make substantial changes to their systems in order to capture and process the information required under IFRS 17 in order to value insurance contracts. This is one of the reasons for the relatively long period of three and a half years between publication and mandatory application.

## 4.4 Scope

The scope of IFRS 17 is **very similar to that of IFRS 4**. It should be noted that it applies to all entities that **issue** insurance contracts, not just insurance companies. An insurance contract is defined by IFRS 17 as:

A contract under which one party (the issuer) accepts **significant insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder if a **specified uncertain future event (the insured event)** adversely affects the policyholder.

Insurance risk in the definition above is risk transferred between the parties to an insurance contract but **excludes financial risk** (risk related to changes in market prices and rates).

The following fall within the scope of IFRS 17:

- **insurance contracts**, including reinsurance contracts, an entity issues;
- **reinsurance contracts** an entity holds; and
- **investment contracts with discretionary participation features** an entity issues, **provided the entity also issues insurance contracts**.

Exclusions from the scope of IFRS 17 include:

- **product warranties or guarantees of residual value** by manufacturers, dealers or retailers
- **financial guarantee contracts** meeting certain criteria
- **contingent consideration** in a business combination
- **fixed fee contracts for the future provision services** which would otherwise meet the definition of an insurance contract under IFRS 17 provided that:
  - the price set is not based on a risk assessment of that customer;
  - the customer receives services not cash compensation; and
  - the insurance risk in the contract arises primarily from the customer's use of services, not from uncertainty over the cost of these services.



### Interactive question 6: Scope

Identify which, if any, of the following contracts fall within the scope of IFRS 17?

- Atlantis plc sells computer hardware. When a customer purchases a computer Atlantis sells contracts under the terms of which they agree to provide support and service in relation to the device purchased for five years.
- Belville plc sells three-year service contracts on used motor vehicles under which the customer pays Belville a fixed fee upfront and in return Belville pays to the customer the costs of vehicle servicing and the cost of replacement parts and labour in the event of mechanical failure over a three-year period.
- Clifton plc offers to extend the manufacturers' warranty period on new televisions that it sells if the customer pays an additional amount upon purchase. Under the terms of the extended warranty Clifton undertakes to repair or replace the television in the event of its failure.

See **Answer** at the end of this chapter.

#### 4.4.1 Separable components

There are some elements of premiums paid to insurance policyholders that may be attributed to components that are separable from the underlying insurance contract. In the case of such combined contracts only the insurance component of the contract is reported under IFRS 17. **Embedded derivatives** or **separable investment components** are measured under IFRS 9, *Financial Instruments* and components involving the **transfer of goods or services** are measured using IFRS 15, *Revenue from Contracts with Customers*. For example, an insurance contract may include an investment component or a service component such as claim handling.

Separable components include:

- **embedded derivatives** – the entity should apply IFRS 9 to identify the existence of embedded derivatives and how to account for them.
- **investment components** – these should be separated from the host insurance contract only if the investment component is distinct, in which case it would be accounted for under IFRS 9.

An investment component is only distinct if:

- it is **not** highly interrelated with the insurance component. This will only be the case if the investment and insurance components are capable of separate measurement without considering the value of the other and the policyholder can benefit from one component without the other being present; and
- a contract with equivalent terms is sold, or could be sold, separately in the same market.



### Worked example: Thad Assurance

A premium of £10,000 is paid by a policyholder to Thad Assurance for a whole of life insurance contract under which the premium is invested in an account to provide a payment on death or surrender. In addition there is a minimum surrender value of £9,000 and a minimum death benefit of £15,000.

To what extent should this contract be accounted for under IFRS 17?

### Solution

This contract could be considered to include two components, life insurance and investment. However, both components either lapse on surrender or have a payment triggered on death. This means that the policyholder cannot benefit from one component of the contract without also benefitting from the other. The two components are therefore highly interrelated and the entire contract must be accounted for only under IFRS 17.

## 4.5 Measurement models

IFRS 17 uses an approach to measurement of insurance contracts based on a '**general measurement method**' which incorporates all available **current information** about an insurance contract's obligations and risks, incorporating observable market information, in order to establish its value.

The **general measurement method**, as we shall see, can be somewhat complex. In the case of **short-term insurance contracts**. IFRS 17 permits the use of a simpler methodology, similar to that used for short-term insurance contracts under IFRS 4. This simplified method is known as the **premium allocation approach (PAA)**. The PAA can be used provided it is expected to arrive at a result that is a **reasonable approximation** of that arrived at using the more complicated general measurement method.

The PAA can always be used if an insurance contract has a life of **no more than 12 months**. It can also be used for contracts with a longer life if the liability for remaining coverage in the statement of financial position would not be materially different to that produced using the general measurement method.

For examination purposes, it should be understood that the PAA is most likely to be used for insurance contracts that provide coverage for a period of up to one year; with the general measurement method likely to be used for contracts with a term of longer than one year.

IFRS 17's measurement models are applied to portfolios of policies. However, for ease of understanding we will initially consider how the measurement models contained in IFRS 17 would apply to an individual insurance contract. The practical complication of the application of measurement to insurance portfolios is dealt with later in this section.

## 4.6 Recognition of profit

IFRS 17 aims to ensure that **all insurance contract revenue is reported on an earned basis**. In other words, in proportion to the coverage provided to the policyholder. This leads to recognition of profit on a consistent basis to different types of contracts covered by other IFRSs, thus facilitating better performance comparisons of insurers with companies in other sectors.

IFRS 17 ensures that all insurance revenue, whether long- or short-term, is reported on a comparable basis. In addition, it seeks to separate the underwriting result from that on investing activities, by requiring a clear distinction in the statement of profit or loss between an **insurance service result** and an **investment result**.

## 4.7 The premium allocation approach (PAA)

As described above the PAA is a simplified method for measuring insurance contracts and can be used where:

- insurance contracts have a **life of no more than 12 months**; or
- where **no significant changes in cash flow estimates** are likely to occur before claims are incurred **and no significant judgement** is required in order to **allocate the premium over time**.

Therefore this will be an approach principally relevant to **non-life insurers** which may be able to utilise this approach for all insurance contracts they issue, as it is more common for non-life insurance contracts to have a maximum period of coverage of one year. Although use of the PAA is **optional**, where the criteria are satisfied, it can be anticipated that insurers will apply it where permitted, as it is a simpler means to get a result that is a reasonable approximation of that of the general measurement method.

The **PAA is similar to the method** used by insurers **under IFRS 4** for general insurance contracts where the insurance liability related to cover beyond the period end is reflected in an **unearned premium reserve** in the statement of financial position.

### 4.7.1 Initial recognition under the PAA

An insurance contract is recognised on the earlier of coverage commencing or payment of premium by the policyholder. On initial recognition of an insurance contract a liability is reflected equal to the **present value of premiums received/receivable, less acquisition costs** paid/payable. (Any amount included in premium related to separable non-insurance components of the contract would also be excluded.)

There is an optional treatment of acquisition costs in the PAA, which allows them to be expensed immediately in profit or loss rather than netted from the premiums receivable. This optional treatment would therefore result in earlier recognition of expenses in profit or loss.

**Acquisition costs**, such as commissions, attributable to the contract are deducted from the liability unless the entity elects to treat them as expenses as they are incurred. This treatment is permitted under IFRS 17 where the **contract life does not exceed 12 months**.

**If premiums are not paid at inception**, future expected premium cash inflows are only required to be **discounted to their present value** if the period from initial recognition of the contract to the receipt of premium is **expected to exceed 12 months**. Therefore, for a large majority of general insurance contracts, the expected timing cash flows related to the receipt of premium will not need to be discounted.



### Worked example: Mayweather Insurance I

On the 1 April 20X7 Mayweather Insurance plc writes a property insurance policy in favour of McGregor Ltd, with a contract life of one year. The premium for the policy is £10,000, which is paid on inception. Mayweather Insurance prepares its financial statements to 31 December. Mayweather has acquisition costs in relation to the policy of £400 and chooses to reflect these in the calculation of the liability.

How would this insurance contract be recorded in at inception.

#### Solution

On inception 1 April 2017

	£	Workings
Cash	9,600	
Insurance liability	(9,600)	(10,000) + 400 (Note)

**Note:** Alternatively Mayweather could have chosen to treat the acquisition costs as an expense of the period since the length of the contract does not exceed one year. This would have resulted in this treatment:

	£
Cash	9,600
Profit or loss	400
Insurance liability	(10,000)

## 4.7.2 Subsequent measurement under the PAA

At the end of the **reporting period subsequent** to an insurance contract's initial recognition the liability is adjusted to the **amount related to coverage after the period end** and **revenue** is recognised to the extent that the **premium relates to coverage prior to the period end**. The basis for apportioning premium between reporting periods will usually be based on the **passage of time**, unless the terms of the contract are such that the risk over the coverage period is not evenly distributed with respect to time eg, if providing cover to a seasonal business where losses are not expected to be incurred at the same rate each month.

In addition the **insurance liability** must reflect **claims that have been incurred, but not paid**. As we shall see when we consider the general measurement method below, IFRS 17 generally recognises the time value of money by discounting cash flows related to insurance contracts to their present value. However, discounting of future cash flows related to claims incurred is only required under the PAA if the period until the expected cash outflow **exceeds 12 months**.



### Worked example: Mayweather Insurance II

Using the information from Mayweather I prepare the financial statements in relation to the insurance contract issued to McGregor for the year to 31 December 20X7 assuming no claims are made in the period.

#### Solution

As at 31 December 20X7	Statement of financial position £	Workings	Year ended 31 December 20X7	Statement of profit or loss £	Workings
Cash	9,600		Insurance revenue	7,200	9,600 × 9/12
Insurance liability	(2,400)	9,600 – 7,200	Insurance service result	7,200	
Equity	(7,200)				



### Worked example: Mayweather Insurance III

Alternatively, now prepare the financial statements in relation to the insurance contract issued to McGregor for the year to 31 December 20X7 assuming a claim is made in November 20X7 in relation to storm damage and Mayweather's loss adjusters estimate the value of the claim at 24,000 and expect it to be settled in the first half of 20X8.

#### Solution

As at 31 December 20X7	Statement of financial position £	Workings	Year ended 31 December 20X7	Statement of profit or loss £	Workings
Cash	9,600		Insurance revenue	7,200	9,600 × 9/12
Insurance liability	(26,400)	9,600 – 7,200 + 24,000	Insurance service expenses	(24,000)	
Equity	16,800		Insurance service result	(16,800)	

The insurance liability at the end of the year is reduced for coverage provided and the amount of the incurred claim is added. The future cash flow related to the claim need not be discounted as it is expected to be paid within 12 months of the period end.

The insurance service result reflects the premium and loss experience from the inception of the contract to the period.

### 4.7.3 Comparison of PAA to IFRS 4

As can be seen from the worked example above, the treatment of short-term insurance contracts using the PAA is substantially similar to the approach used by general insurers under IFRS 4 (albeit presented somewhat differently.) However, IFRS 17 is more directive regarding how and when discounting should be applied on a consistent basis to the general measurement method. It should be appreciated that the PAA is a **simplified method**, the justification for which is that its use will result in a **reasonable approximation** of the general measurement method. Therefore it is inherently consistent with the general measurement method facilitating the presentation of the results of all insurance contracts in a single line.

## 4.8 The general measurement method

Many assets are included in the financial statements of an entity at their market value or fair value, such as many types of financial instrument under IFRS 9 as we will see in subsequent chapters. Consistent with this, IFRS 17 seeks to consider the **current value** of insurance contracts issued.

The **general measurement method** in IFRS 17 should be used in relation to **all insurance contracts for which the PAA is not used**. This will typically be those contracts with a life of **more than one year**.

### 4.8.1 Initial recognition and measurement under the general measurement method

The general measurement method aims to measure the asset or liability related to an insurance contract by first calculating the **value** of future cash inflows and outflows related to it. The value of these cash flows is adjusted both for the time value of money and for non-financial risk. (The resultant value is referred to as the fulfilment cash flows.) For a contract that is expected to be profitable, the fulfilment cash flows will initially be an asset as the present value of expected premiums will be greater than the present value of expected outflows.



#### Definition

**Fulfilment cash flows:** Under IFRS 17, an unbiased and probability-weighted estimate of the present value of the future cash outflows minus the present value of the future cash inflows that arise as an entity fulfils an insurance contract, including a risk adjustment for non-financial risk.

An equal and opposite amount to the fulfilment cash flows, which represents the unearned profit over the contract's life, is then added to the fulfilment cash flows. IFRS 17 refers to this amount as the **contractual service margin**.

Taking each element of the value of an insurance contract in turn:

#### Best estimate of future cash flows

The best estimate of future **cash inflows** includes **premiums received and receivable** (amounts included in premiums that are related to separable non-insurance components of the contract would be excluded).

**Cash outflows** include:

- expected claims
- commissions and other acquisition costs
- claims handling costs
- other directly attributable costs

These future cash flows are **probability weighted to arrive at a best estimate** of what is expected. In respect of cash flows related to future claims, significant input to the measurement process is likely to be required from an entity's actuarial function. Actuaries will undoubtedly need to provide significant inputs into the measurement process.

#### The time value of money

The best estimate of expected future cash flows related to the contract are then **discounted** to arrive at their **net present value**. The **discount rates** applied to the cash flows should reflect timing of the cash flows as well as characteristics, such as illiquidity. The discount rate should **not** take into account **non-financial risk**. IFRS 17 does not prescribe the exact method by which discount rates should be

calculated. However, discount rates (where possible) should be derived from **observable market sources**. They can be arrived at by adjusting risk free rates in the relevant currency for features specific to insurance contract cash flows.

### Adjustment for non-financial risk

The fulfilment cash flows can be thought of as the market value of an insurance contract. To establish this non-financial risk cannot be ignored. **Non-financial risk** results from the **potential variability in the outcome** from the best estimate of future cash flows. The cash outflows in relation to an insurance contract issued by an entity are inherently uncertain. Hence, the probability-weighted cash flows do not reflect fixed cash flows such as those from a bond. Rather, there is a **range of possible outcomes**. The size of that range of non-remote possible outcomes will vary depending on the probability of forecasting claims accurately.

The more uncertain an estimate is, the greater the insurance liability recorded will need to be in order to be reasonably certain that the liability will be sufficient to cover the insurance liabilities. There are some parallels here with the capital add-on methodologies of Solvency II.

The greater the level of uncertainty taken, the greater the investor's return will need to be. Thus, insurance liabilities that are more difficult to forecast, such as casualty losses, will tend to have a higher adjustment for non-financial risk. They will also be expected to generate the greatest level of profit.

As an insurance contract approaches its expiry, the amount of time available for losses to be incurred naturally reduces. This means that the overall level of risk reduces and so also the estimation uncertainty that gives rise to the adjustment for non-financial risk also reduces. This means that, in effect, the adjustment for non-financial risk amortises over time to an eventual value of zero at the expiry of the policy.

Another way to consider the need for an adjustment for risk is to focus on the fact that measurement of insurance contracts under IFRS 17 is based on current information and is thus effectively market value. If another party wished to establish the size of the payment it would require in order to take over an insurance contract's obligations, in other words to establish their market value, it would not simply discount expected future cash outflows at a risk-free rate. It would require an additional sum to compensate for the riskiness of the future cash outflows.

IFRS 17 **does not specify a required methodology** for how this adjustment for risk should be calculated.

### Contractual service margin

The contractual service margin is an equal and opposite amount to the fulfilment cash flows at inception. It generally represents the **unearned profit on an insurance contract over its life**. In pricing insurance contracts an insurer will usually charge a premium such that an insurance contract is expected to be profitable over its life. Therefore the **fulfilment cash flows** at inception will generally be an **asset** and the **contractual service margin** is the inverse of this and thus a **liability**. Therefore with the inclusion of the contractual service margin, the recognised value of an insurance contract in the statement of financial position at initial recognition is **nil**. It will also not generate any income or expense at initial recognition in profit or loss, since no insurance coverage has yet been provided to the policyholder.

We consider the more unusual situation of an insurance contract's fulfilment cash flows at initial recognition being a liability in the section below on **onerous contracts**.

The contractual service margin represents **unearned profit**. IFRS 17 requires that the contractual service margin is **apportioned over the life of the insurance contract** in line with the provision of coverage.

The general measurement method can be thought of as a number of building blocks making up the value of an insurance contract at inception.

The contractual service margin is a credit item in the statement of financial position. Over the period of coverage, this is amortised to profit or loss. This is discussed in the section on profit or loss below.

## IFRS 17 general measurement method at initial recognition

PV of cash expected inflows	Contractual service margin (deferred profit)
	Adjustment for non-financial risk
	PV of expected cash outflows

From this it can be identified that the **contractual service margin equals the net present value of estimated net cash flows less an adjustment for non-financial risk** (also collectively referred to as the fulfilment cash flows). We can also rearrange this relationship as **the net present value of the estimated cash flows equals the contractual service margin plus the adjustment for non-financial risk**.

The fulfilment cash flows, plus unamortised contractual service margin are together referred to as the **liability for remaining coverage (LRC)**.

When we look later at subsequent measurement we will see that the liability for remaining coverage, plus recognised liability for incurred claims (claims notified, IBNER and IBNR) collectively then make up the **total insurance liability**



### Interactive question 7: Jeru

Jeru Ltd issues a three-year life insurance contract. The premium received at inception is £1,000. The present value of the expected cash outflows has been calculated as £600 and the adjustment for non-financial risk has been determined by an actuary as £200.

What is the contractual service margin at inception?

See **Answer** at the end of this chapter.



### Worked example: Benson Insurance I

On 1 January 20X8 Benson Insurance plc writes an employers liability insurance contract with a life of three years with policyholder Farlow Ltd. The total premium of £20,000 is paid up front. Benson estimates that claims incurred will be £5,000 in each of the three years and claims handling and other costs will total £1,000 per annum. Benson has established that the appropriate discount rate is 3%. Benson calculates an adjustment for non-financial risk over the three-year life of the policy as £720.

How is the insurance contract issued to Farlow initially recognised? (Assume all claims incurred in the period are settled in the year and all cash outflows occur at the end of each year, thus meaning that is no remaining liability for claims notified or claims IBNR at the end of the year.)

### Solution

The present value of the cash outflows can be calculated as follows:

Time	Cash flow £	Discount factor @ 3%	Present value £
1	6,000	0.9709	5,825
2	6,000	0.9426	5,656
3	6,000	0.9151	5,491
Total			<b>16,972</b>

The premium is received on inception therefore its present value is the amount received.

## Insurance contract on initial recognition 1 January 20X8

	£
Present value of cash inflows	20,000
Present value of cash outflows	<u>(16,972)</u>
Net present value of cash flows	3,028
Risk adjustment	<u>(720)</u>
Fulfilment cash flows	2,308
Contractual service margin	(2,308)
Insurance contract asset/(liability)	<u><u>—</u></u>

### 4.8.2 Subsequent measurement

At the end of reporting periods subsequent to initial recognition an insurance contract is **remeasured** using the same principles. The remeasurement of the fulfilment cash flows utilises the same principle as on initial measurement. To arrive at the total value of the contract the contractual service margin related to future coverage is combined with the fulfilment cash flows at period end. This amount can be referred to as the liability for remaining coverage.



#### Definition

**Liability for remaining coverage (LRC):** The sum of the remaining fulfilment cash flows at subsequent measurement, plus the unamortised contractual service margin.

IFRS 17 is based around recognising the **current value** of insurance contracts in the financial statements. This means that when the value of insurance contracts is remeasured **latest estimates and market variables** at the period end should be used. There may be changes in the following:

- The **estimated variables** used in order to establish the best estimate of future cash flows – in respect of life insurance contracts this would include variables such as mortality rate, persistency and morbidity rate.
- The **discount rates** applied to expected cash flows – since the rates to be used are derived from market rates changes will occur over time.
- The **adjustment for risk** applied to arrive at the amount of the fulfilment cash flows – additional information may lead to a reassessment of the level of non-financial risk.

As can be seen by the nature of the variables above the actuarial function of insurers will be responsible for providing many of the inputs into the process for measurement of insurance contracts.



#### Worked example: Benson Insurance II

Benson Insurance reports for the year to 31 December. In 20X8 the claims incurred and other costs in relation to the contract with Farlow were exactly in line with those estimated on initial recognition of the contract.

Calculate the amount of the fulfilment cashflows of the contract with Farlow as at 31 December 20X8.

#### Solution

As at 31 December 20X8

	£	
Present value of future cash inflows	Nil	The premium has now been received
Present value of future cash outflows	<u>(11,481)</u>	= £5,825 + £5,656. The PV of £6,000 in 1 year and £6,000 in 2 years as calculated previously above
Net present value of future cash flows	(11,481)	
Unamortised risk adjustment	<u>(480)</u>	= £720 × 2/3 remaining cash outflows on the policy remaining
Fulfilment cash flows	<u><u>(11,961)</u></u>	

Note that this figure does not fully represent the liability related to future coverage for the contract, because we need to include the liability related to the contractual service margin that has not yet been earned in the year to 31 December 20X8 through the provision of coverage to Farlow. The inclusion of this amount will give us the liability for remaining coverage.

To do this we need to reconcile the opening balance in relation to the insurance contract (nil) to the liability as at 31 December 20X8. IFRS requires this reconciliation be disclosed breaking down the changes in the each of the components of value of the insurance liability over the period.

	Notes	PV of future cash flow £	Adjustment for non-financial risk £	(Sub-total) Fulfilment cash flows £	Contractual service margin £	Liability for remaining coverage £
Opening balance 1 January 20X8	1	–	–	–	–	–
Changes related to future service	2	3,028	(720)	2,308	(2,308)	–
Cash inflows	3	(20,000)		(20,000)		(20,000)
Insurance finance expense	4	(509)		(509)	(69)	(578)
Changes related to current service	5	0	240	240	792	1,032
Cash outflows	6	6,000		6,000		6,000
Closing balance 31 December 20X8	7	(11,481)	(480)	(11,961)	(1,585)	(13,546)

#### Notes

- At the beginning of the year the contract with Farlow has not been issued hence opening balances all nil.
- Changes related to future service recognise the components of the liability on initial recognition of the contract as shown in Benson I above.
- Cash inflow represents the receipt on the premium.
- IFRS 17 requires that the effect of the unwinding of the discounting effect on future cash flows is separately identified as **interest finance expense or income**. Because the estimated cash outflows are one year closer to payment at the year end their value has increased due to accretion at the discount rate. Hence the amount related to the cash out flows is  $(£20,000 - £3,028) £16,972 \times 3\% = £509$ . In addition, accretion on the contractual service margin is  $£2,308 \times 3\% = £69$ .
- Changes related to current service reflect the changes in the liability as coverage is provided over the year and are included in the insurance service result in the statement of profit or loss. The contractual service margin with related finance expense is apportioned to the current year in relation to the provision of coverage, which in this case is directly related to time. Therefore the amount of the contractual service margin released into the statement of profit or loss for 20X8 is  $(£2,308 + £69)/3 = £792$ . In addition Benson is released from non-financial risk over time, since the contract is for three years and one year has elapsed the adjustment has fallen by  $£720/3 = £240$ .
- Cash outflows are the claim incurred (and paid) in the year, together with claims handling and other directly attributable costs.
- The closing balance of liability in relation to the insurance contract of £13,538 is split into the building blocks of the general measurement method we saw earlier.

### 4.8.3 The statement of profit or loss

Under IFRS 17 the profit or loss related to the provision of insurance in the period is included as the **insurance service result**. This represents the profit **earned** from the provision of insurance services in the current period.



As we can see in Benson Insurance II above, the insurance service result representing the profit/loss earned in the period can be broken down by source as follows.

- **Apportionment of the contractual service margin** – the reduction in the contractual service margin over the period is recognised in the statement of profit or loss. This amount represents the amount of **profit earned from the coverage provided** in the period and will generally be **apportioned based on time**, unless the terms of the contract lead to an uneven distribution of total coverage over time.
- **Reduction in the adjustment for risk** – as the remaining life of the insurance contract erodes the insurer is **released from risk** reducing the insurance contract liability and contributing to the insurance service result.
- **Change in cash outflows compared with expectations** – the level of claim experience and other costs may differ from that which was expected. (The expected level of cash outflows was incorporated in the opening contractual service margin.)

In addition to the insurance service result, the unwinding of the discounting of future cash flows as their payment becomes more proximate is included in profit or loss. This amount is presented below the insurance service result as **insurance finance expenses (or income)** and is combined with **investment income** to arrive at an investment result for the period. This presentation isolates the effect of discounting and allows for a direct comparison to the returns from investments that the insurer holds to enable it to meet its insurance liabilities.



### Worked example: Benson Insurance III

Show the effect of the contract with Farlow on Benson's statement profit of loss and statement of financial position in relation for the year ended 31 December 20X8.

#### Solution

##### Statement profit of loss

	£	£	
Insurance revenue	7,032		
Insurance service expenses	<u>(6,000)</u>		
Insurance service result		1,032	Changes in the liability for remaining coverage related to current service shown in the table above
Insurance finance expense	(578)		
Investment income	<u>0</u>		Assumed that no interest is earned on cash received
Investment result		<u>(578)</u>	
Profit for year		<u><u>454</u></u>	

##### Statement of financial position

	£	
Cash	14,000	Premium received less claims paid and other expenses (£20,000 – £6,000)
Liability for remaining coverage	(13,546)	Closing balance from Benson II above
Equity	<u>(454)</u>	
	<u><u>–</u></u>	

As can be seen above the insurance service result is presented as insurance revenue less insurance expenses.

**Insurance revenue** is the consideration to which the entity expects to be entitled for the provision in the period of insurance coverage and other services arising from the insurance contracts it issues. This amount should exclude any investment components and include the effect of financing (arising from the fact that insurance premiums are typically paid in advance of cash outflows).

Therefore the revenue for the period is made up of the following components:	£
Claims in the period and other expenses	6,000
The amortisation of the contractual service margin liability in the period	792
Insurance acquisition expenses for the period	0
Adjustment for non-financial risk in this period	<u>240</u>
Changes in liability for remaining coverage related to current service (see above)	<u>1,032</u>
Insurance revenue in profit or loss for the period	<u>7,032</u>

In essence, therefore, revenue is a figure that we work back to, taking claims incurred and then adding profit from underwriting (excluding insurance finance expense) expected to be realised from the long-term insurance policy in the current period.

**Insurance expenses** are those costs related to the insurance contracts for the period. This includes the following:

- The claims incurred in the period, comprising claims paid and movement on the liability for incurred claims (IBNR) (Note that in the example Benson we have simplified by assuming all claims incurred in each year are settled by the end of that year.)
- Other costs for the period attributable to the contracts such as claims handling
- Acquisition expenses related to the period (or paid in the period if that option is taken)

#### 4.8.4 Total insurance liability

In the example Benson we have so far simplified by assuming (as specified in Benson I) that the claims incurred each year are all determined and paid at the end of that year. This assumption means that there are no notified claims that are unsettled, nor any IBNR or IBNER. However, in practice this simplifying assumption will not be realistic. At the end of any period an insurer will typically have claims related to that period that have yet to be paid, as well as incurred claims not reported (giving rise to IBNR) and also claims that have been reported but where case estimates of expected settlement costs are too low (giving rise to IBNER). Therefore the liability for future coverage will not represent the total insurance liability. To arrive at the figure for total insurance liability, we must add in amounts related to the liability for claims incurred in the period, but not paid at the period end.



#### Definition

**Total insurance liability:** Under IFRS 17 this is made up of the sum of the liability for remaining coverage and liability recognised for incurred claims (claims notified, IBNER and IBNR).



#### Worked example: Benson IV

Produce the statement of financial position for Benson as at 31 December 20X8 in respect of the contract with Farlow, identifying the components of total insurance liability. Use the same information already provided, **except for** now assuming the following:

- At the 20X8 year end £4,000 has been paid in relation to claims incurred in the year to 31 December 20X8.
- Case reserves of £1,200 have been reliably established in relation to incurred claims notified in the year.
- It has been estimated that the value of claims incurred, but not reported is £800 (both this amount and that related to claim reserves above are expected to be paid very shortly after the year end).

## Solution

### Statement of financial position

	£	£	
Cash		<u>16,000</u>	Premium received less claims paid (£20,000 – £4,000)
Liability for remaining coverage		(13,546)	Closing balance from Benson II above
Liability for notified claims	(1,200)		This includes an adjustment for claims IBNER
Liability for claims IBNR	<u>(800)</u>		
Liability for incurred claims		<u>(2,000)</u>	
		(15,546)	
Total insurance liability			
Equity		<u>(454)</u>	
		<u>(16,000)</u>	

We can see that in this scenario the total insurance liability is 2,000 higher than was the case in Benson III. This is due to the fact that we have now assumed that all claims incurred in the year were not paid at the year-end creating a liability for incurred claims. IFRS requires that a reconciliation from opening to closing balance is separately disclosed for both the liability for remaining coverage and the liability for incurred claims.

#### 4.8.5 Changes in estimates and experience differences

Our worked example above, Benson Insurance, is a simplification of what is likely to occur in reality as things do not always occur as expected and assumptions and estimates may change. IFRS 17's general measurement method is based on **current information**. Therefore at the end of each period the insurer must remeasure an insurance contract using **current estimates**. Therefore the following will be required to identify any changes that have occurred:

- Re-estimation of **future claims and other expenses**
- Re-calculation of the **discount rate** using latest observable market information
- Re-assessment of the **risk adjustment for non-financial risk** taking account of the entity's most recent experience of the **variability** in the amount for which claims are expected to be settled, any changes in the entity's attitude to risk and other relevant exogenous factors

In addition the **claim and cost experience in the current year may have differed** to that which was estimated at previous measurement. It would, in fact, be rather surprising if claims incurred in a year were exactly the same as those estimated.

IFRS 17 requires that the financial effect of these changes and differences is decomposed into that which is **related to the current service** (the current year) and that which is **related to future service** (future years). The financial effect of changes related to future years is incorporated in the value of the **insurance liability** in the statement of financial position and the amount related to the current year is recognised in **profit or loss**.

#### 4.9 Onerous contracts

In the normal course of business it is to be expected that insurance contracts issued by an insurer would have cash inflows with a present value that exceeds that of the expected cash outflows (including the effect of a risk adjustment). In other words **insurers can generally be expected to price insurance contracts in such a way that they are profitable**.

However, this may not always be the case. For example an insurer might charge very low premiums to build **market share** when it enters a new market, alternatively it might provide an insurance contract below the level where it expects that contract to be profitable due to the value of the **overall relationship with that client**. Such contracts are referred to as **onerous contracts** by IFRS 17 and their accounting treatment is modified.

In the case of an contract which is **onerous at initial recognition** the fulfilment cash flows will be negative (a liability). If the general measurement method were not modified this would give rise to a negative contract service margin representing an 'unearned' loss. The general measurement method is modified in

this situation so that rather than spreading this expected loss over the life of the contract, the **entire amount is recognised immediately** in profit or loss and thus the **liability in the statement of financial position is equal to the value of the fulfilment cash flows**. In other words the **contractual service margin is zero**.

An entity must also **recognise a loss** in the profit or loss when a contract **becomes onerous** in the year, or has **become more onerous**. This could occur due to adverse changes in the estimates of future cash flows or adverse changes in the level of risk margin.

Onerous contracts are dealt with when using the **premium allocation approach** to measurement by calculating the amount by which the fulfilment cash flows exceed the carrying amount of the liability in respect of future coverage. This amount is recognised as a loss in the period and the liability is increased by this amount. This is similar in its effect to the creation of an **unexpired risk provision** permitted under IFRS 4. When calculating the fulfilment cash flows under the PAA the best estimate of future cash flows only need to be discounted if the liability for incurred claims is established using discounting.

## 4.10 Aggregation

Thus far, for simplicity we have considered how the provisions of IFRS 17 would be applied to single insurance contract. In reality this will generally not be the way that IFRS 17 is applied by insurers. In practice the insurance contracts issued by an entity will be aggregated into **groups of contracts with similar characteristics** and measurement will be applied to each of these groups on a collective basis.

IFRS 17 states that an entity's insurance contracts should first be aggregated into **portfolios** of contracts that:

- have **similar risks**; and
- are **managed together**.

Insurance contracts within the **same product line** would be expected to have **similar risks**, conversely those from different product lines would not.

Each such portfolios is then divided into three **sub-portfolios**:

- contracts which are **onerous at initial recognition**;
- contract which at initial recognition have a **significant possibility of becoming onerous**; and
- other contracts (**not onerous** and **no significant possibility** of becoming so).

In many cases there will be no contracts satisfying the first two criteria above and so all contracts in that portfolio would fall into the last category of not being onerous and unlikely to become so.

Each of these sub-portfolios described above is then required to be **further sub-divided** into groups that **do not contain contracts issued more than 12 months apart**. This effectively breaks down the sub-portfolios established above into groups of contracts issued within **12-month periods**.

If an entity so wishes it may choose to break down its contracts with a greater degree of granularity than that required by IFRS 17. Some insurers may, perhaps, choose to split contracts they issue by geography or level of profitability.

A further point to note is that the **estimates of future cash flows do not necessarily have to be directly calculated at the lowest level of granularity**. Cash flows may be estimated at a level of greater aggregation and then allocated across sub-groups. For example, it is likely that claims handling expenses would be estimated at entity or subsidiary level and then allocated to each group of contracts, possibly based on the number of contracts in each group.

## 4.11 Reinsurance under IFRS 17

As mentioned at the start of this section, **IFRS 17 does not generally apply to insurance contracts an entity holds** only those that it issues. However, in the case of **reinsurance, both contracts held and issued fall within its scope**.

The treatment under IFRS 17 of reinsurance contracts held largely mirrors that of the primary insurance contracts to which it is related.

In the financial statements the profit related to reinsurance is presented as a separate component of the insurance service result and the liability or asset related to reinsurance is also presented separately from other insurance liabilities and assets.

Under IFRS 17 the estimates of the present value of the future cash flows for reinsurance contracts held should take into account the effect of any **risk of non-performance** by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes. Thus the **credit risk related to reinsurance contracts held** is re-estimated at each period end as part of the process of re-measurement. This is in contrast with the separate assessment of the impairment of reinsurance assets required under IFRS 4.

#### 4.12 Investment contracts with discretionary participation features

Investment contracts with discretionary participation features (DPFs) provide an investor with the contractual right to receive, in addition to a specified amount, additional amounts the timing or amount of which are contractually at the **discretion of the issuer**.

In addition, to be considered an investment contract with a DPF under IFRS 17, the discretionary element must be expected to be a **significant portion** of the total benefits under the contract and **must be contractually based on**:

- returns on a **specified pool of contracts** or a specified type of contract;
- realised and/or unrealised investment returns on a **specified pool of assets** held by the issuer; or
- **profit or loss of the entity** that issues the contract.

Investment contracts with DPFs are **not insurance policies** as they do not lead to a transfer of insurance risk. However, the uncertainty as to the overall return shares some of the characteristics of insurance contracts and such investment contracts are routinely issued by life insurance companies. For these reasons investment contracts with DPFs are **within the scope of IFRS 17 provided the entity also issues insurance contracts**. The general measurement method is used with certain modifications whereby contractual service margin is recognised over the duration of the contract(s) in a systematic way reflecting the transfer of **investment services** under the contract. An investment contract issued by an entity not falling within the scope of IFRS 17 will fall under IFRS 9, *Financial Instruments*.

#### 4.13 Comparison of IFRS 17 to IFRS 4

As mentioned previously **IFRS 4** as an interim measure is a **very permissive standard** encompassing a variety of pre-existing financial reporting practices in different jurisdictions. **IFRS 17 is far more prescriptive** which is intended to lead to greater **consistency and comparability** of the financial statements of insurers.

As we saw above the **premium allocation approach** is **similar** to the way in which short-term insurance contracts are generally accounted for under **IFRS 4**.

In respect of the approach to **measurement of long-term insurance contracts** by the two Standards there is a much **greater difference**. In relation to the measurement of insurance contract in the statement of financial position the following differences can be identified:

- IFRS 17 requires discounting of future cash flows In calculating the insurance contract liability, IFRS 4 does not make discounting of future cash flows mandatory and is less prescriptive as to how the discount rate should be ascertained where an entity does choose to apply discounting.
- The impact of financial and non-financial risk are not separately identified under IFRS 4.
- Under IFRS 4 there is no recognition of a liability related to unearned profit analogous to the contractual service margin. This would generally lead to more profit being recognised under IFRS 4 in the year in which an insurance contract is written.

There are also considerable differences in relation to the presentation of performance. Under IFRS 4 the statement of profit or loss is based on information related to premium and expenses rather than an apportionment of unearned profit represented by the contractual service margin and the release from risk under IFRS 17. The format of the statement of profit or loss is significantly different under IFRS 17 by not relying on premium related information and breaking down overall performance into an **insurance service result** and an **investment result**. Insurance revenue is not directly related to premium receipt under IFRS 17, rather it is the amount of consideration related to the provision of insurance services in the period and is in essence arrived at by working up from the insurance service result and adding back claims incurred and other expenses. Many anticipate that IFRS 17 will create greater volatility in the reported profits of insurers.

In addition, under IFRS 4 an absence of specific rules regarding the treatment of amounts received from policyholders allowed some insurers to report receipts related to components of insurance contracts, that were in effect deposits, as premium. As we saw above, IFRS 17 specifically requires that the amount of premium received not related to the provision of insurance services is not reported as insurance revenue. The adoption of IFRS 17 by such insurers will consequently lead to a significant reduction in the amount of premium received reported as insurance revenue.

#### 4.14 Systems implications for insurers and their auditors

IFRS 17 represents a very significant change in financial reporting for insurers. Under the new Standard accounting for insurance contracts will increase in complexity and require the use of much information not needed under IFRS 4. Much of this information required to measure insurance contracts and calculate liabilities will be provided by an insurer's actuaries.

This information will need to be used in accordance with IFRS 17's measurement models in order to generate the information in respect of insurance contracts to be included in the financial statements and satisfy the Standard's extensive disclosure requirements. Given the complexity of IFRS 17 and the very large number of contracts that insurers issue it is unlikely that this could be achieved by the use of standalone spreadsheets and manual input to the accounting system (even if possible this would likely be highly inefficient and prone to error). Therefore it is probable that insurers will need to **amend and enhance existing IT-based accounting systems** in order to capture the required actuarial information and other inputs and produce the necessary outputs required for financial reporting. This represents a considerable challenge for insurers, the total costs of which across the EU has been estimated to run into billions of euros. Insurers will need to **design, test and implement** systems to meet the requirements of IFRS 17.

In the first year of adoption by an insurance client auditors will need to perform additional work to ensure that they understand and document the new systems used to produce the information required by IFRS 17. Due to the complexity of the measurement process under IFRS 17 and the large number of insurance contracts issued by an insurer the auditor will wish to place a **high level of reliance on internal controls** to limit the risk of material misstatement and thereby reduce the extent of substantive testing. Accordingly it will be necessary for auditors to undertake testing of internal controls to establish that they are effectively designed and implemented to ensure that:

- aggregation conforms to the requirements of the Standard
- actuarial inputs related to future expected cash flows are appropriate and represent current information
- appropriate market-related variables (where possible) are used to establish the discount rate
- discounting is performed with mathematical integrity
- an appropriate methodology is correctly applied to establish the risk adjustment for non-financial risk
- insurance finance expense and income is correctly calculated

## 5 IAS 40, Investment Property



### Section overview

- An investment property is land or buildings or both that is held by an entity to earn rentals and/or for its capital appreciation potential.
- One of the distinguishing characteristics of investment property is that it generates cash flows largely independent of the other assets held by an entity.
- Owner-occupied property is not investment property and is accounted for under IAS 16, *Property, Plant and Equipment*.