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IFRS 17

Insurance contracts
What you need to know

Effective annual periods beginning on or after **1 January 2023**. IFRS 17, “Insurance Contracts” (IFRS 17) will result in fundamental changes to the way both insurers and non-insurers evaluate, account for and report on insurance contracts.

The key principles of IFRS 17 are that an entity:

- Identifies as insurance contracts those contracts under which they accept significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) were to occur;
- 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:
  i. A risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all of 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);
  ii. 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 cover and as the entity is released from risk. If a group of contracts is, or becomes, loss-making, an entity recognises the loss immediately;
- 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 17 includes an optional simplified measurement approach, or premium allocation approach, for simpler insurance contracts.

The impact will be organisation- wide, affecting processes and systems and requiring greater coordination between business functions including finance, actuarial and IT.

- More contracts in the scope of IFRS 17 - the previous standard IFRS 4, “Insurance Contracts” (IFRS 4) allowed entities such as banks and service companies issuing insurance-like contracts to apply accounting treatments similar to those applied to other non-insurance contracts i.e. financial instruments. Many of these contracts will now be in scope of IFRS 17 and will be subject to specific recognition, measurement and presentation requirements. This is likely to lead to greater comparability.
- Discretionary participation features - the measurement model under IFRS 17 - is likely to represent a major change from existing accounting practices applied currently under IFRS 4.
- Data management - the need to reconcile actuarial and financial data at a much more granular level and allow assumptions and inputs to be audited.
- Transition options are available and, for some, full retrospective application may not be feasible due to the level of historic information required.

Insurance contracts combine features of both a financial instrument and a service contract. Many insurance contracts generate cash flows with substantial variability over a long period. To provide useful information about these features, IFRS 17:

- Combines current measurement of the future cash flows with the recognition of profit over the period that services are provided under the contract;
- Presents insurance service results (including presentation of insurance revenue) separately from insurance finance income or expenses; and
- Requires an entity to make an accounting policy choice of whether to recognise all insurance finance income or expenses in profit or loss or to recognise some of that income and expenses in other comprehensive income.

IFRS 17 provides entities with a choice of liability calculation models to use; the building block approach, a simplified approach and the variable fee approach.

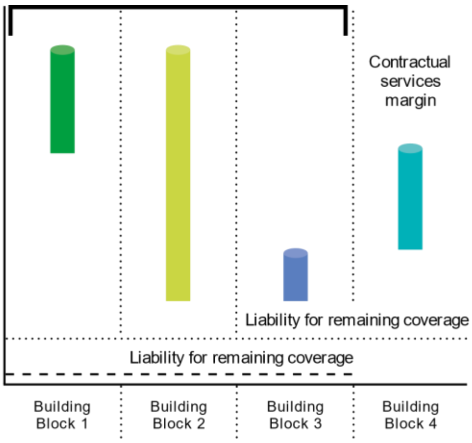
1 Building Block Approach (BBA)

This measurement model is based on discounted best estimate cash flows, a risk adjustment and a contractual service margin (CSM) representing unearned profit.

The CSM reflects the net economic benefit of the insurance contract and is required to be amortised over the insurance coverage period on a straight-line basis. Expected profit arising from the insurance contract is not able to be recognised upon commencement of the contract.

Key

- Sum of future cashflows
- Time value of money
- Risk adjustment
- Profit from coverage to be provided in the future



Profit or loss

Insurance service result

Insurance revenue
+ Revenue for coverage provided in the period
+ Revenue for release of risk adjustment in the period

Insurance service expenses
- Expected claims and other insurance services
+/- Changes in cash flows and in risk adjustment that relate to coverage provided in the period and in the past [3,4]

Insurance finance expenses (optional)

- Unwind of discount rates
+/- Changes in discount rates

Other comprehensive income (optional)
Insurance finance expenses
+/- Changes in discount rates

Building blocks during profit recognition

Changes in cashflows and risk adjustment relating to future services are required to be recognised by adjusting the rate at which the CSM is amortised. Profit relating to past and current services is required to be recognised in profit or loss. Changes in the discount rate are required to be recognised in either other comprehensive income or profit and loss.

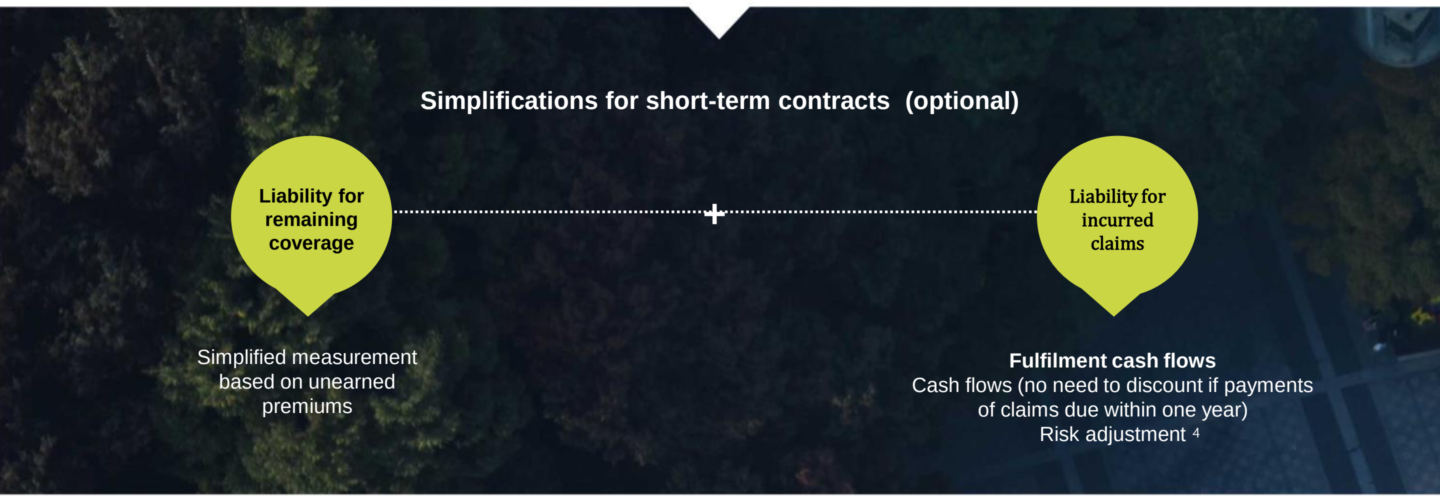
2 Simplified approach/Premium allocation approach

Premium Allocation Approach (PAA) is an optional model for qualifying contracts which allows the liability for unexpired risk to be measured in a simpler way. This is similar to the Unearned Premium Reserve approach permitted under IFRS 4.

Contracts that may qualify for the PAA include:

- Contracts with a coverage period of twelve months or less;
- Contracts where result from the PAA is not materially different from the BBA.

Acquisition costs may be expensed as they are incurred and discounting is not required for liabilities which settle within one year.



3 Variable Fee Approach

The variable fee approach links the insurance liability to the underlying assets invested. This applies to insurance contracts including with-profit contracts, unit-linked contracts and equity index linked contracts. The variable fee approach is similar to the building block approach, except the movement in assets supporting the insurer's share is recognised in the CSM and accumulated at the current interest rate. Changes in the value of options and guarantees are recognised in the CSM but may be presented in profit and loss when there is adequate risk mitigation in place.

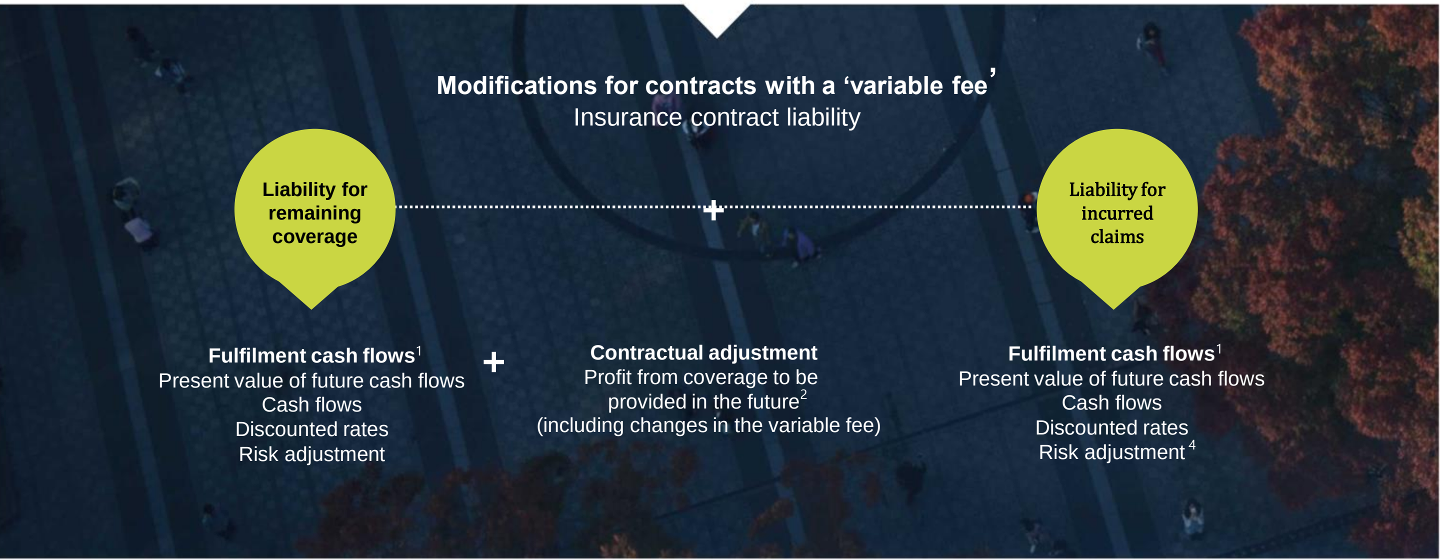
Notes

1. The fulfilment cash flows are at current value: cash flows, discount rates and risk adjustment are updated at each reporting date

2. Changes in cash flows and in risk adjustment that relate to coverage to be provided in the future adjust the contractual service margin

3. Changes in cash flows and in risk adjustment that relate to coverage provided in the period and in the past are recognised in profit or loss

4. The release of risk adjustment within the liability for incurred claims reduces incurred claims in profit and loss.



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Accounting for insurance contracts is likely to require significant change upon adoption of IFRS 17.

For further information on accounting for insurance contracts under IFRS 17 please contact your normal business advisor or Nigel MacPhail at Baker Tilly (BVI) Limited.

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