ACCOUNTING FOR INSURANCE CONTRACTS – IFRS 17

Finally, a two decade long journey by the International Accounting Standard Board (IASB) has concluded with the issuance of the new insurance accounting standard IFRS 17. The new standard is effective from 1 January 2021 with an option to early adopt, only if the company also applies IFRS 9 financial instruments and IFRS 15 revenue from contracts with customers. IFRS 17 will supersede the earlier standard on insurance contracts (IFRS 4).

IFRS 17 is the first comprehensive international accounting standard for insurance contracts issued by a company, including the reinsurance contracts. The existing IFRS 4 does not prescribe any accounting for measurement of insurance contracts. Instead, it permits companies to use local accounting practices (subject to liability adequacy test). As a result, currently many divergent accounting practices are being followed by companies, thereby reducing the comparability of financial statements. IFRS 17 will result in increased comparability of financial statements globally and will improve the quality of the financial information.

The new standard will provide information about the current and future profitability of insurers.

IFRS 17 requires a company to recognize revenue as it performs the insurance services, which is consistent with revenue recognition principle under IFRS 15. It makes the basis of revenue recognition by an insurer at par with other industries.

The major changes under the new standard is envisaged in the accounting of long term insurance contracts as compared to the changes expected for short term insurance contracts (typically non–life contracts such as vehicle or home insurance).

The changes proposed by the new standard are multifold. This publication briefly discusses some of the major developments and provisions under the new standard including the portfolio approach of grouping contracts, accounting model (including the simplified approach), significance of time value of money, relevance of using current estimates, variable fee contracts accounting and the transition approach.

This paper also provides our perspective on the key considerations for implementing the new standard.
Shift from IFRS 4: Fundamental changes

Ensures consistent accounting practice

IFRS 17 eliminates the use of non-uniform accounting policies and practices for similar types of insurance contract, within the industry. In case of large multinational groups, entities are presently following different accounting practices as per the local country specific regulations.

The new standard will ensure:

- Single approach for all insurance components (such as recognition of revenue, profit margin, costs, insurance contract liabilities etc.)
- Consistency in accounting policies for:
  - Accounting for non-insurance components
  - Recognition of revenue and profit margin
  - Accounting for risk adjustments
  - Treatment of acquisition costs and other expenses
  - Accounting for time value of money

Use of current estimates

IFRS 17 ensures the timeliness and transparency of the financial information by requiring the companies to use current estimates based on the most up to date information available at each reporting date, to account for its insurance contracts. For example, under the earlier practice, some companies did not update the contract liability for current changes in the market rate of interest that the company could earn on the underlying investments/assets. As such, the contract liability was understated in case, the market rate of interest on the underlying assets reduced and vice versa.

Appropriate discount rates

As per new standard, the rate used to discount the cash flows should reflect the characteristics of the cash flows arising from the insurance contracts liability as opposed to the discount rate that reflects the expected return on the underlying assets held. Using the correct discount rate will ensure that the liability is not understated and profits not overstated by companies.

Grouping of contracts and separation of non-insurance components

Under IFRS 17, a company shall need to identify portfolio of contracts and divide the contracts into:

a) contracts that are onerous at inception
b) contracts that have no significant possibility of becoming onerous subsequently and
c) remaining contracts (i.e., contracts that may become onerous subsequently)

Losses on onerous contracts should be immediately recognized in statement of profit or loss.

Further, the new standard requires separation of non–insurance components from the insurance contract and requires such components to be accounted for under the relevant IFRS standard (Refer section on scope and exclusions for more details).

Recognition of revenue and contractual service margin (CSM)

Under the new standard, the company shall need to calculate the contractual service margin (CSM) at the inception and recognize the same over the service period.

Insurance companies should not recognize any revenue or profit on the inception of the contract. The premium received shall be allocated towards future obligation for claims, risk adjustment and CSM (Refer section on the accounting model for further discussion).
Sources of revenue and profits

IFRS 17 is expected to make the source of revenue and profitability transparent. At present, some companies recognize deposits received from customers also as revenue. Under the new standard, amount received as deposits will be recognized as a liability on the balance sheet.

The new standard distinguishes the two key sources of revenue and profitability from insurance contracts i.e.;

a) Profit earned from providing insurance coverage and
b) Investment results from managing the financial assets

Claims and expenses

Under the new standard, only incurred claims and other insurance service expenses arising from insurance contracts will be recognized as insurance expenses in the statement of profit or loss. As such, repayment of non-insurance component such as deposits will be treated as repayment of a liability.

Scope and exclusions

IFRS 17 covers the accounting for insurance contracts issued, reinsurance contracts acquired and investment contracts with discretionary participation features issued by the insurer. The scope excludes:

Product warranties - IFRS 17 does not apply to product warranties issued by a manufacturer, dealer or retailer. These should be accounted for as per the provisions of IFRS 15 and IAS 37.

Fixed-fee service contracts - Example of such contracts include roadside assistance programme and maintenance contracts in which the company provides specified repair services in exchange for a fixed fee. IFRS 17 provides an option to choose to account for such contracts using IFRS 15 if the primary purpose of the contract is the provision of services.

Financial guarantee contracts - The standard provides an option to apply IFRS 9 in case an explicit statement was made previously by the company for accounting of the financial guarantee contract as an insurance contract.

Accounting for non-insurance components - IFRS 17 requires non-insurance components to be separated from the insurance component, if certain conditions are met. For example:

<table>
<thead>
<tr>
<th>Non-insurance component</th>
<th>When to be accounted for separately</th>
<th>Apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good and non-insurance related services</td>
<td>If distinct performance obligation and not embedded with the insurance contract</td>
<td>IFRS 15</td>
</tr>
<tr>
<td>Deposit components</td>
<td>If distinct</td>
<td>IFRS 9</td>
</tr>
<tr>
<td>Embedded derivatives</td>
<td>If not closely related</td>
<td>IFRS 9</td>
</tr>
</tbody>
</table>
The Accounting Model

As mentioned in the previous sections, in order to apply the requirements of IFRS 17, a company is required to group all the insurance contracts based on the portfolio of contracts that have similar risks and are managed together.

### Accounting model showing initial & subsequent measurement of Insurance contracts in IFRS 17

<table>
<thead>
<tr>
<th>Initial Recognition</th>
<th>Subsequent measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium Received</td>
<td></td>
</tr>
<tr>
<td>Expected probability weighted net present value of Fulfillment Cash Flows (FCF)</td>
<td>Subsequent changes in estimates at each reporting date</td>
</tr>
<tr>
<td>Risk Adjustment</td>
<td></td>
</tr>
<tr>
<td>Contractual Service Margin (CSM)</td>
<td>Effect of changes in discount rates</td>
</tr>
<tr>
<td>Adjust CSM</td>
<td></td>
</tr>
<tr>
<td>Release of CSM over the service period</td>
<td>Profit or Loss (Insurance service result)</td>
</tr>
<tr>
<td></td>
<td>Profit or Loss (Insurance finance expense or income)</td>
</tr>
<tr>
<td></td>
<td>P&amp;L or OCI (A/C policy choice)</td>
</tr>
<tr>
<td></td>
<td>Accretion of Interest</td>
</tr>
<tr>
<td></td>
<td>Changes in estimates related to past or current coverage</td>
</tr>
<tr>
<td></td>
<td>Changes in estimates related to future services</td>
</tr>
</tbody>
</table>

**Notes:**

1. The date of initial recognition for a group of insurance contracts would be earlier of (a) the beginning of the coverage period (b) the date of receipt of first payment from policy holder or (c) for a group of onerous contracts, when the group becomes onerous.
2. The insurance company will not recognize any revenue or profit at the inception of the contract or on receipt of the premium and the profit from the contract (CSM) shall be recognized over the service period.

**Reinsurance contracts held**

For accounting of the reinsurance contracts held by an insurer, the general accounting model in IFRS 17 is modified to the extent:

- The fulfillment cash flows reflect the risk of non-performance by the issuer of reinsurance contracts.
- CSM at initial recognition will not include the net cost of purchasing the reinsurer related to past events instead this is immediately recognized in the statement of profit or loss.
- A group of reinsurance contracts held is recognized from either the beginning of the coverage period of the group or the initial recognition of the underlying insurance contracts, whichever is later or from the beginning of the coverage period if the reinsurance coverage is not for the proportionate losses of a group of underlying insurance contracts.

**Variable fee model**

The approach for insurance contracts with Direct Participation Feature is referred to as variable fee approach. The ‘Variable Fee Approach’ modifies the accounting model under IFRS 17 to reflect that the consideration that a company receives for the contract is a variable fee.

In general accounting model, the CSM at initial recognition is updated to reflect changes in cash flows related to future coverage and accreted using interest rates at initial recognition. Whereas in variable fee approach, the CSM at initial recognition is updated to reflect changes in the amount of the variable fee, including those related to changes in discount rates and other financial variables.

**Premium allocation model (Simplified approach)**

IASB has provided with the option to apply the simplified approach to contracts for which there is no significant change in estimate is expected from the initial recognition or the contracts which have coverage period of less than a year. Under simplified approach, company measures insurance liability as the Liability for Remaining Coverage (LRC) and the unsettled Liability for Incurred Claims (LIC).

The amount paid by the policyholder for providing insurance coverage during the reporting period is recognized as revenue in the statement of profit or loss. The interest is accreted on the liability.
Transitional Provisions

With 1 January 2021 being the effective date, there is less than three and half year’s time to transition. Subject to the transition options provided under the standard (as mentioned below), IFRS 17 requires full retrospective application (for existing contracts at the date of transition) consistent with the principles contained in IAS 8. For each portfolio of contracts, the cumulative effect on transition date will be recognized in opening retained earnings.

Aware of the challenges poised in the full retrospective application (for example, extracting data in case of life insurance contracts extending over multiple years), the IASB has provided for certain simplifications. In case if it is impracticable to retrospectively apply the standard due to certain reasons then the standard has provided with the option of using either:

<table>
<thead>
<tr>
<th>Modified retrospective approach</th>
<th>Fair value approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under modified approach, an entity should use only the information which is available without undue cost or effort for applying the full retrospective approach. Under this approach use of hindsight is permitted if that is the only practical source of information for the restatement of prior periods.</td>
<td>Under fair value approach, contractual service margin at the transition date is determined as the difference between the fair value of a group of insurance contracts and fulfillment cash flows at that date.</td>
</tr>
</tbody>
</table>

Entities already applying IFRS 9 on the transition date of IFRS 17 may retrospectively re-designate and reclassify certain financial assets linked to the contracts entered within the scope of IFRS 17.

Presentation and Disclosures

In order to increase the transparency, the new standard requires a company to disclose certain qualitative and quantitative information as follows:

**Recognized amounts**
- An entity is required to provide:
  - A reconciliation between the opening and closing balances of insurance contracts issued and reinsurance contracts held
  - Amortization schedule of remaining contractual service margin and
  - Analysis of insurance revenue, insurance finance income and expenses and new business recognized in the period

**Significant judgments**
- Disclose the methods used to measure insurance contracts and the processes used for estimating inputs
- Disclose any changes in above with reasons
- Disclose the yield curve used to discount the cash flows

**Nature and extent of risk**
- The disclosure about insurance and financial risk arising from insurance contracts should be explained by proving a sensitivity analysis, exposures to such risks and methods to manage those risk. Also the liquidity risk shall be disclosed with a maturity analysis showing the estimated cash flows.
Implementation Considerations

IFRS 17 will impact several business functions and processes including product design, financial and MIS reporting and the existing IT systems. There will be an increased requirement to use the actuarial techniques under IFRS 17 to update the contract liability at each reporting date based on current estimates. Further, companies shall need to update their system and processes to derive required data at each reporting date.

The new standard requires careful planning to ensure successful transition. Three years may seem enough, however it will test the nerves of the management to do a gap analysis and impact assessment in order to develop a detailed implementation roadmap and execution of the same.

We expect that most companies issuing long term insurance contracts will need to incur significant costs in implementing IFRS 17. Therefore, it would be imperative to budget the costs and get the sponsorship in advance by forming an implementation committee.

**Key to the smooth transition lies in early planning and rigorous implementation with the help of a dry run.**
Appendix: Definition of key terms

- **Contractual service margin (CSM)**
  It is a component of the asset or liability for a group of insurance contracts representing the unearned profit that the company will recognize as it provides services under the insurance contracts in the group.

- **Experience adjustment**
  A difference between: (a) the estimate at the beginning of the period of premium receipts expected in the period, and the actual premiums received or (b) the estimate at the beginning of the period of insurance service expenses expected to be incurred in the period, and the actual insurance service expenses incurred in the period.

- **Fulfillment cash flows (FCF)**
  An explicit, unbiased, probability-weighted and risk-adjusted estimate of the present value of the future cash outflows minus inflows that will arise as the company fulfills insurance contracts.

- **Insurance contracts with direct participation features**
  An insurance contract for which, at initial recognition: (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items; (b) the company expects to pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and (c) the company expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

- **Insurance finance income or expenses**
  The effect of time value of money related to FCF and CSM is shown as insurance finance expense in statement of comprehensive income. This typically reflects the interest paid on advance payments received in the shape of premiums as policyholder pays premium upfront and receive the benefit at a later date.

- **Liability for incurred claims under Premium Allocation Approach (PAA)**
  The liability for incurred claims is measured based on the expected discounted value of claim payments adjusted for risk.

- **Liability for remaining coverage under Premium Allocation Approach (PAA)**
  The liability for remaining coverage at initial recognition would be equal to premiums received less insurance acquisition expenses. On subsequent measurement the liability for coverage would be reduced on the basis of the passage of the time.

- **Onerous Contracts**
  An insurance contract is onerous at the date of initial recognition if the fulfillment cash flows allocated to the contract, any previously recognized acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.

- **Portfolio of contracts**
  Insurance contracts that are subject to similar risks and managed together.

- **Risk adjustment**
  The compensation a company requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the company fulfills insurance contracts.

How we can help

Protiviti’s Financial Reporting consultants help companies on various financial reporting matters. The conditions in today’s global business market, such as rapidly changing regulations, increased scrutiny of company financials, complex, nonrecurring business transactions, and complex accounting standards, strain the capabilities of many finance organizations. This amplified stress increases an organization’s exposure to mistakes, lost synergies and inability to maintain base-level financial processes. Risk of these errors is typically higher during the adoption of new accounting standards; embarking on significant business transactions; implementation of new IT/enterprise resources planning (ERP) systems; restructurings, acquisitions and divestitures; and expansion into new markets or new businesses.

Our Financial Reporting professionals are qualified Chartered Accountants with extensive practical experience in financial reporting across multiple jurisdictions and under various accounting frameworks (including IFRS and US GAAP).

We at Protiviti, proactively monitor new accounting rules, alert our clients to changing requirements and offer assistance with addressing complex accounting or reporting challenges, including conversion to new International Financial Reporting Standards (IFRS) such as IFRS 9, 15 and IFRS 16.
About Protiviti

Protiviti (www.protiviti.in) is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Through its network of more than 70 offices in over 20 countries, Protiviti and its independently owned Member Firms provide clients with consulting solutions in finance, technology, operations, data analytics, governance, risk and internal audit.

Protiviti has served more than 60 percent of Fortune 1000® and 35 percent of Fortune Global 500® companies. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies. In India, Protiviti’s member firm (Protiviti India Member Private Ltd.) is a leading provider of business consulting, internal audit, risk management, technology, tax and regulatory, financial reporting and IFRS advisory, forensic and fraud investigation, information management and transaction services. Protiviti member firms are separate and independent legal entities, are not agents of other firms in the Protiviti network, and have no authority to obligate or bind other firms in the Protiviti network.

Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Contact Us

Vishal Seth
Managing Director and Leader, IFRS Advisory
+91.124.661.8650
vishal.seth@protivitiglobal.in

Oscar Martins
Director and Leader, Financial Services
+91.22.6626.3330
oscar.martins@protivitiglobal.in

Our Offices:

Bengaluru
GK complex, Ground floor,
Plot No 257, Amarjoythi BHCS Layout,
Inner Ring road, Domlur,
Bengaluru - 560071, Karnataka
Phone: +91.80.6780.9300

Kolkata
PS Srijan Corporate Park #1001B,
10th floor, Tower-2, Plot No. 2,
Block EP & GP, Sector – V, Salt Lake City,
Kolkata - 700091, West Bengal
Phone: +91.33.4601.0028

Delhi(NCR)
15th Floor, Tower A,
DLF Building No. 5,
DLF Phase III, DLF Cyber City
Gurgaon - 122002, Haryana
Phone: +91.124.661.8600

Mumbai
1st Floor, Godrej Coliseum,
Unit No 101, B Wing,
Somaiya Hospital Road, Sion(East)
Mumbai - 400022, Maharashtra
Phone: +91.22.6626.3333

Hyderabad
Q City, 5th floor, Block A, Survey No. 109,
110 & 111/2, Nanakramguda Village,
Serilingampally Mandal, R.R. District
Hyderabad - 500 032, Telangana
Phone: +91.40.6658.8700

This publication has been carefully prepared, but should be seen as general guidance only. You should not act or refrain from acting, based upon the information contained in this presentation, without obtaining specific professional advice. Please contact the persons listed in the publication to discuss these matters in the context of your particular circumstances. Neither Protiviti India Member Private Limited, nor the shareholders, partners, directors, managers, employees or agents of any of them make any representation or warranty, expressed or implied, as to the accuracy, reasonableness or completeness of the information contained in the publication. All such parties and entities expressly disclaim any and all liability for or based on or relating to any information contained herein, or error, or omissions from this publication or any loss incurred as a result of acting on information in this presentation, or for any decision based on it.

© 2017 Protiviti India Member Private Limited