

Bridging the accounting gap under IFRS 17

Re-thinking Insurance Accounting under IFRS 17.



IFRS 17 is a principles-based accounting standard and allows for alternative accounting treatments. Under IFRS 17, changes in financial assumptions can alternatively be routed through Other Comprehensive Income (OCI) (for GMM contracts), instead of the Profit and Loss account and thereby reducing volatility.

INTRODUCTION

Traditionally, actuaries have kept themselves busy with assumptions setting, modelling products on actuarial platforms and projecting cashflows to arrive at liability and solvency numbers for reporting. The actuarial world revolved around more or less the same platforms and processes. Similarly, the accountants have confined themselves to the general ledgers, preparation of financial statements and disclosures. The interaction between the two worlds had been mostly limited to sharing the liability and solvency numbers periodically. The actuarial and accounting systems likewise were not build to interact with each other. With IFRS 17, due to be implemented by 2022, all this is set to change. The challenges which IFRS 17 has introduced will require bringing both the worlds together.

The current standard, IFRS 4 under which Insurance contracts are accounted for was issued in 2004. Under this standard, there is an immediate release of profit/ loss at initial recognition of the insurance contract. And, the subsequent emergence of smaller profits via the release of prudential margins embedded in the policy reserves. In subsequent years, profits primarily came from the difference between the 'unwind' of the reserves and the experience. Further to this, profit is also moved by other drivers like the changes in future estimates and financial and non-financial assumptions. However, Insurer companies club all these changes in one single number viz. 'Change in Insurance Contract Liability' for presentation in its income statement. To understand the main drivers contributing to profitability, Insurers carry out an exercise called an 'Analysis of Surplus' and measure the individual impact of the above elements on their surpluses. The results of this exercise are then used internally for risk management and other decision making. This exercise is an internal exercise, and the outside world had little idea about the real drivers behind the performance of the entity. The new standard seems to have taken a clue from the usefulness of the exercise and fixed its disclosure requirements on similar lines. All those who have seen results of this exercise will be able to relate those with IFRS 17 disclosures.

HOW WILL INSURANCE ACCOUNTING CHANGE AFTER IFRS 17?

Insurance company balance sheets were seen as black boxes for reasons stated above and hence were considered non-transparent and non-comparable. This, amongst other reasons, led to the introduction of the new standard, IFRS 17. At initial recognition of the contracts, IFRS 17 (as against IFRS 4) doesn't allow any initial profit recognition but requires setting up of a CSM component as part of the liability. This is expected to result in a release of profits that is more aligned with the delivery of insurance service and hence is expected to produce more uniform and stable profit signatures, compared to IFRS 4. On the revenue recognition front, IFRS 17 primarily recognizes both the 'unwind' of the insurance component of the liability reserve as well as 'release of CSM' as Insurance Revenue. However, given the complexities of CSM & Liability calculations, further aggravated by the volumes (due to level of aggregation requirements), IFRS 17 poses a significant actuarial and accounting challenge before the Insurers. The accounting entries need to closely follow and reflect liability and CSM at initial recognition and subsequent measurement and also the drivers causing changes in the liabilities and CSM.

Under IFRS 4, all types of assumption changes that affect future liability are treated similarly and go on adjusting the reserves and this often leads to erratic reserve release patterns and profit signatures. IFRS 17 is a principles-based accounting standard and allows for alternative accounting treatments. Under IFRS 17, changes in financial assumptions can alternatively be routed through Other Comprehensive Income (OCI) (for GMM contracts), instead of the Profit and Loss account thereby reducing volatility.

DIFFERENT APPROACHES, DIFFERENT CHALLENGES

Under IFRS 17, suitable approaches will have to be chosen for different groups of contracts or products, applying the prescribed eligibility criterion. All approaches serve a common objective of ensuring a more systematic distribution of profit vis a viz the current practice of a high immediate profit/ loss release and smaller subsequent releases. Another common objective of all the three approaches is to recognize only the insurance portions as revenue.

Amongst the three approaches, the GMM approach is the default approach, and the PAA simplification is permitted on meeting the boundary criterion. Insurers are required to adopt the VFA approach for their contracts that meet the requirements specified in the standard. All three approaches have significantly different calculation methodologies and accounting treatments.

The PAA approach, considered the simplest amongst the three, doesn't mandate holding of a CSM component and recognizes revenue equal to the proportionate amount of premium at every reporting date. However, the method doesn't support the liability measurement of onerous contracts and requires the application of the GMM method in such a situation. Movement from one method to another could be challenging for both actuarial as well as the accounting side.

GMM approach being the default approach is expected to apply to most groups of contracts. The GMM approach, as mentioned in the beginning sets profits aside as CSM and requires a systematic release of CSM into the income statement. Any changes to the fulfilment cash flow either adjust the CSM or are transferred to the profit and loss depending on whether those impact the future service or the current service.

The VFA approach, on the other hand, has its peculiarities and requires recognition of 'present value of the entity's share of underlying' or the 'variable fees' as CSM. Any changes to the fulfilment cashflows impacting the variable fees need to adjust the CSM.

TREATMENT OF ONEROUS CONTRACTS

Presently, losses under loss-making (onerous) contracts are cross-subsidized against profitable contracts, but under IFRS 17, there is the requirement to identify onerous contracts separately and also recognize the losses immediately in profit and loss account. The loss component can also come into being due to adverse changes on subsequent measurement. The loss component is to be immediately recognized and then till the time the loss component is reversed, it also needs to reduce the revenue and thereby not to overstate it. The loss component is to be released systematically over the life of the contract or till the time it is reversed by favorable changes and CSM getting created.

One of the tricky parts that especially the accounting side will need to handle is the possibility of non - onerous contracts at inception turning onerous at subsequent measurement and vice versa and having unified entries that work in both these situations.

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Timing of Event	Event	Debit Account	Credit Account
Initial Recognition	Insurance Contract Initial Recognition (Onerous and Non-Onerous)	Insurance Contract Liabilities - PV of Inflow	Insurance Contract Liabilities - PV of Outflow - Insurance Component
			Insurance Contract Liabilities - PV of Outflow - Investment Component
			Insurance Contract Liabilities - RA
		Loss Component of the Liability	Insurance Contract Liabilities - CSM
Initial Recognition	Loss component recognition	Insurance Service Expense - Loss on onerous contracts	Loss Component of the Liability

When applying the new standard to reinsurance contracts, there will be challenges like differences in contract boundaries, CSM release pattern that will have to be dealt with.

The first sample entry above is for recognition of an insurance contract. The respective amounts for each contract/ cohort need to come from the CSM engine. As there could be reversal of CSM or reversal of the Loss component at any point, one way to handle such situation would be to have entries that have both CSM and Loss component in the same entry. Similar entries need to be passed for changes to future service liabilities and that impact the CSM/ Loss component. Also, as required by the standard, the loss component is immediately realized as an expense (and subsequently moved to Profit and Loss account).

REINSURANCE

IFRS 17 is very clear that the reinsurance held needs to be valued and accounted for separately as against the current practice of netting down of the reinsurance premiums and recoveries, under IFRS 4. When applying the new standard to reinsurance contracts, there will be challenges like differences in contract boundaries, CSM release pattern that will have to be dealt with. Under the PAA approach, reinsurance will be a single line item in profit and loss account under the head of 'Net Gain/ Expense from Reinsurance Contract'. Whereas, under GMM, all three liability components will be set up and runoff. Also, under IFRS 17, reinsurance contract accounting might be done using GMM or PAA even when the underlying insurance contract is under VFA and the usual method selection criterion will apply otherwise. So, we could come across combinations like insurance contract being covered under GMM and reinsurance contract under PAA. Further, more actuarial and accounting challenges can be expected with proportionate and disproportionate reinsurance and the use of multiple types of coverages for the same group of insurance contracts.

Under IFRS 17, groups of reinsurance contracts are to be presented separately from insurance contracts issued. Also, the contracts that are 'Assets' are to be presented separately from contracts that are 'Liabilities'. Insurance Revenue/ Expense and Finance Income/ Expense from reinsurance can be presented as a single number or as separate items from corresponding numbers for insurance contracts.

Disclosures under IFRS 17		
Income statement	2021	2020
Year ended 31 December	GBP	GBP
Insurance contract revenue		
Insurance contract expenses		
Net reinsurance income/ (expense)		
Insurance service/ underwriting result		
Investment return		
Net insurance finance result		
Investment result		

All the above challenges ask for an accounting solution that is tightly integrated with the CSM and Liability calculation engine and which can also be integrated with the entity's accounting hub to get the necessary IFRS 17 postings to General Ledger done.

TRANSITIONARY CHALLENGES

Transitions are never easy, and IFRS 17 certainly not going to be an exception. The standard allows the use of either of Modified Retrospective or Fair Value Approaches over Full Retrospective on meeting certain conditions, but all the three methods come with their challenges. The standard also gives an option to apply a different approach to a different group of contracts. There would, therefore, be challenges from assumptions to account postings stages.

FEATURES OF A DESIRABLE IFRS 17 SUB-LEDGER FUNCTIONALITY

Considering the challenges posed by IFRS 17, the solution that the insurers need to invest in can neither be a solely actuarial owned and driven nor an accounting owned and driven, but a holistic solution that caters to the needs of both actuaries and accountants. The solution needs to be a seamless one, without any gaps between the actuarial and the accounting pieces. Any gaps in the solution can lead to implementation failures, if any of the stakeholders are not comfortable signing off at the time of reporting.

Some of the desirable features the solution needs to possess are as below:

- **Data storage:** All the policy data, market data, assumptions and then the CSM and Liability numbers need to be stored in a system versatile enough to group and ungroup policies/ cohorts, as needed for the use of the sub-ledger functionality.
- **A robust CSM engine:** A robust engine capable of calculating the CSM and Liability numbers at the required level of granularity and then generating the movement analysis and reconciliation of the numbers for all the prescribed approaches.
- **Flexibility:** Subledger functionality that works with a standard set of Chart of Accounts (CoA) which needs to be customizable to the existing set of Chart of Accounts (CoA) that the entity is using.
- **Accounting Rules:** Accounting rules need to be framed for all the prescribed approaches and also the reinsurance contracts held and for most scenarios. These accounting rules need to be customizable to cater to the specific needs of the organisation.
- **Manual Adjustments:** The functionality needs to also allow for manual adjustments or passing entries apart from the regular system generated entries.



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