IFRS 17 – How the insurance industry is assessing and adopting the standard

Essays on IFRS 17 contributed by insurance companies and supplemented with articles by EY insurance professionals

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Content

Foreword/introduction

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After nearly two decades of discussion, a single global accounting standard for the insurance sector has been developed and was finally issued in 2017. With this new standard, the IASB aims to solve the comparison problems created by IFRS 4 by requiring all insurance contracts to be accounted for in a consistent manner, benefiting both investors and insurance companies. In addition, the information provided is designed to be more useful compared to the current reporting regime: Insurance obligations will be accounted for using current values – instead of historical cost.

With all the upcoming requirements, IFRS 17 goes far beyond a change in accounting policy only. The impact currently seen in the market will not only be on financial accounting and actuarial systems but will also impact future performance measurement and operating models for financial reporting.

The new standard has been keeping the entire insurance industry busy for years with its very comprehensive theory. This is why EY decided to compile a bundle of essays on IFRS 17 contributed by insurance companies and supplemented with some articles by EY insurance professionals. Fortunately, there have been many fellow combatants in the insurance market taking a great interest in the topic of IFRS 17, willing to realize this project by contributing articles on the most critical questions as of today.

At this point, I would like to thank all the external authors for their highly constructive contributions and good collaboration in realizing this project. Although a lot of questions and solutions are still open, they positioned themselves with a clear view on how to understand the requirements and discuss solutions on how to meet the high burdens of IFRS 17. Your effort and contribution is highly appreciated.

I hope this book gives readers an insight into how the insurance industry is assessing and adopting the new standard from a very hands-on perspective.

Preface

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These essays on IFRS 17 written by independent outside contributors of the insurance industry and supplemented with two articles by EY insurance professionals explores a topic of great interest. Numerous articles have already been published on the scope and key features of IFRS 17. However, practical challenges in relation to implementing the new standard in insurance companies need to be urgently addressed.

Since 2004, international insurance groups have had to report in accordance with IFRS 4. This reporting standard allows insurers to use national accounting standards provided they do not jeopardize the fundamental objective of the conceptual framework. Some sections of the German Commercial Code ("Handelsgesetzbuch": HGB) are not consistent with the objective of a true and fair view and subsequently bring about the need for adjustments. This concerns, for example, the equalization reserves.

The new IFRS 17 establishes a uniform set of recognition and measurement regulations across the entire insurance sector. Moreover, the new accounting rules are designed to avoid accounting mismatches that would otherwise arise, especially in Germany, when assets are measured at fair value, on the one hand, while liabilities are measured at amortized cost, on the other hand.

The standard becomes effective for reporting periods starting on or after 1 January 2021. Comparative figures must be calculated for the previous period. IFRS 17 represents a paradigm shift in the reporting of insurance contracts by improving comparability and better reflecting the economic reality. The building block approach, the premium allocation approach and the variable fee approach are the main valuation methods. The principles of these approaches form an important part of these essays.

Nevertheless, despite the paradigm shift in the reporting of insurance contracts, there are still a great deal of challenges to be addressed in implementing and applying the new accounting standard.

The development of new evaluation models for actuarial provisions is time-consuming and requires a high level of expert knowledge and finesse. An in-depth understanding is essential, especially for the calculation of cash flow projections, the development of actuarial models and the handling of emerging risks.

The need for high data granularity as well as data modelling, data administration and data utilization requires a special IT infrastructure and a realignment of business processes.

This handbook deals with the issue of classifying onerous contracts which should be attributed to an own portfolio class. In addition to the unit of account, focus is placed on the level of aggregation in IFRSs.

The premium allocation approach and the building block approach as the main valuation models in property and casualty insurance are explained in detail on the basis of possible problematic issues.

The treatment of reinsurance contracts as an instrument of risk minimization is clarified and the functionality of separating components (previously unbundling) from an insurance contract is illustrated from a practical point of view.

Furthermore, the articles used by EY underscore the major significance of IFRS 17 for the German and international insurance sector and address very specialized subjects related to application. Discretionary powers, verifiability and validation are set out and challenges are presented from an auditor's point of view.

The new standard that will affect the entire insurance industry needs to be explained in detail. This handbook of best practices provides a framework for understanding the IFRS on a technical level and applied to practical problems and challenges in implementation. It is a valuable piece of work and highly worth reading.

THE ONEROUS CONTRACT TEST IN IFRS 17

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1 Introduction

While the new standard does not use the term onerous contract test, we would like to use it for the assessment of whether a group of contracts accounted for under the premium allocation approach (PAA) is onerous. In contrast to the general measurement model which determines whether a group of contracts is or has become onerous as part of the regular remeasurement of the liability for remaining coverage (LRC), no such automatism exists under the PAA. Under this approach, the LRC represents the deferred premium receipts, reduced by insurance acquisition costs of the group of contracts which are released over the coverage period. An onerous contract test for such contracts has to be based on a comparison of the LRC under the PAA and the fulfillment cash flows determined based on the general measurement model.

This onerous contract test will be a significant change in comparison to today's liability adequacy test (LAT) under IFRS 4 and the premium deficiency test under US GAAP, which fulfills the minimum requirements for a LAT defined in IFRS 4. The differences relate both to the methodology and the appropriate level of granularity on which the test has to be performed.

In the following sections we will describe the onerous contract test and potential input factors, which could influence the number of onerous contracts. In order to do that, we start with a brief description of the general measurement model and the definition of an onerous contract. Then we will move on to the specific requirements for onerous contract testing under the PAA.

2 General measurement model under IFRS 17

2.1 Building block approach

The measurement of insurance contract liabilities under IFRS 17 is generally based on the building block approach. The insurance contract liability of a group of insurance contracts consists,[1] at initial recognition, of four building blocks:

Cash flows (IFRS 17.33–35)

This block reflects an entity's current estimation of the future cash flows of the insurance contracts within the contract boundary. This includes both future cash inflows like premium payments and cash outflows such as claims and benefit payments, acquisition costs and expenses. These expected cash flows are determined on a best estimate basis, i.e., they are an unbiased reflection of "all reasonable and supportable information available."[2]

1. Discount rates (IFRS 17.36)

In the second step, the estimated future cash flows are adjusted to reflect the time value of money. The discount rates used for this purpose should reflect the cash flow and liquidity characteristics of the insurance contracts and be consistent with observable market variables.

2. Risk adjustment for non-financial risks (IFRS 17.37)

The risk adjustment reflects the consideration that is required by an entity as a compensation for bearing the non-financial risk, i.e., the uncertainty with regard to amount and timing of the cash flows from non-financial risks.

3. Contractual service margin (IFRS 17.38–39)

The contractual service margin (CSM) represents the unearned profits of the insurance contract. The CSM needs to be recognized as part of the insurance contract liability in order to avoid recognizing a day one gain. The CSM is amortized over the coverage period of the insurance contracts.

For subsequent measurement the standard further differentiates between the LRC and the liability for incurred claims (LIC). The carrying amount of a group of insurance contracts is the sum of both liabilities.[3] The LRC represents the fulfillment cash flows (sum of the first three building blocks)[4] related to future service and the CSM; the LIC consists of the fulfillment cash flows for past services, i.e., expired risks. While the release of the LRC due to the provision of services is recognized as part of the insurance revenue, changes to the LIC, either due to incurred claims or due

1 The group of insurance contracts is the unit of account for all recognition and measurement according to the new standard and will be discussed in further detail below (IFRS 17.16 and IFRS 17.29).
2 IFRS 17.33a.
3 Cf. IFRS 17.40.
4 Cf. IFRS 17.Appendix A.

to subsequent changes relating to past claims, are recognized as part of the insurance services expenses. The effect of the time value of money is recognized as part of the insurance finance income or expenses.[5]

Both the LRC and the LIC are measured on a fully current basis, i.e., they are also for subsequent measurement based on fully current assumptions. The further analysis will focus on the LRC, as the LIC relates to incurred claims and has therefore, by definition, no impact on the expected profitability for the remaining coverage of a group of contracts.

2.2 Onerous contracts

According to the standard, a contract is onerous at initial recognition if the expected cash outflows plus the risk adjustment and any previously recognized acquisition cash flows exceed the expected cash inflows. In other words, the insurance contract is onerous if fulfillment cash flows plus pre-coverage cash flows are a net outflow. In contrast to an expected profit, this net outflow needs to be immediately recognized in P&L.[6]

Next to the immediate negative impact on the profit of the reporting period, this also has an impact on the unit of account for measurement of the contracts. IFRS 17 generally requires contracts within a portfolio to be split into three groups. One of these three groups is designated for contracts that are onerous at inception. The other two groups are for contracts which have no significant risk of becoming onerous and other profitable contracts.[7] Hence, the existence of contracts which are onerous at inception increases the granularity of the unit of account. This grouping is not reassessed for subsequent measurement, i.e., the composition of the groups does not change.[8]

Nevertheless, a group of contracts that had not been onerous at initial recognition can become onerous at subsequent measurement as the CSM is not only accreted and amortized over the coverage period, but also adjusted for changes in fulfillment cash flows relating to future services. If an unfavorable change in the fulfillment cash flows exceeds the remaining carrying amount of the CSM, the group of contracts becomes onerous.[9] The amount exceeding the CSM must be recognized immediately in P&L.

An entity needs to establish for each group of onerous contracts a loss component, which reflects the losses as described above. If fulfillment cash flows decrease at subsequent measurement, e.g., due to a favorable change in assumptions, an entity must reduce the loss component and recognize this change as a profit.

2.3 Practical considerations

Based on the definition of a group of onerous contracts in IFRS 17, it can be stated that in order to be onerous at inception, a group must not necessarily be loss making. It is rather sufficient that an entity does not expect to earn the compensation that it generally requires for bearing the uncertainty of the cash flows of the insurance contracts, i.e., the risk adjustment. Assuming an entity is using a cost-of-capital approach for determining the risk adjustment, the insurer is required to recognize a loss on a group of contracts if it does not earn its cost of capital.

In contrast to IFRS 17, the general definition of an onerous contract in IAS 37 is less specific. According to IAS 37.10 an onerous contract is a contract "in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it." While there is some diversity in practice with regard to the interpretation of the "unavoidable costs,"[10] these costs do not include a cost of capital charge. Accordingly, the IFRS 17 definition of onerous contracts is stricter than the definition in IAS 37.

Key questions are: what drivers impact the number of onerous contracts and what areas of discretion exist that IFRS 17 might be providing as a principles-based standard. Two potential levers come to mind:

- First, there will be in practice some degree of freedom in defining the cash flows within the contract boundaries, especially regarding directly attributable acquisition and overhead costs.[11] While an insurer might be able to reduce its cash flows by defining less costs as being directly attributable, one should be aware that there is no accounting policy option not to reflect directly attributable costs as part of the cash flows and the definition of cash flows within the contract boundaries needs to be applied in a systematic and consistent way to all contracts.

- Second, the standard only provides a principles-based guidance with regard to the definition of the risk adjustment.[12] While an entity is required to make a disclosure of the

5 Cf. IFRS 17.41 and 42.
6 Cf. IFRS 17.47.
7 Cf. IFRS 17.16.
8 Cf. IFRS 17.24.
9 Cf. IFRS 17.48. For contracts with direct participating features also a decrease in the entity's share in the so called underlying items could result in a group of contracts becoming onerous. However, the topic of direct participating contracts will not further be discussed in this article.
10 Cf. IFRS Interpretation Committee Meetings of June and September 2017: Costs considered in assessing whether a contract is onerous (IAS 37). No agenda decision has been taken.
11 Cf. IFRS 17.B65.
12 Cf. IFRS 17.B86-B92.

confidence level used to determine the risk adjustment, no confidence level or method of how to determine the risk adjustment is defined in the standard.[13] The risk adjustment still needs to be determined in such a way to appropriately reflect the consideration expected for assuming non-financial risks. However, when management judgment needs to be applied, it should be taken into consideration that the size of the risk adjustment will have an impact on the number of onerous contracts of an entity.

2.4 Onerous contract test in the general measurement model?

It should be clear from the mechanics of the general measurement model and the definition of a group of onerous contracts that no specific onerous contract test is required due to the fully prospective measurement at contract inception and the CSM adjustments at subsequent measurement. For example, if there was an unfavorable change in non-financial assumptions, it would increase the cash flows relating to future services and as such adjust the CSM downward. After exhausting the CSM, a loss component has to be recognized with an immediate impact in the income statement. However, the picture is very different under the PAA, which will be discussed in more detail in the following sections.

13 Cf. IFRS 17.118.

3 Premium allocation approach and onerous contract test

3.1 Eligibility and measurement

The IASB had originally limited the application of the simplified model in its Exposure Draft 2010 to the measurement of the liability for remaining coverage of contracts with a coverage period of one year or less and without any embedded derivatives.[14] While the final standard also limits the eligibility of insurance contracts for the simplified model, which is now labelled as the PAA, the eligibility criteria are less strict. The measurement of a group of insurance contracts can be simplified if the insurer either expects at contract inception that the simplified measurement model would not produce a liability for the remaining coverage that is materially different from the measurement according to the general measurement model or that the coverage period of all contracts within the group of contracts is one year or less.[15] Accordingly, an insurer has an accounting option at the group of contracts level to apply the PAA as long as the eligibility criteria are fulfilled.

For contracts measured based on this approach, the LRC is determined at the inception of a group of contracts as the premium received at the date of initial recognition minus any acquisition cash flows at that date and an adjustment for any amounts arising from the derecognition of an asset or liability relating to acquisition cash flows which had been paid or received before the initial recognition of the group of contracts.[16]

For subsequent measurement the carrying amount of the LRC at the beginning of the reporting period is adjusted for the following items to reach the carrying amount of the LRC at the end of the reporting period:[17]

- Premiums received in the period;
- Minus insurance acquisition cash flows;
- Plus any amounts relating to the amortization of insurance acquisition cash flows recognized as an expense in the reporting period;
- Plus any adjustment for the time value of money (due to a significant financing component);
- Minus the amount recognized as insurance revenue for the coverage provided in that period; and
- Minus any investment component paid or transferred to the liability for incurred claims.

That means that the received premiums are deferred and earned over the coverage period. IFRS 17 states that the insurance revenue is the amount of expected premium receipts –

14 The Exposure Draft 2010 was still dealt with the pre-claim liability instead of the liability for the remaining coverage.

15 Cf. IFRS 17.53.

16 Cf. IFRS 17.55(a).

17 Cf. IFRS 17.55(b).

less any investment components and adjusted for the time value of money if the contracts contain a significant financing component – allocated to the period. This allocation can either be based on the passage of time or the expected pattern of insurance service expenses.[18]

The standard also defines two accounting options within the PAA.[19] First, for groups of contracts comprising of contracts with a coverage period of one year or less, the entity can choose to recognize acquisition cash flows as an expense when they are incurred. Second, an entity can choose not to discount the future cash flows reflected in the LIC if those cash flows are expected to be paid within one year from the date a claim is incurred.

3.2 The onerous contract test

3.2.1 Need for a test

As discussed before, there is no requirement for a separate onerous contract test for the general measurement model. This is due to the fact that the CSM reflects the net cash inflows at initial recognition and it is adjusted for changes in the future fulfillment cash flows for subsequent measurement. For the PAA, on the other hand, the LRC represents a deferral of the received premiums, which is allocated over the remaining coverage period. Accordingly, there is no inherent onerous contract test as part of the measurement of the LRC. In order to test a group of contracts which is accounted for under the PAA, an entity needs to compare the PAA LRC with the fulfillment cash flows. If the fulfillment cash flows exceed the PAA LRC, the group of contracts is onerous. In such a case, an immediate loss needs to be recognized and the LRC is increased to the level of the fulfillment cash flows.[20]

This onerous contract testing, however, entails a major operational obstacle: In order to be able to perform the test, an insurance entity would continuously need to calculate the fulfillment cash flows. In this case the PAA would not be any operational simplification in comparison to the BBA as a major part of the BBA calculation would need to be prepared in parallel. This would be in conflict with the expressed intention of the IASB, which considered the PAA as a simplification in comparison to the general measurement requirements.[21] This issue was also brought to the attention of the IASB by reviewers of the external review draft of IFRS 17. The Board clarified in February 2017 that an entity only needs to assess whether a group of contracts is onerous if there are facts and circumstances indicating that this group of contracts is onerous.[22] Accordingly, an entity would not be required to continuously determine the fulfillment cash flows for each group of insurance contracts measured according to the PAA.

While this decision of the IASB was very important considering the practicability of the simplified measurement model, it also triggered new questions. The major question that needs to be answered by each entity using the PAA is what such "facts and circumstances" could be. The next sections will reflect our view regarding this question.

3.2.2 Facts and circumstances and the unit of account

IFRS 17 states that an entity shall assume that no contracts in a portfolio of insurance contracts are onerous at initial recognition unless facts and circumstances indicate otherwise.[23] While this requirement creates an obvious circularity for the assessment of the eligibility of insurance contracts for the PAA,[24] it is also rather unspecific in what facts and circumstances could be. There is no additional guidance in the remaining section of IFRS 17 regarding the level of aggregation or in the paragraphs specifying the measurement under the PAA.[25] Hence, insurance entities need to find an answer to the question of how to deal with this requirement in practice. However, it can be clearly stated that if contracts are onerous at inception they need to be grouped separately from the non-onerous contracts. A reassessment of the groups of contracts is neither permitted nor required for subsequent measurement.[26]

3.2.2.1 Indicator for onerous contracts

From the previous assessment follows that an entity can regularly assume that all contracts within a portfolio that is eligible for the PAA are profitable if there is no indication that some contracts could be onerous. The question is what this indication or trigger for an onerous contracts test could be, independent of what information sources could be used for that purpose. While the standard clearly states that a contract measured based on the PAA is onerous if the fulfillment cash flows are higher than the liability for remaining coverage under the PAA,[27] the problem that arises in practice is that no modelled fulfillment cash flows will be readily available for the business accounted for under the PAA. Therefore, an entity needs to define a proxy which could indicate that a group of contracts is onerous. An entity would only need to determine the fulfillment cash flows if that indicator is positive, i.e., signaling that a group of contracts is onerous.

18 Cf. IFRS 17.B126.
19 Cf. IFRS 17.59.
20 Cf. IFRS 17.58.
21 Cf. IFRS 17.BC291.
22 Cf. Agenda Paper 2C, IASB Meeting February 2017, Insurance Contracts – Responding to the external editorial review, Issue B6.
23 Cf. IFRS 17.18.
24 This circularity is due to the fact that an entity can assume that none of the contracts in the whole portfolio are onerous at inception if an entity applies the PAA. However, the eligibility for the PAA needs to be assessed based on the group of contracts level according to IFRS 17.53.
25 Cf. IFRS 17.14-24 and IFRS 17.53-59.
26 Cf. IFRS 17.24.
27 Cf. IFRS 17.57-58.

A potential measure that could serve as such an indicator is the combined ratio.[28] While this ratio is already applied today to assess the relative performance of P&C portfolios, it could also serve as an indicator for assessing whether a group of contracts is onerous.[29] The key advantage of this measure is that most stakeholders are already familiar with it. While it is clear that this combined ratio needs to be based on planning data regarding expected claims and expenses and not on incurred amounts, further adjustments would potentially need to be considered:

- **Impact of the time value of money:** Combined ratios applied today are usually based on undiscounted claims and expenses. However, the cash flows used for the general measurement model are determined on a present value basis. Thus, an undiscounted combined ratio would be a biased proxy for the current fulfillment cash flows and would tend, at least in an environment with positive interest rates, to overestimate the number of groups of onerous contracts. Therefore, an appropriate proxy would need to be on a present value basis. However, the adjusted combined ratio should not reflect the investment returns an entity expects to earn on its asset portfolio. Accordingly, the discount rate should be rather determined as under the BBA. While there is generally no requirement to discount the LRC under the PAA,[30] a preparer will need to determine such a discount rate also under the PAA for the measurement of the LIC. Hence, a company could use this discount rate for determining a discounted combined ratio. An open question is whether one would need to apply a fully current discount rate or a locked-in rate. The standard states in IFRS 17.57 that a contract is onerous if the fulfillment cash flows exceed the PAA LRC. The fulfillment cash flows are always a fully current measure, i.e., based on the current discount rates. However, changes in financial assumptions under the BBA would not result in an adjustment of the CSM but rather be recognized either in P&L or OCI. Accordingly, a change in discount rates cannot result in a group of contracts becoming onerous. Hence, it could be argued to use a locked-in rate for subsequent measurement.

- **Risk adjustment:** In addition to the aspect of discounting, current combined ratios do not reflect the consideration that an entity expects to charge for bearing the non-financial risks of a group of insurance contracts. However, as discussed before, according to IFRS 17 it is not necessary for a group of contracts to be loss making to become onerous. It is rather sufficient not to earn the consideration that one would usually charge for bearing the risk. Hence, the proxy needs to be adjusted to also reflect this required consideration.

- **Cost allocation:** The expenses reflected as part of the combined ratio need to be the same expenses that would also be reflected as part of the fulfillment cash flows. If an entity does not use the same cost allocation as for the projection of the fulfillment cash flows under the general model, the adjusted combined ratio will no longer be an unbiased proxy.

In summary, the combined ratio may serve as a starting point for the assessment of whether a group of insurance contracts is onerous. However, further adjustments as described above might be necessary, if material. It could be argued in practice, for example, based on some quantitative assessment, that the opposing effects of discounting and the risk adjustment cancel each other out. If the preparer can provide this evidence as part of the annual audit procedures to an auditor, a simple combined ratio could be used as an indicator for onerous contracts.

In addition, an entity could also supplement the calculation of this modified combined ratio by a sensitivity assessment. Based on this an entity could assess the risk of a group of contracts becoming onerous and allow it to further subdivide into groups without significant risk of becoming onerous and other profitable contracts.[31]

3.2.2.2 Collection and sources of information

Next to defining an appropriate indicator for onerous contracts, a key question is what information needs to be reflected in the assessment of the facts and circumstances and also the granularity level on which this assessment needs to be done. Both can have a direct impact on the onerous contract test as the likelihood of an onerous contract generally increases with decreasing aggregation level. This can be illustrated when considering the current premium deficiency test of US GAAP. The test takes a management perspective with regard to the required level of granularity. Hence, it allows for certain cross-subsidization effects and reduces the likelihood of a deficiency.[32]

As noted before, the IASB did not specify in detail what information an entity would need to use for the facts and circumstances assessment. The Basis for Conclusions of IFRS 17 states that the IASB does not expect that contracts that are priced on the same basis to be grouped separately under normal circumstances. However, it continues to state that

28 The combined ratio represents the total costs and losses divided by the earned premiums. A combined ratio of below 100% usually indicates that the insurance business is profitable.

29 While the PAA can be applied to all eligible insurance contracts, the major field of application will be the P&C business.

30 As discussed above, an accretion of the PAA LRC is only required if the contract contains a significant financing component (IFRS 17.56).

31 Cf. IFRS 17.18. However, following the requirements for the BBA in IFRS 17.19b it can be argued that such an assessment is not required if the sensitivities are not already available in the internal reporting systems.

32 Cf. ASC 944-60 (former FAS 60).

one usually would use the same information that was used for pricing for identifying groups of onerous contracts. The Basis for Conclusions further explains that if a contract is onerous at inception, which is assumed to be very infrequent, it would be often the result of an intentional pricing strategy.[33] Accordingly, it could be argued that facts and circumstances should include all information used as part of the pricing process. At least, an entity would need to use the information of the pricing process as a starting point for the onerous contract assessment. The pricing information would then be considered together with other information in assessing whether a group of contracts is onerous or not. However, interpreting this requirement in a narrow way, i.e., requiring an assessment on the same level of granularity as used for pricing, would make the implementation of this simplified measured model in practice much more difficult than expected.

This is due to several different factors. First, while the importance of technical pricing of insurance risks is increasing, there are many markets in which a technical pricing is still not common practice. For example, it can be seen in the emerging markets that prices in P&C insurance are often driven by market factors and less by an individual risk assessment. In such a case, there would be no relevant pricing information available. Second, the information from technical pricing alone is often not sufficient to assess whether a contract or a group of contracts is onerous as the premium actually paid can deviate from the technical premium, for example due to rebates or other sales incentives. For example, agents often have a certain budget for premium discounts and rebates. Accordingly, a technically well priced contract could become onerous due to the discount applied by the agent. Hence, for a full assessment of whether a contract is onerous or not, the technical pricing information alone is not sufficient. The entity would rather need to combine information from different sources, i.e., technical pricing and sales to make a full assessment. Third, many insurance entities do not have an interface between the technical pricing data bases and the accounting and reserving systems. While both technical pricing and reserving systems might use the same raw data, merging the pricing and reserving information, especially on a contract level, and using this information in the regular financial closing process is generally not possible. Thus, using pricing information as part of facts and circumstances on a low level of granularity would cause very substantial additional costs for information system development in the implementation process. Nevertheless, such additional costs will not be incurred in insurance markets where there is already a close link between technical pricing and reserving and financial closing.

However, there is an indication in the standard that such changes to the information and reporting systems, which come at high costs, are not required. IFRS 17 states that in estimating future cash flows an entity should use "all reasonable and supportable information available at reporting date without undue cost or effort. […] Information available from an entity's own information systems is considered to be available without undue cost or effort."[34] Assuming that such pricing information is not available directly in the closing systems, a system change or the creation of additional interfaces between systems could therefore be considered to create undue costs and efforts. It can be assumed that in many cases the implementation of such a requirement could easily double the implementation costs for contracts accounted for under the PAA. This view is further supported by the Basis for Conclusion that states that the PAA "should not burden entities by creating high costs and operational complexity."[35] Thus, it could be argued that pricing information should be reflected in the assessment of facts and circumstances, but only to the extent and granularity to which it is already available and reflected in the regular reserving, financial reporting and planning processes.

For the overall assessment of what information should be included in facts in circumstance it can further be concluded, especially based on the statement in the standard that an entity should assume that no contracts are onerous and that an active search for evidence that a certain set of contracts within a portfolio is loss making at inception is not required. Thus, an entity would generally only use information that is readily available as part of the regular planning and financial reporting process. Nevertheless, an entity would not be permitted to disregard any information from other data sources readily available to the finance function, but potentially outside the normal closing process, indicating that certain subsets of a portfolio are onerous at inception.

This would mean in practice that an insurance entity regularly only uses data on a granularity that is already available in its planning and controlling process. A further search for facts and circumstances indicating the existence of onerous contracts outside the related information systems is in our opinion not required. Nevertheless, if information is readily available to the finance function on a level of aggregation that is lower than generally used in the planning and closing process, this information cannot be disregarded as it would represent facts and circumstances as described in IFRS 17.18. In addition, an insurance entity would need to develop management methods to monitor and identify information available in the finance function that could be indicative of an onerous contract.

33 Cf. IFRS 17.BC135.

34 IFRS 17.B37.
35 IFRS 17.BC295.

The onerous contract test according to IFRS 17 will not allow cross-subsidization effects like for example current US GAAP, but it still allows for a workable and pragmatic solution.

3.2.2.3 Practical issues – New vs. renewal business

While we have concluded that an entity does not need to actively gather information indicating the existence of onerous contracts, there are certain situations in which an entity commonly has information available that certain types of contracts within a portfolio of insurance contracts are onerous from an IFRS 17 perspective, while it is also clear that the very same contracts are not loss making from an economic perspective.

The treatment of newly issued short-duration P&C contracts can be seen as one example for such a situation. Frequently, the acquisition costs for newly issued insurance contracts are significantly higher than for renewed contracts. One important driver for this difference is that the commissions paid for new insurance contracts are often significantly higher than the subsequent renewal commissions. Under certain circumstances this difference in acquisition costs can lead, everything else being equal, to the result that new insurance contracts are onerous at inception, while renewed contracts are non-onerous. Accordingly, an insurer would be required to group new and renewed business in different groups.

From an economic perspective this split along new and renewed business seems to be counterintuitive as an insurer usually considers expected contract renewals when assessing the economic value of a contract. However, IFRS 17 has a strict contract view and cash flows from contract renewals are outside the IFRS 17 contract boundaries.[36] The importance of this problem is increasing for shorter coverage periods.

However, for certain contracts, which are not onerous from a pure economic perspective, it is possible to avoid recognizing them as onerous contracts. As discussed before, IFRS 17 provides an entity with the accounting option under the PAA to recognize any insurance acquisition cash flows directly as expenses when they are incurred.[37] Accordingly, one would reduce the costs directly attributable to the insurance contracts and the LRC would not be adjusted for the payment of the acquisition cash flows.[38] Hence, the likelihood of a contract becoming onerous should be reduced. However, there is a problem as the standard states that a contract is onerous if the fulfillment cash flows exceed the carrying amount of the LRC under PAA.[39] The fulfillment cash flows have to be determined according to IFRS 17.33–37, i.e., according to the requirements of the general measurement model. The general measurement model does not permit expensing these acquisition cash flows immediately. Accordingly, this would lead to the counterintuitive result of recognizing a loss component at inception. While it is not stated explicitly in the standard, we think that an entity would subsequently remeasure the loss component. That means for this example that an entity would reduce the loss component as soon as the fulfillment cash flows decrease below the carrying amount of the PAA LRC including the loss component.[40] Hence, after the actual payment of the acquisition cash flows the loss component would be immediately corrected to zero. We think, as a consequence, that an entity should not include the acquisition cash flows as part of the fulfillment cash flows for the onerous contract test if they are expensed directly under the PAA. That would also be consistent with the treatment of the second accounting policy option under the PAA. This option allows an entity not to adjust the future cash flows of the LIC for the time value of money if they are expected to be paid in one year or less.[41] In this case the fulfillment cash flows for the onerous contract testing should also not be adjusted for this effect.[42]

Nevertheless, the option of expensing the acquisition costs is only available if all contracts within a group of contracts have a coverage period of one year or less.[43] For groups of contracts with a longer coverage period no similar solution exists.

There might be an alternative solution for this issue. It could be argued that part of the acquisition costs for new insurance contracts actually relate to anticipated renewals and therefore the acquisition costs should be allocated over the expected renewal periods. This could be achieved by recognizing a certain part of the insurance acquisition cash flows as an asset and only recognizing it as costs when the contracts are renewed. While there is no basis for such treatment of acquisition cash flows under IFRS 17, such treatment is allowed under IFRS 15 for incremental costs for obtaining a contract.[44] Considering that the IASB wanted to achieve a measurement basis under IFRS 17 that is broadly consistent with IFRS 15,[45] it could be argued that the two standards should not result in a different treatment of initial acquisition cash flows relating partly to anticipated renewals. We think that this potential solution should be further investigated and discussed.

36 Cf. IFRS 17.34.
37 Cf. IFRS 17.59(a).
38 Cf. IFRS 17.55(b)(ii).
39 Cf. IFRS 17.57.
40 An indication that such a treatment was intended by the IASB can be found in the IASB Webinar August 2018: IFRS 17 Simplified accounting for contracts with short coverage periods.
41 Cf. IFRS 17.59(b).
42 Cf. IFRS 17.57(b).
43 Cf. IFRS 17.59(a).
44 Cf. IFRS 15 TRG Memo No. 23 Costs to Obtain a Contract.
45 Cf. IFRS 17.IN7.

3.2.3 Triggering events for subsequent measurement

The onerous contract test for subsequent measurement is less complex than the assessment at initial recognition. This is mainly due to the fact that the unit of account for the testing does not change after initial recognition, i.e., the group of insurance contracts would not be reassessed.[46] The onerous contract test for subsequent measurement is therefore based on the groups determined at initial recognition.

The standard indicates that this onerous contract test is trigger-based and does not need to be performed on regular, e.g., annual basis. An entity rather has to observe whether facts and circumstances indicate that a group of contracts has become onerous. In such a case, the loss component would again need to be calculated as the difference between the LRC under the PAA and the fulfillment cash flows.[47]

Such facts and circumstances indicating that contracts have become onerous could include the following factors:

- Changes in the regulatory environment which significantly increase the costs to settle certain claims.
- Major shifts in economic environment with a negative impact on future costs or claims.
- Major changes in cost allocation.

Alternatively, an entity could also determine the indicator for onerous contracts, as discussed under section 3.2.2.1, on a regular basis and as soon as it reaches a triggering threshold perform a quantitative assessment by comparing the PAA LRC with the remaining fulfillment cash flows.

46 Cf. IFRS 17.24.
47 Cf. IFRS 17.57.

4 Conclusion

When assessing how to implement the onerous contracts test for insurance business qualifying for the PAA, a preparer should keep in mind that the PAA was developed as a simplified approach that "should not burden entities by creating high costs and operational complexity."[48] This was further clarified by the IASB in February 2017 when the standard was adjusted to permit insurance entities to assume that none of the insurance contracts within a portfolio are onerous unless facts and circumstances clearly show that this is not the case. Therefore, we think that the onerous contract test, both for initial recognition and for subsequent measurement, should only use information available as part of the regular reporting processes. The standard guidance does not define a requirement for an active search for information that could be indicative of onerous contracts.

Nevertheless, the onerous contract test at initial recognition will lead to challenges as IFRS 17 takes a contract perspective and does not consider expected contract renewals which are relevant for the economic business steering of an insurance company.

While insurance companies have some levers, we think that there is a risk that the onerous contract test at initial recognition will, in some situations, result in a higher granularity of the unit of account than under today's accounting regimes. A careful interpretation and practical application of the requirements is needed to keep the costs and benefits of this requirement in balance and limit the operational effort to an acceptable level given the overall intention for the PAA.

48 IFRS 17.BC295.

THE PREMIUM ALLOCATION APPROACH AND BUILDING BLOCK APPROACH FOR NON-LIFE/ ACCIDENT INSURANCE

2

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1 Introduction

Like IFRS 4, IFRS 17 is not designed with a specific industry or sector in mind. A non-life/accident insurer must therefore analyze its insurance contracts (and its new business tariffs) in an IFRS 17 implementation project in order to answer the following questions:

- Does it have any contracts which are outside or only partially within the scope of IFRS 17 (see section 2)?
- Which portfolio and group should its insurance contracts be allocated to and which measurement model is best (see section 3)?

Section 4 contains a discussion of the recognition rules of IFRS 17. The building block approach and the premium allocation approach are presented in sections 5 and 6. Section 7 contains an accounting example and the chapter closes with a conclusion (section 8).

We do not discuss the variable fee approach in this section even though non-life/accident insurers are allowed to offer products with participation features[49] (e.g., accident insurance with premium refund, cf. Sec. 161 VAG ["Versicherungsaufsichts-gesetz": German Insurance Supervision Act]). Similarly, we do not explore investment contracts with participation features.

2 Analysis of insurance contracts to determine which contracts are within the scope of IFRS 17

The new standard on insurance contracts retains the previous definition of an insurance contract (cf. IFRS 4 Appendix A and IFRS 17 Appendix A). However, in contrast to IFRS 4, the time value of money must be considered in deciding whether an insurance risk is significant, i.e., the present value of payments must be taken into account (cf. IFRS 17.B18-21). The significance of the insurance risk may have to be reassessed for certain reinsurance contracts or products calculated in a similar way to life insurance contracts. Apart from this, we do not expect to see any other changes for German non-life/accident insurance as a result of this new standard.

Although IFRS 17 takes a product-based approach, i.e., is designed to provide guidance on accounting for all insurance contracts, some insurance contracts are eligible for recognition in accordance with IFRS 15, *Revenue from Contracts with Customers,* if their primary purpose is the provision of services for a fixed fee (cf. IFRS 17.8). Such contracts entail a significant insurance risk for the entity as the risk associated with the customer is not reflected in setting the price and the contract compensates the customer by providing services (rather than by making cash payments). The main cause of insurance risk in such contracts is uncertainty as to the frequency of the provision of services rather than the cost associated with it. An entity may choose to apply IFRS 15 instead of IFRS 17 on a contract-by-contract basis, but must account for each contract consistently over time. The IASB explains that this option is justified because IFRS 15 and IFRS 17 deliver similar results for such contracts (IFRS 17.BC96). It is primarily geared to entities which do not otherwise offer any insurance contracts (such as providers of assistance services) and would not have to apply IFRS 17 at all if they opted to apply IFRS 15.

The changes described above relate to whether or not a contract is within the scope of IFRS 17. The following separation rules determine whether any components have to be separated from a contract and thus fall within the scope of other IFRSs.

49 The variable fee approach can only be applied when a contract contains direct participation features as defined by IFRS 17.

3 Analysis of insurance contracts with a view to portfolios, groups and measurement models

IFRS 17 retains the requirement to separate embedded derivatives (cf. IFRS 17.11(a)). The withdrawal of the exemptions previously available in IFRS 4 (cf. IFRS 17.BC105 for more details) is unlikely to affect non-life/accident insurers. However, repurchase clauses in accident insurance with premium refund (Sec. 161 VAG) should be reassessed in light of the removal of IFRS 4.8.

The deposit component under IFRS 4 has been replaced by the distinct investment component (cf. IFRS 17.11(b)). An investment component is the amount the insurer has to pay to a policyholder even if an insured event does not occur (cf. IFRS 17 Appendix A). We do not believe that this change compared with IFRS 4 will have a significant effect on the separation of contract components (IFRS 17.11(b)) for non-life/accident insurers as the new provision also requires an investment component to be distinct. Distinct means that (cf. IFRS 17.B31)

- There is, or could be, a market in which the investment component can be sold separately, i.e., without the insurance component; and
- The investment component and the insurance component are not highly interrelated. Such components are highly interrelated if (cf. IFRS 17.B32)
- The insurer is unable to measure one component without considering the other; or
- The policyholder is unable to benefit from one component unless the other is also present.

Investment components which are not distinct fall within the scope of IFRS 17, but are excluded from profit and loss (see IFRS 17.85 and section 5 for details). Such components should therefore be identified when an entity analyzes its contracts. In non-life/accident insurance, they could be, for example, no-claims bonuses paid out at the end of the contract term.

A new separation rule in IFRS 17.12 requires any promises to provide goods or services which are distinct as defined by IFRS 17.B34 et seq. to be separated. In non-life/accident insurance (primary insurance) there is a trend towards offering policyholders an extended range of services (e.g., by combining insurance coverage with smart home solutions), which could make this new separation rule more relevant in the future.

The current classification processes should be modified to consider the above changes compared with IFRS 4 as soon as possible.

The recognition and measurement provisions of IFRS 17 apply to groups of insurance contracts (cf. IFRS 17.24). A group is a subset of a portfolio (IFRS 17.16). A portfolio comprises contracts subject to similar risks and managed together (IFRS 17.14). This definition differs from the wording in IFRS 4 which stated that contracts may be grouped in a portfolio if they are subject to broadly similar risks (IFRS 4.18). In an IFRS 17 implementation project, one of the topics to be addressed will be whether the current portfolio structure can be retained.

If the insurer takes on a range of insurance risks with a single insurance contract, there are various ways of allocating it to a portfolio (e.g., specific risks can be allocated to different portfolios, the entire contract can be allocated to a portfolio based on the primary risk) unless management aspects indicate otherwise. We also see further leeway in the fact that IFRS 17 does not define the level of hierarchy which determines the management perspective.

Before splitting portfolios into groups, the rules set out in IFRS 17 governing the boundaries of a contract will need to be addressed. A contract boundary is the point in time when an existing insurance contract ends for accounting purposes and a new contract begins (cf. IFRS 17.35). The boundaries of a contract define the coverage period which, in turn, determines which measurement model applies. The premium allocation approach can be applied for periods of one year or less. No other criteria have to be met (cf. IFRS 17.53(b)).

The boundary of a contract is not breached as long as the policyholder is compelled to pay premiums or the insurer has a substantive obligation to provide services (cf. IFRS 17.34). The insurer's substantive obligation to provide services ends as soon as

- It is able to reassess the risks associated with the particular policyholder and adjust the premiums or level of benefits to reflect those risks; or
- Both of the following requirements are met:
  - The insurer can reassess the risks of the portfolio that contains the insurance contract and, as a result, can adjust the premiums or level of benefits to reflect the risk of that portfolio.
  - The pricing of the premiums up to the reassessment does not take into account any risks that relate to periods after the reassessment date.

In practice, non-life/accident insurers enter into a number of contractual arrangements which call for an in-depth analysis of contract boundaries (e.g., trustee clauses, waiver of premium

increases in the next year). When the contract boundaries are defined for the insurance contracts, those contracts having a coverage period of more than one year can be identified. A portfolio[50] must be divided into the following groups (cf. IFRS 17.16):

- A group of contracts that are onerous at initial recognition. In simple terms, an insurer applying the premium allocation approach may assume that no contracts in the portfolio have to be allocated to this group unless facts (e.g., combined claims-cost ratio) or other circumstances indicate otherwise (cf. IFRS 17.18).
- A group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently. To apply the premium allocation approach, the likelihood of changes in applicable facts and circumstances must be assessed (cf. IFRS 17.18). For contracts to which the premium allocation approach is not applied, the likelihood of contracts becoming onerous must be assessed (cf. IFRS 17.19). In doing so, the insurer should use information provided by the entity's internal reporting: no additional information is required to be gathered.
- A group of the remaining contracts in the portfolio.

50 Here, we assume that only one measurement model is used for any given portfolio. We understand IFRS 17.24 as requiring that a group use one, and only one, measurement model.

These three groups may be subdivided further if the entity's internal reporting provides more detailed information, but this is not mandatory (IFRS 17.21). Notwithstanding this, the following provisions for grouping contracts apply:

- No group may contain contracts issued more than one year apart (cf. IFRS 17.22).
- A group must be formed even if it contains only a single contract (cf. IFRS 17.23).
- Groups are established at initial recognition and may not be subsequently reassessed (IFRS 17.24). This principle of consistency only applies within the boundaries of a contract (see above). If insurer and policyholder have not exercised their right to terminate a contract after the end of a given year, for accounting purposes a new insurance contract is established (cf. IFRS 17.34) and must be allocated to a group. This means that an insurance policy which was first issued seven years ago can constitute a series of seven one-year insurance contracts and therefore be allocated to different groups over time (e.g., because start-up losses were factored in initially).
- If the insurer can reasonably and supportably assume that a set of contracts (e.g., contracts which share certain tariff features) will all be in the same group, it may allocate the contracts to a group as a set, i.e., assess the set of contracts to determine if the contracts are onerous and how probable it is that they will become onerous subsequently (IFRS 17.17). If no such reasonable and supportable information is available, each individual contract has to be considered to determine the group to which it belongs.

4 Recognition of insurance contracts

Initial recognition is from the earliest of the following (cf. IFRS 17.25):

- The beginning of the coverage period.
- The date when the first premium becomes due. If there is no contractual due date, the first payment is deemed to be due when it is received (cf. IFRS 17.26).
- The date on when the group becomes onerous. However, profitability only has to be assessed if facts and other circumstances indicate that a group is onerous (cf. IFRS 17.26).

Recognition of insurance contracts

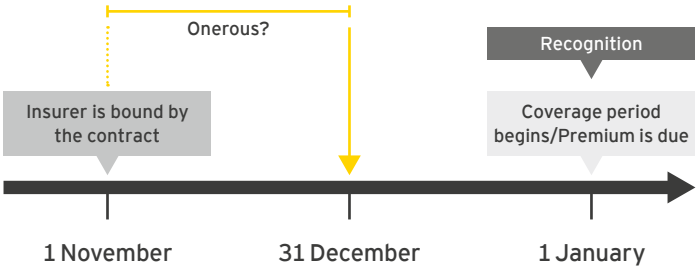

Figure 2.1

Payments made or received for the conclusion of insurance contracts (insurance acquisition cash flows) before the group is recognized are recognized as an asset or a liability and derecognized when the group is recognized for the first time (cf. IFRS 17.27).

5 Measurement of insurance contracts using the building block approach

The building block approach applies, as a rule, to all insurance contracts without any direct participation features (these are subject to the variable fee approach, cf. section 3). Passive reinsurance contracts are governed by additional special provisions, which are not discussed in this section (IFRS 17.63–70).

In practice, the building block approach will probably be less relevant for the liability for remaining coverage of non-life/accident insurers as most of their German insurance contracts will also be eligible for the premium allocation approach (see section 6). However, the building block approach may also be relevant for these contracts because, for instance, an onerous contract test becomes necessary, or because proof must be furnished that they are accounted for appropriately under the premium allocation approach (cf. section 6).

Under the building block approach, the insurance contract liability at the acquisition date is the sum of the fulfillment cash flows (FCF) and the contractual service margin (CSM). The FCF comprises an estimate of future cash flows within the boundary of a contract, a discount and an adjustment for non-financial risks (IFRS 17.32(a)).

The four building blocks

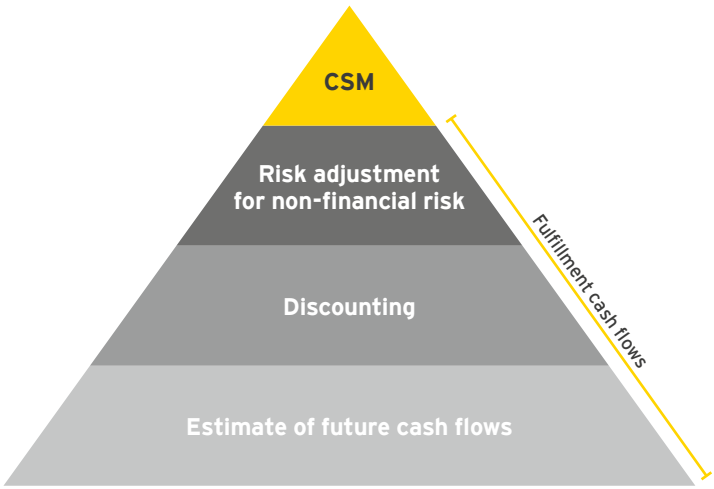

Figure 2.2

When determining future cash flows an expected value is estimated reflecting the perspective of the entity and the assumptions and inputs available on the measurement date (IFRS 17.33). No safety margins are allowed. No level of aggregation is prescribed for the cash flows, but they must be allocated to groups of insurance contracts.

Discounting is described as the adjustment for the time value of money and the financial risks related to the cash flows, except where such risk was not already considered in estimating the cash flows. Instead of discounting cash flows, replicating portfolio approaches are permitted (IFRS 17.33(d) in conjunction with IFRS 17.B46f.).

IFRS 17 does not prescribe any particular method for determining discount rates (IFRS 17.B78). This means that either a bottom-up approach (based on a risk-free discount rate, IFRS 17.B80) or a top-down approach (based on a discount rate for a reference portfolio, IFRS 17.B81) may be used. Please refer to IFRS 17.36 for the criteria to be met by the discount rate. Non-life/accident insurers are likely to favor the bottom-up approach as they will already have had experience using this approach in the context of Solvency II. The IFRS 17 implementation project will need to address whether any of the methods used to determine the discount rate under Solvency II are permitted under IFRS 17, or whether alternative methods will need to be applied.

The adjustment for non-financial risks (e.g., insurance, cancelation and cost risks) reflects the compensation the insurer requires for bearing the non-financial risks affecting the amount and timing of the cash flows.

Any method of determining the risk adjustment which meets the requirement of IFRS 17.B91f. is permitted. This includes the confidence-level method, the value-at risk-method or the cost-of-capital method. In practice, the choice of method will be defined by the preference for Solvency II methods and the need to disclose the corresponding confidence level in the notes (which may require backtesting) (IFRS 17.119).

The contractual service margin represents the unearned profit for a group of insurance contracts which the insurer will recognize as it provides services over time. It is determined and remeasured for a group of contracts, as with the FCF (IFRS 17.38 and 17.43 et seq.) or, if contracts in one group affect cash flows of another group, it is determined on a higher level and subsequently allocated (cf. IFRS 17.BC171). The CSM cannot be or become negative upon initial or subsequent measurement. Any "negative" CSM is recognized separately as a loss component (IFRS 17.49, see also below).

When subsequently measured, the insurance contract liability is split into a liability for remaining coverage (LRC) and a liability for incurred claims (LIC).

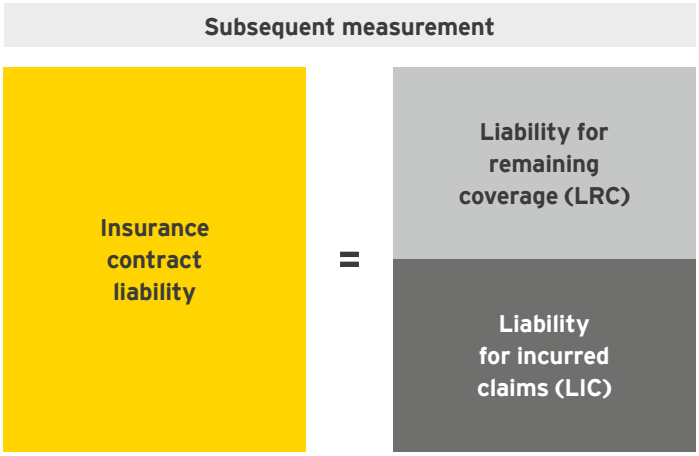

Figure 2.3

The measurement principles described above apply to both liabilities. If the LRC contains a loss component because the amount of the CSM is negative, all changes in the fulfillment cash flows have to be allocated to the loss component and the LRC, excluding the loss component (cf. IFRS 17.50f.).

As the LIC relates to past service, it does not contain a contractual service margin. The risk adjustment for the LIC does not include premium and cancelation risk either.

The change in both liabilities is partly recognized in profit and loss. To explain these effects, the requirements in IFRS 17 for presentation in the income statement are illustrated below (cf. IFRS 17.80 et seq.):

	Profit or loss (extract)
	Insurance revenue (IR)
–	Insurance service expenses
=	**Insurance service result**
+/–	Insurance finance income or expense

Table 2.1

Insurance revenue results solely from the decrease in the LRC because of services provided in the fiscal year (IFRS 17.41(a)). This amount is calculated as follows (IFRS 17.B120 and B124):

Insurance revenues	
a)	At the beginning of the period expected insurance service expenses ‣ Amounts that are related to a loss component ‣ Repayment of non-distinct investment components ‣ Taxes collected on behalf of third parties (e.g. insurance tax) ‣ Insurance acquisition expenses
b)	Changes in risk adjustment ‣ Changes that are recognized as insurance finance income or expenses ‣ Changes that adjust the contractual service margin ‣ Changes that are related to a loss component
c)	Amount of the contractual service margin (for the transfer of service of the period)
d)	Insurance acquisition expenses

Table 2.2

Insurance service expense mainly results from incurred claims. The LRC only contributes to this item for losses from onerous contracts and reversals of losses from such contracts (IFRS 17.41(b)). As with insurance revenue, insurance service expense may not include any investment components.

As insurance service expenses contain the incurred claims, other insurance expenses and the related acquisition cash flows (cf. IFRS 17.B125), the insurance service result is mainly impacted by the

- Change in the risk adjustment
- Amortization of the contractual service margin. This arises when the CSM at the end of each period (see below) is released to profit and loss based on coverage units (cf. IFRS 17.B119) (IFRS 17.44(e)). The number of coverage units is the number of contracts weighted by a factor representing the quantity of benefits (e.g., insured amount)
- Difference between expected and incurred insurance service expenses

Insurance finance income or expense is the result of interest expenses and changes in the discount rate, except when the entity elects to report changes in OCI (IFRS 17.41(c), 42(c) in conjunction with IFRS 17.89f.). With a view to the classification provisions of IFRS 9, Financial Instruments, and the investment pattern of a non-life/accident insurer, insurance finance income or expense will probably have to be split between profit and loss and OCI. Most changes in the fair value of debt instruments resulting from interest rate changes will therefore be recognized in OCI by non-life/accident insurers.

As the contractual service margin at the end of a period represents the unearned profit of a group of contracts, there are changes in cash flows and the risk adjustment that will affect the CSM and therefore not be recognized in either profit or loss or in OCI. This applies when the change relates to future service and the CSM is positive (IFRS 17.44(c)). This means that the contractual service margin absorbs certain changes in estimates, leaving the insurance contract liability unchanged (e.g., because the CSM offsets the increase in the FCF).

Subsequent measurement of the contractual service margin for a group of contracts	
	Contractual service margin (beginning of period)
+	Effect of new contracts added to the group
+	Interest accreted based on the discount rates that were relevant for the measurement at initial recognition (lock-in)
+/–	Change in fulfillment cash flows, that relate to future service (but not to a loss component)
+/–	Effect of foreign currency translation
–	Amount recognized as insurance revenue
=	**Contractual service margin (end of period)**

Table 2.3

6 Measurement of insurance contracts using the premium allocation approach

A simplified approach (the premium allocation approach) may be used instead of the standard (building block) approach for a group of insurance contracts. This applies to contracts with a coverage period of one year or less. No other criteria have to be met (cf. IFRS 17.53(b), IFRS 17.BC291). When contracts have longer terms, the premium allocation approach may only be used if it would produce an LRC that does not differ materially from the LRC under the building block approach (cf. IFRS 17.53(a)). The IASB expects material differences for longer term contracts if there is significant variability in their future cash flows (cf. IFRS 17.54) because, for example, options or guarantees are embedded in the contracts, having a significant impact on cash flows. As a result, the simplified measurement approach is not applicable for most German life and health insurance business. By contrast, in the non-life/accident sector, where business is usually short term, the premium allocation approach will be highly relevant. We believe that test calculations will be needed in practice for the longer-term insurance contracts (usually with three or five-year terms) identified in the contract analysis process, at least when transitioning to IFRS 17 and when introducing new tariffs, if an insurer wishes to account for them using the premium allocation approach.

The main benefit of the premium allocation approach is the simplified calculation of the LRC at inception, where the premiums already received are used as a best estimate of future cash flows. This does away with the need for actuarial calculations as is required under the building block approach. In addition, the LRC does not have to be discounted if there is no more than one year between the date of premium due and the end of the coverage period (IFRS 17.56). When measuring the LRC, any insurance acquisition cash flows already paid are deducted (cf. IFRS 17.55) unless they are recognized as an expense when they are incurred (option under IFRS 17.59(a), but only for coverage periods of no more than one year).

In subsequent periods, any additional premiums received (e.g., from quarterly payers) are recognized in the same way. The amortization of the LRC for past service is presented as insurance revenue (as in the building block approach, i.e., after deducting investment components). Amortization is charged on the basis of the passage of time or based on the expected pattern of risk if this differs significantly (cf. IFRS 17.BC290).

If facts or circumstances indicate that a group of contracts is onerous, this is tested applying the FCF calculation under the building block approach (cf. IFRS 17.57). If the FCFs determined on this basis exceed the LRC calculated under the premium allocation approach, the LRC must be increased, recognizing a loss in profit and loss (cf. IFRS 17.58 and IFRS 17.BC92(b)). As, all other things being equal, the amount of the LRC under the premium allocation approach is greater when insurance acquisition cash flows are immediately recognized as an expense, an IFRS 17 implementation project should check which alternatives could arise from the onerous contract test option based on all advantages and disadvantages.

The LIC is calculated as under the building block approach (i.e., including a risk adjustment). However, the standard-setter has allowed some simplifications here too. First, claims do not have to be discounted if they are expected to be paid within one year. Second, there is an option to measure interest expense using the discount rate at the date the claim is incurred rather than at the initial recognition of the contract (cf. IFRS 17.BC294). The latter is a great relief as claims triangles usually only state the year a claim was incurred and/or the year the claim was reported, but not the inception date of the contract.

Measurement of technical provisions according to the premium allocation approach

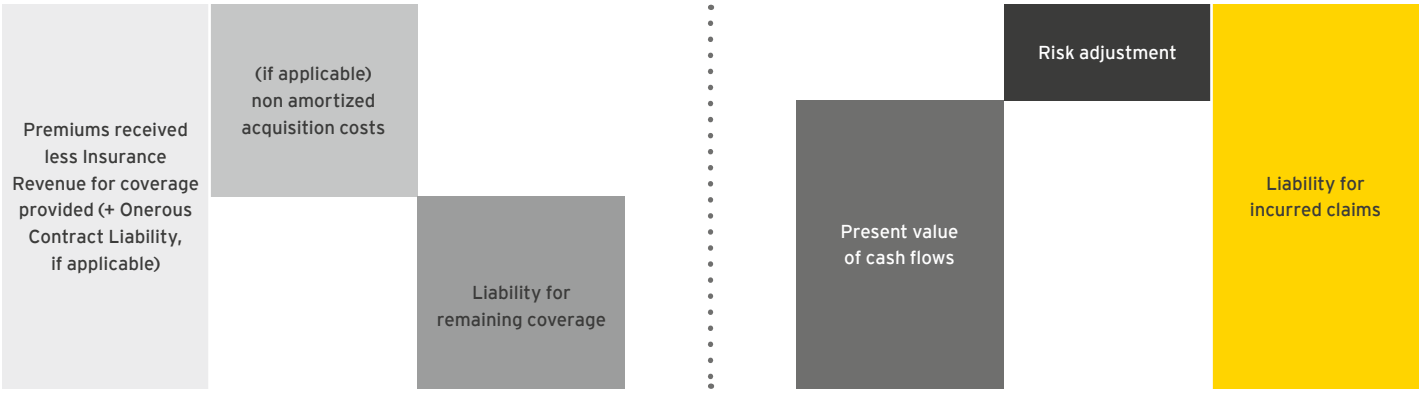

Figure 2.4

7 Accounting example

We will look at a non-onerous group of home contents insurance contracts whose policies have the following features:

Example: contract details	
Begin of coverage	1 August 2021
Coverage period	12 month
Premiums	4,800 (due and paid at the beginning of the coverage period)
Acquisition costs	200 (due and paid at the beginning of the coverage period)

Table 2.4

The contracts do not contain any investment components, nor can they be canceled before the end of the coverage period. The pattern of risk is expected to be straight line. In simplified terms, the following claims pattern is estimated at the beginning of the coverage period:

Example: expected claims	
Incurred claim:	**31 December 2021**
Expected payment	1,500
Expected risk adjustment	250
Incurred claim:	**30 June 2022**
Expected payment	1,800
Expected risk adjustment	320
Incurred claim:	**31 July 2022**
Expected payment	300
Expected risk adjustment	30

Table 2.5

A claim is settled as expected as of 31 August 2022. However, contrary to expectations, the actual amount of the claim was 4,500.

The following chart illustrates how the contract is accounted for under the premium allocation approach. The insurer elects not to discount the LRC and the LIC. The insurance acquisition cash flows of 200 were recognized immediately as an expense, i.e., after premiums were received the LRC was 4,800.

Balance sheet	31.12.2021	30.06.2022	31.12.2022
Financial instruments	4,600	4,600	100
Insurance contract liabilities	4,550	4,270	-
thereof LRC	2,800	400	-
thereof LIC	1,750	3,870	-
Equity	50	330	100

Statement of profit or loss	31.12.2021	30.06.2022	31.12.2022 accumulated
Insurance revenue	2,000	2,400	2,800
Insurance service expenses	−1,950	−2,120	−2,750
Profit or loss	**50**	**280**	**50**

Table 2.6

When the insurance acquisition cash flows are included in the LRC, the calculation is as follows:

Balance sheet	31.12.2021	30.06.2022	31.12.2022
Financial instruments	4,600	4,600	100
Insurance contract liabilities	4,433	4,253	-
thereof LRC	2,683	383	-
thereof LIC	1,750	3,870	-
Equity	167	347	100

Statement of profit or loss	31.12.2021	30.06.2022	31.12.2022 accumulated
Insurance revenue	2,000	2,400	2,800
Insurance service expenses	1,833	2,220	2,867
Profit or loss	**167**	**180**	**−67**

Table 2.7

As expected, including the insurance acquisition cash flows leads to an earlier recognition of profit.

Applying the building block approach to the group of contracts produces the following outcome, assuming the following simplifications:

- Steady interest rate of 0.2% per month.
- Interest effects apply to cash flows only, not to the risk adjustment or the contractual service margin.

- The risk adjustment for the LRC is 648, i.e., 48 (1% of premiums) higher than the total risk adjustments under the premium allocation approach (250 + 320 + 30 = 600). The additional 48 is amortized straight line over the contractual term.

Initial measurement:

LRC at initial recognition	
Present value of cash inflows (premiums)	4,800
Present value of cash outflows (acquisition costs, claims)	200 + 3,508 = 3,708
Present value of cash flows	3,708 – 4,800 = –1,092
Risk adjustment for non-financial risks	648
CSM	1,092 – 648 = 444
LRC	0

Table 2.8

Subsequent measurement of the LRC as of 31 December 2021:

LRC at 31.12.2021	
Present value of cash inflows (premiums)	0
Present value of cash outflows (acquisition costs, claims)	2,067
Present value of cash flows	2,067
Risk adjustment for non-financial risks	320 + 30 + 48 × 7/12 = 378
CSM	444 × 7/12 = 259
LRC	2,704

Table 2.9

Presentation of all reporting dates:

Balance sheet	31.12.2021	30.06.2022	31.12.2022
Financial instruments	4,600	4,600	100
Insurance contract liabilities	4,430	4,227	-
thereof LRC	2,704	370	-
thereof LIC	1,726	3,857	-
Equity	170	373	100

Table 2.10

In this example, because it is discounted, the LIC is always lower under the building block approach than under the premium allocation approach. No such general rule applies for the LRC in this example. Under the premium allocation approach, the LRC as of 31 December 2021 is 99% (= 2,683/2,704) and at 30 June 2022 104% (= 383/370) of the LRC as measured under the building block approach. We therefore view the premium allocation approach as a valid approximation in accordance with IFRS 17.53(a), even though this does not have to be proven because of the term of the contract.

Statement of profit or loss	31.12.2021	30.06.2022	31.12.2022 accumulated
Insurance revenue	2,015	2,459	2,846
Insurance service expenses	1,810	2,213	2,859
Insurance service result	**205**	**246**	**–13**
Insurance finance expenses	35	43	57
Profit or loss	**170**	**203**	**–70**

Table 2.11

Due to discounting, under the building block approach, the insurance service result over the entire period is higher (192) than under the premium allocation approach (100). Over the entire period, this is offset by the insurance finance expenses (92).

8 Conclusion

Non-life/accident insurers face making a crucial decision at the start of any IFRS 17 implementation project, namely, whether or not to apply the premium allocation approach. The contract analysis process delivers the information needed for a sound answer. The more insurance contracts there are that have to be accounted for using the building block approach, the less relevant the premium allocation approach will be for the implementation and ongoing application of IFRS 17.

When the non-life/accident insurer analyzes insurance contracts, attention should be paid to non-distinct investment components (e.g., no-claims bonuses) and the trend towards offering policyholders an extended range of services, which could require separation.

The allocation of insurance contracts to portfolios and groups should provide a proper solution for multi-line covers. In addition, a meaningful presentation of portfolios on a gross basis and after the deduction of reinsurance held is required.

Irrespective of the measurement approach applied, facts and circumstances have to be defined which indicate that a group of insurance contracts is onerous. Although a process might be already in place to ensure that those facts and circumstances are monitored on a regular basis, the recognition of onerous contracts applying the BBA at the appropriate point in time will be challenging.

To implement an IFRS 17 measurement model the non-life/accident insurer has to take several decisions where it could leverage its Solvency II experience (e.g., discounting, adjustment for non-financial risk). Although this might be feasible, evaluating different approaches (that deviate from Solvency II) could be favorable.

THE UNIT OF ACCOUNT AND LEVEL OF AGGREGATION BASED IN IFRS 17

3

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1 Definition of the unit of account

An entity's rights and obligations arise from individual contracts with policyholders (IFRS 17.BC51) and an entity typically enters into transactions for individual contracts (IFRS 17.BC139). One key principle of IFRS 17 is that an entity divides the individual contracts of a portfolio into groups (IFRS 17.IN6 (c)).

Once an entity has established a group of insurance contracts, it becomes the unit of account to which the entity applies the accounting requirements (IFRS 17.BC139) for recognition, measurement, presentation and disclosures.

1.1. Definition of a portfolio

An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together (IFRS 17.14).

IFRS17 does not explicitly define "similar risks" or "managed together" but provides guidance how to interpret these criteria.

Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together (IFRS 17.14).

Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios (IFRS 17.14).

Homogeneous risk groups (HRG) used for Solvency II purposes are defined according to the following two criteria:

(a) There must be no significant differences in the nature and complexity of risks underlying the policies; and

(b) Grouping of policies is likely to give approximately the same results as a calculation per policy.

As such, one interpretation may be that grouping according to HRGs, which by definition have no significant difference in the nature or complexity of risks, satisfies the IFRS17 criteria of "similar risks."

The "managed together" criterion may be more dependent on each individual company than the "similar risks" criterion. Each entity would need to assess whether the "managed together" criterion is met by the HRGs or whether the HRGs would need to be further split in terms of IFRS 17 portfolio definition.

1.2. Definition of a group

An entity shall divide a portfolio of insurance contracts issued *(a portfolio of reinsurance contracts held)* into a minimum of (IFRS 17.16):

(a) A group of contracts that are onerous *(a group of reinsurance contracts held that are contracts on which there is a net gain)* at initial recognition, if any;

(b) A group of contracts *(a group of reinsurance contracts held)* that at initial recognition have no significant possibility of becoming onerous *(of becoming contracts on which there is a net gain)* subsequently, if any; and

(c) A group of the remaining contracts *(remaining reinsurance contracts held)* in the portfolio, if any.

In addition, an entity shall not include contracts issued more than one year apart in the same group (IFRS 17.22).

An entity may add more contracts to the group after the end of a reporting period, subject to the condition of not including contracts issued more than one year apart in the same group. An entity shall add the contracts to the group in the reporting period in which the contracts are issued (IFRS 17.28). Therefore, groups do not necessarily need to contain contracts only issued in one single financial reporting year.

A group of insurance contracts *(reinsurance contracts held)* shall comprise a single contract if that is the result of applying the above definition (IFRS 17.23). In addition, the definition does not exclude the possibility that contracts of a portfolio issued within one year apart being represented by a single group only.

An entity is permitted to subdivide the above minimum groups for insurance contracts issued *(for reinsurance contracts held)*. For example, an entity may choose to divide the portfolios into (IFRS 17.21):

(a) More groups that are not onerous *(more reinsurance groups on which there is no net gain)* at initial recognition – if the entity's internal reporting provides information that distinguishes:

  (i) Different levels of profitability; or

  (ii) Different possibilities of contracts becoming onerous *(reinsurance contracts held becoming contracts on which there is a net gain)* after initial recognition; and

(b) More than one group of contracts that are onerous *(of reinsurance contracts held on which there is a net gain)* at initial recognition – if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous *(to which the reinsurance contracts held are contracts on which there is a net gain)*.

2 Impact of the unit of account on the financial outcome and objective of the IASB

Entities issue individual insurance contracts expecting that some set of contracts will be onerous or more profitable than others. For users of financial statements this information represents useful information about an entity's decisions on pricing contracts and about expected future cash flows when being reported on a timely basis and not being obscured by offsetting with other contracts (IFRS 17.BC119). Therefore, on the one hand measuring contracts individually would provide a clear measurement objective in this sense (IFRS 17.BC118).

However, on the other hand such an individual approach would generally not provide useful information about insurance activities, which often rely on an entity issuing a number of similar contracts to reduce risk (IFRS 17.BC118). A fundamental aspect of the insurance activities is that the entity issues a large number of contracts with similar expectations knowing that some will result in claims and others will not (IFRS 17.BC51).
The large number of contracts reduces the risk that the outcome across all the contracts will differ from that expected by the entity (IFRS 17.BC51).

The nature of insurance activity, combined with the requirement of different timing of recognition of gains and losses related to onerous contracts and not obscuring information by offsetting with other contracts, means that the definition of level of aggregation at which contracts are recognized and measured is an important factor in the representation of an entity's financial performance (IFRS 17.BC51).

The definition of a group of contracts represents a balance to reflect profit and potential losses in the statement of financial performance in appropriate periods. Typical characteristics of insurance activities get considered by issuing a number of similar contracts to reduce risk. Furthermore, the loss of information inevitably caused by the aggregation of contracts and the related operational burden is shown (IFRS 17.BC51; IFRS 17.BC126).

The definition of a group of contracts thus has significant impact on different areas influencing the financial performance which is going to be analyzed in subsequent chapters.

2.1. Impact of the contractual service margin in connection with grouping

The entity is not permitted to recognize any excess as a gain on initial recognition when applying the requirements for measurement of IFRS 17. Instead, the standard requires the recognition of gain as the entity satisfies its obligation to provide services over the coverage period (IFRS 17.BC21).
The contractual service margin represents the gain that is not yet been recognized in profit or loss because it relates to future services to be provided over the duration of the coverage (IFRS 17.38).

The contractual service margin is measured on a level of group of contracts. Therefore, the aggregation of contracts into groups is relevant for the recognition of the contractual service margin in profit or loss. It is necessary to strike a balance between the loss of information and the need for useful information about the insurance activity (IFRS 17.BC123). That means that entities shall not depict one type of contract as cross-subsidized by a different type of contract, but also shall not recognize losses for claims developing as expected within a group of similar contracts (IFRS 17.BC123). In addition, the contractual service margin of an expired contract shall not exist as part of the average contractual service margin of a group long after the coverage provided by the contract ended, but recognizing a disproportionate amount of contractual service margin for contracts lapsing as expected within a group of similar contracts should also be avoided (IFRS 17.BC123).

2.1.1. Onerous groups and groups with different likelihood becoming onerous

The definition of the carrying amount of the contractual service margin includes the nature of gains being treated differently from losses (IFRS 17.BC115). This characteristic is on the one hand driven by the circumstance that entity's issue sets of insurance contracts expecting that, on average, the contracts in one set will be more profitable than the contracts in the other sets (IFRS 17.BC119) as described above and on the other hand by the objective of IFRS 17 to represent useful information to users of financial statements (IFRS 17.BC119). In particular, the less profitable set of contracts would have a lesser ability to withstand unfavorable changes in estimates and might become onerous before the more profitable set would do so (IFRS 17.BC119).

Therefore, if a group of contracts is not onerous, an entity shall recognize a contractual service margin. An amount of the contractual service margin is recognized in profit or loss in each period to reflect the services provided under the group of insurance contracts (IFRS 17.B119) and is released from risk in that period (IFRS 17.IN6(e)). Instead, if a group of contracts is onerous on initial recognition or becomes loss-making, no contractual service margin is recognized. An entity is required to recognize a loss in profit or loss immediately (IFRS 17.BC21).

Separating contracts that are onerous or that have a significant different likelihood of becoming onerous from contracts that have no significant probability to become onerous is necessary since the absence of such a requirement would fail the objective of the contractual service margin to recognize losses promptly in profit or loss of contracts that become onerous.

The decision on how to define groups of contracts is therefore strongly driven by the reporting requirement of recognizing losses of contracts that become onerous in a timely manner

within the appropriate reporting periods in profit or loss. It should be avoided that amounts will offset each other within the measurement of a group of insurance contracts. Moreover, the accounting outcome depends on the level of aggregation, because amounts that would offset each other within the measurement of a group of insurance contracts would be treated differently (and hence not offset each other) if contracts have been measured in different groups (IFRS 17.BC115).

2.1.2. Release of the contractual service margin over the coverage period

In many cases, the coverage period of an individual contract in a group will differ from the average coverage period of the group (IFRS 17.BC121). When this occurs, measuring the contracts on an individual basis would mean that the contractual service margin associated with contracts with a shorter coverage period than average would be fully recognized in profit or loss over that shorter period. Hence, measuring the contracts on a group basis would mean that the contractual service margin associated with contracts with a shorter coverage period than average would not be fully recognized in profit or loss over that shorter period (IFRS 17.BC121).

Thus, measuring the contracts as a group raises the risk that the contractual service margin of the group might fail to reflect the profit relating to the coverage remaining in this group, unless the entity tracked the allocation of the contractual service margin separately for groups of insurance contracts that have similar profitability expected on initial recognition, and for which the amount and timing of cash flows are expected to reflect identically the key drivers of risk (IFRS 17.BC122 (a)). Generally, this condition would ensure the contractual service margin of a particularly profitable individual contract within a group is not carried forward after the individual contract has expired (IFRS 17.BC122 (a)). Additionally the entity would be required to track the allocation of the contractual service margin separately for groups of insurance contracts that have periods of coverage that were expected to end at a similar time (IFRS 17.BC122 (b)). In principle, this condition would ensure the contractual service margin of an individual contract that expired was not carried forward after the contract had expired (IFRS 17.BC122 (b)).

A definition of groups based only on a division of a portfolio of insurance contracts classified in three groups, representing contracts that are onerous at initial recognition, contracts that at initial recognition have no significant possibility of becoming onerous and all other remaining contracts would not be sufficient and could lead to perpetual open portfolios (IFRS 17.BC136). This might lead to a loss of information about the development of profitability over time. In addition, this fact could result in the contractual service margin persisting beyond the duration of contracts in the group, and consequently might result in profits not being recognized in the correct period (IFRS 17.BC136).

Consequently, when classifying contracts into these three groups specified, it is prohibited to include contracts issued more than one year apart in the same group. This is to ensure that trends in the profitability of a portfolio of contracts are reflected in the financial statements on a timely basis (IFRS 17.BC136).

Any alternative principle-based approach to using a one-year issuing period to constrain the duration of groups would require the introduction of additional operationally burdensome assessments for similar profitability (IFRS 17.BC137). Therefore, using a one-year issuing period represents an operational simplification given for cost-benefit reasons (IFRS 17.BC137).

2.1.3. Contractual service margin for reinsurance contracts held

Reinsurance contracts held cannot be onerous (IFRS 17.68). For a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance (IFRS 17.65).

Hence, the definition of the carrying amount of the contractual service margin for reinsurance contracts held does not include the nature of net gains or net costs being treated differently on initial recognition. The contractual service margin is not prohibited from being negative in relation to reinsurance contracts held (IFRS 17.BC284). On initial recognition, the entity recognizes any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfillment cash flows (IFRS 17.65).

However, any change in subsequent reporting periods in the fulfillment cash flows of a group of reinsurance contracts held that relates to future services and results from a change in fulfillment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts (onerous groups) does also likewise not adjust the contractual service margin of the group of reinsurance contracts held (IFRS 17.66).

Therefore, the grouping definition of contracts as well as the strong linkage of any adjustment of the contractual service margin related to future services of a group of reinsurance contracts held to those of the groups of underlying insurance contracts (onerous groups) is relevant when adjusting and when recognizing the contractual service margin of reinsurance contracts held in profit or loss.

2.2. Interdependencies between different groups

Some insurance contracts within one group may affect the cash flows to policyholders of other contracts within a different group (IFRS 17.BC171) by the requirement to share the returns with policyholders of other contracts on the same specified pool of underlying items (IFRS 17.B67 (a)). Therefore, in those insurance

contracts, policyholders may bear a reduction in their share of the returns on the underlying items in favor of other policyholders (mutualization). These amounts payable to policyholders of other groups reduce risks for an entity, in particular if the amounts payable are independent of the amounts that the entity receives from investments; for example, if the insurance contract includes guarantees (IFRS 17.BC250). Thus, policyholders of different groups act as a first layer of risk absorption among themselves and the shareholders act as a second layer only.

Nevertheless, according to the standard, the definition of the unit of account for these specific insurance contracts applies accordingly and there are no exceptions or special rules to be considered. IFRS 17 determines requirements that ensure the fulfillment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other (IFRS 17.BC171). Hence, the fulfillment cash flows for a group include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders. Excluded are payments to policyholders in the group that have been included in the fulfillment cash flows of another group (IFRS 17.B68; IFRS 17.BC171). The application of the requirements to determine the fulfillment cash flows for groups of such contracts provide an appropriate depiction of the results of such contracts (IFRS 17.BC138). For contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio (IFRS 17.BC138).

However, the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts (IFRS 17.BC138). Therefore it may not be necessary for an entity to restrict groups to that effect to achieve the same accounting outcome in some circumstances (IFRS 17.BC138). Different practical approaches can be used to determine the fulfillment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups (IFRS 17.B70). An entity might be able to identify the change in the underlying items and resulting change in the cash flows at a higher level of aggregation than the groups. In this case, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis (IFRS 17.B70).

For instance, the benefits of many insurance contracts include also payments to policyholders resulting from embedded guarantees in the contract if they are not separated from the insurance contract. The expected present value of future cash flows is an estimate based on all possible outcomes of cash flows and therefore includes the effect of financial risk related to the embedded guarantees. However, IFRS 17 allows using techniques in measuring any interrelated guarantees included in the cash flows as a separate and own component.

Contracts in different groups with different guarantees that fully share the financial risk by requiring the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items mitigate the entities financial risk. In particular the time value of the embedded guarantees is expected to be lower in comparison to situations when returns of different groups with different guarantees are not shared. An entity might be able to identify the time value of the embedded guarantees and resulting changes at the higher level of aggregation at which financial risk is fully shared than at group level in order to consider the financial risk mitigation based on the effect of sharing returns between different groups with different guarantees. In such cases, the entity shall allocate the time value of the embedded guarantees to each group on a systematic and rational basis.

2.3. Interest expenses in connection with grouping

For contracts without direct participation features, an entity is required to calculate interest on the contractual service margin (IFRS 17.B272) and to make an accounting policy choice for each portfolio regarding how to present insurance finance income or expenses (IFRS 17.BC42). Such income or expenses for a portfolio of insurance contracts in relation to the fulfillment cash flows is either fully included in profit or loss or disaggregated between profit or loss and other comprehensive income (IFRS 17.BC42).

An entity shall use the following group dependent discount rates (IFRS 17.B72):

(a) To determine the interest to accrete in the reporting period on the contractual service margin for insurance contracts without direct participation features as the current discount rates determined at the date of initial recognition of a group of contracts, applied to nominal cash flows that do not vary based on the returns on any underlying items (IFRS 17.B72 (b))

(b) If an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, to determine the amount of the insurance finance income or expenses included in profit or loss for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders, applying current discount rates determined at the date of initial recognition of a group of contracts, applied to nominal cash flows that do not vary based on the returns on any underlying items (IFRS 17.B72 (e) (i))

Therefore, considering interest expenses in profit or loss for insurance contracts without direct participation features is strongly interrelated with the date of initial recognition of a group of contracts.

3 Recognition of a group/contract

Typically, an entity enters into transactions for individual contracts. Therefore, the following requirements specify how to recognize groups that include contracts issued in more than one reporting period (IFRS 17.BC139).

An entity shall establish the groups at initial recognition and shall not reassess the composition of the groups subsequently (IFRS 17.24). In recognizing a group of insurance contracts in a reporting period, an entity shall include only contracts issued by the end of the reporting period (IFRS 17.28).

3.1. Contracts issued

3.1.1. Insurance contracts issued

IFRS 17 requires onerous groups to be recognized only when facts and circumstances indicate that a group of insurance contracts is onerous. That approach ensures that entities recognize onerous groups without the need to track groups before the coverage period begins (IFRS 17.BC144). An entity shall recognize a group of insurance contracts it issues from the earliest of the following (IFRS 17.25):

(a) The beginning of the coverage period of the group of contracts;

(b) The date when the first payment from a policyholder in the group becomes due; and

(c) For a group of onerous contracts, when the group becomes onerous.

3.1.2. Investment contracts with discretionary participation features

The date of initial recognition of an investment contract with discretionary participation features is defined as the date the entity becomes party to the contract (IFRS 17.71 (a)).

3.2. Reinsurance contracts held

Many reinsurance arrangements are designed to cover claims incurred under underlying insurance contracts written during a specified period. In some cases, the reinsurance contract held covers the losses of separate contracts on a proportionate basis. In other cases, the reinsurance contract held covers aggregate losses from a group of underlying contracts that exceed a specified amount (IFRS 17.BC304). Therefore, an entity shall recognize a group of reinsurance contracts held (IFRS 17.62):

(a) If the reinsurance contracts held provide proportionate coverage – at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) In all other cases – from the beginning of the coverage period of the group of reinsurance contracts held.

4 Information for the grouping assessment

The objective of the requirement to identify contracts that are onerous at initial recognition is to identify contracts that are onerous measured as individual contracts. An entity typically issues individual contracts and it is the characteristics of the individual contracts that determine how they should be grouped (bottom-up assessment). However, this does not mean that the contracts must be measured individually since this objective can be achieved by assessing a set of contracts ("products," "tariffs," "risks") if the entity can conclude using reasonable and supportable information that the contracts in the set will all be in the same group (top-down assessment). In such a case the entity can measure that set to determine whether the contracts are onerous or not, because there will be no offsetting effects in the measurement of the set (IFRS 17.17; IFRS 17.BC129).

The same principle applies to the identification of contracts that are not onerous at initial recognition and that have no significant possibility of becoming onerous subsequently (IFRS 17.17; IFRS 17.BC129).

Under normal circumstances it is not expected to separately group contracts priced on the same basis (IFRS 17.BC135) and an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts (IFRS 17.47). In order to avoid unnecessary complexity in group definition, IFRS 17 allows the use of pricing clusters as a driver for the choice of grouping contracts.

Therefore, under normal circumstances differently priced sets of contracts of a portfolio fulfilling the one year apart criterion are all assigned to the same group based on internal qualitative criteria such as an entity's pricing information, pricing policy or information provided by its internal reporting system (IFRS 17.BC130) representing indicators for an entity's expected profitability and the entity is not required to analyze the sets of contracts in more detail on a lower level or to impose costs of gathering additional information (IFRS 17.BC130). Moreover, under normal circumstances portfolios that fully share risks by requiring sharing returns on the same specified pool of underlying items are either profitable or unprofitable and therefore these portfolios represent one group by definition subject to the condition of not including contracts issued more than one year apart in the same group.

However, if the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which the contracts belong by considering individual contracts (IFRS 17.17).

If contracts within a portfolio would fall into different groups because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. This is for instance relevant in the case of insurance business in which insurers are not allowed to differentiate their pricing between males and females and forced to manage unisex tariffs. However, this exception cannot be applied by analogy to any other items (IFRS 17.20).

4.1. Groups/contracts using the building block and variable fee approach

A difference in the likelihood of a contract being or becoming onerous is an important economic difference between groups of contracts. Grouping insurance contracts that have different likelihoods of becoming onerous reduces the information provided to users of financial statements (IFRS 17.BC134).

An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous (IFRS 17.19):

(a) Based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.

(b) Using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:
   (i) An entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but
   (ii) An entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

4.2. Groups/contracts using the premium allocation approach

The entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances (IFRS 17.18).

4.3. Transfers of insurance contracts and business combinations

When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction (IFRS 17.B93).

5 Derecognition of contracts from a group

IFRS 17 provisions related to the derecognition of contracts from groups are in principle consistent with those of IFRS 9.

An entity typically enters into transactions for individual contracts. Therefore, the following requirements specify how to derecognize contracts from within a group (IFRS 17.BC139).

An entity shall derecognize an insurance contract from within a group of contracts when, and only when the contract is modified and recognized as a new contract or the contract is extinguished (IFRS 17.74).

An insurance contract is derecognized within a group of contracts by adjusting the fulfillment cash flows, the contractual service margin of the group and the number of coverage units for expected remaining coverage to reflect the coverage units derecognized from the group (IFRS 17.76).

5.1. Modified contracts

A modification of an insurance contract amends the original terms and conditions of the contract for example by agreement between the parties to the contract or by a change in regulation. The exercise of a right included in the terms of a contract is not a modification (IFRS 17.72).

If the terms of an insurance contract are modified, an entity shall derecognize the original contract from the group and recognize the modified contract as a new contract, if, and only if, any of the following conditions are satisfied. The conditions are that (IFRS 17.72):

(a) If the modified terms had been included at contract inception:
  (i) The modified contract would have been excluded from the scope of IFRS 17,
  (ii) An entity would have separated different components from the host insurance contract, resulting in a different insurance contract to which IFRS 17 would have applied;
  (iii) The modified contract would have had a substantially different contract boundary; or
  (iv) The modified contract would have been included in a different group of contracts

(b) The original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa; or

(c) The entity applied the premium allocation approach to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach.

All other modifications do not significantly change the accounting of the contract, do not trigger derecognition and are accounted for in the same way as changes in estimates of fulfillment cash flows (IFRS 17.73).

5.2. Extinguished contracts

An insurance contract is extinguished when the obligation specified in the insurance contract expires or is discharged or cancelled (IFRS 17.74 (a)). When an insurance contract is extinguished, the entity is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance contract (IFRS 17.75).

A reinsurance contract held typically protects the entity from the effects of some defined losses on the underlying group of insurance contracts, but does not eliminate the entity's responsibility to fulfill its obligations under those contracts. Therefore, the entity would not derecognize the related underlying insurance contracts upon entering into a reinsurance contract (IFRS 17.BC306).

REINSURANCE

4

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1 Introduction

Reinsurance is an important risk management tool for primary insurance companies. Reinsurance replaces unknown claims costs with fixed costs, that is to say it provides financial compensation for random losses. In this context, risk is transferred to the reinsurer. Reinsurance also improves a primary insurer's underwriting capacity, and reduces its risk capital requirements and own-funds needs. In addition, reinsurance is generally regarded as an essential means of stabilizing an insurer's performance. Reinsurance is therefore an important instrument of annual financial statement policy and improves the planability of a primary insurer's results.

Cedants are mainly interested in the way reinsurance affects their balance sheets. For many years, reinsurance has played a special role in international accounting standards for insurance companies. SFAS 113 was implemented as a US accounting standard in its own right; it defines the criteria according to which contracts are classified as reinsurance contracts and stipulates fundamental accounting rules for long and short-duration contracts, and for retroactive and prospective contracts. SFAS 113 was adopted not least because – in the USA – gains often used to be recognized anticipatorily, although they were not actually covered by the reinsurance contract. That being said, it should nevertheless be the aim of every regulation related to accounting and recognition to correctly reflect the risk management function of reinsurance. Whenever a reinsurance contract provides economic relief for a primary insurer, this effect must also be reflected in a cedant's balance sheet. From a profit and loss point of view, income and expenses need to be recognized such that the impact of the reinsurance contract and the corresponding primary insurance contract is recognized without any distortion in the relevant periods. That is the only way to avoid mismatches in a cedant's financial statements as a result of reinsurance.

In the following, we outline the main provisions of IFRS 17 regarding the definition, recognition and measurement of reinsurance contracts both for ceded and assumed business. We also provide an example of how the transfer of risk to a reinsurer is currently recognized in accordance with the provisions of IFRS 17.

IFRS 17 applies to insurance contracts, in particular to reinsurance contracts. Consequently, the requirements of IFRS 17 are applicable to reinsurance contracts written by a reinsurer. At the same time, some requirements of IFRS 17 are modified for reinsurance ceded (i.e., reinsurance contracts entered into by cedants, referred to as "reinsurance contracts held" in the standard).

1.1 Scope and definition of a reinsurance contract

IFRS 17 applies to insurance contracts, in particular to reinsurance contracts [IFRS17.3a]. Reinsurance contracts are recognized and measured in line with IFRS 17 in the financial statements of both the reinsurer and the primary insurance company ceding the risks [IFRS17.3a–b]. A reinsurance contract is explicitly defined by the standard as a particular insurance contract [IFRS17.App. A]. This means IFRS 17 is applicable to a reinsurance contract if the general definition of an insurance contract is met. The term "insurance contract" is defined in IFRS 17 based on significant insurance risk that is transferred from a party (e.g., a policyholder) to an insurance company [IFRS17.App. A].

There are two specifics with respect to reinsurance contracts.

Generally, lapse risk, persistency risk and expense risk do not constitute insurance risk under IFRS 17. Consequently, contracts exposing an insurer to these risks are not insurance contracts (in terms of IFRS 17) unless they also expose the insurer to significant insurance risk. However, if an insurer enters into a reinsurance contract to transfer (part of) these risks to a reinsurer, the reinsurance contract exposes the reinsurer to insurance risk. Therefore, the reinsurance contract is accounted for applying IFRS 17, unless the insurance risk resulting from lapses, persistency or expenses is not significant [IFRS17.B14–B15].

A contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the insurer can incur a loss on a present value basis. However, even if a reinsurance contract does not expose the reinsurer to the possibility of a significant loss, the reinsurance contract is deemed to transfer significant insurance risk if it transfers substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts to the reinsurer [IFRS17.B19]. An example where this is relevant is a quota share covering a block of homogenous insurance policies written by a primary insurer. While there may be no scenario in which the reinsurer can incur a loss, the quota share reinsurance contract cedes the entire insurance risk for the reinsured portion to the reinsurer and therefore is an insurance contract in terms of IFRS 17.

1.2 Combination of reinsurance contracts

A set-up where a reinsurer accepts business from an external insurer and retrocedes the business to an external reinsurer, related to the external insurer, sometimes referred to as fronting. This can be the case when reinsurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. It may be necessary to account for these reinsurance contracts as if they were one contract [IFRS17.9].

2 Reinsurance ceded

A reinsurance contract is a separate contract and therefore has to be accounted for separately from the underlying insurance contracts to which it relates. IFRS 17 modifies some of the general requirements with respect to reinsurance contracts entered into by a primary insurer, sometimes referred to as the cedant [IFRS17.60].

2.1 Level of aggregation

A reinsurance contract under which business is ceded to a reinsurer, referred to as "reinsurance contracts held" in the standard, cannot be onerous [IFRS17.68]. That means when determining the level of aggregation for the reinsurance contracts (i.e., determining the groups of reinsurance contracts) it is not necessary to distinguish between onerous reinsurance contracts and profitable reinsurance contracts with or without significant risk of becoming onerous subsequently. However, a cedant has to differentiate between reinsurance contracts resulting in a net gain at initial recognition and reinsurance contracts resulting in a net cost at initial recognition with or without a significant possibility of resulting in a net gain at subsequent measurement. Determining groups of reinsurance contracts might result in groups comprising only one contract [IFRS17.61].

2.2 Recognition of reinsurance assets

For recognition, the standard distinguishes between proportional[51] reinsurance contracts (e.g., quota shares) and other reinsurance contracts. If reinsurance contracts provide proportional coverage, a group of reinsurance contracts is recognized by the cedant at the beginning of the coverage period of the group of reinsurance contracts or at the initial recognition of any underlying contract, whichever is the later. Consequently, the reinsured portion of a primary insurance policy is recognized when the primary insurance policy itself is recognized but, naturally, not before inception of the reinsurance contract. Reinsurance contracts providing non-proportional coverage (e.g., excess of loss reinsurance contracts) are recognized from the beginning of the coverage period of the group of reinsurance contracts [IFRS17.62].

2.3 Measurement of reinsurance assets

In general, reinsurance assets are evaluated applying the general measurement model, sometimes referred to as building block approach.

When measuring the present value of future cash flows resulting from reinsurance contracts, in principle assumptions consistent with those used for measurement of the underlying primary insurance contracts have to be used. Additionally, the non-performance risk of the reinsurer (including the effects of collateral and losses from disputes) has to be included in the estimates of the present value of the future cash flows of the reinsurance contracts [IFRS17.63]. Similar to IFRS 9, the non-performance risk of the reinsurer is evaluated based on an expected loss model rather than an incurred loss model currently used under many accounting standards.

As regards measurement of the contractual service margin (see below), at initial recognition non-performance risk will have no impact on the carrying amount of the reinsurance asset. Only subsequent changes in the non-performance risk go through profit or loss, as they do not adjust the contractual service margin. Thus, the carrying amount of the reinsurance asset at initial recognition will not depend on the credit risk of the reinsurer.

An explicit risk adjustment for non-financial risk has to be determined as part of the reinsurance asset rather than calculating the risk adjustment for the underlying primary insurance contracts on a net basis (i.e., after reinsurance). The risk adjustment has to be determined in a way that it represents the amount of risk being transferred by the cedant to the reinsurer [IFRS17.64].

The contractual service margin of the reinsurance asset can be positive or negative in contrast to the insurance liability where the contractual service margin cannot become smaller than zero.

For prospective reinsurance[52], the contractual service margin at initial recognition is calculated as the sum of the fulfillment cash flows, the amount of any asset or liability previously recognized and derecognized at initial recognition of the reinsurance asset for cash flows related to the group of reinsurance contracts, and any cash flows arising at that date. For retroactive reinsurance[53], this amount is recognized as the contractual service margin if it is positive and recognized in profit or loss as an expense if the amount is negative (i.e., for retroactive reinsurance, the contractual service margin cannot be negative) [IFRS17.65].

Effectively, for prospective reinsurance contracts any net gain or net loss on purchasing the reinsurance is deferred and amortized over the coverage period of the reinsurance contract. Such a net gain or net cost results from better or worse conditions agreed upon with the reinsurer compared to conditions agreed with the policyholder.

51 IFRS 17 refers to reinsurance contracts held providing "proportionate coverage." We assume "proportionate" has the same meaning as "proportional" in the context of reinsurance contracts.

52 A prospective reinsurance contract provides coverage for future losses resulting from events insured under the underlying primary insurance contracts.

53 A retroactive reinsurance contract provides coverage for losses from events insured under the underlying primary insurance contracts that may have occurred in the past.

As under the general measurement model, at subsequent measurement the effect from new business is added to the contractual service margin, interest is accreted on the contractual service margin, it is adjusted for changes in the fulfillment cash flows relating to future services, currency exchange differences are taken into account and the contractual service margin is amortized. However, compared to the measurement of insurance liabilities there are two differences with respect to adjusting. Firstly, the contractual service margin is adjusted for changes in the fulfillment cash flows relating to future services unless there is no corresponding adjustment to the contractual service margin of the insurance liability. The rationale behind this seems to be the avoidance of accounting mismatches between the reinsurance asset and the insurance liability covered by the reinsurance contract with respect to subsequent measurement. Secondly, the contractual service margin is adjusted for changes in the fulfillment cash flows relating to future services, even if this results in a negative contractual service margin [IFRS17.66]. This is consistent with the provision that a reinsurance contract under which business is ceded to a reinsurer cannot be onerous.

Beyond that, the amortization period of the contractual service margin for underlying primary insurance contracts might be different from the amortization period of the contractual service margin of the reinsurance asset as a result of differences in the coverage period.

As mentioned above, changes in the fulfillment cash flows that result from changes in the non-performance risk of the reinsurer do not adjust the contractual service margin but have an impact on profit or loss [IFRS17.67].

Example n: Measurement of a reinsurance asset

A primary insurance company has written business which is allocated to one group of insurance contracts under IFRS 17 and enters into a reinsurance contract with a reinsurer. The reinsurance contract is a 100% quota share[54] reinsurance contract, i.e., the primary insurance company cedes all of the underwritten risks to the reinsurer. For the primary insurance policies, the primary insurance company expects to receive premiums, i.e., cash inflows of 100 currency units (CU) immediately after initial recognition. The primary insurance company evaluates the estimate of discounted future cash outflows at 70 CU and the risk adjustment for non-financial risk at 20 CU.

The measurement of the primary insurance policies at initial recognition is as follows.

Present value of future cash inflows	–100
Present value of future cash outflows	70
Present value of future cash flows	**–30**
Risk adjustment	20
Fulfillment cash flow	**–10**
Contractual service margin	10
Insurance liability	**0**

Table 4.1

Scenario A: The conditions for the 100% quota share reinsurance contract agreed between the primary insurance company (i.e., the cedant) and the reinsurer are beneficial to the primary insurance company. Since the reinsurer is better diversified compared to the primary insurance company it reinsures 100% of the primary insurance policies for a reinsurance premium of 85 CU. All other conditions are the same as under the underlying primary insurance policies. The primary insurance company concludes that the relevant group of reinsurance contracts comprises only this particular reinsurance contract.

Consequently, the measurement of the reinsurance contract at initial recognition is as follows.

Present value of future cash inflows	–70
Present value of future cash outflows	85
Present value of future cash flows	**15**
Risk adjustment	–20
Fulfillment cash flow	**–5**
Contractual service margin	5
Reinsurance asset	**0**

Table 4.2

54 While ceding 100% of a block of business to a reinsurer is not common in practice, this example is used to illustrate certain effects.

According to IFRS 17, the contractual service margin corresponds to a net gain on purchasing the reinsurance contract. This net gain is deferred and amortized over the coverage period of the reinsurance contract rather than recognized immediately in profit or loss. This does not reflect that the cedant replaces uncertain future results with certain future results by ceding risks to the reinsurer.

Assuming the cedant receives the premiums from policyholders and pays the reinsurance premium to the reinsurer just after initial recognition, the measurement of the primary insurance policies and the measurement of the reinsurance contract are as follows.

	Reinsurance asset	Insurance liability
Present value of future cash inflows	–70	0
Present value of future cash outflows	0	70
Present value of future cash flows	**–70**	**70**
Risk adjustment	–20	20
Fulfillment cash flow	**–90**	**90**
Contractual service margin	5	10
Reinsurance asset	**–85**	**100**

Table 4.3

Basically, the carrying amount of the reinsurance asset is equal to the reinsurance premium. The measurement of the reinsurance asset suggests that the primary insurance company has ceded an 85% share to the reinsurer.[55] This might be difficult to interpret for users of financial statements.

Scenario B: A similar effect occurs if the reinsurer assumes 100% of the primary insurance policies for a reinsurance premium of 101 CU, which may occur in rare cases.[56] All other conditions of the reinsurance contract are the same as under the underlying primary insurance policies. In this example, assuming the cedant receives the premiums from policyholders just after initial recognition the measurement of the primary insurance policies does not change (neither at initial recognition nor just after initial recognition).

The measurement of the reinsurance contract at initial recognition is as follows.

Present value of future cash inflows	–70
Present value of future cash outflows	101
Present value of future cash flows	**31**
Risk adjustment	–20
Fulfillment cash flow	**11**
Contractual service margin	–11
Reinsurance asset	**0**

Table 4.4

Assuming the cedant pays the reinsurance premium to the reinsurer just after initial recognition, the measurement of the reinsurance contract is as follows.

Present value of future cash inflows	–70
Present value of future cash outflows	0
Present value of future cash flows	**–70**
Risk adjustment	–20
Fulfillment cash flow	**–90**
Contractual service margin	–11
Reinsurance asset	**–101**

Table 4.5

The table below shows a comparison of the measurement of the primary insurance policies and the measurement of the reinsurance contract.

	Reinsurance asset	Insurance liability
Present value of future cash inflows	–70	0
Present value of future cash outflows	0	70
Present value of future cash flows	**–70**	**70**
Risk adjustment	–20	20
Fulfillment cash flow	**–90**	**90**
Contractual service margin	–11	10
Total asset/liability	**–101**	**100**

Table 4.6

The measurement of the reinsurance asset suggests that the primary insurance company has ceded a 101% share to the reinsurer.[57] However, a reinsurance premium exceeding the primary insurance premiums is highly unlikely.

55 85 CU (reinsurance asset)/100 CU (insurance liability) = 85%.

56 A reinsurance premium exceeding the primary insurance premiums is highly unlikely. However, this situation may occur when the reinsurance contract provides comprehensive services in addition to reinsurance cover. In this example, we assume that the cedant analyzed if any promise of the reinsurer to transfer distinct goods or non-insurance services has to be separated from the host insurance contract applying paragraph 7 of IFRS 15 and concluded that this was not the case.

57 101 CU (reinsurance asset)/100 CU (insurance liability) = 101%.

Example n+1: Reinsurance contract covering a group of onerous contracts

A primary insurance company has written the group of contracts described in example n above. However, in contrast to example n, the primary insurance company receives premiums of 85 CU immediately after initial recognition. All other conditions are the same as in example n above.

The measurement of the primary insurance policies at initial recognition is as follows.

Present value of future cash inflows	–85
Present value of future cash outflows	70
Present value of future cash flows	**–15**
Risk adjustment	20
Fulfillment cash flow	**5**
Contractual service margin	0
Insurance liability	**5**

Table 4.7

At initial recognition, the insurance liability is 5 CU, and a loss of 5 CU is recognized in profit or loss, i.e., the group of insurance contracts is onerous. The insurance liability of 5 CU is disclosed as a loss component.

The conditions for the 100% quota share reinsurance contract are the same as under scenario A in example n. In particular, the reinsurance premium is 80 CU. The measurement of the reinsurance asset is the same as in example n, scenario A.

Present value of future cash inflows	–70
Present value of future cash outflows	80
Present value of future cash flows	**10**
Risk adjustment	–20
Fulfillment cash flow	**–10**
Contractual service margin	10
Reinsurance asset	**0**

Table 4.8

While a loss of 5 CU from writing the primary insurance policies is recognized in profit or loss, the gain of 10 CU from the reinsurance contract is deferred over the coverage period of the reinsurance contract rather than recognized immediately.

2.4 Measurement of reinsurance assets under alternative models

So far, we have discussed measurement of reinsurance assets under the general measurement model. There is also the option to measure reinsurance contracts using the premium allocation approach, if the coverage period of each contract in the group of reinsurance contracts (including coverage from all premiums within the contract boundary determined at inception) is one year or less or the resulting measurement would not differ materially from the result of applying the requirements described above [IFRS17.69]. For risk-attaching reinsurance contracts[58] with a coverage period of one year the first criterion is generally not met. The reason is the following: if the underlying primary insurance contracts have a coverage period of, for example, one year, the reinsurance contract covers losses occurring over a two year period.

Reinsurance contracts cannot be measured using the variable fee approach. IFRS 17 explicitly mentions that reinsurance contracts are not insurance contracts with direct participation features [IFRS17.B109]. Thus, the criteria for applying the variable fee approach cannot be met, even if a reinsurance contract covers participating contracts that have to be measured under the variable fee approach.

Applying the variable fee approach when measuring direct insurance contracts and the general measurement model when measuring reinsurance contracts covering those direct insurance contracts can lead to significant divergence between the contractual service margins, i.e., an accounting mismatch. The reason are the differences between the treatment of both changes in discount rates (more precisely changes arising from changes in financial assumptions) and the accretion of interest under the general measurement model and the variable fee approach. While the contractual service margin for the underlying direct insurance contracts is adjusted for the insurer's share in the fair value of underlying items [IFRS17.45b], the contractual service margin of the reinsurance asset is accreted with interest using locked-in interest rates[59] and adjusted for changes relating to future service [IFRS17.66]. Future service does not include changes in financial assumptions.

2.5 Intra-group reinsurance contracts

When business is ceded within an insurance group preparing financial statements, intercompany business resulting from intra-group reinsurance contracts needs to be consolidated. There are unavoidable intercompany differences resulting from different measurement requirements applying to reinsurance business assumed and ceded. That means measurement of the same reinsurance contract from the perspective of a legal entity assuming the business (i.e., the reinsurer) differs from measurement of the reinsurance contract from the perspective of a legal entity ceding the business (i.e., the cedant). This results

58 Risk-attaching reinsurance contracts cover insured events on underlying primary insurance contracts that begin at any time during the coverage period of the reinsurance contract.

59 Locked-in interest rates means that the interest rate curve is determined at the date of initial recognition of a group of (re)insurance contracts.

3 Reinsurance assumed

from specific requirements of IFRS 17. At the same time, there may be additional intercompany differences which can be avoided by accounting policy choice.

Unavoidable intercompany differences are, for example, resulting from:

- Differences in initial recognition of reinsurance contracts
- Differences in future cash flows, e.g., with respect to contract boundaries and non-performance-risk
- Differences in measurement of the contractual service margin both at initial recognition (see examples n and n+1 above) and subsequently, e.g., if the variable fee approach is applied to the underlying primary insurance contracts

Avoidable intercompany differences may, for example, result from

- Application of different optional measurement approaches, e.g., application of the general measurement model by the reinsurer and premium allocation approach by the cedant
- Different presentation of changes resulting from changes in discount rates, if the OCI option is exercised for the portfolio including the underlying primary insurance contract but not for the portfolio including the reinsurance contract

For assumed reinsurance business, the general requirements of the standard apply [IFRS17.3a]. That means the same recognition and measurement approach is used for the valuation of reinsurance contracts written by a reinsurer (also referred to as reinsurance assumed) as for primary insurance contracts.

3.1 Level of aggregation

In general, a reinsurance contract covers a block of primary insurance business consisting of (generally many) underlying primary insurance contracts. While IFRS 17 prohibits grouping of contracts issued more than one year apart, a "look through" test for determining the level of aggregation is not required by IFRS 17 [IFRS17.14-23]. Consequently, the dates when the reinsurance contracts were issued are relevant rather than the issue dates of the underlying primary insurance policies when determining which contracts were issued more than one year apart.

3.2 Recognition and contract boundary

The cedant recognizes reinsurance contracts providing proportional coverage at the beginning of the coverage period of the group of reinsurance contracts or at initial recognition of any underlying contract, whichever is the later [IFRS17.62]. At the same time, the reinsurer estimates the new business the cedant will write under the reinsurance contract applying the contract boundary of the reinsurance contract [IFRS17.34].

An example is shown in the diagram (figure 4.1) below.

As at the end of the reporting period the reinsurer recognizes the (entire) reinsurance contract. Measurement includes cash flows resulting from underlying insurance contract 1, which is also recognized as an insurance liability by the cedant, and estimated cash flows resulting from underlying insurance contracts 2 and 3, which will be underwritten by the cedant after the end of the reporting period. The cedant has not yet written insurance

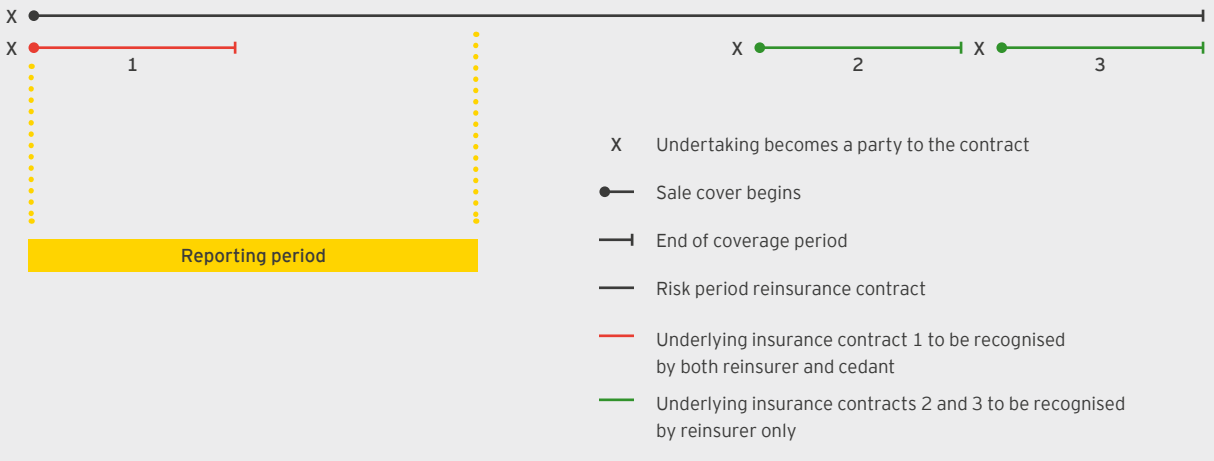

Figure 4.1

contracts 2 and 3. Therefore, these will not be recognized as an insurance liability by the cedant. At the same time, the cedant will not include cash flows from insurance contracts 2 and 3 in the measurement of its reinsurance asset, since these underlying insurance contracts do not exist yet. Hence, the boundary of the reinsurance contract is different on the balance sheet of the cedant when compared to the balance sheet of the reinsurer.

3.3 Measurement

Certain reinsurance contracts provide cover for a number of similar or identical risks. As mentioned above, the reinsurer estimates the new business the cedant will write under such reinsurance contracts applying the contract boundary of the reinsurance contracts. In general, the number of these reinsured risks is unknown at the beginning of the coverage period of these reinsurance contracts. The reinsurance premiums are directly linked to the number of underlying insurance risks which are finally covered. This is common for certain types of reinsurance contracts, which are typically proportional.

In such cases, the initial measurement of both the fulfillment cash flows and the contractual service margin is based on an estimate of underlying insurance risks that are expected to be written by the cedant in future. In subsequent periods the fulfillment cash flows are adjusted to reflect the actual business volume. The contractual service margin is adjusted for those changes resulting from changes in business volume.

3.4 Measurement under alternative models

Reinsurance contracts cannot be measured using the variable fee approach. IFRS 17 explicitly mentions that reinsurance contracts are not insurance contracts with direct participation features [IFRS17.B109]. This makes sense as the substance of reinsurance contracts substantially differs from participating contracts for which the variable fee approach was developed. Thus, the criteria for applying the variable fee approach cannot be met.

4 Summary and outlook

Even after the issue of IFRS 17, the accounting and reporting of reinsurance remains a key discussion point. Generally speaking, the standard has not brought about full symmetry between reinsurance contracts and their corresponding underlying insurance contracts. In particular, it has become clear that, at the inception of a reinsurance contract, a primary insurer in a loss situation does not get the relief from reinsurance that it needs from a risk management policy angle. The reason given by the IASB is that a reinsurance contract is a separate agreement and that all kinds of day-one gains must be avoided. From an economic perspective, however, primary insurers do not gain any benefit, apart from the fact that the net position is reflected in a realistic manner. In addition to the reinsurance asset issue outlined here, other important issues and their interpretation are still being discussed, including in particular the unit of account in reinsurance contracts, the contract boundary and questions surrounding the treatment of accounts receivable and payable, and deposits retained and accounts receivable and payable. In this regard, it is important that we continue to work on a constructive interpretation of the standard.

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1 Scope of IFRS 17

IFRS 17 focuses, similar to IFRS 4, on different types of (re)insurance contracts, instead of focusing on entities.

IFRS 17 defines an insurance contract 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." (IFRS 17 App A)

It is generally expected that contracts that have previously met the definition of an insurance contract under IFRS 4 will also be classified as insurance contracts under IFRS 17.

Investment contracts with discretionary participation features issued by entities also issuing insurance contracts fall under the scope of IFRS 17 (IFRS 17.3(c)). Note that such contracts are currently accounted under IFRS 4 regardless of whether the entity also issues insurance contracts (IFRS 4.2(b)). Investment contracts, such as some pension plans or savings contracts that do not transfer significant insurance risk to the insurer consequently do not fall under the scope of IFRS 17 as it is also the case with IFRS 4. Such contracts are accounted for under IFRS 9.

Insurance companies are not only subject to the requirements of IFRS 17 but also to other applicable standards (e.g., IFRS 9 or IFRS 15). There are contracts that are treated as one contract under civil law, however, they economically consist of different contracts. When parts of contracts are not insurance contracts, the entity shall examine whether one or more of these components meets the separation criteria of IFRS 17.10–17.13. The following section deals with this issue.

2 Separating components from an insurance contract

Insurance contracts create a bundle of rights and obligations that coincide to generate a package of cash flows.[60] Some insurance contracts only provide insurance coverage, e.g., most short-duration non-life contracts. Many types of life insurance, unit-linked and participating contracts contain one or more components that would fall under the scope of another IFRS if the entity accounted for those components as if they were separate contracts, e.g., an investment component or a service component (IFRS 17.10–12).

IFRS 17 must be applied to all contracts within the scope of IFRS 17 unless part of the contract has to be separated and falls under the scope of another IFRS standard. Basically, IFRS 17 prohibits the separation of components. An insurance contract with different components should only be separated if IFRS 17.B31–B32, IFRS 17.B33–B35 or IFRS 9 require separation. IFRS 17.B31–32 states the underlying conditions for separating investment components, while IFRS 17.B33–B35 explains how to separate distinct goods or non-insurance services. IFRS 9.B4.3 presents the separation rules for embedded derivatives.

The standard includes separation requirements for the following three types of non-insurance components (IFRS 17.BC102):

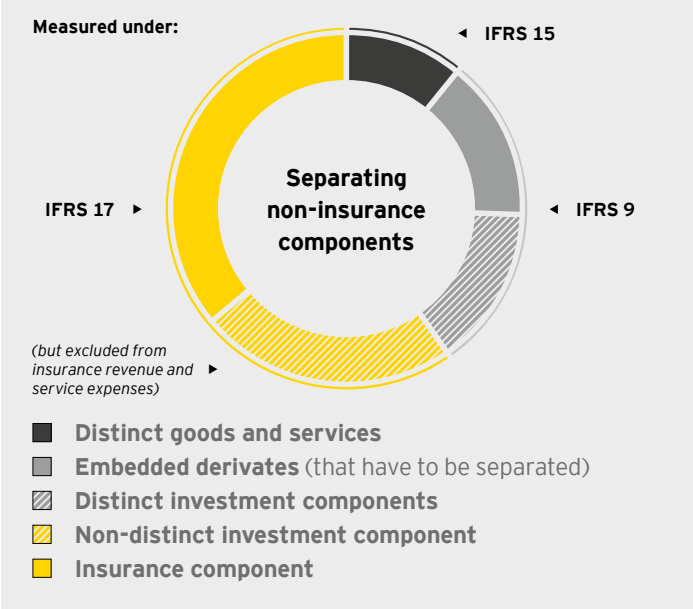


Figure 5.1 (Reference from KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 21)

These different areas of separation will be explained and in order to give a high practical use, several posting examples will be provided.

60 KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 21.

2.1 Separating embedded derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host – with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative (IFRS 9.4.3.1). An **embedded derivative** can modify the cash flows of the host contract because the **derivative** can be related to an exchange rate, commodity price or other variables which frequently change.

An **embedded derivative** shall be separated from the host contract if, and only if, it meets all of the following criteria of IFRS 9 (IFRS 17.11(a) in conjunction with IFRS 9.4.3.3):

- The economic characteristics and risks of the embedded derivative are **not closely related** to the economic characteristics and risks of the host contract (see IFRS 9.B4.3.5 and B4.3.8); and
- A separate financial instrument with the same terms as the embedded derivative would **meet the definition of a derivative;** and
- The hybrid contract is not measured at fair value with changes in fair value recognized in profit or loss (i.e., a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

The entity shall measure the embedded derivative that have to be separated in accordance with IFRS 9 at fair value through profit or loss, as if it had issued it as a standalone financial instrument and attribute any remaining cash flows to the other components of the insurance contract.

In accordance with IFRS 9, the economic characteristics and risks of the embedded derivative would be **closely related** to the economic characteristics and risks of a host insurance contract if, for example, the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately – i.e., without considering the host contract (IFRS 17.11, IFRS 9.B4.3.8(h)).

There are different types of embedded derivatives that are **prohibited from separation:**

- **Embedded derivatives that are insurance contracts** (example: a catastrophe bond that provides for reduced payments of principal, interest or both, if a specified event adversely affects the issuer of the bonds. If the specified event creates significant insurance risks, this catastrophe bond is an insurance contract according to IFRS 17.B26(j)).
- **Embedded derivatives according to IFRS 9 that are closely related to insurance contracts** (example: minimum interest rate [=embedded floor/derivative] to be used in determining the surrender or maturity value that is at or out of the money [in other words the floor is at or below the market interest rate]. If the embedded minimum interest rate is not leveraged in relation to the host contract, this embedded derivative is closely related to an insurance contract in terms of IFRS 9.B.4.3.8(b)).

"Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because the payment is triggered by an uncertain future event – the survival of the person who receives the annuity. The link to the price index is a derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the resulting transfer of insurance risk is significant, the derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract" (IFRS 17.B10).

The following table includes examples based on IFRS 9 Appendix B and on the implementation guidance included in IFRS 4 which has not been included in IFRS 17. However, the implementation guidance examples taken from IFRS 4 may provide some insight into the application of the above requirements.[61]

Concrete **examples** of embedded derivatives that are **prohibited from separation:**

Example	Embedded derivatives are insurance contracts	Embedded derivatives are closely related to insurance contracts
Death benefit that is the greater of the unit value of an investment and a guaranteed amount (IFRS 4.IG4).	✕	
Option to take a life-contingent annuity at a guaranteed rate (IFRS 4.IG4).	✕	
Minimum annuity payments if the annuity payments are linked to investment returns and the guarantee relates only to life-contingent payments (IFRS 4.IG4).	✕	
Option to cancel a deposit component that triggers cancellation of the insurance component and that cannot be measured separately (IFRS 4.IG4).		✕
Minimum annuity payments if the annuity payments are linked to investment returns and the policyholder can select to receive a life-contingent payment or a fixed amount of payments at predetermined terms (IFRS 4.IG4).	✕	✕
A repurchase option at the surrender value of the contract (IFRS 9.B4.3.8 b)).		✕
A guaranteed minimum interest (interest option/floor) (IFRS 9.B4.3.8 b)).		✕
A termination option (option) (IFRS 9.B4.3.8 h)).		✕
A renewal option (option) (IFRS 9.B4.3.8 h))		✕

Table 5.1

Concrete examples of embedded derivatives that have to be separated (because they are neither insurance contracts nor closely related to insurance contracts):[62]

- Minimum interest rate to be used in determining a surrender or maturity value that is in the money when it is issued or leveraged (IFRS 4.IG4).
- Equity-linked return that is available on surrender or maturity (IFRS 4.IG4).
- Persistency bonus paid at maturity in cash (IFRS 4.IG4).

Risks and rewards of these embedded derivatives and insurance contracts may have economically contrasting effects.

Change in requirements of IFRS 17 compared to IFRS 4:

- Under IFRS 4, an entity has the option to separate embedded derivatives from an insurance contract that do not meet the criteria for separation under IFRS 9 (IFRS 4.IG3). This option no longer exists under IFRS 17. Separation is prohibited unless it is explicitly required under IFRS 17. As the accounting policy under IFRS 4 is not widely applied, this change is expected to have little impact in practice.[63]
- IFRS 4 did not require separation of an embedded derivative if the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately – i.e., without considering the host contract. IFRS 17 replaced this option by prohibiting the separation of such closely related embedded derivatives from the host contract (IFRS 17.BC 105(a), .11, IFRS 9.B4.3.8(h)).
- The exception for a policyholder's option to surrender an insurance contract for a fixed amount or for an amount based on a fixed amount and an interest rate under IFRS 4, has not been carried forward to IFRS 17. Instead, the entity is required to analyze this embedded derivative based on the requirements of IFRS 9 to decide whether it should be separated.[64] Given that the value of a typical fixed-price surrender option and the host insurance contract are likely to be interdependent, it is expected that this change will have no significant impact in practice.[65]

The following posting example illustrates separation of an insurance contract with an embedded derivative using the premium allocation approach.

Posting example: Accounting of a separated embedded derivative:

Accounting entries regarding separation of an embedded derivative

Example 1: PuC retail contract (1 year) on a foreign currency base (embedded fx derivative)

61 KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 21.
62 KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 22.
63 PwC in depth IFRS 17, 30 June 2017, S. 6; KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 22.
64 IFRS 17.BC 105(b); PwC in depth IFRS 17, 30 June 2017, S. 6.
65 KPMG Insurance Contracts First Impressions IFRS 17, July, page 22.

One-year house-and contents-insurance (German risk) on US dollar basis. Both parties of the contract are German residence companies; therefore their functional currency is the euro. The foreign currency derivative has an initial fair value of zero. For simplification reasons, we do not consider interest and risk margin. The effects of changes in the foreign currency is not separated instead it is included in every P&L position. In this case, we consider this US dollar basis embedded derivative to be separated from the host euro-insurance contract. The conditions of IFRS 9.B4.3.8 (d) are not satisfied, therefore the economic characteristics and risks of the underlying euro-insurance contract are not closely related to the embedded derivative. In certain circumstances the economic characteristics and risks of the insurance here could be at least partly negatively influenced/ reversed by a respective US dollar/euro exchange rate.

Additionally this US dollar embedded derivative would not be an insurance contract as a standalone instrument but a financial instrument within the scope of IFRS 9.

Premium	800 USD
Commission	20%
No-loss discount	20%
Transaction rates EUR: USD 1 January 2015	1.00 USD
Transaction rates EUR: USD 31 March 2015	0.95 USD

Table 5.2 [66, 67, 68, 69, 70, 71]

2.2 Separating investment and service components

Investment and service components – i.e., a performance obligation to provide goods or non-insurance services – shall be separated from an insurance contract if the investment or service component **is distinct** (IFRS 17.11(b), 12(a) and B33). An entity is prohibited from applying IFRS 15 or IFRS 9 to components of an insurance contract when separation is not required (IFRS 17.13, IFRS 17.BC114).

2.2.1 Investment components

IFRS 17 defines an investment component as the amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur (IFRS 17 App. A), e.g., pure deposits, such as financial instruments whereby an entity receives a specified sum and repays the amount under all circumstances under the same contract. An investment component shall be separated from the host insurance contract and accounted for in accordance with IFRS 9 if that investment component is distinct. An investment component would be *distinct* if it is **not** highly interrelated with the insurance contract and a contract with equivalent terms is sold or could be sold separately in the same market or jurisdiction (IFRS 17 B31). Highly interrelated investment components are not considered to be distinct (IFRS 17 B32).

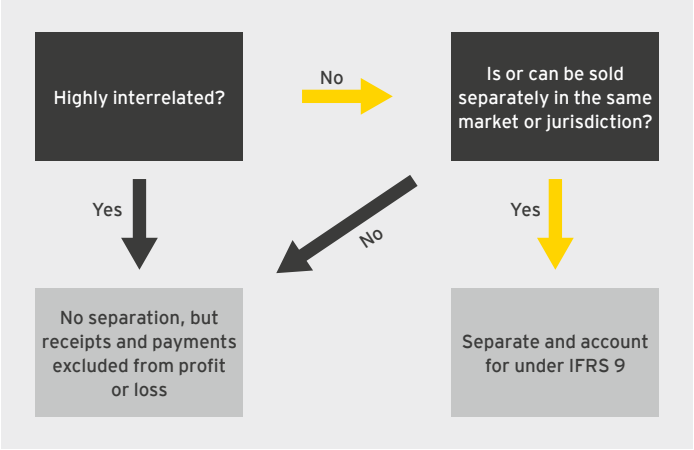


Figure 5.2

Investment and insurance components are highly inter-related if:

- The policyholder cannot benefit from one component without the other being present – e.g., the lapse, cancellation or maturity of one component causing the lapse, cancellation or maturity of the other; or
- The entity cannot measure one component without considering the other.

For example, if an investment component of a life insurance with a death benefit ceases to exist on death or lapse of the contract, the investment component is considered non-distinct from the life insurance contract. The same applies to experience refunds or no-claims bonuses often included in property-casualty insurance contracts if termination of the insurance contract results in termination of those components.[72]

Investment components that are not distinct from the insurance contract **have to be separated from the insurance contract, but accounted for together with the insurance component under**

66 640 = 800 – 20% (commissions) × 800.
67 Because of the decrease of the exchange rate, the USD investment rises to EUR 674 (640/0.95).
68 Assumed fair value of the embedded derivative USD 20 = EUR 21.
69 LRC would be 480 in the case of an unchanged exchange rate (per quarter, EUR 160 is recognized using a linear risk distribution). Because of the exchange rate of 0.95, the LRC is 505 (480/0.95).
70 Pro rata quarterly profit participation (no-loss discount) (USD 160/4) USD 40, EUR 42.
71 Linear revenue recognition (USD 480/4) including acquisition costs (USD 160/4).

72 IFRS 17.IE43; PwC in depth IFRS 17 June 2017, page 8.

IFRS 17. However, receipts and payments from these investment components **have to be excluded from insurance revenue and insurance service expenses in profit or loss** (IFRS 17.85).

The concept underlying the regulation is that these investment components do not represent consideration for providing services even though they are part of premiums.[73] That means that investment components which do not have to be separated are not shown in the P&L. In the case of an unexpected termination of the contract, these investment components do not change the CSM, for instance. Cash flows for investment components are direct entries to be separated from insurance contract revenue, i.e., the expected claims incurred and expenses incurred do not include the incurred investment components. The investment component becoming payable in the period is transferred directly from the Liability for remaining coverage (LRC) to the Liability for incurred claims (LIC) without going through profit or loss.

In Germany, insurance contracts are commonly structured in a way that the investment component cannot be separated due to it being highly interrelated with the insurance contract. In traditional endowment insurance, a lapse benefit is always closely related to the insurance contract, pension insurance with a minimum payment at the beginning of the pension payout period is not to be separated from the insurance contract either.

Examples for non-distinct investment components in an insurance contract:

- Financial instruments whereby an entity receives a specified sum and undertakes to repay that sum with interest because the entity cannot measure the insurance component without the other financial component, i.e., highly interrelated.
- Surrender value because the policyholder cannot benefit from the surrender value without the underlying insurance contract.
- Unit linked life insurance with death benefit amounting to 1% of the fund because the policyholder cannot benefit from the account balance without the underlying insurance contract.
- Policy loans: depends if the loan can only be disbursed if the underlying insurance contract is in force. In this case, the loan is non-distinct because the policyholder cannot independently benefit from this contract feature.

Lapse benefit in an endowment insurance

- Personal accident endowment insurance
- Private medical insurance, where the policyholder gets partially reimbursed in the case of not using medical service
- Pension insurance with guaranteed minimum payment
- Claim-sensitive or price-adjusting components for (re)insurance contracts (e.g. profit shares, no-claims bonuses, proportional commissions, etc.) if they lead to a partial refund to the insurer

Only contracts with constellations in which the insurance contract has a completely independent investment component that can even be cancelled separately have to be unbundled. In this case, the contract has to be separated and the investment component has to be accounted for using IFRS 9, while the insurance component is calculated using IFRS 17.

You can find post examples for the accounting of an insurance contract with a non-distinct investment component in the appendix.

- I.a Example premium allocation approach (page 62)
- I.b Example building block approach (page 64)

2.2.2 Service components

Service components – e.g., non-insurance services, such as pension administration, underwriting or claims settlement services, claim protection services, asset management or custody services.

Note: For the purpose of separation, the entity shall not consider activities that it must undertake to fulfil a contract unless the entity transfers a good or service to the policyholder as those activities occur. That means activities in fulfilling the host contract are not-distinct service components, i.e., if they contribute only to the overall service of the host contract rather than providing a direct separate service to the policyholder. An example of such an activity is performing various administrative tasks to set up a contract (IFRS 17.B33). Therefore, initially, an activity shall be scrutinized against these criteria.

A promise to transfer goods or services would be distinct and separated from the insurance contract if the policyholder can benefit from the service either on its own or with resources that are readily available to the policyholder. Readily available resources are goods or services that the entity (or another entity that does not issue insurance contracts) regularly sells separately in the same market or jurisdiction or that the policyholder has already got (IFRS 17.B34).

73 KPMG Insurance Contracts First Impressions IFRS 17, July 2017, page 88, IFRS 17.BC99-B100.

However, a service is not distinct and shall be accounted for together with the insurance component if:

- "The cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract; **and**
- The entity provides a significant service in integrating the good or non-insurance service with the insurance components" (IFRS 17.12, B35) – e.g., the entity is using the service as an input to produce the output specified in the insurance contract.

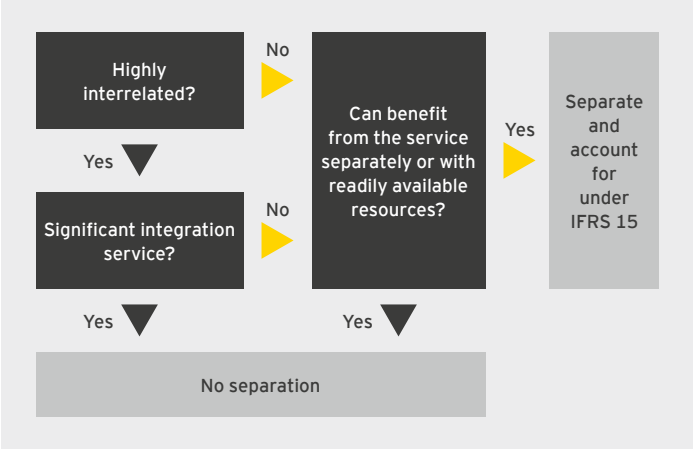


Figure 5.3

Examples of non-distinct service components:

- Administrative tasks to fulfil the contract (underwriting, claims management, asset management) fulfilled by the insurer

Example: Separating components from a life insurance contract with an account balance (IFRS 17 Illustrative Example 4 [IE43–50])

A life insurance contract with an account balance has the following terms.

- The policyholder pays a premium of CU 1,000 when the contract is issued.
- The account balance is:
  - Increased annually by voluntary amounts paid by the policyholder;
  - Increased or decreased by investment returns from specified assets; and
  - Decreased by asset fees charged by the entity
- The entity has a claims processing department to process the claims and an asset management department to manage investments.
- The pay-out comprises:
  - A death benefit of 5,000 if the policyholder has died; plus
  - An amount equal to the account balance, whether the policyholder has died or cancelled the contract.

Another financial institution sells an investment product equivalent to the account balance, but without the insurance coverage.

Analysis

Separating claims processing services
Claims processing services are part of the activities the entity must undertake to fulfil the contract, and the entity *does not transfer a good or service* to the policyholder because the entity performs those activities. Therefore, according to IFRS 17.B33, these activities shall not be considered for the purpose of separation (are not distinct).[74]

Separating the asset management services
The asset management services, similarly to claims processing services, are part of the activities the entity *must undertake to fulfil the contract,* and *no transfer of goods or services* to the policyholder occurs because the entity performs those activities. The same conclusion as above applies. (IFRS 17.IE50)

Separating the account balance (investment component)
The fact that a comparable investment product is sold by another financial institution indicates that the components may be distinct. However, if the right to death benefits provided by the insurance coverage either lapses or matures at the same time as the account balance, the insurance and investment components are highly interrelated (IFRS 17.IE48). As a result, the account balance is not considered distinct and is, therefore, not separated from the insurance contract. However, if the policyholder could at any time withdraw amounts from the funds without affecting the coverage and the amounts would even in the case of death remain until maturity date, the investment component could be distinct.

In practice, this means, that all usual administrative tasks that the insurer fulfills for his policyholder that are needed to fulfil the contract are highly interrelated and therefore, don't have to be separated. In cases where the (re)insurer fulfills tasks in addition to the normal administrative tasks, this task can be a distinct and independent service component that has to be separated.

74 IFRS 17.IE49.

Examples for distinct service components:

- Outsourced claims handling in a stop-loss contract as shown in the IFRS 17 Illustrative examples no. 5 (see below)

Example: Separating components from a stop-loss contract with claims processing services (IFRS 17 Illustrative Example 5 [IE51–55])

Assumptions: An entity issues a stop-loss contract to an employer (the policyholder). The contract provides health coverage for the policyholder's employees and has the following features:

- Insurance coverage of 100% for the aggregate claims from employees exceeding CU25 million (the stop-loss threshold). The employer will self-insure the aggregate health cost from employees up to CU25 million.

- Claims processing services (without any check of validity of claims) for employees' claims during the next year, regardless of whether the claims have passed the stop-loss threshold of CU25 million. The entity is responsible for processing the health insurance claims of the employees on behalf of the employer.

The entity considers whether to separate the claims processing services (assumption: the compensation is per case of payment). The entity notes that similar services to process claims on behalf of customers are sold on the market.

Analysis

Note: It is important that it is not claims settlement with checking for validity but only reimbursement of any delivered bill. If it were to include checking of validity, it would contribute to the protection of the insurer regarding the stop-loss and would therefore be non-distinct.

Separating the claims processing services
The criteria for identifying distinct non-insurance services (in IFRS 17.B34) are met in this example:

- The claims processing services, similar to the services to process the employees' claims on behalf of the employer, are sold as a standalone service without any insurance coverage; and

- The claims processing services *benefit the policyholder independently of the insurance coverage*. Had the entity not agreed to provide those services, the policyholder would have to process its employees' medical claims itself or engage other service providers to do this.

Additionally, the criteria in paragraph B35 that establishes if the service is not distinct are not met because the cash flows associated with the claims processing services are not highly interrelated with the cash flows associated with the insurance coverage, and the entity does not provide a significant service of integrating the claims processing services with the insurance components. In addition, the entity could provide the promised claims processing services separately from the insurance coverage.

Accordingly, the entity separates the cost payment services from the insurance contract and accounts for them applying IFRS 15, Revenue from Contracts with Customers.

In this example the insurer and the reinsurer have a stop-loss contract. In addition to fulfilling the contract when the stop-loss threshold is reached, the reinsurer manages all the claims for the policyholder. This service does not normally belong to the activities of a reinsurer in a stop-loss contract and therefore has to be treated as a separate service component for the reinsurer.

In addition to these types of traditional service components, there are also fixed-fee service components.

2.2.2.1 Fixed-fee Service Contracts

"A fixed-fee service contract is a contract under which the level of service depends on an uncertain event."[75] Fixed-fee service contracts meet the definition of insurance contracts because:

- "It is uncertain whether, or when, a service will be needed;

- The policyholder is adversely affected by the occurrence of the event; and

- The issuer compensates the policyholder if a service is needed."[76]

The fact that the issuer provides goods or services to the policyholder to settle its obligation to compensate the policyholder for insured events would not preclude a contract from being an insurance contract.[77] IFRS 17.8 permits a fixed-fee service contract whose primary purpose is the provision of services for a fixed fee to be accounted under IFRS 15 like other service contracts with customers instead of applying IFRS 17 if, and only if, the following conditions are met:

- The contract price set by the entity does not reflect an assessment of the risk that is associated with an individual; and

75 IFRS 17.BC95.
76 IFRS 17.BC95.
77 IFRS 17.B6.

- The contract compensates customers by providing a service, rather than by making cash payments; and
- The insurance risk that is transferred by the contract arises primarily from uncertainty about the frequency of the counterparty's use of service rather than from uncertainty over the cost of those services.

This choice can be made on a contract-by-contract basis and is irrevocable for each contract.[78]

Examples for contracts that may be accordingly excluded from the scope of IFRS 17:[79]

- Roadside-assistance programs
- Fixed-fee service arrangements
- Maintenance contracts

Fixed-fee service contracts may also be part of an insurance contract (for example: a classical car insurance contract that includes a roadside-assistance contract instead of a standalone roadside-assistance contract). As there is a choice whether to account for the standalone fixed-fee service contract as an IFRS 15 or an IFRS 17 contract according to IFRS 17.8, our opinion is, there must be the same choice for a distinct "service" within an insurance contract which fulfills as a standalone contract the definition of a fixed fee service (see illustration below). Otherwise, an entity would be in a less favorable position in the case of combining a fixed-fee service contract with an insurance contract. In that case the insurance component is accounted for using IFRS 17 and the service component using IFRS 15.

78 IFRS 17.8.
79 IFRS 17.BC95.

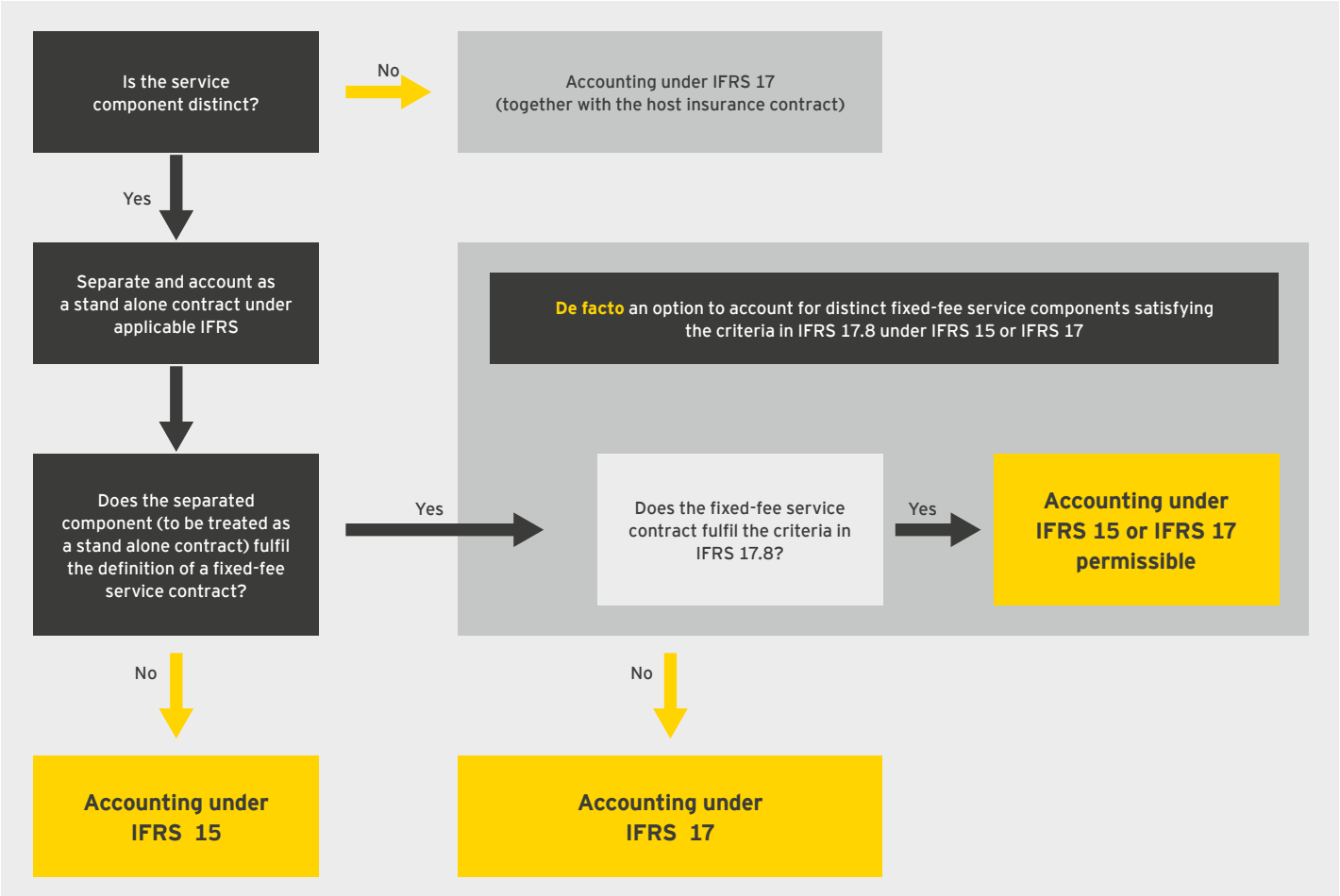


Figure 5.4

2.2.2.2 *Accounting of fixed-fee service components – to separate or not to separate?*

In case of separation, the amount of the service component has to be determined. IFRS 15.7(a) states that if one or more parts of the contract fall under the scope of other IFRSs specified in IFRS 17.5, the measurement requirements in these other IFRS standards shall be applied first if those other standards specify how to measure the other components. IFRS 17 contains measurement requirements for insurance contracts. So, after having applied IFRS 17.12, to identify and, if applicable, to separate any distinct service components from the contract, the entity applies IFRS 17 to all remaining components of the insurance contract (IFRS 17.13), i.e., the value of all remaining components is determined applying the measurement requirements of IFRS 17.32 ff. The service component may be determined as a residual value. The effects of the insurance component are shown as an insurance service result, whereas the result of the service component is shown in the other result.

By following the "true and fair view" principle under IFRSs, the IFRS 15 component cannot have a value that differs too much from the standalone selling price. That means, it is not allowed to improve the profitability of an insurance contract by assuming higher profit margins than in standalone contracts in order to get a better insurance result and a worse other result. An onerous standalone contract cannot become profitable by adding a service component.

Simplified examples:

An insurer issues an IFRS 17 contract combined with a service component, e.g., a roadside-assistance feature. In the example, the PAA is used. The expected results on an estimation basis are shown below:

Example 1

		Insurance	Service	Sum
Pricing	Premium/revenue	1,200	200	1,400
–	Claims/expenses	1,100	100	1,200
=	**P&L**	**100**	**100**	**200**
%	Loss ratio	91.67	50.00	85.71

Table 5.3

Assuming that the service qualifies for a distinct fixed-fee service contract, there could be non-accounting reasons for separating the service component from the insurance contract. In example 1, an insurer would probably choose no separation as the loss ratio of the entire contract (85.71%) would be better than the standalone insurance contract (91.67%).

Insurance-oriented controlling with a focus on typical KPIs, like loss ratio or combined ratio could prefer separation in the situation shown in example 2:

Example 2

		Insurance	Service	Sum
Estimation	Premium/revenue	1,200	200	1,400
–	Claims/expenses	1,000	200	1,200
=	**P&L**	**200**	**0**	**200**
%	Loss ratio	83.33	100.00	85.71

Table 5.4

Accounting for the separated components:

1 Jan	Cash	1,400	LRC	1,200
			Deferred Revenue	200
31 Dec	Insurance revenue			1,200
	Insurance service costs			–1,000
	Insurance results			**200**
	Non technical income			200
	Non technical expenses			–200
	Non technical income			**0**
	Net income P&L			**200**

Table 5.5

In the second example, the loss ratio of the standalone insurance contract (83.33%) would be better than the loss ratio of the combined contract (85.71%). Moreover, the insurance result in the P&L would also be better by separating both components.

In the case that the service component has a negative result or a worse result than the insurance component (as shown in the second example), it would be reasonable for an insurer to separate the service component in order to achieve a better insurance result. In our opinion, in the majority of insurance companies it will probably be too expensive to calculate a separated service component. Moreover, we expect that most insurance companies, at least in Germany, only have immaterial amounts of service components, so separation will not need to be performed.

In our opinion, there are only a few service components that are distinct and have to be separated in the German insurance business. Most service components are closely related to the insurance contract as they are fulfilled by the insurer itself. Moreover, most insurance companies will probably not have large numbers of insurance portfolios with distinct (fixed-fee) service components. A low percentage of service within the insurance portfolios is expected.

3 Points to consider within the IFRS 17 implementation process

In particular during the IFRS 17 implementation process for insurance groups, it is initially absolutely crucial to have all the information needed to assess whether there are terms and conditions or components within the insurance and reinsurance contracts that could lead to the separation issue.

Therefore, it is advisable to break down the separation-issue into four sub-topics or tasks within the scope of the IFRS 17 project:

- Analysis and identification
- Measurement
- Accounting
- Intercompany-issues

The following sections offer some practical insights with regard to the IFRS 17 separation issue.

3.1 Analysis and identification

In practice, most insurers will place particular emphasis on the identification and assessment of embedded derivatives and service components rather than on distinct investment components. At least in the German insurance practice we observe a very strong link between the insurance and the investment components that regularly results in classification as highly related components according to IFRS 17.B32. Since highly related investment components are not considered distinct under IFRS 17 (see IFRS 17.B31(a)) we have yet to identify any examples of distinct investment components in the German insurance practice.

Nevertheless, these processes can be certainly combined with the process of the analysis and identification as well as with the process of measurement of non-distinct investment components. Since the accounting of non-distinct investment components will be an important item, e.g., in the commercial lines of property & casualty of insurers and reinsurers as well as in the life insurance business, a database which includes all issued and ceded groups of contracts, e.g., line of business (LoB) by LoB, should be implemented with all of their components and features, for example sliding-scale provisions and other profit-sharing features.

Although the non-distinct investment component does not lead to separate accounting according to IFRS 17, it is recommended to include this issue in the analysis and identification as well as in the measurement projects. Note that all types of profit participation such as sliding scale provision in the property and casualty (P&C) or guaranteed surrender values in the life insurance are very likely, however, subject to an individual assessment, should to be classified as non-distinct investment components with impact on the technical IFRS 17 accounting. That is why, in our opinion, the majority of issues will come from non-distinct investment contracts which actually will not have to be separated from IFRS 17 but accounted for within IFRS 17 in a specific manner. In general, when it comes to the analysis and identification of the existing contracts, a complete database with information about all features of the crucial points must be set up.

3.2 Measurement

Separation requirements of service components, embedded derivatives or in more seldom circumstances distinct investment components lead to measurement and accounting under IFRS 15 and/or IFRS 9. Insurance groups with relevant items have to develop non technical know-how regarding measurement, revenue recognition and accounting to estimate the value of these components.

In this context, it could be interesting to consider the opportunities of the distinct fixed-fee service component already during the product and pricing process of service features. This is why they may be accounted for under IFRS 15 in certain circumstances.

In terms of the non-distinct investment component, the minimum repayments have to be considered. Furthermore these components must be monitored separately when setting assumptions, respectively projecting cash flows for both, life and non-life insurers.

3.3 Accounting

A very close commitment between the controlling and accounting functions regarding the influence of the separation effects on the group key performance indicators is recommended.

The group accounting manuals should include instructions regarding separation items. Once they are identified and measured, the accounting itself should not be a big challenge, except the issue of non-distinct investment components.

The accounting for fixed-fee service contracts using IFRS 15 is similar to using the IFRS 17 PAA approach (IFRS 17 BC 96). That is why the IASB expects insurers to generally apply the PAA for such contracts. We expect these contracts to have a higher impact on the non-life insurance business than on the life insurance business.

Accounting for non-distinct investment components under IFRS 17 will be the more complex part compared with separated services, embedded derivatives or even distinct investment components. The insurance revenues and expenses will be reduced by the effects of the investment components. Consequently, especially life insurers will experience large impacts on their revenues and expenses as they typically have significant investments components. Thus the release of CSM and risk adjustment are the relevant drivers for presenting insurance revenue of these companies. Moreover, the non-life (re)insurers with significant profit sharing features and other investment components will see a reduction in insurance revenue as well.

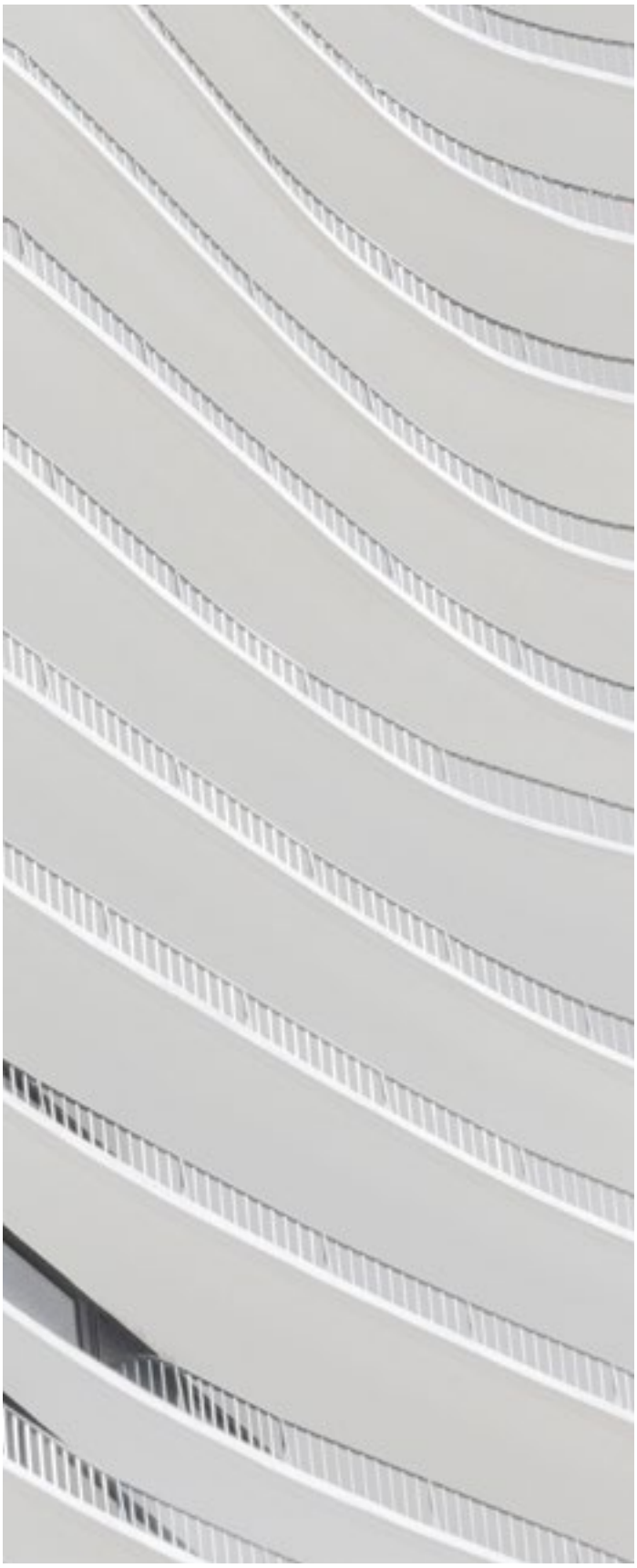
Finally, there should be a group-wide commitment on a materiality concept with regard to the accounting simplification for non-significant components.

3.4 Intercompany differences

When service components, embedded derivatives or in more seldom circumstances distinct investments components have to be accounted for under IFRS 15 or IFRS 9, group internal issues could arise. In this case of group-internal transactions (intercompany transactions), for example internal reinsurance, the separation requirements could lead to differences between the measurement and presentation of separate components. An example could be a claims management feature as a separate service component of an intercompany reinsurance contract. It may be the case that in the IFRS 8 segment reporting an insurer presents ceded premiums and/or claims handling expenses, however, insurance-technical items, whereas the partner within the same group has to show non-technical IFRS 15 revenues in its specific segment reporting.

Regarding both internal and external insurance contracts, a group manual with permissible and prohibited contract components and features is recommended. There might be complexity which could be monitored by a group internal clearing office.

In terms of IC reconciliation, a uniform measurement of the non-distinct investment component, gross and ceded, within an entire insurance group is needed to avoid IC differences on both the gross-ceded and the intersegment reconciliation.



4 Conclusion

There will not be significant differences or new requirements in terms of the separation issue. However, there will be big changes in the treatment of non-distinct investment components which will lead to lower revenues as well as lower technical expenses.

Potential new separation requirements will result from contracts with service components and embedded derivatives.

One first outcome of the initial implementation steps is that the complexity and resource-consuming issue will be the non-distinct investment components. We refer specifically to section 3 (points to consider within the IFRS 17 implementation process).

For embedded derivatives, IFRS 4 contains one option (accounting policy concerning separation) and one exception (policyholder option to surrender) that have not been carried forward to IFRS 17 (see 2.1). However, these changes are expected to have little impact in practice. Moreover IFRS 17 explicitly prohibits the separation of an embedded derivative if the embedded derivate and the host contract are so interdependent that the entity cannot measure the derivative separately (see 2.1). The rules for separation are mostly the same and there are only a few practical examples for embedded derivatives that have to be separated as most embedded derivatives are highly interrelated with the insurance contract. The examples shown in the former IFRS 4.8 for embedded derivatives or in the implementation guidance of IFRS 4 have not been transferred to IFRS 17. Every embedded derivative has to be checked under IFRS 17 in accordance with IFRS 9 whether a separation is required, or not.

A new requirement affects the non-distinct investment components. For non-distinct investment components that do not have to be unbundled, there is a difference in the presentation compared to IFRS 4. Under IFRS 17, the investment component will only be shown in the statement of financial position (part of LRC/LIC), however, it does not have an effect on the P&L.[80] Under IFRS 4, the entire contract is shown in the technical result. From our point of view, this new accounting for non-distinct investment components results in a high level of complexity and is very cost-consuming especially regarding processes and IT (e.g., set-up of new database) and will be one of the challenges for the determination of insurance revenue. Amounts such as some explicit account balances, some no-claim-bonuses and cash surrender values of whole-life contracts etc. need to be considered in the future.

Service components do not need to be separated under IFRS 4. The entire contract is disclosed as an insurance contract, regardless of whether the service component is distinct or not. Under IFRS 17, service components only need to be separated if they are distinct. Most administrative tasks such as underwriting, claims handling, asset management, etc. are closely related to the contract and cannot be measured on a standalone basis if the insurer itself fulfills these tasks. Only additional services of the normal administrative services that are needed to fulfil the insurance contract can be distinct and therefore be separated. In the case of separation, the service result is shown in the other result and the insurance component is shown in the technical result.

Finally there is an option to account for fixed-fee service contracts according to IFRS 15 contracts only if they fulfil the specific definition. From our point of view, that option also exists if an insurance contract and a distinct fixed fee service contract are combined as described in section 2.2.2.1. This gives management room for accounting policies.

80 Excluded from (re)insurance revenue and insurance service expense in the income statement, see section 2.2.1.

5 Appendix

a. Example premium allocation approach

Posting example for the accounting of an insurance contract with a non-distinct investment component (PAA):

- Coverage period 01.01.2015–31.12.2015
- Premium is paid on 1 January 2015
- Expected claims: 80, linear risk distribution
- Claims will be paid at the end of year 3 (31.12.2017)
- Expected compensation payments will be reserved linear until Q3 2017
- Profit participation for the policyholder will be paid after claims are paid at the end of year 3 and amount to 40% of the technical result (in case the expected claims experience happens : 40% (100–80) = 8)

For simplification reasons, we do not consider interest, costs, risk margin.

With these contractual terms, the policyholder will receive at least 40, even if no damage occurs. That means the investment component amounts to 40 and has to be separated from the insurance revenue.

Payments in case of expected development:		
01.01.2015	100	Premium
31.12.2017	–80	Claims payments
21.12.2017	–8	Profit participation
P&L	**12**	

Table 5.6

The investment component that needs to be separated consists of the profit participation of 8 and the claims of 32 and are expenses in the P&L.

01.01.2015	100	Premium
31.12.2017	–48	Claims payments (shown as claims expenses in the p&l)
31.12.2017	–32	Claims expenses (shown as investment component)
21.12.2017	–8	Profit participation (shown as investment component)
P&L	**12**	

Table 5.7

Posting records: 01.01.2015

Debit: cash 100/Credit: LRC 100

PAA/Balance sheet as at 1 January 2015			
	A	P	
Cash	100	0	Share capital
		0	Retained earings
		100	Liability for remaing coverage
		0	Liability for incurred claims (compensation payments)
		0	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 1 January 2015	
Insurance revenue	0
Claims expenses	0
P&L	**0**

Table 5.8

Posting records: 31.03.2015

Debit. LRC 15/Credit: insurance revenue 15
Debit: claims expenses 12/Credit: LIC (compensation payments) 12
Debit: LRC 10/Credit: LIC (investment component) 10

Balance sheet as at 31 March 2015			
	A	P	
Cash	100	0	Share capital
		3	Retained earings
		75	Liability for remaing coverage
		12	Liability for incurred claims (compensation payments)
		10	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 31 March 2015 (Q1 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.9

Posting records: 30.06.2015

Debit: LRC 15/Credit: insurance revenue 15
Debit: claims expenses 12/Credit: LIC (compensation payments) 12
Debit: LRC 10/Credit: LIC (investment component 10)

Balance sheet as at 30 June 2015			
	A	P	
Cash	100	0	Share capital
		6	Retained earings
		50	Liability for remaing coverage
		24	Liability for incurred claims (compensation payments)
		20	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 30 June 2015 (Q1 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.10

Posting records: 30.09.2015

Debit: LRC 15/Credit: insurance revenue 15
Debit: claims expenses 12/Credit: LIC (compensation payments) 12
Debit: LRC 10/Credit: LIC (investment component 10)

Balance sheet as at 30 September 2015			
	A	P	
Cash	100	0	Share capital
		9	Retained earings
		25	Liability for remaing coverage
		36	Liability for incurred claims (compensation payments)
		30	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 30 September 2015 (Q3 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.11

Posting records: 31.12.2015

Debit: LRC 15/Credit: insurance revenue 15
Debit: claims expenses 12/Credit: LIC (compensation payments) 12
Debit: LRC 10/Credit: LIC (investment component 10)

Balance sheet as at 31 December 2015			
	A	P	
Cash	100	0	Share capital
		12	Retained earings
		0	Liability for remaing coverage
		48	Liability for incurred claims (compensation payments)
		40	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 31 December 2015 (Q4 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

P&L as at 31 December 2015 (Q1–Q4 2015)	
Insurance revenue	60
Claims expenses	48
P&L	**12**

Table 5.12

Posting records: 31.12.2016

No posting records as the statements of financial position remain unchanged

Balance sheet as at 31 December 2016 (=Balance sheets as at 31.12.2015)			
	A	P	
Cash	100	0	Share capital
		12	Retained earings
		0	Liability for remaing coverage
		48	Liability for incurred claims (compensation payments)
		40	Liability for incurred claims (investment component)
	100	**100**	

Table 5.13

Posting records: 31.12.2017

Debit: LIC (compensation payments) 48/Credit: cash 48
Debit: LIC (investment component) 40/Credit: cash 40

Balance sheet as at 31 December 2015			
	A	P	
Cash	12	0	Share capital
		12	Retained earings
		0	Liability for remaing coverage
		0	Liability for incurred claims (compensation payments)
		0	Liability for incurred claims (investment component)
	12	**12**	

P&L as at 31 December 2015 (Q4 2017 stand alone)	
Insurance revenue	0
Claims expenses	0
P&L	**0**

P&L as at 31 December 2015 (Q1 2015–Q4 2017 stand alone)	
Insurance revenue	60
Claims expenses	48
P&L	**12**

Table 5.14

5 Appendix

b. Example building block approach

Posting example for the accounting of an insurance contract with a non-distinct investment component (BBA):

- Coverage period 01.01.2015–31.12.2015
- Premium is paid on 1 January 2015
- Expected claims: 80, linear risk distribution
- Claims will be paid at the end of year 3 (31.12.2017)
- Expected compensation payments will be reserved linear until Q3 2017
- Profit participation for the policyholder will be paid after claims are paid at the end of year 3 and amount to 40% of the technical result (in case the expected claims experience happens : 40% (100 – 80) = 8)

For simplification reasons, we do not consider interest, costs, risk margin.

With these contractual terms, the policyholder will receive at least 40, even if no damage occurs. That means the investment component amounts to 40 and has to be separated from the insurance revenue.

Payments in case of expected development:		
01.01.2015	100	Premium
31.12.2017	–80	Claims payments
21.12.2017	–8	Profit participation
P&L	**12**	

Table 5.15

The investment component that needs to be separated consists of the profit participation of 8 and the claims of 32 and are expenses in the P&L.

01.01.2015	100	Premium
31.12.2017	–48	Claims payments (shown as claims expenses in the p&l)
31.12.2017	–32	Claims expenses (shown as investment component)
21.12.2017	–8	Profit participation (shown as investment component)
P&L	**12**	

Table 5.16

Posting records: 01.01.2015

Debit: Cash 100/Credit: LRC.SM 12/Credit: LRC.CF 88

BAA/Balance sheet as at 1 January 2015			
	A	P	
Cash	100	0	Share capital
		0	Retained earings
		12	LRC.CSM
		88	LRC.CF
		0	Liability for incurred claims (compensation payments)
		0	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 1 January 2015	
Insurance revenue	0
Claims expenses	0
P&L	**0**

Table 5.17

Posting records: 31.03.2015

Debit: LRC.CSM 3/Credit: insurance revenue 3
Debit: LRC.CF 12/Credit: insurance revenue 12
Debit: claims expenses 12/Credit: liability for incurred claims (compensation payments) 12
Debit: LRC.CF 10/Credit: liability for incurred claims (investment component) 10

Balance sheet as at 31 March 2015			
	A	P	
Cash	100	0	Share capital
		3	Retained earings
		9	LRC.CSM
		66	LRC.CF
		12	Liability for incurred claims (compensation payments)
		10	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 31 March 2015 (Q1 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.18

Posting records 30.06.2015

Debit: LRC.CSM 3/Credit: insurance revenue 3
Debit: LRC.CF 12/Credit: insurance revenue 12
Debit: claims expenses 12/Credit: liability for incurred claims (compensation payments) 12
Debit: LRC.CF 10/Credit: liability for incurred claims (investment component) 10

Balance sheet as at 30 June 2015			
	A	P	
Cash	100	0	Share capital
		6	Retained earings
		6	LRC.CSM
		44	LRC.CF
		24	Liability for incurred claims (compensation payments)
		20	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 30 June 2015 (Q2 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.19

Posting records 30.09.2015

Debit: LRC.CSM 3/Credit: insurance revenue 3
Debit: LRC.CF 12/Credit: insurance revenue 12
Debit: claims expenses 12/Credit: liability for incurred claims (compensation payments) 12
Debit: LRC.CF 10/Credit: liability for incurred claims (investment component) 10

Balance sheet as at 30 September 2015			
	A	P	
Cash	100	0	Share capital
		9	Retained earings
		3	LRC.CSM
		22	LRC.CF
		36	Liability for incurred claims (compensation payments)
		30	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 30 September 2015 (Q3 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

Table 5.20

Posting records 31.12.2015

Debit: LRC.CSM 3/Credit: insurance revenue 3
Debit: LRC.CF 12/Credit: insurance revenue 12
Debit: claims expenses 12/Credit: liability for incurred claims (compensation payments) 12
Debit: LRC.CF 10/Credit: liability for incurred claims (investment component) 10

Balance sheet as at 31 December 2015			
	A	P	
Cash	100	0	Share capital
		12	Retained earings
		0	LRC.CSM
		0	LRC.CF
		48	Liability for incurred claims (compensation payments)
		40	Liability for incurred claims (investment component)
	100	**100**	

P&L as at 31 December 2015 (Q4 2015 stand alone)	
Insurance revenue	15
Claims expenses	12
P&L	**3**

P&L as at 31 December 2015 (Q1-Q4 2015)	
Insurance revenue	60
Claims expenses	48
P&L	**12**

Table 5.21

Posting records: 31.12.2016

No posting records as the statements of financial position remain unchanged

Balance sheet as at 31 December 2016 (=Balance sheets as at 31.12.2015)			
	A	P	
Cash	100	0	Share capital
		12	Retained earings
		0	LRC.CSM
		0	LRC.CF
		48	Liability for incurred claims (compensation payments)
		40	Liability for incurred claims (investment component)
	100	**100**	

Table 5.22

Posting records 31.12.2017

Debit: LIC (compensation payments) 48/Credit: cash 48
Debit: LIC (investment component) 40/Credit: cash 40

Balance sheet as at 31 December 2017			
	A	P	
Cash	100	0	Share capital
		12	Retained earings
		0	LRC.CSM
		0	LRC.CF
		0	Liability for incurred claims (compensation payments)
		0	Liability for incurred claims (investment component)
	100	**12**	

P&L as at 31 December 2017 (Q4 2017 stand alone)	
Insurance revenue	0
Claims expenses	0
P&L	**0**

P&L as at 31 December 2017 (Q1-Q4 2017)	
Insurance revenue	60
Claims expenses	48
P&L	**12**

Table 5.23

IFRS 17 AND ITS IMPACT ON GERMAN AND INTERNATIONAL INSURANCE BUSINESS

6

EY
Dr. Thomas Kagermeier
Dr. Catharina Wintermantel

1 Introduction

1.1 Not an "accounting project" but an accounting-driven project

IFRS 17 is the international accounting standard previously known as IFRS 4 – after 20 years of development – and introduces new accounting rules for the recognition, measurement, presentation and disclosure of insurance contracts and increases the transparency of reported profit and loss over time. But the accounting world for insurance companies will not only be changed by IFRS 17: IFRS 9 focuses on financial assets and brings insurers more in line with banks. Most insurers have delayed the adoption of IFRS 9 to the IFRS 17 transition date and will apply both standards for the first time for the year 2021. The standards will have a significant impact on the whole insurance industry: for those who have to prepare the financial statements, for those who have to explain it and for those who have to understand it for future economic decisions.

Insurers are currently at different stages in approaching IFRS 17. The year 2018 will generally be a year of impact assessment, planning, solution blueprint design and business case development.

IFRS 17 affects the financial reporting, financial planning and analysis and the way the business is managed. The impact of this standard covers the full range of people, systems, data, processes and investor story. The first wave of work started in 2017, focusing on financial and operational impact assessment and followed by a second wave of design and building to be delivered across 2018 and 2019. IFRS 17 solutions include a significant amount of accounting and actuarial components, but there are also major IT and data-related challenges to be addressed in order to successfully implement the new requirements.

For this reason, the standard cannot be regarded as a pure technical accounting standard, encompassing fundamental changes in accounting and reporting methodology and on the measurement of business. It is clear that this change, and the ongoing projects demonstrate this, has to be considered as an accounting-driven project, influencing many aspects such as actuarial aspects, IT components and finance change. The new standard is not triggered by an accounting element, which is usually the case for accounting changes, but heavily driven by actuarial and IT-related challenges. The big effort (and cost) comes with building and implementing new IT landscapes, proper IT-operating models as well as actuarial solutions. But ultimately the accounting rules are driving the direction of all the changes.

1.2 Proactive responses to IFRS 17

IFRS 17 includes many areas that have to be involved in the whole workstream of assessing and implementing the standard. Thus, the new accounting standard IFRS 17 calls for many proactive steps in the actuarial function, business finance and operations, controllership, taxation, management implications as well as pricing and investing. Below, it will be illustrated what type of areas essentially will be included in the transformation process. Due to the large amount of integrated functions the whole transformation process will be complex and extensive.

Actuarial function:

- Allocate time and resources to projects to design, build and test new data, modelling and systems capability
- Update methodology guidance for risk adjustment, discount curve and assumption setting
- Create a new calculation engine for amortizing and adjusting the contractual service margin (CSM)
- Work with the finance team to estimate impacts on transition and design optimal approaches
- Assist in ensuring the reported figures are auditable
- Analysis of earnings volatility and how to mitigate
- Perform in-depth analysis on impacts on ALM strategies

Business finance and operations:

- Assess current data availability against new data requirements for both model inputs and outputs
- Change the content and structure of data captured from business units to support group reporting
- Change the process for reporting that data to the group reporting team
- Enhance scrutiny of data quality, storage and archiving – given the retrospective transition requirements. This should happen ahead of the date of implementation.
- Enhance data reconciliation based on new data needs
- Enhance scrutiny of data governance and management
- Design new target operating model for finance
- Select, design and implement new IT-systems to facilitate efficient reporting

Controllership in accounting:

- Update the chart of accounts and accounting mappings to cover new disclosures
- Prepare pro forma statement of financial position, profit and loss (P&L) and note disclosure formats to meet new requirements
- Update accounting policies and practice manuals
- Analyze closing and reporting processes, including target operating model of finance function and updated responsibilities and timelines
- Design specific controls to drive new process quality, robustness and integration into existing control frameworks, enhancing efficiency to drive cost-effectiveness
- Update process and controls documentation and operating procedures
- Create new, or revise, existing internal (e.g., forecasts and other management reports) and external (e.g., investor and analyst packs) reporting templates
- Design and complete the significant note disclosures for each reporting period

Taxation:

- Determine the impact of IFRS 17 on current tax and deferred tax
- Engage with local tax authorities to discuss treatment if tax follows IFRS financials
- Consider other impacts such as data requests for tax compliance, tax impacts of new KPI's and changes to reward plans

Management implications:

- Communicate early to key stakeholders, including market analysts and shareholders, providing clarity around the expected impacts to the financial statements and profit profiles
- Analyze current management reporting, key performance indicators and incentive frameworks for ongoing applicability, and incorporate necessary changes for analyzing margins and volatility
- Update volatility and asset-liability management frameworks for measurement changes under IFRS 17 and assets under IFRS 9
- Evaluate any tax, capital or distributable profit implications

Pricing:

- Perform detailed reviews of product offerings and pricing strategy to adapt to changes in profit profiles

Investing:

- Review investment policies and asset liability management strategy based on the impact of the new measurement models on both insurance contracts and financial instruments
- Introduction

2 A proven program

2.1 IFRS 17 implementation program

In the next three years, insurers will face significant technical and practical changes. Most or all insurance companies launched their IFRS program in 2017 to assess the impact of these changes on their business, mobilize their implementation programs and inform their stakeholders. In our experience, it is essential to proactively maintain market confidence in an insurer's ability to execute these programs.

With the standard finalized and the effective date approaching, external stakeholder interest will increase. Insurers must be prepared to inform stakeholders of the expected impact and communicate their execution plans. This will require a well-planned program and a clear organizational view of the effects of the new standard.

EY has the experience to help insurers assess these effects and design and implement a cohesive program – as illustrated in Exhibit 6.1. The timing is based on the application of the temporary exemption to defer the IFRS 9 effective date until 1 January 2021.

Insurers will initially be faced with many issues, such as the decision of whether this is an insurance contract and if so, what is its relevant duration for determining the measurement approach? Further, the insurer will have to decide to what extent individual contracts can be grouped. Are any of the contracts onerous? In addition, it has to be determined whether non-insurance components need to be separated. Which of the three measurement models should be applied? What changes do we need to make to our valuation systems and processes?

This may require vast amounts of further additional data, one of the weightiest influences of the new standard. The insurance company will face the difficulty that additional data will be necessary for disclosures and presentation. Further, the insurer has to assess what the implications for the asset and liability management (ALM) will be. Finally, the insurance company must address the issue of which transition approach to use.

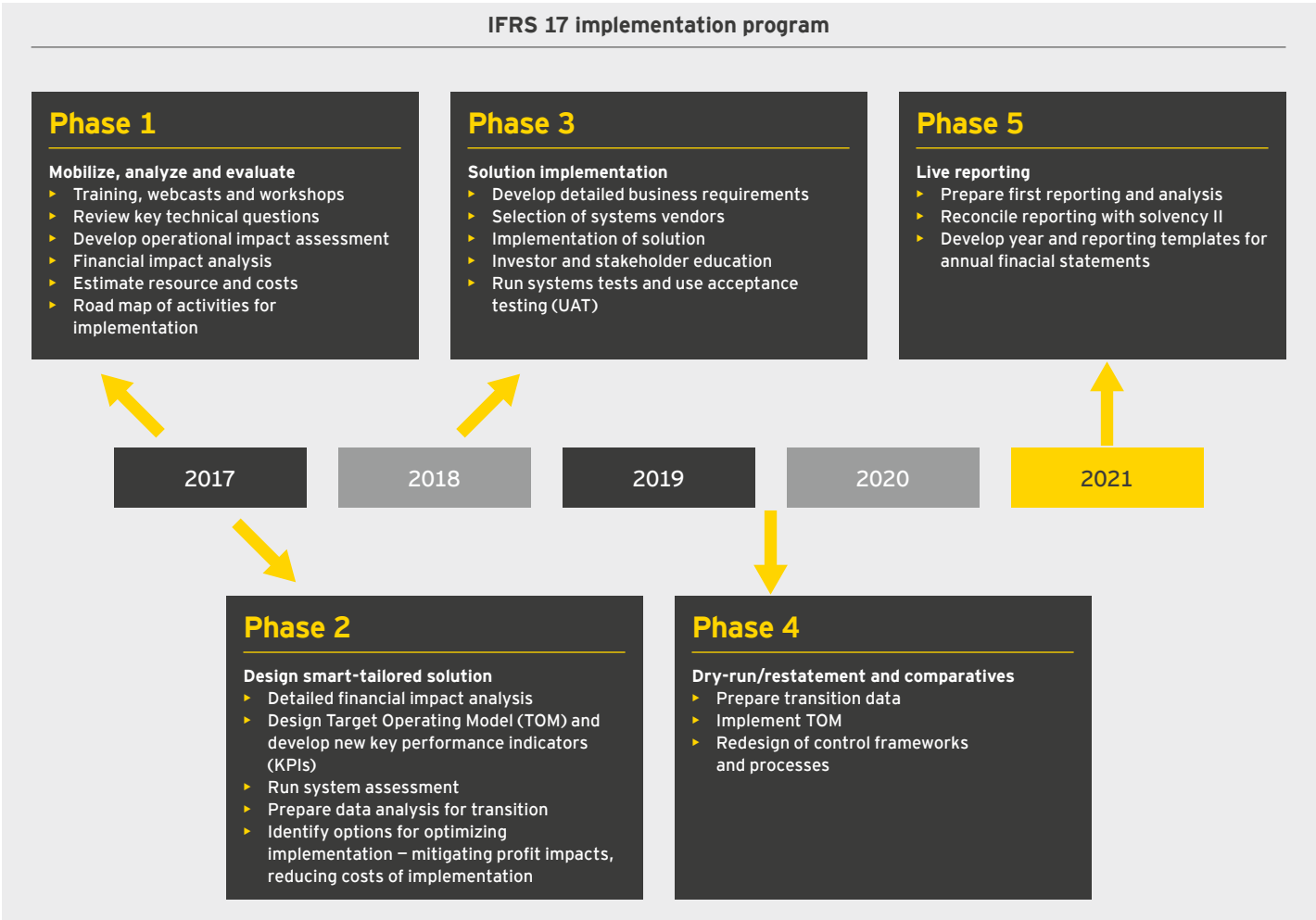


Exhibit 6.1

3 Features and challenges of the standard

2.2 The three measurement models

The new standard comprises three measurement models, the building block approach (BBA), the premium allocation approach (PAA) and the variable fee approach (VFA). These three approaches will be considered throughout this booklet, but they are briefly presented below.

The building block approach represents the default measurement approach. The insurance contract is measured using fulfillment cash flows – the present value of future cash flows, plus a risk adjustment. Any day one gain is offset by the contractual service margin (CSM), which represents unearned profit the insurer recognizes as it provides services under the contract. The CSM is unlocked for the impact of changes in cash flows and risk adjustment relating to future service.

The premium allocation approach (PAA) reflects an optional simplified approach for contracts with a coverage period of one year or less, or where it is a reasonable approximation to BBA. Many non-life, and some life, insurance contracts are expected to meet this criteria. The insurance contract is represented by a pre-claims coverage liability and an incurred claims liability. It is similar to existing non-life insurance contract approaches for pre-claims coverage liability (unearned premium). The incurred claims liability is measured using the fulfillment cash flows similar to Solvency II best estimate claim reserving.

The standard also introduces the variable fee approach (VFA) which applies to direct participating contracts, as defined by three criteria, based on policyholders being entitled to a significant share in the profit from a clearly identified pool of underlying items. The insurance contract liability is based on the obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a consideration charged for the contract – a "variable" fee. Changes in the financial assumptions are offset against the contractual service margin if they relate to future services. Insurance finance expenses match the investment income recognized on underlying items if the underlying items are held on the basis of the "current period book yield approach."

3.1 Marathon project

The IASB's Insurance Contracts project has been a marathon, not a sprint. However, we have passed the finish line now. In 2013, the Board issued a revised exposure draft (ED) on the accounting for insurance contracts.

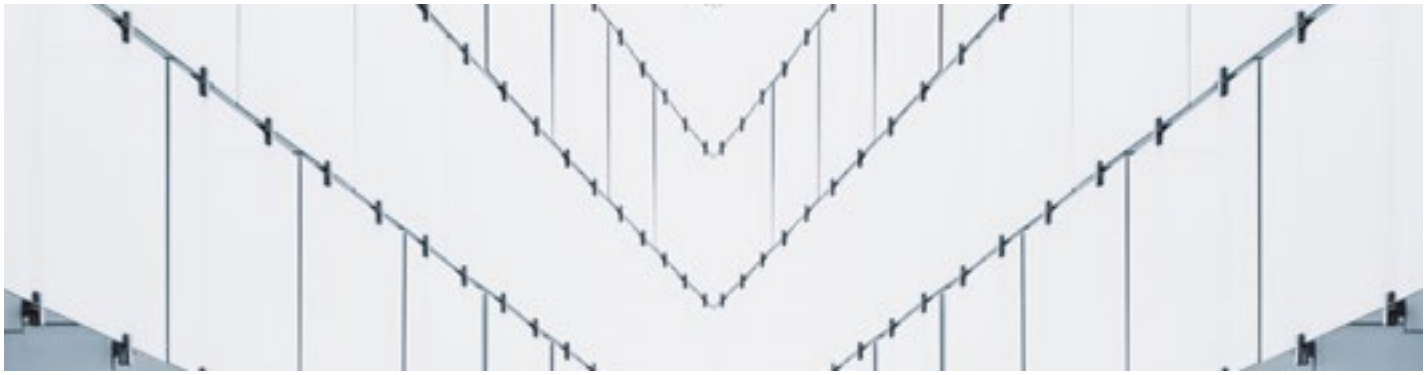
The Board received extensive feedback on the ED, including concerns that it would result in:

- Volatility in results that did not appropriately reflect the underlying performance
- A profit release pattern for participating contracts that did not reflect underlying economics
- Increased complexity that outweighed benefits

In response to the industry's concerns, the Board recognized the need to revisit many aspects of the standard. Its deliberations led to a number of extensive changes to the measurement model. On a number of topics, the IASB appears to have selected a number of pragmatic solutions with the aim of developing a standard acceptable to most in the international industry. Between September and November 2016, the IASB conducted targeted field testing with 12 insurance groups to further look into the impact of their proposals.

The standard has 1 January 2021 as the mandatory effective date (with early adoption permitted). Given this timing, insurers expressed concern that the introduction of the new standard is not in line with IFRS 9, Financial Instruments, which becomes effective from 1 January 2018. In response, the IASB issued amendments to IFRS 4, providing conditional options to address the issue of different effective dates of IFRS 9 and IFRS 17. These will mean that most insurers will be able to defer implementation of IFRS 9 until the date that IFRS 17 has become effective.

The accounting project of IFRS 17 will lead to a fully new accounting landscape. The standard will implicate many implementation challenges.



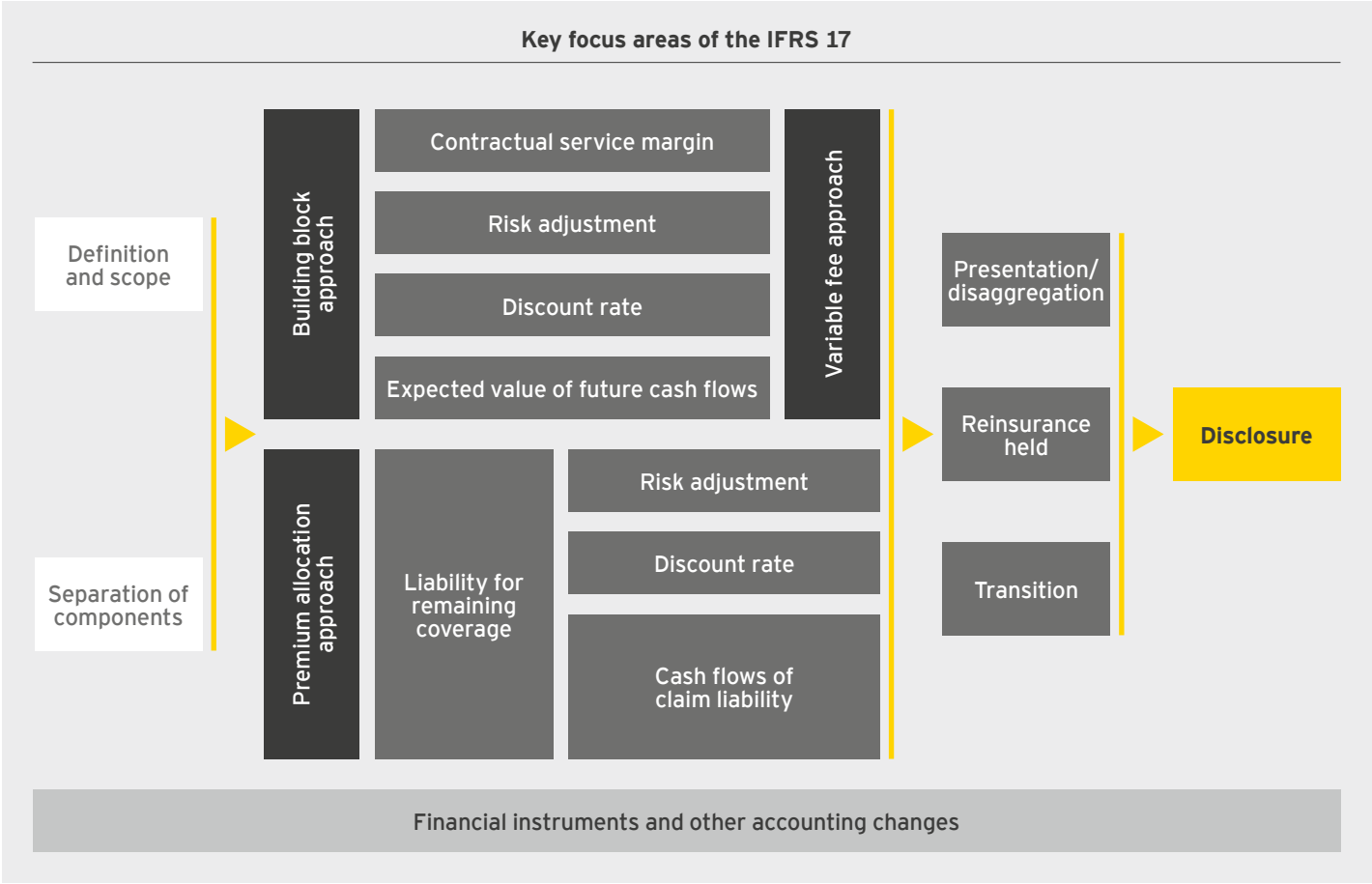


Exhibit 6.2

More granularity in contract groupings for measurement purposes will create additional complexity in the measurement models, process and data requirements. Furthermore, the liability adequacy test (LAT) will be replaced by an "onerous contracts" recognition test. This new test is expected to be measured at a more granular level than the current LAT, in many cases, with the potential for certain contracts to enter into loss recognition.

When law or regulation constrains the entity's ability to set a different price for policyholders with different characteristics, the entity may be able to include those contracts in the same group. Some life insurance contracts may be considered short term, potentially accelerating profit recognition and amortization of acquisition costs.

Some general insurance contracts may have to be treated as long term, becoming subject to a more complex measurement methodology. Additional guidance on the "significant insurance risk" test means contracts that are currently borderline or with deferred payment features may not meet the insurance contract definition. Key criteria such as the definition of an insurance contract, the level of aggregation (unit of account), and the mutualization will be portrayed in below mentioned sections of this booklet.

We generally expect these aggregation rules to result in more granular groupings than current European practice, necessitating more complex modelling, valuation processes and data requirements. This is particularly the case for long-duration participating business, with certain options and guarantees requiring stochastic valuation as in Solvency II.

Derecognition and the contract boundary is critical as it determines which measurement models are applicable, the periods over which profits are released and which future cash flows should be included for valuation purposes. Cash flows are within the boundary of an insurance contract when the entity can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage or other services. The insurer's substantive obligation ends when it can set a price or level of benefits that fully reflects the risk of the particular policyholder (or the portfolio of insurance contracts

that contains that contract) and the pricing of the premiums for coverage up to the date when risks are reassessed does not take into account the risks that relate to future periods. This means insurers will need to assess contract boundaries for all their contracts. For European companies, some life insurance products, such as stepped premium yearly renewable term, or regular premium unit linked contracts, could be subject to a one-year boundary. Depending on the relative size of the acquisition costs, some may fail the onerous contracts test in their first year, and will have accelerated amortization of their acquisition cash flows. Some general insurance contracts, such as engineering, construction or lenders mortgage insurance, are expected to have a contract boundary greater than one year and therefore may need to apply the building block approach rather than the premium allocation approach.

The requirement to be able to set a price or benefit that fully reflects the risk of that portfolio also raises the issue of whether some regulated or community-rated products have a one-year contract boundary or a boundary greater than one year.

3.2 Presentation and disaggregation

The standard includes specific requirements for presenting insurance-related balances in the financial statements. The biggest change for insurers can be seen in the statement of comprehensive income (SCI), which will now separate investment performance explicitly from an insurance services (or underwriting) result.

Exhibit 6.3 provides an example of which line items certain income and expense items will be recognized in. An entity will be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with the commonly understood notion of revenue, governed by IFRS 15, Revenue from Contracts with Customers. However, premium-related information could still be disclosed in the notes to the financial statements or in the segment reporting.

Rather than premium revenue, insurance revenue will be shown and calculated as described in Exhibit 6.3. This represents a fundamental change from today's top-line income statement presentation for life insurance contracts.

Claims and other expenses related to the insurance contracts will then be disclosed, leading to an underwriting result for the entity.

Illustrative statement of comprehensive income

Statement of comprehensive income	
Insurance revenue	✕
Insurance service expenses	(✕)
Insurance service result	✕
Investment income	✕
Insurance finance expense	(✕)
Finance result	✕
Other profit and loss	✕
Corporate tax	(✕)
Profit after tax	✕
Other comprehensive income	✕
Total comprehensive income	✕

- Release in contracual service margin
- Change in risk adjustment
- Expected claims (in fulfillment cash flows)
- Expected expense (in fulfillment cash flows)
- Allocating premium relating to the recovery of directly attributable acquisition costs
- **Excluding investment components**

- Actual claims incurred
- Actual expenses incurred
- Allocating premium relating to the recovery
- Onerous contacts
- **Excluding investment components**

- Calculated using locked-in rates (if the OCI option is selected)

- Effect of discount rate changes on fulfillment cash flow (if the OCI option is selected)

Exhibit 6.3

Premium revenue will no longer appear on the face of the P&L, but will be replaced by "insurance contracts revenue." This is calculated based on movements in a number of different elements, requiring stakeholder education about its meaning and importance. There is a risk that, if the new format does not provide useful information to investors, further supplementary information outside the financial statements will proliferate.

3.3 Disclosures

Some of the required disclosures are similar to the current disclosures insurers provide. Extensive new disclosures are required to show how the components of recognized amounts have moved during the period. Judgement will be needed to determine the appropriate level of disaggregation for the disclosures. It is likely that insurers will need to provide reconciliations to Solvency II information, embedded value reporting and cash metrics – both externally and for internal review purposes. Reconciliation between different reporting bases will be a key control over the accuracy and completeness of information provided.

One of the primary objectives of the IASB's project on insurance contracts is to increase transparency in insurers' financial statements. This includes providing information about: how much risk the insurer has taken on, how much uncertainty is contained in the amounts reported, what drives performance, how much an insurer expects to pay to fulfil its insurance contracts, and the value of embedded options and guarantees. Although some of this information can be provided on the face of the financial statements, much will come in the form of more detailed disclosures in the footnotes. Exhibit 6.4 provides a summary of these new disclosure requirements.

Some disclosure requirements are comparable to existing requirements under IFRS 4. However, new and more extensive disclosures are required for recognized amounts and roll-forwards. Furthermore, the guidance and discussion provided to date by the IASB suggests more granularity is expected than is currently the practice. In particular, the entity will need to determine the appropriate level of disaggregation of these disclosures, which might include:

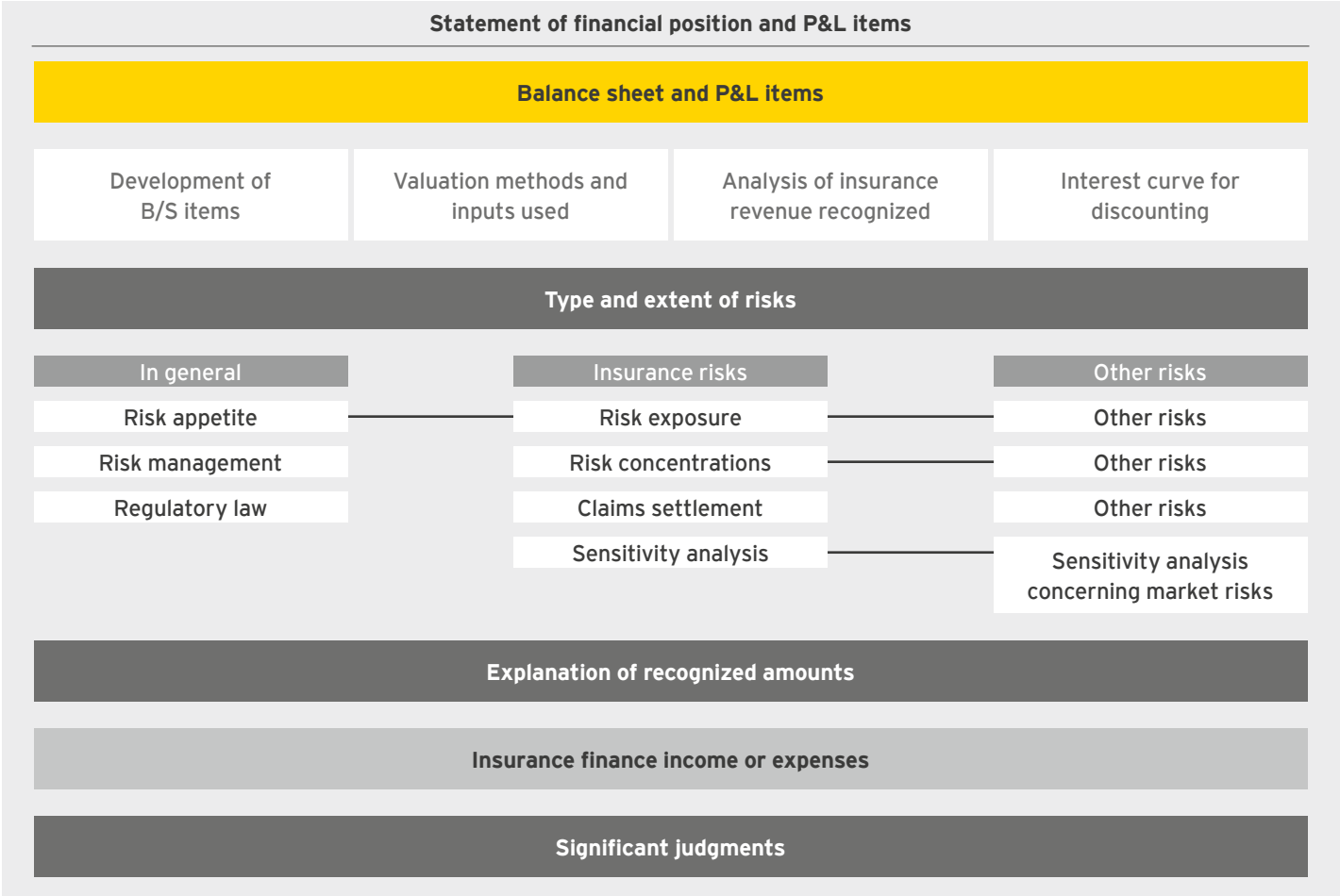


Exhibit 6.4

- Type of contract (e.g., major product lines)
- Geographical area
- Reportable segment

Insurers will need to develop systems, source data and valuation models to meet detailed and granular disclosure requirements on how the insurance contract liability and asset balances have moved during the period. These are comparable to analysis of movement disclosures reported by those adopting Embedded Value reporting measures. In any case, insurers will need to be able to reconcile between the different reporting bases. Management and external stakeholders are likely to be interested in why reported asset and liability balances, profit and equity/capital are different when measured under IFRS, Solvency II, Embedded Value and other reporting regimes.

Key changes will be that groups of insurance (or reinsurance) contracts that are in an asset position presented separately from groups of insurance (or reinsurance) contracts that are in a liability position. Acquisition cost cash flows, premiums receivable and unearned premiums are included in the measurement and presentation of the insurance contract liability.

How presentation will change: Statement of financial position

IFRS 4	IFRS 17
Assets	**Assets**
▸ Reinsurance contract assets ▸ Deferred acquisition costs ▸ Value of business acquired ▸ Premiums receivable ▸ Policy loans	▸ Reinsurance contract assets ▸ Insurance contract assets
Liabilities	**Liabilities**
▸ Insurance contracts liabilities ▸ Unearned premiums ▸ Claims payable	▸ Insurance contracts liabilities ▸ Reinsurance contracts liabilities

Exhibit 6.5

4 What we see in the market

We conducted the EY IFRS 17 Insurance Survey with large and medium-sized European insurers to understand their current progress with the implementation of IFRS 17 and the expected cost and operational impacts on the business.[81]

All of the companies interviewed have already launched their IFRS 17 program. 80% have appointed an external advisor. The vast majority (>90%) expect the impact to be significant. The budget range varies between $25m and $400m and therefore exceeds the costs of Solvency II implementation in many cases.

Companies expect to complete approximately 55% of implementation work in-house, with the rest of the spend split between external consultants and hired contractors.

Almost half of the IFRS 17 implementation costs will be spent on technology/systems/data – more than twice as much as any other element of IFRS 17.

As shown in Exhibit 6.6, actuarial and financial data & systems are the areas where IFRS17 implementation will have the greatest impact on business. Process redesign and target operating model changes are the areas that are expected to see the least impact.

A further step in the survey was to classify the insurers into five medium ($100bn–$200bn total assets) and five large (>200$bn total assets) companies. We wanted to know if the two groups of insurers are combining the implementation of IFRS 17 and IFRS 9 into one project or if they are separating them into two projects.

Large insurers are more likely to run IFRS 17 and IFRS 9 implementation as separate projects than medium-sized firms – 30 to 20%. Some of the key challenges companies anticipate during IFRS 17 implementation include:

- Tight implementation time frames – especially for IT changes
- Understanding the volatility of their IFRS 17 results and how the market will ultimately react
- Resource constraints both internally and externally
- Uncertainty over how to interpret/apply the requirements of the standard
- Internal reluctance to spend more money straight after Solvency II compliance
- Data requirements and its complexities.

81 The survey was taken in June/July 2017 on the European insurance market. 10 respondents took part in the survey.

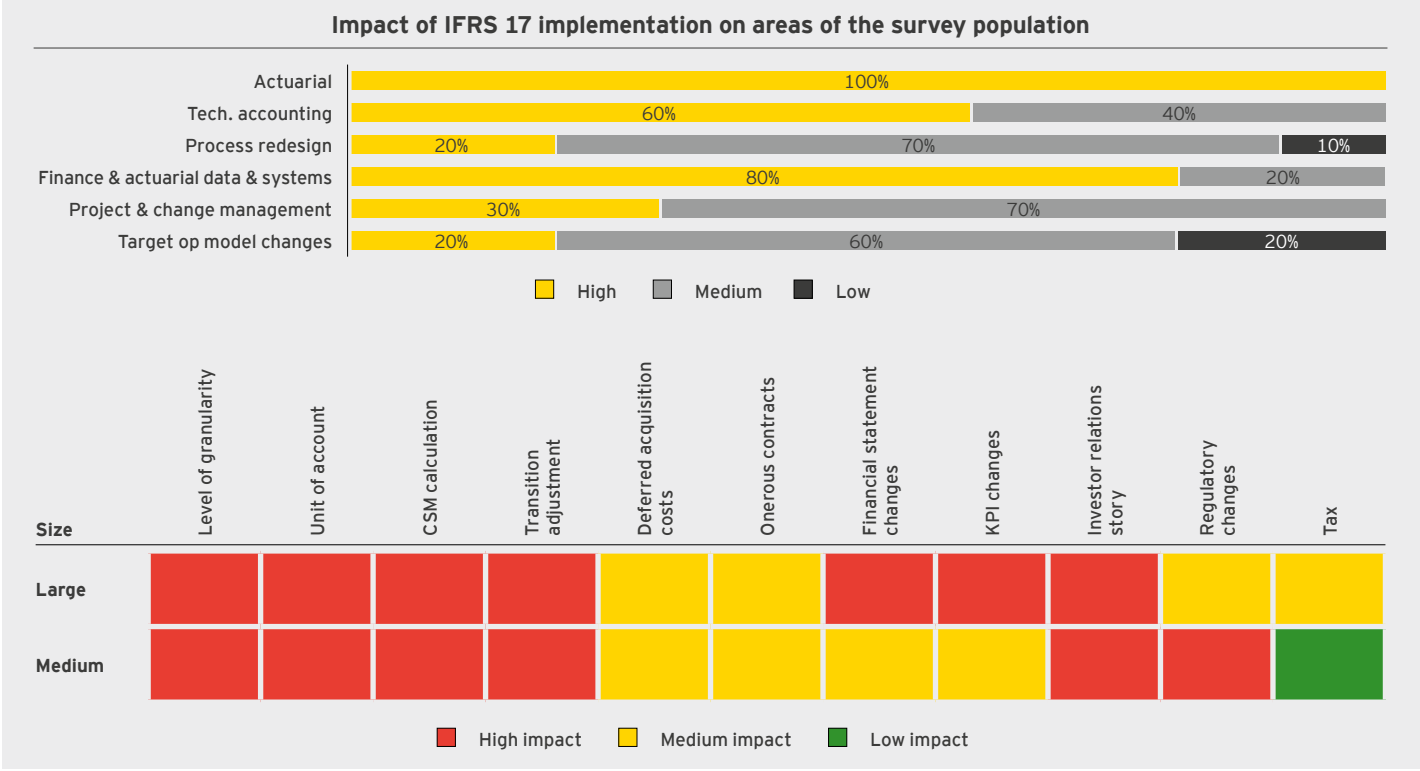


Exhibit 6.6

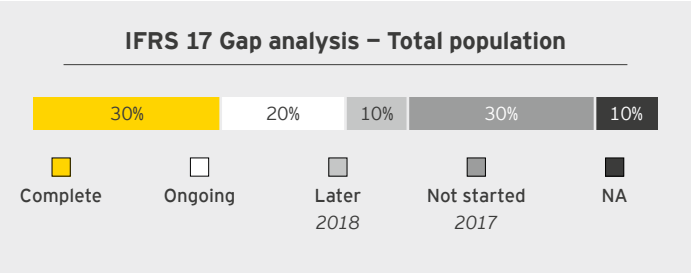


Exhibit 6.7

50% of the insurance companies interviewed in the survey have yet to start a detailed IFRS 17 gap analysis (see Exhibit 6.7). Looking at large insurance companies, only 10% of respondents have completed a detailed gap analysis.

Medium-sized insurers are more likely to have completed, or be in the process of conducting, a gap analysis – 30% of medium insurers have started compared to 20% of large insurers.

Out of these insurance companies surveyed, 30% planned to start their gap analysis late in 2017, while 20% plan to defer it to 2018 or have not yet decided when a gap analysis will be performed.

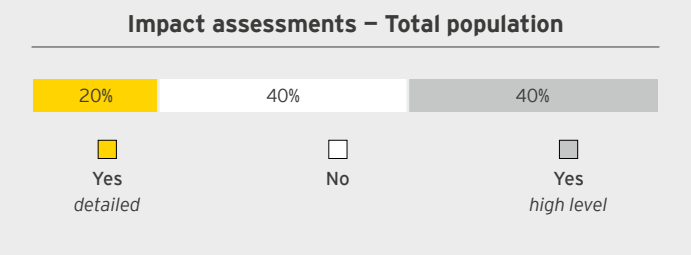


Exhibit 6.8

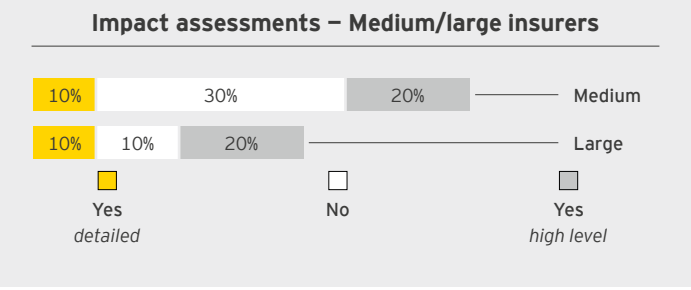


Exhibit 6.9

The majority of large companies are undergoing impact assessments in order to understand costs related to the implementation of IFRS 17 and how this fits into their wider change agenda. Medium-sized insurers will start to look at the cost impact later in 2017 or early in 2018 (if they have not yet started). Only 20% of the insurers surveyed have performed a detailed financial impact assessment – 80% still only have a high level view of the cost impact of IFRS 17 implementation on their business.

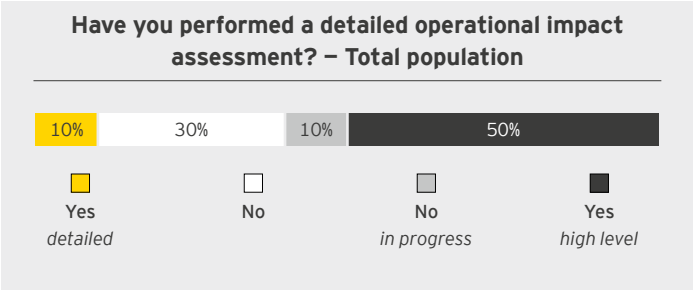


Exhibit 6.10

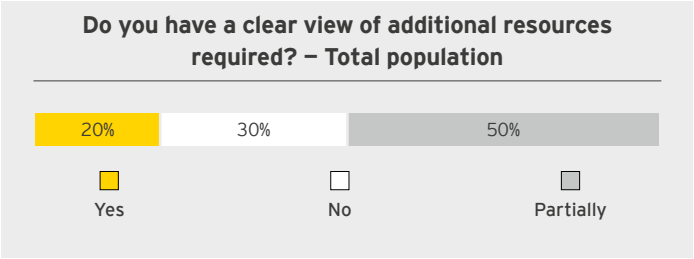


Exhibit 6.11

Only 10% of the insurance companies surveyed have completed a detailed operational impact assessment to fully understand how IFRS 17 implementation will impact their business. 50% of the insurers have started, but only have a high level view of operational impact. Only 20% of the insurance firms surveyed have a clear view of the additional resources required for full IFRS 17 implementation. Half of firms surveyed have a partial view of the resources required, but to date there is a lack of clarity across the industry over the level of resources required for full implementation.

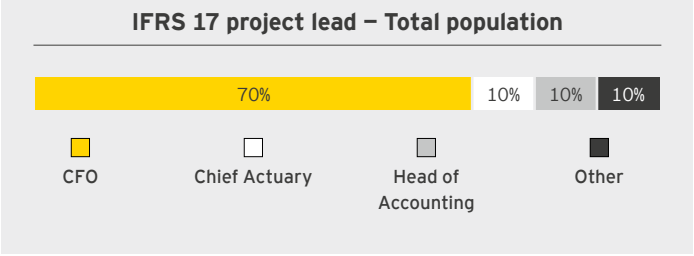


Exhibit 6.12

5 Outlook

Most IFRS 17 implementation projects are being lead centrally by CFOs. Medium-sized insurers are more likely than larger companies to run a more decentralized implementation lead by a function other than the CFO.

Budgets for IFRS 17 implementation projects different within the various insurance groups widely. Within the biggest 10 insurance groups in Europe, we see figures from 80 mio USD up to 500 mio USD. The size (and complexity) of the budget is mostly driven by the ambition level of the company and its existing complexity in the IT landscape. Some insurance groups seem to be aiming "compliance only"-meaning that their IFRS 17 projects covers all but only these steps to fulfill the external future accounting and reporting requirements. Other insurance groups seem to be using this accounting change to re-shape their finance processes and landscape by implementing additional elements like a new data warehouse, centralizing processes and functions and see IFRS 17 as a unique possibility to (re)define their finance target operating model. Overall, approved budgets for all companies seem to be higher than the budgets spent for implementing Solvency II requirements.

The results show how large the cost impact is estimated by leading international insurance companies.

Conversion to IFRS 17 will be a high cost factor for insurance companies as extensive investments in IT and processes are required which might lead to costs similar to those incurred for Solvency II, at a minimum.

However, the new standard can be regarded as a kind of revolution within the accounting scene. IFRS 17 is a big step forward to raise the standardization, harmonization and transparency in financial reporting – at least in the view of the IASB. This is expected to lead to a better understanding of the sources of profitability of insurance companies. With the new standard, the period of inconsistent international accounting policies may come to end. Consistent, internationally standardized accounting rules can find their way into financial reporting.

IFRS 17 will more clearly show the strengths and weaknesses of insurance companies than previously. The requirement of new measurement models for insurance contracts nevertheless will be based on certain assumptions. The profitability of new policies for which the first premium has been paid will be more transparent. Sources of profit will be increasingly identifiable.

IFRS 17 – SELECTED CHALLENGES FOR AUDITORS

7

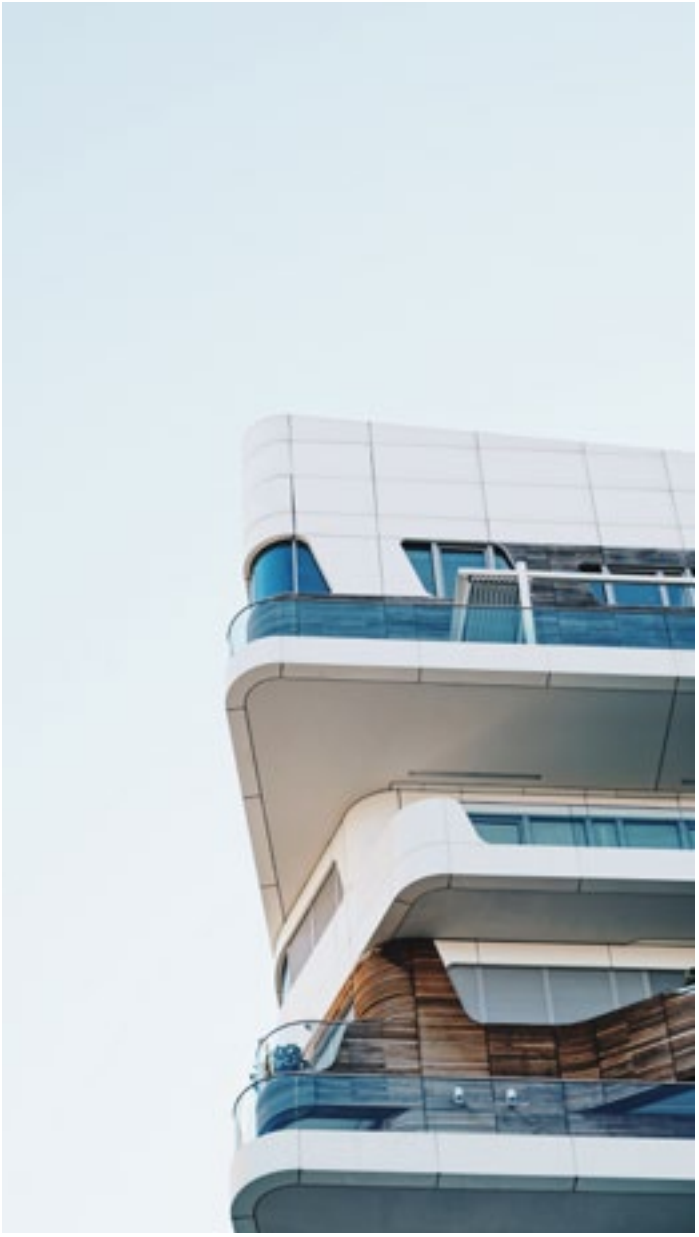
EY
Dr. Markus Horstkötter
Frederic Esser

1 Introduction

The new standard for insurance contracts will fundamentally change the accounting for all entities that issue insurance contracts. From the current introductory phase to its full application, several issues still need to be clarified.

The new standard will raise a variety of questions and challenges not only for insurance companies but also for auditors on how to apply the new accounting rules. Clients as well audit firms will need to question which interpretations of the standard are deemed acceptable and stand up to scrutiny and which do not.

This section highlights selected questions arising from three material issues of the new insurance standard and offers practical advice as well as potential actions to consider.



2 Transition

Insurance companies must apply IFRS 17 for annual periods beginning on or after 1 January 2021. However, according to IFRS 17.C3, all entities must apply the new accounting rules retrospectively in full unless impracticable. This retrospective application encompasses the identification, recognition and measurement of each group of insurance contracts as if IFRS 17 had always been applied.[82] Any existing balances that would not exist under IFRS 17 must be derecognized. The net difference should be recognized in equity.

Hence, the first step in applying the standard is to identify those contracts that allow for the full retrospective approach. For short-duration contracts especially in the P&C business and long-duration contracts with an issuance date in periods close to transition date, the full retrospective approach should be considered practicable. However, for a large proportion of the in-force life business, the approach might be considered impracticable due to the lack of data availability. For life insurance companies, these blocks of business represent a material part of their insurance liabilities and constitute a major driver of their profitability. Thus, in assessing the applicability and practicability of each transition approach for the different cohorts of insurance contracts, insurance companies could use opportunities for discretionary decisions to manage their future profits. In order to determine whether the transition approach has only been assessed with a view on managing profit, auditors need to ensure that the fully retrospective approach is either impracticable or at least accompanied by an unreasonable effort. Therefore, insurance companies have to provide in-depth information on why gathering the required data is not possible at a reasonable expense. Data migration over the life span of the in-force life business can constitute a strong argument to support that position. However, in most cases, especially when data migration has been performed in the recent past, companies keep a second database containing the entire data prior to migration. Auditors might then expect the application of the full retrospective approach to be deleted.

In cases where the fully retrospective approach cannot be deemed practicable, insurance companies will have to apply one of the two alternative approaches offered by IFRS 17.C5: the modified retrospective approach or the fair value approach.[83]

The modified retrospective approach as outlined in paragraphs IFRS 17.C6-C19 aims to achieve the closest possible outcome to the fully retrospective approach by using the same method, while permitting some simplifications to overcome its inapplicability in particular with regard to the assessments of insurance contracts or groups of insurance contracts, the determination of the CSM and to the insurance finance income or expense.[84]

82 IFRS 17.C4.
83 IFRS 17.C5.
84 IFRS 17.C7.

The fair value approach allows insurance companies to determine the CSM at the transition date as the difference between the fair value of a group of insurance contracts and the fulfillment cash flows measured at that date.[85] For the identification of groups of insurance contracts and the way discretionary cash flows are determined, an entity may choose the date of initial recognition or the transition date, depending on the availability of reasonable and supportable information.[86] Other simplifications pertain to annual cohorts[87] and the recognition of the cumulative amount of insurance finance expense in OCI at transition date.[88]

With respect to operational complexity, the fair value approach will be the first choice for most insurance companies. Its reference to IFRS 13 confirms that the underlying concept for the fair value measurement is based on an exit price, i.e., insurer assesses the price it would need to pay to transfer the insurance liability to a third party in an arm's length transaction. With several market transfers of in-force life businesses taking place at present it remains to be seen if a critical mass will be reached at transition date that will allow for reasonable comparisons and the derivation of market values. In this case it might be feasible to assess the insurance portfolio using market multiples. If there are no comparable market transactions on the other hand, fair value could be determined using the income approach.

If so, the CSM under the fair value approach reflects the margin an average market participant expects to earn for taking over the respective contracts. Under the retrospective approach, even the modified one, on the other hand, the CSM is based on an entity specific value (building block approach) respectively on an entry price concept (premium allocation approach) and thus reflects the profits expected from writing business in the retail market. The application of the fair value approach would thereby lead to a presentation of similar profits for homogeneous in-force business of all market participants, irrespective of their actual profitability, instead of a fair display and a meaningful CSM. Particularly for insurance companies with above-average profitability, the transition date CSM under the fair value approach would in many cases be lower than the actual value of the in-force business.

The modified retrospective approach, on the other hand, has the potential to increase the operational challenges when being applied. It is not yet clear whether the simplifications in IFRS 17. C6–C19 allow for a sufficient calculation of a meaningful CSM.

The determination of the CSM for groups of insurance contracts with direct participation features is based on the steps described in IFRS 17.C17. The difference between the fair value of the fulfillment cash flows at the date of transition and the total fair value of the underlying items should not pose a major challenge for insurance entities, as it is a solely prospective calculation. However, IFRS 17.C17 requires further adjustments. The amount needs to be complemented or reduced by the actual charges to policyholders, payments without varying changes in underlying items and releases of risk adjustment that have occurred before the date of transition. The result would be the CSM at contract inception. To achieve the required value of the CSM at transition date, the CSM at contract inception would have to be amended by the CSM releases for past services. For most life insurance contracts with, for example, an issuance date dating back more than two decades, the data for the amounts charged to policyholders as well as the amounts paid that would not have varied based on the underlying items might simply not be available.

For each of the abovementioned issues, auditors will have to decide whether the use of discretion and uncertain assumptions is adequate. As outlined above, the first step is to identify the basis behind the company's assessment of which approach to use and especially whether the determination was based on an actual evaluation of the practicability or rather as a central element to control its results.

Secondly, auditors will have to deepen their understanding of the client's product portfolio. Irrespective of the approach chosen, it will significantly affect future profits, the insurance result and add to the already high level of complexity. Currently, a broad understanding can serve as a basis to form expectations and compare and assess results, in future, however, a detailed product comprehension including past, current and future cash flows will be required to assess the abovementioned adequacy. Taking into account the importance of analytical considerations audit companies use to validate the plausibility of financial reporting, this level of complexity needs to be addressed and reduced. Enhanced data analytics could potentially discover, analyze and test different patterns such as the release of the CSM for contracts at and after transition. However, auditors are facing two major hurdles: data integrity and empirical values.

Data completeness and a deeper level of granularity are required to create useful and reliable information via data analytics. However, as experience shows, valuable data is frequently not available either due to system or data migrations over the course of time or due to the fact that the level of granularity has never been required or had to be stored. However, even if data can be recovered and used for data analytics, auditors cannot test the insurance companies' assumptions in the usual way by comparing patterns with historical data or benchmark figures since those are not available. The only way to approach this from an auditors' perspective is for the auditor to build up and acquire such a deep understanding of the products to allow him or her to determine a justified and reliable expectation and test it against the clients' one.

85 IFRS 17.C20.
86 IFRS 17.C21–C22.
87 IFRS 17.C23.
88 IFRS 17.C24.

3 Level of aggregation

The level of aggregation is one of the most critical aspects regarding the practicability of IFRS 17. The final standard requires insurance companies to identify contracts that are subject to similar risk, managed together, and aggregate them into portfolios.[89] Due to similarities to the current concept, such as the homogeneous risk groups under Solvency II, the definition of the portfolio is rather uncritical. However, those portfolios have to be divided further into at least three groups:[90]

(a) "A group of contracts that are onerous at initial recognition, if any;

(b) A group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

(c) A group of the remaining contracts in the portfolio, if any."

Breaking this portfolio down is the more challenging task. As shown, insurance companies need to differentiate at least between profitable and unprofitable contracts for the grouping. The decision whether contracts fall within a certain group may be based on whether there is reasonable and supportable information that all contracts within a certain set of contracts actually belong to the same group. However, if the entity does not have such information, the entity needs to consider the individual contracts.[91] For business with a high degree of mutualization, policyholders act as the first layer of risk absorption for other policyholders. Hence, all contracts in a given cohort are either profitable or onerous at inception. Dividing contracts into different groups will thereby be less of a problem, since there will only be one group of contracts per cohort.

For non-mutualized business, slicing each portfolio into groups constitutes a much larger challenge for both the insurance companies and the auditors. The profitability in the form of the CSM of a contract can only be determined based on a cash flow projection. Yet, most insurance companies project the cash flow based on the level of a group of contracts rather than on a single contract basis. The standard thereby introduces a circularity in the proposed temporal sequence of grouping and measuring the profitability. Hence, insurance companies argue that the most logical order for the CSM determination is a grouping of contracts upstream, followed by the cash flow projection based on this grouping. The determination of the CSM, and thus the profitability, would be determined in a subsequent step. It would also need to be consistent over time as it is the basis for the granularity of the cash flow projections, especially in cases where stochastic valuations are required as those models cannot be changed ad hoc at each reporting date.

It is therefore unavoidable for insurance companies to find qualitative criteria which can act as indicators for consistency – ex ante – of the expected profitability. Nevertheless, even if such criteria can be found and the grouping can be operationalized to an acceptable level, it seems to be impossible to ensure for all contracts within one group that each of them is either profitable or onerous. Hence, the distribution of contracts to the different groups will not comply with the standard for all contracts.

With regard to IFRS 17, however, testing in samples if contracts are assigned to the correct groups could potentially be a key audit procedure to confirm the correct revenue recognition in form of the CSM per group. Assuming that cash flow projections on a single contract basis exist, auditors can perform the testing on this basis, albeit time-consuming, and obtain high validity for their audit results. However, if cash flow projections only exist on a group level and insurance companies perform their contract grouping as described above, auditors would require conclusive qualitative criteria for testing purposes. Insurance companies intending to do so will come up with ex ante parameters to distinguish between profitable and onerous contracts. To conclude on the appropriateness and suitability of those parameters, auditors would again need to understand each group of contracts in detail – including those contract characteristics that drive profit. If deemed adequate, auditors can then simply test the correct grouping by comparing the identified parameters with the contract details on a single contract basis.

Beside the use of sampling as one of the key aspects of the traditional audit approach, data analytics will be a necessary element of applied audit procedures, in particular since reasonable assurance cannot be obtained by mere substantive testing. Auditors will need to find ways to quantify the qualitative indicators for profitable and onerous contracts. Similar methods are already being used under the current local GAAP accounting as well as Solvency II in similar situations. Groups of insurance contracts are currently analyzed on the basis of tariff groups or by line of business in those cases where evaluations of one contract can be used as a stable indicator for the profitability of all contracts within that tariff group or line of business. Once identified for the grouping under IFRS 17, data analytics can be used meaningfully to investigate and confirm a correct grouping over time.

89 IFRS 17.14.
90 IFRS 17.16.
91 IFRS 17.17.

4 Risk adjustment

The estimated future cash flows not only need to be discounted to reflect the time value of the money but also have to be adjusted to reflect non-financial risks according to IFRS 17.37. The non-financial risk adjustment shall reflect the company's own risk aversion by measuring the effect of uncertainty of the insurance contract rather than the uncertainty resulting from financial risks.[92]

The standard does not specify the estimation techniques to be used for determining the risk adjustment. However, the standard provides minimum aspects and risk characteristics to be taken into account, including the fortuity risk, the risk of change as well as the risk of error.[93] Naturally, through those projections, the risk adjustment shall include all risks for the whole coverage period. A disaggregation of the change in the risk adjustment between the insurance service result and the insurance finance result, on the other hand, is not required. Insurance companies can include the change in the insurance service result.[94] Moreover, since the risk adjustment reflects the compensation for taking over the insurance risk for the whole coverage period, diversification effects can be included for the full contract time. For future periods, the estimation can be based on expected diversification effects, with no restrictions from any existing contract boundaries.[95]

The risk adjustment concept itself is not new. The idea of including non-financial risk factors is already covered in Solvency II. However, the use of already existing Solvency values is only possible with amendments. The Solvency concept does not entail the specification of the company's own risk aversion, which is explicitly required according to IFRS 17. Moreover, the Solvency II risk adjustment could appear to be too conservative as the capital-cost-method with its six percent rate is rather driven by supervisory objectives. The same effect could result from the lack of balancing effects between different legal unities under Solvency II. In addition, it is not given that the capital-cost-method itself would adequately reflect the non-financial risk, especially in cases of extreme loss events in non-life business.

For the first case, audit firms will have to ensure that all limitations and boundaries of the Solvency risk adjustment have been taken into account for IFRS accounting purposes. In case insurance companies only chose this path, it might trigger a potential conflict between the auditor and auditee. The own assessment of risk aversion on the other hand, due to its high level of judgment, may impose a fraud risk which the audit firms have to address.

In order to mitigate the above risk scenarios and achieve sufficient assurance reliability, auditors must understand and assess the non-financial risk themselves. By doing this, auditors can judge the appropriateness of a company's own risk aversion or Solvency II risk adjustment to IFRSs. Since most assumptions with regard to IFRS 17 are similar to Solvency II, there are already established audit procedures to verify and evaluate those. To obtain reasonable assurance, those measures need to be expanded to include the company's own risk aversion.

92 IFRS 17.B89.
93 IFRS 17.B91.
94 IFRS 17.81.
95 IFRS 17.B88.

5 Outlook

Finally, the following figure illustrates the potential changes and challenges in insurance accounting under IFRS 17. Main audit considerations and possible impacts under the new standard can be regarded as below-mentioned.

What's new	Auditing considerations	Could impact
Contract boundaries	▸ Exercise of judgment required in determining contract boundary ▸ Vigilance needed by auditors ▸ Disclosure of estimation uncertainties	Reliability
Contract classification/applying VFA	Accounting implications of judgment used will likely be significant	Reliability
Mutualisation	▸ Complexity arises when different lines of businesses are involed ▸ Impact of changes unknown	Relevance, reliability
Discounting	Exercise of professionals judgment to determine discount rates	Relevance, reliability
Risk adjustment	Discretion to determine risk adjustment ▸ Judgement may be difficult to challenge	Relevance, neutrality
Reinsurance contracts held	New effects will require: ▸ Education for preparers, users, auditors ▸ Vigilance by auditors	Relevance, reliability, comparability
Presentation and disclosure	Impact of changes under IFRS 17 unknown	Reliability
Balance sheet presentation	▸ Different in concept from current reporting requiring insurers and auditors to adapt	Reliability

Table 7.1

Source: Accountancy Europe, EFRAG Board meeting 20 March 2018, Auditor's views on IFRS 17 Insurance Contracts, p. 13.

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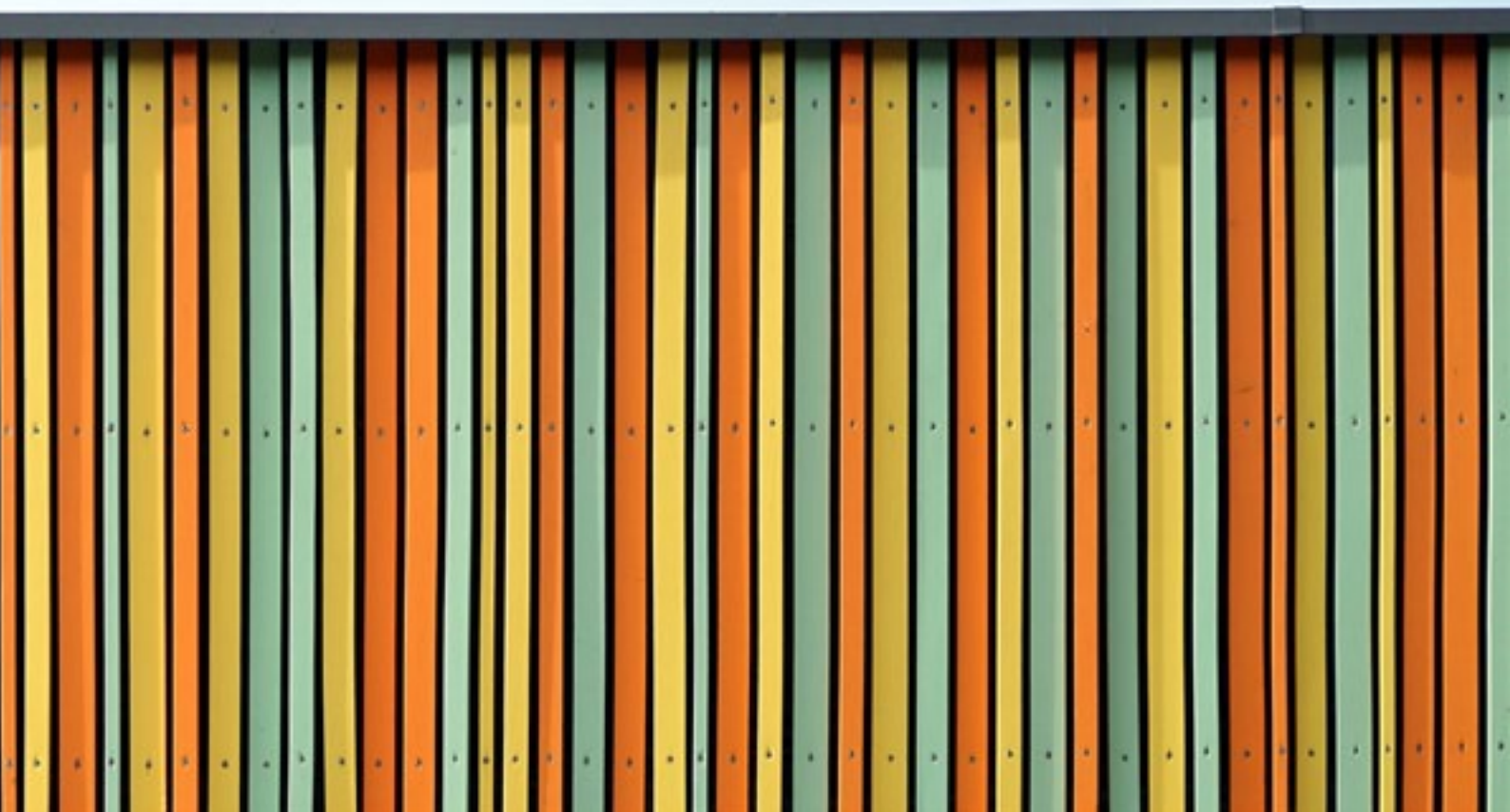

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