Raymond Chabot Grant Thornton

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Adviser alert – *Get ready for IFRS 17: A fundamental change to the reporting for insurance contracts*

June 2017

Overview

The Grant Thornton International IFRS team has published *Get ready for IFRS 17: A fundamental change to the reporting for insurance contracts*. IFRS 17 *Insurance contracts* extensively rewrites the rulebook for insurance reporting.

IFRS 17 is effective for annual accounting periods starting on or after January 1, 2021. It supersedes IFRS 4 *Insurance contracts* as revised in 2016 and marks the conclusion of the IASB's twenty-year long insurance project.

IFRS 4 was designed to be an interim standard and therefore allowed entities issuing insurance contracts to carry on accounting for them using policies that had been developed under their previous local accounting standards. This meant that companies continued to use a multitude of different approaches for accounting for insurance contracts, making it difficult to compare and contrasts the financial performance of otherwise similar companies. IFRS 17 solves the comparison problems created by IFRS 4 by requiring all insurance contracts to be accounted for in a consistent manner.

This publication is designed to get you ready for the standard. It explains the key features of the standard and provides insights into their application and impact.

The publication includes the following sections:

- Scope;
- Initial recognition and measurement;
- Subsequent measurement;
- Onerous contracts;
- Modification and derecognition;
- Modification to the general model – variable fee approach;
- Other modifications – premium allocation approach;
- Reinsurance;
- Presentation and disclosure;
- Effective date and transition.

Resource

Get ready for IFRS 17: A fundamental change to the reporting for insurance contracts follows this *Adviser alert*.

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Discussion

Get ready for IFRS 17

A fundamental change to the reporting for insurance contracts

June 2017

Contents

Section	Page
Introduction	02
Background	04
Scope	06
Initial recognition and measurement	13
Subsequent measurement	22
Onerous contracts	26
Modification and de-recognition	29
Modifications to the general model – variable fee approach	31
Other modifications – premium allocation approach	35
Reinsurance	40
Presentation and disclosure	44
Effective date and transition	56
Glossary	65

Introduction

After twenty years of development the IASB has published IFRS 17 ‘Insurance Contracts’ (the Standard).

The Standard introduces insurance contract measurement principles requiring:

- current, explicit and unbiased estimates of future cash flows
- discount rates that reflect the characteristics of the contracts' cash flows
- explicit adjustment for non-financial risk.

Day one profits should be deferred as a contractual service margin and allocated systematically to profit or loss as entities provide coverage and are released from risk.

Revenue is no longer equal to written premiums but to the change in the contract liability covered by consideration.

A separate measurement model applies to reinsurance contracts held. Modifications are allowed for qualifying short-term contracts and participating contracts.

Increased disclosure requirements apply.

This publication is designed to get you ready for the Standard. It explains the key features of the Standard and provides insights into their application and impact.

Grant Thornton International Ltd comment

IFRS 17 rewrites the rulebook for insurance reporting and will transform data, people, technology solutions and investor relations.

Implementation costs are likely to be substantial especially for those entities which cannot leverage modelling and reporting capabilities created during Solvency II implementation.

Staff training, management education and communication with investors will be crucial for achieving the Standard's objectives and for improving transparency, consistency and comparability across the insurance markets.

Over the next three years, we expect the key focus areas for entities to be:

- understanding the financial and operational impacts on transition and for new business
- implementing efficient data collection and storage solutions, and streamlining production processes and IT systems
- developing and explaining new performance measurement and business steering metrics.

A strategic approach to IFRS 17 transition can give CFOs powerful insight on risk and performance drivers and create an agent for change that will harness the resources of entities and the talent of their people.

Background

IFRS 17 ‘Insurance Contracts’ is effective for annual accounting periods starting on or after 1 January 2021. It supersedes IFRS 4 ‘Insurance Contracts’ as revised in 2016 and marks the conclusion of the IASB’s twenty-year long insurance project.

This is a standard about insurance contracts, not a standard for the insurance industry. Its effect will be felt beyond the entities authorised to carry out regulated (re)insurance activities in a jurisdiction.

Insurance project timeline

- **1997: IASC starts a project on insurance contracts**
- **2004: IFRS 4 issued as an interim standard**
- **mid 2004: Phase II Insurance Working Group formed**
- **2007 May: Discussion Paper Preliminary views (162 comment letters)**
- **2010 July: Exposure Draft (253 comment letters)**
- **2013 June: Exposure Draft (194 comment letters)**
- **2016 Field work: other outreach activities and deliberations**
- **2017 Jan-Mar: Final deliberations post editorial review**
- **2017 May: IFRS 17 'Insurance Contracts' issued**

Why did it take so long?

IFRS 17 could probably qualify for an entry in a book of records: this is the Standard that took the longest time to complete (20 years); reflected contributions by 30 full-time IASB members; and was completed by a new generation of standard setters (having been started under the IASC). Some of the reasons behind the lengthy completion include:

- very diverse local practices for insurance accounting
- huge range of jurisdiction-specific products, tax implications and regulations that had to be captured by a uniform measurement model
- significant local regulatory impact on pricing and solvency that interfered with measurement principles and could not be ignored even though the objectives of the Standard setters and regulators were never meant to be fully aligned
- convergence effort with other standard setting bodies (eg, the equivalent FASB project)
- significant effort to align financial reporting principles to the economics of insurance products and related practices for asset-liability management (eg, reflecting link to pricing, management actions and policyholder behaviour, etc.)
- need to resolve dependencies and align with the principles of other major standards (eg, IFRS 9 'Financial Instruments', IFRS 15 'Revenue from Contracts with Customers')
- change fatigue and expense strain from Solvency II implementation across Europe.

What comes next?

2018 – 2020: Implementation support; constitution of a Transitional Working Group; consideration of other implications (eg implementation for Islamic finance products, etc.)

2021: Effective date

Scope

IFRS 17 applies to all insurance contracts an entity issues (including those for reinsurance), reinsurance contracts it holds and investment contracts with a discretionary participation feature (DPF), provided the entity also issues insurance contracts.

All references to insurance contracts issued also apply to insurance contracts acquired in a transfer or a business combination other than reinsurance contracts held.

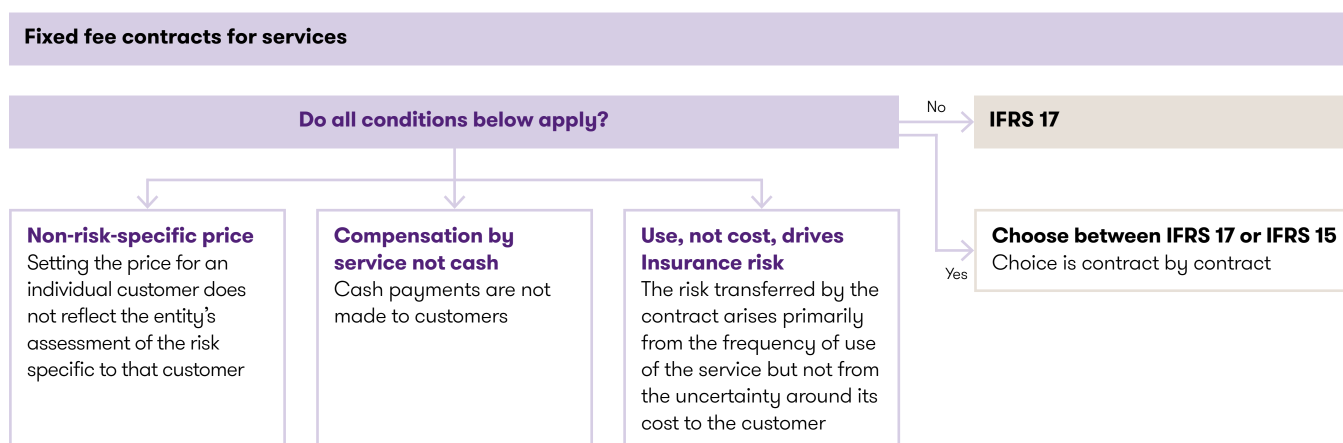
The scope exclusions are similar to those under IFRS 4 and are summarised in the table below:

Scope exclusion	Standard to apply
Warranties provided by a manufacturer, dealer or retailer in connection with the sale of a product	IFRS 15 Revenue from Contracts with Customers
Employers' assets and liabilities that arise from employee benefit plans	IFRS 2 Share-based Payment
Retirement benefit obligations reported by defined benefit retirement plans	IAS 26 Accounting and Reporting by Retirement Benefit Plans
Contractual rights or obligations contingent on the future use of, or the right to use, a non-financial item	IFRS 15, IAS 38 Intangible Assets and IFRS 16 Leases
Residual value guarantees provided by a manufacturer, dealer or retailer, or a lessee (embedded in a lease)	IFRS 15 and IFRS 16
Financial guarantee contracts (unless a prior explicit assertion has been made and insurance accounting has been applied)*	Choice to apply IFRS 17 or IAS 32 Financial Instruments: Presentation, IFRS 7 Financial Instruments: Disclosure and IFRS 9 Financial Instruments
Contingent consideration in a business combination	IFRS 3 Business Combinations
Insurance contracts where the entity is the policyholder (unless these contracts are reinsurance contracts)	

* For financial guarantees contracts where no prior explicit assertion has been made an entity can make the choice between IFRS 17 and the Financial Instruments standards noted above on a contract-by-contract basis. Such choice is irrevocable.

Some contracts meet the definition of an insurance contract but their primary purpose is to provide services for a fixed fee. An entity issuing such contracts may choose to apply IFRS 15 to them if, and only if all of the following conditions are met:

Fixed fee contracts for services



What is an insurance contract?

IFRS 17 defines an insurance contract in a similar way to IFRS 4 and provides additional guidance on how to assess the significance of insurance risk based on the possibility of a loss on a present value basis (rather than nominal), and how to evaluate changes in the level of insurance risk.

Insurance contract

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.

The Standard's application guidance draws a specific distinction between insurance risk and other risks, and defines insurance risk as other than financial risk transferred from the holder of a contract to the issuer.

The acceptance of a risk to which the policyholder was already exposed is a key condition for the existence of an insurance contract. Therefore lapse or expense risks are not insurance risks because the resulting variability in the payments to policyholders or the unexpected increase in contract servicing costs are not contingent on uncertain future events which adversely affect the policyholders. However, if an entity transfers lapse or expense risk to another party (eg reinsurer), the second contract exposes the other party to insurance risk.

A reporting entity should assess the significance of insurance risk contract by contract. Insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts (eg due to risk diversification across a portfolio).

The following considerations should be made when assessing if insurance risk is significant:

Insurance risk is significant if:

- There is a scenario with commercial substance which exposes the issuer to a possibility of a loss on a present value (PV) basis. If a reinsurance contract does not expose the issuer to a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk of the reinsured portions of the underlying insurance contracts.
- An insured event could cause the issuer to pay additional amounts that are significant in any single scenario, ie:

PV additional amounts paid* PV amounts payable if no insured event occurred

*Include claims handling and assessment costs

Changes in the level of insurance risk

A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (discharged, cancelled or expired) unless the contract is derecognised or as a result of contract modification.

Amounts excluded from the assessment of significant risk

Loss of the ability to charge for future services

Eg, loss of unit-linked management charges on the death of a policyholder – not relevant for assessing transfer of insurance risk.

Waiver on death of charges made on cancellation or surrender

The waiver does not compensate a pre-existing risk for the policyholder and is therefore not relevant for the assessment.

Payments conditional on events that do not cause a significant loss to the policyholder

Eg a loss of currency unit (CU) CU1 triggering a CU 1m payment.

Possible reinsurance recoveries

They are accounted separately.

An entity can accept significant insurance risk only if it is separate from the policyholder. Therefore, as noted below, self-insurance does not constitute an insurance contract. However, the Standard clarifies that for mutual entities, although policyholders bear the pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.

Examples of insurance contracts	Examples of items, which are not insurance contracts
• Insurance against theft or damage • Liability insurance (product, professional, civil, legal expenses) • Life insurance and prepaid funeral plans • Life contingent annuities and pensions (including those linked to a cost of living index) • Insurance against disability and medical cost • Surety bonds, fidelity bonds, performance bonds, bid bonds • Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer • Title insurance • Travel insurance • Catastrophe bonds if a specified event adversely affects the issuer and creates significant insurance risk • Insurance swaps for variables specific to a party to the contract	• Investment contracts with a legal form of an insurance contract but do not transfer significant insurance risk • Financial reinsurance (return the insurance risk to the policyholder by non-cancellable adjustments of future policyholder payments based on insured losses) • Self-insurance* • Gambling contracts (do not have as a contractual precondition for payment that an event adversely affects the policyholder) • Catastrophe bonds, financial or weather derivatives with variables not specific to a party to the contract • Credit related guarantees that require a payment even if the holder has not incurred a loss on the failure of a debtor

* Self-insurance does not constitute an insurance contract because there is no agreement with another party. Therefore, from the point of view of consolidated financial statements, there is no insurance contract for the group when an entity issues an insurance contract to its parent, subsidiary or a fellow subsidiary. However, in the financial statements of the issuer or holder there is an insurance contract.

Practical insight – impact for entities, which are not insurers

IFRS 17 does not constitute industry specific guidance but instead specifies the principles, which should be applied to contracts that meet the standard definition of an insurance contract irrespective of the legal and regulatory status of their issuer.

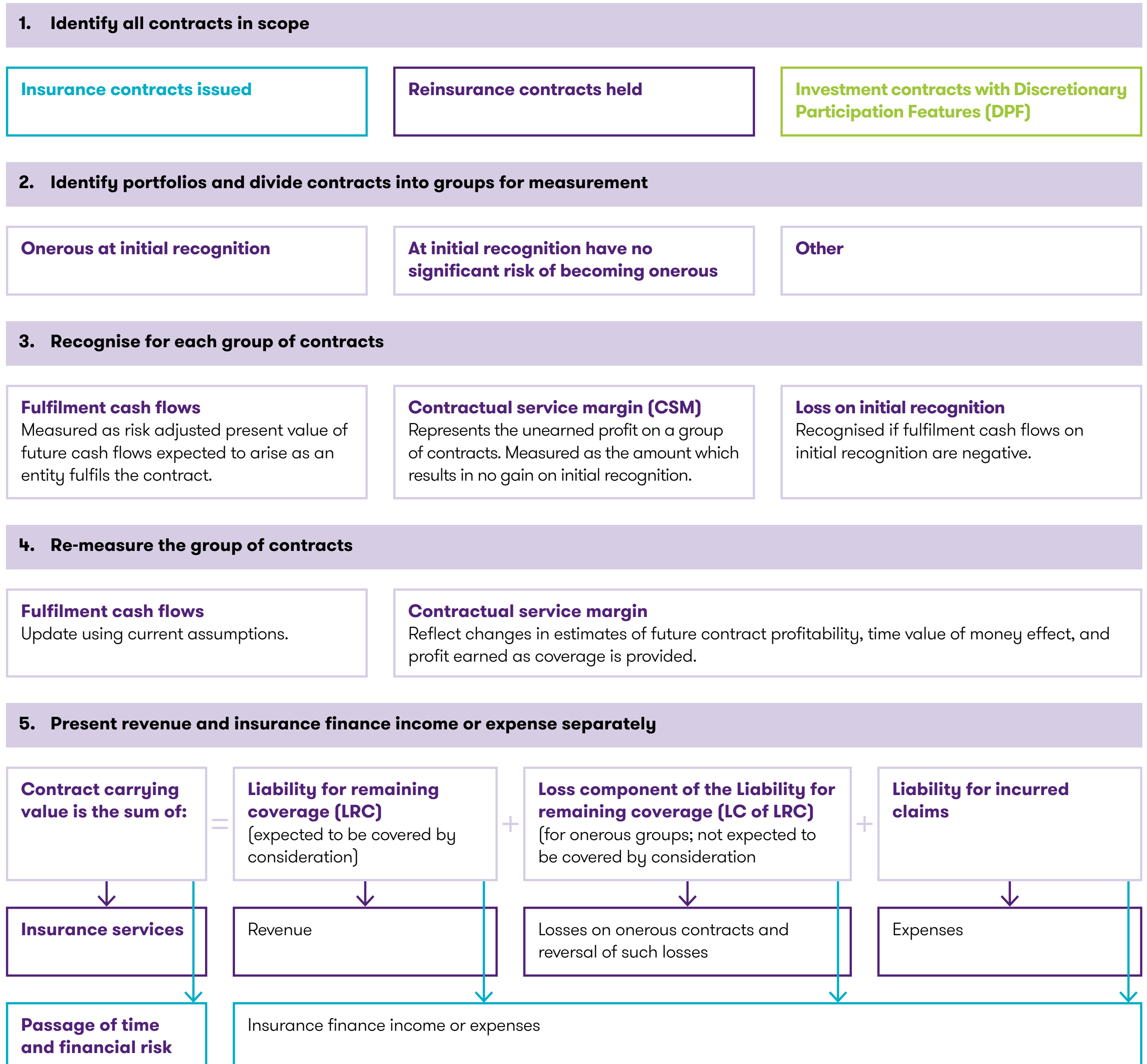
Therefore, entities issuing warranties, credit related guarantees, guarantees of pension obligations of Group entities, bonds related to participation in tenders or for contract execution, weather derivatives, etc. should analyse carefully the terms of such arrangements even when they do not have the legal form of an insurance contract. Such analysis should establish the existence and extent of insurance risk transfer in order to achieve correct accounting treatment under the applicable IFRS. Where non-insurance entities conclude that they have issued contracts within the scope of IFRS 17, they need to consider their staff education, information systems, data requirements and preparedness for much more complex measurement routines and demanding disclosures.

Objective

The objective of the Standard is to ensure that a reporting entity faithfully represents in its financial statements the effect that insurance contracts have on its financial position, financial performance and cash flows.

When applying the Standard a reporting entity should consider its substantive rights and obligations from a contract, law or regulation, but should disregard terms that have no commercial substance.

The blueprint for an entity to follow is outlined below:



6. Disclose information on amounts, judgements and risks

Amounts from insurance contracts

- Disclose separately for contracts which are assets and which are liabilities
- Disclose separately for insurance contract issued, reinsurance contracts held and investment contracts with discretionary participation feature (DPF)
- Reconcile opening to closing balance for each component of the carrying amount of insurance contracts
- Analyse changes in the carrying amount of contracts between insurance services and amounts not related to insurance service
- Analyse changes between those related to current, past or future coverage and services
- Disclose expected pattern for CSM allocation to profit or loss per type of contract

Key judgements and estimates

- Approach to determine discount rates
- Yield curves
- Method to calculate the risk adjustment and the corresponding confidence level
- Approach to determine investment components in contracts
- Composition and fair value of underlying items for contracts with discretionary participation feature
- Exercise of discretion on contracts without DPF
- Method for disaggregation (if option is taken) of insurance finance income or expenses between P/L and OCI

Risks

- Policies, processes and methods to manage and measure risks
- Concentration and contagion across assets and liabilities
- Exposure and sensitivities (link to return on invested assets)
- Claims development reconciled to carrying values at reporting date
- Expected cash outflows for each of the five years post reporting period end

Practical insight – IFRS 17 objective: an opportunity and a lever for change

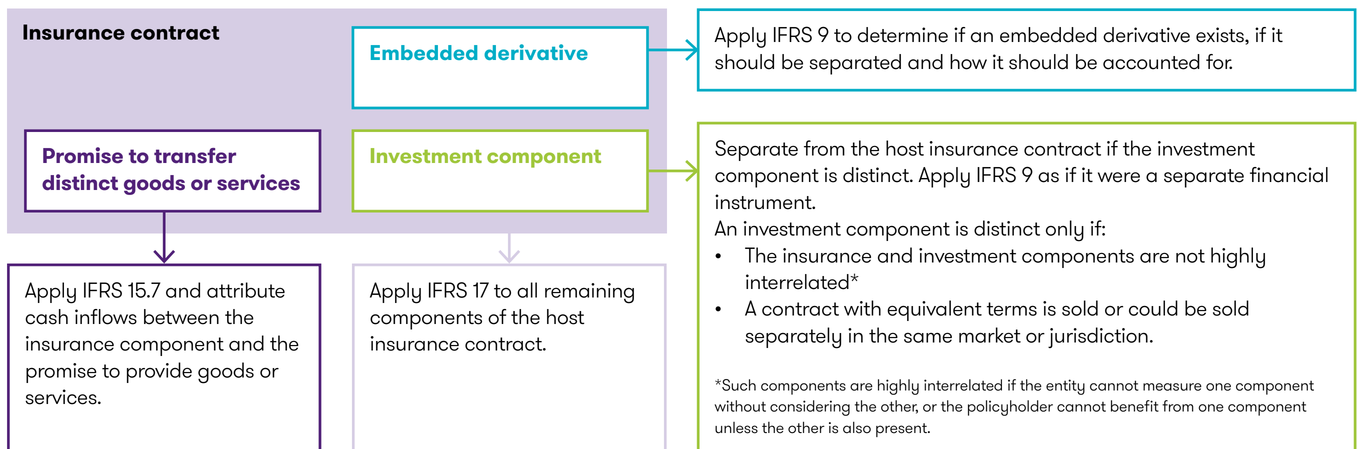
IFRS 17 implementation coincides with a period when margins for all insurers will likely remain under significant pressure from prolonged periods of low-interest rates and volatile equity prices, rising prudential and conduct compliance standards, slow recovery in living standards, political instability and economic uncertainty across the globe. For entities in Europe, this will be yet another major change soon after the regulatory overhaul of Solvency II that saw project implementation costs soar often in multiples of initial management estimations. Insurers will understandably seek tangible benefits from any IFRS 17 implementation costs.

For those insurers, which have historically underinvested in data and systems, applying the above implementation blueprint will likely pose significant operational challenges. Policy choices and underlying judgements may become even more difficult to embed. However, if it is not approached as 'yet another accounting conversion exercise', the new Standard can also represent a powerful lever for change around how insurers use financial information and technology for business steering, and attracting investors and customers. It could create an opportunity to harness the talent of insurers' finance, actuarial, data and technology teams via a new collaborative operating culture.

Combination of insurance contracts and separation of components

When a set of insurance contracts with the same or related counterparty achieves an overall commercial effect, in order to report the substance of the arrangement, it may be necessary to treat the set as a single contract.

An insurance contract may contain one or more components that would have been in the scope of another standard if they were separate contracts. A reporting entity should identify and account for the components of a contract as outlined below:



Practical insight – contacts management

IFRS 17's requirement to combine contracts, which achieve common overall commercial impact may influence the way certain fronting arrangements are reported.

For example, where an insurer issues a contract to a direct policyholder or assumes reinsurance but at the same time enters into a mirroring back-to-back outwards reinsurance contract, when combined, these arrangements may not meet the criteria for significant insurance risk transfer for the fronting cedent. As a result, unforeseen impacts may arise on key performance indicators (KPIs) or capital and risks management targets (eg from additional counterparty risk).

Practical insight – product development

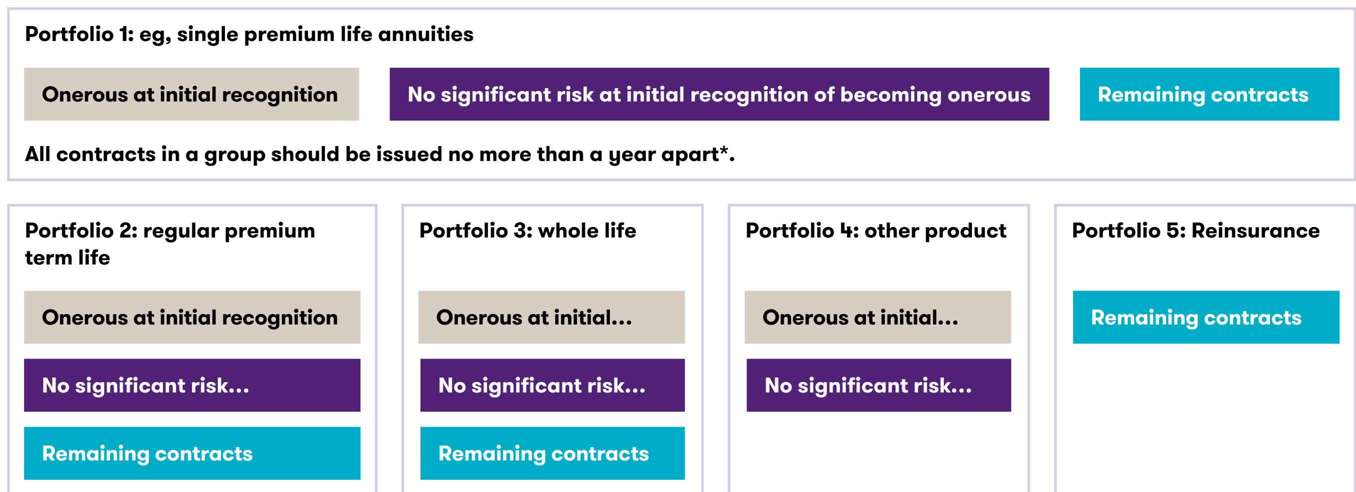
IFRS 17 may pose a challenge to existing interpretations of contract clauses or certain products' Terms and Conditions. When preparing for IFRS 17 transition, entities may have to revisit prior analysis before they confirm or rebut historic decisions on unbundling. Entities may have to redesign controls around future product development and approval to achieve sufficient rigour over identification of components outside IFRS 17's scope. The same applies to IT systems capability for processing, and appropriate data capture for measurement and disclosure. Much closer collaboration will be needed between financial reporting specialists, actuaries and underwriters.

Initial recognition and measurement

Level of aggregation

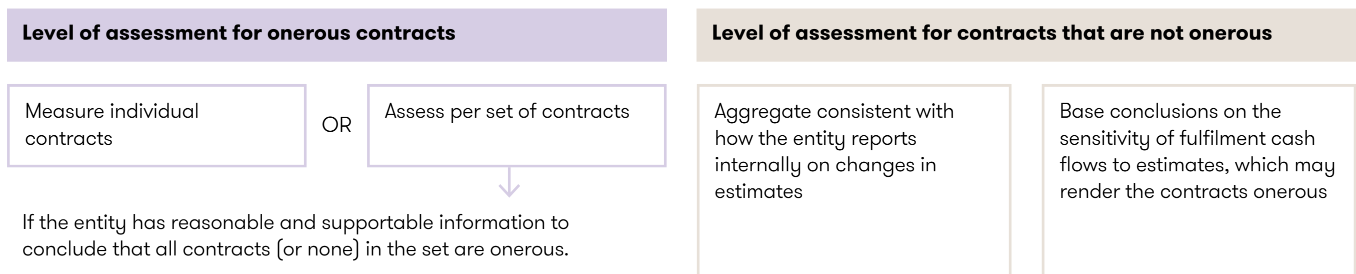
The risks underlying insurance contracts and the corresponding management practices adopted by reporting entities are the main factors, which determine the level of aggregation under IFRS 17.

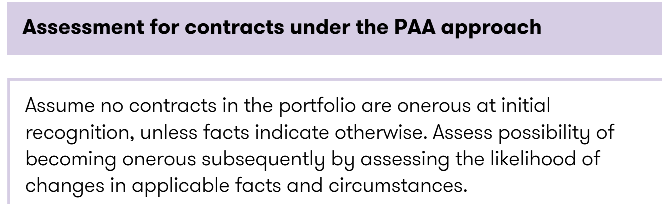
Contracts that are subject to similar risks and are managed together as a single pool constitute a portfolio of insurance contracts. Portfolios are then divided into three groups of contracts as follows:



* An exemption of the one-year rule is allowed only to contracts that would fall into different groups because law or regulation (eg for gender-neutral pricing) constrains the entity's ability to set a different price or level of benefits for policyholders with different characteristics.

Onerous contracts and contracts to which the premium allocation approach (PAA) is applied are discussed in more detail in a dedicated section below. A group may comprise a single contract, if this is the result of applying the Standard's aggregation rules. A reporting entity is permitted to divide portfolios in more than three groups of contracts, if internal reporting and performance monitoring distinguishes at a more granular level the risks of contracts becoming onerous, or can measure at more granular level the extent to which the contracts are onerous. The level of assessment on initial recognition should be as follows:





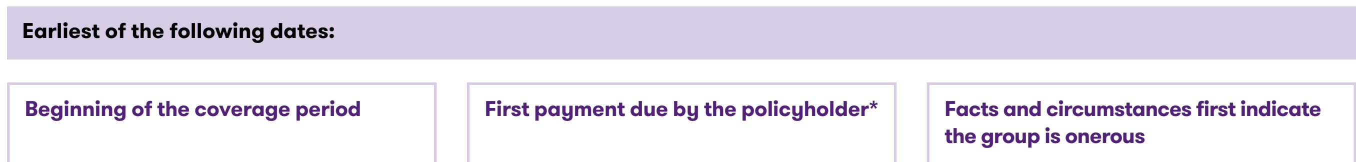
Once the groups are established at initial recognition, their composition should not be reassessed subsequently.

Practical insight – aggregation approach

For some reporting entities the existing policies and bases for performing liability adequacy testing under IFRS 4 may not meet the IFRS 17 principles for contract aggregation. Entities should allocate sufficient time and resources on transition when deciding on their unit of account approach. It will impact profoundly not only the pattern of future profit emergence, but will also influence most operational solutions on systems and data, and measurement and disclosure routines (eg the number of discount rates to be calculated).

Recognition

The point of recognition for contracts within the scope of IFRS 17 should be:

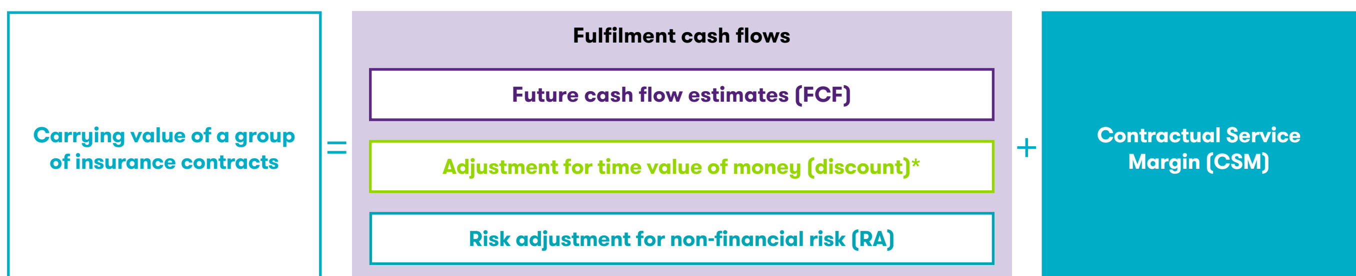


* or first payment made if no contractual due date

An entity should recognise an asset or a liability for any insurance acquisition cash flows, which the entity pays or receives before the related group of contracts is recognised unless it chooses to expense them in profit or loss. Such an asset or liability from pre-coverage cash flows should be de-recognised when the group of insurance contracts to which the cash flows are allocated, is recognised.

Measurement

The following measurement principles apply to all groups of contracts within IFRS 17's scope, except for contracts measured under the premium allocation approach, reinsurance contracts held, and certain recognition and measurement aspects of investment contracts with a discretionary participation feature. Dedicated sections of this publication explain each of the modifications to the general measurement approach.



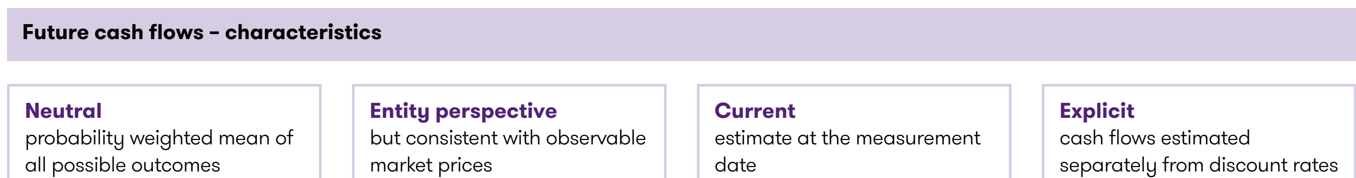
* should also reflect financial risk associated with FCF to the extent not included in the estimates of FCF

A group of contracts should include only contracts issued by the end of the reporting period (subject to the aggregation rule of 'issue within 12 months apart'). Such contracts should be added into the reporting period in which they are issued. This may result in a change in the determination of discount rates at the date of initial recognition. An entity should apply the revised rates from the start of the reporting period in which the new contracts are added to the group.

Future cash flow estimates

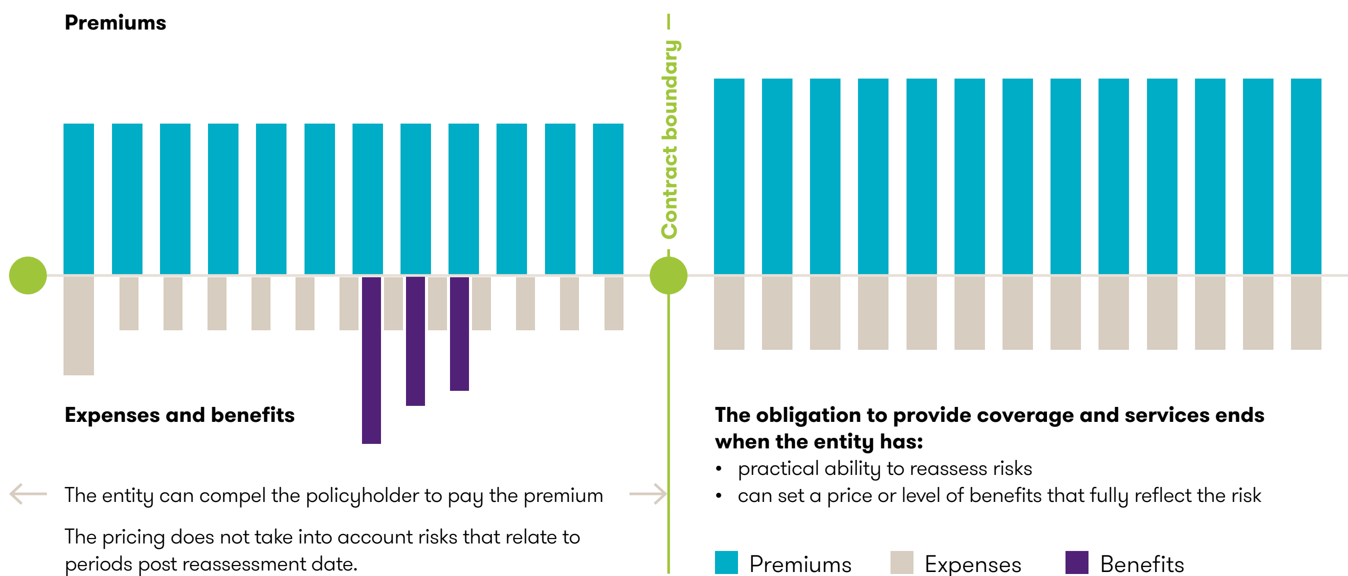
The recognition and measurement requirements of the Standard should be applied at the aggregation levels as specified above. However, to measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher aggregation level, as long as it is able to allocate such estimates to groups of contracts.

When measuring a group of insurance contracts a reporting entity should include all cash flows within the contract boundary and ensure the FCF estimate has the following characteristics:



A reporting entity should incorporate in the future cash flow estimates all reasonable and supportable information available without undue cost or effort. The estimate should capture the full range of possible outcomes about the amount, timing and uncertainty of the cash flows. Any market variables underlying the estimates should be consistent with observable market prices. The estimates should reflect the conditions existing at the measurement date and should include explicit adjustments for non-financial risk separately from other estimates (ie rather than doing this implicitly via the estimates of the discount rate).

The future cash flow estimates should only include cash flows, which are in the boundary of an insurance contract as illustrated below:



A reporting entity should not recognise as an asset or a liability any amounts related to expected premiums or claims outside the boundary of the insurance contract.

Cash flows within the contract boundary include:	Cash flows that should not be included in contract measurement:
• premiums, claims/benefits (including those paid in kind), claims handling costs • attributable acquisition expenses, policy administration and maintenance costs (including trailing commissions) • payments to policyholders which vary depending on the returns of underlying items • cash flows from options and guarantees embedded in the contract (if not separated) • premium taxes and taxes paid in fiduciary capacity for the policyholder • potential cash inflows from recoveries from salvage and subrogation • allocation of fixed and variable overheads (following systematic and rational methods consistently applied) • other costs specifically chargeable to the policyholder per contract terms	• cash flows outside the contract boundary • investment returns • cash flows under reinsurance contracts held (reported separately) • costs that cannot be directly attributed to the portfolio comprising the contract (reported in P/L when incurred) • income tax payments not made in a fiduciary capacity (ie not on behalf of policyholders) • cash flows between components of the reporting entity • cash flows arising from components separated from the insurance contract and accounted for under different standards

A group of contracts that generate cash flows in a foreign currency should be treated as a monetary item (including the CSM) when applying IAS 21 'The Effects of Changes in Foreign Exchange Rates'

The fulfilment cash flows should not reflect the entity's own non-performance risk (as defined in IFRS 13 'Fair Value Measurement').

Discount rates

When measuring insurance contracts, a reporting entity should adjust the estimates of the future cash flows to reflect the time value of money and financial risks associated with those cash flows (to the extent not already included therein). The discount rate should have the following characteristics:

Discount rate should reflect:

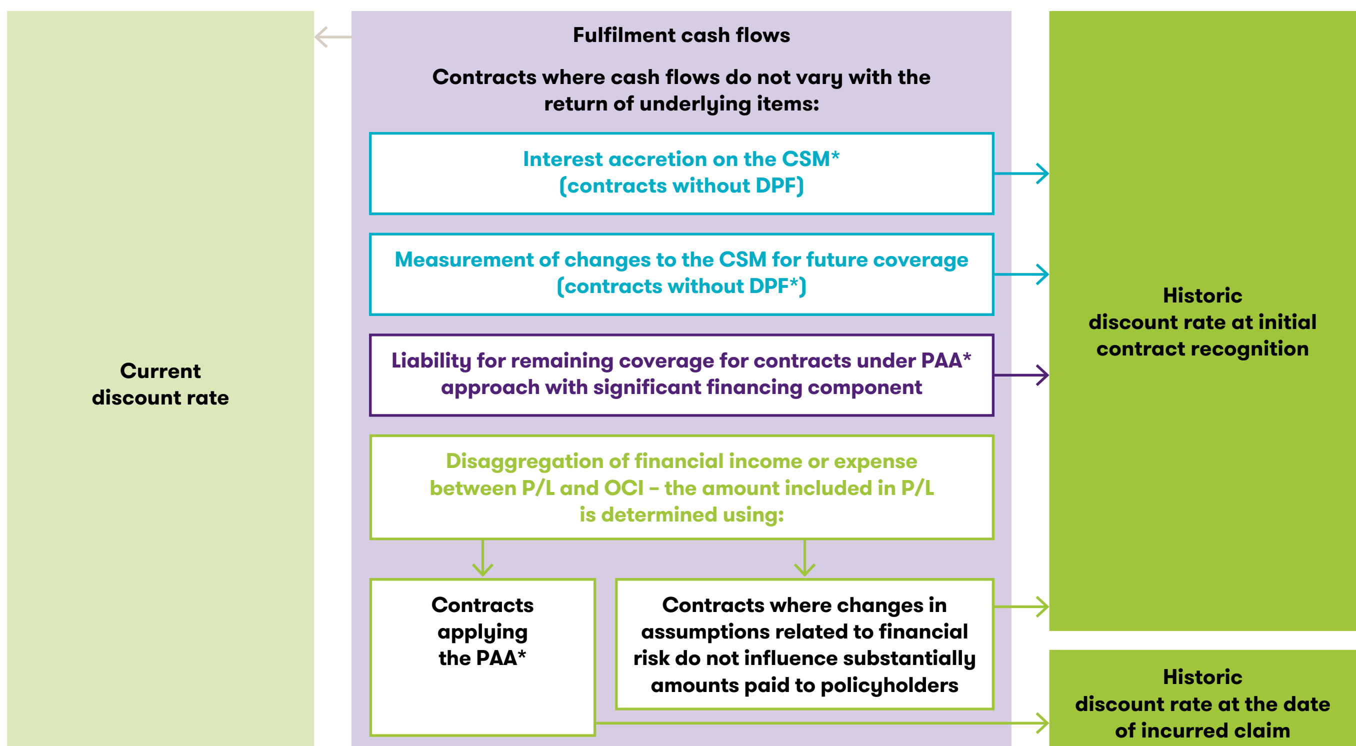
Characteristics of the cash flows and the liquidity of the insurance contracts	**Observable current market prices** of financial instruments with cash flows consistent with those of the insurance contracts (timing, currency, liquidity)	**Excludes market price factors,** which do not affect the fulfilment cash flows of the insurance contracts

The discount rate estimates should be consistent with the characteristics of the cash flows to avoid duplication or omission as follows:

Cash flow characteristics	Discount rates to be used
Do not vary based on the returns of any underlying items	Rates that do not reflect such variability
Vary based on the returns of underlying financial items (regardless of whether contractual or due to entity's discretion): • not adjusted for such variability • adjusted for the effects of that variability	 Rates that reflect that variability Rates that reflect the adjustment
Nominal cash flows (ie include the effects of inflation)	Rates that include the effects of inflation
Real cash flows (ie exclude effects of inflation)	Rates that exclude the effect of inflation

The Standard requires that fulfilment cash flows are remeasured at current discount rates at each reporting period end.

The following diagram illustrates when historic rates should be used (at the date of initial contract recognition or at the date of incurred claim (for PAA contracts)).



*refer to glossary

Determination of the discount rate

When determining the discount rates at initial recognition, an entity may use weighted average discount rates over the period that the contracts in the group (as per the Standard aggregation principles) are issued. The entity is allowed to estimate the appropriate discount rates using estimation techniques when observable market rates for instruments with cash flow characteristics similar to those of the insurance contract are not readily available, or cannot be approximated by adjustments based on market observable inputs.

Estimation techniques should:

Maximise the use of observable market inputs and should not contradict observable market variables	**Reflect current market conditions** from the perspective of a market participant	**Use judgement to adjust observable market prices** for differences between a market instrument and the insurance contract

Reflect the yield curve in the appropriate currency for instruments that expose the holder to **no or negligible credit risk**, adjusted to reflect the **liquidity characteristics** of the insurance contract.

For cash flows of insurance contracts that do not vary based on performance of underlying items, an entity is allowed to choose between a bottom-up approach or a top-down approach to estimate the discount rate as outlined below.

Bottom up approach	Determine the discount rate by adjusting a liquid risk-free discount rate for the differences between the liquidity characteristics of the financial instrument that underlie the market observable rate and the liquidity characteristics of the insurance contract.
Top-down approach	Determine the discount rate by using a yield curve that reflects current market rates of return implicit in a fair value measure of a reference portfolio of assets. Adjust to eliminate any factors that are not relevant for the insurance contract but not required to adjust for differences in liquidity characteristics between the insurance contracts and the reference portfolio.

ADJUST

Differences between the amount, timing and uncertainty of cash flows of the reference assets and the insurance contracts.	Risk premium (exclude) for credit risk relevant only to the reference assets.

The Standard does not specify restrictions on the reference portfolio of assets used in applying the top-down approach where there are observable market prices in active markets for those assets. An entity is not required to reconcile the discount rate determined under its chosen approach with the rate that would have been determined under the other approach.

Practical insight – leverage of existing capabilities (Solvency II or Embedded Value)

Determination of the discount rate is a highly judgemental area with profound effect on the measurement of insurance contracts. IFRS 17 principles for determination of the discount rate are different from those under Solvency II or existing embedded value reporting frameworks. However, subject to a robust gap analysis of current methodologies and practices, entities may be able to utilise effectively their existing modelling capabilities and reference data. Additional IT systems investment may be required, so that entities can track historic discount rates at contract inception and perform calculations (subject to policy choice) to disaggregate the impact of discount rate changes between OCI and Profit or loss.

Where entities adopt a top-down approach, the choice of reference portfolios will be crucial in order to minimise the required adjustments and controls burden over calculation routines and data quality.

Risk adjustment for non-financial risks

The risk adjustment to the estimates of future cash flows reflects the compensation a reporting entity expects for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risks.

Risk adjustment = compensation that makes an entity indifferent between:

Fulfilling a liability with a range of possible outcomes eg, 50% probability for CU 50 and 50% probability for CU 500	AND	**Fulfilling a liability with the same expected present value** (CU 275 in this example) **but generating fixed cash flows**

The purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows of insurance contracts that arise from risks other than financial risks. It should not reflect risks that do not arise from the rights and obligations created by an insurance contract, eg general operational risks.

The risk adjustment is an entity-specific measure of uncertainty and should have the following characteristics:

Characteristics of the risk adjustment

Explicit	**Reflects entity's risk diversification**	**Reflects entity's risk appetite**
The risk adjustment is separate from the estimates of the cash flows or the discount rate. It should not result in double counting.	The entity should allow for its own risk profile and any benefits arising from diversification in its management of non-financial risks.	Both favourable and unfavourable outcomes should be reflected in a way that reflects the entity's degree of risk aversion.

The Standard does not specify what estimation technique entities should use when calculating the risk adjustment. However, the following guidelines apply:

Risk adjustment for:	GENERALLY >	**Risk adjustment for:**
Contracts with: • low frequency and high severity of claims • longer duration for similar risks • wider probability distribution • emerging experience increases the uncertainty on non-financial risks.		Contracts with: • high frequency and low severity of claims • shorter duration for similar risks • narrower probability distribution • emerging experience decreases the uncertainty on non-financial risks.

A reporting entity should disclose the technique used in the estimation of the risk adjustment and the confidence level corresponding to the result of that technique.

Practical insight – entities' own view on risk and diversification for risk adjustment

IFRS 17 allows a choice of estimation method and gives entities an opportunity to eliminate the high interest rate sensitivity from the cost of capital approach mandated by Solvency II. An entity specific pattern of risk release could also prove a useful basis for revenue recognition under the Premium Allocation Approach. Subject to the operational challenges of confidence level disclosures, entities could align their financial reporting to their own risk appetite.

Contractual service margin (CSM)

The contractual service margin is a component of the asset or liability for a group of insurance contracts and represents the unearned profit the entity will recognise as it provide services in the future.

Unless a contract is onerous, on initial recognition (see example below) the CSM is measured as follows:

Fulfilment cash flows on initial recognition = FCF+ discount+ RA	+	De-recognition of assets or liabilities for pre-contract cash flows	+	Cash flows arising on date of initial recognition	+	CSM	=	0 Zero income or expense on initial recognition

In case of business combination or Group contract transfers, the above principle for measuring the CSM on initial recognition is modified as follows (unless the contracts are accounted for under the premium allocation approach):

Consideration received or paid = Premium proxy* (excludes any element related to any other acquired assets or liabilities)	–	Fulfilment cash flows on date of business combination or group transfer	=	CSM

* In a business combination the consideration received or paid is the fair value of the contracts at that date

If the contracts are onerous, the following principle will apply instead:

Fulfilment cash flows on date of business combination or group transfer	–	Consideration received or paid = Premium received	=	Goodwill or gain on a bargain purchase** OR Loss in P/L***

** in a business combination

*** in a Group transfer. The entity should establish a loss component of the liability for remaining coverage and allocate subsequent changes in fulfilment cash flows to it.

Example 1: Initial measurement

An entity issues 100 three-year contracts of product A and 50 three-year contracts of product B with the following terms.

	Product A	Product B
Expected total premiums, payable immediately after initial recognition	CU 13,500	CU 13,500
Annual expected cash outflows (assumed paid immediately when incurred)	CU 3,000	CU 6,000
Estimated risk adjustment for non-financial risk on initial recognition	CU 1,800	CU 1,800
Estimated discount rate on initial recognition	2.50%	2.50%
The entity has concluded that the contracts meet the conditions to be combined in a group for product A and for product B.		

The measurement of the contracts on initial recognition is as follows:

	Product A CU	Product B CU
Expected present value of cash inflows (premiums) over 3 years	(13,500)	(13,500)
Expected present value of cash outflows over 3 years	8,568	17,136
Expected present value of net future cash flows (FCF)	**(4,932)**	**3,636**
Risk adjustment for non-financial risk (RA)	1,800	1,800
Fulfilment cash flows	**(3,132)**	**5,436**

Summary:

	FCF CU	RA CU	CSM CU	Total liability CU	Insurance service expenses (P/L) CU
Product A	(4,932)	1,800	3,132	0	0
Product B	3,636	1,800	0	5,436	(5,436)

Contracts from product B represent a group of onerous contracts resulting in a loss on initial recognition of CU 5,346.

Subsequent measurement

The carrying amount of a group of insurance contracts at the end of each reporting period is the sum of the liability for remaining coverage and the liability for incurred claims. If the contracts are accounted for under the premium allocation approach, the principles described in the dedicated section of this publication will apply.

At the end of each reporting period the liability for remaining coverage and the liability for incurred claims for a group of insurance contacts comprise the following components:

Liability for remaining coverage		Liability for incurred claims
Fulfilment cash flows related to future service allocated to the group	**Contractual service margin of the group (CSM)**	**Fulfilment cash flows related to past service allocated to the group**

An entity should then recognise income and expenses for the following changes in the carrying amount of the above liabilities:

	Changes in	
	Liability for remaining coverage	**Liability for incurred claims**
Insurance revenue	For the reduction in liability because of services provided in the period	n/a
Insurance service expenses	For losses on groups of onerous contracts, and reversals of such losses	For the increase in the liability due to claims and expenses incurred during the period (excluding any investment component)
	n/a	For any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses
Insurance finance income or expenses	For the effect of time value of money and the effect of financial risk	For the effect of time value of money and the effect of financial risk

The fulfilment cash flows are measured following the same principles as for initial measurement. The contractual service margin at the end of the period represents the profit in the group of insurance contracts that has not yet been recognised in profit or loss because it relates to future services.

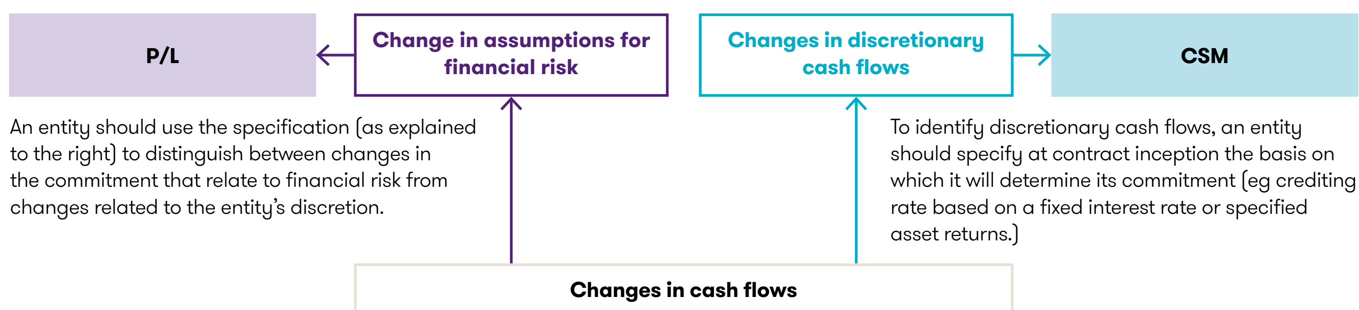
Contractual service margin (CSM) on contracts without discretionary participation feature (DPF)

The approach for measuring the CSM for contracts without discretionary participation feature at the end of the reporting period is illustrated below:

	CSM	P/L	Notes
Carrying amount at the beginning of the period	X		
Effect of any new contracts added to the group	X		
Interest accrued during the period*	X	(X)	* at historic rate determined on initial recognition
Changes in fulfilment cash flows related to future service**	X		** exclude: • increases in fulfilment cash flows > CSM carrying amount, giving rise to a loss or • decreases in fulfilment cash flows allocated to the loss component of the liability for remaining coverage
Foreign currency gains/losses	(X)	X	
Carrying amount before allocation	X		
Amount recognised as insurance revenue in the period***	(X)	X	*** The allocation is based on the number of coverage units provided in the current period as a proportion of total coverage units in the current and future periods
Carrying amount at the end of the period	X		

Examples of changes in fulfilment cash flows that relate to future services include: experience adjustments from premiums received in the period that relate to future service and related acquisition expenses and taxes; changes in the risk adjustment that relate to future service; difference between actual investment component payable in the period and the one expected to become payable, etc.

Changes in estimates of cash flows in the liability for incurred claims and changes in assumptions that relate to financial risk are not regarded as relating to future services; therefore, they do not adjust the CSM. However, changes in the discretionary cash flows of contracts without DPF are regarded as relating to future service, and accordingly adjust the CSM.



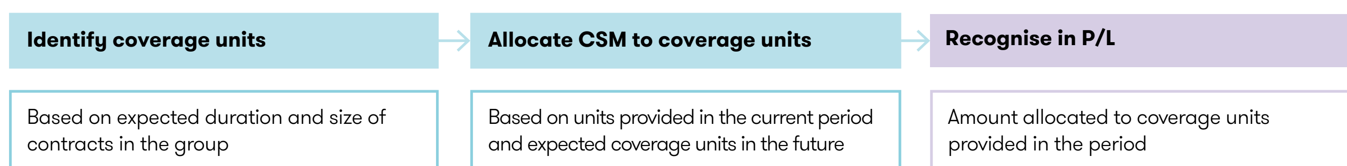
Where an entity cannot distinguish at contract inception between what it is committed to and what it regards as discretionary, it should regard its commitment to be the return implicit in the estimate of fulfilment cash flows at contract inception, updated to reflect current assumptions related to financial risk.

Contractual service margin (CSM) on contracts with discretionary participation feature (DPF)
The approach for measuring the CSM for contracts with DPF at the end of the reporting period follows the same logic as outlined above for contracts without DPF. The changes in fulfilment cash flows represent the changes in the entity's share in fair value changes of the underlying items.

A reporting entity should recognise in profit or loss the combined effect of the changes in fulfilment cash flows (excluding cash flows arising in the period) and the changes in the CSM, and analyse those between insurance services revenue, insurance services expenses and insurance finance income or expenses (for more detail, please refer to the section on Presentation and Disclosure.)

The modifications to the above general measurement approach are referred to as the 'Variable fee' approach and are discussed in a dedicated section of this publication.

Recognition of the CSM in profit or loss
The release of CSM to profit or loss in each reporting period should reflect the service provided under the group of insurance contracts in that period and should follow the process illustrated below.



Example 2: Allocation of the CSM to profit or loss

In the example below the following assumptions have been made:
- The contracts are of equal size, therefore one unit of coverage is provided under each contract each year.
- The contracts expire in year 3 to the extent the holder has not terminated them earlier.

	Year 1 number	Year 2 number	Year 3 number
Contracts in force – start of year	100	90	70
Contracts in force – end of year	90	70	0
Coverage provided in the current year	100	90	70
Coverage provided in the current year and expected to be provided in the remaining years	260	160	70
Percentage of remaining coverage provided in the current year**	38.5%	56.3%	100.0%

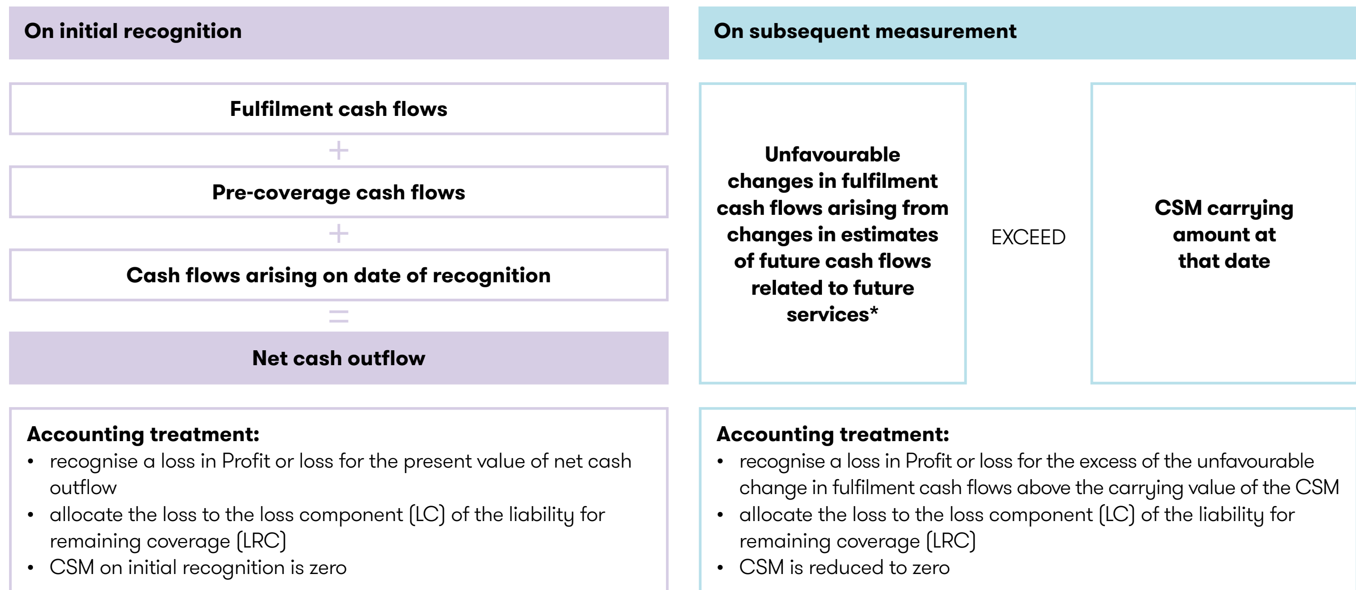
	Year 1 CU	Year 2 CU	Year 3 CU
CSM – start of the year	1,500	923	404
CSM release in the year*	(577)	(519)	(404)
CSM – end of the year	923	404	0

* Year 1 release for the year = CU 1,500 × 38.5% = CU 577
** Year 1 percentage of remaining coverage = 100/260 = 38.5%

Practical insight – CSM calculation engine
The CSM implementation will pose complex operational challenges and may require significant IT investment, process re-design and changes to data capture and analysis. A CSM calculation engine should (i) 'read' actuarial models for future cash flows; (ii) identify the correct historic discount rates per aggregation cohort for interest accretion; (iii) link to financial records and 'track' recouping of previously recognised losses on onerous contracts; (iv) retranslate for FX rate changes, and (v) 'mine' operational and actuarial databases to update remaining units of coverage (based on actual experience and future assumptions). Outwards reinsurance will make the task even more demanding (see separate insight on Reinsurance.)

Onerous contracts

A contract is onerous if any of the following apply:



Accounting treatment:
- recognise a loss in Profit or loss for the present value of net cash outflow
- allocate the loss to the loss component (LC) of the liability for remaining coverage (LRC)
- CSM on initial recognition is zero

Accounting treatment:
- recognise a loss in Profit or loss for the excess of the unfavourable change in fulfilment cash flows above the carrying value of the CSM
- allocate the loss to the loss component (LC) of the liability for remaining coverage (LRC)
- CSM is reduced to zero

* For a group of contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items should be indicated in the above comparison.

Example 3: Onerous contract – on initial recognition

On initial recognition:
- Net cash outflow = CU 500. The financial statements will report the following balances

	Liability for remaining coverage (LRC) excluding loss component CU	Loss component of LRC CU	Total liability for the group CU	P/L (loss) CU
	–	500	500	(500)

The loss component of the liability for remaining coverage determines the amounts that are presented in Profit or loss as reversals of losses on onerous groups and are consequently excluded from the determination of revenue.

Subsequent changes in the fulfilment cash flows of an onerous group should be allocated on a systematic basis between the loss component of the liability for remaining coverage and the liability for remaining coverage excluding the loss component. The total amounts allocated to the loss component should equal zero by the end of the coverage period of the group of contracts.

Such subsequent changes that require allocation include the following:

- estimates of future cash flows for claims and expenses released from the liability for remaining coverage as claims and expenses are incurred
- changes in the risk adjustment for non-financial risk
- insurance finance income or expense (eg unwind of the discount).

Future decrease in fulfilment cash flows allocated to an onerous group of contracts that arise from changes in assumptions relating to future coverage or services should be allocated solely to the loss component of the liability for remaining coverage until it is reduced to zero. Then any excess of the decrease in future cash flows over the loss component of the liability for remaining coverage can adjust the contractual service margin.

Example 4: Onerous contract – subsequent measurement

To illustrate the principles outlined above, let us assume that in year 2 of an insurance contract an entity has the opening balances of the liability for remaining coverage as outlined in the table below.

The entity has determined a discount rate of 5% and has made an election not to analyse the changes in risk adjustment between Insurance contract revenue and Insurance finance income or expenses (ie it reports the entire change in Insurance services result). Risk adjustment expected to be released in year 2 is CU 50.

On initial recognition, the entity expected to pay benefits of CU 300 each year until contract expiry. However, at the end of year 2 the entity revises its estimate for year 4 to CU 150 instead, which represents a decrease in present value of net expected cash flows of CU 136 (ie CU 150 cash flow decrease discounted at 5% over a 2-year period). The entity does not change its estimate of the risk adjustment or the pattern of its release.

For simplicity, let us assume that claims are paid when incurred and other expenses are negligible and can be ignored.

Based on the above, the reconciliation of the opening to the closing balance of the contract carrying amount for year 2 will be as follows:

	Future cash flows CU	Risk adjustment CU	Loss component of LRC CU	CSM CU	Total LRC CU	Incurred claims CU	Total liability for the group CU
Opening balance	**550**	**150**	**130**	**–**	**830**	**–**	**830**
Insurance finance expenses (unwinding of discount)	28		6		34		34
Insurance contract revenue	(253)	(42)			(295)		(295)
Insurance service expense	8	(8)	(55)		(55)	300	245
Changes in assumptions related to future years	(55)		(81)	55	(81)		(81)
Cash flows						(300)	(300)
Closing balance	**278**	**100**	**0**	**55**	**433**	**–**	**433**

Explanation:
Insurance contract revenue is calculated as the total of the changes in the liability for remaining coverage (LRC) for which the entity expects consideration. The latter include incurred claims measured at the amounts expected at the beginning of the period, changes in the risk adjustment, which do not relate to future coverage and the amount of CSM allocated to profit or loss in the period. Insurance contract revenue excludes any changes in the LRC related to amounts allocated to its loss component.

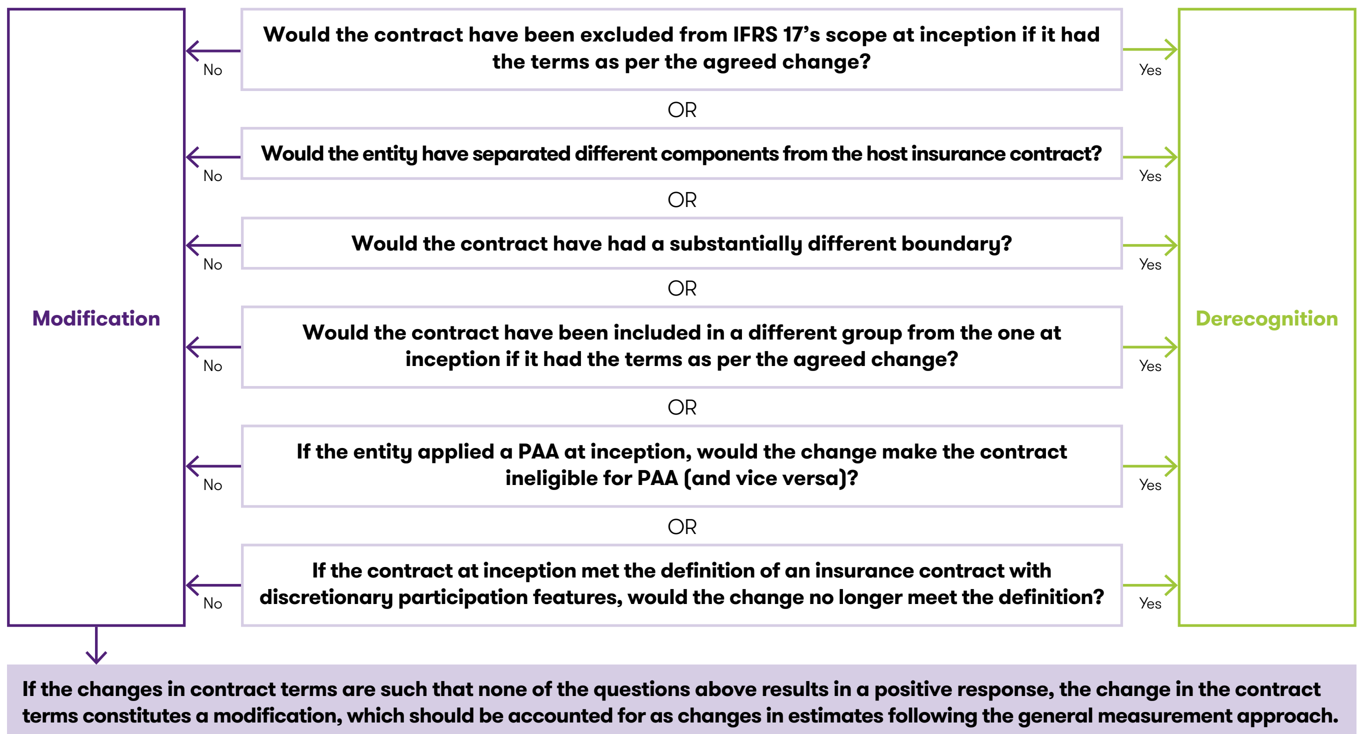
As noted above, IFRS 17 requires allocation of changes in fulfilment cash flows between the LRC excluding loss component, and the loss component of the LRC. In the above example the allocation has been based on the share of the opening balance of the loss component of LRC and the total opening LRC = CU 130/CU 830 = 15.66%.

	100% Total	84.34% LRC excluding Loss component CU	15.66% Loss component of LRC CU	CSM CU
Allocation of estimated claims and expenses related to coverage	300	(253)	(47)	
Release of risk adjustment not related to future coverage or services	50	(42)	(8)	
Insurance contract revenue		(295)		
Reversal of loss component			(55)	
Changes in assumptions related to future years* (The total is first allocated to the loss component of LRC to reduce it to zero and any residual balance goes to CSM)	(136)	(55)	(81)	55

Modification and de-recognition

When the parties to an insurance contract agree to change its terms or the terms are modified by a change in regulation, the issuer should assess if the change qualifies as a modification or requires de-recognition.

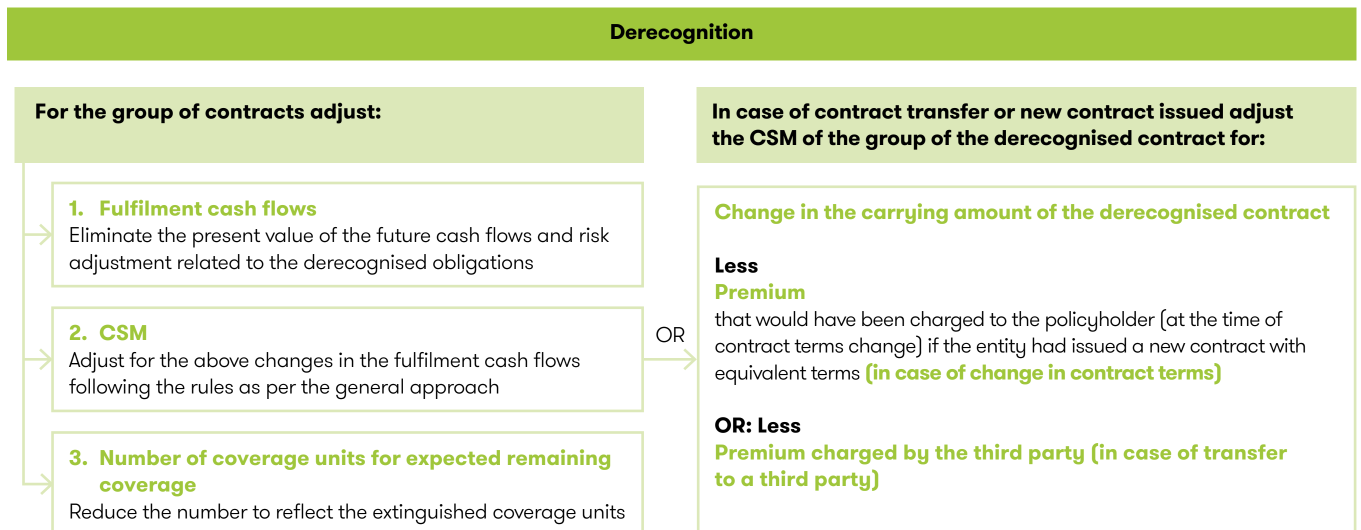
The following thought process should be followed:



If the changes in contract terms are such that none of the questions above results in a positive response, the change in the contract terms constitutes a modification, which should be accounted for as changes in estimates following the general measurement approach.

An insurance contract (or a part of it) should be derecognised if, and only if it has been extinguished (ie the obligation specified in the contract expires, or is discharged or cancelled), or following a change in contract terms, the response to any of the questions in the diagram above is positive.

The following adjustments should be made in relation to the rights and obligations that have been extinguished in relation to a contract from within a group of contracts:



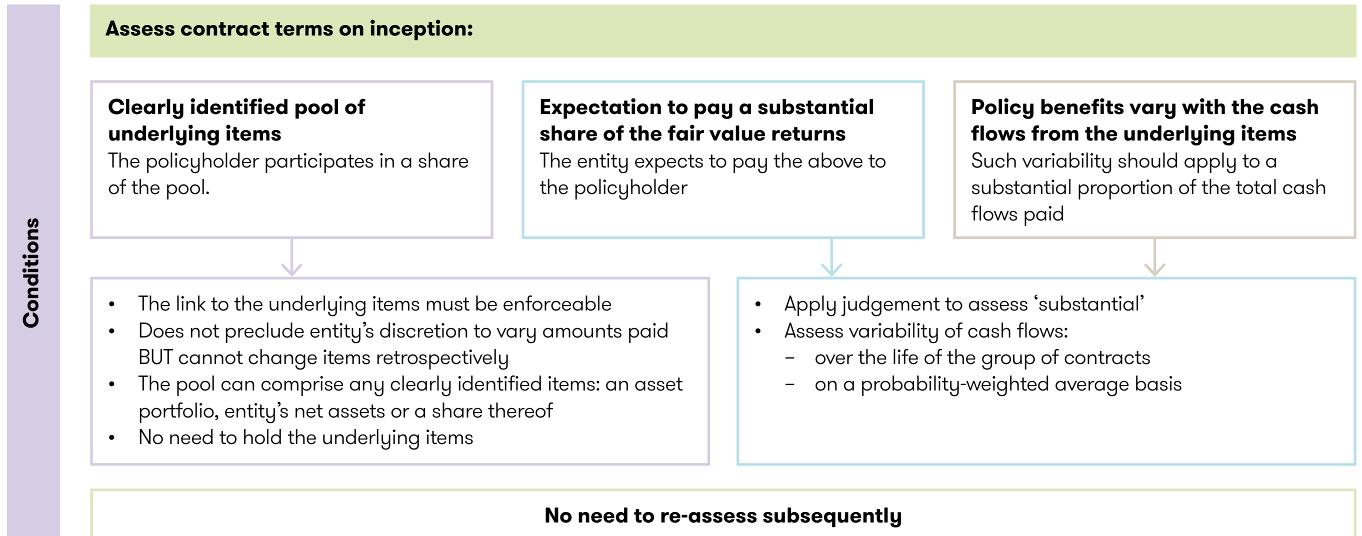
Practical insight – product optimisation initiatives

In order to improve capital and operational efficiency under Solvency II, many insurers have launched initiatives to optimise their legacy product offerings. These initiatives are often complex exercises likely to run over several years and potentially span beyond IFRS 17 transition. In addition to the careful consideration of conduct risks that are usually associated with changes to product terms and conditions, entities may wish to consider how such amendments may be interpreted under the IFRS 17 principles for contract modification or de-recognition to avoid unintended IFRS reporting results.

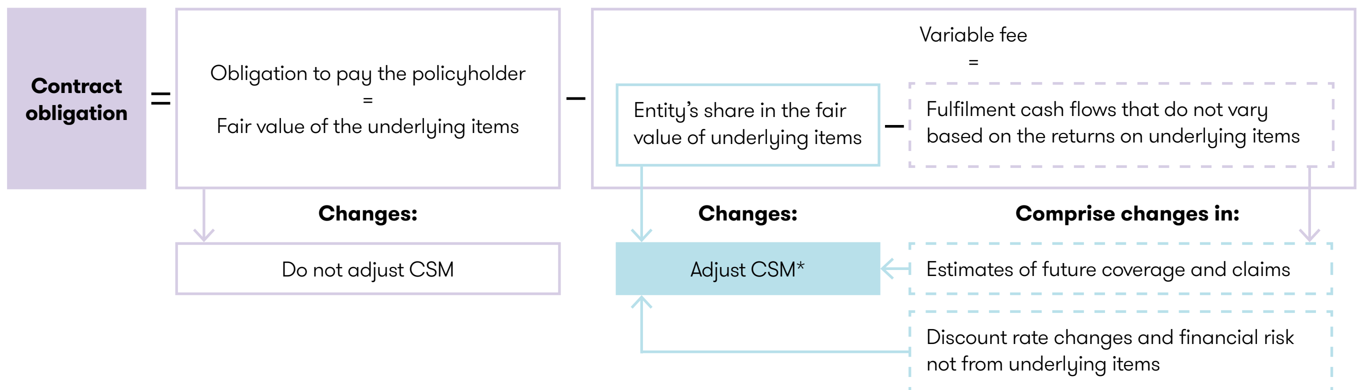
Modifications to the general model

– variable fee approach

In the cases where contract terms at the time of inception meet the following conditions, the contracts are defined by the Standard as contracts with discretionary participation features (DPF):



For contracts with DPF, the Standard permits the use of a modification to the general measurement principles referred to as the 'Variable fee approach'. The name stems from the components of the entity's obligation:



* Except to the extent that risk mitigation does not apply as explained in the 'Risk mitigation' section.

An entity is not required to identify the above adjustments to the CSM separately. A combined amount may be determined for some or all of the adjustments.

Example 5: Variable fee approach for measurement

An entity issues 100 contracts with a coverage of 3 years which for this example are assumed to meet the definition of insurance contracts with DPF. Each policyholder pays a premium of CU 200 at the beginning of the coverage period.

Beneficiaries will receive either (i)CU 220 or the account balance, if higher, if the policyholder dies during the coverage period, or (ii) the value of the account balance at the end of the coverage period if the policyholder survives.

Per contract terms, the entity charges a 2% annual charge of the policyholder account balance at the end of each year.

At initial recognition, the entity expects that one policyholder will die each period. The entity purchases the specified pool of assets and measures them at fair value through profit or loss. It expects that the pool will yield an annual return of 10%; determines the risk free discount rate at 8%, and estimates the risk adjustment to be CU 50.

The specified pool of assets yield 10%, 8% and 10% in years 1, 2 and 3 respectively.

The entity has calculated the fair value of the underlying items in which the policyholders participate as follows:

Account balance (underlying items)

	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance (A)	20,000	21,344	22,363
Change in fair value (B)	2,000	1,708	2,236
Annual charge (C = 2% x (A+B))	(440)	(461)	(492)
Death claims deduction D=y[n] x(A+B+C); y1 = 1/100, y2=1/99, y3=1/98)	(216)	(228)	(246)
Payment on maturity			(23,861)
Closing balance	**21,344**	**22,363**	**0**

In year 1, the entity will pay the guaranteed benefit of CU 220, which is bigger than the account balance of CU 216.

The entity has measured the expected present value of cash outflows to reflect the characteristics of the expected cash flows including an estimate of the time value of guarantees for providing a minimum death benefit as follows:

	Year 1 CU	Year 2 CU	Year 3 CU
Present value of expected cash outflows	19,578	20,548	21,886

Based on the above information the entity measures the contracts on initial recognition as follows:

	Initial recognition CU
Expected present value of cash inflows	20,000
Expected present value of cash outflows	(19,578)
Expected present value of net cash flows	422
Risk adjustment for non-financial risk	(50)
Fulfilment cash flows	372
Contractual service margin (CSM)	(372)

Applying the Standard, the entity will recognise the following balances in relation to the CSM in the following periods:

Contractual service margin

	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	(372)	(784)	(460)
Changes in the fair value of underlying items	(2,000)	(1,708)	(2,236)
Change in the fulfilment cash flows related to future coverage	1,190	1,567	2,221
CSM before release (E)	(1,182)	(925)	(475)
Release for the year	398	465	475
Closing balance	(784)	(460)	0

Example 5: Variable fee approach for measurement (continued)

Changes in the fulfilment cash flows related to future coverage have been calculated as follows:

Year 1	1,190	=	20,548	-	19,578	+	220	(death benefit)
Year 2	1,567	=	21,886	-	20,548	+	228	(death benefit)
Year 3	2,221	=	23,861	-	21,886	+	246	(death benefit)

The release of the CSM has been calculated as follows:

	Year 1	Year 2	Year 3
% of coverage provided in the year (F) (y1 = 100/(100+99+98);y2=99/(99+98)	33.67%	50.25%	100.00%
CSM allocated based on the above (E x F)	398	465	475

The example assumes that the entity chooses as an accounting policy to include insurance finance income and expense for the period in profit or loss.

Risk mitigation

A reporting entity may choose not to recognise a change in the CSM (but report in profit or loss instead) to reflect some or all of the changes in the entity's share of the underlying items or fulfilment cash flows that are caused by discount rate changes or financial risk not arising from the underlying items. Such choice can be exercised if all of the following conditions are met:

Report Variable fee changes to Profit or loss

IF the following apply:

Previously documented risk management objective and strategy for using derivatives

Use of derivatives to mitigate financial risk arising from a group of insurance contracts

Economic offset exists The derivative and the contracts move in opposite directions as the mitigated risk changes. Accounting measurement differences should not be considered in assessing the economic offset.

Credit risk does not dominate the economic offset

IF any condition ceases to be met:

Report in CSM

Cease to report changes to profit or loss

No need to adjust for changes previously reported to profit or loss (when conditions were met)

Practical insight – hedging

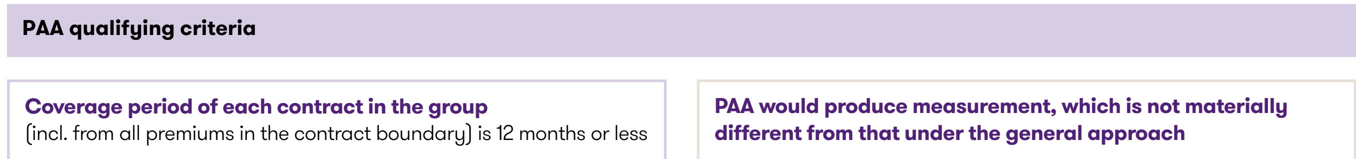
Where reporting entities are considering the use of the option to report variable fee changes to Profit or loss post transition, management may wish to assess the extent to which existing hedging arrangements meet the IFRS 17 qualifying criteria. For example, entities may need to formalise or enhance their documentation and link it explicitly to a formal risk management strategy, evaluate the degree of economic offset between the derivatives and the relevant group of insurance contracts and assess to what extent credit risk affects such offset.

Other modifications

– premium allocation approach

Liability in scope of the simplification

The premium allocation approach (PAA) is an optional (ie not mandated) simplification of the general approach. It applies to the contracts where all of the following qualifying criteria are satisfied:



The above condition is not likely to be met where at contract inception the entity expects significant variability of the contractual cash flows that would affect the measurement of the liability for remaining coverage, before a claim is incurred. Such variability would usually arise from embedded derivatives or uncertainty in the coverage period.

Initial measurement of the liability for remaining coverage

On initial recognition, the PAA liability for remaining coverage comprises the following:

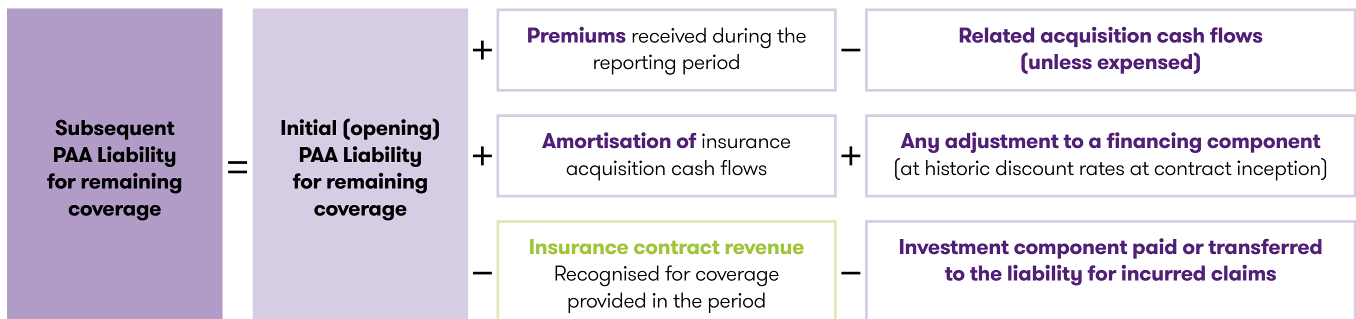
An entity may choose to recognise insurance acquisition cash flows as expenses when it incurs these costs provided that the coverage period of each contract in the group is no more than one year.

The liability for remaining coverage need not be adjusted for the time value of money, if at contract inception the time between providing each part of the coverage and the related premium due date is no more than a year, or where no discounting is applied to the liability for incurred claims.

Where facts and circumstances indicate that a group of contracts is onerous, an entity should assess if the fulfilment cash flows that relate to remaining coverage of the group exceed the liability for remaining coverage determined as described above. If this is the case, the entity should recognise a loss in profit or loss and increase the liability for remaining coverage.

Subsequent measurement of the liability for remaining coverage

In subsequent periods the opening carrying value of the liability for remaining coverage changes in line with the receipt of premiums, amortisation of acquisition cash flows (where not previously expensed) and the recognition of insurance contract revenue as illustrated below:



Where qualifying contracts include an investment component, the changes in such a component does not affect profit or loss, as they are not included within the recognised insurance contract revenue.

Revenue recognition
Under the PAA approach, the insurance contract revenue for the period is the amount of expected premium receipts (adjusted for the impact of the time value of money if applicable) allocated to the reporting period.

PAA Revenue: bases for premium allocation

Straight-line passage of time	OR	**Expected timing of incurred claims and benefits** (if the expected pattern of risk release differs significantly from the passage of time)

If facts and circumstances change, an entity should change between the above-allowed bases as necessary.

The liability for incurred claims should be measured at the fulfilment cash flows relating to incurred claims, applying the principles of the general approach. The entity need not adjust for the time value of money if those cash flows are expected to be paid or received in one year or less fom the date the claims are incurred.

Example 6: Premium Allocation Approach for measurement

An entity issues insurance contracts with a coverage period of 12 months that starts on 1 October 20X1. At initial recognition the entity expects to receive premiums of CU 2,400 payable quarterly in advance. The first quarterly instalment is paid on initial recognition. Direct attributable acquisition cash flows are CU 480 and the entity pays them on contract inception. The policy choice is not to expense the acquisition cash flows on initial recognition.

The entity expects to incur claims of CU 1,440, which will be settled within 12 months after they are incurred. The entity estimates that 45% of total expected claims will be incurred by 31 Dec 20X1 and the remaining 55% of expected claims will be incurred between 1 Jan 20X2 and 31 Aug 20X2. The entity further estimates a risk adjustment for non-financial risk of CU 120. For simplicity, the risk adjustment is released as claims are incurred. The assumption is that no policyholder will terminate their contract during the coverage period. On 1 March 20X3 the entity revises its estimate for total claims to CU 1,710 and settles them as expected by 30 Sep 20X3.

Liability for remaining coverage

	31 Dec 20X1 CU	31 Dec 20X2 CU	31 Dec 20X3 CU
Opening balance	**120**	**66**	**0**
Cash inflows	0	1,800	–
Insurance contract revenue	(270)	(2,130)	–
Amortisation of acquisition cash flows	216	264	–
Closing balance	**66**	**0**	**0**

Liability for incurred claims

	31 Dec 20X1 CU	31 Dec 20X2 CU	31 Dec 20X3 CU
Opening balance	**0**	**702**	**912**
Insurance service expenses	702	858	150
Cash outflows	0	(648)	(1,062)
Closing balance	**702**	**912**	**0**

Example 6: Premium Allocation Approach for measurement (continued)

Explanation:

Liability for remaining coverage opening balance

	At inception
Premium received	600
Acquisition cash flows paid	(480)
	120

Insurance contract revenue represents allocation of premium received in the period. It is based on the expected pattern for incurring claims (as it differs significantly from the passage of time: 45% of claims will be incurred in the first quarter of contract coverage (ie whilst only 25% of time will have elapsed).

45% x CU 600 = CU 270; 55% x CU 600 + CU 1,800 = CU 2,130.

The amortisation of acquisition cash flows follows the same pattern as a portion of premium is allocated to recover such expenses.

Insurance service expenses represents expected claims and the corresponding risk adjustment:

45% x (CU 1,440+ CU 120) = CU 702; 55% x (CU 1,440+ CU 120) = CU 858;

CU 150 = CU 1,710 (revised total claims estimate) – CU 1,440 (initial claims estimate) – CU 120 (risk adjustment)

CU 150 are reported in the income statement as they represent change in estimate for past service.

Statement of financial performance

	31 Dec 20X1 CU	31 Dec 20X2 CU	31 Dec 20X3 CU
Insurance contract revenue	270	2,130	0
Acquisition costs	(216)	(264)	0
Insurance service expenses	(702)	(858)	(150)
Profit / (loss)	**(648)**	**1,008**	**(150)**

Statement of Financial Position

	31 Dec 20X1 CU	31 Dec 20X2 CU	31 Dec 20X3 CU
Cash	120	1,272	210
Liability for insurance contracts	(768)	(912)	0
Equity	**(648)**	**360**	**210**

Practical insight – PAA policy choice considerations

Composite insurers and non-life insurers that write significant volumes of multi-year coverage contracts will have to weigh very carefully the benefits from using the PAA modification on certain blocks of business against the challenge of operating more than one measurement model.

Decisions to expense acquisition cash flows when incurred may influence conclusions whether a group of contracts is onerous at inception or not and potentially also impact the point of recognition of such contracts.

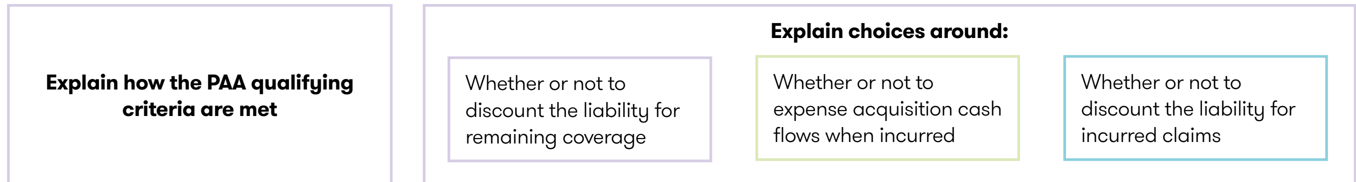
The renewal terms and pricing clauses of multi-year non-life contracts will have to be very carefully analysed to establish correctly the contract boundaries and then assess the contact against the PAA qualifying criteria.

Entities will have to demonstrate that any revenue recognition pattern different from the straight-line passage of time is consistent with the methodology applied for risk adjustment release.

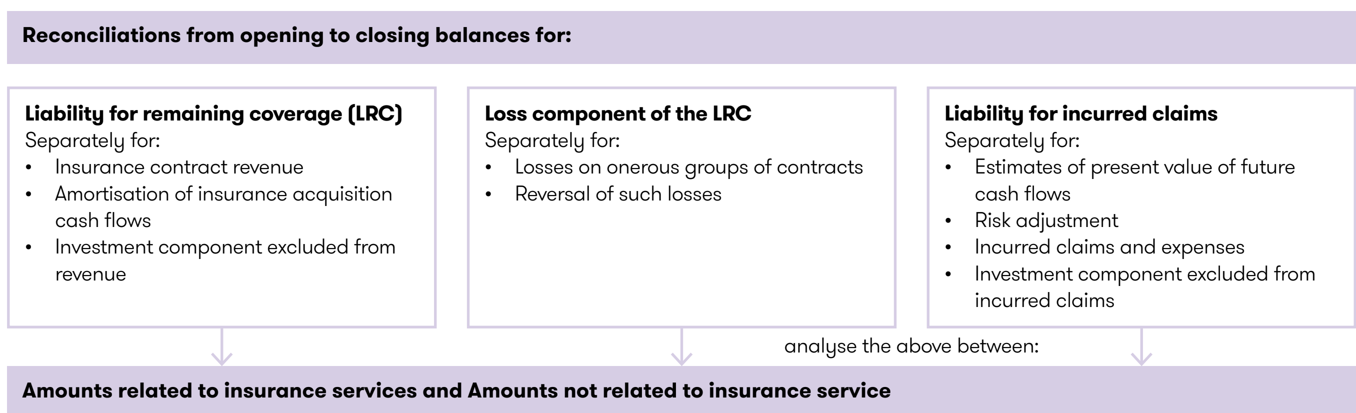
Information system and data quality considerations should also be made around the ability to monitor accurately the actual cash flows on premiums and expenses, store multiple earning patterns and discount rates data based on contract inception and per accident year of claims occurrence.

Presentation and disclosure

An entity applying the PAA should make the following qualitative disclosures:



In addition, the following reconciliations are required:



Sufficient information should be provided to allow users to identify changes that arise from cash flows and those which are recognised in the statement of financial performance. To complete the above reconciliation, an entity should also disclose separately each of the following amounts not related to insurance services:

i cash flows in the period (premiums, claims paid, acquisition expenses, other insurance expenses paid)

ii insurance finance income or expenses

iii the effect of changes in credit risk by reinsurers on reinsurance contracts held.

In addition, the reconciliations should be disaggregated between the total for groups of contracts in an asset position and the total for groups of contracts in a liability position.

Practical insight – PAA disclosures considerations

IFRS 17 specifies more granular tabular disclosures of the roll-forward of insurance contract liabilities than the existing practices adopted by non-life insurers in most markets.

The explicit disclosure of actual cash flows and separate identification of cash flows related to deposit components may pose a challenge to some insurers whose policy and claims administration systems are not fully integrated with their cash and treasury ledgers and systems. Additional cash flow reconciliation controls may have to be introduced.

The separate disclosure of claims and expenses expected at the beginning of the reporting period could be potentially commercially sensitive (especially for new business, as it will be indicative of the technical pricing structure of an entity). It will also require closer collaboration between financial reporting teams, underwriters and pricing and reserving actuaries.

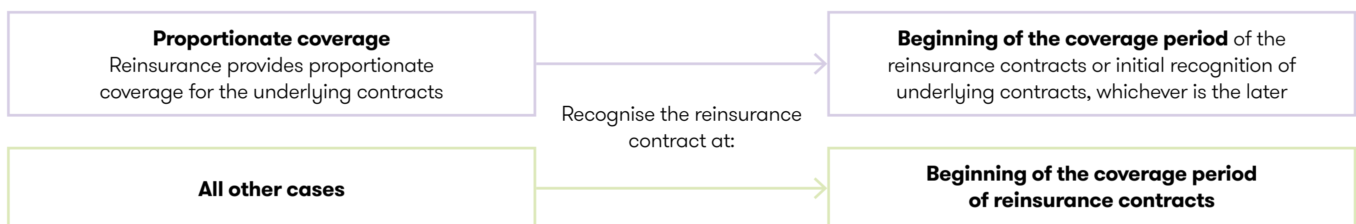
Reinsurance

The cedent's view (reinsurance contracts held)

Contract classification
The reinsurance contract classification follows the general rules on transfer of significant insurance risk.

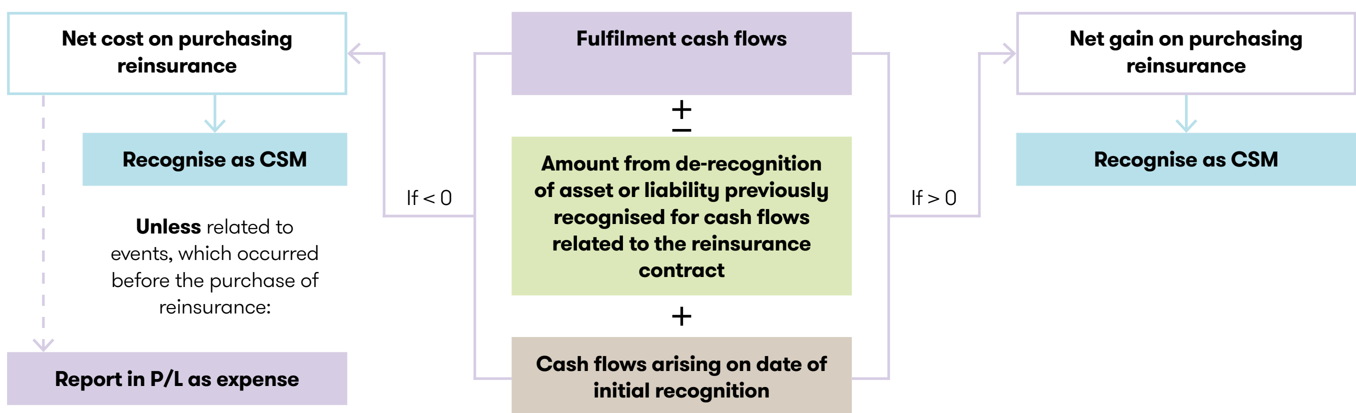
Level of aggregation
The level of aggregation of reinsurance contracts may not mirror the aggregation of the underlying contracts and may result in groups which include a single contract. Portfolios of reinsurance contracts held should be divided into groups following the principles of the Standard, except that references to onerous contracts should be replaced with a reference to contracts on which there is a net gain on initial recognitition.

Point of recognition
The point of recognition of reinsurance contracts held depends on the nature of the provided coverage as illustrated below:



Initial measurement
The fulfilment cash flows of reinsurance contracts held should be measured using assumptions consistent with those used for the underlying direct contracts. The effect of any risk of reinsurer default or dispute losses should be included in the fulfilment cash flow estimates net of any collateral. The risk adjustment for non-financial risk should represent the amount of risk on the underlying direct contracts that the cedent has transferred to the reinsurer.

As a modification to the general approach, for a group of reinsurance contracts held, there is no unearned profit on initial recognition but instead a net cost or net gain from purchasing reinsurance. It should be recognised as a contractual service margin, as illustrated below:



Subsequent measurement of the contractual service margin

The requirements of the general approach are modified. At the end of the reporting period, the remaining amount of the contractual service margin should be measured as the carrying amount at the beginning of the period, adjusted for:

i the effect of any new contracts added to the group
ii interest accrued using the historic discount rate at initial recognition of the group of reinsurance contracts
iii changes in fulfilment cash flows related to future services unless the change results from a change in fulfilment cash flows of underlying insurance contracts that does not adjust the CSM for those contracts (see the illustrative example below)
iv currency exchange differences, and
v the amount allocated to profit or loss (based on units of coverage).

Changes in reinsurance contract cash flows do not adjust the reinsurance contract's contractual service margin if they result from changes in the underlying direct contracts cash flows, which do not adjust the CSM of such underlying contracts. Any changes in the fulfilment cash flows related to the reinsurer risk of default should be recognised immediately to profit or loss.

An asset or liability that arises in respect of a group of reinsurance contracts held may be regarded as comprising both a remaining coverage component and an incurred claims component. The premium allocation approach (PAA) may be used for reinsurance contracts if the criteria for its application (as outlined in the section above) have been met. The PAA should be adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue.

Example 7: Measurement of a reinsurance contract held

An entity issues a group of insurance contracts and at the same time enters into a 40% quota share reinsurance contract.

The entity recognises the reinsurance contract held from the date of initial recognition of the underlying group of insurance contracts. Immediately before the end of Year 1 the carrying values of the contracts issued and the reinsurance contract held (before change in assumptions) are as follows:

	Insurance contract liability CU	Reinsurance contract asset CU
Fulfilment cash flows	400	(160)
Contractual service margin	130	(45)
Insurance contract liability/reinsurance contract asset	**530**	**(205)**

At the end of Year 1, the entity estimates an increase of CU 160 in the fulfilment cash flows of the underlying contracts.

This change makes those contracts onerous and the entity decreases the CSM to zero and recognises a loss of CU 30 in profit or loss (=CU 130 CSM – CU 160 of increase in cash flows).

As a result at the end of Year 1 the entity measures the insurance contracts issued and the reinsurance contract held as follows (after change in assumptions):

	Insurance contract liability CU	Reinsurance contract asset CU
Fulfilment cash flows	560	(224)
Contractual service margin	0	7
Insurance contract liability/reinsurance contract asset	**560**	**(217)**
Loss at the end of Year 1	**(30)**	**12**

The change in the reinsurance contract CSM is limited to 40% of the fulfilment cash flows of the underlying contract that adjust those insurance contracts' CSM: 40% x CU 130 = CU 52. The remaining change in the reinsurance contract fulfilment cash flows is recognised immediately in profit or loss:

Total change in reinsurance contract fulfilment cash flows = 40% x CU 160 = CU 64;

CU 64 (total change) – CU 52 (change reported in CSM) = CU 12 (change in P/L).

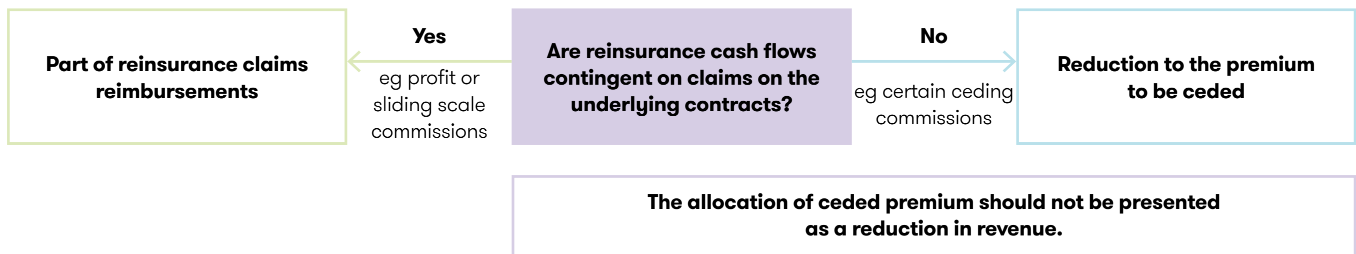
The reinsurer's view (reinsurance contracts issued)

The reinsurer should evaluate whether to account for a reinsurance contract issued under the general or premium allocation approach in the same manner in which a direct insurance contract would be evaluated. This would be independent (and likely different) from the model the cedant is using for the underlying direct insurance contracts. Financial reinsurance contracts where no significant insurance risk is transferred will be accounted for under the financial instruments standard.

Presentation and disclosure

A reporting entity may present the income or expense from reinsurance contracts held other than insurance finance income or expense as a single amount or may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single account.

Where a separate presentation is adapted, the following requirements apply:



Income or expenses from reinsurance contracts held should be presented separately from income or expenses for insurance contracts issued. The disclosure requirements applicable to insurance contracts issued (as specified in the dedicated section on 'Presentation and disclosure' below) apply to reinsurance contracts held but should be adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued (eg generation of expenses or reduction in expenses rather than revenue).

Practical insight – Reinsurance: beyond the 'new look'

Although reinsurers will continue to 'follow the fortune' of their cedents, under IFRS 17 ceded quota share balances and profit and loss items may no longer be a simple proportion of the balances for underlying direct contracts (as was usually the case under IFRS 4). This is because reinsurance contracts cannot be onerous and assumption changes will adjust the reinsurance CSM only to the extent that they have adjusted the CSM of the underlying direct contracts.

Certain commissions paid by reinsurers to cedents or minimum and deposit premiums under non-proportional reinsurance may no-longer qualify as income or expense but may have to be reported as deposit components. Profit commissions or overriding commissions previously reported as technical income will have to adjust premiums ceded or claims recoveries. These changes will impact loss ratios and reinsurance effectiveness KPIs where derived from financial statements captions.

Valuation of non-proportional reinsurance contracts held will likely result in higher estimation uncertainty due to the need to estimate at contract inception the volume of business expected to be ceded. Similar practical challenges are likely to arise in relation to the remaining units of coverage under proportional contracts as ceded contracts continue attaching over time.

Existing Solvency II estimation models may need adjusting before they can be used for IFRS 17 due to potential differences in contract boundaries (eg certain Solvency II mandated treatment of committed premiums under non-proportional programs).

Presentation and disclosure

Presentation

Statement of Financial Position

The Statement of Financial Position should present in separate captions the assets and liabilities arising under insurance contracts issued and reinsurance contracts held.

In contrast to practices existing under various local GAAPs, the entities should adopt a gross-up presentation where contracts, which are assets, are not netted off against contracts, which are liabilities and vice versa. IFRS 17 does not mandate a layout for the Statement of Financial Position. The reporting entities should follow the principle requirements of IAS 1 'Presentation of Financial Statements' but need to ensure that the following captions are presented as a minimum on the face of the statement:

Statement of Financial Position (SOFP) (extract)

	Notes*	20X1	20X0
Assets			
Insurance contracts issued which are assets		XX	XX
Reinsurance contracts held which are assets		XX	XX
Total assets		**XXX**	**XXX**
Liabilities			
Insurance contracts issued which are liabilities		XX	XX
Reinsurance contracts held which are liabilities		XX	XX
Total liabilities		**XXX**	**XXX**

* **Note**

Related assets or liabilities for pre-coverage acquisition expenses cash flows should be included in the carrying amount of the groups of contracts presented as assets or liabilities in each of the SOFP captions.

Aggregation and disaggregation in the notes should follow IAS 1 principles not to obscure relevant information.

Practical insight – format of the primary statements

IFRS 17 will change significantly the face of the primary statements compared to the previously established local practices. As a result, significant effort may be required to educate users. Non-GAAP information may continue to be used whilst the new IFRS 17 concepts are being embedded and gain users' confidence. In the meantime, reporting entities will have to agree with their auditors the most appropriate format and place of such non-GAAP disclosure and its reconciliation to IFRS 17 balances.

Management will have to exercise judgement about the level of detail presented in the notes and the primary statements in order to meet the Standard's objectives and not obscure relevant information. These judgements are likely to have significant operational impact and shape decisions around IT systems and data architecture, operational finance (around statements production routines and interaction between functional teams), related governance and financial reporting controls.

Statement of Financial Performance. Measurement of revenue and expenses.

IFRS 17 does not mandate a layout for the Statement of Financial Performance. The reporting entities should follow the principle requirements of IAS 1 'Presentation of Financial Statements' and the measurement rules of IFRS 17, which require that the revenue and incurred expenses presented in profit or loss exclude any investment components.

Statement of Financial Performance (extract)

	Notes*	20X1	20X0
Insurance contracts revenue	(1)	XX	XX
Insurance service expenses	(2)	(XX)	(XX)
Insurance service result		**XX**	**XX**
Finance income	(3)	XX	XX
Insurance finance income /expense	(4)	(XX)	(XX)
Finance result		**XX**	**XX**
...			
Profit / loss before tax		**XX**	**XX**
Tax		(X)	(X)
Profit / loss after tax		**XX**	**XX**
Other comprehensive income			
...			
Effect of discount rate changes on insurance contract assets and liabilities (optional)	(5)	**(XX)**	**(XX)**
...			
Total comprehensive income		**XXX**	**XXX**

*** Note**

(1) Reporting entities should not present premium information in profit or loss if that information is inconsistent with the revenue recognition requirements of IFRS 17.

Income and expense from reinsurance contracts held should be presented separately from those under insurance contract issued.

Insurance service result

Recognition and presentation – choices

Reporting entities have the choice not to disaggregate the changes in the risk adjustment between the Insurance service result and Insurance finance income or expense, but to report the entire change in Insurance service result.

As noted in the section on Reinsurance contracts held above, the income or expenses from reinsurance contracts held may be presented as a single amount or separately: to report the amount recovered from reinsurers and an allocation of the ceded premium that give a net amount equal to the single amount.

A suggested presentation format (assuming a single reinsurance amount) could be as follows:

	20X1	20X0
Revenue from insurance contracts issued	XX	XX
Reinsurance contracts held income/expense	(XX)	(XX)
(Losses) / reversal of losses on onerous contracts	(XX)	(XX)
Incurred claims	(XX)	(XX)
Insurance acquisition cash flows expensed	(XX)	(XX)
Other insurance service expenses	(XX)	(XX)
Insurance service result	**XX**	**XX**

*** Note**

(1) Insurance contract revenue

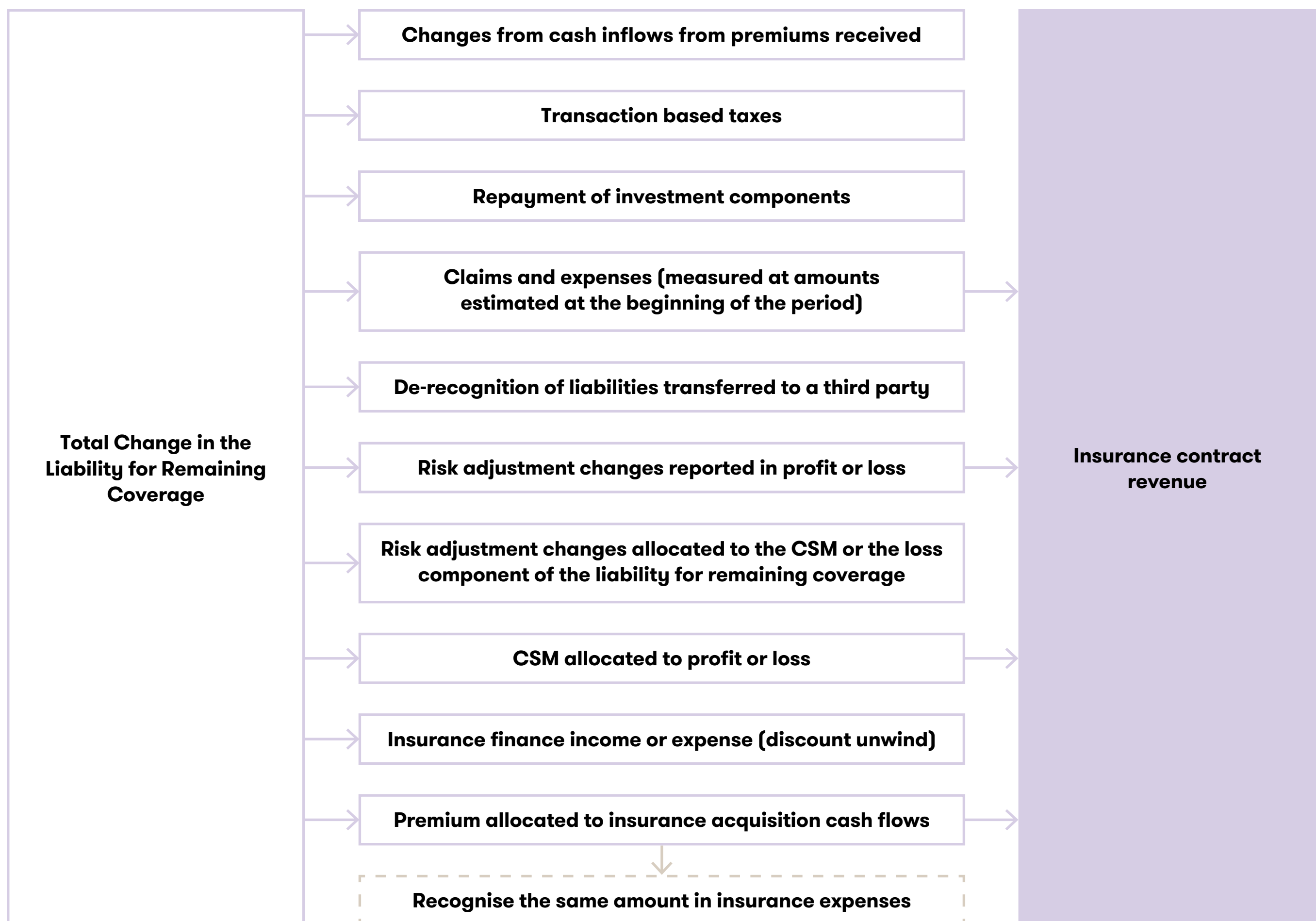
(2) Insurance service expenses

Measurement of insurance contract revenue

Revenue recognition is an area where IFRS 17 principles represent a significant change from practices previously followed in various local GAAPs. Previously revenue was reported by reference to premium cash received or receivable.

IFRS 17 requires that revenue depicts the transfer of services at a consideration to which the entity expects to be entitled in exchange for these services. IFRS 17 revenue is measured as follows:

Revenue for the period	=	Total change in the liability for remaining coverage that relates to coverage and services during the period for which the entity expects to receive consideration.



The total revenue for a group of insurance contracts is the premium paid by the policyholder adjusted by:

- any financing impact (ie time value of money)
- excluding any investment component.

Revenue can be determined as the amount of premium related to coverage and other services and the amount related to insurance acquisition expenses (no net impact as the same amount is recognised in insurance expenses).

As reporting entities do not expect consideration for the changes in the loss component of the liability for remaining coverage, the latter do not constitute part of revenue.

Practical insight – revenue

To apply IFRS 17 revenue recognition policies, entities will rely on actuarial models and may need to redesign them in order for them to be sufficiently granular and robustly controlled. Changes to charts of accounts and period end routines may be needed (revenue represents a change in contract liability). Key Performance Indicators will change and may require re-conciliation to prior premium volume based ratios.

Measurement of insurance finance income or expenses

Insurance finance income or expenses comprise the changes in the carrying amount of the group of insurance contracts arising from the time value of money (and changes in it), and the effect of financial risk and changes in financial risk.

Measurement and presentation – accounting policy choices at portfolio level

Reporting entities have the accounting policy choice (at portfolio level) to report the total insurance finance income or expense in profit or loss, or to disaggregate the insurance finance income or expense for the period between profit or loss and other comprehensive income (OCI). The accounting policy choice should be applied at portfolio level applying the requirements of IAS 8.13. Reporting entities should consider for each portfolio what assets the entity holds and how it accounts for these assets.

The application of the accounting policy choice for disaggregating insurance income and expenses between profit or loss and OCI depends on the type of the contracts included in the portfolio. (See the dedicated section below for more detail.)

A suggested (extract) presentation format could be as follows:

	Notes	2021	2020
Profit or loss (extract)			
Insurance finance income or expense arising from the time value of money		(XX)	(XX)
Effect of changes in financial risk assumptions		XX	XX
Foreign currency gains and losses	(6)	(XX)	(XX)
…			
Total insurance finance income /expenses	(4)	(XX)	(XX)
Other comprehensive income (extract)			
…			
Effect of discount rate changes on insurance contract assets and liabilities	(5)	(XX)	(XX)
Foreign currency gains and losses	(6)	XX	XX
…			
Total comprehensive income		**XXX**	**XXX**

Foreign exchange differences

Paragraph 30 of IFRS 17 requires that insurance contracts be treated as monetary items for the purpose of translating foreign currency balances into the functional currency of the entity. Any such foreign exchange differences should be reported in profit or loss unless they relate to changes in insurance contract items reported in OCI, in which case they should be reported in OCI too.

*** Note**

(4) Insurance finance income or expenses

(5) Effect of discount rate changes on insurance contract assets and liabilities (optional in OCI)*

(6) Foreign exchange gains and losses

* If an entity makes this policy choice, it should include in OCI the difference between:

a) the insurance finance income or expenses measured to include in profit or loss:
   - i an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts, or
   - ii an amount that eliminates accounting mismatches with income or expenses included in profit ir loss on the underlying items held (for contracts with DPF),

b) and the total insurance finance income or expenses for the period.

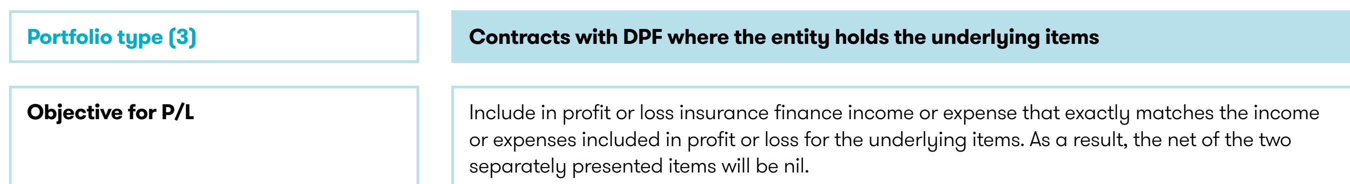
The figures below illustrate the approach for implementing the accounting policy choice for different portfolios of contracts.

Portfolio type (1)	**Policyholder benefits are NOT substantially affected by changes in financial risk assumptions**
Objective for P/L	To include in profit or loss an amount determined by a systematic allocation of the expected total finance income or expense over the duration of the contracts.
Objective for OCI	Cumulative amounts recognised in OCI over the life of the contract total zero.
Discount rate (amount in P/L)	Discount rate at the initial recognition of the contract.

Portfolio type (2)	**Policyholder benefits ARE substantially affected by changes in financial risk assumptions**
Discount rate (amount in P/L)	Different rates apply for systematic allocation depending on whether insurance finance income or expenses arise from changes in future cash flows, risk adjustment or CSM.

Future cash flows	**Risk adjustment**	**CSM**
Use a discount rate that allocates the remaining **revised** expected finance cost over the remaining duration of the contract **at a constant rate**. OR For contracts using a crediting rate – use an allocation based on amounts credited in the period and expected to be credited in future periods.	If separately disaggregated from other changes (policy choice): • use a discount rate, which achieves allocation consistent with the allocation of finance income or expenses arising from the future cash flows.	Contracts without DPF: • use discount rate at contract initial recognition Contracts with DPF: • use a discount rate, which achieves allocation consistent with the allocation of finance income or expenses arising from the future cash flows.

The figure below illustrates the approach for implementing the accounting policy choice for contracts with discretionary participation features where the entity holds the underlying items.



Portfolio type (3)	**Contracts with DPF where the entity holds the underlying items**
Objective for P/L	Include in profit or loss insurance finance income or expense that exactly matches the income or expenses included in profit or loss for the underlying items. As a result, the net of the two separately presented items will be nil.

Entities may qualify for the accounting policy choice described under Portfolio type 3 in one period but not in another (eg if an entity ceases to hold the underlying items or vice versa). In such cases, the reporting entity should include the accumulated amount previously included in OCI by the date of the change as a reclassification adjustment in profit or loss in the period of change and in future periods. Prior period comparatives need not be restated. The accumulated amount previously included in OCI is not recalculated as if the new disaggregation had always applied and the assumptions used for the reclassification in future periods are not updated after the date of the change.

In the period of change, the following additional disclosures are required:

- an explanation why the entity was required to change its basis of disaggregation
- for the current period, the amount of adjustment for each financial statement line affected
- the carrying amount of the contracts to which the change applied at the date of the change.

Disclosure

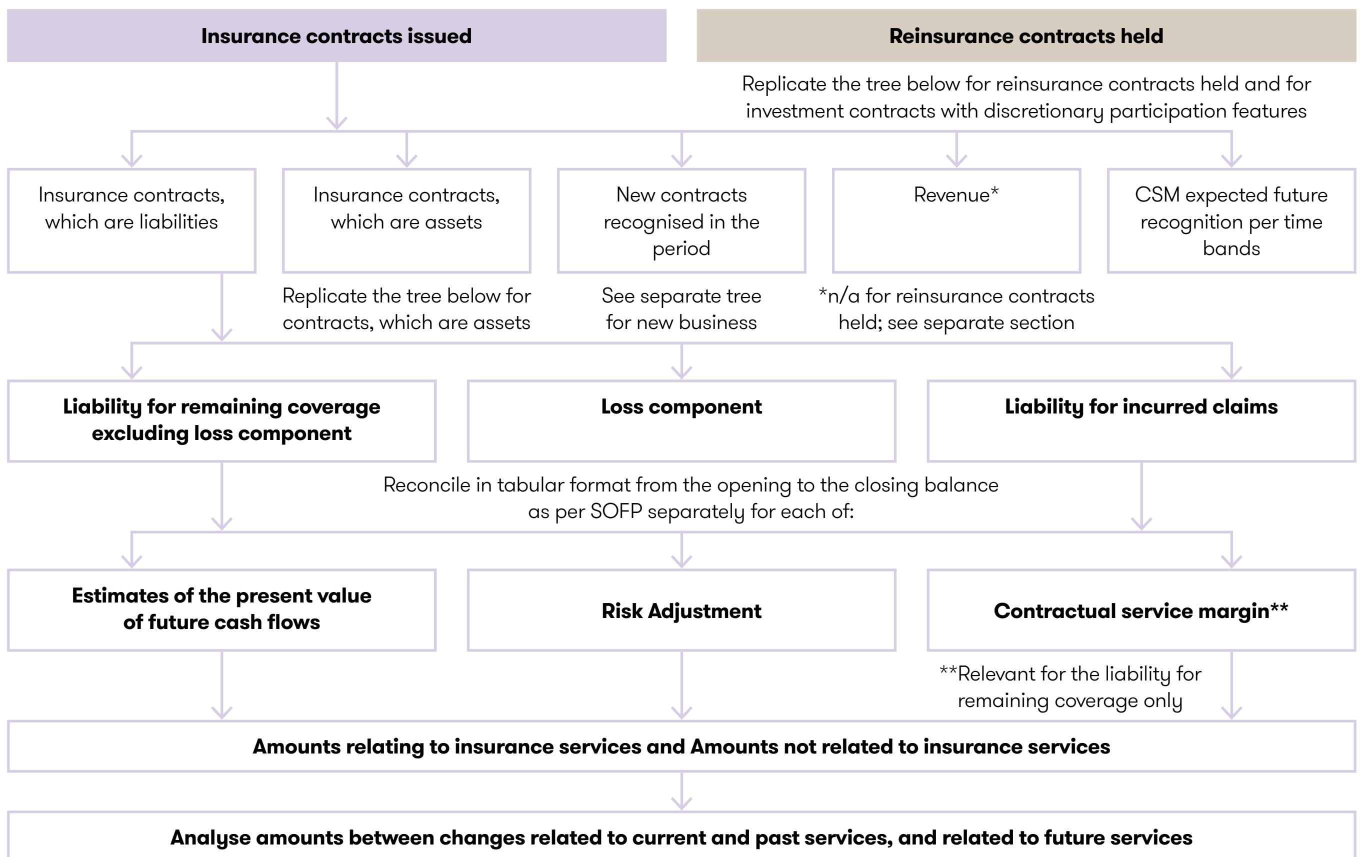
Objective and bases

The objective of the disclosure requirements of IFRS 17 is for entities to disclose information, which allows the users of financial statements to assess the effect that contracts within the scope of the Standard have on the entity's financial position, financial performance and cash flows. Entities should provide quantitative and qualitative information about amounts recognised in the financial statements, significant judgements (and changes thereof), and the nature and extent of risks arising from contracts in the Standard scope.

Reporting entities are required to follow the IFRS 1 requirements around materiality and aggregation when deciding what aggregation bases are appropriate for disclosure. The type of contract, geographical area or reportable segment as defined in IFRS 8 'Operating Segments' are all examples suggested but not mandated by the Standard.

Explanation of recognised amounts

The tree below illustrates the disclosure logic prescribed by the Standard. For simplicity, the illustration is developed in detail only for insurance contracts issued, however it applies in the same manner for reinsurance contracts held.



(See illustrative tabular reconciliation of the opening to closing balances of the insurance contract liability for more detail.)

The tabular reconciliation of the opening to closing balances of the liability for remaining coverage, the loss component of the liability for remaining coverage and the liability for incurred claims should include each of the following amounts (see Example 4 for a numerical illustration):

	Expected PV of future cash flows	Risk adjustment	CSM	Loss component of the liability for remaining coverage	Liability for incurred claims	Total liability for the group
Opening balance	**X**	**X**	**X**	**X**	**X**	**XX**
Amounts not related to insurance services*:						
• premiums received	X					X
• insurance acquisition cash flows	(X)					(X)
• claims paid					(X)	(X)
• insurance non-acquisition expenses paid	(X)					(X)
• insurance finance expenses (or income) [unwinding of discount]	X		X	X	X	X
Amounts related to insurance services**:						
• insurance contract revenue	(X)	(X)	(X)			(X)
• incurred claims and expenses					X	X
• investment components excluded from incurred claims	(X)				X	–
• amortisation of insurance acquisition cash flows	X					X
• losses on onerous groups/(reversal of losses)				X		X
Closing Balance	**X**	**X**	**X**	**X**	**X**	**XX**

* For reinsurance contracts held the cash flow items will instead be ceded premiums, and claims and expenses recovered.
** For reinsurance contracts held there is no requirement to disclose a breakdown of amounts related to insurance services.

As reinsurance contracts cannot be onerous, there is no requirement to disclose a loss component of the liability for remaining coverage. The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held should be disclosed within amounts not related to insurance services provided in the period.

For contracts to which the premium allocation approach has been applied, there is no requirement to analyse the liability of remaining coverage into future cash flows, risk adjustment and CSM.

Practical insight – insurance contract liability reconciliations

The tabular roll-forward disclosures analyse insurance contract liability changes between changes in estimates and actual cash flow movements. The notes have to pass consistency checks with the statement of cash flows and the statement of financial performance. The logic underlying the model may need a significant change from the formats that served the IFRS 4 requirements (eg, all cash flows should be modelled explicitly and gross of reinsurance). The related model documentation and financial statement controls may also require enhancement.

The increased granularity of disclosure and multiple cross-checks will require a higher degree of automation in the production process and better coordination between the involved teams within a reporting entity (pricing and reserving actuaries, finance, cash management, distribution, etc.).

The reconciliation required between the opening to closing balances of the future cash flows (FC), risk adjustment (RA) and contractual service margin (CSM) should further be analysed for the items related to insurance services as follows:

Reconciliation of FC, RA and CSM for items related to insurance services			
Changes in estimates related to future service • those that adjust CSM • those that do not adjust the CSM (eg onerous contract losses and reversals of such losses) • the effects of contracts initially recognised in the period	**Changes related to current service** • CSM released to profit or loss for the transfer of services • change in the risk adjustment that does not relate to future service or past service losses and reversals of such losses • experience adjustments	**Changes related to past service** • Changes in fulfilment cash flows relating to incurred claims	**Effect of new contracts** • Changes relating to groups of contracts acquired or issued during the period from other entities in transfers or business combinations (separate disclosure for onerous contracts)

The following analysis of insurance contract revenue should be disclosed for insurance contracts and investment contracts with discretionary participation features:

Insurance contract revenue			
• CSM recognised in profit or loss for transfer of services in the period	• Insurance claims and expenses expected (at the start of the period) to be incurred (excluding repayment of investment components and allocation to the loss component of the LRC) transaction taxes and acquisition expenses	• Changes in the risk adjustment (excluding those related to future coverage and allocation to the loss components of the LRC)	• Allocation of the portion of premium that relates to the recovery of acquisition cash flows

The above disclosure is not required for contracts to which the premium allocation approach has been applied. The same holds true for the requirement to explain the effect on the Statement of Financial Position from contracts initially recognised in the period. The disclosure below should be made separately for insurance contracts issued and reinsurance contracts held.

Impact of contracts initially recognised in the period			
• Expected present value of future cash outflows (separately for acquisition cash flows)	• Expected present value of future cash inflows	• Risk adjustment for non-financial risk	• Contractual service margin

The analysis should be provided separately for contracts acquired from other entities in Group transfers or business combinations and for groups of contracts that are onerous.

Practical insight – new business disclosures

Investors are likely to take a keen interest in the cash generation potential and profitability of new business. Significant changes in expected risk release patterns will likely be scrutinised against the entity's own back book of business, declared business strategies and similar competitors' data. The cost of acquiring new business will be visible to competitors and distribution partners and may impact on an entity's negotiation position with its distribution channels in the future.

The new business disclosure is likely to attract attention not only by competitors, investors and analysts but also by regulators. In many jurisdictions, regulators are focusing on business conduct, renewal practices, fair outcomes for customers and product value propositions. Therefore, entities have to explain drivers behind any marked differences in new product profitability or liquidity profiles (eg billing and settlement practices), where the latter may suggest less favourable terms for new or existing customers.

The Standard requires a disclosure of the expected pattern of CSM recognition in profit or loss. It can be provided as a qualitative explanation or as a tabular disclosure. (See suggested example below.)

Expected pattern for CSM recognition in profit or loss

	Balance at 31 Dec 202X	within 1 year	1 to 3 years	3 to 5 years	5 to 15 years	More than 15 years
Insurance contracts issued	X	X	X	X	X	X
Reinsurance contracts held	X	X	X	X	X	X
Total	**X**	**X**	**X**	**X**	**X**	**X**

Practical insight – patterns for CSM recognition in Profit or loss

The disclosure about the expected profit allocation will be a litmus test for management's judgements and estimation approaches. As comparative data emerges over time, the users of financial statements will be in a position to compare actual CSM recognition to prior expectations and assess the reliability of estimation methodologies, the effectiveness of management actions and the ability of management to adapt the entity's strategies to changes in market conditions, legislation, regulation and business practices.

Insurance finance income or expenses

Reporting entities should explain the relationship between insurance finance income or expenses in the reporting period and the investment return on the related assets they hold. The disclosures should enable a user of the financial statements to evaluate the sources of finance income or expenses recognised in profit or loss and OCI.

For contracts with DPF, the entity should describe the composition of the underlying items and disclose their fair value. (See also the dedicated section on variable fee approach.)

Significant judgements in applying the standard

In order to meet the disclosure objective of the Standard, reporting entities should explain the significant judgements (and changes thereof) in relation to methods used to measure contracts, processes to estimate key valuation inputs, assumptions and estimation techniques to implement policy choices. Unless impracticable, quantitative information should be provided for key valuation inputs. In case of changes in estimation methods or processes, reporting entities should explain both the underlying reasons and identify the types of contracts impacted.

The Standard specifically requires that entities address the following areas in their disclosures:

Estimation methods, processes and quantitative information for:

Contracts without DPF

Exercise of discretion
Approach to distinguish changes in estimates in future cash flows arising from the exercise of discretion from other changes in estimates in FCF.

Discount rate

Approach to determine

Investment component

Approach to determine

Risk adjustment

Presentation of changes
Explain decision to present in full in the insurance services result or to disaggregate between insurance services and insurance finance component

Method to calculate Confidence level
Disclose: (i) the technique used if other than confidence level; (ii) confidence level corresponding to the results of that technique

Yield curve for cash flows, which do not vary with the returns of underlying items

Single curve or a range of curves
May disclose in the form of weighted averages or narrow ranges when disclosure is given in aggregate for a group of contracts.

Disaggregation of insurance finance income or expenses

Method
Explain the methods used to calculate the amounts recognised in profit or loss

Nature and extent of risks arising from contracts within the scope of IFRS 17

The objectives of the insurance and financial risk disclosures is to provide information to the users of financial statements to enable them to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of the Standard.

The disclosure framework of IFRS 17 carries forward the principles underlying IFRS 4 and introduces additional specific requirements as summarised below.

In focus: What is new?

Risk exposures, policies and processes for managing and methods for measuring risk

IFRS 17 specifically requires that the summary quantitative information on risk exposures be based on the information provided internally to key management personnel.

There is also a requirement to explain the effect of the local regulatory frameworks in which entities operate (eg minimum capital requirements, interest rate guarantees, etc.). If an entity applies paragraph 20 of IFRS 17 when determining the level of aggregation (eg to contracts subject to gender-neutral pricing), it should disclose that fact.

Risk concentrations

Reporting entities are required to consider concentration risk arising from contagion between assets and liabilities on the Statement of Financial Position (eg, where an entity provides insurance for a particular business sector and at the same time invests in financial instruments issued by the same sector).

In focus: What is new?

Insurance and market risk: sensitivities

Sensitivities for each type of market risk should be disclosed in a way that explains the relationship of sensitivities arising from insurance contracts and those arising from financial assets held by the entity.

Insurance risk: claims development

Reporting entities should reconcile the disclosure about claims development with the aggregate carrying amount of the group of insurance contracts, which the entity discloses to comply with the Standard's requirements around liabilities for incurred claims.

Credit risk

The amount that best represents the maximum credit risk exposure at the end of the reporting period should be disclosed separately for insurance contracts issued and reinsurance contracts held. The credit quality of reinsurance contracts held which are assets should also be disclosed.

Liquidity risk

The Standard specifies the time bands for maturity analysis of the recognised liabilities. The disclosure is not required for the liability for remaining coverage under contracts to which the premium allocation approach has been applied.

To prepare the analysis, reporting entities may use either remaining undiscounted cash flows (as in the suggested illustrative disclosure below) or the amounts recognised in the Statement of Financial Position.

Net undiscounted cash flows arising from recognised liabilities (number of years after the reporting date)

	on demand	in 1 year	in 2 years	in 3 years	in 4 years	in 5 years	in >5 years	Total
Insurance contracts issued that are liabilities	X	X	X	X	X	X	X	X
Reinsurance contracts held that are liabilities	X	X	X	X	X	X	X	X
Total	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**

Practical insight – risk sensitivities and qualitative disclosures on estimation uncertainty

The risk management disclosures under IFRS 17 are likely to bring in public domain information about risk, and asset and liability management practices that in the past entities may have only communicated to their Board of Directors or privately to their regulators. This is an opportunity for businesses to demonstrate best practices and to distinguish themselves from competitors but also a potentially commercially sensitive disclosure. The same applies to the Standard's specific requirements around key judgements and areas of estimation uncertainty underlying the measurement if insurance contract balances.

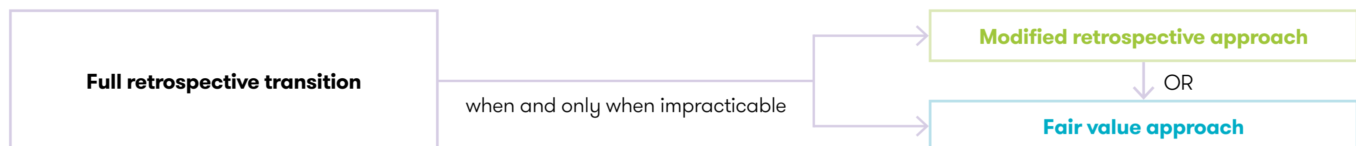
These disclosures are likely to be a focal point for analysts and other financial statements users. They will have to explain complex technical concepts in the context of the specific entity, its business mix and management strategy. As result, more senior staff involvement may be required for drafting and the governance arrangements for validation and approval may have to be modified.

Effective date and transition

An entity should apply the Standard for annual reporting periods starting on or after 1 January 2021. Early application is permitted for entities that apply IFRS 9 and IFRS 15 at or before the date of initial application of this Standard.

A reporting entity should follow the following decision map when choosing an approach for initial application of the standard.

The date of initial application of the Standard is the beginning of the annual reporting period in which an entity first applies IFRS 17. The transition date (T-1) is the beginning of the annual reporting period immediately preceding the date of initial application.

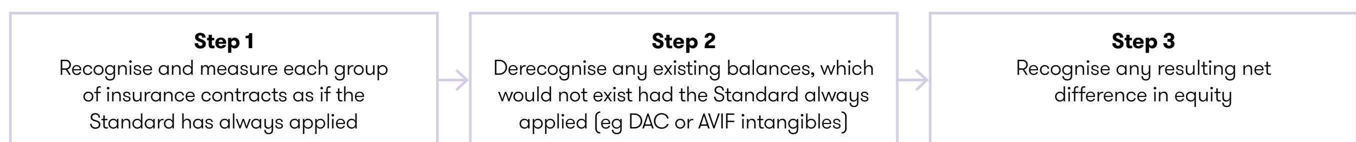


Full retrospective transition

A reporting entity should apply the Standard retrospectively unless impracticable, with two exceptions:

- **Exception 1:** There is no requirement to disclose for the current period and each prior period presented the transitional impact on each financial statement line item or on the basic and diluted earnings per share (where applicable)
- **Exception 2:** It applies to insurance contracts with direct participation features where entities have previously documented an objective and strategy to use derivatives in order to mitigate financial risks arising from insurance contracts. In such cases, entities should only apply prospectively the option not to adjust the contractual service margin for the changes in the entity's share of the underlying items caused by financial risk or for changes in fulfilment cash flows attributable to guarantees.

To apply the Standard retrospectively, at the beginning of the period immediately preceding the date of initial application an entity should follow the steps outlined below:



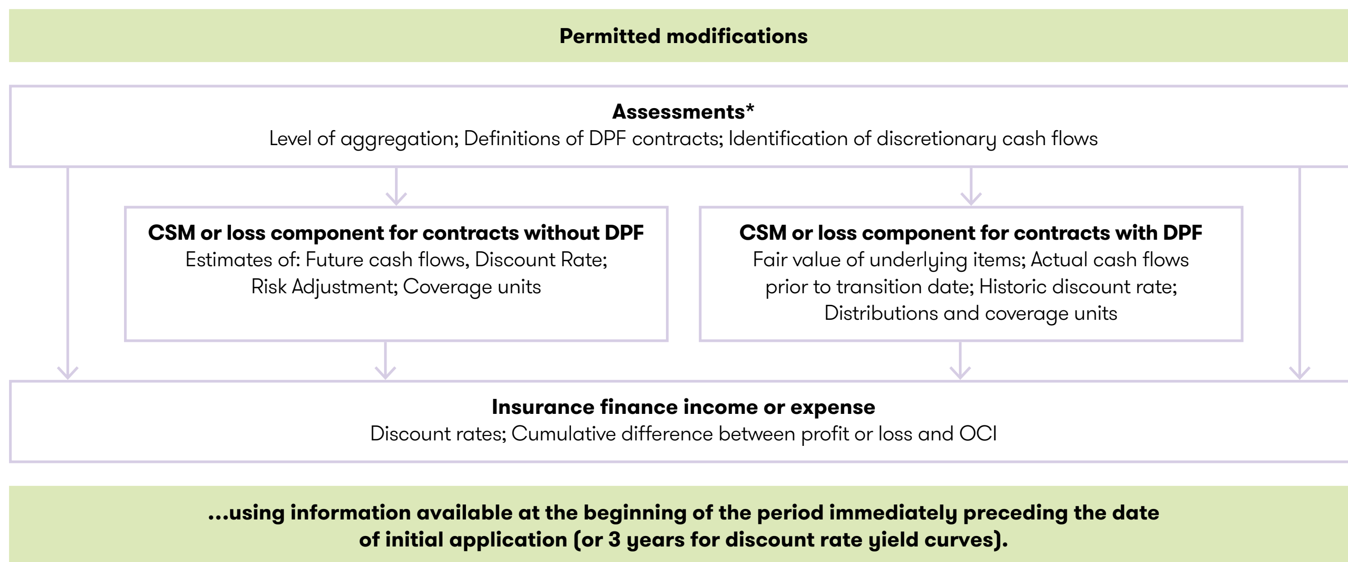
Practical insight – choices on transition

The availability and quality of historic data will be a major factor influencing decisions when policy choices are made on IFRS 17 transition. Reporting entities will have to consider the burden of proof about what constitutes 'impracticable' circumstances for full retrospection before they can exercise any of the available alternative options.

Management should exercise caution not to undermine future reporting policy choices by the arguments supporting their approach on transition. Separate disclosures are required for 'in-force' books on transition reported under each of the transitional options and for new business written thereafter. Therefore, any decisions on transition may have a lasting effect on future performance reporting, managing capital and steering product development.

Modified retrospective approach

The objective of the modified retrospective approach is to achieve the closest outcome to a full retrospective application using reasonable and supportable information available without undue cost or effort. The permitted modifications influence four areas summarised below.



* These assessments would have been done at the date of contracts inception or initial recognition.

To achieve the objective of the modified retrospective approach, entities are permitted to use each of the above modifications only to the extent that there is no reasonable and supportable information for a retrospective approach.

Assessments at initial recognition

<table>
<tr><th>Task:</th><th>Permitted modification</th><th></th></tr>
<tr><td>Identify groups of insurance contracts</td><td>No need to divide the groups of contracts (ie onerous, no significant risk of becoming onerous and remaining) into groups which only include contracts issued one year apart</td><td rowspan="3">Use information available at T-1 date** (rather than at the time of initial contract recognition)</td></tr>
<tr><td>Determine whether an insurance contract meets the definition of an insurance contract with DPF</td><td>n/a</td></tr>
<tr><td>Identify discretionary cash flows for contracts without DPF</td><td>n/a</td></tr>
</table>

** T-1 date = the beginning of the period immediately preceding the date of initial application (transaction date).

Determining the contractual service margin or loss component for contracts without DPF

The following modifications are permitted on transition when calculating the fulfilment cash flows of contracts without discretionary participation features.

Fulfilment cash flows		Permitted modifications
Estimates of future cash flows at the date of initial recognition	=	Amount of future cash flows at T-1 date, adjusted for the cash flows that are known to have occurred between that date and the date of initial recognition for a group of contracts.
+		
Discount rate at the date of initial recognition (where an observable yield curve exists)	=	Use an observable yield curve, which for at least three years before the T-1 date, approximates the yield curve to be derived following the principles governing the Standard's general approach.
+		
Discount rate at the date of initial recognition (where an observable yield curve does not exist)	=	Determine an average spread between an observable yield curve and the yield curve to be derived following the principles governing the Standard's general approach. That spread should be an average over at least three years immediately before the T-1 date.
+		
Risk adjustment at the date of initial recognition	=	Adjust the risk adjustment at the T-1 date by the expected release from risk before that date. Use as a reference similar contracts issued at T-1 date.
=		
CSM recognised in profit or loss for transfer of services	=	Determine the CSM recognised in profit or loss before the T-1 date by comparing the remaining coverage units at T-1 date with the coverage units provided before T-1 date.
OR		
Loss component of the liability for remaining coverage at T-1 date	=	Determine any amount allocated to the loss component before T-1 date using a systematic basis of allocation.

Determining the contractual service margin or loss component for contracts with DPF

The following modifications are permitted on transition when calculating the fulfilment cash flows of contracts with discretionary participation features.

Permitted modifications

CSM at T-1 date (the beginning of the period immediately preceding the date of initial application) is equal to:

Total fair value of the underlying items at T-1 date (a)	–	the fulfilment cash flows at T-1 date (b)	–	If (a) - (c) = CSM, the amount of CSM that relates to services provided before T-1 date.
		+/–		
		An adjustment for: • amounts charged to policyholders before T-1 date • amounts paid before T-1 date that would not have varied based on the underlying items • change in the risk adjustment caused by the release from risk before T-1 date.* (c)		Note: CSM should be estimated by comparing the remaining coverage units at T-1 date with the coverage units provided before the T-1 date.

*The change in RA should be estimated by reference to similar contracts that the entity issues at T-1 date.

If the difference (a) - (c) result in a loss component, the entity should adjust the loss component to nil and increase the liability for remaining coverage (excluding the loss component) by the same amount.

Insurance finance income or expense

The contract aggregation choices, which entities make on transition, will influence the measurement of insurance finance income or expense and their disaggregation (subject to policy choice) between profit or loss and other comprehensive income.

The impact of the above choices on the determination of the discount rate and the cumulative difference between the insurance income or expenses recognised in profit or loss and the total thereof at the T-1 date (beginning of the period immediately preceding initial application) is summarised below:

	Aggregation of contracts issued > 1 one year apart?	
At T-1 date*	**Yes**	**No**
Discount rate at initial recognition Discount rate at date claim incurred (PAA contracts)	permitted to determine discount rate at T-1 date instead of at date of initial recognition or incurred claim	determine discount rates applying the approach described above to derive CSM or loss component at T-1 date
Cumulative finance income or expense in OCI (if disaggregated)		
• contracts with DPF and the entity holds the underlying items	cumulative OCI balance = cumulative amount recognised in OCI on the underlying items	cumulative OCI balance = cumulative amount recognised in OCI on the underlying items
• contracts to which the PAA is applied	nil	determine cumulative OCI by using discount rate at date claim incurred (follow transitional approach described above to derive CSM or loss component at T-1 date)
• contracts where financial risk assumptions have no substantial impact on policyholder benefits	nil	determine cumulative OCI by using discount rate at date of initial recognition (follow transitional approach described above to derive CSM or loss component at T-1 date)
• contracts where financial risk assumptions have substantial impact on policyholder benefits	nil	nil

* T-1 date = beginning of the period immediately preceding the Standard initial application (ie the beginning of the first comparative period)

Where on IFRS 17 transition entities choose to aggregate contracts issued more than one year apart, the discount rates determined at the beginning of the period immediately preceding the date of initial application (T-1 date) will be used as if they were discount rates at initial recognition of the contract. In other words, discount rates are determined following the general principles of the Standard as if the transitioned contracts were issued on the T-1 date. Under this aggregation approach, the cumulative insurance finance income or expense recognised in OCI at the T-1 date is nil, except for insurance contracts with direct participation features where the entity holds the underlying items. In the latter case, the insurance finance income or expense recognised in OCI is equal to the cumulative finance income or expense on the underlying items recognised in OCI.

Where on IFRS 17 transition entities choose not to aggregate contracts issued more than one year apart, the discount rates used to determine the CSM or loss component on transition (as explained in the dedicated section above) will be used as if they were discount rates at initial recognition of the contract or at date claim incurred (for PAA contracts). The latter discount rates will also be used in order to determine the cumulative insurance finance income or expense recognised in OCI at T-1 date for contracts where financial risk assumptions have no substantial impact on policyholder benefits as well as for contracts to which the premium allocation approach is applied. At T-1 date for insurance contracts for which changes in financial risk assumptions have a substantial effect on the amounts paid to policyholders, the cumulative insurance finance income or expense recognised in OCI is nil. For contracts with DPF where an entity holds the underlying items, at T-1 date the cumulative insurance finance income or expense recognised in OCI is equal to the cumulative finance income or expense on the underlying items recognised in OCI.

Example 8: Measurement of contracts without DPF on transition applying the modified retrospective approach

An entity has a group of 100 contracts without discretionary participation features which it has aggregated in a single group as allowed by the Standard. The entity has reasonable and supportable information which although insufficient to apply the full retrospective approach, allows it to adopt the modified retrospective approach (T-1 is the beginning of the period immediately preceding the date of IFRS 17 initial application.)

The contracts in the group were issued 8 years prior to T-1 and none of them have lapsed. The contracts in the group expire within 3 years after T-1. For simplicity, coverage units have been assumed to be unchanged year on year (ie 100 each year). Expected cash flows under the group of contracts at T-1 = CU 3,000 (CU 1,000 outflow each year).

Cash flows known to have occurred between initial recognition and T-1 are CU 5,000 net inflows evenly spread over the eight year period to T-1.

The effect of discounting is determined using an observable yield curve that, for at least three years before T-1, approximates the yield curve estimated applying the Standard's initial measurement rules. For the purposes of this example the discount rate has been estimated as 2.5%. The risk adjustment at T-1 has been estimated at CU 210.

	(a) At T-1 CU	(b) From initial recognition to T-1 CU	(c) At Initial recognition (as derived) CU
Total expected cash flows	3,000	(5,000)	(2,000)
Effect of discounting	(144)	519	375
Expected present value of cash flows	2,856	(4,481)	(1,625)
Risk adjustment (RA)	210	560	770
Fulfilment cash flows	3,066	(3,921)	(855)
Contractual service margin (CSM)	233		855

Explanation:

Expected present value of cash flows: column (c) = (a)+(b).

The risk adjustment for the period from initial recognition to T-1 has been estimated based on the expected release of similar contracts issued at T-1 (which is assumed to be even over the life of the contract) ie:

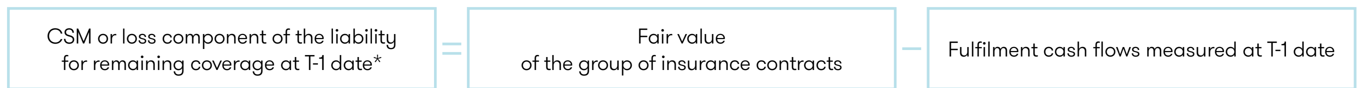
CU 560 = CU 210/(3/8) (The contracts have duration of 11 years and have been issued 8 years prior to T-1, ie at T-1 there are 3 years of remaining risk release). RA at initial recognition = CU 770 = CU 210/(3/11) = CU 210 + CU 560

CSM at T-1 = CU 855 × (300 coverage units remaining / total coverage units of 1,100))

CSM released to P/L up to T-1 = CU 855 × (800 coverage units provided to T-1 / total coverage units of 1,100)

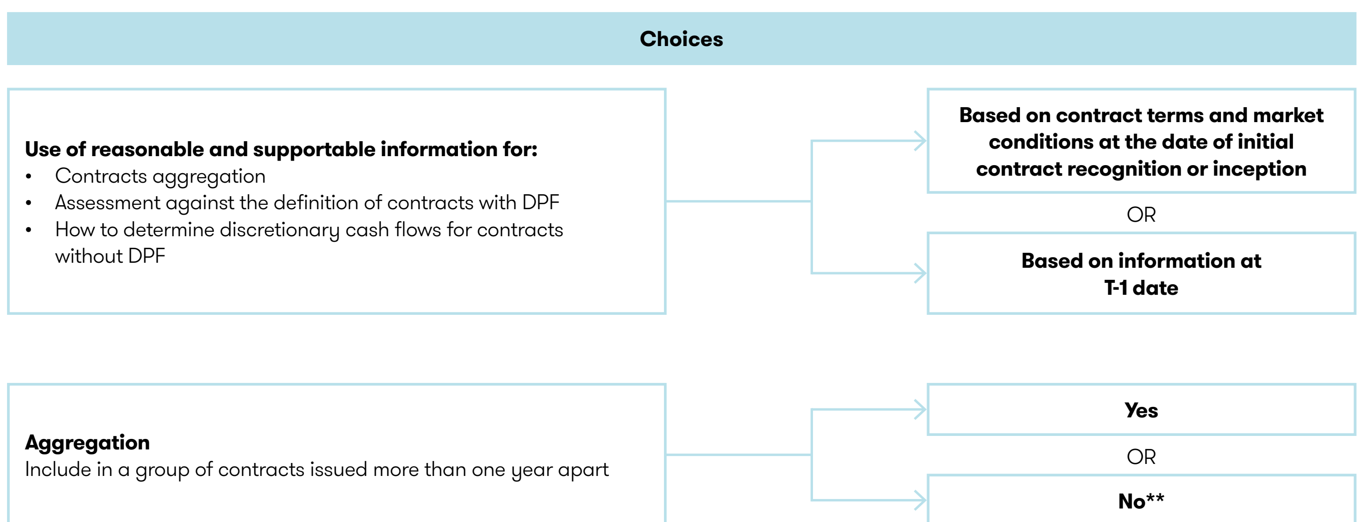
Fair value approach

When and only when it is impracticable for an entity to apply the retrospective approach it can apply the fair value approach for transition. Under the fair value approach, the contractual service margin at the beginning of the immediately preceding period is determined as follows:



* T-1 date = beginning of the period immediately preceding the Standard initial application.

In applying the fair value approach, an entity has the following choices:



* This choice should only be adopted when there is reasonable and supportable information to make the division.

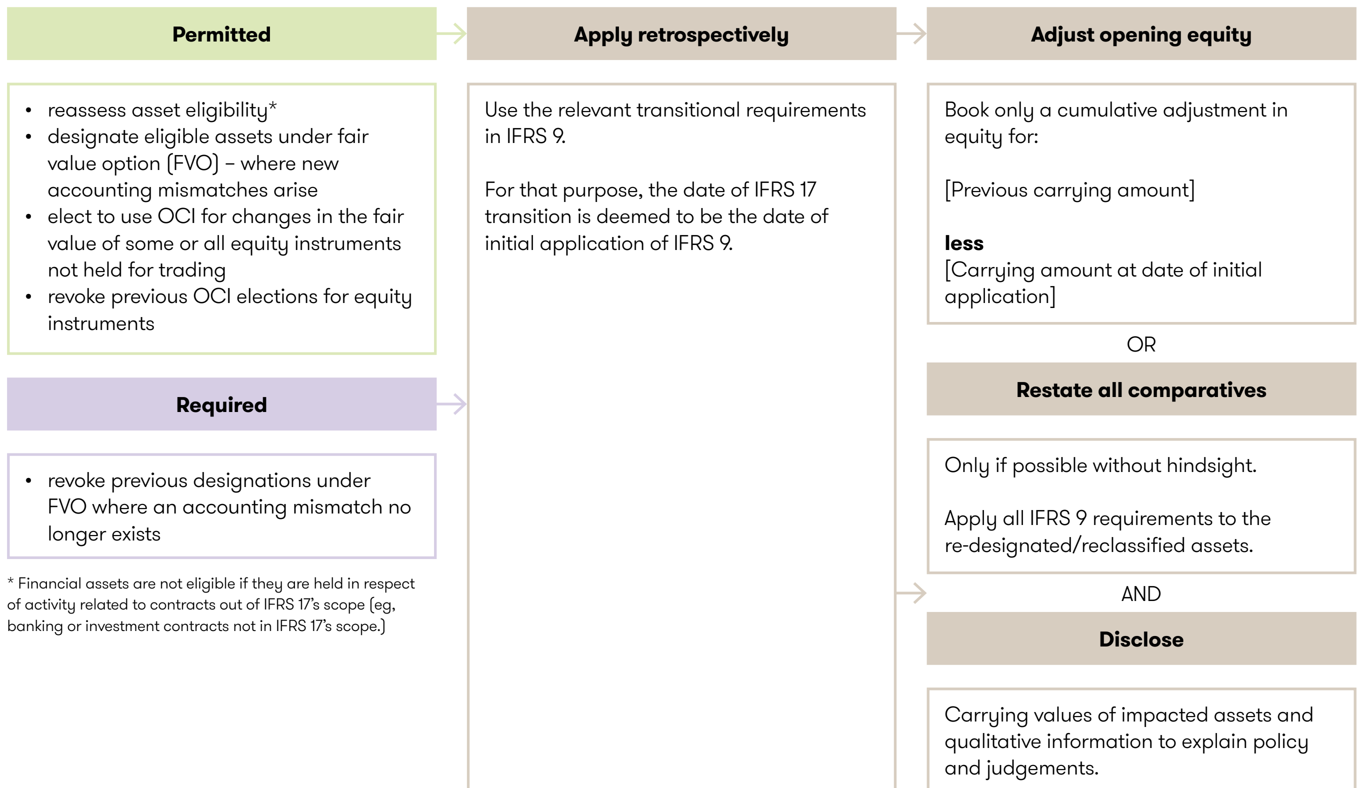
The impact of the above choices on the determination of the discount rate and the cumulative difference between the insurance income or expenses recognised in profit or loss and the total thereof at the T-1 date (beginning of the period immediately preceding initial application) is summarised below:

	Aggregation of contracts issued > 1 one year apart?	
At T-1 date*	**Yes**	**No**
Discount rate at initial recognition Discount rate at date claim incurred (PAA contracts)	permitted to determine discount rate at T-1 date instead of at date of initial recognition or incurred claim (for PAA contracts)	permitted to determine discount rate at T-1 date instead of at date of initial recognition or incurred claim (for PAA contracts)
Cumulative finance income or expense in OCI (if disaggregated)		
• all contracts, if reasonable and supportable information is available	determine cumulative OCI balance retrospectively	determine cumulative OCI balance retrospectively
• contracts with DPF and underlying items held	cumulative OCI balance = cumulative amount recognised in OCI on the underlying items	cumulative OCI balance = cumulative amount recognised in OCI on the underlying items
• other contracts not included above	nil	nil

Re-designation of financial assets

Entities that applied IFRS 9 prior to the initial application of IFRS 17

The transitional provisions of IFRS 17 in relation to re-designation of financial assets apply to entities that have already adopted IFRS 9 in prior periods. Such entities may reassess assets based on the facts and circumstances that exist at the date of initial IFRS 17 application (no matter that IFRS 9 allows reclassification only upon a change in business model) as outlined below:



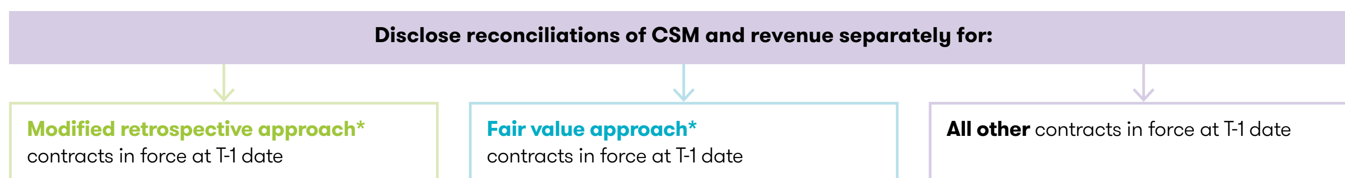
The disclosures in the annual reporting period of transition should explain the entity's basis for determining eligible assets, the measurement category and carrying amounts of impacted assets before and after re-designation/reclassification, amounts of assets, which were previously designated and measured under FVO but no longer are so reported. Qualitative disclosures should clarify the reasons for any designation or de-designation and why the entity came to different conclusions in the new assessment of its business model.

Practical insight – a need for a holistic view on transition

The transitional provisions in relation to re-designation of financial assets impact those entities, which did not qualify or opt for the deferral approach under the IFRS 4 amendment from September 2016. In order to identify whether previous designations have to be revoked or new designations are allowed on IFRS 17 transition, management should perform test calculations early to assess whether prior accounting mismatches continue (or new ones arise) under IFRS 17 measurement of insurance contracts. This exercise is particularly relevant where significant judgements are made around asset hypothecation between insurance contract groups.

Transitional disclosures

Where entities have applied the modified retrospective approach and/or the fair value approach on transition to IFRS 17, the Standard requires them to explain the effect of these methods on CSM and revenue in subsequent periods as illustrated below:



* Until balances transitioned under the above approaches are reported in the financial statements, there is a necessity to explain the nature and significance of methods, and judgments applied to measure the contracts at T-1 date

* When the entity chooses to disaggregate insurance finance income or expense between profit or loss and OCI for all periods in which amounts transitioned under the modified retrospective and/or fair value approach exist, reconcile the opening to the closing balance of the cumulative amounts included in OCI for related financial assets measured at fair value through OCI.

Comparative information

IFRS 17 transitional provisions refer to the beginning of the period immediately preceding the date of initial application (T-1 date). Reporting entities may also present adjusted comparative information for any earlier period but are not required to do so.

IFRS 17 disclosure requirements need not be applied for any period presented before the T-1 date.

If a reporting entity presents unadjusted comparative information for any earlier periods, it should clearly identify it as unadjusted and explain the different basis on which it has been prepared.

An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies IFRS 17. If an entity has used this exemption, it should disclose that fact.

Practical insight – A road to transition

The transformational nature of IFRS 17 is likely to pose a significant challenge against what could seem a long three and a half years' implementation period. To achieve successful outcomes at optimal cost, entities should start preparations now. Policy choices need to be tested against business steering objectives and resource constraints, so that such analyses can inform technology solutions.

An efficient IFRS 17 transition project will require seamless collaboration between finance and actuarial teams. A much wider range of skills will be needed together with agile working involving IT specialist, data analysts and experienced project managers. To be successful in an environment of competing priorities and strain on resources, entities will have to:

- plan and deliver the IFRS 17 transition project in a holistic manner
- assess the financial impact on key products
- evaluate data quality and potential modelling capability gaps
- secure executive sponsorship and communicate early the implications beyond financial reporting
- train staff and educate management and the investor community
- allow for dependencies with other change projects, and implement rigorous project management routines.

Glossary

AVIF
Acquired value of in-force business

DPF
Discretionary participation features

CSM
Contractual service margin

CU
Currency unit (of the reporting entity)

FCF
Fulfilment cash flows

FX
Foreign exchange

FVO
Fair value option

KPI
Key performance indicator

LC
Loss component

LRC
Liability for remaining coverage

OCI
Other comprehensive income

Onerous contract
Refer to IFRS 17.47-52

PAA
Premium allocation approach

P/L
Profit or loss

PV
Present value

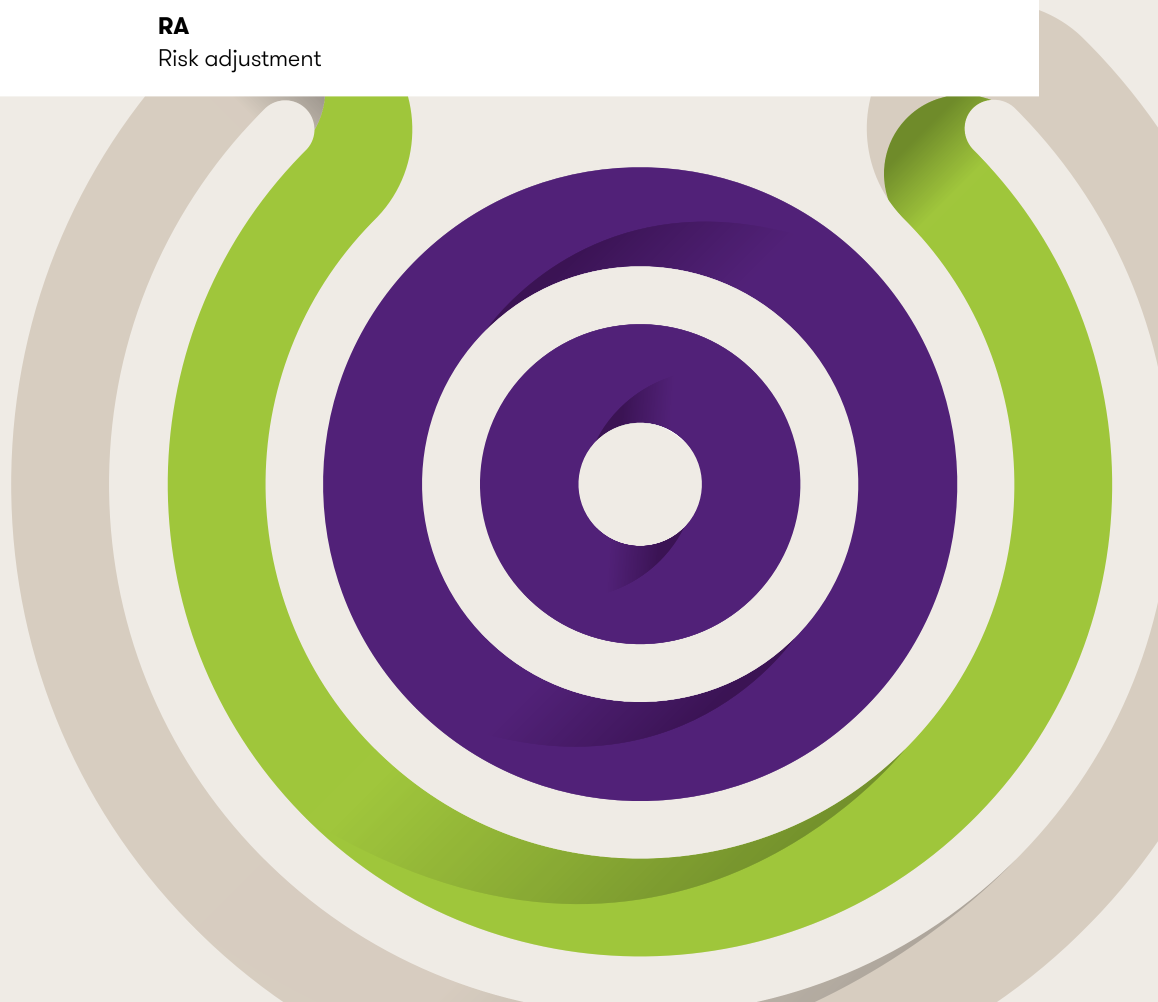
RA
Risk adjustment

Solvency II
Is a Directive in European Union law that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency.

SOFP
Statement of Financial Position

T-1
Beginning of the first comparative period (on reporting the transition to IFRS 17)

Variable fee approach
See IFRS 17.B110-118



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