

IFRS in Focus

IASB issues IFRS 17 – Insurance Contracts

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The Bottom line

- The new Standard establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts and supersedes IFRS 4 *Insurance Contracts*.
- The Standard outlines a General Model, which is modified for insurance contracts with direct participation features, described as the Variable Fee Approach. The General Model is simplified if certain criteria are met by measuring the liability for remaining coverage using the Premium Allocation Approach.
- The General Model will use current assumptions to estimate the amount, timing and uncertainty of future cash flows and it will explicitly measure the cost of that uncertainty; it takes into account market interest rates and the impact of policyholders' options and guarantees.
- Profit from selling insurance policies is deferred in a separate liability component on day 1 and aggregated in groups of insurance contracts; it is then reported systematically through profit or loss over the period during which insurers provide cover after making adjustments from changes in assumptions relating to future coverage.
- The implementation of the Standard is likely to bring significant changes to an entity's processes and systems, and will require much greater co-ordination between many functions of the business, including finance, actuarial and IT.
- The Standard is effective for annual periods beginning on or after 1 January 2021 with early application permitted; it is applied retrospectively unless impracticable, in which case the modified retrospective approach or the fair value approach is applied.

For more information please see
the following websites:

www.iasplus.com

www.deloitte.com

Introduction

Project development

The Standard is the result of a project started in April 1997 by the International Accounting Standard Committee, the predecessor body of the IASB. The IASB completed Phase I of this project when IFRS 4 was issued in March 2004. However, IFRS 4 was intended only as an interim solution which allowed insurers to use a wide variety of accounting practices, pending the completion of a comprehensive Standard. These differences in accounting practices across jurisdictions and products have made it difficult for investors and analysts to understand and compare insurers' financial position, performance and risk exposures. Phase II of the project was designed to address these concerns, resulting in this new Standard, which replaces IFRS 4.

Objective

The objective of the Standard is to ensure that an entity provides relevant information that faithfully represents rights and obligations from insurance contracts it issues. The IASB developed the Standard to eliminate inconsistencies and weaknesses in existing accounting practices by providing a single principle-based framework to account for all types of insurance contracts, including reinsurance contracts that an insurer holds. The Standard also specifies presentation and disclosure requirements to enhance comparability between insurers.

What are the main features of the Standard?

The Standard measures insurance contract either under the General Model or a simplified version of this, called the Premium Allocation Approach (PAA).

The main features of the measurement approach applied in the General Model are that:

- estimates and assumptions of future cash flows are always current;
- measurement reflects the time value of money;
- estimates make maximum use of observable market consistent information;
- there is a current and explicit measurement of risk;
- expected profit is deferred and aggregated in groups of insurance contracts at initial recognition; and
- expected profit is recognised over the coverage period after adjustments from changes in the cash flows assumptions related to each group of contracts.

Observations

What are the most significant changes for non-life insurance?

Existing accounting practices vary by jurisdiction. However, for most non-life insurance contracts the major accounting change is the introduction of discounting and an explicit risk adjustment for non-financial risk in measuring the liability for incurred claims along with the more transparent reporting of any movements in these elements. Of the insurance contract eligible to use the PAA, many are expected to be non-life insurance contracts (e.g. annual motor insurance contracts). The PAA simplifies the General Model accounting for the liability for remaining coverage, but not for incurred claims.

What are the most significant changes for life insurance?

While existing accounting practices vary, for most life insurance contracts the most significant financial reporting changes are expected to be:

- the introduction of a single accounting model for all insurance contracts, rather than different accounting models based on product type;
- updated, rather than locked-in, assumptions;
- current value measurement of guarantees and options previously not fully recognised;
- more information about the effects of financial and non-financial risk, time value of money and other estimates;
- discount rates reflecting the characteristics of the insurance contract liability, excluding future investment spreads unless they are part of the characteristics of the contract;
- new presentation of revenue and service result; and
- deferred acquisition costs forming part of the insurance contract's measurement replacing the need for separate release mechanisms.

Scope

An entity shall apply the Standard to issued insurance contracts including reinsurance contracts issued, reinsurance contracts held, and also to investment contracts with a discretionary participation feature (DPF) it issues, provided the entity also issues insurance contracts.

Fixed fee contracts

Some contracts meet the definition of an insurance contract but have their primary purpose the provision of services for a fixed fee. Such issued contracts are in the scope of the Standard, unless an entity chooses to apply to them IFRS 15 *Revenue from Contracts with Customers* and provided the following conditions are met:

- the entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
- the contract compensates customers by providing a service, rather than by making cash payments to the customer; and
- the insurance risk transferred by the contract arises primarily from the customer's use of service rather than from uncertainty over the cost of the service.

Observation

An example of such contract could be a fixed-fee roadside assistance, where the insurance risk arises from the frequency of vehicle breakdowns, rather than from their cost, and the compensation is through the provision of towing and other roadside services.

Investment contracts with a DPF

An investment contract with a DPF is a financial instrument and it does not include a transfer of significant insurance risk. It is in the scope of the Standard only if the issuer also issues insurance contracts.

The requirements of the Standard are modified for such investment contracts.

Separating components from an insurance contract

An insurance contract may contain one or more distinct components that would be within the scope of another Standard if they were separate contracts. The Standard include criteria to determine when a non-insurance component is distinct from the host insurance contract. IFRS 9 *Financial Instruments* should be applied to determine whether there is an embedded derivative to be separated and how to account for such a derivative. Many insurance contracts contain investment components, defined as amounts payable to policyholders irrespective of insured events occurring. An investment component should be separated from a host insurance contract, if that investment component is distinct, with the separated element accounted under IFRS 9. A distinct obligation to sell an insurer's goods and services should be separated from a host insurance contract and accounted for under IFRS 15.

Level of aggregation

An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts that are subject to similar risks and managed together. Contracts within a particular product line, such as motor policies, are expected to have similar risks, and if they are managed together would be in the same portfolio.

For all issued insurance contracts in a portfolio, an entity shall divide it into:

- a group of contracts that are onerous at initial recognition, if any;
- a group of contracts that at initial recognition have no significant risk of becoming onerous, if any; and
- a group of the remaining contracts in the portfolio, if any.

An entity is permitted to divide portfolios into more groups than required above. However, groups cannot include contracts issued more than one year apart.

If contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group.

The groups are established at the inception of the contracts and not subsequently reassessed.

An entity shall divide portfolios of reinsurance contracts held in the similar way to insurance contracts issued, except that the reference to an onerous contract should be read as referring to contracts for which the entity that purchases the reinsurance contract has a net gain on initial recognition. Groups of reinsurance contracts held may include only one contract.

Observation

The requirements for the level of aggregation of insurance contracts have been simplified compared to the original proposal in order to reduce the operational complexity of applying most of the measurement requirements at a group of contracts level. Nonetheless, this will be one of the most challenging aspects of implementing the Standard.

Recognition

An entity shall recognise a group of insurance contracts it issues from the earliest of (a) the beginning of the coverage period; (b) the date when the first payment from a policyholder becomes due; and (c) when the group becomes onerous.

Measurement

General Model

On initial recognition, an entity shall measure a group of contracts at the total of the amount of fulfilment cash flows ("FCF") and the contractual service margin ("CSM"). FCF comprises the estimate of future cash flows, an adjustment to reflect the time value of money and the financial risks associated with the future cash flows and a risk adjustment for non-financial risk.

An entity shall include all the cash flows within the boundary of each contract in the group. The estimates of future cash flows shall be current, explicit, unbiased, and reflect all the information available to the entity without undue cost and effort about the amount, timing and uncertainty of those future cash flows. They should reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices.

The discount rates applied to the estimate of cash flows shall reflect the time value of money (TVM), the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. They should be consistent with observable market prices of those financial instruments whose cash flow characteristics are consistent with those of the insurance contracts, but shall not reflect risks not present in insurance contract.

The estimate of the present value of the future cash flows is adjusted to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of future cash flows that arises from non-financial risk.

The FCF shall not reflect the non-performance risk, i.e. own credit risk, of the entity issuing the contract.

The CSM represents the unearned profit the entity will recognise as it provides services in the future. This is measured on initial recognition of a group of insurance contracts at an amount that, unless the group of contracts is onerous, results in no income or expenses arising from (a) the initial recognition of an amount for the FCF; (b) the derecognition at that date of any asset or liability recognised for acquisition cash flows; and (c) the cash inflows and outflows arising from the contracts in the group at that date. The CSM cannot be negative, as this would indicate the contract is onerous.

At the end of each subsequent reporting period, the carrying amount of a group of insurance contracts is remeasured to be the sum of the liability for remaining coverage and the liability for incurred claims, both determined as at that date.

The liability for remaining coverage comprises FCF relating to future services, plus a measure of the CSM yet to be earned. The liability to handle and pay already incurred claims arises from past coverage service. It includes also a liability for claims incurred but not yet reported.

An entity shall recognise income and expenses for changes in the carrying amount of the liability for remaining coverage and that for incurred claims separately, as set out in the table below.

	Changes in the carrying amount of the liability for remaining coverage	Changes in the carrying amount of the liability for incurred claims
Insurance revenue	<ul style="list-style-type: none"> Reduction in the liability for remaining coverage because of service provided in the period 	<ul style="list-style-type: none"> Not applicable
Insurance service expense	<ul style="list-style-type: none"> Losses on groups of onerous contracts and reversal of such losses 	<ul style="list-style-type: none"> Increase in the liability because of claims and expenses incurred in the period Subsequent changes in FCF relating to incurred claims and incurred expenses
Insurance finance income or expense	<ul style="list-style-type: none"> Effect of the TVM caused by the passage of time; and Effect of changes in assumptions that relates to financial risk 	<ul style="list-style-type: none"> Effect of the TVM caused by the passage of time; and Effect of changes in assumptions that relates to financial risk

Onerous contracts

An insurance contract is onerous at initial recognition if the total of the FCF, any previously recognised acquisition cash flows and any cash flows arising from the contract at that date is a net outflow. An entity shall recognise a loss in profit or loss for the net outflow, resulting in the carrying amount of the liability for the group being equal to the FCF and the CSM of the group being zero.

On subsequent measurement, if a group of insurance contracts becomes onerous (or more onerous), that excess shall be recognised in profit or loss. Additionally, the CSM cannot increase and no revenue can be recognised, until the onerous amount previously recognised has been reversed in profit or loss as part of a service expense.

Insurance contracts with direct participating features (direct par insurance contracts)

Many insurance contract allow policyholders to participate in investment returns with the insurer, in addition to compensation for losses from insured risk. Not all participating contracts meet the definition of direct par insurance contracts, which need to satisfy all three of the following criteria:

- the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and
- a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

Direct par insurance contracts are viewed as creating an obligation for the entity to pay to the policyholder an amount equal to the underlying items less a variable fee for service. A variable fee comprises the entity's share of the fair value of the underlying items less amounts payable to the policyholder that do not vary based on the underlying items (e.g. expenses paid to fulfil the contract). The General Model is modified for such contracts and it is referred to as the "variable fee approach" or "VFA". This is described in the section on CSM below.

Those participating contracts not meeting the definition of direct par insurance contracts are called indirect participation contracts, and are accounted for using the General Model.

Subsequent measurement of the CSM

The CSM for a group of insurance contracts represents an unearned expected profit for that group. Subsequent to initial recognition it is measured differently under the General Model and the VFA approach.

General Model

The CSM of a group of contracts at the end of the reporting period equals the opening balance adjusted for the addition of new contracts to the group (if the group does not cover the same twelve months as the reporting period), accretion of interest at the locked-in rate, changes in FCF relating to future coverage or other services, foreign currency exchange differences and the amount recognised in profit or loss relating to the transfer of services in the period.

The changes in FCF relating to future coverage or other services comprise changes in risk adjustment for non-financial risks and certain experience adjustments, provided they both relate to future service. Experience adjustments are measured at the discount rates applicable at initial recognition (the locked-in rates) and comprise:

- differences between expected and actual premiums received in the period that relate to future services and associated cash flows;
- changes in estimates of the present value of expected future cash flows in the liability for remaining coverage (excluding estimate changes due to TVM and financial risks); and
- differences between expected and actual investment components payable in the period.

Variable Fee Approach

For direct par insurance contracts, the CSM is adjusted for any new contracts added to the group and the effects of foreign exchange movements. However, it is also adjusted for the changes in the entity's share of the fair value of the underlying items, except to the extent the changes give rise to a loss or a reversal of such loss. It is adjusted for the changes in the FCF relating to future coverage or other services (except to the extent that the changes give rise to a loss or its reversal). Unlike in the General Model, under the VFA this includes changes in estimates relating to the time value of money and financial risks, since for direct par insurance contracts these are considered related to future coverage. After making all these adjustments, part of the CSM is released and recognised as revenue because of the transfer of services in the period. This is determined by the allocation of the CSM at the end of the reporting period (before any allocation) over the current and remaining coverage period.

Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items or changes in estimates of incurred claims and incurred expenses do not relate to future service and therefore do not adjust the CSM.

Observations

The principle determining which changes in the insurance liability adjust the CSM and which changes are included in profit or loss is based on whether they relate to past or future service. For example, in the case of experience adjustments, those that relate to past service are immediately recognised in profit or loss, whereas those that relate to future service adjust the CSM.

The VFA closely reflects the economic substance of direct par insurance contracts. It can only be applied where the definition of a direct par insurance contracts is met.

Premium allocation approach

An entity may simplify the measurement of the liability for remaining coverage of a group of insurance contracts using the PAA on the condition that, at initial recognition, the entity reasonably expects that this will be an approximation of the General Model. Where, at the inception of the group, an entity expects significant variances in the FCF during the period before a claim is incurred, such contracts are not eligible to apply the PAA. Contracts with a coverage period of one year or less are automatically eligible for PAA.

The simplifications arising from the PAA do not apply to the measurement of the group's liability for incurred claims, measured under the General Model. However, there is no need to discount those cash flows if the balance is expected to be paid or received in one year or less from the date the claims are incurred.

Using the PAA, the liability for remaining coverage shall be initially recognised at the premiums, if any, received at initial recognition, minus any insurance acquisition cash flows. This is subsequently adjusted for change in the composition of the group and amortisation of acquisition cash flows and reduced over the coverage period, with the reduction recorded as revenue, excluding any investment component paid or transferred to the liability for incurred claims.

If insurance contracts in the group have a significant financing component, the liability for remaining coverage needs to be discounted, however, this is not required if, at initial recognition, the entity expects that the time between providing each part of the coverage and the due date of the related premium is no more than a year.

In applying PAA, an entity may choose to recognise any insurance acquisition cash flows as an expense when it incurs those costs, provided that the coverage period at initial recognition is no more than a year.

Observations

The PAA is likely to be widely adopted by non-life insurers writing property and casualty business, where the coverage period of contracts is one year or less. This approach may be easier to apply and is likely to be similar to the current accounting methods for such contracts.

Where the coverage period is greater than one year, general insurers may need to measure a representative sample of such contracts using both approaches in order to demonstrate that the PAA produces a reasonable approximation of the measurement under the General Model.

Modification and derecognition

Modification of an insurance contract

If the terms of an insurance contract are modified, an entity shall derecognise the original contract and recognise the modified contract as a new contract if there is a substantive modification, based on meeting any of the specified criteria.

Derecognition

An entity shall de-recognise an insurance contract when it is extinguished or substantially modified.

Recognition and presentation in the financial statements

Presentation in the statement of financial position

An entity shall present separately in the statement of financial position the carrying amount of groups of: a) insurance contracts issued that are assets; (b) insurance contracts issued that are liabilities; (c) reinsurance contracts held that are assets; and (d) reinsurance contracts held that are liabilities.

Recognition and presentation in the statement(s) of financial performance

An entity shall disaggregate the amounts recognised in the statement(s) of financial performance into an insurance service result (comprising insurance revenue and insurance service expense) and an insurance finance income or expense. Income or expenses from reinsurance contracts held shall be presented separately from the expenses or income from insurance contracts issued.

Insurance service result

An entity shall present in profit or loss revenue arising from the groups of insurance contracts issued, and insurance service expense arising from a group of insurance contracts it issues, comprising incurred claims and other incurred insurance service expense. Revenue and insurance service expense shall exclude any investment components.

Insurance finance income or expense

Insurance finance income or expense comprise the change in the carrying amount of the group of insurance contracts arising from the effect of the TVM and the effect of changes in assumptions that relate to financial risk, but generally excludes any such changes for groups of direct par insurance contracts that would instead adjust the CSM.

An entity has an accounting policy choice between including all of insurance finance income or expense for the period in profit or loss, or disaggregating it between amount presented in profit or loss and amount presented in other comprehensive income ("OCI"). Where the accounting policy choice is to disaggregate insurance finance income or expense, the amounts presented in OCI unwind naturally over time, with any remaining OCI amounts reclassified to profit or loss on derecognition of the group of contracts accounted for under the General Model (but not VFA).

An insurance contract is treated as a monetary item under IAS 21 *The effect of Changes in Foreign Exchange Rates*, with exchange differences on changes in the carrying amounts of groups of insurance contracts included in profit or loss, unless they relate to changes included in OCI.

Observation

The statement(s) of financial performance are likely to present the results of insurance contracts very differently from the current presentation, particularly for insurers writing life business and specifically in respect of their revenue from insurance contracts. Revenue is derived from changes in the calculation of the components of liability for remaining coverage, excluding investment components, rather than simply reflecting premiums. Premiums will not be able to be shown in profit or loss if that information is inconsistent with insurance revenue.

Disclosure

An entity shall disclose qualitative and quantitative information about (a) the amounts recognised in its financial statements that arise from insurance contracts; (b) the significant judgements, and changes in those judgements; and (c) the nature and extent of the risks that arise from insurance contracts. There are also extensive disclosures relating to transition.

Observations

The disclosure requirements of the Standard are extensive, but an entity will need to consider whether these satisfy the disclosure objective and how much emphasis to place on each of the various requirements.

The changes in presentation of insurance contracts in the financial statements may result in the need to develop new key performance indicators.

Effective date and transition

Effective date

The Standard is applicable for annual reporting periods beginning 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 the Standard. For the purpose of the transition requirements, the date of initial application is the start of the annual reporting period in which an entity first applies the Standard, and the transition date is the beginning of the period immediately preceding the date of initial application.

Observations

The IASB set the effective date as 1 January 2021 with the consideration of the time and cost that will be involved in implementing IFRS 17. This time allows entities to consider the effects of the Standard, for example in respect of:

- Changes needed to their systems and processes (for example to aggregate insurance contracts into portfolios and groups, to perform new calculations and to meet the transition requirements);
- Judgements required, particularly in relation to accounting policy choices;
- Any potential tax impacts if the tax treatment is based on financial statements;
- The Standard's impact on, for example, key metrics, debt covenants and management compensation; and
- Additional information that entities will need to gather to make the required disclosures.

Transition

An entity shall apply the Standard retrospectively unless impracticable, in which case entities have the option of using either the modified retrospective approach or the fair value approach.

Under the modified retrospective approach, an entity shall utilise reasonable and supportable information and maximise the use of information that would have been used to apply a full retrospective approach, but need only use information available without undue cost or effort. Under this approach the use of hindsight is permitted, if that is the only practical source of information for the restatement of prior periods.

Under the fair value approach, an entity determines the CSM at the transition date as the difference between the fair value of a group of insurance contracts at that date and the FCF measured at that date. Using this approach, on transition there is no need for insurance contracts to be aggregated into annual groups.

At the date of initial application of the Standard, those entities already applying IFRS 9 may retrospectively re-designate and reclassify financial assets held in respect of activities connected with contracts within the scope of the Standard. Entities can choose not to restate IFRS 9 comparatives with any difference between the previous carrying amount of those financial assets and the carrying amount at the date of initial application recognised in the opening equity at the date of initial application. Any restatements of prior periods must reflect all the requirements of IFRS 9.

Observation

The proposed transition requirements, although simplified substantially late in the project, remain to be one of the most challenging aspects of the Standard, particularly for insurers with outstanding contract liabilities originated long before the date of transition.

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