Abstract

The insurance industry has long been lacking a global accounting standard. The existing insurance International Financial Reporting Standard, IFRS 4, was published in 2004 as an emergency standard while the final version was in the works. IFRS 4 was meant to address the most urgent issues in the industry, while mostly allowing insurers to continue their existing practices. Currently the insurance industry is filled with a myriad inconsistent practice, making it difficult for users of financial statements to understand and compare them. IFRS 17 Insurance Contracts is the finalized comprehensive standard coming into effect on 1 January 2023, with the transition proceedings having already begun.

This study examines the implementation of IFRS 17 and its impact on how insurers measure insurance contracts they have issued or acquired and how resulting profits or losses are presented in financial statements. It focuses on the main principles and objectives of IFRS 17 through the three measurement approaches used to calculate the carrying amounts of insurance contracts. Following with examining the transition requirements and the three transition approaches insurers will use to measure existing insurance contracts to achieve appropriate opening balances ahead of the effective date. Lastly it looks at the key changes IFRS 17 brings to the presentation of financial statements and disclosure requirements. To bring insurance accounting in line with other industries using the accrual method, IFRS 17 introduces the contractual service margin to ensure timely recognition of profits and expenses in corresponding periods. It requires the use of current estimates about the timing, amount and uncertainty of future cash flows throughout the duration of insurance contracts. To bring transparency about arising profits, IFRS 17 excludes from its scope distinct good and service components and investment components, shifting them under the scope of their respective IFRS Standards.

IFRS 4 does not include specific presentation requirements for financial statements. In contrast, IFRS 17 will require the balance sheet to present portfolios of insurance contracts that are either assets or liabilities. The presentation of profit or loss is split into insurance service result and insurance finance result to bring transparency about the sources of profit. IFRS 17 builds on existing disclosure requirements and entities must include information about all significant methods and assumptions used and changes in them.

This thesis is meant to provide its readers with an understanding of the objectives of IFRS 17 and how it will affect insurers measuring methods and financial reporting. As the standards has yet to come into effect, the actual effects of IFRS 17 will be seen after implementation. Thus, this study could be used as a foundation for further studies post-implementation.

Keywords IFRS 17, IFRS 4, Insurance contracts
# TABLE OF CONTENTS

1 **Introduction** ............................................................................................................. 1

2 **IFRS Standards** ....................................................................................................... 3  
   2.1 Usefulness of IFRS Standards ................................................................................. 3  
   2.2 Timeline of the project ......................................................................................... 4

3 **Measuring insurance contracts under IFRS 17** .................................................... 6  
   3.1 Scope of IFRS 17 .................................................................................................. 7  
   3.2 Level of Aggregation ........................................................................................... 8  
   3.3 The General Measurement Model ....................................................................... 9   
      3.3.1 Initial recognition ....................................................................................... 9  
      3.3.2 Subsequent measurement ........................................................................... 12  
      3.3.3 Modifications for reinsurance contracts held ............................................. 13  
   3.4 The Premium Allocation Approach ..................................................................... 14  
   3.5 The Variable Fee Approach ............................................................................... 16   
      3.5.1 Identifying direct participating contracts ............................................... 16  
      3.5.2 Measurement under the Variable Fee Approach ....................................... 17

4 **Transition to IFRS 17** ........................................................................................... 18  
   4.1 The Full Retrospective Approach ...................................................................... 19  
   4.2 The Modified Retrospective Approach .................................................................. 19  
   4.3 The Fair Value Approach .................................................................................... 20  
   4.4 Implications of transition approaches ................................................................ 21

5 **Financial reporting** ............................................................................................... 23  
   5.1 The balance sheet ............................................................................................... 23  
   5.2 The statement of comprehensive income ........................................................... 24  
   5.3 Disclosure requirements ..................................................................................... 25

6 **Conclusion** ............................................................................................................ 26
1 Introduction

As foreign investments have grown rapidly in recent years, the demand for internationally comparable accounting standards has increased (Brüggemann, Hitz, & Sellhorn, 2013; Carmona & Trombetta, 2008; Houqe, 2018; Jermakowicz & Gornik-Tomaszewski, 2006; Yip & Young, 2012). Thus far, the insurance industry has been lacking a comprehensive standard, resulting in extremely varied accounting practices which in turn makes it difficult for investors to understand and compare financial reports (Diffey et al., 2022; Horton, 2007; Kosi and Reither, 2014; Liu and Liao, 2020; Palmborg et al., 2021; Yousuf et al., 2020).

The existing insurance accounting standard, IFRS 4, was published in 2004 by the International Accounting Standards Board (IASB) as a temporary solution to a lack of guidelines and transparency in the insurance industry. IFRS 4 introduced some basic disclosure requirements, while allowing insurers to continue following national accounting practises for the measurement of insurance contracts. Most existing practices are distorted in that insurance contracts are often measured using historical data, and profit and expenses are recognised based on when cash is received or paid out (IASB, 2017a). IFRS 17 Insurance Contracts is effective from 1 January 2023 and will replace IFRS 4. It is an extensive overhaul of existing measurement and financial reporting practices, requiring the use of use current estimates and concurrent recognition of insurance revenue and provided insurance coverage. IFRS 17 is designed to enhance transparency and comparison of the obligations and profit drivers of insurance contracts, and thus enabling more efficient capital allocation in the insurance industry worldwide (IASB, 2020).

Since IFRS 17 has yet to come into effect, it has not been extensively studied. The standard introduces three measurement approaches for calculating the carrying amount of insurance contracts. Of the limited research there is, the perceived majority focus on mathematical interpretations of different components of the measurement approaches e.g., Zhao et al. (2021) studied methods of calculating risk adjustments, Diffey et al. (2022) studied common weaknesses, solutions and data challenges in reserve validation, Yousuf et al. (2020) examined technical, operational and commercial issues arising from profit recognition from a life insurance perspective and Palmborg et al. (2021) attempted to define an algorithm for profit or loss recognition in accordance with the standard.
This study will not delve into such mathematical interpretations, but rather aims to provide readers with a deeper understanding of the main principles and objectives of IFRS 17, and its effect on how insurers measure insurance contracts they issue or acquire and how resulting profits or losses are reported.

The structure of this study is as follows. Section two starts by giving context for the objectives, scope and usefulness of IFRS Standards, following with an overview of the project of developing a global insurance accounting standard. Section three will introduce the main principles and objectives of IFRS 17 and the three measurement approaches. To guide insurers in the implementation of IFRS 17, the standard includes specified transition requirements and a set of transition approaches designed to assist entities in achieving the necessary opening balances ahead of the effective date, all of which will be examined in section four. Section five considers the key effects on financial reporting, followed by section six which will conclude the study.
2 IFRS Standards

Formed in 2001, the International Accounting Standards Board (IASB), is an independent group of experts that develops and approves International Financial Reporting Standards (IFRS). It is the objective of IFRS Standards to contribute to transparency through enhancing the comparability and quality of financial information, to reduce the information gap between investors and entities and to improve capital allocation by helping investors identify opportunities and risks across the world (IASB, 2010, para. SP1.5). IFRS Standards are principle-based meaning they provide rules and guidance on a conceptual basis, rather than a strictly rules-based approach which is arguably not flexible enough to cover the variety of situations worldwide (Carmona & Trombetta, 2008; Houqe, 2018).

The scope of applying IFRS Standards varies by jurisdiction, but currently over 140 countries require applying the standard to some extent. For example, since 2005 all domestic public companies in the European Union have been required to apply IFRS Standards to consolidated financial statements. In the US domestic public companies use US GAAP (Generally Accepted Accounting Principles), but foreign public companies have been permitted to apply IFRS Standards since 2007 (IASB, 2018c).

2.3 Usefulness of IFRS Standards

Studies have found the implementation of IFRS Standards to improve the comparability of national and international information (Neel, 2017; Yip & Young, 2012), having a positive effect on information asymmetry (Benkraïem, Bensaad, & Lakhal, 2022; Karamanou & Nishiotis, 2009) and reducing the cost of capital (Góis, Franco de Lima, Alves de Sousa, & Malacrida, 2018; Karamanou & Nishiotis, 2009).

It is however the flexibility caused by IFRS Standards being principle-based that is most often criticised as it requires entities to apply a significant amount of judgement, leading to different interpretations and thus hindering the comparability of results. Proponents of rules-
based approaches, like the US GAAP, argue that strict rules and the elimination of choice leads to consistent application and better comparability (Lee, 2006). Other topics of criticism pertain to e.g., Brüggemann et al. (2013) who found past empirical research to be immature and to give conflicting results on whether the objectives of IFRS Standards have been achieved. Nobes (2013) argued that while the adoption of IFRS is arguably widespread, the requirement or permission to use IFRS Standards is often restricted to listed companies or consolidated financial statements or both, which hinders the objective of comparability. Moreover, a study done by Jermakowicz and Gornik-Tomaszewski (2006) found the implementation process to be costly, complicated and burdensome especially for those who must or choose to run two parallel accounting systems for consolidated and individual financial statements.

2.4 Timeline of the project

The project of developing a consistent global standard for insurance accounting began in 1997. Failure to agree on how such a standard should look led to the project being split into two phases. Phase I was completed in 2004 when IFRS 4 was issued as an emergency interim standard, to address the most urgent issues in insurance accounting, while a more comprehensive version was in the works (IASB, 2017b). The insufficiency of IFRS 4 is perhaps best described by following contradicting ‘temporary exemption’ included in it, which “explicitly stated that an entity need not ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements or that such accounting policies are reliable. “ (IASB, 2017a, p. 5).

The main objective of IFRS 4 was to make minimal improvements to insurance accounting practices, avoiding major changes that may need to be reversed in Phase II, and to require entities to identify and explain in financial statements any amounts arising from insurance contracts (IASB, 2004). By and large insurers were able to continue their existing practices, usually based on local GAAP. Many insurers use a cash basis method, where profit and expenses are recognized when cash is received or paid out. As often a policyholder pays a premium in advance while the amount and timing of future claim payments are uncertain, using a cash basis method contradicts many other industries using the accrual method, where expenses and revenue are recognized in corresponding periods (Palmborg et al., 2021). It is also common to use historical estimates made at the beginning of even long-
term contracts and to disregard the time value of money. IFRS 4 does not dictate how insurance contracts should be managed, thus insurers are able to put together large groups of varying contracts, allowing results from loss-making contracts be offset by profitable ones.

Phase II was technically completed in May 2017 when IASB originally issued IFRS 17 Insurance Companies, with the intention of it being applied from January 2021 onwards. However, following a lot of feedback and raised concerns from the insurance industry, a set of proposed amendments were published in June 2019 for public consideration. Based on that feedback, the Amendments to IFRS 17, and thus the final version of the standard, was issued in June 2020. Along with other amendments, the effective date was deferred to be applied from annual periods beginning on or after January 2023 in order to give the insurance industry the appropriate time to implement the amendments (IASB, 2019a).
3 Measuring insurance contracts under IFRS 17

IFRS 17 Insurance Contracts is an accounting framework of principles for the recognition, measurement, presentation and disclosure of all insurance contracts within its scope. It guides entities in providing a faithful representation of those contracts, enabling users of financial statements to assess their financial position, financial performance and cash flows (IASB, 2020).

An insurance company measures the rights and obligations arising from insurance contracts it issues or acquires and reflects the net carrying amount on its balance sheet. IFRS 17 defines that the carrying amount should represent the entity’s obligation to provide future services to the policyholders. Measuring insurance contracts under IFRS 17 is built on the idea of dividing contracts into groups based on specified level of aggregation requirements and calculating a contractual service margin (CSM) for those groups (IASB, 2017b). The CSM is a fundamental concept introduced in IFRS 17, that will bring insurance accounting in line with the accrual accounting method by combining two main principles: that at initial recognition no profit is recognized from a profitable group of contracts, and it is instead recognized based on the pattern of services provided over the coverage period. And that any losses from loss-making groups are recognized immediately in profit or loss, rather than deferred (Yousuf et al., 2020). At each reporting date, insurers must review past measurements ensuring the use of current estimates of the timing, amount and uncertainty of future cash flows. Requiring the use of current estimates will harmonize insurance accounting with other comparable industries, such as the accounting of financial instruments (Palmborg et al., 2021).

These concepts are put into effect as IFRS 17 introduces three approaches to measure insurance contracts: the General Measurement Model (GMM), the Variable Fee Approach (VFA) and the Premium Allocation Approach (PAA). The GMM is the default approach, whereas the VFA is mandatory for specified contracts with significant direct participating features and the PAA is a simpler alternative designed mainly for contracts with coverage periods of 1 year or less (IASB, 2020).
IFRS 17 is expected to have a significant impact on the insurance industry and require a lot of effort, time, money and education from insurers. The effect of the standard will vary depending on e.g., jurisdiction, size and structure of organization, skill and education of workforce. IASB (2017b) has acknowledged the inevitable significant costs entities face as they implement IFRS 17 but conclude that the need for a comprehensive insurance accounting standard, and the benefits expected from it, outweigh them. Implementation costs will depend on how different current accounting practices are to the new standard and the amount and variety of contracts issued. IASB expects the bulk of implementation costs to consists of project design and implementation, systems set-up, process changes, education and communication (IASB, 2017b).

3.3 Scope of IRS 17

Insurance contracts are complex bundles of rights and obligations and can combine financial instruments with insurance services. As a result, insurance contracts can provide their insurers with different sources of income in a single contract. Under IFRS 4 any investment components in insurance contracts are not required to be monitored separately as projected cash flows and assumptions are determined, and the performance of those contracts analyzed (IASB, 2017a).

To give a more accurate representation of insurance service performance IFRS 17 excludes from its scope some specified non-insurance components. IFRS 15 Revenue from Contracts with Customers shall be applied on any distinct goods and non-insurance services featured in insurance contracts. Similarly, embedded derivatives and, if distinct, investment or deposit components shall be accounted for under IFRS 9 Financial Instruments. Any non-distinct components, which are highly interrelated with the insurance contract and one component cannot be benefited from without the other, are accounted for together with the insurance contract under IFRS 17. However, any cash flows from such investment components are excluded from the insurance service result and presented separately in the insurance finance result in profit or loss. The distinction was designed to improve transparency particularly about the sources of profit recognized from insurance contracts (IASB, 2017b).
3.4 Level of Aggregation

IFRS 17 defines a level of aggregation for measuring insurance contracts and their profitability. These guidelines are key in identifying onerous\(^1\) contracts and determining how profit or loss is recognized and presented in the financial statement (EY, 2021). Aggregation starts by identifying portfolios of contracts that have similar risks and are managed together, typically contracts from the same product line. Then contracts within each portfolio are further divided into the following groups on initial recognition based on their profitability (IASB, 2020):

1. a group of contracts that are onerous
2. a group of contracts with no significant likelihood of becoming onerous
3. a group of the remaining contracts

Groups are established at initial recognition, and cannot be changed subsequently, hence a group of onerous contracts can later become profitable and vice versa. Hence entities should actively consider the suitability of past aggregation decisions (Palmborg et al., 2021). An entity is also prohibited from grouping together contracts issued or acquired more than 1 year apart, this is referred to as the annual cohort requirement. Meaning that new groups, following the above profitability rules, are created at least annually for each portfolio.

It is important to note, that initial recognition is not synonymous with the date a contract is issued. Initial recognition refers to how an entity first recognizes a group of insurance contracts that it issues, from the earliest of the following three dates: the beginning of the coverage period of the group, the date when the first payment from a policyholder becomes due or when a group is determined to be onerous (Palmborg et al., 2021). For contracts that are issued in advance of the coverage period beginning or before the first premium becomes due, the date of issuance and initial recognition may happen in different annual periods. Grouping such contracts according to the annual cohort requirement may be difficult as it requires pedantic tracking of the dates of issuance. In fact, during the creation of IFRS 17, many entities in the insurance industry raised concerns about the annual cohort requirement

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\(^1\) A contract is or becomes onerous when the unavoidable costs of meeting the contract obligations exceed the economic benefits expected to be received from it (IASB, 2018b).
especially, but IASB concluded that the benefits of the level of aggregation requirements outweighed the costs (EY, 2021).

The aggregation requirements aim to fix a flaw in insurance accounting, where IFRS 4 lacked instructions on how contracts should or should not be grouped together. Thus, it is common practice to form large groups of insurance contracts where profitable and onerous contracts are allowed to offset one another (Diffey et al., 2022). In its IFRS 17 Effects Analysis (IASB, 2017b) publication IASB also names grouping contracts as a key cost relief, as it allows entities to measure contracts at group level. This is unusual as generally IFRS Standards, like IFRS 15 Revenue from Contracts with Customers and IFRS 16 Leases, require accounting for individual contracts in order to achieve the most transparent information.

Many insurance companies currently have some method of grouping contracts for internal reporting and management purposes, but they need to be regrouped according to IFRS 17. Determining portfolios should be somewhat straightforward, as contracts from the same product line will often include similar risks and are logically managed together. But as no specified methods of calculation are given for identifying groups of contracts, entities are forced to use their own judgement in determining e.g., what they consider a non-significant likelihood of becoming onerous (KPMG, 2020).

3.5 The General Measurement Model

IFRS 17 introduced the General Measurement Model (GMM) as a comprehensive, coherent framework to give a more accurate reflection of the many different types and features of insurance contracts, and how entities earn income from them. It is the default approach and should be used on all groups of insurance contracts bar the exceptions addressed in sections 3.3 and 3.4. Groups of contracts are first measured at initial recognition, and then subsequently at each reporting period until all contracts in a group have expired or been terminated.

3.5.1 Initial recognition

The General Measurement Model calculates the carrying amount of groups of insurance contracts as the sum of the fulfilment cash flows and the contractual service margin (CSM). IASB describes fulfilment cash flows as “the current estimates of the amounts that an insurer
expects to collect from premiums and pay out for claims, benefits and expenses, adjusted to reflect the timing and the uncertainty in those amounts” (IASB, 2017b, p. 16).

The present value of fulfilment cash flows is calculated from the following three parts (as seen in Figure 1):

1. estimates of future cash flows
2. a discount rate that reflects the time value of money and financial risks
3. a risk adjustment for non-financial risk

Estimates of future cash flows include the inflows and outflows, such as future premiums and claims, arising from existing insurance contracts in a group. Entities must estimate the probability-weighted mean of the full range of possible outcomes, incorporating all reasonable and supportable information about the amount, timing and uncertainty of those cash flows. Though insurance contracts are valued at group level, IFRS 17 permits entities to estimate future cash flows at portfolio level and then allocate them to individual groups of contracts (EY, 2021).

Existing discounting practice lacks proper guidance from IFRS 4, and many insurers base them on expected returns on assets backing the insurance contract liability while some do not discount future cash flows at all. IFRS 17 requires all insurance contracts to be discounted to reflect the time value of money and financial risk but does not specify an estimation technique – just that the discount rate should be market consistent and reflect the timing, currency and liquidity of underlying liabilities (IASB, 2020). Since there is no liquid market where insurance liabilities are sold, entities must make such judgements based on other financial instruments with similar qualities and adjust them to better reflect the characteristics of the insurance contract in question (EY, 2021).

The risk adjustment for non-financial risk refers to the uncertainty in the amount and timing of future cash flows, and it is an entity-specific requirement of compensation for bearing such a risk. Like the discount rate, IFRS 17 does not specify an estimation technique for non-financial risk (KPMG, 2020).
Figure 1 (based on EY, 2021, p. 148) illustrates the carrying amount of a profitable group of contracts

The CSM of a profitable group of contracts at initial recognition is the amount that ensures no profit arises from the present value of fulfilment cash flows (as seen in Figure 1). In an onerous group, the present value of fulfilment cashflows is negative, and that net value must be immediately recognized as a loss component in profit or loss. Therefore, an onerous group of contracts does not have a CSM (Palmborg et al., 2021).

IFRS 17 also includes insurance acquisition cash flows (IACF) in the assessment of the CSM. They refer to any payments that are directly attributable to a group of insurance contracts e.g., from selling or starting groups, and that incur before that group is initially recognized. Under IFRS 4 IACF were usually not included in measuring insurance contracts, but rather shown separately on the balance sheet as deferred acquisition cost assets and gradually written off, or recognized immediately as expenses (EY, 2021). IFRS 17 requires entities to recognize acquisition costs paid as assets, until the related group is recognized. Then IACF are essentially included as a negative liability in the assessment of the CSM at initial recognition. This way costs and related revenue are recognized simultaneously, and acquisition costs are a part of the insurance contracts liabilities in the balance sheet (Liu & Liao, 2020).

The contractual service margin of a group is recognized in profit or loss over the coverage period, based on coverage units determined at group level based on the coverage provided and its duration. IASB introduced coverage units to aid in appropriate allocation of the CSM
of a group that contains contracts of different durations and levels of coverage. The CSM is evenly allocated to the coverage units, and at the time of reporting the amount of CSM that represents the units of insurance coverage provided is recognized as insurance revenue in profit or loss (IASB, 2020). Beyond this, the standard does not give much more detail in how coverage units should be calculated and thus it is up to entities to establish appropriate approaches.

The contractual service margin makes valuing insurance contracts unique, in that they will be the only type of contracts under IFRS that are required to disclose the expected remaining profitability of a group, and an estimation of the timing of it being recognized in future periods (EY, 2021). How entities determine and evaluate coverage units and the CSM is expected to be critical in how useful the IFRS 17 accounting model will be for them (EY, 2021; KPMG, 2020; PwC, 2020a). Considering the amount of insurance products entities usually offer, they may want to consider approaching them at a product or portfolio level where possible.

3.5.2 Subsequent measurement

After initial recognition, the carrying amount of a group of contracts is the sum of (IASB, 2020):

1. **liability for remaining coverage**, which is the sum of:
   a) fulfillment cash flows related to future service
   b) the remaining CSM, if any

2. **liability for incurred claims**, which consists of fulfillment cash flows related to past or current events

At subsequent measurement, the reduction in the liability for remaining coverage from services provided, based on the allocated CSM in the period, is recognized as insurance revenue. Entities must review past estimates of fulfilment cash flows, so that any resulting changes in future cash flows adjust the remaining CSM and any changes in financial risk assessments are recognized as insurance finance income and expenses (KPMG, 2020).

The CSM at subsequent measurement is therefore the remaining CSM, after the appropriate portion based on services provided is recognized in profit or loss, adjusted for potential changes in future cash flows. The liability of remaining coverage is also affected by if a
previously onerous group becomes profitable or vice versa, as a CSM must be created for the former or a loss component in the latter. Entities must also review past determinations of coverage unites at each reporting date, to ensure they reflect current estimates (Yousuf et al., 2020).

The liability for incurred claims refers to insurance contract services that have already been provided, but for which no claims have been made or for which there are outstanding claims. Changes related to past or current service are recognized in insurance service expenses in profit or loss. IFRS 17 requires disclosure of the actual claims versus previous estimates of incurred claims, which are referred to as experience adjustments (IASB, 2020).

3.5.3 Modifications for reinsurance contracts held

In order to transfer some of the risks arising from issued insurance contracts, insurance companies often enter into reinsurance contracts with other insurance companies. A reinsurance contract is issued by a reinsurer who agrees to compensate the cedant for claims arising from underlying insurance contracts issued by the cedant (see Figure 2). For the cedant, such contracts are called reinsurance contracts held.

Accounting for reinsurance contracts under IFRS 4 aligns with the accounting methods applied to underlying contracts. IFRS 17 maintains that correlation to some extent but introduces the level of aggregation requirements. KPMG (2020) expects the aggregation of reinsurance contracts proving more difficult, since their terms and conditions are much less standardized. It therefore foresees entities having to consider reinsurance contracts on an individual basis and expects some groups comprising of single contracts. IFRS 17 also enforces the separation of a reinsurance contract held and underlying contracts. A cedant must account for reinsurance contracts held separately from the underlying contracts, which IASB explains is because the cedant’s contractual obligations to the underlying policyholders are not eliminated as a result of those contracts being reinsured. Furthermore, the standard
requires results from reinsurance contracts held, though part of the insurance service result, to be presented independently of other insurance contracts in financial reporting (EY, 2021).

A reinsurer applies the General Measurement Model to reinsurance contracts issued as normal, and thus the following modifications apply only to reinsurance contracts held. The GMM is modified to reflect groups of reinsurance contracts held in that:

a. They are assets to the cedant, rather than liabilities
b. Insurers do not typically make profits from reinsurance contracts held

This is because the cedant pays a margin to the reinsurer, as an implicit part of the premium, and only receives reimbursements from the reinsurer if it pays valid claims arising from the underlying contracts. Hence, a cedant can have a net gain or a net cost on purchased reinsurance i.e., unlike in regular insurance contracts, the contractual service margin can be negative. A net gain is, however, unlikely since usually the amounts paid by a cedant exceed any reimbursements from reinsurance contracts held. The fulfilment cash flows of reinsurance contracts are determined normally, except for the inclusion of any expected credit losses arising from the risk of the reinsurer defaulting or disputing claims. The timing of fulfilment cash flows should also not be based on those of underlying contracts, as they are unlikely to correspond with each other (Yousuf et al., 2020).

3.6 The Premium Allocation Approach

The Premium Allocation Approach (PAA) is a simplified version of the General Measurement Model. IASB provides the PAA as a substantially less costly option, that when applied for the appropriate contracts, should cause minimal loss of useful information (IASB, 2017b). Entities can choose to apply the PAA to contracts with coverage periods of 1 year or less, or to contracts that an entity can reasonably expect the PAA to produce similar results as if GMM was applied.
When measuring contracts under the PAA the liability for incurred claims is measured as it is in the GMM, but liability for remaining coverage is (EY, 2021):

a. at initial recognition: the amount of premium received at that point, if any, less any acquisition cash flows paid

b. at subsequent measurement: the amount of premiums received in the period, minus the amount recognized as insurance revenue in that period

The PAA deviates from the GMM in that insurers must only adjust the liability for remaining coverage for a discount rate when applying the PAA on a group of contracts with durations longer than 1 year. And in that there is no CSM, as the recognition of insurance revenue is based on the passage of time or the expected timing of incurred claims or benefits, whichever better reflects the entity’s release from (Yousuf et al., 2020). Therefore, if a group of contracts is not expected to have significant variability in its estimated fulfilment cash flows, the PAA might give a similar result for the liability for remaining coverage as the GMM. KPMG (2020) foresees many general insurance contracts, such as property and casualty contracts, being eligible for the PAA based on their short duration.

The PAA is also applicable for reinsurance contracts, that meet the requirements. However, since the assessment of a reinsurance contract held being eligible for the PAA is done separately, it may differ from the eligibility of the underlying contracts. IASB has acknowledged the possible accounting mismatch arising from entities applying different measurement models to reinsurance contracts held and the underlying contracts but concluded that separate accounting is more important in giving a faithful representation of both contracts (IASB, 2017a).

The PAA shares similarities with many accounting methods used under IFRS 4, especially for short-duration contracts, but earlier use of a similar approach does not permit the use of the PAA. And even eligible contracts are not exempt from many other IFRS 17 requirements e.g., level of aggregation, risk adjustment for non-financial risk, revenue recognition patterns and revenue presentation (IASB, 2017b). Both KPMG (2020) and EY (2021) expect difficulties in assessing eligibility for contracts with coverage periods longer than 1 year, since IFRS 17 does not offer specifics on how entities should judge a ‘reasonable’ expectation of similar results to the GMM or what the threshold for variation in fulfillment cash flows being too significant is.
3.7 The Variable Fee Approach

Many insurance contracts include investment features that share returns with the policyholder on specified underlying items, such as a portfolio of assets. IFRS 17 makes a clear distinction between direct participating and non-direct participating features, requiring a modified measurement for the former. In doing so, the standard seeks to better reflect all the components of direct participating contracts, and how they generate profit.

3.7.1 Identifying direct participating contracts

Paragraph B101 of IFRS 17 (IASB, 2020) gives a more elaborate definition of direct participating contracts:

a. The policyholder participates in a clearly identified pool of underlying items
b. The entity expects to pay the policyholder a substantial share of the fair value of the underlying items
c. The entity expects a substantial proportion of changes in the amounts payable to the policyholder to vary with changes in the fair value of the underlying items

In the 2017 Basis for Conclusions publication, IASB further emphasizes that a direct participating contract must clearly specify a determinable fee that should be expressed as “a percentage of portfolio returns or portfolio asset values rather than only as a monetary amount[,]” (IASB, 2017a, p. 71). As without it, returns on underlying assets would be entirely at the discretion of the entity. The assessment of whether a contract meets the above conditions is done at initial recognition and cannot be changed unless the contract itself is modified. Contracts with investment-related services but that fail to meet the above definition, are thus considered non-direct participating contracts, and apply the General Measurement Model without any modifications (Yousuf et al., 2020).

The guidance on determining a direct participating contract may seem sufficient, but the definitions of “a clearly identified pool of underlying items”, “a substantial share” and “substantial portion of changes” leave much room for interpretation. Yousuf et al. (2020) mention contracts with minimum return guarantees or payouts linked to indices as possibly eligible for the VFA. But none of these contract features are automatically eligible, and entities will have to make their own judgements on how to distinguish participating contracts that meet all the requirements.
Reinsurance contracts cannot meet the definition of direct participating contracts and are not eligible for the Variable Fee Approach. IASB considered modifying the VFA to include reinsurance contracts, if the underlying contracts were direct participating contracts, but concluded that including reinsurance contracts would be inconsistent with the IFRS 17 requirement of reinsurance contracts held being accounted for separately from any underlying contracts (IASB, 2017a).

3.7.2 Measurement under the Variable Fee Approach

The Variable Free Approach (VFA) is a mandatory measurement model for direct participating contracts which obligate an entity to pay policyholders an investment return that is “equal to a substantial share of the fair value of the underlying items, less a variable fee for service.” (IASB, 2017c, p. 17). The VFA adjusts the contractual service margin to reflect the variable nature of that fee, which is equal to the entity’s share of the fair value of the underlying items.

Direct participating contracts are measured using the GMM at initial recognition, but at subsequent measurement the VFA adds the following modifications (IASB, 2017a):

1. Changes in the obligation to pay the policyholder the fair value of the underlying items are recognized immediately in profit or loss; and
2. Changes in the variable fee adjust the CSM

In the GMM any changes in discount rates at subsequent measurement are reflected in insurance finance income and expenses, whereas the VFA adjust the CSM based on such changes as they affect the fair value of any underlying items, which affects the value of the entity’s share i.e., the variable fee. Since the variable fee relates to future service, changes in it adjust the CSM of the group of contracts in question. This affects the distribution of insurance service and finance service results, profit timing and volatility in contracts accounted for under the VFA compared to the GMM (Moody’s Analytics, 2019).
4 Transition to IFRS 17

To achieve as frictionless a transition to IFRS 17 as possible, the standard offers three transition approaches. Retrospective application gives entities the necessary opening balances for them to apply IFRS 17 as smoothly as possible from the effective date of 1 January 2023. Entities must also provide a comparative financial statement from the year prior to the effective date – that is from the transition date, which is 1 January 2022 for the majority. The purpose of a comparative financial statement is that “it provides the most useful information to users of financial statements by allowing comparisons between contracts written before and after the date of initial application of the Standard.” (IASB, 2017b, p. 103).

The diversity in current insurance accounting practices complicate transitioning to IFRS 17, which led to IASB offering three different transition approaches. The choice of approach is done at group level and determined primarily by the amount of available historical data – or lack thereof. The Full Retrospective Approach is the primary method, and it requires a significant amount of time, effort and historical data. IASB acknowledged it likely being impracticable, i.e., requiring undue effort, for a variety of contracts, hence they developed the Modified Retrospective Approach and the Fair Value Approach (IASB, 2020).

Choices and estimates insurers make at transition may have a long-lasting impact on their accounting measures and results, for as long as the contracts that exists at the date of transition are ongoing. For instance, the CSM at transition represents the profit insurers will earn from ongoing contracts in the future, meaning the higher the CSM at transition, the more profit insurers will recognize in the future. This may impact an entity’s solvency\(^2\), ability to pay dividends and how stakeholders and investors assess their performance at and post transition (PwC, 2020b).

\(^2\) The possession of assets in excess of liabilities and thus the ability to pay one’s debts
4.3 The Full Retrospective Approach

The Full Retrospective Approach (FRA) requires entities to identify, recognize and measure each group of insurance contracts and assets for insurance acquisition cash flows, as if IFRS 17 had always been applied. Simultaneously it derecognizes any existing balances that do not exist under the standard, and any resulting differences are recognized in equity (KPMG, 2020). The retrospective requirement pertains to all issued and acquired insurance contracts that are in effect at the date of transition.

Forming groups of contracts in accordance with the level of aggregation will be tricky, as they need to be determined as if at initial recognition. Measuring the carrying amounts of those groups will not be any easier, as all but the estimate of future cash flows must be determined starting from initial recognition all the way to the transition date. That is so that the accumulation of e.g., insurance service and finance service income and expenses can be reliably measured. IFRS 17 forbids the use of hindsight in transition approaches, so all measurements and decisions must be made using relevant and supportable estimates and assumptions (EY, 2021).

The level of detail required in the FRA will make it impracticable for many contracts, especially those issued a long time prior to transition (KPMG, 2020; PwC, 2020b). The approach should, however, be less troublesome for short-term contracts and contracts issued or acquired close to the transition date, as well as contracts to be accounted for under the Premium Allocation Approach. However, if determining an asset for insurance acquisition cash flows is the only reason making the FRA impracticable for a group of contracts, IFRS 17 allows entities to use either of the modified approaches to determine that asset, and then apply the FRA to all other amounts (IASB, 2017a).

4.4 The Modified Retrospective Approach

The objective of the Modified Retrospective Approach (MRA) is “to achieve the closest possible outcome to retrospective application using reasonable and supportable information available without undue cost or effort.” (IASB, 2020, para. C6). The approach offers some specific permitted modifications to the FRA, most of them reducing the need for historic estimates, in order to avoid using hindsight. Entities should use the modifications only to the
extent that they cannot apply the Full Retrospective Approach. This way entities with lacking data can achieve opening balances as close to the FRA as possible (PwC, 2020b).

The MRA permits insurers to determine groups and identify direct participating contracts and therefore eligibility for the Variable Fee Approach, based on information at the transition date. Insurers are also allowed to group together contracts issued or acquired more than 1 year apart (IASB, 2020). For contracts that will be accounted for under the General Measurement Model, the MRA includes modifications on how to determine:

a. Cash flows, discount rates and a risk adjustment at initial recognition
b. Allocation of insurance acquisition cash flows to groups initially recognized at the transition date or after the transition date
c. The amount of CSM or loss component that would have been recognized before the transition date
d. Loss recovery components for reinsurance contracts held that provide contracts for onerous underlying contracts, if any

The MRA also details how to determine the CSM or loss component for groups of contracts that will be accounted for under the Variable Fee Approach (PwC, 2020b).

4.5 The Fair Value Approach

The Fair Value Approach (FVA) is a less costly transition approach that enables entities lacking reasonable and supportable information about contracts to determine the necessary opening balances to implement IFRS 17. Like the MRA, entities can choose to apply the FVA for groups of contracts for which the FRA is impracticable (IASB, 2020).

The Fair Value Approach calculates the CSM or loss component of the liability for remaining coverage at transition, as the difference between fulfilment cash flows and the fair value of the group of insurance contracts measured at that date. The approach is based on the IFRS 13 Fair Value Measurement which estimates the price at which the asset would be sold, or the liability transferred between market participants at the measurement date under current market conditions (IASB, 2011, para. B2). The FVA also permits the same modifications as the MRA concerning grouping contracts and identifying direct participating contracts based
on information at the transition date, as well as allowing grouping contracts issued or acquired more than 1 year apart.

EY (2021) expects determining the fair value of groups of contracts to be challenging and requiring a lot of judgement concerning whether to base fair value measurements on observable market data or a valuation technique. It also notes that measuring groups of contracts based on their fair value fails to consider any benefits of diversification that would likely be considered when determining fulfilment cash flows.

### 4.6 Implications of transition approaches

While the Full Retrospective and Modified Retrospective Approaches may give relatively similar opening balances, the Fair Value Approach is likely to be very different. And so, when entities can choose between the MRA and the FVA approach, they ought to carefully consider the practicality, costs and benefits between the two. The Fair Value Approach being a less costly transition approach, does not automatically make it the better option (Yousuf et al., 2020). For example, when measuring an onerous group of contracts, using the FRA and the MRA would likely result in no CSM whereas the FVA may give one. This is because IFRS 13 Fair Value Measurement standard specifies that “the fair value includes the profit margin that a market participant would require to accept obligations under insurance contracts. “ (PwC, 2020b, p. 5). PwC further emphasizes the importance of entities understanding the potential operational impacts of choices made at transition to IFRS 17, and the effect they have on e.g., taxes, solvency and dividend distribution. It also mentions the complexity of application, no matter the approach used, and the cost of transition.

IASB acknowledged that having different transition approaches will hinder the comparability of financial statements – especially the FVA compared to the other two - until contracts effective at transition have expired. The Board recalled trying to balance the usefulness of financial statements and the practicality of retrospective application as the two modified approaches were developed. To support comparability, the CSM and insurance revenue from any groups of contracts measured under the MRA or the FVA, must be presented separately from other contracts in future financial statements until all the contracts in question have expired. An entity must also disclose how it determined opening balances at transition for such contracts. These will enable users of those financial statements to differentiate between
the different approaches (IASB, 2019b). EY (2021) expects this to require significant effort from entities, and they must consider these requirements when building financial reporting processes and systems.
5 Financial reporting

The magnitude of change IFRS 17 brings to financial statements depends on current accounting practices. IASB expects a greater change for long-term contracts especially, as there are substantial national differences in how they are accounted for as of now (IASB, 2017c). The changes in the insurance contract measurement practices may lead to significantly different amounts of revenue recognized at and after transition, as current practice of premium volumes driving revenue recognition come to an end. The requirement of using current estimates at each reporting date is also expected to increase income volatility (Diffey et al., 2022; Kosi & Reither, 2014; Yousuf et al., 2020).

5.3 The balance sheet

There is no requirement for the presentation of the balance sheet under IFRS 4, but Figure 3 illustrates a simplified example of a common presentation. Most insurers present a net amount of insurance contract assets and liabilities, including reinsurance contracts held. Revenue recognition under IFRS 4 is usually based on premiums received, and insurers would often account for them at a higher level of aggregation, even at entity level. This resulted in premium cash flows and claims payable presented as if they are separate assets and liabilities from the contracts (IASB, 2018a).

Figure 3 (inspired by IASB 2018b, p. 6) shows the changes IFRS 17 brings to presentation requirements
In contrast, IFRS 17 includes acquisition costs, premium cash flows and claims payable in the measurement of groups of contracts. Offsetting results is prevented by presenting separately insurance and reinsurance contracts that are either assets or liabilities at portfolio level. These revisions are expected to give a better reflection of assets and liabilities arising from insurance contracts. How the initial application of IFRS 17 will affect reported equity, IASB expects to largely depend on whether an insurer currently measures insurance contracts using historical or current information. (IASB, 2019a).

5.4 The statement of comprehensive income

IFRS 17 will typically not change the total amount of profit or loss recognized over the duration of insurance contracts, but rather the recognition pattern and how profitability is divided between the components of the statement of comprehensive income. As seen in Table 1, IFRS 17 depicts profitability arising from contracts more accurately, as the key profit drivers, the insurance service result and the net financial result, are shown separately. Where under IFRS 4 any effects from discounting would be included in the ‘change in insurance contract liabilities’, IFRS 17 shows them as ‘insurance finance expenses’ to better reflect the effect of investment and market interest rates.

Table 1 (based on IASB, 2017b, p. 83) shows the basic composition of a comprehensive income statement
Under IFRS 4 insurers also often present premiums from short-term and long-term contracts separately, as they are typically accounted for differently. In IFRS 17 premiums no longer drive profit, and insurance revenue is calculated the same for all insurance contracts. Recognized revenue will typically be more than premiums received – especially for long-term contracts, as insurance revenue is adjusted for the time value of money. Insurers that considered the time value of money under IFRS 4, included it in the ‘changes to insurance contract liabilities’ (IASB, 2017b).

IFRS 4 included any deposits from investment components in premiums and claim expenses. IFRS 17 presents them in other comprehensive income, since the obligation to pay a policyholder regardless of if the insured event happened, does not relate to the provision of insurance services. According to IASB this should strengthen the insurance industry’s comparability with similar industries such as banking and investment management, as banks applying IFRS Standards do not recognize deposits received as revenue (IASB, 2017b).

5.5 Disclosure requirements

IFRS 17 will build on existing disclosure requirements in IFRS 4 about significant judgements and the nature and extent of risks arising from insurance contracts. Like previous disclosure requirements, they aim to make it easier for investors to understand and compare amounts recognized and measured in financial statements.

Insurers must disclose assumptions and techniques used, including but not limited to: methods used to measure insurance contracts and any changes in those methods, the approach used to determine the risk adjustment, discount rates, separating investment components. Entities must disclose and report separately all groups of contracts measured at transition using the Modified Retrospective Approach or the Fair Value Approach, for as long as such contracts are in effect.
6 Conclusion

This thesis analyzed the ways in which IFRS 17 will impact how insurers measure insurance contracts they issue or acquire, and how resulting profits or losses are reported. Starting with a brief overview of the timeline of IASB’s project towards IFRS 17, and the main objectives and flaws of IFRS 4 in section two, section three looked at the principles of IFRS 17 through the three measurement approaches. Section four examined the transition process requirements and the three transition approaches enabling entities to achieve the necessary opening balances for implementation, following with an overview of the impacts on financial reporting in section five.

The standard’s impact on how insurers will measure insurance contracts lies in the three measurement approaches: the General Measurement Model, The Variable Fee Approach and the Premium Allocation Approach. IFRS 17 will improve investors’ ability to observe and compare the profitability of certain types of insurance contracts, as the level of aggregation requirements are likely to group together contracts from the same product lines. The use of current estimates about the timing, amount and uncertainty of future cash flows all throughout the duration of contracts will give a truer reflection of financial performance and position. The contractual service margin will introduce a more accurate profit pattern and bring insurance accounting in line with other industries using the accrual method of recognizing revenue and expenses in corresponding periods. Further enhancing the transparency of profits arising from insurance contracts, is the separation of accounting for distinct good and service components and investment components to their respective IFRS Standards.

Though the effective date of IFRS 17 is 1 January 2023, the transition proceedings have already begun with insurers having to prepare comparative financial statements and accounting for existing insurance contracts as if the standard had always applied. Three transition approaches are introduced to guide insurers to achieve opening balances ahead of the effective date. IFRS 17 also requires entities using any of the modified measurement or transition approaches to disclose doing so, and how it affects the measured results as opposed to the primary method.
Following the lack of presentation requirements for financial statements in IFRS 4, IFRS 17 will introduce just that to enhance investors’ ability to understand and compare insurance companies’ financial statements. The inconsistent balance sheets of the past will be replaced by a clear presentation of portfolios of insurance contracts that are assets and those that are liabilities. Similarly, profit or loss in the comprehensive income statement is split into insurance service result and insurance finance result, with any cash flows from non-distinct investment components included in the latter. In addition to already existing disclosure requirements, insurers must give further disclosures about significant methods and assumptions used, and changes in them.

The transition and implementation to IFRS 17 will require significant effort, time and money from insurers. Ultimately it is up to the judgement of insurers to determine, based on given methods and requirements, the appropriate accounting method that best reflects all the elements of insurance contracts they issue.

The significance of this study is the conclusive examination of the main principles and objectives of IFRS 17 Insurance Contracts, and its impact on measuring insurance contracts and financial reporting. Due to the magnitude of changes IFRS 17 will bring, a lot of detail about e.g., specific calculation methodologies had to be left out of this thesis. The study could be used as a foundation for further studies especially post-implementation, that could for example delve deeper into specific aspects of the measurement approaches.
References


IASB. (2004). *IFRS 4 - Basis for Conclusions*.


