

OPINION

# IFRS 17, Insurance Contracts, to spur a fundamental accounting change

IN 1997, the International Accounting Standards Board's predecessor first set up a steering committee to carry out initial work on what was then called the "Insurance project," and nobody expected that it would take 20 years to publish the final result. With the issuance of the new insurance accounting standard called International Financial Reporting Standards (IFRS) 17, Insurance Contracts, the Board closes a long and eventful journey to define the basic objectives, accounting principles and reporting guidelines for insurance contracts. IFRS 17 was on May 18, and will become effective for annual reporting periods beginning on or after Jan. 1, 2021. Early application is permitted provided that IFRS 9, Financial Instruments, and IFRS 15, Revenue from Contracts with Customers, are also applied.

## WHY THE NEED FOR CHANGE?

Insurance companies currently apply insurance accounting practices which are largely driven by local regulatory requirements, as allowed under IFRS 4, the current insurance accounting standard. The lack of a single globally acceptable insurance accounting standard made it difficult for investors and analysts to understand and compare insurance companies' results, both within the industry and vis-à-vis other industries. Such deficiency triggered the use of other so-called "non-GAAP" measures to evaluate the performance of insurance companies. GAAP stands for Generally Accepted Accounting Principles.

The issuance of IFRS 17 is a defining event for the insurance industry because for the first time, there is now a global accounting standard for insurance contracts. IFRS 17 introduces a consistent framework for the recognition, measurement, presentation and reporting of insurance contracts, which is expected to result in more useful and transparent financial reports from insurance companies. The significant changes in the standard will provide more information about the value of insurance obligations as companies will measure insurance contracts at current value; companies will reflect the time value of money in estimated payments to settle incurred claims; and companies will measure their insurance contracts based only on the obligations created by these contracts. Similarly, information about profitability is expounded on as companies will now have to provide consistent information about the components of current and future profits from insurance contracts.

## SCOPE OF IFRS 17

IFRS 17 will be applicable to insurance contracts, including reinsurance contracts issued by the companies; reinsurance contracts held; and investment contracts with discretionary participation features, provided the entity also issues insurance contracts.

## OVERVIEW OF IFRS 17

The core of IFRS 17 is the General (building block) model, supplemented by a specific adaptation for contracts with variable participation features (the Variable Fee Approach) and a simplified approach (Premium Allocation Approach) mainly for short-duration contracts.

The General Model prescribes how the insurance contract assets or liabilities should be measured using the following "building blocks:" (a) estimates of future cash flows; (b) adjustment for the time value of money (i.e. discounting), (c) risk adjustment for non-financial risks, and (d) contractual service margin (CSM).

CSM represents the unearned profit for a group of insurance contracts that the insurance company will recognize over time as it provides the services. Since the estimates of future cash flows are remeasured every reporting period, certain changes in the expected future cash flows are adjusted against the CSM and thereby recognized in profit or loss over the remaining contract service period. On the other hand, companies are given an accounting policy choice whether to reflect the effects of changes in discount rates either in profit or loss or other comprehensive income.

Insurance contract revenue will be reported in the statement of comprehensive income as the entity's consideration for providing services under the contracts (similar to the concept under IFRS 15) while insurance service expenses will be reported based on claims and expenses incurred during the period. These revenue and expense amounts exclude any non-distinct investment component. Entities will have to present insurance service results (i.e., the net of insurance revenue and insurance service expenses) separately from insurance finance income or expenses.

IFRS 17 likewise requires extensive disclosures to provide information on the recognized amounts from insurance contracts and the nature and extent of risks arising from insurance contracts. These disclosures include the reconciliations of the carrying amounts of

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insurance contracts from the opening to the closing balance, classified according to the building block component and type of liability, and with linkages between the movements in the liability to the amounts recognized in the statement of comprehensive income.

In principle, the new standard will have to be applied retrospectively and entities are required to restate comparative information. However, recognizing the challenges in sourcing reliable data to apply a full retrospective approach, companies are provided with two options for transition purposes: (1) the modified retrospective approach where simplifications are allowed; or (2) the fair value approach.

## IMPLICATIONS

For Philippine reporting purposes, IFRS 17 will have to be approved for adoption by the Financial Reporting Standards Council and then submitted to the Board of Accountancy and Professional Regulation Commission for adoption and implementation. With the implementation of Insurance Commission (IC) Circular 2016-67 effective Jan. 1, 2017, Philippine insurance companies will need to undergo another adoption for Philippine Financial Reporting Standards (PFRS) financial statements in 2021 given that there are differences between the local valuation methodology (as prescribed by IC Circular 2016-67)

and the IFRS measurement requirements.

Moving forward, IFRS 17 will trigger fundamental changes in how insurance companies generate and report on their financials, both internally and externally. Adoption of the new standard will mean making considerable adjustments in the data, systems and processes used to produce financial reporting, relevant governance and controls, as well as the personnel involved. Notably, the new standard will require a new dimension of data granularity with the introduction of the concept of "groups of insurance contracts" within a portfolio.

Additionally, the new model under IFRS 17 combines a current balance sheet measurement with reporting an entity's performance in profit or loss over time which is expected to have significant impact on profit and total equity for some insurance companies and groups. Insurance companies should anticipate changes to key performance indicators and a possible increase in volatility for reported equity and earnings compared to today's accounting models. It is also advisable for affected insurance companies to prepare a detailed communications strategy in order to provide key stakeholders, including market analysts and shareholders, with more clarity on the expected changes to the financial statements and profit profiles.

Given that the new model will affect key performance indicators, it is expected that companies will perform detailed reviews of their product offerings and pricing strategies to adapt to changes in profit profiles to improve earnings. Investment policies and asset-liability will likewise be looked at more closely based on the impacts of the new measurement models on both insurance contracts and financial instruments.

## NEXT STEPS

As early as now, companies should start planning for the implementation of IFRS 17. Impact assessment studies will aid companies to plan implementation steps, identify the extent of effort necessary to achieve compliance, and understand and explain the financial impacts.

More important, now that the wait is finally over, companies are encouraged not to perceive the new standard as being just another expensive and cost-intensive regulatory requirement. Instead, we hope that they view this transition as a possible catalyst for essential operational adjustments to the finance and risk functions of insurers. In the long run, IFRS 17 can help insurers improve efficiency and reduce complexity. With the convergence of risk and regulatory reporting with the new insurance and accounting operations, there can be better synergy between the Finance and Risk/Actuary departments. Outdated system landscapes can be upgraded, current reporting processes can be streamlined and integrated performance metrics and dashboards can be redesigned to help companies reap more benefits beyond mere compliance. The changes that IFRS 17 will bring may also spur companies to redefine and redesign the foundation of their future financial reporting landscape.

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