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IFRS 17 accounting: Turning theory into practice

Introduction

The goal of IFRS® Standards is to create a global framework for how public companies prepare and disclose their financial statements. These standards provide general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting.

IFRS 17 is an International Financial Reporting Standard issued by the International Accounting Standards Board (the Board) in May 2017.

The aim of IFRS 17 is to standardize insurance accounting globally to improve comparability and increase transparency, and to give users of accounts the information they need to understand the insurer's financial position, performance, and risk exposure. IFRS 17 will replace IFRS 4 on accounting for insurance contracts.

The standard sets a paradigm that introduces several new concepts and terminologies, leading to updated financial statements based on revised aggregates.

The new IFRS 17 unit of account requires more granular information, resulting in new disclosures and notes. However, these updated valuation methods require more calculations. They lead to an increasing complexity for understanding the components of the liabilities and explaining the main drivers for changes from an opening position to a closing position.

The weight of actuarial data into the financial statements and actuarial team involvement in the closing process has an impact on the accounting practice.

Design of a chart of accounts (CoA) for IFRS 17

One could consider that the shift to IFRS 17 may be easier for insurers applying Solvency II. It certainly is. But if we focus on the reporting side, there are key differences that lead to calculation, accounting, and reporting challenges when implementing the IFRS 17 standard:

» There is no income statement in Solvency II.

» The disclosures (including, for instance, the economic balance sheet) are named Quantitative Reporting Templates and are therefore predefined reports; the IFRS 17 standard provides guidance about financial statements but no standard templates.

» There is a need for a CoA that allows the reporting entity to meet the requirements of the IFRS 17 standard; under Solvency II, this was an option but not a duty as it is a regulatory requirement and not an accounting standard.

Due to the significant changes from IFRS 4 to IFRS 17, the review of the CoA is essential. A chart of accounts differs from one company to another and is tailored to reflect a company's operations and/or organization.

Its design is of crucial importance because even if the CoA evolves over time, it must ensure that accurate comparisons of the company's finances can be made between reporting periods.

The CoA intends to ease the feeding of the accounting system from the upstream sources of transactions as well as the supplying of financial statements, internal and external disclosures, and notes.

Particular attention must be paid to:

» The level of granularity of information: IFRS 17 strengthens the need for detailed feeding of reports.

» The flexibility of its design to facilitate eventual evolutions. Some information may need to be carried by dimensions (attributes of the accounts or of the journal entries) and not, for example, the accounts themselves.

There is often also a difference between the CoA designed in the accounting system of an insurer that wants to follow up business activity, and the CoA settled in the consolidation tool (or for consolidation purposes) intended to gather the relevant information to produce the consolidated financial statements and the financial communication key indicators.

A chart of accounts that supports IFRS 17 adequately should:

» Distinguish between portfolios and direct versus reinsurance business

» Classify insurance liabilities according to the standard General Measurement Model (GMM), Premium Allocation Approach (PAA), Variable Fee Approach (VFA), or some modification of each

» Segregate accounting policy by Profit and Loss (P&L) or Other Comprehensive Income (OCI)

» Isolate the different components of an insurance liability or asset, such as Fulfillment Cash Flows (FCF), Risk Adjustment (RA), and the Contractual Service Margin (CSM)

» Group components based on the Liability for Remaining Coverage (LRC) and the Liability for Incurred Claims (LIC)

» Isolate the several types of movements (such as changes to a group of contracts induced by new business, experience variance, assumption changes, interest accretion, foreign exchange impact, and so on)

The chart of accounts design involves not only classification, but also calls for decisions on how to meet all IFRS 17 disclosure requirements. One can choose a "thick" approach, in which each cell of disclosure reports can be mapped of individual account balances. This obviously requires a large number of accounts that provide maximum granularity. Alternatively, one can choose a "thin" approach with fewer accounts. This makes the CoA and posting logic less voluminous but demands more work in the report mapping logic. In such a structure, mapping account numbers on report cells will not be sufficient; a query on the journal is also required, with a "where clause" extension on the journal entries' attributes.

Posting logic becomes more complex

Insurers face another significant challenge in their accounting practices with the fundamental changes in the posting logic from IFRS 4 to IFRS 17.

In fact, accounting entries can no longer be restatements from local Generally Accepted Accounting Principles (GAAP) as was often the case using IFRS 4. The journal entries are based on the results of the calculations. While IFRS 4 equals limited restatements added to local GAAP, IFRS 17 represents a new set of data. As for a Solvency II balance sheet, reconciliation between local GAAP[1] and IFRS 17 looks like a "reverse and restate" of liabilities.

The translation from the actuarial view of the measurement of liabilities into the accounting presentation and framework works through posting rules. These rules reinforce the logic and thoroughness embedded in accounting practices. Posting rules are meant to transform information into accounting entries and drive financial statements.

Different posting rules apply for each measurement model: GMM, VFA, and PAA. They support the accounting policy options as impacting profit and loss versus other comprehensive income, as well as the reinsurance specificities.

Much more complexity exists in the accounting schemes due to the criteria based on onerosity since non-onerous groups can become onerous and vice-versa. The Loss Component (LC) can appear through different scenarios:

» A non-onerous group at initial recognition may become onerous by the end of the reporting period.

» An onerous group at initial recognition can remain onerous.

» An onerous group at initial recognition may change to non-onerous.

Experience working with IFRS 17 calculations results led Moody's Analytics to extend the rigorous and methodological approach developed in the calculations into the accounting logic.

Analysis of movements is key to trace the evolution of the liabilities over time. Building accounting entries along the calculation steps provides relevant details to populate roll-forward of liabilities, for example.

Posting rules, therefore, control how calculated variables are translated into journal entries, and which accounts they will debit and credit. Posting rules act as a decision table. And for each variable, the posting rules evaluate the attributes that define it. These attributes include its name, whether its value is positive or negative, measurement approach, portfolio validity, and so on. Based on this analysis, the posting rules determine the account to which the value is debited and the account to which it is credited.

It is worth considering using suspense accounts as they can add transparency to the analysis. For example, instead of posting a movement from Present Value of Cash Flows (PV[CF]) to CSM through a single journal entry (that is, debit PV[CF] and credit CSM), we debit and credit these accounts against an intermediary suspense account that carries the name of the movement (for example, "experience adjustment"). Using such suspense accounts is not mandatory but offers several advantages:

1. They give a simple comparison between actual and expected cash flows by looking at the journal entries on the suspense account and the variables that are posted.

2. They offer an easy analysis per type of movement, even for such movements that are not posted through P&L or OCI.

   Here is a practical illustration: Experience adjustment might want to make you reduce Best Estimate Liability (BEL) in favor of CSM. In this case, BEL is a proxy name for Present Value of Cash Flows (PV[CF]). When you debit BEL and credit CSM against each other directly, you have no way of isolating this type of movement on the chart of accounts because there is no movement account on the P&L: it does not go through the P&L. A look into the journal and filtering on the postings is needed. However, if you split it into two postings through a dedicated expense account called "Experience adjustment impact," then this suspense account's statement offers a nice overview of all such movements. Given that there is a suspense account for each type of movement, it is enough to look at the account statement of the relevant suspense account.

3. Each suspense account implies a reconciliation rule, because at the end of the period its net balance should be zero. If this does not occur, the posting logic is faulty.

[1] Not applicable in jurisdictions where IFRS Standards apply as local GAAP.

GMM use case for accounting entries starting from the analysis of change

In this example, we discuss a proposed accounting scheme for a non-onerous contract group under the General Measurement Model (GMM) approach. We suggest names for accounts, explain the transactions that impact the P&L, and show how the contractual service margin (CSM) mechanics translate into journal entries.

Analysis of change

The journal entries are generated after all the calculation steps have been completed and reviewed. The results for the analysis of change at the end of Year 1 is shown in Table 1. This example looks at a term life insurance group (that is, benefits payment in case of death) with a three-year coverage. This IFRS 17 group is non-onerous and represents new business at initial recognition. Thus, it starts with an opening balance of zero. The addition of new business will be the first journal entry.

Table 1 Analysis of change for a non-onerous IFRS 17 group—General Measurement Model

At end of Year 1	BEL	RA	CSM	Total Liability
Opening Balance	0	0	0	0
Opening Balance (@Inception)	0	0	0	0
New Business	-163	120	43	0
Expected Premium	250	0	0	250
Expected Claims	-200	0	0	-200
Release of RA	0	-40	0	-40
Interest Accretion	3	0	1	4
Experience Adjustment	-20	0	20	0
Non-Financial Assumption change	-115	0	115	0
Release of CSM	0	0	-62	-62
Financial Assumption Change	-5	0	0	-5
Closing balance (Inception)	-246	80	118	-48
Closing Balance	-251	80	118	-53

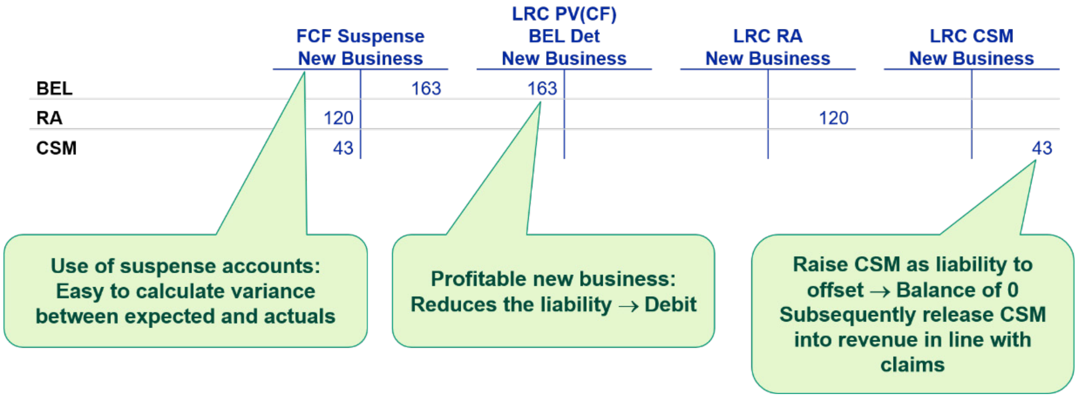
The BEL, RA, and CSM columns comprise total liability while the row lines list the various steps of analysis of change. There may be other steps than the ones depicted here, but Table 1 shows only the primary ones.

New business recognition

The new business recognition calculates initial recognition of any new business that has been written in the reporting period and valued at inception basis (using the "locked-in" market rates that were applicable at inception, which are the current market rates in the case of new business). Figure 1 illustrates the posting logic for new business recognition of a group that was non-onerous at the beginning of the period.[2] This example uses a suspense account, so the change is posted in the BEL, the RA, and the CSM against this suspense account. Using suspense accounts makes it easier to calculate the variance between expected and actual cash flows, and also acts as a simple reconciliation tool.

[2] Note for all figures: The blue T-accounts represent balance sheet accounts. Red is used for expense accounts and green for revenue accounts in the income statement.

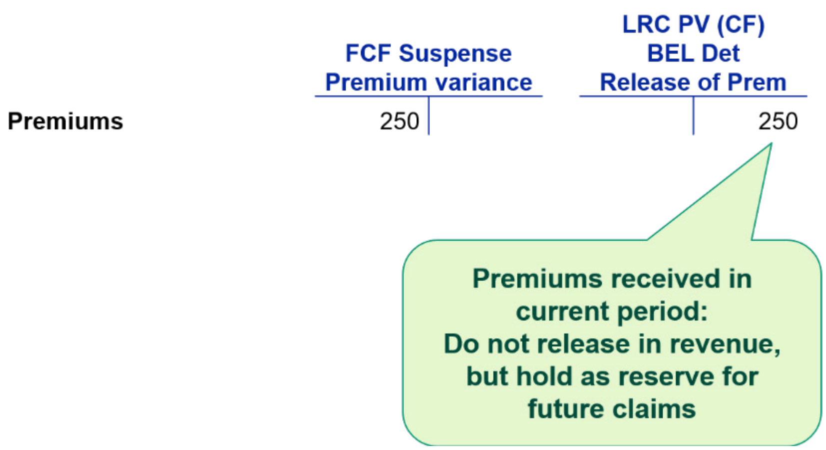
Figure 1 New business recognition: Insurance contract liability (IFRS 17 group)



In the posting scheme, profitable new business is added, so the present value of fulfillment cash flows is negative. Because new business reduces the insurance liability, we debit the *LRC PV(CF) BEL Det* account. We credit the *LRC RA* account as the risk adjustment increases the insurance liability. The remainder of *BEL minus RA* is the present value of future expected profits on this group, which we credit to raise an insurance liability: the CSM. Across this and subsequent reporting periods, we gradually release this CSM into the income statement in line with the service offered.

Release of fulfillment cash flows—Future service

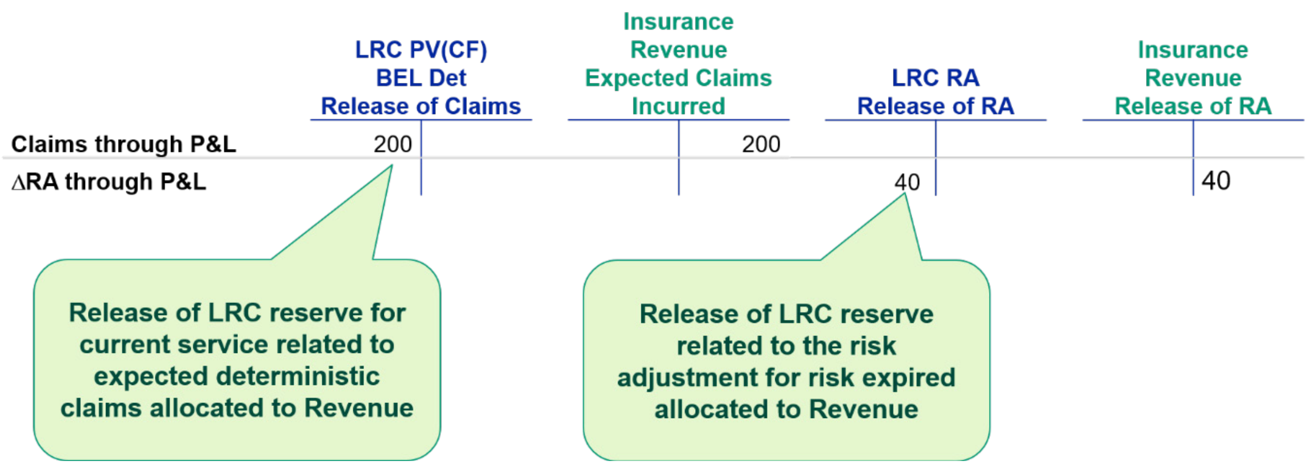
Figure 2 Release of FCF—Future service



This section identifies the variance between expected and actual cash flows that are related to future service. Any variance in the premiums expected to be earned and premiums actually earned is fully allocated to the CSM. In Figure 2, we consider only the LRC account (we have not disclosed the LIC to simplify the example). Therefore, the posting scheme shows that premiums received in the current period are not released in revenue but are held as a reserve for future claims. Thus, it is credited on the balance sheet on the insurance liability and debited against a suspense account for premium variance on fulfillment cash flows.

Release of fulfillment cash flows—Current

Figure 3 Release of FCF—Current service

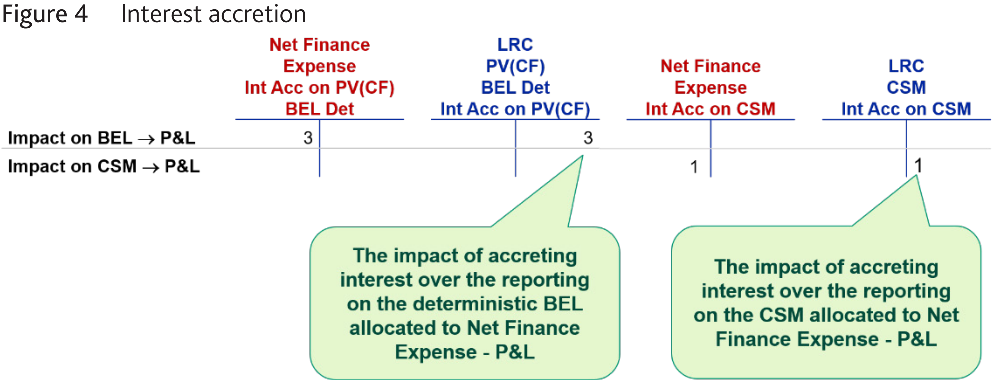


This step identifies the variance in the release of expected cash flows over the reporting period that are related to current service (Figure 3). In this posting scheme, the release of LRC reserve for current service related to expected deterministic claims is allocated to revenue. Release of LRC reserve related to the risk adjustment for risk expired is also allocated to revenue.

Interest accretion

This step calculates interest accreted in the valuation period on in-force and new business. In Figure 4, for new business only, there are several components: interest accretion on BEL, on RA, and on CSM. For RA, the standard permits accounting policy choice for interest accretion to be captured separately or to be combined with the release of RA. In this example, we chose to combine it with the release of RA.

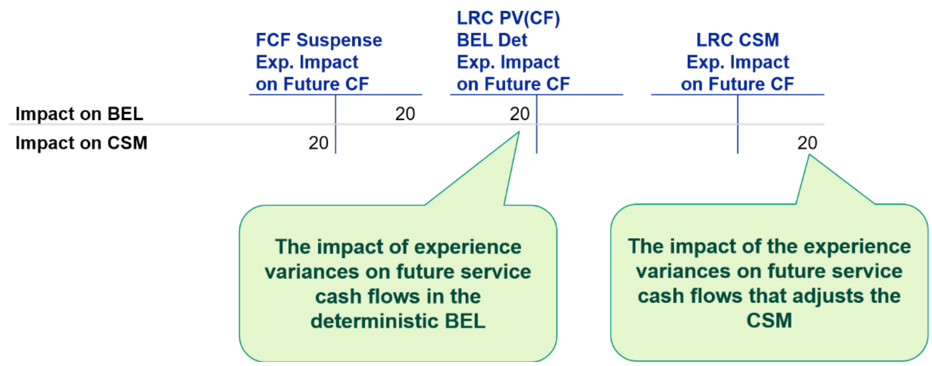
Figure 4 Interest accretion



We can highlight that the effect of accreting interest over the reporting period on the deterministic BEL is allocated to Net Finance Expense (in P&L). This value is credited in the balance sheet account *LRC PV(CF) BEL Det*, as it increases the insurance liability. It is debited in the income statement under *Net Finance Expense*, as it is recognized as an expense. The impact of accreting interest over the reporting period on the CSM is allocated also to Net Finance Expense. This value is credited equally in the balance sheet as it increases the liability (the CSM) while it is also recognized as an expense. We can mention the accounting policy choice (which was not used in this example): the disaggregation of insurance finance income or expense. Paragraphs 88 and B130 of IFRS 17 do allow the recognition of insurance finance income or expenses, which includes interest accretion, either entirely in P&L or disaggregated between P&L and Other Comprehensive Income (OCI).

Experience adjustments—Future service

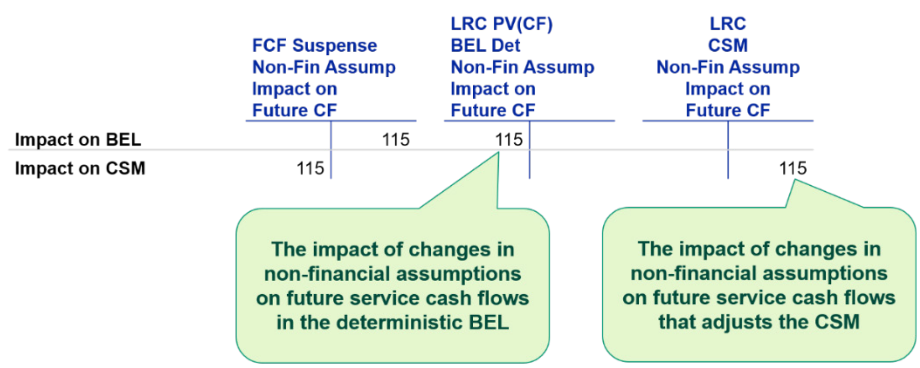
Figure 5 Experience adjustments—Future service



Based on experience, this step recalculates fulfillment cash flows by adjusting the expected future cash flows based on the actual number of lives under in-force at the end of the reporting period (because this example looks at a term life insurance group with benefits payment in case of death). In this posting scheme, the impact of experience variances on future service cash flows in the deterministic BEL is debited in the liability, because as shown in Figure 5, it reduces the liability. The impact of the experience variances on future service cash flows that adjusts the CSM credits the CSM because in this example, it increases the CSM (so additional future revenue is expected). Both liability accounts (PV[CF] and CSM) are posted against a suspense account for experience impact.

Changes in non-financial assumptions

Figure 6 Changes in non-financial assumptions



This step calculates the fulfillment cash flows at the end of the reporting period based on the updated non-financial assumption basis. If the CSM is positive, the changes to fulfillment cash flows due to non-financial changes are allocated to the CSM; otherwise, they are allocated to Loss Component (LC).

This posting logic is similar to experience adjustment. Non-financial assumption changes have an effect on future service, and are calculated according to the locked-in rate and stay on the balance sheet (they do not impact P&L). As shown in Figure 6, the impact of changes in non-financial assumptions on future service cash flows in the deterministic BEL is debited here to show that it reduces the liability. The impact of changes in non-financial assumptions on future service cash flows that adjust the CSM is credited here to reflect that it increases the CSM. We post these liabilities against a dedicated suspense account.

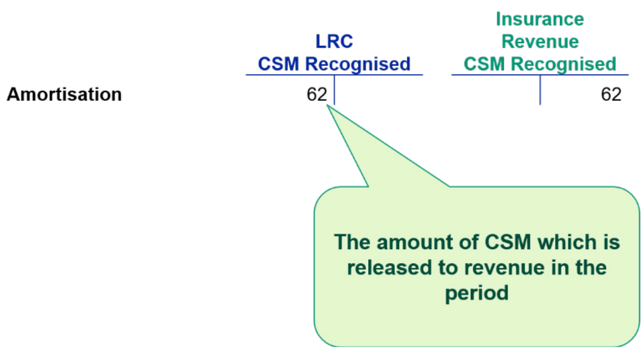
Amortization: Release of CSM

This step amortizes the CSM according to the coverage unit percentage. The value is equal to the CSM balance multiplied by the coverage unit percentage.

Now that we have incorporated the impact of various types of movements on the PV(CF), the RA, and the CSM, we can finally start releasing revenue off the CSM into the income statement for this reporting period.

The posting scheme consists of the release of the calculated amount into net income (P&L) in the period (Figure 7). This explains how the CSM, as an expression of expected future profits, trickles down as revenue in P&L over time to correspond with service offered in the period. In P&L, revenue is credited and the CSM, which was initially raised as a liability, is now debited to express its amortization over time.

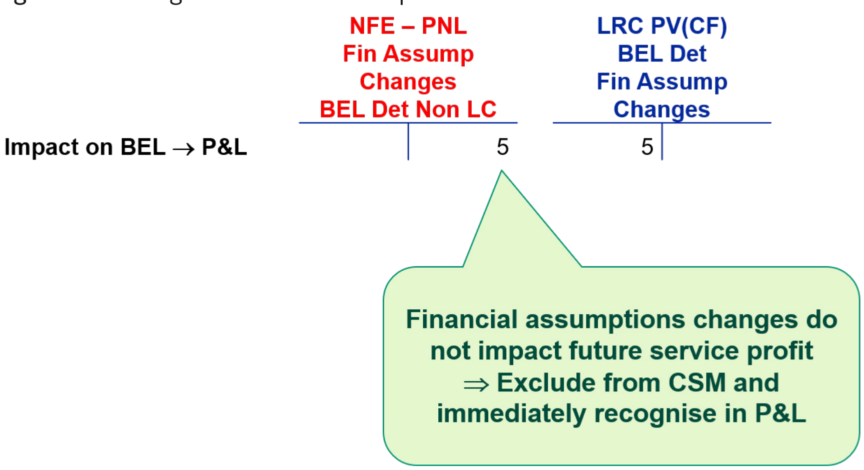
Figure 7 Amortization: Release of CSM



Changes in financial assumptions

This is the last step of Table 1. It calculates the fulfillment cash flows at the end of the reporting period based on the updated financial assumption basis. Financial assumption changes do not have an effect on future service profit, so their impact is excluded from CSM and immediately recognized as revenue or expense. In the posting logic, it is an accounting policy choice to either post this revenue or expense in net revenue (P&L) or in OCI. In Figure 8, we have chosen to post it in P&L. For the variable fee approach (VFA), this is a change in the underlying asset return assumptions. This affects the future values of the variable fees received to the insurer, which is allocated to the CSM.

Figure 8 Changes in financial assumption



To summarize, after going through the various steps, we reach the closing balance. A distinction is made between the final balances of BEL, RA, and CSM/LC valued under the inception basis, and the final balances of BEL, RA, and CSM/LC valued under the current basis. These closing balances are brought forward from Year 1 to Year 2 as opening values without calculation or adjustments.

Conclusion

In this paper, we discussed a proposed accounting scheme for a non-onerous group under the GMM approach, which would be the most typical case for the life business. We have suggested some names for accounts, explained which transactions affect the P&L, shown how the CSM mechanics translate into journal entries, and proposed using suspense accounts to add transparency to the analysis.

There are many more complex challenges in IFRS 17. For example, think about what must happen when this non-onerous group turns onerous, or conversely, when an onerous group turns profitable again. In addition, accounting logic must be added for the liability of incurred claims (LIC) to this group. There are other challenges, such as:

- Accounting treatment of non-distinct investment components
- Accounting treatment of non-distinct services components
- Release of OCI into P&L
- Multi-currency IFRS 17 groups: Which discount factor to apply?
- Acquisition expenses
- The other measurement approaches: PAA, VFA, and modifications (for example, modified GMM)

Nevertheless, this accounting scheme can be used as a foundation upon which more complex challenges can be built.