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Transition From IFRS 4 to IFRS 17: Impact on Shareholders' Equity

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The new accounting standard for insurance contracts, IFRS 17, brings about an unprecedented change in the way an insurer's financial performance will be measured and reported. Adopting this change will require significant changes to an insurer's information technology infrastructure, actuarial, finance and accounting processes.

The new standard is based on different fundamentals from current accounting standards, which could lead to a difference in shareholders' equity as measured under IFRS 17. The provisions of IFRS 17 regarding transition require that any difference in the shareholders' equity due to transition should be accounted for as a one-time impact at the time of transition. This impact is dependent on a multitude of factors, and whether it would increase or decrease shareholders' equity would be specific to each insurer. The factors that could impact shareholders' equity upon transition can be grouped into factors related to the insurer's business and accounting practices up to the transition date and factors related to implementation of IFRS 17. This article explores both categories of factors.

IFRS 17 WILL IMPROVE COMPARABILITY OF FINANCIAL STATEMENTS

The ultimate result of the change in reporting standard to IFRS 17 is a financial performance measurement and reporting framework that:

- **Is market consistent.** Reflects the most recent information by requiring valuation of insurance contracts using current and market consistent assumptions;
- **Has fewer accounting choices.** Significantly restricts accounting policy choices available to insurers;
- **Reflects the level of services rendered.** Recognizes profit from a group of insurance contracts over the term of the contracts in proportion to the level of services rendered during each reporting period and recognizes the entire loss from a group of insurance contracts at the time it becomes reasonably certain that the contracts would lead to a loss; and
- **Provides more information and disclosures.** Provides sufficient information and disclosures to the users of the financial statements to enable them to identify and evaluate the sources of profits or losses.

The above improvements in the accounting framework address one of the greatest criticisms of the previous standard, IFRS 4, by improving comparability of financial statements between insurers writing similar types of products, between insurers writing different types of products, and between insurers and entities in other industries.

The new standard requires that the financial performance of an insurance contract be split into "insurance service" and "insurance finance" components. This segregation essentially implies that the embedded investment aspect of an insurance contract (such as in a typical unit-linked or universal life plan) should be reported separately. This segregation improves the comparability of the financial statements of insurers writing different types of products. The segregation also improves the quality of the consolidated financial statements of insurance groups composed of entities writing different types of insurance products.

FACTORS RELATED TO INSURER'S BUSINESS AND ACCOUNTING PRACTICES UP TO THE TRANSITION DATE

Recognizing profits in proportion to services rendered is the cornerstone of the new accounting framework. The impact on equity upon transition to the new framework, therefore, depends on how closely the profits recognized under the current framework resemble the service-related pattern. The pattern of recognizing profits under the current accounting standards varies with the type of insurance products and with the accounting policy choices made by the insurer, particularly those related to the valuation of insurance contract liabilities.

Profit and Revenue Recognition Principles

Both the current and new accounting standards have different measurement models for different types of products. A rudimentary classification of the measurement methods can be based on the insurance contract duration. Most long-term contracts (such as term life, unit-linked and universal life, and endowment plans) are measured differently from short-term contracts (such as motor insurance and medical expense insurance). However, there are certain long-duration casualty lines (such as some classes of engineering business and liability coverages) that are measured in a manner similar to short-term products.

Given the accounting policy choices available under current accounting standards, various measurement and reporting practices are being used by insurers globally. The differences in measurement and reporting practices between different regions are more profound for long-term products than for short-term products.

Measurement and reporting practices for long-term products can be broadly classified into two categories. The first category consists of practices that measure profits in a way that more closely resembles the pattern of net cash flows than the pattern of services rendered. The second category consists of practices that measure and recognize the entire expected profit from the contract at initial recognition regardless of the pattern of services rendered. The impact on equity would be different for the two categories of accounting practice.

Insurers that follow the first category of accounting practice for their long-term products can expect a significant impact upon transition, but the direction of the impact cannot be generalized and would depend on the exact product structure. The impact essentially depends on how different the net cash flow pattern is from the pattern of services rendered. For instance, a back-end-loaded unit-linked product generally has large net cash inflows in later policy years, but services are provided throughout the term (and are not proportionally higher in later policy years). The current accounting practice for such products is likely to have postponed the recognition of profits; therefore, transition to the new standard is likely to have a positive impact on the equity.

Insurers that recognize the entire profit from long-term contracts upon policy inception will perhaps be most significantly and adversely impacted by the introduction of the new accounting standard. The new accounting framework eliminates the possibility of Day 1 profits (i.e., profits at policy inception) and requires that profits be recognized in relation to the level of services delivered. Therefore, insurers following such practices are likely to experience significant adverse impact on their shareholders' equity upon transition.

Most short-term products can be expected to be eligible for the simplified model of the new framework. Such products are not likely to experience a significant impact on the shareholders' equity, barring a possible impact from the treatment of acquisition costs discussed below.

There may be products that are currently measured in a similar way to short-term products but do not qualify for the new framework's simplified model. The magnitude and direction of the impact on equity cannot be generalized for such products.

Basis of Insurance Contract Valuation Assumptions

Under current accounting standards, insurers value insurance contract liabilities using either current assumptions or locked-in historical assumptions. However, the new standards make it mandatory to use current and market-consistent assumptions to the maximum extent possible. This could have a significant impact on shareholders' equity for those insurers currently using locked-in assumptions.

Another important aspect associated with valuation assumptions is the requirement of IFRS 17 to value liabilities for incurred claims on a discounted cash flow basis. Insurers do not generally discount claims-related cash flows when determining claim liabilities. This new requirement would—all things being equal—reduce the claim liabilities, and the impact could be significant for insurance products with long tail claims.

Other Accounting Policy Choices

The current framework provides many accounting policy choices. Two of the choices that are particularly important with respect to the impact on shareholders' equity upon transition to the new framework are the choices related to the treatment of acquisition costs and those related to the treatment of contracts that are likely to produce a deficit or loss.

Under the current accounting standard, there is a wide variety of practices used to recognize acquisition costs. The new standard unifies the treatment of these costs. The impact of this change upon an insurer's equity would depend on the insurer's current practice for recognizing acquisition cash flows and how closely it conforms with the principles set out in the new standard. Since a wide variety of practices are currently used, no generalized comment can be made on the magnitude and direction of the impact.

Both the current standard and the new standard require that the expected loss from contracts that are likely to produce a loss should be recognized at the time it becomes reasonably certain that the contract would lead to a loss. The tool used to achieve this principle under the current framework is the premium deficiency reserve. Although the principles under both standards are similar for loss-making contracts, the classification of a contract as loss making could be different based on different aggregation requirements. The new framework sets out a much more specific method for aggregation, whereas the current framework largely leaves it up to the insurer to decide the level of aggregation, particularly for the purpose of determining premium deficiency reserves.

FACTORS RELATED TO IMPLEMENTATION OF IFRS 17

The most critical financial aspect of transition from IFRS 4 to IFRS 17 is the determination of the contractual service margin (CSM), or the unearned profit as of the transition date. IFRS 17 sets out three approaches for determining the CSM at the transition date: the full retrospective approach, the modified retrospective approach and the fair value approach.

The full retrospective approach, as its name suggests, requires that the CSM at the transition date be determined as if IFRS 17 had always been applicable. This essentially requires that each group of insurance contracts should be identified, recognized and measured from its inception to the transition date using IFRS 17 principles.

If it is not practical to apply the full retrospective approach, the modified retrospective approach allows the insurer to modify the full retrospective approach to achieve the closest outcome to the full retrospective approach using all possible reasonable and supportable information available without undue cost or effort.

If it is not possible to apply either the full or the modified retrospective approach, the fair value approach can be adopted. Under the fair value approach, the CSM at the transition date is determined as the difference between the fair value of the group of insurance contracts and the fulfillment cash flows for the group of contracts.

The three different transition options are likely to lead to a different estimate of CSM at the transition date; therefore, the impact on shareholders' equity upon transition also depends upon the transition approach adopted by the insurer. An insurer's choice of transition approach depends on the data available or obtainable, the complexity of the products, and the time and other resources available.

CONCLUSION

IFRS 17 is a long-awaited remedy to the shortcomings of IFRS 4; however, transitioning to the new standard could have an impact on an insurer's reported shareholders' equity. The impact is dependent on a multitude of factors and cannot be generalized. Insurers should undertake early efforts to identify the impact under each possible transition option to avoid last-minute surprises. Although transition from the current to the new accounting standard will have an impact on equity, it should be noted that any accounting standard is just a measurement and reporting framework and it has no impact on the aggregate profitability over the term of the group of insurance contracts. That is to say, when an insurer has fulfilled all its obligations to a group of insurance contracts, the total shareholders' equity will be the same regardless of whether the group of insurance contracts was measured under IFRS 4 or IFRS 17 while it was active.

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