IFRS 17 INSURANCE CONTRACTS (SHORT TERM INSURERS)-FOCUS AREAS FOR CHIEF FINANCE OFFICERS AND CHIEF EXECUTIVE OFFICERS

Introduction

The effective date for the implementation of IFRS 17 Insurance Contracts (IFRS 17) has been moved by the International Accounting Standards Board (IASB) to periods beginning on or after 1 January 2023 from the initial date of 1 January 2021. While this gives entities more time to prepare, we believe the shifting of the implementation date should serve as a warning to entities that there is a lot of work on the horizon. BAOA as the local standard setter for Botswana is championing the implementation of IFRS 17 by affected entities. As part of that process, we have started discussions with various insurance companies to establish their implementation status and strategy/roadmap. This article serves to support the efforts of entities as they prepare by highlighting some of the key focus areas which we believe the leadership of these entities need to be aware of and possibly track. The analysis below applies more to ***short term insurers.***

The Premium Allocation Approach

Short term insurers may choose the option to use a simplified model for measuring a group of insurance contracts called the premium allocation approach. This is an option to the more complex general measurement model /Building Block Model which life insurers and similar long term insurance groups of contracts will use. Below is a summary of the areas which we believe the Chief Finance Officers and Chief Executive Officers should focus on and monitor on an ongoing basis, though it is not exhaustive. IFRS 17 does not specifically distinguish between long term insurance contracts and short term insurance contracts. The major distinction is on the ability by short term insurers to choose to use the simplified premium allocation approach to measure insurance contracts which option is almost non-existent for long term insurers.
We start with a diagrammatic snap short of the premium allocation approach

SNAP SHOT OF THE PREMIUM APPLICATION APPROACH (PAA)

assess eligibility for PAA

- no material difference with general measurement model
- contracts less than one year

analyse contracts

- combine
- separate

aggregate contracts

- portfolio (similar risks,managed together)
- groups (3 groups)

PREMIUM ALLOCATION (APPROACH)

Revenue

(passage of time or incurred insurance service expenses)

Liability

(a)Remaining coverage

(b)Incured claims(fulfilment Cashflws)

- no time value of money
- may not capitalise acquisition costs
- no onerous assessment , unless facts and circumstances.
- no CSM

1. **Eligibility to use the premium allocation approach (PAA).**

   Groups of insurance contracts qualify to use the premium allocation approach if and only if:

   (a) Use of the premium allocation approach would produce an ***insurance contract liability for remaining coverage*** that is not materially different from using the general measurement model; or

   (b) All the contracts in the group have a coverage period of one year or less.[1]

   When assessing (a) above, the entity ***would not*** use the premium allocation approach if it expects significant variability in the fulfilment cashflows.[2]

   The leadership of the entity should review if all their groups of insurance contracts qualify for the premium allocation approach as required by IFRS 17 as some may not qualify.

2. **Insurance contract analysis**

   Insurance Contracts under IFRS 17 will need to be analysed for different aspects and there are two ways in which contracts can be analysed

   (i) **Combining contracts:** a set or series of insurance contracts with the same or related counterparty may achieve or be designed to achieve an overall commercial effect. Such a set or series of contracts may be treated as a whole. [3]

   (ii) **Separating components of a contract:** An insurance contract may contain one or more components which when separated, will be accounted for within the scope of another IFRS, for example, some contracts will have investment components which are distinct and when separated will be accounted for under IFRS 9 and some will contain promises to transfer distinct goods or non-insurance services which when separated will be accounted for under IFRS 15.[4]

   Entities need to set up a process that ensures that contracts are combined and separated according to the criteria noted in IFRS 17.

[1] IFRS 17.53
[2] IFRS 17.54
[3] IFRS 17.9
[4] IFRS 17.10-13

3. Aggregation of contracts

Once insurance contracts have been appropriately separated into their various components and merged as appropriate, the next stage is to aggregate the contracts. Two levels of aggregation are required, starting with establishing portfolios of contracts and then splitting the portfolios into a minimum of three groups as follows :

(a) Portfolios

Identify portfolios of different insurance contracts. Insurance contracts will fall into the same portfolio if they have similar risks and are managed together.[5]

(b) Groups

Once different portfolios have been identified, IFRS 17 requires ***each*** portfolio to be divided into a ***minimum*** of three different groups which are essentially profitability groups:

(i) *A group of contracts that are onerous on initial recognition*

(ii) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently *(in their lifetime)*

(iii) A group of remaining contracts in the portfolio.[6]

However, for short term insurance contracts that apply the premium allocation approach, the ***entity shall assume no contracts in the portfolio are onerous unless facts and circumstances indicate otherwise*** both at initial recognition and subsequently. [7] This is an important because under the general measurement model for long term insurance contracts, all insurance contracts are required to be subjected to an onerous assessment at initial recognition and subsequently at each reporting date. All losses on onerous contracts are written off to profit or loss immediately in the reporting period in which they are identified.

For the purposes of grouping contracts, an entity shall not include contracts issued ***more than one year apart*** in the same group. [8] The implication of this requirement is that the composition of portfolios and groups of insurance contracts are not reassessed in subsequent years and will need to be maintained for the lifetime of the groups until the group is derecognized(cohorts). Consequently, each financial year will have its own set of portfolios and groups and these are never mixed with portfolios and groups recognised in subsequent years.

[5] IFRS 17.14

[6] IFRS 17.16

[7] IFRS 17.53, 57

[8] IFRS 17.22

This stage is critical because it involves assessing all groups of contracts for profitability at initial recognition. This is still a requirement under the premium allocation approach.

4. Insurance revenue under the premium Allocation Approach

Under the premium allocation approach, revenue recognition is simpler. Revenue is the amount of expected receipts allocated to the period based on either of the following:

(a) the basis of passage of time or

(b) the basis of expected timing of incurred insurance service expenses.[9]

This is significantly different from the general measurement model for groups of long term insurance contracts which measure revenue as a sum of, among other items, contractual service margin allocated to the period, insurance service expenses incurred and risk adjustments.
The entity needs to decide the basis of allocating premiums to various reporting periods.

5. Insurance contract liability

At the end of each reporting period, the insurance contract liability will be a sum of the following two components:

(a) Liability for remaining coverage

The insurance liability for remaining coverage under the premium allocation approach is simplified with no elaborate modelling for future expected costs[10]. Liability for remaining coverage is the entity's obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred(unexpired portion obligation)

(b) Liability for incurred claims

The liability for incurred claims is the entity's obligation to investigate and pay valid claims for insured events that have already occurred including those claims that have not yet been reported.

This comprises fulfilment cashflows related to the entity's obligations for insured events that have already occurred including those claims that have been incurred but not reported (see below for further discussion).

[9] IFRS 17.B126

[10] IFRS 17.55

6. **Liability for incurred claims and non-financial risk adjustment under the premium allocation approach**

The liability for incurred claims is measured at the fulfilment cashflows for incurred claims. The entity is ***not required*** to adjust future cashflows for the effect of the time value of money and financial risk if those cashflows are expected to be paid or received in one year or less ***from the date the claims are incurred.***[11]

With respect to the non-financial risk adjustment, fulfilment cashflows include the effect of the non-financial risk adjustment. Note that, while the effect of the time value of money is exempted under the premium allocation approach, the non-financial risk adjustment has not been exempted. An entity is required to calculate the non-financial risk adjustment of a group of short term insurance contracts[12].

7. **Summary of simplifications of the premium allocation approach**

The following are other simplifications of the premium allocation approach:

(a) Insurance revenue and the insurance liability for remaining coverage are calculated based on premiums
(b) No requirement to assess if groups of insurance contracts are onerous at initial recognition and subsequent to initial recognition unless facts and circumstance indicate so.
(c) no requirement to calculate contractual service margin and amortise it over the life of contracts
(d) The time value of money and the effect of financial risk may not be adjusted for both in the insurance contract liabilities and liability for incurred claims that will be settled within one year.[13]
(e) Acquisition cashflows may be expensed in the year that they are incurred if the entity chooses to do so[14]
(f) Only assess (subsequent to initial recognition) if groups of contracts are onerous if facts and circumstances indicate so[15].

NB: Under the premium allocation approach, only two situations is an entity required to calculate fulfilment cashflows in a similar way to the general measurement model for long term insurance contracts (a) if a

[11] IFRS 17.59(b)
[12] IFRS 17.59(b).
[13] IFRS 17.56 and IFRS 17.59b
[14] IFRS 17.59a
[15] IFRS 17.57

contract is onerous[16] and (b) in calculation of the liability for incurred claims[17]. In these two cases, there is need to calculate the non-financial risk adjustment.

8. Accounting

While there are no major differences between IFRS 4 and IFRS 17, the accounting function still needs to understand the new terminology and various simplifications available to be able to record transactions properly and deliver the required disclosures that are compliant with IFRS 17. We would like to point out that some groups of contracts in some short term business entities may not qualify for the premium allocation approach because, for example, their coverage periods exceed one year.

9. Transition provisions and comparative information

9.1 Transition choices

The transition requirements of IFRS 17 gives insurers three choices: (a) Full retrospective application (b)modified retrospective application and ((c) Fair value. While the full retrospective approach may be very difficult to achieve for long term insurers, it is a practical choice for short term insurers since most contracts will be less than 12 months and data for the comparative period maybe available. The modified retrospective approach has a list of allowed modifications which try to achieve the closest result to full retrospective approach without undue cost or effort. Under the fair value approach, an entity determines the contractual service margins or loss component at date of transition for a group of contracts based on the difference between the fair values (mostly using IFRS 13) of the group and fulfilment cashflows at transition date. The key issue is for the entity to assess availability of historical information and decide on which approach to take.

9.2 Comparative information on transition

An entity is required to present **three balance sheets** in the year of initial application, being balance sheets for the year of initial application, the immediately preceding year and the beginning of the preceding year. This requires a lot of work for insurers.

[16] IFRS 17.57

[17] IFRS 17.59(b)

10. Conclusion and implementation date

These notes have been prepared based on the premium allocation approach (see eligibility criteria). The notes for the general measurement model for long term insurance contracts were separately prepared and are available on our website

The implementation date is now revised to financial periods beginning on or after 1 January 2023 as at the date of writing this article

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