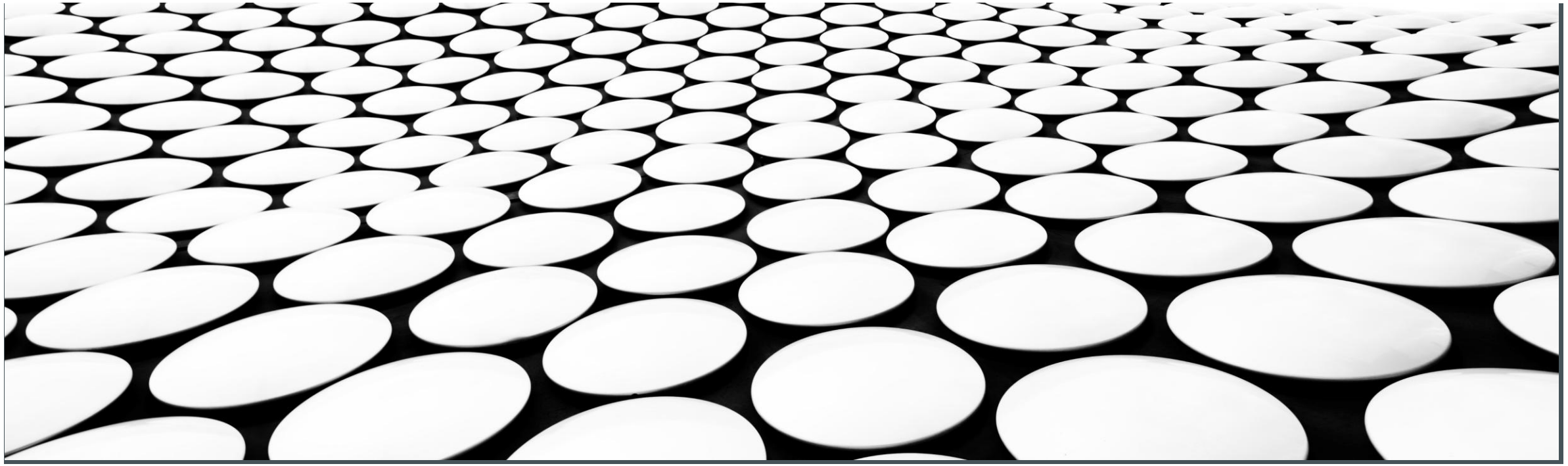
INTERNATIONAL FINANCIAL REPORTING STANDARDS INSURANCE CONTRACTS – IFRS 17

BY B D CHATTERJEE *FCA, ACMA, ACS, DIP (IFR) ACCA – UNITED KINGDOM*



INTERNATIONAL FINANCIAL REPORTING STANDARDS
INSURANCE CONTRACT – IFRS 17

INSURANCE CONTRACT – IFRS 17

INTRODUCTION

- IFRS 17 replaces IFRS 4 for insurance contracts.
- Issued by the International Accounting Standards Board (IASB).
- Effective from January 1, 2023
- It introduces significant changes to how insurance companies recognize revenue, measure insurance contracts, and present financial statements.
- Aims to provide a consistent and transparent framework for insurance accounting.

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WHAT IS AN INSURANCE CONTRACT UNDER IFRS 17?

An insurance contract is a contract where:

- One party (insurer) accepts significant insurance risk from another party (policyholder).
- The insurer agrees to compensate the policyholder upon the occurrence of a specified uncertain event.
- The contract involves risk transfer, differentiating it from investment contracts.

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OBJECTIVE

- ❑ The objective of IFRS 17 is to establish a comprehensive framework for the recognition, measurement, presentation, and disclosure of insurance contracts.

- ❑ It aims to:
  - Ensure uniform accounting treatment for insurance contracts.
  - Improve comparability and transparency in financial reporting.
  - Reflect the economics of insurance contracts by recognizing profits as services are provided.

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KEY PRINCIPLES

- Recognition of insurance contracts at their current value.
- Separate identification of insurance revenue and expenses.
- Apply the following measurement models:
  - General Measurement Model (GMM),
  - Variable Fee Approach (VFA), and
  - Premium Allocation Approach (PAA).
- Discounting of future cash flows for present value measurement.

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OVERVIEW OF MEASUREMENT MODELS

- **General Measurement Model (GMM):**

  Used for long-term contracts; considers fulfillment cash flows, risk adjustment, and contractual service margin (CSM).

- **Variable Fee Approach (VFA):**

  This approach applies to contracts with direct participation features, adjusting for market fluctuations in fees.

- **Premium Allocation Approach (PAA):**

  A Simplified model for short-duration contracts, mainly recognizing liabilities for remaining coverage.

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GENERAL MEASUREMENT MODEL

- Used for long-duration insurance contracts.
- **Key components:**
  - Fulfillment cash flows (expected cash inflows and outflows).
  - Risk adjustment for uncertainty in cash flows.
  - Contractual Service Margin (CSM) to defer profits over time.
- Ensures that profit is recognized as services are provided.

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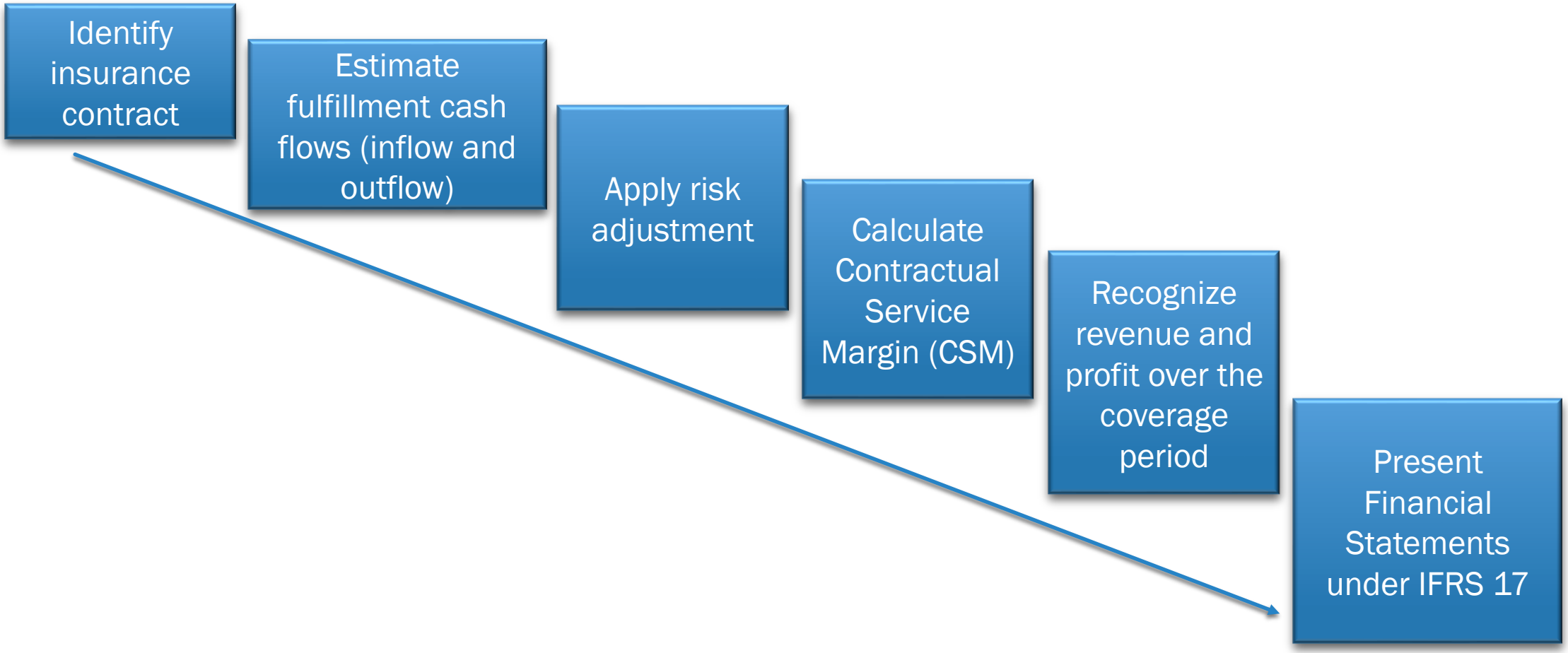
FLOW CHART OF GENERAL MEASUREMENT MODEL



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BREAKDOWN OF GENERAL MEASUREMENT MODEL

- **Step 1: Identify Insurance Contract**
  - Determine contract classification under IFRS 17.
  - Assess contract boundaries and relevant cash flows.
- **Step 2: Estimate Fulfillment Cash Flows**
  - Identify expected inflows (premiums, investment returns).
  - Identify expected outflows (claims, expenses, policyholder benefits).
  - Discount future cash flows to present value.
- **Step 3: Apply Risk Adjustment**
  - Adjust for uncertainty in cash flows.
  - Reflects compensation required for bearing non-financial risk.

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BREAKDOWN OF GENERAL MEASUREMENT MODEL

- **Step 4: Calculate Contractual Service Margin (CSM)**
  - Establish a CSM to defer unearned profits.
  - Recognize revenue systematically over the contract period.
- **Step 5: Recognize Revenue and Profits**
  - Release CSM into profit over time as services are provided.
  - Account for changes in estimates affecting future CSM allocation.
- **Step 6: Present in Financial Statements**
  - Reflect insurance liabilities, revenue, and profit under IFRS 17.
  - Disclose key assumptions and methodologies used.

CASE STUDY ONE

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CASE STUDY ONE: GENERAL MEASUREMENT MODEL

❑ Case Overview

- ABC Insurance Co. issues a **10-year life insurance policy**.
- The company needs to apply IFRS 17 using GMM.

❑ Contract Details

- **Future cash inflows** (premiums over time) = $100 million
- **Future cash outflows** (expected claims, expenses) = $80 million
- **Risk adjustment** (to reflect uncertainty in claims) = $5 million
- **Discounting impact** (present value adjustment) = ($3 million)
- **Contractual Service Margin (CSM) at inception** = $18 million (representing unearned profit)

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CASE STUDY ONE: GENERAL MEASUREMENT MODEL

Initial Measurement

Component	Amount ($ million)
Future Cash Inflows (Premiums)	100
Future Cash Outflows (Claims, Expenses)	(80)
Risk Adjustment	(5)
Discounting Effect	(3)
Contractual Service Margin (CSM)	18
Total Measurement (Liability)	**30**

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CASE STUDY ONE: GENERAL MEASUREMENT MODEL

Subsequent Measurement

- Each year, the entity releases part of the CSM into profit based on the service provided.
- The entity reassesses assumptions (e.g., mortality rates, expenses) and adjusts the fulfilment cash flows accordingly.
- Any favorable or unfavorable changes in estimates affect the CSM unless they relate to past service.

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CASE STUDY ONE: GENERAL MEASUREMENT MODEL

Same illustration with Roll forward over the next five years

Let us assume:

- The insurer provides coverage evenly over the 10-year period.
- The CSM is released evenly over the service period (i.e., 10% per year).
- The insurer earns interest on the CSM based on an initial discount rate of 4%.
- Assumptions about future cash flows remain unchanged.

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CASE STUDY ONE: GENERAL MEASUREMENT MODEL

Same illustration with Roll forward over the next five years

Year	Opening Liability (FCF + CSM)	Interest on CSM (4%)	CSM Release (10%)	Changes in Future Cash Flows	Closing Liability
0	**30.0**	-	-	-	**30.0**
1	30.0	0.72	(1.8)	0	28.92
2	28.92	0.69	(1.8)	0	27.81
3	27.81	0.66	(1.8)	0	26.67
4	26.67	0.63	(1.8)	0	25.50
5	25.50	0.60	(1.8)	0	24.30

Explanation of Columns

- **Opening Liability:** The liability at the start of the year, including fulfilment cash flows and CSM.
- **Interest on CSM (4%):** The CSM accrues interest at the locked-in discount rate.
- **CSM Release (10% per year):** As the insurer provides service, it recognizes profit systematically.
- **Changes in Future Cash Flows:** Any adjustments in assumptions (none in this example).
- **Closing Liability:** The remaining total insurance liability at year-end.

CASE STUDY TWO

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CASE STUDY TWO: GENERAL MEASUREMENT MODEL

Insurance liability Roll forward with multiple assumption changes

Scenario: Life Insurance Contract (10-Year Term)

An insurance company issues a **10-year term life insurance policy** with the following initial assumptions:

- **Expected premiums (inflows):** $100 million
- **Expected claims and expenses (outflows):** $80 million
- **Risk adjustment for non-financial risk:** $5 million
- **Discounting impact (time value of money):** ($3 million)
- **Contractual Service Margin (CSM) at inception:** $18 million
- **Total liability at inception: $30 million** (Sum of fulfilment cash flows and CSM)

- **CSM release pattern:** Instead of a **linear (10% per year) release**, assume a **weighted release based on coverage units**:
  - **Years 1–3:** 8% per year
  - **Years 4–6:** 12% per year
  - **Years 7–10:** 15% per year
- **Discount rate (for accretion of interest on CSM):** 4%

Roll-Forward Including Assumption Changes

In **Year 3**, the insurer revises its assumptions:

- **Claims increase by $5 million** (higher mortality rate).
- **Interest rates increase, lowering the discounting impact by $2 million**.

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CASE STUDY TWO: GENERAL MEASUREMENT MODEL

Insurance liability Roll forward with multiple assumption changes

Year	Opening Liability	Interest on CSM (4%)	CSM Release (Variable %)	Change in Future Cash Flows	Closing Liability
0	**30.0**	-	-	-	**30.0**
1	30.0	0.72	(1.44) (8%)	-	29.28
2	29.28	0.70	(1.44) (8%)	-	28.54
3	**28.54**	0.68	**(1.44) (8%)**	**+5 (higher claims), -2 (discounting)**	**30.78**
4	30.78	0.80	(2.16) (12%)	-	29.42
5	29.42	0.76	(2.16) (12%)	-	28.02
6	28.02	0.72	(2.16) (12%)	-	26.58
7	26.58	0.68	(2.70) (15%)	-	24.56
8	24.56	0.64	(2.70) (15%)	-	22.50
9	22.50	0.60	(2.70) (15%)	-	20.40
10	20.40	0.56	(2.70) (15%)	-	**18.26**

Key Observations

1. **CSM is released in a non-linear pattern**, reflecting the coverage units (higher release in later years).
2. **Year 3 assumption change impacts the liability:**
   - **The increase in claims (+5M)** raises the liability.
   - **Discounting effect (-2M)** reduces the liability.
   - **Net effect: +3M added to the liability.**
3. **CSM Accretes Interest:** Even as CSM is released, it grows due to the 4% interest.
4. **Liability Reduces Over Time:** The total liability declines as service is provided and profit is recognized.

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CASE STUDY TWO: GENERAL MEASUREMENT MODEL

Insurance liability roll forward with multiple assumption changes

Conclusion

- **IFRS 17 allows assumption updates**, preventing the overstatement of profits.
- **CSM acts as a buffer**, absorbing changes in future service without an immediate P&L impact.
- **Discounting effects matter:** Changes in interest rates can significantly affect liability valuation.

The non-linear CSM release reflects coverage reality, making reporting more accurate.

CASE STUDY THREE

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CASE STUDY THREE: GENERAL MEASUREMENT MODEL

Insurance liability Roll forward with multiple groups of contracts

Scenario: Two Groups of Contracts

An insurance company issues **two types of contracts**:

1. **Group A: Profitable Contracts**

- **Future cash inflows** (premiums over time) = $100 million
- **Future cash outflows** (expected claims, expenses) = $80 million
- **Risk adjustment** (to reflect uncertainty in claims) = $5 million
- **Discounting impact** (present value adjustment) = ($3 million)
- **Contractual Service Margin (CSM) at inception** = $18 million (representing unearned profit)

1. **Group B: Loss-Making Contracts (Onerous)**

- No CSM (as losses are recognized immediately)
- Expected claims and expenses = **$120M**
- Discounting impact = **($5M)**
- Risk adjustment = **$8M**

Key Assumptions

- **10-year coverage period**
- **CSM release follows a weighted pattern** (lower in early years, higher in later years)
- **CSM earns interest at 4% per year**
- **Year 3: Assumption changes**
  - **Group A:** Higher expenses (+$3M), discounting impact (-$2M)
  - **Group B:** Higher claims (+$5M), lower discounting impact (-$3M)

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CASE STUDY THREE: GENERAL MEASUREMENT MODEL

Insurance liability Roll forward with multiple groups of contracts

Year	Group A: Opening Liability	Interest on CSM (4%)	CSM Release	Change in Future Cash Flows	Group A: Closing Liability	Group B: Opening Liability	Change in Future Cash Flows	Group B: Closing Liability
0	**30.0**	-	-	-	**30.0**	**123.0**	-	**123.0**
1	30.0	0.80	(2.0) (10%)	-	28.80	123.0	-	120.0
2	28.80	0.76	(2.0) (10%)	-	27.56	120.0	-	117.0
3	**27.56**	0.72	**(2.0) (10%)**	**+3 -2**	**27.28**	**117.0**	**+5 -3**	**119.0**
4	27.28	0.68	(3.0) (12%)	-	24.96	119.0	-	115.0
5	24.96	0.64	(3.0) (12%)	-	22.60	115.0	-	110.0
6	22.60	0.60	(3.5) (15%)	-	19.70	110.0	-	105.0

Key Takeaways

1. Group A (Profitable Contracts)
   - CSM amortizes gradually (10% initially, then 12%, then 15%).
   - Changes in assumptions (Year 3) adjust the liability without affecting profit immediately.
   - The liability declines over time, reflecting the service provided.
2. Group B (Loss-Making Contracts)
   - No CSM (since the loss was taken upfront).
   - Assumption change in Year 3 (+5M higher claims, -3M discounting) increases liability.
   - The liability reduces slowly over time as claims are paid.

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CASE STUDY THREE: GENERAL MEASUREMENT MODEL

Insurance liability roll forward with multiple groups of contracts

Conclusion

This scenario shows how **profitable and loss-making contracts behave differently** under IFRS 17:

- **Profitable contracts (Group A) use CSM** to spread profit over time.
- **Onerous contracts (Group B) recognize losses upfront** but still adjust for assumption changes.
- **Assumption changes are absorbed into the CSM** for profitable contracts but increase liability directly for loss-making contracts.

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VARIABLE FEE MODEL

- Applied to insurance contracts with direct participation features.
- Policyholders share in investment returns generated by the insurer.
- The insurer’s fee is adjusted based on market variables.
- Measurement based on the fair value of underlying items.

CASE STUDY FOUR

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CASE STUDY FOUR: VARIABLE FEE MODEL

- XYZ Insurance issues a 10-year investment-linked policy.

  - **Initial Premiums Collected:** $500 million
  - **Investment Fund (Underlying Assets):** $500 million
  - **Expected Claims & Expenses:** $350 million
  - **Risk Adjustment for Non-Financial Risk:** $10 million
  - **CSM at Inception (Insurer's Share):** $50 million
  - **Total Initial Liability: $410 million**

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CASE STUDY FOUR: VARIABLE FEE MODEL

Roll forward over five years

Key Considerations for VFA:

- **CSM Adjusts for Market Movements**
  - The **insurer's share (30%) of investment returns** affects the CSM.
  - If asset returns increase, the insurer earns more, increasing CSM.
  - If asset returns decrease, the insurer earns less, reducing CSM.
- **CSM Release Pattern**
  - Recognized as **profit over time** based on the coverage period.
  - The release reflects **services provided** (e.g., asset management & mortality coverage).

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CASE STUDY FOUR: VARIABLE FEE MODEL

Roll forward over five years – Investment returns scenario

Year	Opening CSM	Interest on CSM (4%)	CSM Release	Investment Return (30% share)	Updated CSM	Closing Liability
0	**50.0**	-	-	-	50.0	410.0
1	50.0	2.0	(5.0)	**+6.0 (20% return)**	**53.0**	408.0
2	53.0	2.12	(5.3)	**+4.5 (15% return)**	**54.3**	406.0
3	54.3	2.17	(5.5)	**-3.0 (market drop, -10%)**	**48.0**	410.0
4	48.0	1.92	(5.0)	**+5.0 (10% recovery)**	**49.9**	407.0
5	49.9	1.99	(5.0)	**+6.5 (15% return)**	**53.4**	404.0

Key Observations

1. **CSM Grows When Investments Perform Well**
   - **In Year 1, a 20% investment return increases the insurer's share by +6M**, boosting CSM.
   - **In Year 3, a market decline (-10%) reduces CSM by -3M.**
2. **CSM Releases Over Time**
   - The insurer **gradually earns profit** as the contract matures.
   - **CSM amortization reflects asset management & insurance coverage services.**
3. **Closing Liability Reflects Market Changes**
   - As investment returns fluctuate, the **total liability changes dynamically.**
   - Market gains **increase the insurer's share**, reducing liability through CSM adjustments.
   - Market losses **reduce the insurer's share**, increasing liability.

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CASE STUDY FOUR: VARIABLE FEE MODEL

Roll forward over five years

Conclusion

- **VFA dynamically adjusts CSM** based on market returns.
- **Higher investment returns increase insurer profit**, while **poor market performance reduces it.**
- **CSM releases reflect both insurance coverage & investment-related services.**

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PREMIUM ALLOCATION MODEL

- A simplified model is used for short-term insurance contracts.
- Similar to the unearned premium reserve method under IFRS 4.
- Recognizes revenue over the coverage period.
- Used when the contract duration is typically one year or less.

CASE STUDY FIVE

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CASE STUDY FIVE: PREMIUM ALLOCATION MODEL

An insurer issues **a portfolio of motor insurance policies** with the following assumptions:

❑ **Initial Assumptions (Year 0)**

- **Total Premiums Received:** $100 million
- **Expected Claims & Expenses:** $70 million
- **Risk Adjustment:** $5 million
- **Premium Earning Pattern:** 1/12 per month (evenly over the policy term)
- **Discounting Effect:** Negligible (since policy duration is short)

❑ **Recognition Under PAA**

- The insurer **recognizes the premium as a liability for remaining coverage (LRC)**.
- Over time, **the liability is released as the insurance service is provided**.
- Claims & expenses are **recognized when incurred**, forming the **liability for incurred claims (LIC)**.

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CASE STUDY FIVE: PREMIUM ALLOCATION MODEL

Roll-Forward Over 1 Year

Month	Opening LRC	Premiums Earned	Claims Paid	Remaining LRC	LIC (Outstanding Claims)
0	**100.0**	-	-	**100.0**	-
1	100.0	(8.3)	(6.0)	91.7	6.0
2	91.7	(8.3)	(5.5)	83.4	11.5
3	83.4	(8.3)	(6.2)	75.1	17.7
4	75.1	(8.3)	(5.8)	66.8	23.5
5	66.8	(8.3)	(6.5)	58.5	30.0
6	58.5	(8.3)	(6.3)	50.2	36.3
7	50.2	(8.3)	(5.7)	41.9	42.0
8	41.9	(8.3)	(6.1)	33.6	48.1
9	33.6	(8.3)	(6.0)	25.3	54.1
10	25.3	(8.3)	(5.8)	17.0	59.9
11	17.0	(8.3)	(6.2)	8.7	66.1
12	8.7	(8.3)	(5.9)	0.4	72.0

Key Observations

1. **Premiums are initially recorded as a liability (LRC)**
   - At inception, the entire **$100M premium is unearned**.
   - **Each month, 1/12 of the premium is recognized as revenue**.
2. **Claims are recognized as incurred (LIC grows over time)**
   - As claims occur, the **LIC increases**.
   - The **LIC represents unpaid claims and outstanding reserves**.
3. **PAA is simpler than the General Model**
   - No need to track Contractual Service Margin (CSM).
   - No complex discounting (unless there is a long settlement period).
   - The focus is on **unearned premium & claims liability**.

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CASE STUDY FIVE: PREMIUM ALLOCATION MODEL

Conclusion

- **PAA is ideal for short-term contracts** where premium revenue recognition is straightforward.
- **Liability for Remaining Coverage (LRC) declines over time** as the premium is earned.
- **Liability for Incurred Claims (LIC) grows** as claims materialize and remain unpaid.

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KEY CHALLENGES IN IMPLEMENTATION OF THE STANDARD

- **Complexity of Measurement Models** – Requires actuarial and accounting expertise.
- **Data and System Requirements** – Legacy systems may need costly upgrades.
- **Integration with Financial and Actuarial Systems** – Need for accurate calculations and reporting.
- **Operational and Process Changes** – More collaboration between finance, actuarial, and IT teams.
- **Increased Disclosure Requirements** – Detailed disclosures on profitability and contract groupings.
- **Regulatory and Compliance Challenges** – Adapting to country-specific regulatory interpretations.
- **Training and Change Management** – Training programs needed for employees.
- **Transition from IFRS 4 to IFRS 17** – Managing impact of transition adjustments on financials.

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KEY DIFFERENCES BETWEEN IFRS 4 AND IFRS 17

Item	IFRS 4	IFRS 17
Measurement Models	No uniform model; insurers used different methods.	Introduces three models: GMM, VFA, and PAA.
Recognition of Revenue	Premiums were recognized as revenue when received.	Revenue is recognized as services are provided over time.
Contractual Service Margin (CSM)	No concept of CSM.	CSM defers unearned profits and releases them over time.
Discounting of Liabilities	Not mandatory for all insurance contracts.	Requires discounting of future cash flows.
Disclosure Requirements	Limited disclosure requirements.	More extensive disclosures on cash flows, risks, and assumptions.

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BENEFITS IN IMPLEMENTATION OF THE STANDARD

- ❑ Enhanced Transparency and Comparability
- ❑ Improved Financial Reporting
- ❑ More Accurate Profit Recognition
- ❑ Greater Investor Confidence
- ❑ Alignment with Other IFRS Standards
- ❑ Better Risk Management Insights

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DISCLOSURE REQUIREMENTS OF THE STANDARD

- IFRS 17 requires insurers to disclose:
  - Reconciliation of insurance contract balances.
  - Key assumptions used in measurement (e.g., discount rates, risk adjustment).
  - Impact of changes in estimates on profit/loss.
  - Nature and extent of risks arising from insurance contracts.

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TRANSITION REQUIREMENTS OF THE STANDARD

- On initial application of IFRS 17, entities must apply one of the following approaches:
  - **Full Retrospective Approach**
  - **Modified Retrospective Approach**
  - **Fair Value Approach**
- Each approach has specific requirements for recognizing the impact of transitioning to IFRS 17.

THANK YOU!