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IFRS 17 : a comparison with IFRS 4 and an analysis of the impact of its application.

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Summary

This thesis has been thought because the arrival of the new IFRS 17 is a revolution in regard to the way of accounting for insurance contracts. It has a clear objective of requiring more in that sense, with models that are defined in a much more precise manner and allow for a better understanding of the financial statements that are presented with insurance contracts (and the rest of the items in scope) in them. It will be focused on the general model which encompasses most of the key concepts and is the one the others are derived from.

The studied problematic doubles down from the explanation above : Can it be expected that the new standard is really a solution to the problems of quality of information it is supposed to solve and what can we expect in practice from the impacted entities, in order from them to implement the new standard in an effective manner? This is a recent topic that is sufficiently complicated to be studied even though the fact that it is not applied yet clearly limits the possibilities (see the last part of the thesis).

The analysis that I have conducted is centered around studying literature from the IASB as well as other organizations that have a relevant and useful insight on the topic to determine whether the standard is really as much of a miracle solution as it is supposed to be or not, as well as the practical impacts and solutions, implementation wise.

This literature being usually broad documents at a multinational scale or bigger (example : big four documents or EIOPA), I have tried to confront my findings with opinions of professionals at a "lower" level to see whether it was adapted to their knowledge in practice (beside workers in insurance companies which are mostly helped by consulting firms to tackle the problem and for which I had an international survey of secondary data that was more useful than one or two small interviews on these topics).

The confrontation of those elements has allowed me to get these conclusions :

- The new standard is by far an amelioration in comparison with IFRS 4 but it has a number of flaws that are mostly linked to the leveraging that is let in IFRS standards. Correct explanations will be required but the deepness of those will depend on what the stakeholders of the entities expect and what they will deem necessary.

- The practical changes will be broad and affect anyone in the insurance landscape, not just the financial professionals but it is possible to find solutions that will be helpful like Solvency II which resembles IFRS 17 despite some differences, which are discussed in the chapters of this master's thesis and in the interviews.

The results are mostly qualitative, no numbers in terms of impact on the financial analysis of insurance companies and other affected entities are available yet to determine a figured impact on debt, revenue, cost or whatever elements that can arise from the application of the standard.

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Abbreviation list

CF : Cash flow

CSM : contractual service margin

EFRAG : European Financial Reporting Advisory Group

EIOPEA : European Insurance and Occupation Pension Authority

FCF : fulfillment cash flows

FVTPL : fair value through profit or loss

IAS : International Accounting Standard

IASB : International Accounting Standard Board

IASC : International Accounting Standard Committee

IFRS : International Financial Reporting Standard

LIC : liability for incurred claims

LRC : Liability for remaining coverage

OCI : Other comprehensive income

P&L : Profit and loss

RA : Risk adjustment

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Introduction

My master's thesis's goal is to compare both financial reporting standards (IFRS) that account for insurance contracts : IFRS 4 and 17. This comparison will lead to determine expected impacts for insurers and on the financial information when it comes to the application of the new standard. This is an exploratory study since this is destined to explore this specific study and find expected outcomes of this new topic.

The first step was to gather literature from sources as different as possible. From then onwards, I could study three main themes in theory :

- The objective and the reason for creating the new standard which creates a frame about what the consequences of the standard should be if everything goes according to the plan of the IASB.
- A comparison of technical points of both standards (4 and 17) in order to understand the consequences in the accounting/financial reporting side, namely if the goals discussed above were met in that regard or not.
- Discovering what the insurance companies could expect in practice when the standard is applied, in a more practical manner, and what will come from the changes in the standards.

These hypothesizes will be compared with interviews from experts. The interview guide in appendix 6 gives a structure on how the interview should occur in the best-case scenario. It is still very likely that the questions and topics are mixed in case the respondents speak themselves about a topic that was supposed to be asked afterwards or speak a lot by themselves (which should in any case avoid bias due to the formulation of questions if that happens).

There will not be any interview of an insurance company (or any insurance company's worker) because it would not be especially representative and some of the data found during my research have already discussed most topics with insurers in the world and across all types of insurers. In addition, insurance companies may not be ready to answer about this new norm which would undermine the usefulness of those interviews.

Beside the studied literature which comes mainly from experts from accounting firms, IASB and EFRAG, some secondary data from studies and surveys will also be used to confirm the hypothesizes and/or to construct some of them. No quantitative study is really possible due to the

theme that I have chosen. Sending questions to a panel of people is irrelevant due to the small number of respondents that would have a sufficient knowledge of the standard at this point in time and a case study would have needed to have insight in an insurance company, which I could not have for my thesis and would not really be relevant either due to the high number of decisions needing to be taken by reporting entities.

1. Presentation of the Norm

This first chapter describes the conception of the norm IFRS 17 as well as its scope and objective. The further parts will examine the norm in itself in comparison with IFRS 4 and the things that the targeted companies will need to change in order to implement it.

1.1 History of the Project and Timeline

The project of a norm for insurance accounting is not new and starts from the transformation of the IASC into the IASB back in 2001. This project of a common norm on insurance contracts was not feasible in time for all the companies in scope and was thus split into two parts:

- The norm that is known as IFRS 4, the first step towards the current norm appeared in 2004. The main gain of this first standard was to enhance the quality of the disclosure regarding specific pieces of information and not to make the applicable model(s) uniform. Nor was it to make the insurance accounting economically reliable since an exemption of IFRS 4 explicitly states that accounting policies do not need to be relevant with the economics of the accounted transaction. This along with other factors led to problems that will be analyzed in the next sub-chapter and in comparison with IFRS 17. The norm was set to be temporary and to be replaced by the board down the line. This is stated in the first paragraph of the basis for conclusions that accompanies the IFRS standard (BC1).
- The second phase is IFRS 17 which should repair the flaws of its previous version by setting a common frame and thus common accounting models regarding insurance contracts while keeping the amount and quality of disclosures required. A company can apply it as far as periods starting on January 1, 2023 (deferring the application of IFRS 9 to this same date simultaneously), as stated on the official site of the IASB.[1]

In order to get this version of the norm completed, the IASB completed multiple documents and exposure drafts as you can see in the first appendix of this thesis, from the firm Grand Thornton. Those various documents came from insurance professionals, auditors, regulators and people with the right experience in this field in order to get feedback about the practical issues that would

[1] https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-17/

possibly come along the models developed in the norm. This variety of documents, available in the project history of IFRS 17, summarized by the IASB, led to the norm being issued in 2017. [2]

The norm will be effective at the latest for accounting periods starting on January 1, 2023, and companies will have the possibility to defer the application of IFRS 9 to the same date as well (as stated before). Insurance companies might apply the standard sooner on the condition that they also apply IFRS 9 and IFRS 15 at the adoption date of IFRS 17 or earlier. (KPMG, July 2017)

Additionally, amendments are currently worked over to enhance the standard regarding some specific points (further explanations in the dedicated section below). The issues which are addressed by the amendments have been discussed in October 2018 and an exposure draft has been published mid-2019. Comments are expected for September of that year and in order to be consistent with their timeline before mandatory application, the amendment's case should be closed in the second half of 2020 at the latest.[3]

1.2 The Need of IFRS 17

The new standard of accounting for insurance contract IFRS 17 has always been intended to be developed since the first step had two major flows. The first one is that IFRS 4 allows for a variety of accounting policies with links to the local jurisdictions. That provides with accounts that are difficult to compare with others.

In addition to this, IFRS 4 explicitly states that the given information does not have to be relevant economics wise. It made for a fragmented view of the insurance contracts which only reflected the company's expectations of what the contract was. The information was therefore incomplete and difficult to compare once again. (International Accounting Standard Board, 2017)

Those problems also bring a logical third one, stated in the IASB fact sheet about IFRS 17 (IASB, 2017). When a group presents its consolidated financial statements, it is not required that the possibly different accounting policies between its subsidiaries become a common one. It ensures a variety of accounting methods under IFRS's for the same type of contracts, which are not the purpose of IFRS standards.

[2] https://www.ifrs.org/projects/2017/insurance-contracts/#project-history
[3] https://www.iasplus.com/en/projects/narrow-scope/ifrs-17-amendments

The goal of IFRS 17 is thus to repair those inadequacies in terms of transparency and comparability of the financial statements. The impact of this new standard will depend on the consistency already applied by an entity in its reporting as well as the degree of distance between its actual accounting policy(-ies) and the ones that are now mandatory due to IFRS 17.

Regardless, it is expected that the new standard will require the affected companies to gather new data and train people sufficiently to publish comparable overall, economically relevant and transparent financial statements regarding insurance accounting. This is a problem that even insurers themselves can acknowledge, as seen in the report from the European Financial Reporting Advisory Group in 2017.

Beside the comparability aspect of things, one thing that should be enhanced is the relevance of the information compared to IFRS 4 by including elements such as up-to-date information, time value of money as well as information regarding profitability. The interested third parties such as investors and auditors should be helped by these changes. That is the objective of the IASB when issuing this standard as shown in their effect analysis (IASB, 2017).

1.3 Which entities are the firms affected by the norm and the new way of accounting?

The first consideration to have while thinking about the affected companies is to examine to which companies IFRS standards usually apply. They apply to consolidated account mostly for listed companies (with exceptions for individual accounts as well). Particularly in Europe, following the European regulation, all companies listed on a member's market and ruled by the law of a member state shall prepare their consolidated accounts in accordance with IAS/IFRS's. There is also a possibility to make other categories of firms prepare their accounts in IAS/IFRS's (more on this in the next paragraphs). This comes from the 1606/2002 regulation from the European parliament and council.

Those companies represent mainly the insurance sector (for IFRS 17) with some possible deviation which is expected to be marginal.

The first and main part are the listed insurance companies that will need to apply IFRS 17. A study of the IASB has shown that 72% of those listed insurers are required to present accounts under IFRS's. That makes for 449 listed companies across the world that will be very impacted by the new standard (excluding insurance brokers).

When it comes to unlisted insurers, there are a couple of jurisdictions that either make it mandatory or optional to apply such standards:

- Twelve countries require the use of IFRS's for all unlisted insurers: South Korea, Canada, Australia, South Africa, Malaysia, Portugal, Turkey, United Arab Emirates, Saudi Arabia, New Zealand, Iran and Venezuela;
- Other countries, among which Belgium stands, require the standards for some unlisted insurers (consolidated accounts);
- Some countries like Germany and France allow the use of them to some extent.

Yet, insurers are not the only possibly affected companies even though they are the main target of the board with this standard.

The banking industry as well as investment firms typically could, under certain circumstances, see some of their contracts fall under IFRS 17:

- Financial guarantees if they transfer significant insurance risk even though they could be accounted for under IFRS 9;
- Investment companies issue contracts very similar to those of insurance companies and an impact could be felt.

Lastly, even outside of the financial sector, there may be some contracts like warranties in a particular case (where one firm issues an insurance to a holder regarding goods of a manufacturer), or to fixed-fee contract. However, those contracts are expected to be very marginal especially with fixed-fee contract possibly being accountable for under IFRS 15.

All of this is explained in the effect analysis document from the IASB (2017).

1.4 Endorsement

The endorsement is not a part that will be developed in this thesis. This short sub-chapter will be the only one to discuss this process by which IFRS standards are accepted into the EU regulation and are thus accepted for use within the countries of Europe. Furthermore, this process is not over yet, and no implication can be learned out of it. I will just assume that the applicable standard will be the one issued by the IASB and its amendments over time leading to 2023.

The three European supervisory authorities, which are the European Banking Authority (EBA), the European Securities and Market Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) [4] will have a mission of monitoring the endorsement process of the EFRAG for the adoption of IFRS 17.[5]

It is expected that an agreement will be found about the new standard in time for its application date. As underlined in the letter from the three aforementioned authorities, the possibility of applying the new standard together with IFRS 9 is an opportunity not to neglect. The urgency also comes from the fact that IFRS 4, IFRS 17's previous version, is not appropriate because it does not allow for enough comparability between the different companies that would use it. Therefore, IFRS 17 should be endorsed. That will is shown in the letter from all three authorities to Mr. Jean-Paul Gauzès in October 2018. (Enria, Bernardino and Maijoor)

[4] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/european-system-financial-supervision_en

[5] https://www.esma.europa.eu/press-news/esma-news/eu-enforcers-focus-new-ifrs-standards-and-non-financial-information

2. Scope

Hereunder will be explained to what transaction the standard will apply and whether or not every part of the contracts are to be accounted for under IFRS 17 or another standard.

2.1 Basics

The scope of IFRS 17 will be quite similar to IFRS 4. An entity shall apply IFRS 17 to (as stated in the third chapter of the IFRS 17 standard):

- Insurance contracts it issues only;
- Reinsurance contracts it issues and it holds;
- Investment contracts with direct participation features granted it also issues insurance contracts.

In practice, an insurance contract is defined as a contract where the issuer agrees to compensate an uncertain future event that would affect the policyholder, thus taking a significant insurance risk. Multiple ambiguities can arise from this definition with the significance of the risk. This is determined if there is a possible scenario where the issuer of the contract has to pay additional amounts in comparison to a scenario in which the insured event had not occurred or if there is a possibility of a loss happening with that particular contract. A minor change that arose with the new standard is the confirmation that the insurance risk has to be measured on a discounted basis. This was not explicit under IFRS 4 but most entities did so; the change is thus not important.

A quick side note that will make the impact of such norms bigger is that it applies to insurance contracts and not only to insurance companies. It will thus affect more companies than what could be expected at first glance. (PricewaterhouseCoopers, 2017)

The second type of contract which is in the scope of the new norm is reinsurance contracts. Those will be required to meet the criteria of an insurance contract. It is not needed from the reinsurer to be exposed to the possibility of a loss as long as the contract transfers all the insurance risk arising from the reinsured underlying insurance contracts. If this condition is met, then the reinsurance contract meets the scope of this norm. (KPMG, July 2017)

The third and last part of the scope of IFRS 17 is investment contracts with DPF's. Those are contracts with which the investor will be granted an additional amount based on either the issuer's financial results or return on specified specific items depending on the characteristics of the contract. The change that arises with the former norm is that those will be accounted for with the norm only if the issuer also issues insurance contracts. Previously, they would have been accounted for under IFRS 4 no matter what.

This could create some mismatches between consolidated accounts in the hypothesis of a subsidiary with DPF contracts only accounted for in stand-alone accounts with IFRS9 or IAS 32 but accounted for in the consolidated accounts with IFRS 17 if the group also issues insurance contracts. (PwC, 2017)

2.2 Scope Exclusions

Some contracts are not taken in the scope of this new norm and those exclusions are overall similar to the ones in IFRS 4. The table hereunder is a recapitulative of all those exceptions :

Table 1 : Scope exclusions

Scope exclusion	Standard to apply
Warranties provided by a manufacturer, dealer or retailer in connection with the sale of a product	IFRS 15 Revenue from Contracts with Customers
Employers' assets and liabilities that arise from employee benefit plans	IFRS 2 Share-based Payment
Retirement benefit obligations reported by defined benefit retirement plans	IAS 26 Accounting and Reporting by Retirement Benefit Plans
Contractual rights or obligations contingent on the future use of, or the right to use, a non-financial item	IFRS 15, IAS 38 Intangible Assets and IFRS 16 Leases
Residual value guarantees provided by a manufacturer, dealer or retailer, or a lessee (embedded in a lease)	IFRS 15 and IFRS 16
Financial guarantee contracts (unless a prior explicit assertion has been made and insurance accounting has been applied)*	Choice to apply IFRS 17 or IAS 32 Financial Instruments: Presentation, IFRS 7 Financial Instruments: Disclosure and IFRS 9 Financial Instruments
Contingent consideration in a business combination	IFRS 3 Business Combinations
Insurance contracts where the entity is the policyholder (unless these contracts are reinsurance contracts)	

[6]

[6] Grant Thornton, June 2017 (pp.7)

In addition to those exclusions, the amendments that are currently in the work for IFRS 17 are mentioning further exclusions for credit card contracts and loan contracts under certain circumstances as mentioned in the latter part of this thesis dedicated to the amendments.

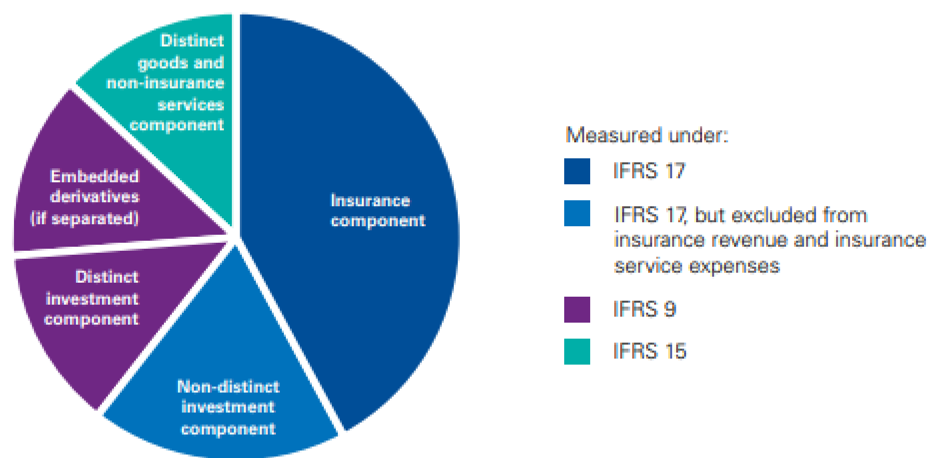
2.3 Combination and Separation of Components

According to the issued standard (IFRS 17), an entity might have to combine contracts if they are contracted with the same or related counterparts. In that case, the entity could report the contracts in one set if the rights and obligations need to be considered together to achieve the substance of those contracts.

Alternatively, under certain circumstances, an entity reporting under IFRS 17 might have to separate components from the insurance contracts and account for them under other standards like IFRS 9 and 15 among others. This is stated in the paragraphs 7 and 8 from the IFRS 17 standard.

The graph below, from the first impressions document of KPMG, illustrates the components separable from the contract and thus accountable differently:

Graph 1 : Different components



[7]

If the amendments discussed below are accepted (see the exposure draft in June 2019) the investment component will be defined as "the amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances" and it needs to be distinct to be accounted for under IFRS 9. An investment component is called distinct if it is possible to sell a similar contract under the same jurisdiction or market conditions or if the component and the insurance are not highly

[7] KPMG, July 2017 (pp.19)

interrelated (needing one another for calculation or not being able to exist separately) as explained in the BC108 paragraph of the basis for conclusions.

The embedded derivatives are not separated from the insurance contract under roughly alike conditions to the investment component. The relation and comparability between the host contract and the derivative are taken into account as well as the possibility or not for the derivative to be sold without being an insurance contract. (KPMG, July 2017) These characteristics are also in the 31st and 32nd paragraph of appendix B of the IFRS 17 standard.

Similarly to the first two elements, the transfer of goods or non-insurance services should be separated from the insurance component under certain circumstances similar to IFRS 15. Those goods and services are to be accounted for under IFRS 15 if the transferee can benefit from them on their own or with other "readily available" resources meaning sold separately or already owned by the transferee. In such cases, the services are accounted for under IFRS 15.

Usually, services needed to fulfill the contract, such as administration are not separated and thus accounted for together with the cash flows of the insurance components.

3. Technical Comparison Between IFRS 17 and IFRS 4

The following chapter will discuss the differences in terms of accounting between IFRS 4 and IFRS 17. Those will be separated in (de)recognition, measurement, presentation and disclosure, some special cases like acquired insurance contracts and contracts with discretionary participation features will be added along the way.

3.1 Recognition and derecognition

3.1.1 Aggregation of contracts

There is no such thing as an aggregation of contracts under IFRS 4. It doesn't include how and whether to separate onerous contracts from others or anything in that regard. It lets the door open for presenting contracts that may offset each other, which will be more difficult in IFRS 17. Based on a study from EFRAG, most of the respondents of its study do not use the group of contracts (let alone as defined by IFRS 17) as the unit of account but mostly calculate at the level of the contract and sometimes, they are using other units of accounts for specific types of contracts. This is nevertheless different from the requirements at the group of contracts. (EFRAG, October 17, 2017)

Indeed, under IFRS 17, the required level of granularity is much more demanding and carried out in apart steps:

- The determination of portfolios of insurance contracts, those portfolios are defined as contracts that are subject to similar risks and that managed together. An example being contracts from the same product line managed together. (paragraph 14 of IFRS 17)
- Within those portfolios, an entity shall disaggregate the portfolio into at least three groups being the contracts that are onerous, the ones that show no significant signs of becoming onerous afterwards, at initial recognition and the rest of the contracts. (paragraph 16)

A contract is onerous if the sum of all cash flows related to the contract results in a cash outflow (fulfillment cash flows, acquisition cash flows, cash flows at the acquisition date).

The entity shall base its assumptions on the facts and circumstances (changes in assumption regarding cash flows for example) that might make the said contract onerous in the future and what is the likelihood of those circumstances actually happening in reality. Multiple contracts form a set of contracts and such sets can be assessed together if the entity can reasonably expect that they will end up in the same group of contracts. This is stated in the paragraph 17 of the IFRS 17 standard.

Two other problematics are to be considered when it comes to the aggregation of insurance contracts.

The first is the fact that contracts in the same group can't be separated in time for more than one year. This will make cohorts appear in the portfolio of contracts, regarding periods of maximum one year. After that one year timing is expired, new contracts within the same portfolio will form one new group. This will avoid groups with everlasting CSM (= future profitability as explained in the dedicated chapter below), due to new contracts being potentially added infinitely. It will also make for a clearer, more transparent view on the profitability of the insurer for each group of contracts.

It could make it possible that groups of contracts are not complete at the reporting date. For example, if a group gets its first contract on June first 20XX, new contracts can be added until June first 20XX+1. If the insurer has a reporting date on December 31st, new contracts could be added after that date.

The second problematic is that an entity might measure the fulfillment cash flows, risk adjustment and discount rates at a higher level than group level if they can then allocate these at each group at the lower level. That is a problematic that can require changes in the valuation systems of the entities which would not be able to be in adequacy with the group requirement of IFRS, either by not being able to calculate at a low enough level or that cannot allocate the higher-level data to the groups efficiently. (KPMG, July 2017)

3.1.2 Recognition

IFRS 4 doesn't contain a lot of requirements for initial recognition of insurance contract by insurers. It only exempts insurers of 3 paragraphs from IAS 8 (10–12). Those paragraphs explain criteria to account for items that don't have specific IFRS rules attached to them. It frees them from applying these criteria for the recognition of insurance assets and/or liabilities except for some aspects that are developed in the IFRS 4 standard, paragraph 14:

- Insurers shall not recognize a provision for possible future claim as a liability if the underlying contract doesn't exist yet.
- Insurers shall execute the liability adequacy test properly (see measurement).

- Insurers shall not offset reinsurance assets, income and expense against the related insurance contract's liabilities, expense or income.
- Insurers shall consider impairing their reinsurance assets.

Regardless of those considerations, an entity shall still respect the definitions of assets and liability in the conceptual framework to recognize one, may it be an insurance asset or liability arising from a contract.

IFRS 17 has a lot more complex and precise manner of describing the initial recognition of insurance contract.

First of all, IFRS 17 requires the aggregation of contracts by groups within a portfolio of insurance contract as explained in the section "aggregation" atop this one.

Afterwards, the entity shall recognize these groups of contracts at the earliest date between:

- The beginning of the coverage period;
- The first payment from a policyholder becomes due (or received if no due date in the contract);
- Facts and circumstances are such that the group of contracts becomes onerous. (Grant Thornton, June 2017)

The determination of this date is important because two key components in the measurement of the insurance liability/asset: the discount rate and the contractual service margin, which have both to be determined on initial recognition. The discount will also be used in an unwinding of discount of the discounted cash flows and other tasks described below. When it comes to contracts recognized at the end of a period, they can only include contracts that have been issued by the end of the period. Additional contracts issued later will be added to the group during their respective issuing period.

Furthermore, an entity shall recognize an asset or liability for insurance acquisition cash flows that are paid or received before the issued contracts related to those cash flows are recognized. Such insurance acquisition cash flows can be recognized immediately as income or expense if the premium allocation approach is applied. When the contract is recognized, the asset or liability relating to the insurance acquisition cash flows is derecognized. (Paragraph 27 of the IFRS 17 standard)

Beforehand, such acquisition cash flows could be recognized as expenses or deferred assets that were amortized over the life of the contract, with the problematic of recoverability of the asset. Right now, with the new norm, such an asset will be included in the insurance liability and will reduce the unearned expected profit (=CSM). Companies applying such policies will need to review their manners of accounting in order to match with the new method of accounting for insurance acquisition cash flows. The costs that can be included in such cash flows are also determined by the new norm which can (depending on the previously applied model) imply more immediate losses if you were deferring things that are no longer included or a lot less than others if you were expensing everything as incurred, adaptation but comparability nonetheless. (KPMG, July 2017)

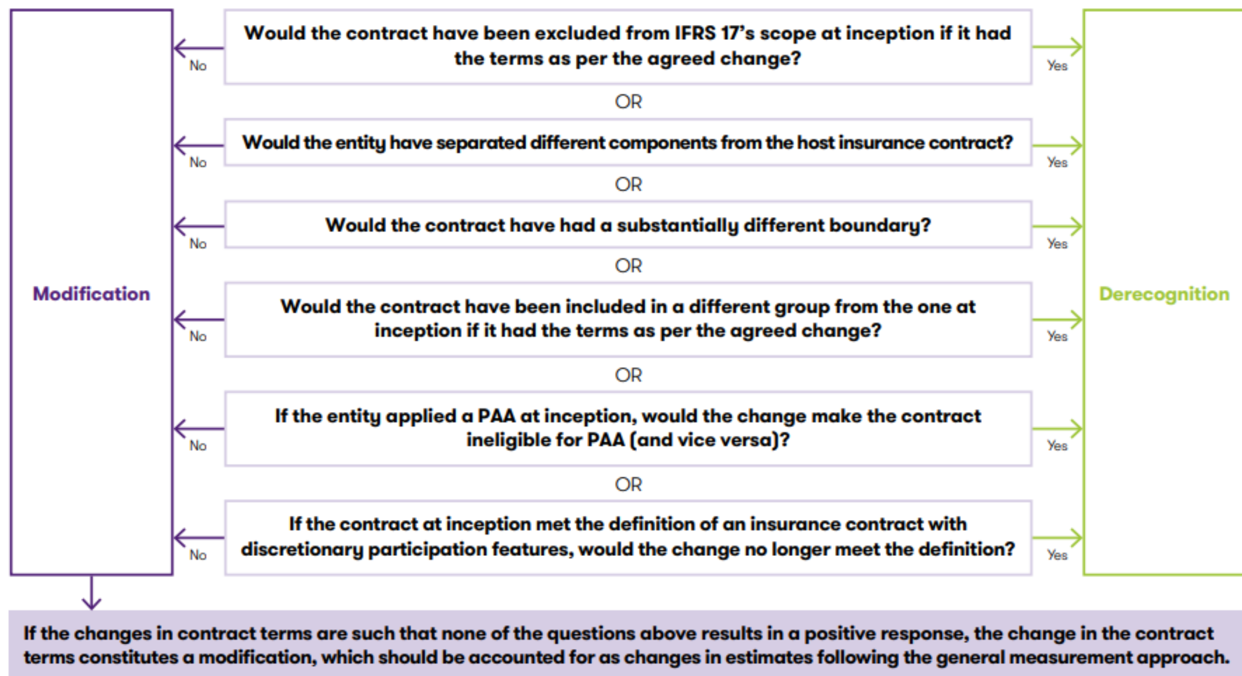
As expected by the body setter when issuing this standard, we can see that for the initial recognition alone, the standard will bring a lot more comparability on the information disclosed, by no longer permitting multiple accounting technique and the match between costs and products should also be better divided between the periods.

3.1.3 Derecognition

The former standard of IFRS 4 specifies that an entity shall remove an insurance liability (or part of an insurance liability) from its balance sheet when and only when, it is extinguished: when the obligation specified in the contract is discharged or canceled, or expires. This wording is used in the paragraph 14 c) of the IFRS 4. The derecognition of an insurance item under IFRS 4 did not address the derecognition of insurance assets because of the complexity of derecognition of financial assets as pointed out in the paragraph 105 of the basis for conclusions of the IFRS 4 standard.

IFRS 17 is once again much more detailed on the derecognition of an insurance contract. The first thing considered is the modification of an insurance contract and whether or not it would need to be derecognized and then re-recognized as a new contract under the rightful IFRS. It means in fact that the 6 criteria described in the chapter 72 a, b, c of IFRS 17 are to determine whether there would be a significant change in the group in which the new contract should be recognized and whether or not the accounting for that contract would be significantly different from the accounting used before the modification of the contract. Find below a summarizing graph from grant Thornton containing the six criteria:

Table 2 : Change in the contract



[8]

If any of these criteria are met, the derecognition/recognition scheme will be used, if not, then the change due to the modification of the contract will be reflected by adjusting the fulfillment cash flows related to that contract.

Beside this special case of modification, the general rule is that an insurance contract shall be derecognized when, it is extinguished, i.e. when the obligation specified in the insurance contract expires or is discharged or canceled. It means that the entity shall no longer have to transfer economic resources to fulfill its obligations, as stated in the paragraph 74 of the IFRS 17 standard. It is similar to the requirement of IFRS 4. A problem that could have arisen is that claims can appear years after the end of the coverage period. Still, the board estimated that recognizing a very small amount for the liability of derecognizing it completely wouldn't change anything significantly, as they explain on the chapter 322 of the basis for conclusion.

[8] Grant Thornton, June 2017 (pp.30)

When an insurance contract is derecognized, the entity shall adjust multiple elements:

- The fulfillment cash flows for the group of contract the derecognized contract was accounted for;
- The contractual service margin that is related to the adjusted fulfillment cash flows;
- The number of coverage units for remaining coverage to eliminate those related to the contract derecognized.

Once again the same conclusion can be made, the new standard might make things way more standardized for recognition since it applies to both insurance contracts that are liabilities and assets, and provides with much more guidance. It should thus enhance the comparability of the financial statements.

In conclusion, for the comparison between IFRS 4 and IFRS 17, we can outline that the most recent standard is evidently more detailed than the old one. It also provides a much less optional and much clearer framework for recognizing and grouping contracts under common rules. It seems to comply with the objective of comparability and transparency at first glance.

3.2 Measurement

This chapter of the thesis outlines the difference in the models (with their counterpart in IFRS 4) that are required to account for insurance contracts and the difference between both standards in that regard. Firstly, we will have a look at how entities shall measure the contract at initial recognition. Then what happens at subsequent reporting dates or events. The final part of this chapter examines the possibility of leveraging in terms of accounting policies between both norms. The focus is on the general model as already described above, because it is the most common and the other two are derived from it.

3.2.1 Initial measurement

IFRS 4

No requirement is mentioned in IFRS 4 when it comes to initial measurement. However, an insurer reporting under IFRS 4 will have to perform one specific test that will be discussed in subsequent measurement.

It means that an insurer can continue to apply existing accounting policies (not change them into whatever it wants as explained in the specific section below). It means that policies such as undiscounted basis, measuring at a value different than fair value or inconsistency of policies across subsidiaries and groups (examples given at the chapter 25 of the standard) can continue to apply. Fair value is also not required at this stage for either insurance assets or liabilities, the board considering that it- at the first stage -would not be practicable and inadequate as stated in the paragraphs BC 224–226 of IFRS 4.

IFRS 17

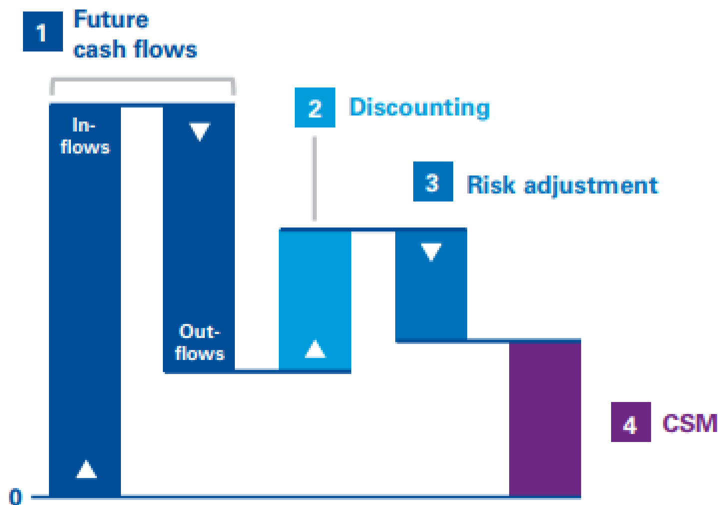
There are three separate measurement models in the IFRS 17 standard. The general model is the one that will be developed as it will apply to most insurance contracts. The two other models will be developed subsequently and in the right sections but in much fewer details. You can find in the second appendix a table summarizing those models.

The general model is also called the “building block approach” (BBA) because it considers the carrying amount of the insurance liability as a construction per block. These blocks are the fulfillment cash flows (themselves separated in multiple parts) and the contractual service margin which is the carry forward of first-day gain that can’t be recognized as such and remains in the balance sheet until it can be allocated as revenue (over the course of the contract). This concept of

the model is explained more precisely in the paragraph 32 of the standard and in the dedicated section below.

The steps that should be taken to calculate the insurance liability relating to a group of contract are illustrated by this graph from KPMG:

Graph 2 : Step-by-step approach



[9]

The measurement is thus separated into four steps:

1. First you need to determine the cash inflows and outflows that will (/are expected to) arise from the insurance contract over its duration.
2. Those cash flows will be discounted with a discount rate that will reflect time value of money and financial risk.
3. This value will be adjusted for non-financial risk.
4. If this amount results in a net cash inflow, the entity will recognize the CSM (contractual service margin) to avoid day one profit. If the amount is a cash outflow (onerous contracts), the counterpart is recognized in profit or loss. (Ernst and Young, May 2018)

Each of those blocks needs to be determined explicitly and are demanded to meet certain criteria.

[9] KPMG, July 2017 (pp.29)

Cash flows:

In the view of the board, the cash flows that need to be used for the measurement of the insurance liability should be the cash flows arising within the contract boundaries, current, explicit, incorporating every information that can be found without unnecessary cost or effort and reflecting the entity's perspective. (paragraph 33 of IFRS 17)

The information that must be used to determine the cash flows shall represent the possible outcomes that have an impact on the cash flows arising from the contract. Those shall be probability-weighted to take all the possibilities into account. The range of possibilities must meet a certain level of precision to get an unbiased amount for the cash flows. The entity shall thus use all amounts in stochastic manner and not use the most likely outcome (deterministic method) to determine the amount. (PwC, June 2017) IFRS 4 did not disallow accounting policies using this deterministic method which could have an impact on the relevancy of the amount presented in the financial statement.

Those cash flows must also be based on all sources of data like the entity's own experience about claims in similar contracts, market conditions and prediction modeling for the future before discounting the amount found to get their present value. This is explained in the paragraphs 37 to 40 of the Appendix B of IFRS 17.

IFRS 17 defines two types of variables that can affect the cash flows: market and non-market variables. The estimates made by the entity should be consistent with market variables which have the primacy over non-market variables. Those non-market variables must be relevant with the activity and insured population of the entity. (EY, May 2018)

The norm also requires the cash flows to be based on current estimates and be explicit. The current character means that they should reflect the present assumptions available for the entity (hence why the changes in estimates and necessary subsequent measurement). The explicit side requires that the estimates of cash flows are separated from the risk adjustment block and the discounting for time value of money and financial risk (those two blocks being independent as well obviously). This is explained in the paragraphs 54 to 60 of the appendix B of IFRS 17.

Lastly, the cash flows need to fall under the contract's boundaries. The boundaries are defined as "the reporting period in which the entity can compel the policyholder to pay the premiums or in

which the entity has a substantive obligation to provide the policyholder with services". This definition is given in the chapter 34 of IFRS 17.

The cash flows are within the boundaries if they permit to fulfill the contract, examples of which include :

- Premiums from and payments to the policyholder;
- Insurance acquisition cash flows;
- General costs that can be attributable to the contracts.

Components from separated items, returns or non-directly attributable costs are excluded from the boundaries of a contract.

The insurance acquisition cash flows specified above must also be attributable to the group of contracts in question and arise after initial recognition. If they were to be paid or received before initial recognition, they would be recognized as either an asset or a liability and derecognized at the date of initial recognition to calculate the CSM (see below).

This is a difference with the previous standard under which most entities would recognize acquisition cash flows as deferred assets amortized over the course of the contract. Here, the asset would be derecognized and reduce the deferred profit which has a similar impact on financial performance. (KPMG, July 2017)

Discount rates:

The cash flows that are determined by respecting the criteria explained above must now be discounted at a rate that reflects time value of money and financial risks (currency, liquidity) if those are not included in the cash flows, as logically stated in the paragraph 36 of IFRS 17. In practice, it means that the sum of the adjustment within the cash flows and discount rates should reflect the characteristics of the cash flows and underlying items. For example, if the cash flows vary with the variation of some underlying items, the discount rate shall include such variability except if the probability weighting of the cash flows have already included it.

The use of a single discount rate for every cash flow within the boundary of the contracts if possible but it shall reflect the characteristics of all cash flows in the contract. Otherwise, cash flows shall be discounted with different discount rates. A yield curve or a single discount rate can be used at

choice but the assumptions and method used to determine them are estimates in accordance with IAS 8.

This definition of the discount rate puts an end to a practice under IFRS 4 that was to discount cash flows using rates from the pool of financial assets in the balance sheet. If such assets present the same characteristics as the cash flows, such an asset-based rate might be the start and be used as the discount rate after adjustment. (PwC, June 2017)

In appendix 3 is a table recapitulating the rates that need to be used and at what moment of the life of the contract.

Risk adjustment:

The risk adjustment under IFRS 17 is an adjustment of the cash flows for their uncertainty arising from risks other than financial risks, like lapsing or mortality risk. The definition given by the standard is the compensation that makes the entity indifferent between a situation with a range of probability-weighted outcomes and a situation with a single outcome with the same present value as the current contract, as defined in the paragraphs 85 and 86 of the appendix B of the standard.

The amount of risk adjustment per group of similar contract is personal to the reporting entity and depends on the diversification of the entity for the purpose of mitigating such risks and its risk appetite (how much she loves/hates risking). There is no specific given method to determine such adjustment but a set of principle (B91) has to be respected:

- low frequency and high severity of claims will be riskier than high frequency and low severity of claims;
- longer duration for similar risks will be riskier than shorter duration for the same risks;
- wider probability distribution will be riskier than narrower probability distribution;
- contracts with emerging experience increases the uncertainty of non-financial risks will be riskier than those with emerging experience decreases the uncertainty on nonfinancial risks.

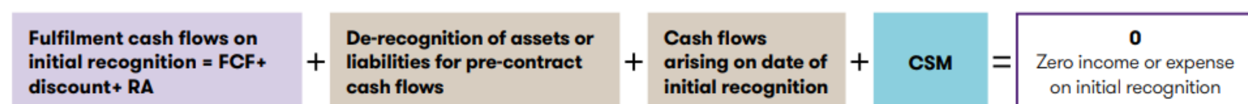
CSM (contractual service margin):

The newly introduced element from IFRS 17 is this contractual service margin which depicts the future profitability for the insurance contracts. Technically wise, to report profit in the future periods, it should be a passive account that will be credited at initial recognition and debited when profit if recognized in future periods. (Paragraph 38 of the standard) This is an element that cannot be negative. It implies that it does not permit to carry forward losses (which are thus recognized immediately) and that changes in estimates for subsequent measurement that would make the CSM negative are reported in P&L immediately. This is explained in the paragraphs 218 and 219 of the basis for conclusions of IFRS 17.

That CSM for a group of contract is calculated on initial recognition as the opposite of the sum of:

- The fulfillment cash flows on initial recognition as described above;
- The derecognition of any assets or liabilities attributable to insurance acquisition cash flows for the group of contracts;
- Any cash flows paid at the acquisition date.

Figure 1 : Elements of the CSM



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The contractual service margin will change over the duration of the contract for different reasons (which will be more deeply examined in the subsequent measurement below):

- Changes in estimates for the unearned remaining profit. This can come from a change of the fulfillment cash flows or from the adjustment for non-financial risk, for example.
- Currency exchange differences.
- Insurance income or expenses which come from the accretion of interest keeping consistency with IFRS 15 which requires that unearned profit from such contracts take the time value of money into account.

[10] Grant Thornton, June 2017 (pp.20)

Those elements are explained deeper in the next chapter and are also included in the IFRS 17 standard.

The CSM is a novelty for insurance contracts with no previous mandatory concept had to be used in the accounting for such contracts. (EY, May 2018)

Overall:

At initial recognition, the carrying amount of an insurance contract is thus the sum of the fulfillment cash flows, RA and the contractual service margin. In the case where a group of contract would be onerous at initial recognition, the entity shall recognize no CSM but a loss in P&L. Consequently, the liability for remaining coverage (see subsequent measurement) will include a loss component which represents the amount initially recognized in profit or loss. (KPMG, July 2017)

In some places under IFRS 4 and local GAAP's, excessive prudence was of application in the calculation of the liability for incurred claims by some practices like undiscounted liabilities or calculation on an ultimate loss ratio basis. Such behavior will be prohibited under IFRS 17 since it requires discounting and a risk adjustment for non-financial risks. (KPMG, July 2017) As we can see, the initial recognition for IFRS 17 is precise, while letting elements at the appreciation of the entity (determining the discount rate, estimating the cash flows and the RA which really depends on the entity). The most important parts needed to measure the insurance contract are well defined and there are given guidelines to be respected. On the contrary, IFRS 4 did not give entities such framework and let them develop their own way which, even though, was the objective while doing a two-step approach made for less comparability and reliability for the financial statements of insurers.

An exception : the premium allocation approach (PAA)

Another modification from IFRS 4 is that multiple models are used under IFRS 17, as seen in the appendix 2. The first one is the premium allocation approach which is used for groups of contracts in which every contract whose duration is no longer than a year **or** whose measurement using the PAA would not be materially different, had the general model been used. This simplified model brings change to the measurement of the liability for remaining coverage and not to the liability for incurred claims which is still measured in accordance with the principles of the general model at the exception that it may not be discounted if all of the cash flows from incurred claims are to be

received within a year from the incurring. This is a special part of the standard, namely at its paragraphs 53 to 59.

The liability for remaining coverage is measured based on the premium received. At initial recognition, the value of the liability for remaining coverage is equal to the premium received at initial recognition minus the acquisition cash flows and adjusted for any assets or liabilities recognized as deferred acquisition cash flows.

The aforementioned acquisition cash flows might be expensed immediately and not over time if the coverage period of every contract of the group is less than one year. (KPMG, July 2017) In the same sense, the liability for remaining coverage needs not be discounted if the period between each premium and the related services is less than one year according to the paragraph 56 of the standard.

When a contract is suspected to be or is onerous, the entity measures it using the general model (undiscounted) and any excess compared to the carrying amount using the PAA is recognized as a loss.

The temptation of using the PAA will be strong for insurers since it allows them to skip the measurement of the CSM and the liability for remaining coverage as a whole but the eligibility criteria, namely, the "materially different from the general model" will be depend on one's interpretation and will affect its use. A solution could be to compare the methods outcome per outcome and see whether it is materially different or not. It would take multiple things into account such as discounting and RA. (EY, May 2018) The release of the revenue will also be a key decision-making factor to consider for entities (see in subsequent measurement). (PwC, June 2017)

3.2.2 Subsequent measurement

IFRS 4

Under the paragraphs 15 to 18 of IFRS 4, an insurer shall execute what is described as the "liability adequacy test". This test is there to assess the carrying amount of the insurance liability less any deferred acquisition costs and related intangible assets by comparing it to the current estimates of future cash flows under the contract. If the liability is inadequate, the deficiency must be recognized in profit or loss, which means increasing the liability and recognize the counterpart as a loss. It is like a reversed impairment test for the insurance liability.

The frequency of this test is annual (once again similar to some impairment tests) and shall respect minimum requirements:

- The use of current estimates of all contractual cash flows, those resulting from claims handling costs and from embedded options and guarantees.
- The entire deficiency is recognized in profit or loss.

If those requirements are not met, another step-by-step approach shall be taken to test the liability, according to the paragraph 17 of IFRS 4 :

1. Determine the carrying amount of the relevant liabilities or assets;
2. Compare it with the amount it would be, had it been determined under IAS 37 (provisions, contingent liabilities and contingent assets) and take the same actions in case the current amount of the liability is less.

As we can see, the measurement procedure is fairly open for accounting policies to be widely different once again, since there are only two requirements for the test, the remaining being determined by the entity. It makes it, of course, difficult to compare entities with each other, the methods being potentially very different. Furthermore, as stated in the basis for conclusions of IFRS 4 (paragraphs BC 94–104), this "model" meets the objective of IFRS 4 of giving a minimal framework of measurement with as few mistakes significance wise as possible by substituting an existing model if necessary (IAS 37).

IFRS 17

The carrying amount at the end of a reporting period for a group of insurance contracts is defined in the paragraph 41 of the standard as the sum of the liability for remaining coverage (services to come) and the liability for incurred claims (past services). The contractual service margin remains existing only for the remaining coverage part since the rest has been taken into profit for services already provided.

All three of those elements (liability for remaining coverage and incurred claims and CSM) must be adjusted for different reasons during the reporting period. Those changes are either reported in profit or loss, or transferred into another heading of the balance sheet / sub-part of the contract.

First, the liability for remaining coverage is adjusted for:

- The time value of money and financial risks. Indeed, as it was explained above, the cash flows used at initial measurement (fulfillment cash flows) are discounted using a rate that takes both those things into account. In a logical manner, the discount is unwound with the passage of time and the consequent changes are recognized as insurance finance incomes or expenses. The exact same phenomena will be happening for the liability for incurred claims which is the second item discussed.
- The reduction of the liability for remaining coverage for services provided in the period. Such changes in the liability are recognized as insurance revenue, cash or liability for incurred claims, since it is a decrease in the liability.
- Losses on onerous contracts and reversal of such losses in insurance service expenses.

The second item is the liability for incurred claims logically changes for two things aside the changes relating to time value of money and financial risks:

- The increase of claims and expenses related to contracts issued, which have arisen during the period.
- The changes in the fulfillment cash flows that are related to already incurred claims and expenses. For example, a reduction of the amount claimed by the policyholder due to an insured event.

Both these changes are recognized as insurance service expenses and the first change does not include investment component. (Grant Thornton, June 2017)

Lastly, the contractual service margin must also be adjusted for different reasons. In a consistent manner with the changes for both liabilities, the CSM is adjusted for time value of money and financial risks by accreting the interest on the margin. This is in fact the second adjustment with the rise of the CSM for the addition of new contracts to the group to which the CSM is linked (see the level of aggregation sub-chapter above). This change for accretion of interest is still considered as insurance finance income. This change in the CSM using the historical discount rate (as required) will create a need for tracking such rates to know which cash flows are accreted with which rates and thus, what amount needs to be recognized in profit or loss. (EY, May 2018)

As also described in the appendix B paragraph 96 of the standard, the changes in the fulfillment cash flows for future services (thus linked to the liability for remaining coverage) as explained below are also recognized in the CSM.

The experience adjustment, being the difference between expected and really received amount during the period, that relates to future services are recognized in CSM and will be classified in profit or loss when necessary. Most experience adjustments relate to past and current services and are thus recognized directly in profit or loss. A change for the actual cash flows relating to future services (thus the liability for remaining coverage) are also recognized as a move in the CSM. An increase of the cash-outflows will result in a decrease of the CSM and the other movements can be deduced therefrom. (PwC, June 2017)

The changes in estimates for the adjustment for non-financial risks that relates to the fulfillment cash flows on future services are also recognized in CSM. At last, the difference in timing between the expected repayment of an investment component (as defined by the standard) and the moment when it becomes due is also recognized in the CSM since it has an impact on the future cash flows (in a direction or another). If an entity has the ability to pay discretionary cash flows, a change in these cash flows is linked to a change in the commitment of the entity to pay them and is regarded as a change in future services, thus recognized in the CSM. (KPMG, July 2017)

The CSM is then adjusted for currency exchange differences and for the amount that has been recognized in profit or loss due to services provided in the period, which is the basic use of the

contractual service margin to begin with. This adjustment is explained in the paragraph 44 of IFRS 17.

The requirements for the subsequent measurement relating to insurance contracts under IFRS 17 are de facto much more important in terms of number of guidelines than those on IFRS 4. Still there is an emphasis put on evaluating the faithfulness of the amounts recognized even if much less detailed in IFRS 4 since no real framework or accounting model is given. The liability adequacy test is a measurement that can be seen as prudent since its goal is to avoid understating liabilities or overstating assets, and thus misleading the reader of the statements more than the permission in IFRS 4 already can. The IFRS 17 models using multiple elements like discounting or RA just to name a few, requires more elements to be subsequently measured but it is, in my opinion, logical with the rest of the standard and not fundamentally better than IFRS 4.

The case of onerous contracts is once again fairly unique since no precision is made in IFRS 4 regarding such contracts. For onerous contracts under IFRS 17, no CSM is adjusted since there is none, only the liability for remaining coverage and a loss component within. The liability adequacy test along with other practices have also been used so far to recognize the risks for such contracts, by insurers. (EFRAG, October 17, 2017)

There are two categories of changes that will be recognized differently as stated in the paragraphs 50 and 51 of the norm:

- The changes that happen in the normal occurrence of the contract such as annual reclassification to liability for incurred claims, changes in the RA and unwinding of discount of the cash flows, similar to the general models, are allocated on a pro rata basis to the liability for remaining coverage without the loss component and the loss component. This pro rata will need to be tracked and followed and will lead to system updates as discussed in the practical consequences below.
- Events that reduce the onerous side of the contracts only reduce the loss component until it is equal to zero and a CSM is created afterwards. (KPMG, July 2017)

PAA :

The PAA, as developed in initial measurement already, also has its share of requirements subsequent to recognition. The liability for incurred claims is changed in the same manner as in the general model.

The liability for remaining coverage sees its carrying amount being adjusted for the following things in the PAA:

- Augmented for the amounts of premiums received in the period similarly to the premiums initially used;
- Diminished for new acquisition cash flows (unless expensed) and augmented for the amortization of such cash flows;
- Diminished in case of an investment component (see definition) is transferred to incurred claims;
- Augmented to adjust to a financing component;
- Diminished as revenue is recognized in profit or loss. (KPMG, July 2017)

The last point is important and could result in a mismatch between the amortization of insurance acquisition cash flows and revenue. Indeed, the recognition might be made on a release-of-risk basis while the amortization and the cash flows must be made on a straight-line basis which will make for differences. (PwC, June 2017)

3.2.3 Changes in Accounting Policies

Under IFRS 4, paragraph 22, it is allowed for insurers to change their accounting policies if and only if it makes for more relevant and not less reliable financial statements for decision-making. Those criteria being judged by the criteria in IAS 8. It doesn't force them to change their accounting policies otherwise. It remains a possibility only.

It lets the possibility open to continue some accounting practices like measuring liabilities on an undiscounted basis (even if stating in the basis for conclusions that it was less reliable in their view), measure investment management fees at a higher amount than their fair value or using non-uniform accounting policies across subsidiaries for consolidation. Those can't be adopted but can continue to be used, creating volatility and difficulties between the statements.

Various other specific point's accounting policies important in regard to insurance contracts are also discussed:

- The discounting of claims liabilities which are mostly not discounted at the time of issuing IFRS 4 and can continue to be undiscounted. Changing from a discounted to an undiscounted basis (which would be going from good to bad essentially) is still not permitted. When it comes to discount rates, it is allowed to make rates reflect current market interest rates. This election is not required for all similar liabilities, exception to what IAS 8 would prescribe. (paragraph 24 and BC 126–127)
- For the prudent side of insurance liabilities, IFRS 4 does not make it mandatory to change accounting policies whose prudence is too high but does not allow to make them more prudent if they already are enough. In addition, the liability adequacy test will take care of underestimated liabilities. (BC133)
- The use of future investment margins in discount rates used to measure the insurance liabilities is presumed to make financial statements less reliable and relevant. Indeed, in the board's view, including the returns of financial assets in the discount rate is not relevant. Entities need not change their accounting policies to prevent this from happening but mostly cannot change them in a way that makes it the case except if the changes make it such that the increase in reliability and relevance outweighs the increase brought by the inclusion of such margin in the rate. (BC 134–136 and paragraphs 27–29)

- IFRS 4 did not require to change the practice of shadow accounting estimating it was not the time yet to do so in the first phase because it would require the insurers to change their systems. Therefore, this practice is still allowed for insurance companies under IFRS 4. (BC 181–184)
- Finally, IFRS 4 provides insurers with a possibility to reclassify their financial assets (and not solely those backing insurance liabilities) as fair value through profit or loss when they improve their policies for insurance liabilities. The board wants to avoid creating an accounting mismatch by doing so.

As we can see in this chapter of changes in accounting policies, the first step of an IFRS standard on insurance contracts allows a lot of possibilities and imperfections in terms of accounting policies which should be more restricted in the second phase.

In the opposite, IFRS 17 does not allow any exemption against any of the principles of IAS 8 or anything related to a change in accounting policies. The accounting policies should comply with the principles of economical relevance, reliability as presented in IAS 8 and IFRS 17 and its concepts, like with any other norms. This is clearly an enhancement in regard to the transparency, reliability and comparability of the statements since the practices allowed like the different policies among subsidiaries and so on can no longer be applied.

3.3 Special Cases

This chapter examines the procedure to be used in some cases, described in the titles, that are not simply issued contracts by the entity. This is not the main focus of this thesis but it needs to be addressed to give a complete comparison.

3.3.1 Business Combination

Under IFRS 4, an insurer is supposed to account for insurance liabilities and insurance assets it acquires from a business combination or portfolio transfer at fair value. This way of doing would be consistent with the accounting for other assets and liabilities obtained by a business combination under IFRS 3 (paragraph 31).

However, the board's decision was to issue a first step standard and avoid systematic changes that would need a reversal under the second phase (IFRS 17). Therefore, they decided to let the possibility for insurers of splitting the fair value of the acquired contracts into two different items in a manner already used in certain local GAAP's (BC147- IFRS 4):

- A liability measured in compliance with the acquirer's accounting policies;
- An intangible asset that amounts to the difference between the fair value of rights and obligations arising from the acquired contracts and the amount described first. (Amortized over the course of the contract.)

Furthermore, IFRS 3 sets an exemption for measuring the contract acquired following the characteristics at the inception of the contract or its significant modification but not at the acquisition date. (IFRS 17 page 87)

While the intention of the board of doing a two-step approach is respected, this lets again a hole in the standard that does not define nor the fair value of an insurance contract, nor the calculation for it.

The main key differences between both standards when it comes to insurance contracts acquired in a business combination or in a portfolio transfer is that:

- The characteristics used to measure it and to determine which model applies, are those at the date of acquisition and no longer at the inception of the contracts as in IFRS 4.

- The acquired contracts do no longer need to be measured at fair value (like any other assets or obligations) but following the guidelines of the new standard, IFRS 17. It makes the split explained above inconsistent with IFRS's.

Practically, the premiums received will be replaced by the amount received or paid to calculate the contractual service margin. If the contracts acquired are onerous, the amount that makes them onerous is recognized in the goodwill or as a bargain purchase in case of a business combination (no loss is recognized in a business combination) and in profit or loss in the case of a portfolio transfer. (EY, May 2018)

3.3.2 Contracts With DPF's

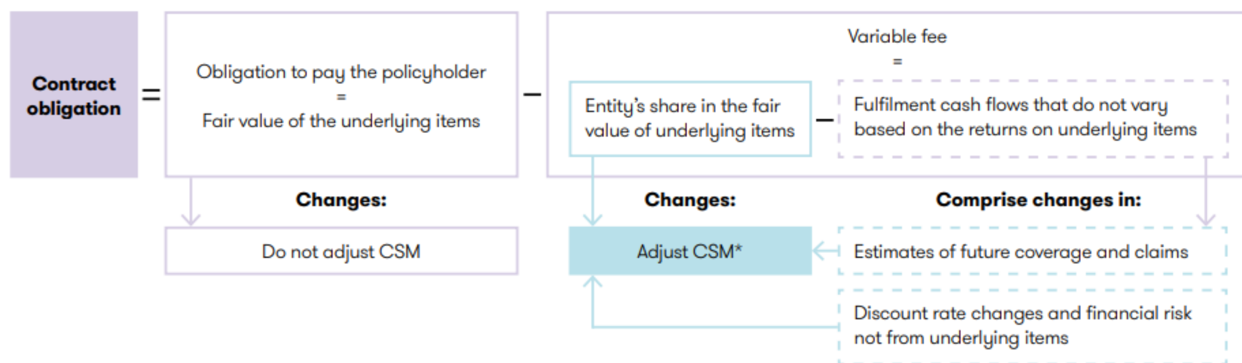
Some contracts may contain a discretionary participation feature in addition to the guaranteed elements. A DPF is defined as a right to receive an additional amount that is a significant portion of the contract, contractually paid at the discretion of the insurer and depends on the evolution of a pool of different contracts or instruments held by the issuer. That definition can be found in the Appendix A of the IFRS 17 standard.

In case an entity deals with a DPF insurance contract under IFRS 4, it can choose to recognize the guaranteed elements and the DPF separately or not. In the first scenario, the guaranteed element is recognized as a liability. In the second case, the whole contract is. If recognized separately, the feature is recognized as equity or liability depending on what it is but IFRS 4 does not provide guidance therefore except for features that are derivative which are accounted for under IAS39 or IFRS9. The entity must use consistent policies for that split, though the consistency across subsidiaries is still wishful thinking. The entity's accounting policy must continue to apply for such contracts unless a change complies with the explanation described above in the "changes in accounting policies" section. The revenue recognized for parts of the contract that are guaranteed elements or feature classified as liability are in profit or loss whereas parts relating to feature classified as equity are as allocation of profit or loss and not as income or expense, respecting the classification as such. (paragraph 34 of the IFRS 4 standard)

A specific model is also used for contracts with discretionary participation features under IFRS 17. Those are defined as contracts where the policyholder participates in a clearly identified pool of items, the entity must pay an amount depending on the fair value of said items and the amounts to be paid mostly vary with the fair value of the items. (PwC, June 2017)

The image below explains how the entity shall measure the value of its obligation towards the policyholder and how changes in the different parts should be accounted for following the variable fee approach (VFA) :

Figure 2 : Variable-fee approach



[11]

If an entity uses a derivative to mitigate risk, the variation for the derivative is recognized in profit or loss. In the meantime, the consequent variation of the share of the entity's fair value of the underlying items or the effect of financial risk of the fulfillment cash flows should be recognized in the CSM, creating an accounting mismatch. Therefore, IFRS 17 allows for those elements to be recognized in profit or loss if the risk policy is documented and the link between the derivative and the insurance contracts exists. That is called the risk mitigation option. (KPMG, July 2017)

Accounting for such contracts under IFRS 4 lacked anything near transparency, relevancy and comparability. Here with IFRS 17, a defined model exists and lets this kind of contracts to be accounted for in a clearer framework even though the judgment used to determine which model is of application and whether or not to use derivatives might result in some differences.

3.3.3 Reinsurance Contracts Held

The reinsurance contracts are accounted for as assets by the cedant (covered person) as a separate contract from the covered insurance contract. In that regard, IFRS 4 requires those assets to be impaired if necessary. If the paragraph 20 of the said standard is applied, a reinsurance asset is impaired if:

[11] Grant Thornton, June 2017 (pp.32)

- There is an objective evidence that the cedant may not receive all the amounts due under the terms of the contract or
- An event has reliably altered the amounts that the cedant might receive from the reinsurer.

Nothing additional is required by this standard beside some elements of disclosures that will be discussed in the dedicated chapter below.

Under IFRS 17, reinsurance contracts held are accounted for using the general model or the premium allocation approach only. The manner of calculating the contractual service margin and the fulfillment cash flows are similar at one big exception: the CSM will exist to report a loss as well as a profit, whereas for insurance contracts, it would only depict future profits. Loss that are related to events that happened in the past may be taken into profit or loss immediately. (Grant Thornton, June 2017)

The RA in the case of reinsurance contracts held is defined as "the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts" (paragraph 64).

The phenomena explained above as well as others may cause accounting mismatches. It is the case if the models used to measure the reinsurance contracts held are different from the ones for the underlying insurance contracts issued and if the coverage periods are different. (PwC, June 2017)

Furthermore, for the changes in fulfillment cash flows of an underlying contract that do not adjust the CSM, the corresponding changes in the cash flows of the reinsurance contract are directly recognized in P&L reducing the impact of the change on the profit. Some actual practices will also be abolished thanks to this new model like recognizing a gain on reinsurance on an onerous underlying contract. The impairment required in IFRS 4 is also roughly recreated here with the risk of non-performance (credit loss) of the reinsurer taking its place. (KPMG, July 2017)

3.4 Presentation

The objective of this chapter is to compare the requirements in terms of presentation of insurance contracts between the two IFRS norms. First, in terms of financial position and then in terms of financial performance.

3.4.1 Financial Position

Not much information is given in IFRS 4 when it comes to presentation of financial statements. Following its guidance, an entity shall not offset reinsurance assets held against the insurance liabilities that they cover, or recognize a provision for claims arising from non-existing contracts.

Under IFRS 17, groups of contracts shall be grouped under 4 different sections: insurance contracts that are assets or liabilities respectively and the same separation for the reinsurance contracts held. The acquisition cash flows will be taken into the carrying amount of the groups to which it is attributable. That principle of presentation can be found in the paragraphs 78 and 79 of the standard.

It means that groups of contracts are presented on a net basis and that no information for the subparts (like the CSM) is required to be presented in the balance sheet of the financial statements. Still, no prohibition is in existence for insurers to present more lines than the required minimum as it is stated in IAS 1 that additional headings, titles and totals can be relevant for an understanding of the financial statements. It leads to the fact that insurers will need to keep tracking disaggregated cash flows and elements useful to the measurement per group of contracts which might be difficult. (EY, May 2018)

It will be very dependent on the practical things that were used by the insurance companies under IFRS 4, case per case, but here is an illustration from EY that summarizes how the number of elements to present will lower :

Figure 3 : Summary of change in presentation

How presentation will change: Statement of financial position

IFRS 4	IFRS 17
Assets	**Assets**
Reinsurance contract assets Deferred acquisition costs Value of business acquired Premiums receivable Policy loans	Reinsurance contract assets Insurance contract assets
Liabilities	**Liabilities**
Insurance contracts liabilities Unearned premiums Claims payable	Insurance contracts liabilities Reinsurance contracts liabilities

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3.4.2 Financial performance

In the same way as for the assets and liabilities, the income and expense of a reinsurance contract shall not be offset against those of the related insurance contracts under IFRS 4.

As written in the paragraphs 80 and 82 of the IFRS 17, an entity shall disaggregate its profit or loss and OCI (the sum being the statement of financial performance) into insurance result (insurance revenue and insurance services expense) and insurance finance income or expenses. Furthermore, the amounts arising from reinsurance contracts held and from insurance contracts issued shall be distinguished from each other.

The entity recognizes as revenue the amount that he considers being entitled to for the provision of services and coverage during the period. In accordance with IFRS 15, when a service is provided, the entity derecognizes the performance obligation that it has (which here is the liability for remaining coverage) and recognizes revenue that is in relation with the service. The changes in risk-adjustment related to the services provided during the period and the allocation of the CSM for the period, are also recognized as insurance revenue.

[12] EY Germany, 2018 (pp.75)

This will be a change in regard to current practices which are considering in many places that received premiums during the period equal revenue. This is no longer the case here and it is in fact concordant with the requirements of IFRS 15 on contracts with customers when it comes to revenue recognition. (EY, May 2018)

When it comes to the changes in the RA, it might not be possible to split the changes between the effect of time value of money and financial risk (insurance finance income or expense) and adjustment for services provided in the period (insurance result). In that case, like explained at the paragraph 81, the entire change shall be taken into insurance service result.

The insurance service expenses will encompass :

- The liability for incurred claims and the changes related to the cash flows for past services;
- Moves in the loss component for onerous contracts (recognition and reversal of such losses);
- The amortization of insurance acquisition cash flows.

The difference between both those elements (insurance revenue and services expense) makes for the insurance result.

For reinsurance contracts held, payments from the reinsurer and premiums paid to it can be presented in two different manners: on a net basis or with a separate line for each of those items. If the second solution is chosen, the cash flows that are contingent to claims on underlying contracts shall be distinguished from those who are not and who just diminishes the premiums paid to the reinsurer. (PwC, June 2017)

The next part of the statement of financial performance is the insurance finance income or expense which depicts the change in the carrying amount of a group of insurance contracts for time value of money or financial risks, with the exception of changes in the entity's share in fair value of underlying items under the VFA which are in the services provided.

These changes can be taken entirely in profit or loss or they can be dispatched between profit or loss or OCI. That decision should be applied at the portfolio level.

If an entity has a contract with DPF's and the entity holds the underlying items, then the entity shall recognize an amount of insurance finance income or expense that eliminates mismatches between

the contract liabilities and the underlying items. In other cases, it depends on whether the changes in financial assumptions have an impact on the amount paid to the policyholder. If no, the normal approach with a discount rate determined at initial recognition is used. If yes, then, a systematic allocation of the revised amount shall be recognized over the course of the contract. (KPMG, July 2017)

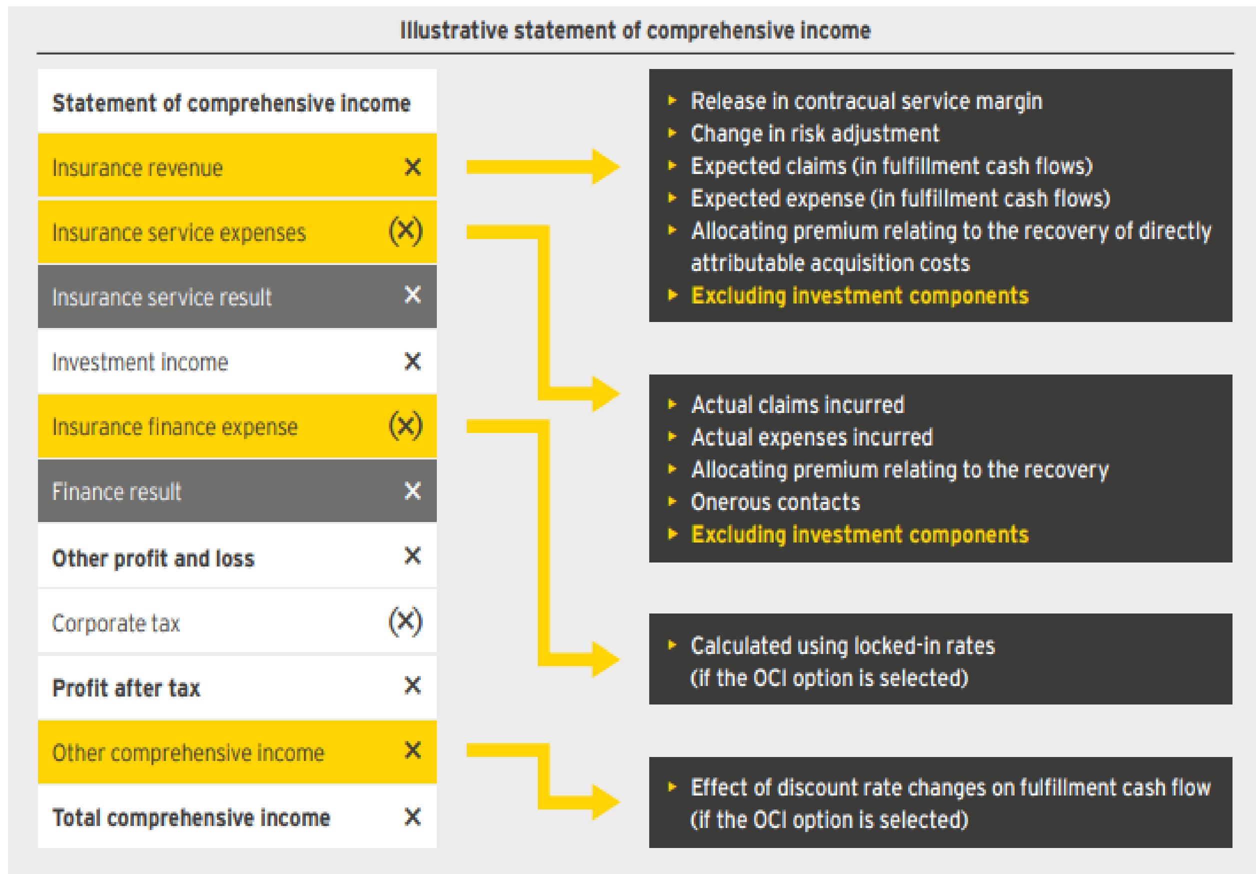
As stated in the paragraph 90, the difference between these amounts and the one recognized in P&L is recognized in OCI. The difference in OCI is not reclassifiable if the difference arises from avoiding a mismatch with underlying items held.

As a reminder, IFRS 9 which determines the possibilities for financial assets, allows different manner of measuring them (cost, FVTOCI, FVTPL) and this makes the look for different combinations with the possibilities for insurance liabilities, a stake of the new norm, to avoid accounting mismatches in profit or loss (or to minimize them). Additionally, harmonization between subsidiaries might be difficult but required to know what to apply to which portfolio and to put this together. Hence why, IFRS 17 and 9 can be transitioned towards together. (PwC June 2017)

The presentation requirements in the statement of financial performance are much wider than under the previous standard as you can see in appendix 4. Yet, it also brings difficulties in separating the changes in the different components over the course of the contracts which might cause problems in the application of the requirements.

Similarly to the graph used in the previous section, the one below depicts how the P&L (+OCI) should look like under IFRS 17 :

Figure 4 : summary of the P&L



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[13] EY Germany, 2018 (pp.73)

3.5 Disclosures

This chapter is going to compare the requirements in terms of disclosure between IFRS 4 and IFRS 17. Those should be widely similar since the point of IFRS 4 was to improve disclosures while IFRS 17 was more solely focused on putting together a consistent framework of measurement and reporting.

The disclosures required in IFRS 4 are structured in two major themes which are the explanation of the amounts in the financial statements (logical since the standard is not very detailed on the policy to use to measure the items relating to insurance contracts), and disclosure on the uncertainty and timing of future cash flows.

For the first part, it requires, as stated in the paragraph 36 of the IFRS 4 standard to disclose in the notes:

A. The key amounts of liabilities, assets, income, expense and cash flows related to insurance contracts and the relevant accounting policies to measure those items.
B. The key assumptions and policies used to determine the assumptions and the process to get to those, as well quantified disclosure if possible. The relevant assumptions might be plenty and thus costly to disclose. Hence why there is a focus on the process to get the most important assumptions. Quantitative disclosures might encompass discount rates, for example.
C. The changes in said assumptions and the material effects of such changes on the financial statements.
D. A reconciliation between the start amounts and end amounts of the items described in point A.

In that regard, in the specific case of reinsurance contracts held, an entity shall disclose gains and losses from reinsurance and if they amortized the assets under their accounting policies (which is free to do or not), the amounts of those that are amortized and unamortized at the start and end of the period. (O'Shea and Ruparelia, 2005)

The second principle of disclosures is to disclose about the future of cash flows and precisely about the uncertainty of their timing and amount. In a clarification in the basis for conclusions (BC216 of the IFRS 4 standard), the board of the IASB indicated that it was a disclosure about the cash

flows and not of the cash flows. Systems to be able to predict cash flows in a precise manner are not the intent of the first phase beyond the necessary ones for the liability adequacy test (see the chapter about measurement above).

That principle requires disclosure about:

A. The terms and conditions that have an effect on the insurer's cash flows.
B. Interest rate risks for insurance contracts and derivative that are not accounted for at fair value (following the possibility in the standard).
C. Different information about insurance risk, namely :
    1. What the insurance risks arising from the activity is and the policies used to mitigate them.
    2. The concentration of such risks.
    3. A sensitivity analysis of all variable that can have an impact on the net income reported and the measurement of insurance assets and liabilities. (In addition to the strengths and limits of this analysis) (O'Shea and Ruparelie, 2005)
    4. The claim developments comparing estimates with currently arising claims, all the way back to the claims for which there still exists uncertainty and not further. (Paragraph 39 c. of the IFRS 4 standard)

Under IFRS 17, the disclosure requirements are revolving around the same themes as for IFRS 4. According to the paragraphs 93–96, an entity shall give information in the disclosures about:

- An explanation of the amounts recognized in the financial statements;
- The judgments made when applying the standard and the changes therein;
- The nature and amplitude of risks of contracts falling under the scope of the standard.

Those themes are very similar to the ones under the previous standard but are completed by a consideration for the level to which they have to be given. It is specified that less is more when it comes to the relevancy of the information and that contracts with different characteristics shall not be considered together when it comes to disclosures (paragraph 95). Examples are given as to what can be a satisfying level of disaggregation for the disclosures like the type of contract or the geographical area.

This can bring a difference in terms of detail required to comply with the new standard since even though the elements to disclose are the same, they might have to be broken down into multiple levels or segments which render the work more difficult. (KPMG, July 2017)

But when diving deeper into the requirements of the norm, are they really similar to the previously required ones?

The information about the amounts in the financial statements shall show a reconciliation between the opening and the closing balance for the elements that have an impact on the carrying of the groups of contracts presented in the balance sheet. These changes in the elements to the insurance liabilities provide insight on the result presented for the period (for example what CSM is recognized in the period or the amount of incurred claims).

To get to this, the entity shall present the changes in terms of:

- Liability for incurred claims, liability for remaining coverage and loss component. The changes are attributed to those elements and then to the total liability (reimbursement of investment component, reversal of losses, unwinding of discount…) or
- The building blocks as defined in the general model (FCF, RA and CSM), which are adjusted for changes for current, past and future services, attributed to each element.

Both these methods should lead to the same total liability obviously. Separate disclosures are required for reinsurance contracts held and insurance contracts issued.

When the PAA is applied, disclosures should be made about the revenue recognized and still to be recognized as well as the consequence of newly recognized contracts on the statement of financial position. The entity shall also disclose how it meets the criteria for applying this model as well as its policy choice relevant to it (acquisition cash flows and time value of money as explained already in the previous chapters). (KPMG, July 2017)

According to the paragraphs B110–113 and B115 of the IFRS 17 standard, an entity shall also disclose relevant information for the users of its statement to understand the disaggregation of finance income and expense between OCI and P&L. Further disclosures are also required for the VFA regarding the underlying assets and the changes in fulfillment cash flows that do not adjust the CSM (disclose the effect).

The second part of the disclosures treats of significant judgments made in applying IFRS 17. In short, an entity shall disclose the methods and inputs (including quantitative information if possible) to measure the carrying amounts of contracts as well as changes and related impact in these methods. It shall additionally show how it determines discount rates, investment components and the disaggregation of finance income or expense between OCI and P&L. The method to determine the risk adjustment for non-financial risk and time value of money must be disclosed as well as the confidence level related to the results. The yield curve that is used to discount cash flows (if relevant) must also be disclosed.

It is not explicitly required to disclose accounting policies as under IFRS 4 but IAS 1 requires to disclose the significant ones regardless. (EY, May 2018)

The last theme over which disclosures are required under IFRS 17 relates to the risk and uncertainty related to cash flows arising from the insurance contracts. The entity shall disclose the risk itself, how it affects the cash flows, how it is measured and managed and specifically if the risk management changes. The concentration of risks shall also be disclosed.

At least, minimum disclosures should appear regarding :

- Insurance risk and market (financial assets) risk with a sensitivity analysis and a claim development (idem than under IFRS 4);
- Credit risk with amounts representing maximum risks and disclosures representing credit risk for reinsurance held;
- Liquidity risk related to cash outflows payable within five years. (PwC June 2017)

The disclosures required under IFRS 17 are usually more important than IFRS 4 but it needs to be stated for each part of the new models which justifies the size of it. All in all, the disclosures are following the exact same pattern and will possibly result in similar contents with the exception that the information must be much more granular.

This conclusion is also shown in the illustration document from PwC (2019). Most of the disclosures that are required under IFRS 17 are always either :

- Developments of what was asked under IFRS 4. For example, the sensitivity analysis is now expanded into two categories; one for assets, the other for market risks linked to the insurance contracts that are issued. (chapters 128-129) or
- New elements that come from the fact that specific elements of IFRS 17 did not exist under IFRS 4. For example, disclosures linked to the OCI option or terms that were not defined under IFRS 4 like insurance revenue. This remains in the same spirit as what was required under IFRS 4.

Very few elements are new. The impact of newly issued contracts in the period is the one that is the most likely of having a significant influence on the insurers.

3'. Amendments

IFRS 17 is a standard that got a lot of different amendments on various topics and that will be discussed appropriately with the due process. Since the amendments are happening during the writing of this master's thesis, the comparison between IFRS 4 and 17 has been done with the version of IFRS 17 available as of May 2017 and the impact of the amendments might be discussed afterwards if necessary. These amendments will be submitted to a public-comments period after an exposure draft is published in April 2019. The proposed amendments following the board's meetings include these discussion topics:

- Aggregation of contracts in the balance sheet at the portfolio level and not at the group level, allowing offsetting between groups within a same portfolio for simplicity purposes (IASB, December 2018);
- Two changes in regard of reinsurance contracts held to avoid accounting mismatch between the reinsurance contract and the underlying contracts issued, a change of allocation of the CSM for DPF contracts with the apparition of investment return service (new concept), the possibility to allocate cash flows to renewals of insurance contracts and recognize them as assets until the renewal can be effectively recognized (IASB, January 2019)
- A change in some types of loans with a limited insurance coverage, making them accountable with IFRS 9 or 17 (irrevocable choice) and one of the modified retrospective approach to allow firms unable to get necessary data to keep both liabilities from issued or acquired contracts under the same column (IASB, February 2019)
- An exclusion from the scope of the norm for some credit card depending on a criterion regarding the insuring character, changes regarding the transition regime with the risk mitigation option (applicable prospectively or at the earliest retrospective period published) and the fair-value approach, plus disclosure requirements in regard to the cash flow linked with contract renewals as discussed above (IASB, March 2019)
- A new clearer definition of an investment component (= the amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances) and clarification over other measurements such as CSM and insurance cash flows (IASB, April 2019)

At last, the exposure draft of June 26, 2019, contained changes regarding:

I. Scope exclusions for credit cards and some types of loans transferring significant insurance risks (accountable for under IFRS 17 or 9), as per the project of norm including the amendments from the IASB. (June 2019)
II. Risk mitigation option being available for reinsurance contracts held as well as the possibility to recognize a first-day gain on reinsurance contracts held;
III. The possibility to present contracts in the statement of financial position per portfolio of insurance contracts and not per group (as it should be for measurement);
IV. Insurance acquisition cash flows for contract renewals;
V. The possibility to allocate the CSM on the basis of the coverage units related to both insurance coverage and investment-related services. Additional disclosures thereabout could be added as well;
VI. Simplification of the transition reliefs regarding the risk-mitigation option used prior to the transition and the possibility to use the fair value approach in case such an option is elected, as per the draft of the amendments from the IASB. (June 2019)

Those amendments are expected to be done mostly to avoid mismatches and inconsistency in the accounting for some practices (like risk mitigation for reinsurance contracts and profit recognition for investment-related services). Otherwise, it mostly simplifies and reduces the costs of the new standards for the insurers that need to apply IFRS 17 and even avoids some non-targeted entities to be hit by the standard (with the scope exclusions). The simplification of the presentation may bring some shadier statements with groups being presented and offset together.

These amendments represent most of the concerns that were raised by the relevant stakeholders. Therefore, they are considered sufficient to address them. They are very targeted at specific points of the standard and do not bring fundamental changes to the principles of accounting for insurance contracts, which, given the difficulty of it, is important because it would make the implementation more volatile. The application date has already been delayed and would probably need to be again if the amendments were too big, as per the snapshot realized by the IASB. (June 2019)

These amendments are open for comments until September 2019 and subsequent developments will happen, with expected final amendments being released in mid-2020. (PwC, October 2019)

During their November and December 2019 meetings, the IASB has decided to confirm part of the amendments that were discussed in the previously mentioned exposure drafts. The confirmed amendments concerned the scope exclusion for loans, the change of principle for DPF when it comes to the coverage leading to taking profit into P&L, the presentation at a portfolio level, the risk mitigation option with reinsurance contracts held and transition procedures that were discussed. (PwC, December 2019)

4. Links with Other Regulations

Both examined standards are linked with other specific norms or regulations that the affected companies have to work with. Therefore, an examination of those links is needed. The link with IFRS 9 has been hinted at previously but will be specifically talked about here as well as in more details. The other regulation, solvency II, is about provision requirements for insurers, which thus have to combine these requirements with IFRS's. Some concepts are pretty similar and may be used in both cases with adjustments. A distinguished sub-chapter is explaining how it is relevant.

4.1 Link Between IFRS 17/4 and IFRS 9

As a reminder, the results from insurers come from the variation of the value of their insurance liabilities (developed heavily in the previous chapters) and of their financials assets, those possibly backing the aforementioned liabilities. The standard that regulates the accounting for financial assets was IAS 39, which was replaced with IFRS 9 for 1 January 2018. This replacement could lead to changes in the way those assets are accounted for and also to accounting mismatches between the insurance liabilities (currently under IFRS 4) and the financial assets which saw their accounting models revised. To avoid this mismatch, two possibilities were left open for insurance companies :

- An exemption to the application of IFRS 9 until the new standard on insurance contracts is applied (that being January 1, 2023).
- An overlay approach that makes adjustment between the P&L and the OCI to represent things as if IAS 39 was applied for eligible financial assets. (Longerstaey, 2019)

Those solutions to the accounting mismatches arising from IFRS 9 are only available for insurance activities. It means that companies whose core business is not insurance are not allowed to be exempted from the application of IFRS 9. This exemption has an impact on the entirety of the financial assets of the examined entities. Since it is supposed to be helpful for insurance companies, allowing it for companies who are not in accordance with this criterium is not the goal of this exemption.

Still the overlay approach can be used for all assets that are backing insurance activities (it's not a complete exemption obviously) and who are measured at FVTPL under IFRS 9 and that would be accounted for following a different method under IAS 39. If they were accounted for in the same

way, such an approach would not make sense, as stated in the project summary of September 2016 of the IASB regarding interactions between IFRS 9 and 4.

Practically, the overlay will be characterized by a statement of profit or loss and other comprehensive income that will be the same as if IFRS 9 had been fully applied with a line on each statement that would be the difference between the amount of P&L that should be recognized with IFRS 9 and the amount that would have been recognized, had IAS 39 still been applied. This amount allows the volatility arising from the new standard to disappear from the P&L. Additional disclosures explaining the changes in the financial statements are also required. (Grant Thornton, July 2016)

Under IFRS 9, multiple models can be used to account for financial assets, from FVTPL/OCI to amortized cost. Those methods will have various impacts on the statement of profit or loss. Therefore, choosing the right method that would present the best P&L, depending on the variation of the insurance liabilities is possible and can be used to present a better performance. This being limited depending on what instruments are on the balance sheet (→ SPPI test) with not every option being available.

Furthermore as already explained in the presentation of financial performance, the amount of insurance finance income or expense can be split between OCI and P&L. In case the entity holds the underlying items of a direct participating contract, the discount rate used to determine the two amounts eliminates the mismatches. If not, then the amounts recognized in P&L and OCI depend on interest rates not linked with the assets. (KPMG, July 2017)

Therefore, for insurers, the challenge arises for two separate reasons :

1. The new IFRS 9 will have an impact with the new business model tests and SPPI tests, possibly making big changes in the balance sheet and P&L, which need to be evaluated.
2. The asset management even beyond the first point, will need to be careful to match the changes in P&L and OCI as properly as possible to avoid performance being reported in different ways and different places of the financial statements. (Deloitte, 2017)

This is even truer in case the entity elects for the overlay approach, with the adjusting line bringing another element to consider when managing assets.

Granted most insurance companies hold bonds as assets backing their insurance liabilities (Deloitte, 2017), the SPPI test should be a pass for most of these items. As a reminder, under IFRS 9 paragraph 4.1.7, if a financial asset is not characterized by cash flows that are solely the payment of interests and of the principal amount, then the business model test is not relevant and the assets should be accounted for using the fair value to P&L model. For such items, the balance sheet as well as the P&L will be matched as long as the insurer does not elect for the OCI option regarding finance income or expense.

The trick exists for items that pass the SPPI and that is where the evaluation of the business model takes an important role. Agreeing to the chapter 4.1.2 of the IFRS 9 standard, one entity can have multiple business models depending on the management of different groups of assets to get to the objectives. This makes leveraging possible depending on which assets are managed and how they are managed.

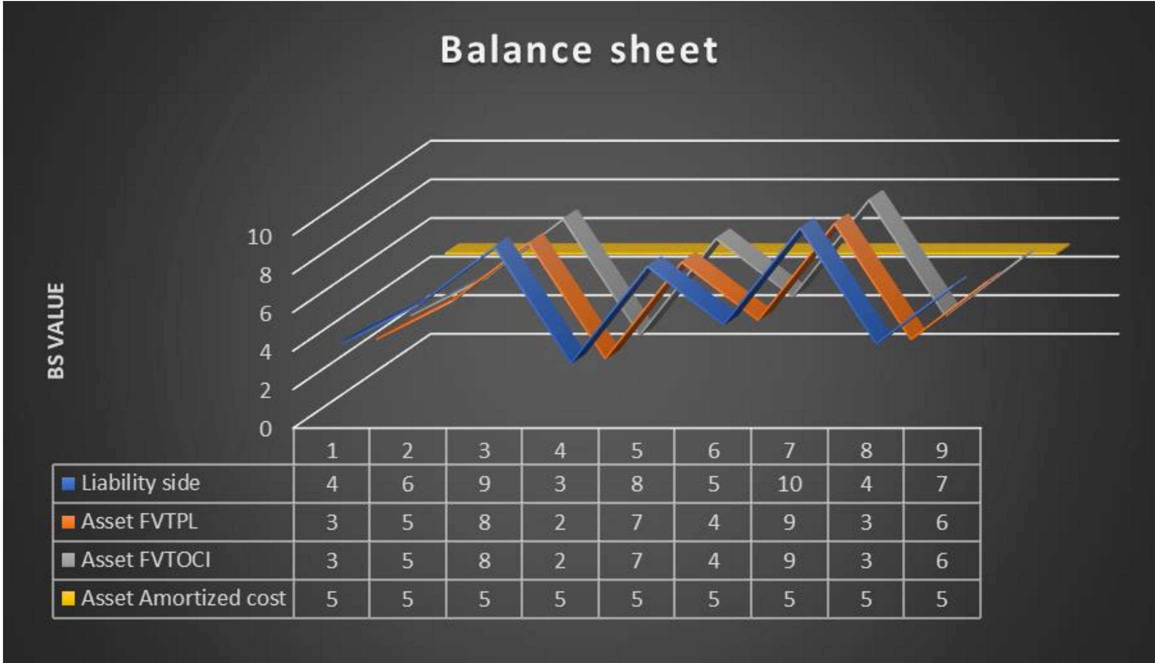
According to the chapter 4.1.4 of the IFRS 9 standard, if the business model is to hold financial assets to collect cash flows, amortized cost can be used as a model to account for the items. If both collecting cash flows and selling items is the business model, then FVTOCI can be used. In the case where selling assets is your business model, FVTPL is the designated model to use. An option of FVTPL can also be used irrevocably at initial recognition to account for items if and only if it allows eliminating accounting mismatches. That possibility can clearly be helpful since the FVTPL is a model that would fit very well with the measurement of insurance liabilities.

Indeed, the amortized cost would mean that the value of the asset would not change in the balance sheet because of changes in the interest rates, which would affect the liability side. That change in the value of the insurance liabilities would be either recognized in P&L or in OCI depending on whether the OCI option is used or not, but either way, no change in the asset value would come in counterpart (except for the amortization which could potentially make the mismatch even bigger).

As for the FVTOCI model, it could be used if the OCI option is elected in the liability side. Indeed, both side of the balance sheet would fluctuate together and the changes would be recognized potentially both in OCI.

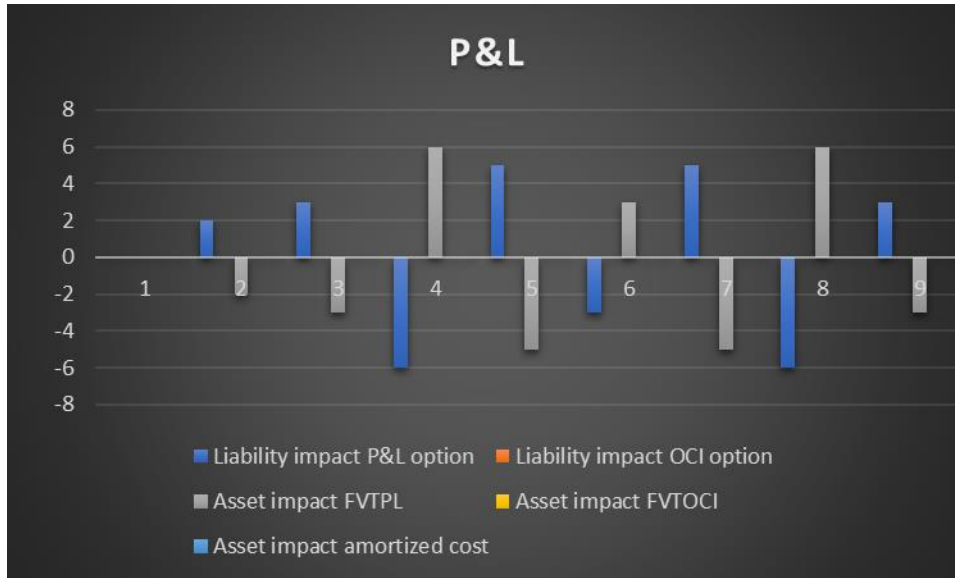
In conclusion, the FVTPL is probably the go-to model to easily match the general model of IFRS 17 but there is another possibility with OCI when the conditions and criteria in both standards are met. That is summarized in the self-produced graphs below, which only take interest rate variation into account, not potential depreciation :

<u>Graph 3 : Impact on the balance sheet depending on the models used</u>

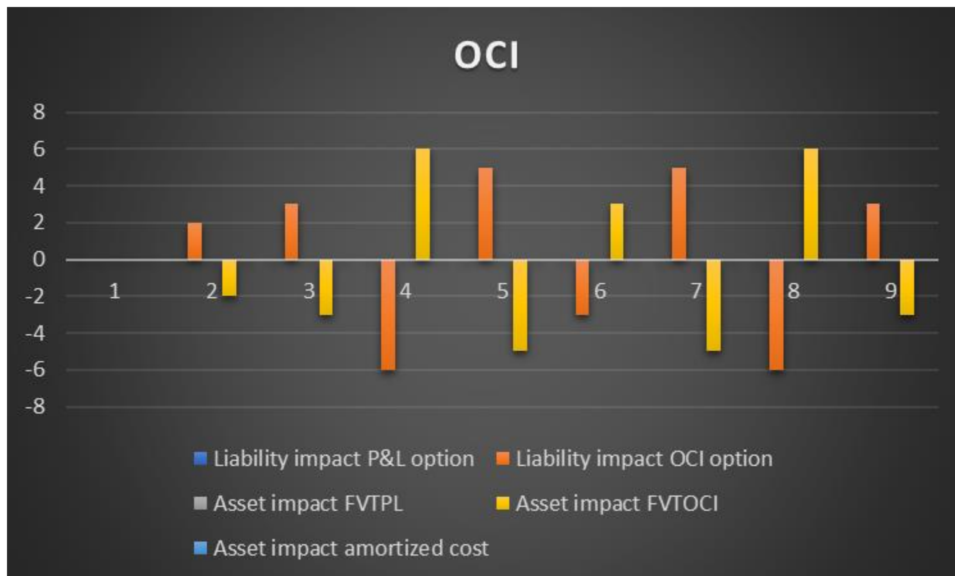


	1	2	3	4	5	6	7	8	9
Liability side	4	6	9	3	8	5	10	4	7
Asset FVTPL	3	5	8	2	7	4	9	3	6
Asset FVTOCI	3	5	8	2	7	4	9	3	6
Asset Amortized cost	5	5	5	5	5	5	5	5	5

Graph 4 : P&L impact depending on the models used



Graph 5 : OCI impact depending on the models used



As for the equity instruments, the accounting method to account for these instruments is FVTPL according to paragraph B5.2.3 and 4.1.4. As we have already discussed above, that method can match the insurance liabilities if the value of the equity instruments and of the insurance liability

change simultaneously but that could be less straightforward than for debt securities which varies depending on interest rates, just like insurance liabilities. Either way, FVTOCI is also an irrevocable possibility at initial recognition for equity instruments and the same reflection as with FVTPL can be made.

We can say that the choices that one insurer will make as to how he accounts for financial instruments will have an impact on how the P&L and OCI statements will be impacted and to what measure mismatches will arise or not.

One thing that can create volatility accounting wise to reduce economic volatility is a derivative. The goal of such items is to cover the entity for changes in the underlying assets or liabilities they may hold (typically a financial asset in the case of an insurance entity here) . That is referred to as hedging. Most derivatives are accounted for at FVTPL. Yet in case of a hedging relationship that meets the criteria of IFRS 9 (for fair value hedge : 6.5.8, cash flow hedge : 6.5.11 or hedge of a net investment in a foreign operation : 6.5.13/14) the hedging item can be recognized at FVTOCI. (Stempnierwsky, 2018-2019)

That is, of course interesting to eliminate volatility with the financial assets alone but in our case of an insurance company, that would make the changes in value of the underlying insurance liability unbacked by anything. If those changes are positive or if the insurance contract himself is covered by a reinsurance contract, that could be a minor impact but that is a choice that needs to be made (and thought) at the level of each entity, taking all the possibilities into consideration.

4.2 Link with Solvency 2

First things first, the recent regulation Solvency II and the new accounting standard IFRS 17 are not conceived for the same purpose. On the one hand, Solvency's goal is to provide a safe character regarding the capital of insurers. It requires minimum levels of capital and provisions depending on all the contracts issued by the insurers with an emphasis on economic representation of the entity, focusing thus on the balance sheet.

On the other hand, IFRS 17 is an accounting standard whose goal is to set a common framework of financial reporting regarding insurance contract within its scope only. Furthermore, beside that scope difference, IFRS also cares about financial performance reporting with the income statement, profit or loss and OCI. It implies specific requirements that are not part of Solvency II. (Desroches, 2017)

When it comes to the measurement model and some disclosures, these norms share some similarities regarding the overlapping parts of their respective scope:

- The valuation of the contracts will both be calculated using present value method and under the risk management of the entity, with the entity's judgment and assessment of risk being used. (Hein, no date)
- Both measurement models are based on the cash flows that can arise from the contract (or portfolio of contracts) evaluated. While the cash flows are not 100% similar (example: acquisition costs in IFRS), the principle of calculation remains the same.
- Both models include risk adjustment in their respective models. Once again, the risk defined in Solvency II is not exactly the same as in the new standard IFRS but could serve as an approach to calculate the risk adjustment needed for the measurement in IFRS by erasing the general operational risk and financial risk since the IFRS risk adjustment is supposed to represent non-financial risks.
- Also for the disclosures, the information that needs to be presented under Solvency II will overlap some of the needed information under IFRS 17. In a similar way as for the other elements, the similarity might make it possible to use the experience from the earlier application of Solvency II to be in compliance with IFRS 17.

Of course, the fundamental differences between Solvency II and IFRS 17, in terms of purpose, as already explained, make some differences arise regarding the concepts as well. They mostly appear

due to the fact that IFRS 17 requires additional elements in regard to financial performance, income and expenses about the insurance contract, that are not pertinent in regard to Solvency II. This is noticeably the reason we find the CSM (contractual service margin) in the accounting standard and no such concept in the solvency regulation which is not a performance-driven regulation. (PwC, September 2017)

Other differences that can be included in this consideration are :

- Different grouping of contracts under IFRS and Solvency II with IFRS being more granular by requiring different categories of contracts within one portfolio (see in the recognition part).
- There is no separate model in Solvency II compared with the PAA or VFA in IFRS 17, nor does the Solvency regulation make any difference between issued and acquired insurance contracts.
- The concept of modification of a contract is also exclusive to IFRS even though derecognition criteria are identical: obligations must be extinguished. (PwC, June 2017)

The requirements of the new standard being heavy and demanding to be met in time, Solvency II might be a helpful tool for some insurers. The models that arise from it might thus be used to assess and measure some aspects of the requirements from IFRS 17 but new models will still need to be developed in order to match with concepts like the contractual service margin, Solvency II being a useful tool already.

As for the elements that may be transitioned towards using the help of the solvency requirements :

1. The grouping of contracts under Solvency II can be used to a certain extent under IFRS 17. Solvency II requires insurers to make lines of businesses for their contracts, that being groups of contracts that are homogenous in terms of risks and are the basis of calculation for the further steps of the regulation. This definition of line of business is similar to the definition of a portfolio of insurance contracts under IFRS 17 even though it is required afterwards to differentiate between onerous contracts, non-onerous contracts and other contracts afterwards. The fulfillment cash flows under IFRS 17 can be calculated at whatever level as long they can be attributed to the groups.
2. Those fulfillment cash flows under IFRS 17 could be approximated using the best estimate liability concept under Solvency II. The best estimate liability and FCF are both required

to be calculated using market input but they do not cover exactly the same matter even though they give similar results. The administrative overheads are also not always included for IFRS 17, neither are the payments of reinsurance. (European Insurance and occupational pension authority, 2018)

3. The discounting of the cash flows is required in both standard. IFRS 17 allows for two different approaches to determine the discount rate:
   a) Top-down with a rate based on a pool of items adjusted for mismatches and losses depending on the insurance liabilities considered.
   b) Bottom-up with a risk-free rate that is corrected with an "illiquidity premium" in order to better represent the insurance liabilities.

The data under IFRS 17 needs to be determined on a market basis. Out of those two approaches, the bottom-up could be approximated by the method for the discount rate under Solvency II. This method uses a risk-free curve of interest rates that can be adjusted for matching or volatility problems. The matching adjustment is similar to what is needed for the top-down approach and the risk-free curve with a volatility adjustment as defined in Solvency II approximates the bottom-up approach.

4. Lastly, for the measurement of insurance contracts, a risk adjustment for non-financial risks needs to be calculated, the concept is very similar to the one required under Solvency II and could probably be found using a similar method, that method being a cost of capital method that describes the cost of holding the required capital (which is an objective of Solvency II). (Visser and McEneaney, 2015)

The subsequent accounting requirements of IFRS 17 can't be implemented using Solvency II since it is not this regulation's main goal and there is thus no real concept that could be helpful to transfer the parts of the insurance liabilities in results depending on services provided or to separate LRC and LIC. Additionally, the CSM which is supposed to depict profitability over time does not exist under Solvency II and is the main representation of profit for IFRS 17 does not have an equivalent. Therefore, it is impossible to calculate or estimate it with Solvency II.

5. Practical consequences

5.1 Transition

As already stated in the prior chapters, IFRS 17 will be effective for the periods starting from January 1, 2023 onwards, meaning that the transition date is 1 January 2022, it being defined as the beginning of the period preceding the date of initial application. Furthermore, the delay for applying IFRS 9 has been augmented to the same date as for the initial application of IFRS 17.

Three approaches are applicable on the transition date to comply with IFRS 17: the full retrospective approach, the modified retrospective approach and the fair value approach. The full retrospective method should be used unless impracticable. Impracticability meaning that restatement is not possible because of the information not being available or the need of decision that would have been made at the time of inception of the contract, for example. Those options might lead to very different manner of measuring and presenting contracts depending on the available information and thus less comparable statements but the cost of using the full method right away would outweigh the advantages of using it.

The full retrospective approach requires the entity who uses it to:

- Recognize all contracts that it has issued in accordance with the new standard and derecognize any amounts that would not be present otherwise;
- The difference between those 2 moments shall be recognized in equity;
- The entity is exempted of disclosing each line affected in the financial statement and the effect on earnings per share, and is forbidden to apply the risk mitigation option for contracts with DPF's (see above) per paragraph C3-5 of the standard. (PwC, June 2017)

If the entity is unable to use this first approach, the entity can use the modified retrospective approach whose goal is to make the retrospection possible and as precise as possible with the information that are available without unnecessary effort or cost. To meet its goal, it allows for simplification related to different measurements or aggregation:

- For the grouping of insurance contracts, an entity may define insurance contracts and groups of insurance contracts with no more information than available and can aggregate contracts that are issued more than one year apart from each other if necessary.
- Multiple simplifications in regard to the calculation of the cash flows, discount rates based on the yield curve on spreads and risk adjustment for non-financial risks based on more historical data if such data are available for contracts without DPF's. Depending on the policies used to do so by the entities, this may result in significant differences in the financial statements.
- For contracts with DPF's, the CSM or loss component should be measured by adjusting the difference of the FV of underlying items and the fulfillment cash flows of the contracts by the amounts charged to the policyholder, amounts paid that do not vary based on the performance of underlying items and RA released before the transition date. This amount will be reduced by the part released over the course of the contract until now.
- When it comes to insurance finance income or expense with the modified retrospective approach, it depends on whether the examined group encompasses contracts issued more than one year apart:
    1. If yes, then the discount rate for future finance income or expense can be the one at initial recognition or at transition for incurred claims, and the cumulative amount of OCI at the transition date can be set to nil in most cases or apply the full retrospective approach except for contracts with DPF's where the entity holds the underlying items, in which case it is equal to the amounts recognized for those items in OCI previously.
    2. If no, the entity shall determine the discount rate for future finance income or expense the same way it determined others, using simplifications or not, and the amount recognized is the same for contracts with DPF's and for which financial assumptions have a significant effect on the amounts paid to the policyholder mentioned in the first case. For contracts applying the PAA and the general model, it should use a rate in accordance with the full retrospective approach or the modified retrospective approach.

Those simplifications shall be done using supportable and reasonable information in a manner that brings the results as close as possible from the objective; that is doing a full retrospective approach. Otherwise, the third approach should be used. (Ernst and Young, May 2018)

If it needs to use the fair value approach, an entity shall measure the CSM as the difference between the fair value of the group of insurance contracts and the fulfillment cash flows of the group. The division and characteristics of the contracts can be determined whether by using information available at the transition date or the date of inception of the contract. The calculation of such fair value is the challenge of this approach because it is fairly uncommon to need it. It is only used in business combination and does thus not happen every day. Furthermore, no valid market data really exists and other inputs will need to be considered while measuring the fair value. (Global public policy committee, 2020)

The determination of insurance finance income or expense is done using the discount rate at initial recognition or at the date of transition. The amount recognized in OCI is either calculated in retrospective manner if it is practicable or equal to the amounts in OCI for the underlying items if possible. Otherwise, it amounts to zero.

All in all, the relevant information needed might be difficult to obtain for any of those approach but especially for the full retrospective approach and for longer-term contracts which may have been issued a long time ago and for which relevant and supportable information may not be available right away, if at all. (KPMG, July 2017)

Specific disclosures are also required for the transition period before initial application of the standard. It shall disclose separate information in regard to CSM and revenue for contracts using the fair value approach and the modified retrospective approach, explaining the methods and judgments used to apply these methods. If the disaggregation between P&L and OCI is applied, the entity shall reconcile the opening and closing balance for OCI about related financial assets.

The entity will need to state comparative information with the transition period and any prior ones if it wants to. If the amounts for the preceding periods are not adjusted, it needs to be mentioned as well. (Grant Thornton, June 2017)

5.2 Operational impact expected and solutions by professionals in insurance and accounting

5.2.1 Financial statement

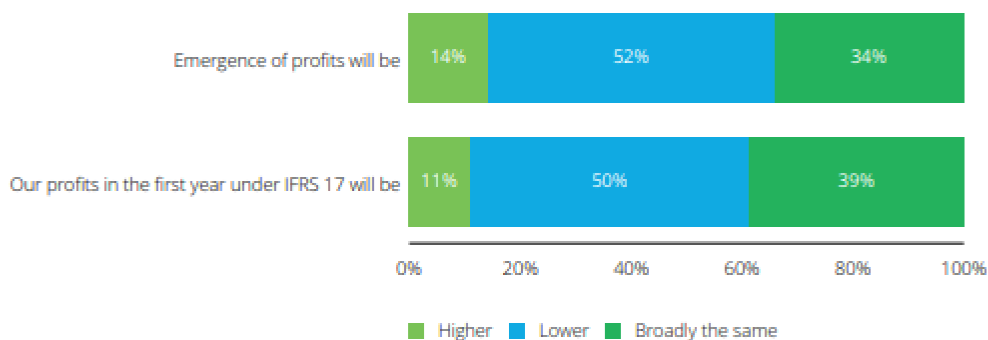
The financial statements under IFRS 17 will see wide changes in comparison with the previous ones, mostly in terms of performance and reporting of it, as we have heavily discussed above while comparing the models under IFRS 4 and 17.

The main elements that will have an impact are namely :

- The CSM which makes the profit being spread across the lives of the contracts. This makes the influence of the new business on profit less significant.
- The onerous contracts being measured at a more granular level and thus no longer being compensated with similar profitable contracts. Immediately recognized losses will also have a negative impact on the performance.
- The new financial statements will have, as a consequence, the need for new KPIS and ratios for financial analysis that will reflect the performance of the entity better than the previously used ones. (Deloitte, April 2018)

Overall, we can see that profit should be lower under IFRS 17 according to insurers in that survey from Deloitte:

Graph 6: Expected impact on profit in the financial statements



[14]

[14] Deloitte, 2018 (pp.23)

In this perspective there are multiple choices that will need to be made in the near future leading to the initial application of IFRS 17. The alignment between IFRS 17 and 9 is one of them. Indeed, there is a possibility that these two norms are applied and therefore, simulations and thoughts about business models and SPPI tests will be needed to see how the assets should be handled and how it will affect key amounts and KPIS as the CSM, equity, level of debt, … For instance, even some basic ratios that explain the performances of the insurance companies are going to be affected by all the new methodologies. Among others, the gross margin, ROE or the IFRS operating result will be affected by the new ways of accounting. Especially with the new manner of accounting for insurance revenue, which was explained above, the definition and thus the resulting indicators will be changed compared to what was done before, with revenue being previously considered in accordance with premiums due with some adjustments for reinsurance investment income. (EFRAG, October 25, 2017)

That aside, a focus should also be made on a new chart of accounts to base their new disclosures on. This is a necessity to ensure efficient disclosures to stakeholders reading the financial statements. Furthermore, stakeholders should be clearly informed of the impact of the new standard(s) applied and what impact it should have on the statement of financial position and on revenue and profit. (PwC, 2018)

So what financial elements of reporting should be impacted? According to the IASB study, beside obvious differences in terms of presentation, which have already been discussed, different factors will have an impact on the level of equity compared to debt. You can find a recapitulative table of those factors in appendix 5. In short, the more severe the currently used policies are in comparison with IFRS 17 (in terms of measurement of the liabilities and revenue recognition), the higher the reported equity post initial application will be.

The effect on revenue has been discussed: it should be spread overall more over the length of the contracts, but in that case, indicators of performance can be remotely different from what it was. For short-term contracts, the amount of premiums received will still be a relevant indicator but for longer-term contracts, the newly added CSM will be a measure of performance that will reflect the future revenue and profitability. For entities that issue both types, a combination of such ratios could be a good idea. Other typical ratios such as ROI, profit and the ratio of incurred claims per

premiums received could still be relevant. That is disclosed in the effect analysis document from the IASB (May 2017).

The financial statements that should all in all be more transparent and more comparable (with other users of IFRS) will also bring a case for a change in the product mix (as it will be discussed below) but also, since it will be easily more comparable, the cost of financing themselves might lower for insurers . Institutions as well as markets should have a more practical way of assessing companies and thus could lower the cost of those to raise money. A point can still be made that comparability with other non-IFRS users might be difficult, though. (Muller, Hausemer, Kàbrt and Pitton 2018)

5.2.2 Systems and Products

The second and last part focuses on the changes in systems and data. This part has also been quoted by the IASB to be one of the main focus points when it comes to cost of implementing the new standard.

Indeed, with the new norm and calculation methods, entities that apply IFRS 17 should see a need in data of all types to meet the requirements. Indeed, they will need them when it comes to cash flow estimates, yield curves for the discount and expected RA just to name a few. In that consideration, the need of managing these data as a true asset should be blatantly evident. This shows that the new standard may have an impact beyond the accounting or finance department; it will also have one on the development of the IT department. The calculation that will need to be done will also be based on actuarial models that are usually the job of an actuarial department, which will thus be part of the implementation.

The availability of systems and data - historical as well as current- is a stake that will impact multiple elements such as the data management but also the planning and reporting, the calculation of reporting elements (CSM namely) or the risk and governance policy. Insurers shall thus start to seek and find solutions to tackle all these problems. The processes used and management solutions would also impact their internal control quality which should be reviewed by the auditors when appropriate. (EY, 2018)

A solution or help that could be used to implement the new standard is the use of rates and elements of risks already in place for the regulatory framework Solvency II, as discussed in the "link with other regulations" chapter above.

The solvency framework can be helpful in terms of initial recognition with the principle of recognition of technical provisions being similar to the initial recognition of an insurance contract. Cash flows attributable to contracts are broadly similar at the exception of reinsurance which is accounted for separately under IFRS. The approach of the risk-free rate adjusted for volatility and matching to an asset spread volatility can be close to what IFRS requires but may need a slight adjustment in itself. Those are the main elements where Solvency II may be helpful in implementing the new standard, to calculate certain blocks in the measurement models. (EIOPA, 2018)

One last effect that can be considered regarding the application of IFRS 17 is whether or not the pricing of the insurance contracts or products as well as their availability could be in question for profitability and/or presentation problems.

A study of the EFRAG treated this topic and their conclusions were that in terms of pricing, questioned insurers would mostly not change their pricing policies but there is still a possibility that the new products proposed would be designed to avoid onerous contracts. Logically, it would be done in a concern of avoiding first day losses as required to do under IFRS 17. This would just give a bad picture of the entity since losses are now much more perceivable in the financial statements.

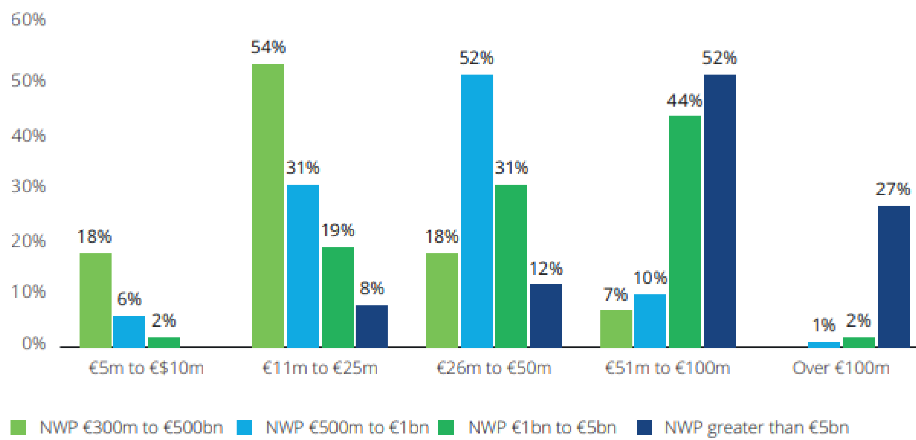
When it comes to the product mix, however, there may be some changes, namely in the longer-term contracts such as life contracts because they are more complex to manage and, due to their length, are riskier than short-term ones. The reduction of the mix by scrapping some products may also be a consequence of the granularity requirements. Indeed, the groups of products must be separated firstly by types of products, subject to similar risks and/or managed together. In that case, the more products you have, the more specific you need to be in your management of data. (EFRAG, September 2018)

In addition to that possible impact on the pure insurance product mix due to the clarity of the financial statements and its consequences beyond (like raising money), the application of IFRS 17

will have an impact on the assets – mostly composed of financial instruments- of the insurance companies. The manner of accounting for them will also change with the application of IFRS 9 and avoiding mismatches, along with more traditional asset and risk management may cause changes in the choices of assets. That is a case per case problem that needs to be evaluated within each entity. (Muller and al, 2018)

These efforts in reviewing technologies and models are expected to be very costly as this graph illustrating expected budget to comply with IFRS 17 shows:

Graph 7 : Total budget expected in terms of size of the entity



[15]

[15] Deloitte, 2018 (pp.17)

6. Intermediate conclusions and hypothesizes

First, let's take a reminder of what the initial objective was when this standard was issued.

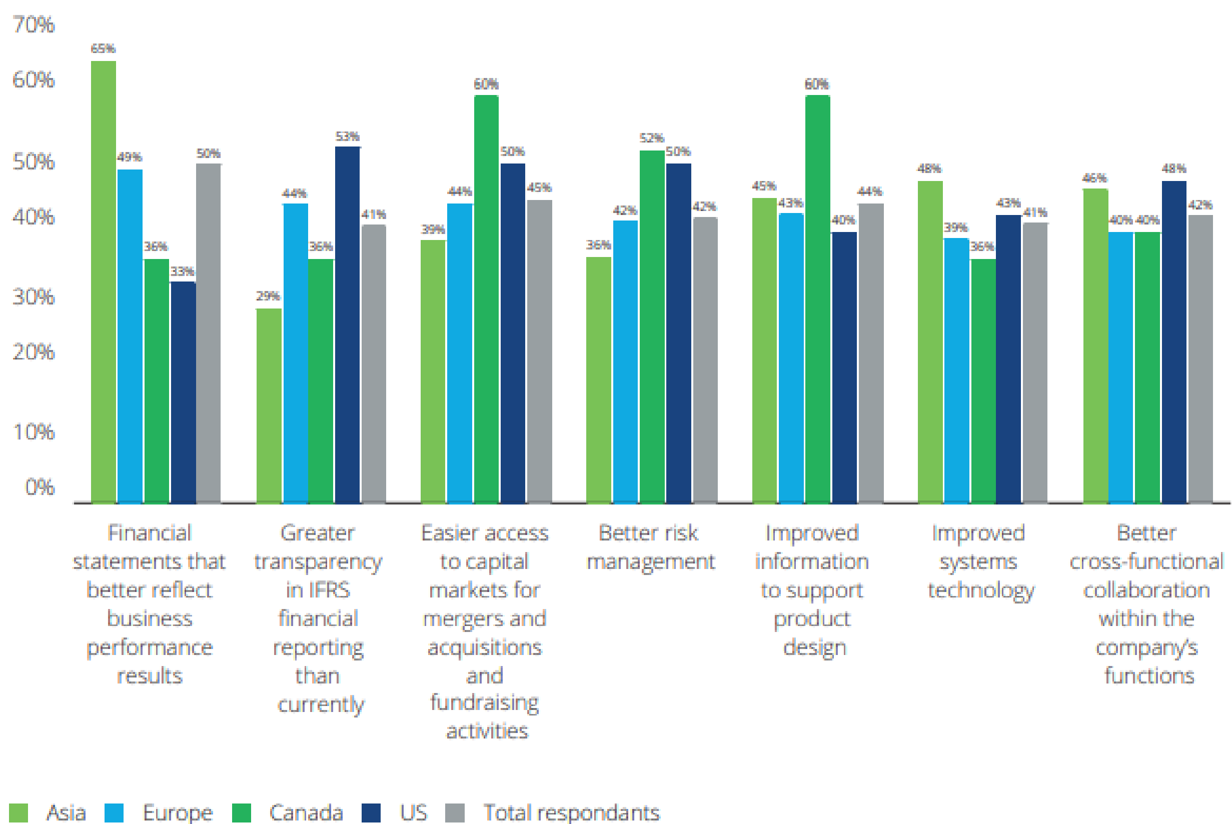
This standard is supposed, while superseding IFRS 4, to correct its flaws. It includes giving a consistent framework of accounting for insurance contracts. This consistent framework would provide more comparability since no side models and policies are allowed to account for with anymore. It is also supposed to increase the relevancy and transparency of the financial statements by eliminating the possibilities of using economically irrelevant policies and presentation, as well as aggregating non-profitable contracts with profitable ones to give a better, less faithful, image of the entity. (Even though that last advantage is reduced by the amendment regarding presentation per portfolio of contracts.)

Besides, the recognition of profit is changed to be closer to the way IFRS 15 (contracts with customers) requires it to be: recognize profit during the period in which services are provided. It is done through the CSM when the contract is profitable. This element while having an impact on reported profit, will make the future profit for currently issued contracts clearer and should be beneficial. Those expected impacts are explained in the project summary from the IASB (May 2017).

In the organizational side, we saw that technologies will need a change as well as models, data and people management. According to a study from Deloitte, people from multiple departments are expected to be involved from IT to actuarial and financial employees. They should be affected with an expected number of almost 50 for each department on a full-time basis.

Though those changes are not viewed negatively, they are going to ask for efforts and a lot of costs for insurers as already discussed. In addition, letting the impacts be known by stakeholders and manage the changes in the performance reporting regarding profit will also be needed.

Graph 8 :Expected benefits arising with IFRS 17 according to insurers per region of the world



[16]

Out of this review of the studies and comparison between the two standards, a few hypothesizes can be deducted and checked with opinions from professionals (see the interview analysis chapter right after):

I. The new framework for insurance contracts accounting will provide more comparability and transparency in the financial statements of affected companies because of the common methods and the impossibility of using different policies in the same set of financial statements and better, more modern systems within insurance companies.

II. The new models of measurement will allow the values in the statements to better represent the obligations and risks assumed by the entity for insurance contracts it issues, namely by

[16] Deloitte 2018 (pp.31)

eliminating former practices such as undiscounting and presenting revenue based on premiums.

III. The CSM will properly depict the future profit expected to be recognized in the future and reduce the impact of newly recognized contracts in the financial statements in comparison with the practices under IFRS 4.

IV. The CSM in the case of evaluating a reinsurance contract allows the CSM to depict a loss as well as a gain over the course of the contract. This is inconsistent with the measurement for issued insurance contract (onerous contract) as reinsurance on onerous contracts should be allowed to recognize a gain on initial recognition.

V. The required disclosures will provide relevant information about the financial statements but are not fundamentally different from what was required previously.

VI. The presentation in the statement of financial position is detailed at the level of the group of contracts and gives a better representation of the financial position than under IFRS 4.

VII. The complexity of the new requirements is a downside to the positive side of the standard and could lead to trouble with the timing of application even if it has been deferred.

VIII. The difficulty of acquiring the needed data or even having them at all will be a challenge for the entities to apply the standard especially for the already issued contracts.

IX. The new standard’s implications will cause the birth of new KPIS and reporting schemes to the stakeholders because of the new, more prudent manner of reporting revenue in the financial statements.

X. Accounting mismatches in P&L could arise if the wrong choices are made with the options provided by both IFRS 17 and 9 between assets and liabilities.

XI. One solution to help implement IFRS 17 is to use Solvency II for the elements that are similar.

XII. The cost of the standard will be huge and could outweigh the quality that comes out of it.

7. Interviews (analysis here, full text in the appendix)

This last chapter will summarize the content of the three interviews I have made to support the elements that I have found in the documents and references as well my personal understanding of the subject. I have tried to interview people from different backgrounds and not only from an accounting background, as you can find in more details in the last 3 appendixes, with the complete transcriptions of all interviews. Hereafter will they be summarized per themes (see subtitles) and linked with the theoretical elements already discussed above.

7.1 Influence of the Standard on the Accounting

This section is used to summarize the expected impact of the standard on the accounting of insurance companies and if it brings actual benefits regarding financial information or not. The hypothesizes that are addressed are the numbers I, II, IV, V, VI, VII and X respectively. The information that is referred to is highlighted in red in the last three appendixes. Most of the content in this sub-chapter comes from the second and third appendixes.

What comes out from most of the content of the interviews is that IFRS 17 is without any doubt a better way of accounting for insurance contracts than what existed under IFRS 4 for two main reasons :

- The models are the same for everyone, the use of local GAAP's like under IFRS 4 is no longer permitted;
- The goal of the models are to represent faithfully, consistently with the market and the items that are used for the calculation are market-consistent.

Overall, the standard is thus an amelioration in every sense that it can be understood. Across the interviews, the following elements have also been discussed.

The CSM and the way that is allowed to account for reinsurance contracts is fitting, despite the fact that it could allow for profit to be taken into P&L. The main reason is that it is explainable and it makes accounting mismatches disappear between the insurance contracts and the reinsurance contracts. Those discussions are contradictory with my hypothesis number IV.

As for the subsequent measurement, it brings mandatory changes in the value of the balance sheet (unlike the liability adequacy test) but it has been pointed out by mister Meuleman that it remains

to be seen to what extent the liability for remaining coverage and for incurred claims will be possible in the reality of insurance contracts.

The same argument has been brought to justify the transition towards IFRS 9 together with IFRS 17. Indeed, the different models under IFRS 9 lead to taking profit into P&L or OCI and the same can be said about IFRS 17. Transitioning towards both together makes it easier to make the different allocations match to avoid mismatches. That is only allowed in the limit of use of each models of each standard obviously. The hypothesis number X stated that accounting mismatches would arise but if entities were to find solutions to eliminate them, they would not exist or only in minor cases.

When it comes to the presentation and disclosures, the most interesting discussion occurred during the interview of Mister Johan Meuleman but the element concerning the presentation per portfolio and/or contract can be implicitly the same as with Mister Zabinski from the national bank since he said to agree with the amendments that this element is part of. The presentation per portfolio of contracts instead of per group of contracts would not be a fundamental roadblock in regard to the quality of the information. The calculation would still need to be done at the level of the group and then and only then, you would reunite the groups to determine whether it is an asset or a liability and should be presented as such. The hypothesis number VI is wrong if we follow that argument.

As for the P&L and the disclosures, the justification of the appropriate character of the standard is linked with the hypothesis regarding the complexity (number VII). The IFRS standards are typically made more of principles that allow for leveraging in their use. In the case of IFRS 17, this leveraging is what makes the standard possible in practice and thus letting freedom in the P&L and disclosures among other things (which remain the same even if slightly developed) is consistent.

Another argument that was made by Mister Meuleman and not by Mister Zabinski is that if the market wants something to be shown and some insurance companies do it, the other ones will naturally follow and the information given will automatically become better by this process. That will depend on the stakeholders and what they hope to find in addition to the requirements in terms of explanation in the disclosures and in the P&L. That should be especially true in the beginning of its application when nobody will really have a model to start with and will adapt depending on what happens in the market. That both validates the fact that disclosures have not changed fundamentally and that the complexity will largely depend on what was done before and how deep insurers will be willing (or have) to go.

7.2 Practical Consequences

This part of the analysis encapsulates the practical consequences that we can expect from the point of view of the interviewees and how the insurers may react to the application of the standard in practice. It will address the hypothesizes number III, VIII, IX and XII. The information that is referred to is highlighted in green in the last three appendixes.

First things first, the practices accounting wise and when it comes to the product mix. Every interviewee agrees to say that the prudence used under IFRS 4 was non-satisfactory and that behaviors in regard to evaluations of the contracts and the use of provisions were not sufficient. One thing that deserves to be highlighted is that Mister Zabinski noted that the new standard might make some prudent behaviors disappear because they would have been linked to some specific entities and that they would no longer have the freedom to do it. That is pretty inconsistent with what we have spoken about in the previous chapter and forbidding a practice that is more prudent would be counterproductive if it is economically relevant. This confirms with a nuance the hypothesis number III.

As for the product mix, the elements raised in the documents from EFRAG (and thus with which its interviewees agree) are also confirmed as possible by Mister Meuleman. If the products alone are now onerous, it could lead to their disappearance. The same scenario could happen if the bundling of products with others was no longer allowed. That second scenario may be less possible now that the presentation can be made at the portfolio level.

The next thing concerns the KPIS and how they would change, all three interviewees agreed that there would be change but not necessarily the arising of new ones. The changes would arise from the fact that the ingredients of the ratios and indicators would change and not represent the same thing or in a different manner. The numbers behind the values will be more faithful and will thus give better overall ratios. Mister Jacobs from EFRAG said that the benchmark for the ratios would also change because most companies would probably see their ratios change in the wrong direction.

The last element linked to ratios was mentioned by Mister Meuleman who said that the CSM would probably be a complex element to estimate therefore because nobody knows whether it is equity or not, what will be the importance and characteristics of the CSM in the analysis of the investor, whether it will be big, growing and in which cases. This is linked with the hypothesis number IX

and is pretty contradictory with it because the KPIS could not exactly be new but most likely would need to be interpreted differently because their composing parts would be partly different.

Concerning the new data and people, most of the information came from the last two interviews. Everybody agreed that the need will be huge in every corner of the insurance companies. Concerning the implementation, an improvement of the data management will be mostly needed as well as experts in the standard but it will ultimately have an impact for everyone from the actuary to the recruitment, even to the marketing since the standard can have an impact on the product mix.

The modernization of the way insurance companies are managed and work- across all departments- is another reason why the new complex IFRS 17 could be beneficial to these companies according to Mister Meuleman. If they take action and gain something from the compliance, it will outweigh the costs of its implementation in addition to the information enhancement that is reckoned by all interviewees. That makes the hypothesis XII wrong.

7.3 Solvency II

This last part of the analysis highlights the interaction between IFRS 17 and Solvency II and the possibility to use the latter to help implement the former. This addresses the last hypothesis which is the number XI. The points discussed here are also highlighted in yellow in the appendixes 7-9.

One thing that has been pointed out during my interview with EFRAG was that while the concepts of Solvency II can be used to start the calculation of the elements required in the measurement of insurance contracts under IFRS 17, there exist differences on every concept but the fundamental differences include- in their opinion- the fact that the discount rate under Solvency II follows a European guidelines which is the same for every entity while under IFRS 17, it should be almost a case per case rate. The second great difference can be found in the objective of each standard respectively because IFRS 17 wants to report on profitability, the CSM needs to be calculated and is inexistent under Solvency II, which wants to ensure the sufficiency of the equity. That is a fundamental concept and it is not replicable. This is highlighted in the latter part of the interview, last page of the 7th appendix.

The fact that the concepts used for Solvency II are usually slightly different from those under IFRS 17 is an opinion that is shared across all three of my interviews but not everyone agrees that it will have a wide impact on the use of the formers or not. Mister Meuleman from PwC agrees with the

same conceptual differences but brings out the fact that actuarial assumptions and calculations would remain the same and that this is more than possible that insurers would use all the leveraging they can use to make the assumptions and calculations of both regulations match the best way they can match. These elements are in the last 2 pages of his interview in the 9th appendix.

Every twist between the two regulations are also recognized by Mister Zabinski of the national bank and we can also add other elements that were mentioned off the record as explained in this specific section at the end of the 8th appendix. The two main elements that are added were that the level of granularity required under IFRS 17 was much more demanding than under Solvency II, which means that while it would potentially be possible to extrapolate its calculations, you would need to dispatch it at the level required by the accounting standard. That element was also slightly contradicted by Mister Meuleman who thinks that some methods might be possible to extrapolate the concepts once calculated, as highlighted in the interview in the 9th appendix. According to him, IFRS 17 allows more leveraging, which remains in the spirit of IFRS's and the methods could be twisted in a way that matches Solvency II more or less.

The second point that could have a huge impact on the calculation, according to Mister Zabinski is the discount rate, which under Solvency II is extrapolated thanks to a last liquid point which is determined by authorities. Using other techniques would possibly change the discount rate significantly and that would have an important effect on the value of some contracts in the balance sheet, potentially for the longer-term contracts with cash flows being discounted with a significantly higher or lower rate.

In conclusion, the use of Solvency II is possible since the calculations are similar especially when it comes to actuarial assumptions but the discount rate is a main problem because the methods may be near one another, but the impact of the choices under Solvency II might be huge on the valuation of the cash flows and thus the contracts at whatever aggregation level. The CSM which does not exist under Solvency II must also be taken into account. Another thing to note is that the possibility to use other regulations has also been discussed in the interviews but this is not the focus here, both for a matter of size of the thesis and because Solvency II matches the new standard the best. Another thing that confirms that use is that executives are trying, at the moment, to make Solvency II and IFRS 17 (and 4 in some cases) match the best to avoid difficulties, according to Mister Meuleman. The hypothesis XI is confirmed even though nuanced.

Conclusion

First a reminder of what this thesis was looking for: the consequences of the application of IFRS 17 in comparison with IFRS 4 and the consequences of the new standard in practice for affected entities. My research and analysis should allow me to find answers that match those two researched elements (with the restrictions and limits explained in the last chapter).

The consequences of the application of IFRS 17 should look pretty straightforward at first. The standard looks indeed like a much enhanced version of its predecessor. The fact that a model is prescribed can only bring comparability to the financial statements built with the standard. In the same way, IFRS 17 requires to economically reflect the contracts that are accounted for in the standard unlike IFRS 4 and its exemptions.

However, some elements pointed out in my research indicates that while better, IFRS 17 may not be the miracle solution it can be presented as.

Judgment is a big part of the assessment of insurance contracts even in IFRS 17 and such a judgment is by definition not objective. That is something to keep in mind when considering the accounting under IFRS 17. Examples of this include the Risk adjustment which can change depending on the company or the use of a regulation like Solvency II as an implementation tool. As already explained, the discount rate under Solvency II and the way it is determined can have an important impact on the amount reported.

The presentation and disclosures will be very important for the understanding and the requirements of IFRS 17 in that regard are not severe. The presentation must be at the portfolio level in the balance sheet, the number of required P&L lines is limited and the disclosures have fundamentally remained the same. The judgment of what is needed will thus depend on what the stakeholders will deem necessary.

Explanations are key, especially since the transition will be led together with the one towards IFRS 9, which can lead to accounting mismatches between asset revenue and insurance revenue/cost. Multiple options within both standards should be scrutinized all the more to avoid this in as many cases as possible.

As for the second sub-topic, the consequences in practice are expected to be important as well. It should impact everyone in the affected entities from the data management, the financial

professionals (obviously) and indirect impact on product mix, marketing, recruitment and formation, to be aware of what has changed and what to do because of it.

KPIS are also expected to be changing substantially since the numbers used will differ and be made better or most likely worse. New benchmarks for investors and subsequent explanation will be needed just like for the rest of the application.

It is expected that insurers, at least in Europe will try to match Solvency II and IFRS 17 the best way possible to make the transition. That is possible thanks to the leveraging that is traditionally let in IFRS's but some elements are problematic overall, the CSM and the discount rate being the two most prominent differences.

The amelioration is undeniable but the leveraging and the fact that reflecting actuarial reality is very complex makes the perfection unreachable. If the wide changes are an opportunity that can outweigh the compliance, that compliance may not be enough if the interpretation is too aggressive.

Critical Reflection

This last chapter of the thesis is dedicated to show its limits, due to both the theme and the scope I was willing to use when writing this master's thesis. This will also highlight different manners of going deeper into the topic or taking other angles to tackle it in future works, thesis or studies.

The first part concerns the limits that are inherent to the topic. IFRS 17 being a recent norm that will only be applied in 2023, the base of references and documents I could use for my work was not very broad. The number of different authors- people as well as organizations- is even more limited. That comes from the fact that no real empirical studies could have been made yet because it is not applied by any company yet. There exists references from when IFRS 17 had not seen exposure drafts yet but these sources are less relevant and to be avoided if possible as well.

The second limit is linked to the same problematic. With the application date of the standard being 2023, it is not possible to make a precise prediction of what the impact will be and get to precise figures. As it was expressed in the interviews discussed and in the fact that amendments were still ongoing at the time I wrote this thesis, things are still evolving and the behaviors of the stakeholders at first application will have an impact on the consequences of its application. The conclusion of this work is thus temporary and is a "best estimate".

The last limit is that the methodology I chose for this work is an exploratory one and the conclusions are limited to the interviews I could have with people in my reach. While the interviewees work in an international environment, people from other backgrounds, using other accounting rules to begin with, could have enticed me to different conclusions. The way I chose to work was also influenced by the fact that most insurers are currently using consultancy firms to help implement this norm and may not have been especially ready to answer questions about the norm. A mass study could be relevant in a few years but just not right now in my opinion.

The second part of this reflection is how further work could be done on the same topic. The emphasis is on consequences of the norm, mostly in regard to the general model which will concern most of the insurance contracts. Therefore, working separately on the other two models to evaluate them precisely (VBA and PAA) is a way to go. In the future, trying to quantify the impact on the financial statements or the performance indicators or in regard to other elements, will be possible after the implementation of the standard. One last way to work on this would be to study the

differences between IFRS 17 and a number of other GAAP's- on specific elements- to see what the differences are. Focusing on the recognition of profit for example is an easy example.

In short, the fact that my focus was on the general consequences of the new standard leads to specific studies on specific points could obviously be made, and working on a standard that has yet to be applied leads to limitations in the precision of the predictions and conclusions one can make on the topic right now.

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