

IFRS 17

Insurance Contracts

March 2023
Addis Ababa



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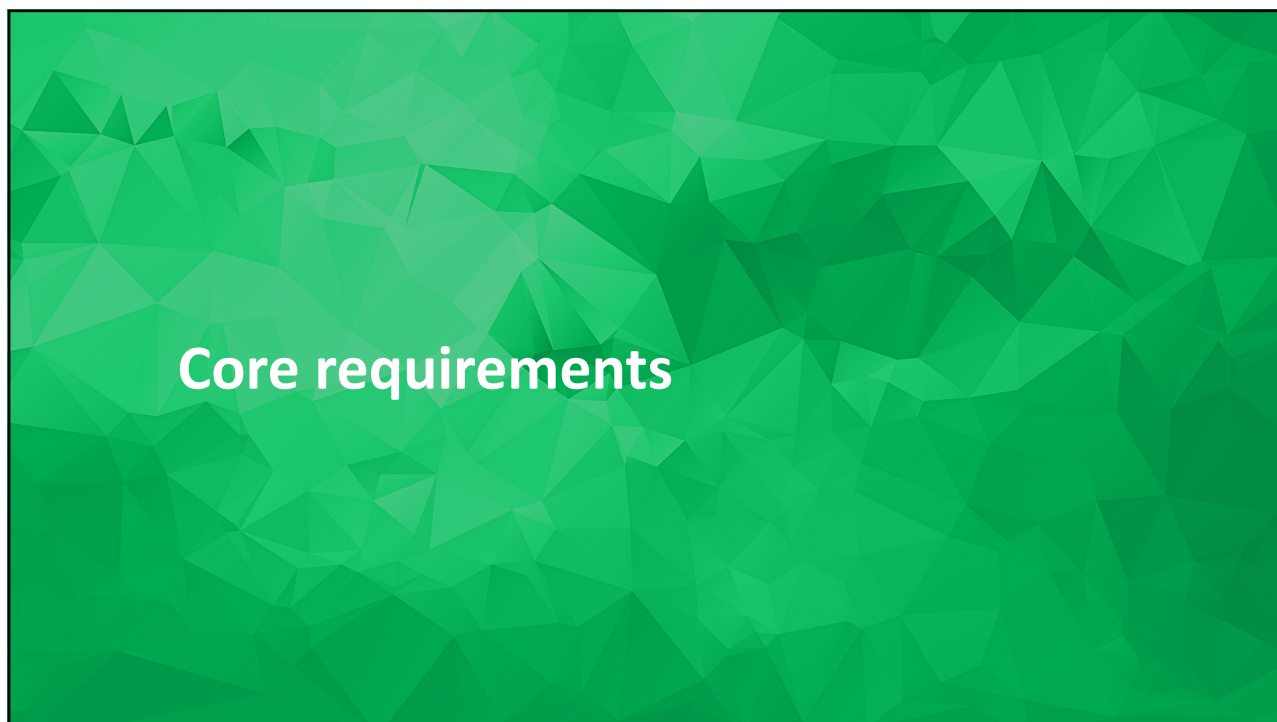
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IFRS 17 Programme	
Session 1 & 2	Introduction to IFRS 17 and Important concepts
Session 3 & 4	Measurement of contracts (general approach)
Session 5 & 6	Measurement of contracts (premium allocation approach)
Session 7	Reinsurance
Session 8	Transition

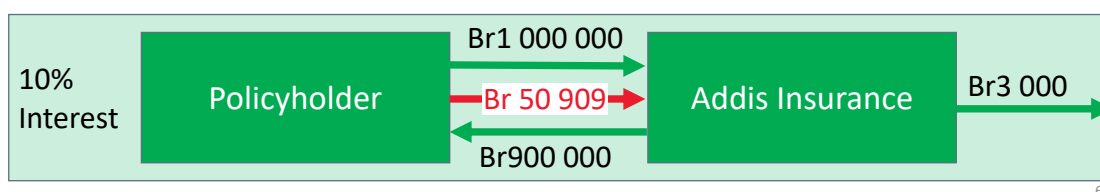
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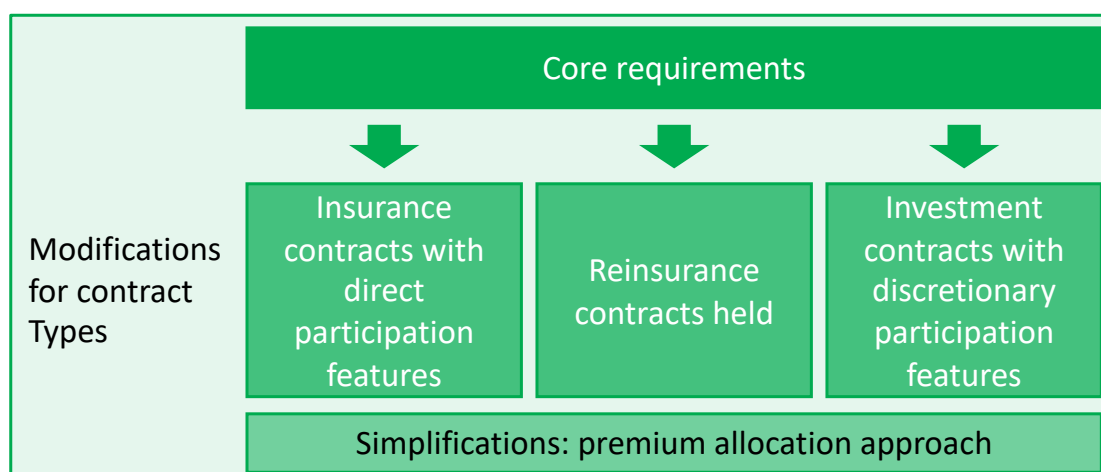
Example Recap and amend

- » Addis Insurance writes 100 car contracts and expects that:
 - » Interest rate is 10%
 - » Addis pays Br3 000 in car inspection costs on 1 January
 - » Policyholders pay an annual premium of Br10 000 each on 2 January
 - » Risk premium is Br50 909
 - » **Addis expects claims of Br900 000, Br 50 000 per month for 1st 6 months, Br100 000 per month for 2nd 6 months**

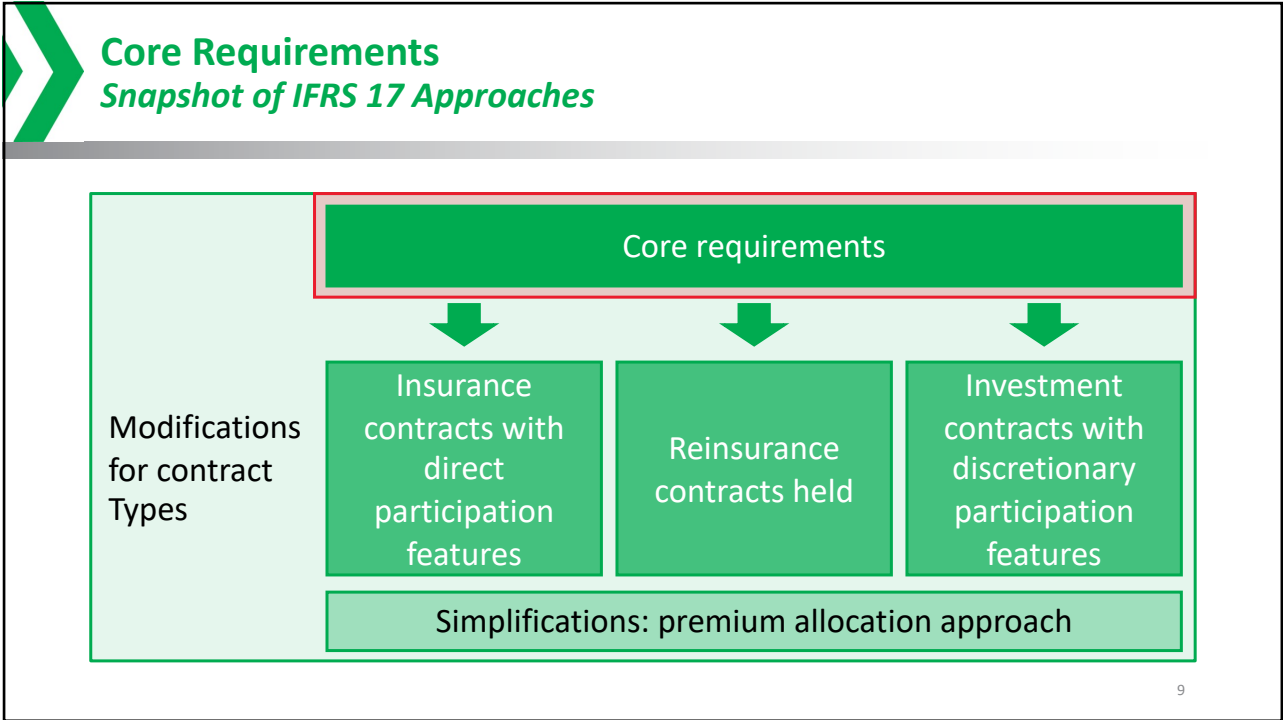


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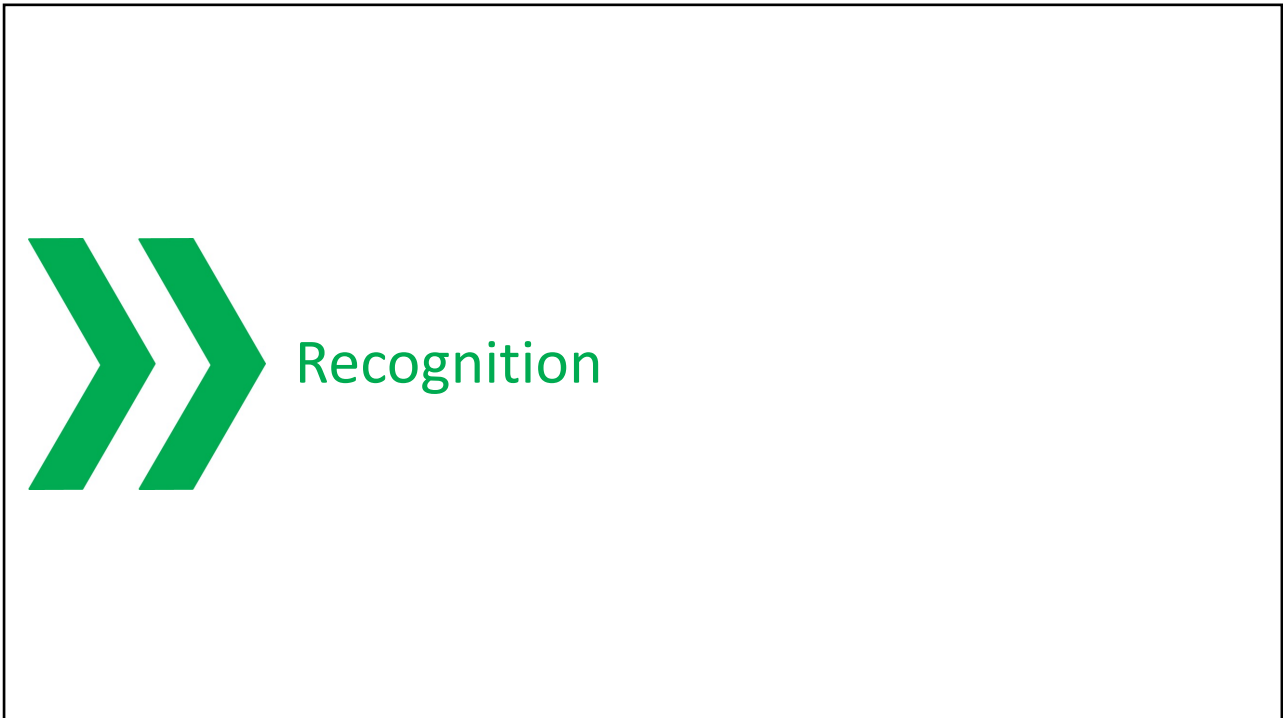
Snapshot of IFRS 17 Approaches



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Recognition

- » Insurance contracts are recognised from the earliest of:
 - » beginning of coverage period of first contract in group
 - » date when first payment from a policyholder becomes due, or
 - » for onerous contracts, when the group becomes onerous
- » If no contractual due date, the date received
- » Acquisition cash flow asset or liability is recognised when incurred, and derecognised when the group of insurance contracts to which the cash flows are allocated is recognised

IFRS 17.25 to 28

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Initial measurement

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Core Requirements *'Building block Approach'*

All insurance contracts measured as **the sum of:**

- » Fulfilment cash flows (FCF)
 1. Present value of probability-weighted expected cash flows
 2. Plus an explicit risk adjustment for non-financial risk (eg insurance risk)
- » Contractual service margin (CSM)
 3. The unearned profit from the contracts

1 PV future cash flows - 2 Risk adjustment = Fulfilment cash flows

3 Unearned profit - CSM

= IFRS 17 liability

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1 Present value of future cash flows *Cash flows*

» Current estimate of future cash flows in contract boundary

Contract boundary

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Example Contract Boundary

» Addis Insurer issues three types of car insurance contracts:

	A contract that....	Contract boundary
1	Can be cancelled by either party with 30 days notice, expected to continue for 2 years	30 days/1 year/ > 1 year
2	Signed for 1 year, automatic renewal, annual inflation increase, only policyholder can cancel	30 days/1 year/ > 1 year
3	Signed for 1 year, automatic renewal, annual increase decided by Addis, only policyholder can cancel	30 days/1 year/ > 1 year
4	Signed for one year, no automatic renewal	30 days/1 year/>

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Example Contract Boundary

» Addis Insurer issues three types of car insurance contracts:

	A contract that....	Contract boundary
1	Can be cancelled by either party with 30 days notice, expected to continue for 2 years	30 days/1 year/ > 1 year
2	Signed for 1 year, automatic renewal, annual inflation increase, only policyholder can cancel	30 days/1 year/ > 1 year
3	Signed for 1 year, automatic renewal, annual increase decided by Addis, only policyholder can cancel	30 days/1 year/ > 1 year
4	Signed for one year, no automatic renewal	30 days/1 year/>

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1 Present value of future cash flows

Cash flows

» Current estimate of future cash flows in contract boundary

» Probability weighted and unbiased

» Stochastic modelling for financial options and guarantees, where relevant

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Examples

Cash flows to include

» Addis Insurance sells a one-year car insurance policy to 100 customers on 1 January 2022. Addis expects the following expenses:

		Insurance liability (Y/N)
1	Vehicle inspection cost before accepting client	
2	Commission paid to broker on accepting client	
3	Bonus to CEO for the 1 millionth contract	
4	Premiums received	
5	Claims paid	
6	Admin costs for managing the contract	

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Examples

Cash flows to include

» Addis Insurance sells a one-year car insurance policy to 100 customers on 1 January 2022. Addis expects the following expenses:

		Insurance liability (Y/N)
1	Vehicle inspection cost before accepting client	Yes, but
2	Commission paid to broker on accepting client	Yes
3	Bonus to CEO for the 1 millionth contract	No
4	Premiums received	Yes
5	Claims paid	Yes
6	Admin costs for managing the contract	Yes

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Present value of future cash flows

Example 1: Contract Boundaries

» Entity issues a whole life, stable premium contract. Contract includes right to reprice individual contracts after ten years. Insurer is not however permitted to re-underwrite.

» A substantive obligation ends when:

- » the insurer has the **practical ability to reassess risks** of a policyholder and can **set/reset price or benefits** to fully reflects those risks

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Present value of future cash flows

Example 1: Contract Boundaries

- » Entity issues a whole life, stable premium contract. Contract includes right to reprice individual contracts after ten years. Insurer is not however permitted to re-underwrite.
- » A substantive obligation ends when:
 - » the insurer has the practical ability to reassess risks of a policyholder and can set/reset price or benefits to fully reflects those risks
 - » Insurer can reprice to reflect risk However can't re-underwrite (ie can't test changed risk), most jurisdictions would not be able to price for risk therefore contract boundary is longer than 10 years
 - » May depend on strength of regulator

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Present value of future cash flows

Example 2: Contract Boundaries

- » Entity issues 1 year health contracts. Insurer can be forced to renew yearly
 1. Insurer cannot reprice renewed contracts
 2. Insurer cannot reprice individual repriced contracts, but can fully reprice the portfolio each year
- » A substantive obligation ends when:
 - » practical ability to reprice reassessed risks; or
 - » both:
 - » practical ability to reprice portfolio reassessed risk; and
 - » reassessment pricing doesn't consider risks for periods after that date

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Present value of future cash flows

Example 2: Contract Boundaries

- » Entity issues 1 year health contracts. Insurer can be forced to renew yearly
 1. Insurer cannot reprice renewed contracts
 2. Insurer cannot reprice individual repriced contracts, but can fully reprice the portfolio each year
 - » A substantive obligation ends when:
 - » practical ability to reprice reassessed risks; or
 - » both:
 - » practical ability to reprice portfolio reassessed risk; and
 - » reassessment pricing doesn't consider risks for periods after that date
1. Long boundary, 2. short boundary

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Present value of future cash flows

Example 3: Contract Boundaries

- » Entity issues one year vehicle insurance contracts. The insurer prices the contracts on the expectation that 90% of policyholders will renew. The insurer can fully reprice the contracts on renewal, but in practice only does so if it has specific information to indicate this is appropriate.
- » A substantive obligation ends when:
 - » the insurer has the practical ability to reassess risks of a policyholder and can set/reset price or benefits to fully reflects those risks

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Present value of future cash flows

Example 3: Contract Boundaries

- » Entity issues one year vehicle insurance contracts. The insurer prices the contracts on the expectation that 90% of policyholders will renew. The insurer can fully reprice the contracts on renewal, but in practice only does so if it has specific information to indicate this is appropriate.
- » A substantive obligation ends when:
 - » the insurer has the practical ability to reassess risks of a policyholder and can set/reset price or benefits to fully reflect those risks
 - » Intent not relevant, it is whether has the right/obligation
 - » Does not appear to have either, but is an obligation created by its practice?

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1 Present value of future cash flows

Acquisition cash flows

- » Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts (issued or expected to be issued) that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

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1 Present value of future cash flows

Acquisition cash flows

- » Acquisition cash flows incurred before the recognition of a group are:
 - » Recognised as an **asset**,
 - » Until the group is recognised
- » **Collapsed** into the initial recognition of group
- » This may **imply the inclusion of a liability** on initial recognition for acquisition costs as well

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1 Present value of future cash flows

Discount rates

Reflect time value of money and financial risks

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Example
Present value – effect of discount rates

» What is the value today of Br1 000 000 to be paid to me in 1 years time?

		Present value	Present value
1	Interest rate is 0%	Smallest	Biggest
2	Interest rate is 5%	↓	↓
3	Interest rate is 10%		
4	Interest rate is 20%		
5	Interest rate is 20%	Biggest	Smallest

?

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Example
Present value – effect of discount rates

» What is the value today of Br1 000 000 to be paid to me in 1 years time?

		Present value
1	Interest rate is 0% <u>=PV(0%,1,1000000)</u>	Br 1 000 000
2	Interest rate is 5% <u>=PV(5%,1,1000000)</u>	Br 952 381
3	Interest rate is 10% <u>=PV(10%,1,1000000)</u>	Br 909 091
4	Interest rate is 20% <u>=PV(20%,1,1000000)</u>	Br 833 333
5	Interest rate is 20% <u>=PV(30%,1,1000000)</u>	Br 769 231

Why do different products in the same economy change different interest rates?

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1 Present value of future cash flows

Discount rates

Reflect time value of money and financial risks

- » Characteristics of the cash flows
- » Liquidity of the insurance contracts
- » To extent that financial risks are included in the cash flows

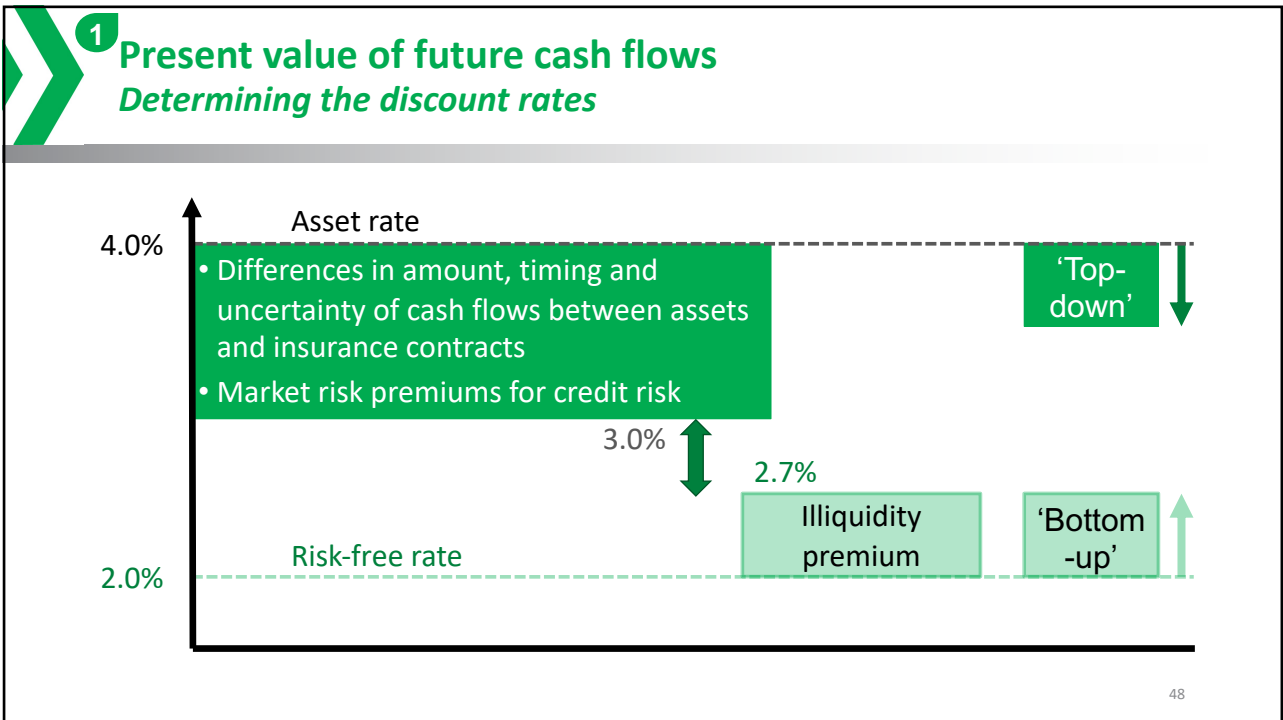
Consistent with observable market prices (if any)

Timing Currency Liquidity

Exclude the effect of factors in the observable market prices not relevant to insurance contracts eg credit risk

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Example

What is the risk free rate in Ethiopia

» Treasury bill auction from 30 November 2022/25 January 2023

		30 Nov	25 Jan
1	28 day bills	8.303%	8.244%
2	91 day bills	8.285%	8.771%
3	182 day bills	9.780%	10.201%
4	364 day bills	9.675%	9.347%

<https://nbe.gov.et/treasury-bills-auction-results/>

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2 Risk adjustment

- » Explicit, current adjustment for compensation insurer requires for bearing non-financial risk (eg insurance risk)
- » Compensation that makes a company indifferent between:
 - » fulfilling a liability that has a range of possible outcomes; and
 - » fulfilling a liability that will generate fixed cash flows

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2 Risk adjustment

- » Explicit, current adjustment for compensation insurer requires for bearing non-financial risk (eg insurance risk)
- » Compensation that makes a company indifferent between:
 - » fulfilling a liability that has a range of possible outcomes; and
 - » fulfilling a liability that will generate fixed cash flows

Group A	
Probability	Pay-off
50%	1 000 000
50%	0

Probability weighted average $(0.5 \times 1m) + (0.5 \times 0) = \text{CU}0.5m$

Group B	
Probability	Pay-off
100%	500 000

$1 \times 0.5m = \text{CU}0.5m$

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3 Contractual Service Margin (CSM) Initial measurement

The unearned profit of the group of contracts that relates to future service to be provided

The amount determined so that no gains are recognised in profit or loss on initial recognition

Example—Consider a group of contracts with PV of future cash flows of CU4,250 and risk adjustment of CU750

If premiums
CU5,500

If premiums
CU3,500

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Example

Contractual service margin

» What is the unearned profit?

		Example 1	Example 2
1	Present value of future payments	4 250	4 250
2	Risk adjustment	750	750
3	Total outflow	5 000	5 000
4	Premium receivable	5 500	3 500
5	Contractual service margin (Unearned profit)	?	?

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Example

Contractual service margin

» What is the unearned profit?

		Example 1	Example 2
1	Present value of future payments	4 250	4 250
2	Risk adjustment	750	750
3	Total outflow	5 000	5 000
4	Premium receivable	5 500	3 500
5	Contractual service margin (Unearned profit)	500	-1 500

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3 Contractual Service Margin (CSM) Initial measurement

The unearned profit of the group of contracts that relates to future service to be provided

The amount determined so that no gains are recognised in profit or loss on initial recognition

Example—Consider a group of contracts with PV of future cash flows of CU4,250 and risk adjustment of CU750

If premiums CU5,500	<ul style="list-style-type: none"> Contracts profitable at inception CSM = CU500 [CU5,500 – CU750 – CU4,250]
If premiums CU3,500	<ul style="list-style-type: none"> Contracts onerous at inception Day-one loss CU1,500 recognised in P&L – No CSM

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Example One year contract

- » Addis Insurance writes 100 car contracts and expects that:
 - » Interest rate is 10%
 - » Addis pays Br3 000 in car inspection costs on 1 January
 - » Policyholders pay an annual premium of Br10 000 each on 2 January
 - » Risk premium is Br50 909
 - » Policyholders submit claims of Br 1 000 000, paid on 1 January 2023

10% Interest

Policyholder

Br1 000 000

→

Br 50 909

→

Br1 000 000

←

Addis Insurance

→

Br3 000

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Building block approach
Journals

» Recording of payment of acquisition cost (1 Jan 2022)

Journals	Debit	Credit
Acquisition cost assets	3 000	
Cash		3 000

» What account is debited?
1) Insurance liability, 2) Debtors, 3) acquisition cost asset?

10% Interest Policyholder Addis Insurance Br3 000

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Building block approach
Journals

» Expects premium of Br1 million (2 Jan 2022), and claims of Br1 000 000 (31 Dec 2022),

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091

10% Interest Policyholder Addis Insurance

Br1 000 000 Br1 000 000

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Building block approach Journals

» Expects premium of Br1 million, and claims of Br1 000 000, risk margin is Br50 909

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091
FCF (Risk margin)		50 909

10% Interest

Policyholder

Addis Insurance

Br1 000 000

Br 50 909

Br1 000 000

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Building block approach Journals

» Expects premium of Br1 million, and claims of Br1 000 000, risk margin is Br50 909, acquisition cost of Br3 000

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091
FCF (Risk margin)		50 909
Acquisition cash flow payable		3 000

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Building block approach

Journals

- » Expects premium of Br1 million, and claims of Br1 000 000, risk margin is Br50 909, acquisition cost of Br3000, [CSM balancing amount](#)

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091
FCF (Risk margin)		50 909
FCF (Acquisition cash flow payable)		3 000
CSM		37 000
<i>Recognition of contract on 2 January 2022</i>		

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Building block approach

Journals

- » Collapse acquisition cost asset

Journals	Debit	Credit
FCF (Acquisition cash flow payable)	3 000	
Acquisition cost asset		3 000
<i>Recording acquisition cost payable already paid</i>		

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Building block approach

Journals

» Receipt of premium of 1 000 000 on 2 January 2022

Journals	Debit	Credit
Cash	1 000 000	
FCF (PV of future cash inflows)		1 000 000
<i>Recording receipt of premium on 2 January 2022</i>		

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Building block approach

Balance sheet at 2 January 2022

Dr/(cr)	Cash	Acq asset	Insure liab.
Acquisition cost paid	-3 000	3 000	
Insurance Liability (premium)			1 000 000
Insurance Liability (claims)			-909 091
Insurance Liability (risk margin)			-50 909
Insurance Liability (acq cost payable)			-3 000
Insurance Liability (CSM)			37 000
Sub total	-3 000	3 000	-

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Building block approach

Balance sheet at 2 January 2022

Dr/(cr)	Cash	Acq asset	Insure liab.
Sub total	-3 000	3 000	-
Acquisition cost asset subsumed		-3 000	3 000
Premium received	1 000 000		1 000 000
2 January Total	997 000	0	-997 000

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Subsequent measurement

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Subsequent Measurement

	Initial Measurement	Subsequent Measurement
1 PV future cash flows	Current assumptions	Current assumptions
2 Risk adjustment	Current assumptions	Current assumptions

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Fulfilment cash flows

Liability for remaining coverage and liability for incurred claims¹

» *LfRC*: Insurer's obligation to pay and right to receive amount for insurance events **that have not occurred** and service that have not been provided.

After notification of first claims, liability is split:

- » *LfIC*: An entity's obligation to investigate and pay for:
- » valid claims for insured events that **have already occurred**,
 - » Valid claims for insured events that have occurred but for which claims have not been reported,
 - » other incurred insurance expenses, and
 - » amounts related to services that have already been provided

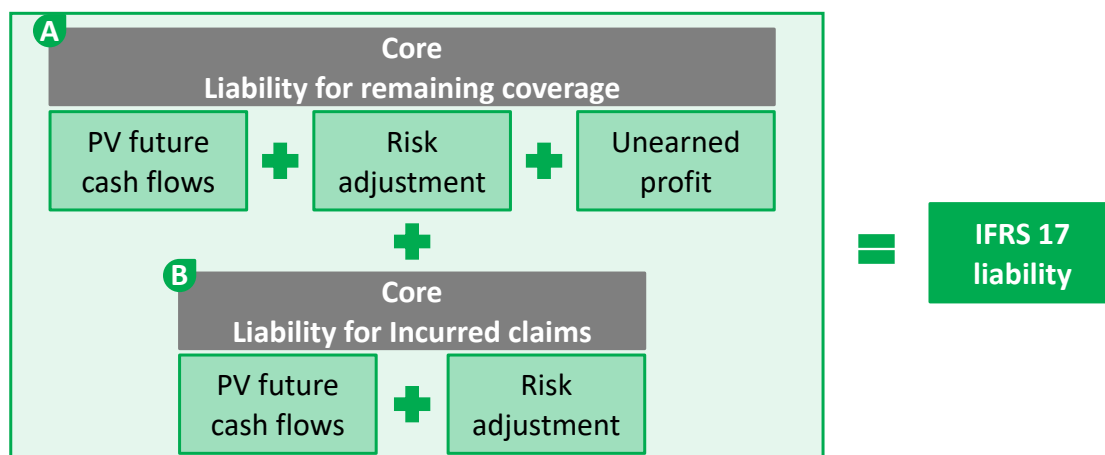
¹ *LfRC* – Liability for remaining coverage, *LfIC* – Liability for incurred claims

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Fulfilment cash flows

Subsequent measurement



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Example

One year contract

» Addis Insurance receives notification of claim of Br 1 000 000 on 31 Dec 2022, and expects to pay claim on 1 Jan 2023

Journals	Debit	Credit
FCF – LfRC (PV of future cash outflows)	1 000 000	
FCF – LfIC (PV of future cash outflows)		1 000 000
<i>Transfer of incurred claim to Liability for incurred claims on 31 December 2022</i>		
FCF – LfIC (PV of future cash outflows)	1 000 000	
Cash		1 000 000
<i>Settlement of claim at 1 Jan 2023</i>		

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Example One year contract

- » Addis Insurance receives notification of claim of Br 1 100 000 on 31 Dec 2022, and expect to pay claim **on 31 December 2023**
- » **Present value for Br 1 100 000 for one year at 10% is Br 1 000 000**

Journals	Debit	Credit
FCF – LfRC (PV of future cash outflows)	1 000 000	
FCF – LfIC (PV of future cash outflows)		1 000 000
<i>Transfer of incurred claim to Liability for incurred claims on 31 December 2022</i>		

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Example One year contract

- » Addis Insurance receives notification of claim of Br 1 100 000 on 31 Dec 2022, and expect to pay claim **on 31 December 2023**

Journals	Debit	Credit
Interest unwind)	100 000	
FCF – LfIC (PV of future cash outflows)		100 000
<i>Interest unwind, year to 31 December 2023 at 10%</i>		
FCF – LfIC (PV of future cash outflows)	1 100 000	
Cash		1 100 000
<i>Settlement of claim at 31 Dec 2023</i>		

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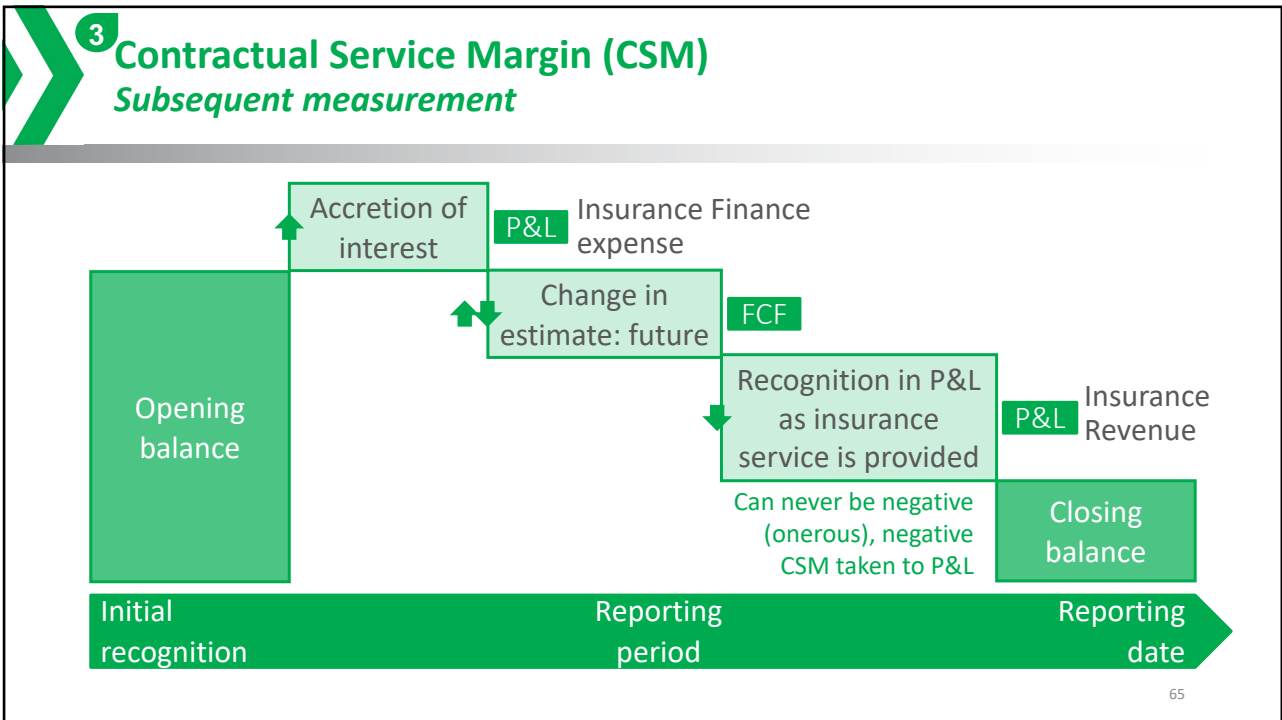
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Subsequent Measurement

	Initial Measurement	Subsequent Measurement
1	PV future cash flows	Current assumptions
2	Risk adjustment	Current assumptions
3	Unearned profit	Update by reflecting: <ul style="list-style-type: none"> • <u>Time value Adjustments</u> for future service (<u>fixed</u>) • <u>Allocation</u> of the amount earned

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Building block approach Journals

» Profit for 12 months

Journals	Debit	Credit
Interest expense (997 000 x 10%)	99 700	
Service margin (income) (37k +(37k x 10%))		40 700
Risk margin (income) (50.9k +(50.9k x 10%))		56 000
Insurance liability		3 000
Cash	99 700	
interest received		99 700
<i>Recognition of income and expenses on 30 June 2022</i>		

Assume bank interest of 10%

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Building block approach Balance sheet at 2 January 2022

Dr/(cr)	P&L	Cash	Insure liab.
2 January total	-	997 000	-997 000
Service profit recognised	-40 700		40 700
Risk Margin released	-56 000		56 000
31 December subtotal	-96 700	997 000	-900 300
Interest cost	99 700		-99 700
Interest income	-99 700	99 700	
31 December total	-96 700	1 096 700	-1 000 000

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Onerous contracts

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Onerous contract *Initial recognition*

- » An insurance contract is **onerous at date of initial recognition** if sum of
 - » fulfilment cash flows allocated to the contract,
 - » any previously recognised acquisition cash flows and
 - » any cash flows at the date of initial recognition
 in total **are a net outflow**
- » An entity shall **group such contracts separately** from contracts that are not onerous
- » An entity shall **recognise a loss in profit or loss** for the net outflow for the group of onerous contracts

IFRS 17.47

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Building block approach Journals

- » Expects premium of Br1 million, and claims of Br1 million, risk margin is Br50 909, **total costs including acquisition cost of Br50 000**

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091
FCF (Risk margin)		50 909
FCF (other direct costs)		50 000

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Building block approach Journals

- » Expects premium of Br1 million, and claims of Br1 000 000, risk margin is Br50 909, other cost of Br50 000, **CSM or P&L balancing amount**

Journals	Debit	Credit
FCF (PV of future cash inflows)	1 000 000	
FCF (PV of future cash outflows)		909 091
FCF (Risk margin)		50 909
FCF (Other costs)		50 000
Profit or loss	10 000	
<i>Recognition of contract on 2 January 2022</i>		

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Building block approach

Balance sheet at 2 January 2022

Dr/(cr)	P&L	Cash	Acq asset	Insure liab.
Acquisition cost paid	0	-3 000	3 000	
Insurance Liab (premium)				1 000 000
Insurance Liab (claims)				-909 091
Insurance Liab (risk margin)				-50 909
Insurance Liab (other cost)				-50 000
Profit or loss	10 000			-
Sub total	10 000	-3 000	3 000	-10 000

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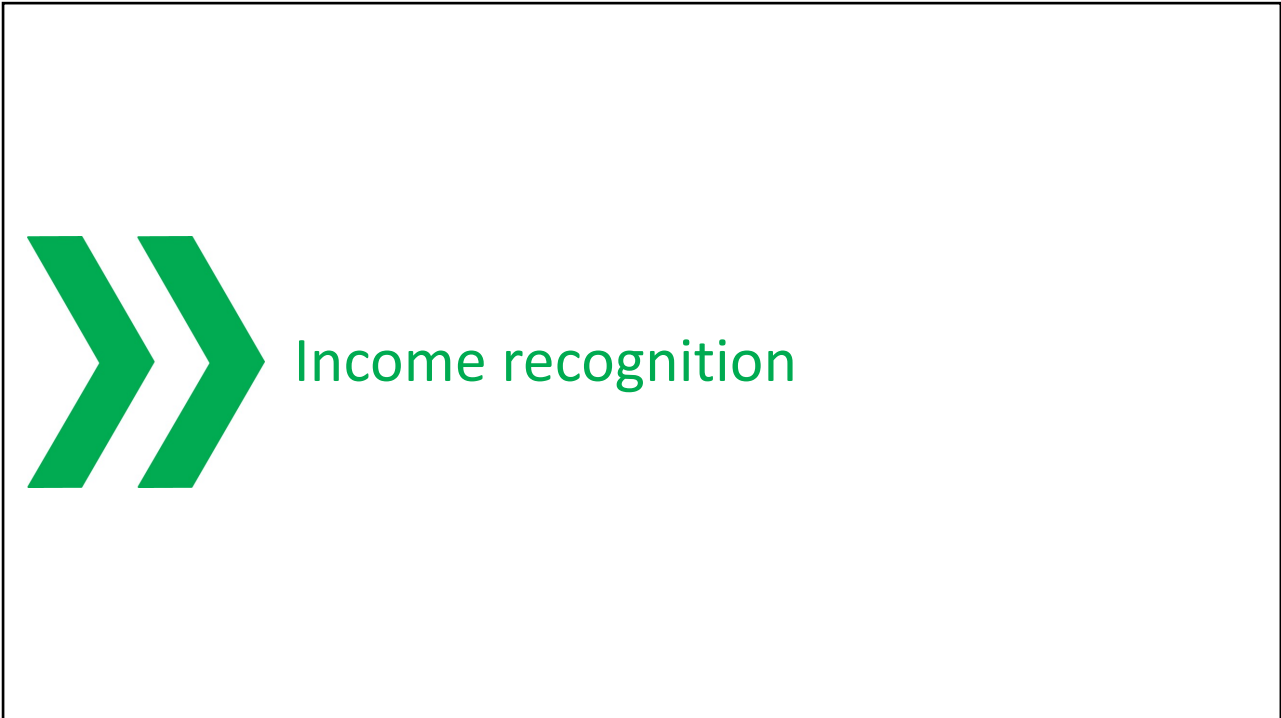
Building block approach

Balance sheet at 2 January 2022

Dr/(cr)	P&L	Cash	Acq asset	Insure liab.
Sub total	10 000	-3 000	3 000	-10 000
Acquisition cost asset			-3 000	3 000
Premium received		1 000 000		1 000 000
2 January Total	10 000	997 000	0	-1 007 000

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When is group profit recognised
Coverage units

The recognition in P&L of profits and losses for insurance services is based on 'coverage' units in the group

Under groups, contracts are **not tracked individually**
Objective is to reflect different levels of service

<p>Quantity of <u>benefits</u></p> <ul style="list-style-type: none">• <u>Expected benefits received</u>• <u>Stand by</u>, not actual claims• <u>Sum assured</u> reasonable basis• Must consider <u>valid claims</u>	<p>Expected coverage <u>duration</u></p> <ul style="list-style-type: none">• <u>Average expected duration</u> for the group• Can be <u>discounted</u>
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When is group profit recognised

Example: Coverage units

- » Insurer writes 5-year life contracts and treats as a single group:
 - » 5 contracts with expected total profit of 50, 5 contracts with expected total profit of 40, all contracts provide the same level of cover per year
- » Insurer expects that one contract will claim per year

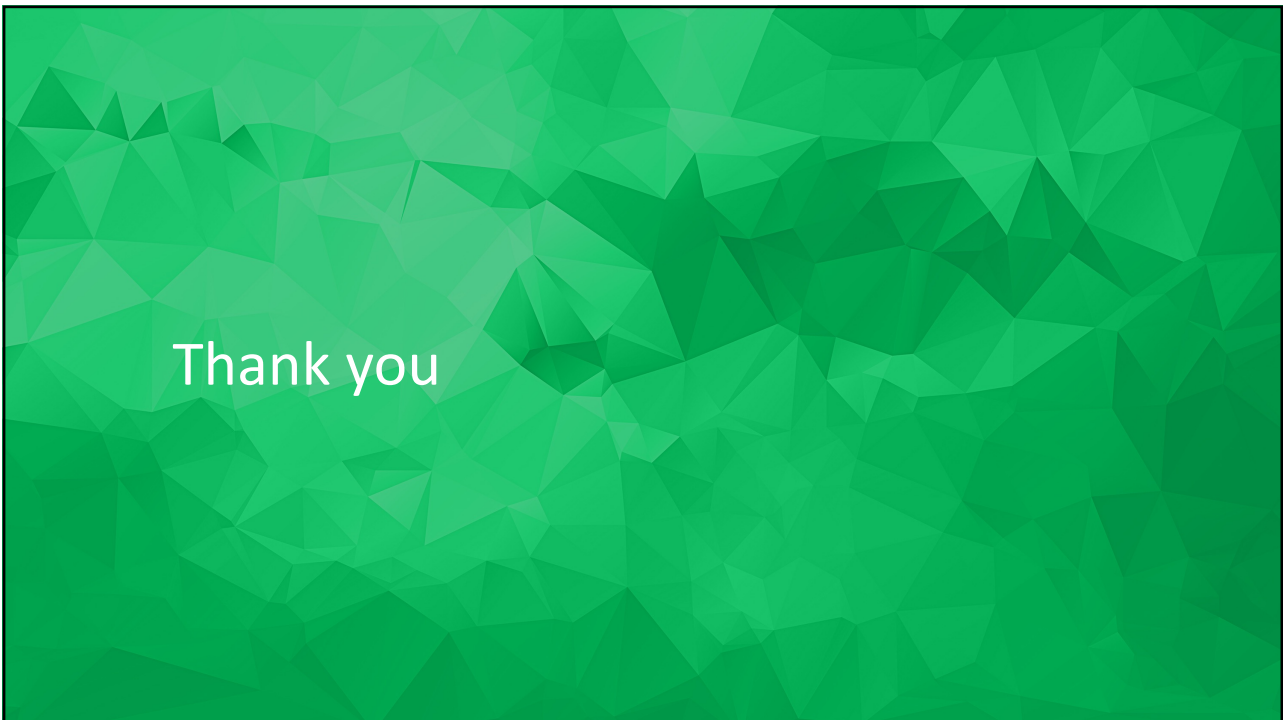
	Initial	Year 1	Year 2	Year 3	Year 4	Year 5
Remaining coverage units	40	40	30	21	13	6
Coverage units per year		10	9	8	7	6
Unearned profit	90.0	90.0	67.5	47.2	29.2	13.5
Earned profit		22.5	20.3	18.0	15.8	13.5

$$90 \times (10/40) \qquad 47.2 \times (8/21)$$

$$67.5 \times (9/30)$$

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