Insurance Contracts —Accounting to reflect economics

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Darrel Scott, a member of the International Accounting Standards Board (Board), offers his perspective on the new information about insurers' financial performance that will be available when IFRS 17 *Insurance Contracts* is applied. Existing insurance accounting differs a lot by region and by company and is often perceived as opaque. So, today, investors typically rely on generation of cash or regulatory capital to analyse and compare insurers across regions. IFRS 17 will shine a light on the development of insurers' profitability over time, which will assist investors to make investment decisions and to fulfil their stewardship responsibilities.

It is generally underappreciated that, in the IFRS 17 model, the **unit of account** is a cornerstone that ultimately will be responsible for many of the transparency improvements that will emerge under this new IFRS Standard. This *Investor Perspectives* article discusses why the unit of account matters to investors.

As a reminder, there is no front-end loading of reported profits under IFRS 17.

IFRS 17 is based on the concept that profit is only recognised when the associated service is provided. Consequently, unearned profit for insurance services —the contractual service margin—is presented as part of the insurance contract liability on the insurer's balance sheet.

On the other hand, losses for insurance services will flow through the insurer's income statement as soon as expected by the insurer.

The requirements for determining the unit of account in IFRS 17 reflect the economic practice of the insurance industry. When insurers apply IFRS 17 in 2021, insurers will account for the contracts with their customers on an aggregated basis rather than on a contract-by-contract basis.

Other IFRS Standards generally specify the accounting for an individual contract to provide the most transparent information for each contract.

When insurers apply IFRS 17 in 2021, they will initially account for loss-making contracts, contracts with low profitability and other profitable contracts in three separate buckets, so that gains on profitable contracts will not obscure losses on other contracts.

Over time gains on some insurance contracts will offset losses on other insurance contracts within the same bucket. However, contracts may not be grouped if they are written more than 12 months apart. As a result, differences in the profitability development of contracts written in different periods will be visible in insurers' financial statements, providing insights that investors do not have today.

How insurance works

People that buy policies (insurance contracts) are willing to pay a known amount of money (premium) to have an insurer assume the financial consequences of future uncertainties (pay claims). The insurer assumes the responsibilities from many policyholders knowing that:

- most whole-life insurance contracts will result in claims but their timing is uncertain; and

- claims will occur for some non-life (and term-life) insurance contracts but it is impossible to determine in advance which insurance contracts will result in claims.

Pooling reduces the volatility of losses and the level of the uncertainty narrows. In other words, losses become more predictable in large numbers.

Why does the unit of account in IFRS 17 matter so much?

The unit of account was a controversial issue during the development of IFRS 17 because it affects the timing of recognition of profit for insurance services.

The unit of account, however, does not change the total profit recognised over the life of a contract or the fulfilment cash flows of insurance contracts. For the fulfilment cash flows, insurers can estimate expected cash flows at any level—contract level, portfolio level or group level—and then allocate those expected cash flows to different groups of contracts.

The unit of account matters for determining the pattern of profitability. It aims to ensure that trends in the profitability of a portfolio of contracts are reflected in the financial statements of insurers in a timely way, by reporting profit when the insurance coverage is provided and losses as soon as it becomes apparent that losses are expected.
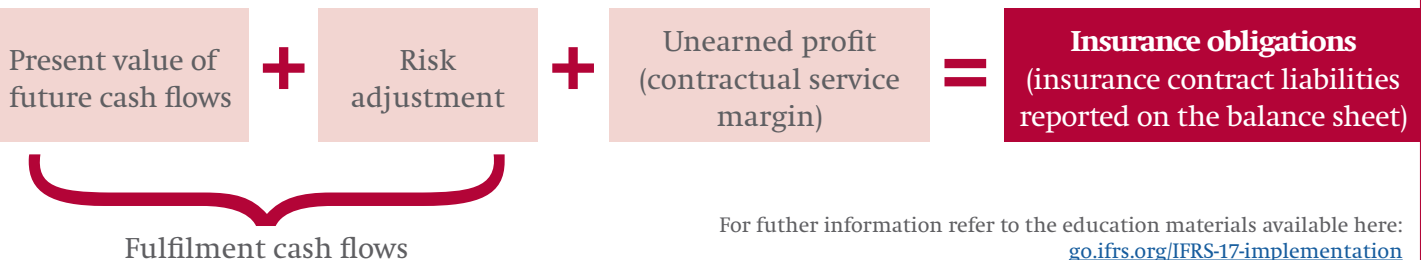
At the same time, the unit of account provides cost relief to insurers and a better reflection of the insurance economic practice, by allowing them to group insurance contracts for measurement purposes, based on the characteristics of the contracts and the insurers' approach to managing them.

What is a unit of account?

The 'unit of account' is a key concept in accounting that specifies what is to be accounted for in a company's financial statements.

It refers to the level of aggregation at which an asset or liability is recognised and measured. For example, the unit of account determines whether a company's set of contracts is to be measured at the individual contract level or at the aggregate contract level. Depending on the perspective taken about the unit of account, the amounts reported in the company's financial statements may be different. The unit of account can affect the pattern of profit recognition and ultimately the insights investors can obtain about financial performance.

Reminder—what are the components that make up the insurance contract liability in IFRS 17?

Present value of future cash flows **+** Risk adjustment **+** Unearned profit (contractual service margin) **=** **Insurance obligations** (insurance contract liabilities reported on the balance sheet)

Fulfilment cash flows

For futher information refer to the education materials available here:
go.ifrs.org/IFRS-17-implementation

For companies applying IFRS 17, the unit of account is a group of insurance contracts. The way contracts are grouped affects the timing of recognition of profit for insurance services, but does not affect the measurement of the cash flows to fulfil the insurance contracts.

Despite differences in the unit of account among IFRS Standards, the key principles in IFRS 17 are consistent with those applied by companies using other IFRS Standards. For example, in applying IFRS 15 *Revenue from Contracts with Customers*, utility companies generally recognise profit when a service is provided to a customer; in applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, construction companies book a provision for loss-making contracts when the costs of fulfiling a contract exceeds the economic benefits expected to be received under the contract.

Why aggregate insurance contracts for accounting purposes?

The following example explains why aggregating insurance contracts for accounting purposes is appropriate and provides useful information to investors and other users of financial statements.

Assume that:

- an insurer writes three insurance contracts with a coverage period of three years;

- each policyholder pays a single premium of CU10 at inception;

- the insurer expects each contract to be subject to a claim of CU3.5 each year until termination of the contract; and

- the insurer expects one contract to be terminated at the end of each year.

Accordingly, at inception, the insurer expects to provide coverage for all three contracts in Year 1, for two contracts in Year 2 and for only one contract in Year 3. However, the insurer does not know which contract will terminate at what date.

As is common practice in the insurance industry, the insurer makes estimates about the amount and timing of the cash flows that will arise as the insurer fulfils the contracts. These estimates are valid on average for each contract in a group of insurance contracts, even though the experience of an individual contract will ultimately differ from the average.

Consequently, each contract has an expected length of two years, expected cash outflows of CU7 and expected profit of CU3. However, only one of the three contracts will have actual cash flows that equal the average cash flows, even when everything occurs as expected.

The expected cash flows are summarised in the following table:

Amounts in currency units (CU)	Contract A	Contract B	Contract C	Total	Average per contract
Expected term	**1 year**	**2 years**	**3 years**	**6 years**	**2 years**
Premiums	10.0	10.0	10.0	30.0	10.0
Claims	(3.5)	(7.0)	(10.5)	(21.0)	(7.0)
Profit or (loss)	**6.5**	**3.0**	**(0.5)**	**9.0**	**3.0**

After one year, the insurer knows that Contract A has terminated. Depending on the perspective taken about the unit of account, the profit recognised in the insurer's financial statements in each year may differ.

Accounting at group level

If the insurer accounts for contracts on a group basis, a better reflection of the economics of the contracts would be observed. This is because when Contract A has terminated the group of contracts behaved as expected and there is consequently no change in expectations.

The insurer still expects to recognise the total expected profit of CU9 over the duration of the contracts. Under a group approach it will do that in proportion to the coverage provided over the expected duration of the contracts within the group. For example, by allocating the expected profit in proportion to the coverage years provided for the period, the insurer will recognise CU4.5 of expected profit in Year 1. This is because the proportion of the coverage provided for the period equals half of the expected coverage to be provided for the whole group (three contracts for one year over a total of six coverage years) and half of the expected profit of CU9 is equal to CU4.5.

On a group basis, there is no change compared to the expectations after one year. However, on an individual contract basis, there is a change in expectations for all three contracts.

> When contracts subject to the same average assumptions are grouped for financial reporting, favourable and unfavourable changes in estimates relating to individual contracts within the group are offset and only any net change in estimate is reported in the financial statements.
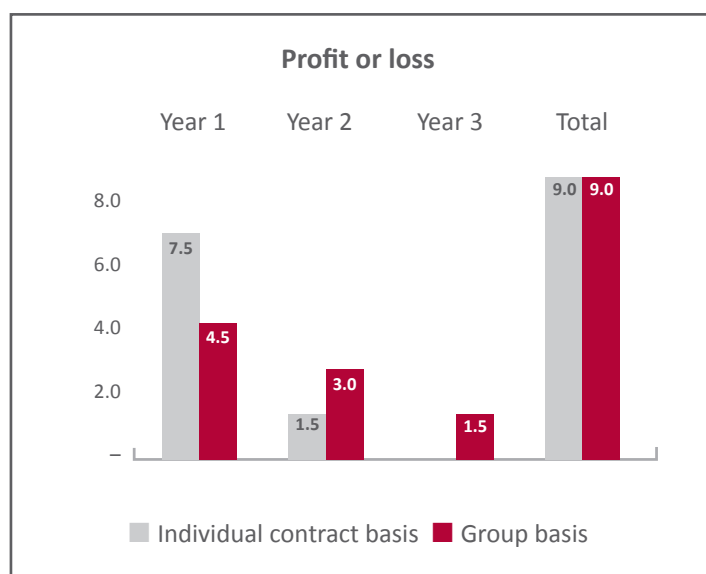
Profit or loss

Note: on individual contract basis, at the end of Year 2 the insurer knows that one contract is onerous; the profit or loss in Year 2 reflects the expected loss on that contract.

Accounting at individual contract level

If the insurer were to account for each individual contract on a separate basis, then as explained above, the average assumption would apply to each contract individually. Thus, when Contract A terminated there would be a change in expectations for all contracts. This is because Contract A has performed better than the average, and Contracts B and C are now expected to perform correspondingly worse than the average.

At a detailed level

For Contract A there was a change because this contract terminated after one year and therefore it incurred claims for one year instead of the expected average of two years. Consequently, the expected cash outflows for this contract will decrease and the expected profit for the contract will correspondingly increase from CU3 to CU6.5, all of which is recognised in the year it terminates.

In contrast, for the remaining two contracts, the average expected cash outflows will increase. This increase reflects the fact that based on the averages at inception, both contracts were expected to only have two claims each; however, now one of the remaining contracts is expected to have three claims in total. As a consequence, the revised expected profit for the two contracts together will decrease from CU6 to CU2.5.

In Year 1, the insurer recognises a profit of CU7.5, including the profit of CU6.5 for Contract A that has terminated and the portion of expected profit for Year 1 for the contracts that remained in force amounting to CU1 (CU2.5 / 2.5 years x 1 year).

What does this example show?

This example shows that investors are unlikely to find information about losses relevant when expectations of claims across a group of similar contracts as a whole have not changed, but it is now clearer which contracts in that group will result in claims. This is because the same change in expectations that could cause some contracts to be loss making would also make some contracts less profitable.

What drives aggregation for financial reporting?

The difficulty in aggregating insurance contracts to accurately reflect the underlying economics is determining what drives the aggregation. In principle, aggregation should not occur at a level that masks real economic differences.

Each insurance contract issued by an insurer may result, substantially, in:

(a) a profit, when, on a risk-adjusted discounted basis, the premiums received from the policyholder are greater than the payments made to the policyholder for claims; or

(b) a loss, when, on a risk-adjusted discounted basis, the premiums received from the policyholder are lower than the payments made to the policyholder for claims.

When applying IFRS 17, the accounting treatment for the expected profit from an insurance contract differs from that for the expected loss. An insurer will recognise:

(a) the expected profit for providing coverage as the coverage is provided over time; and

(b) the expected losses as soon as it becomes apparent that losses are expected (at inception or subsequently).

The requirements in IFRS 17 regarding the unit of account are designed to mitigate the loss of information caused by inappropriate offsetting so that financial statements faithfully represent the effect of managing insurance contracts on an aggregated level.

How will insurance contracts be aggregated under IFRS 17?

When applying IFRS 17, an insurer will firstly identify its portfolios of insurance contracts. A portfolio of insurance contracts comprises contracts that are:

(a) subject to similar risks; and

(b) managed together.

For example, whole-life insurance contracts, annuities and car insurance contracts represent three different portfolios of contracts.

Once the insurer has identified portfolios of contracts, it will divide each portfolio into groups considering differences in the expected profitability of the contracts.

1 For contracts that at initial recognition are expected to be loss making (that is, onerous), the insurer will recognise losses immediately in the income statement. So losses and profits will not be offset by grouping loss-making contracts with profit-making contracts.

2 For contracts that at initial recognition are expected to be profitable, the insurer will recognise the expected profit as it provides the insurance coverage. The expected profit will be allocated to two groups:

(a) a group of contracts that at initial recognition have no significant possibility of subsequently becoming onerous; and

(b) the remaining contracts.

This means that contracts that have a significant possibility of becoming onerous will not be grouped with those that have a lower possibility of becoming onerous. As a result, unexpected losses on future onerous contracts are more likely to be visible in insurers' financial statements in a timely way, enabling investors to evaluate how the performance of insurers changes over time.

Each portfolio is divided into groups		
1	**2 Profitable contracts**	
Onerous contracts ☹	Significant possibility of becoming onerous 😐	No significant possibility of becoming onerous ☺

The way contracts are aggregated will affect the recognition of profit arising from insurance contracts as the insurance coverage is provided. Expected losses on contracts within a group will be recognised only when the entire group of contracts is onerous (that is, when expected losses for a group of contracts are greater than the remainder of the expected profits for that group).

To provide trend information about the profitability of contracts written in different periods, contracts may not be grouped if they are written more than 12 months apart—a contract issued in May 2021 cannot be grouped with a contract issued in June 2022, for example.

This requirement is sometimes referred to as the 'annual cohort requirement' in IFRS 17.

Why do annual cohorts benefit investors with better information?

The annual cohort requirement in IFRS 17 aims to prevent perpetual open portfolios where the duration of each group of contracts is extended by the ongoing underwriting of new policies (insurance contracts). Perpetual open portfolios cause the profitability of old contracts to be averaged with the, likely different, profitability of new contracts.

The requirement mitigates the problem of 'earnings smoothing', as losses on contracts written in the past will no longer be offset with profits on new business or vice-versa (as may be the case with some insurers today). Importantly, once IFRS 17 is applied, investors will be able to analyse the development of the profitability of contracts written in different years.

Implementing the annual cohort requirement will result in two main benefits in terms of information about insurers' financial performance:

- a timely recognition of losses; and
- the recognition of profit when insurance coverage is provided.

The following examples illustrate these benefits for investors and other users of financial statements.

Example 1—Timely recognition of losses

Suppose:

- in Year 1, an insurer writes four-year contracts with a total expected profit of CU120m—expected profit of CU30m for each year;
- in Year 2, the insurer writes four-year contracts with a total expected profit of CU36m—expected profit of CU9m for each year; and
- in Year 3, due to changes in expectations, the group of contracts written in Year 1 is now onerous, with an expected loss of CU20m.

Example 1—Profit or loss
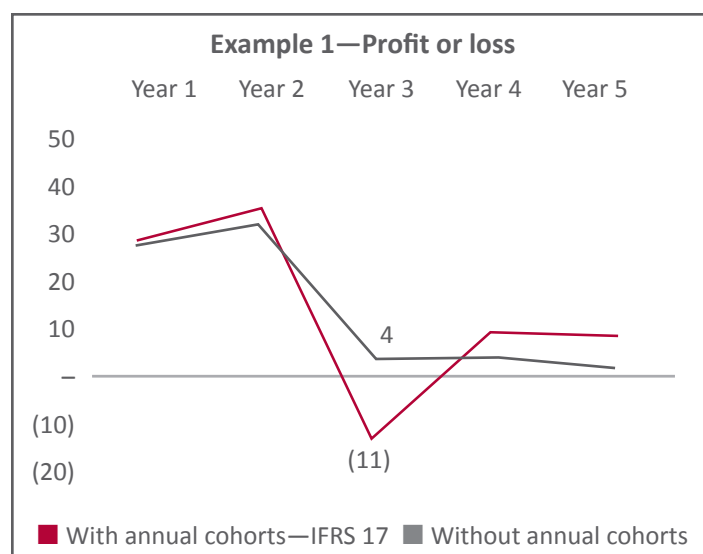
See the Appendix for detailed calculations relating to Example 1.

Without the annual cohort requirement:

- information about the change in profitability would not be reflected in the insurer's income statement on a timely basis.

- in Year 3, the insurer would still report a profit of CU4m—it would not fully recognise in the income statement the loss of CU20m for contracts that are no longer profitable (contracts written in Year 1). This is because it would have grouped those contracts with profitable contracts written in a different period (contracts written in Year 2).

- the loss of CU20m resulting from contracts written in Year 1 would be averaged with the remaining expected profit of contracts written in Year 2 and would be recognised as lower profit in the income statement over Years 3–5.

> Information about changes in profitability over time—by contracts written in different years—will provide insight that investors did not have before.

Example 2—Recognition of profit when insurance coverage is provided

Consider a similar example where no changes in expectations occur after contract inception. As in the previous example, suppose:

- in Year 1, an insurer writes four-year contracts with a total expected profit of 120m—expected profit of CU30m for each year; and

- in Year 2, the insurer writes four-year contracts with a total expected profit of CU36m—expected profit of CU9m for each year.

Annual cohorts are needed to maintain separate groups so that the profit of both groups is not averaged.

Example 2—Profit or loss
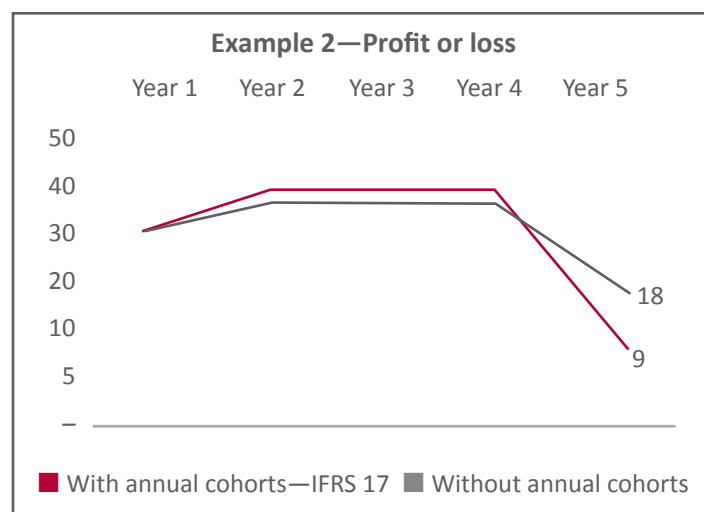
See the Appendix for detailed calculations relating to Example 2.

Without the annual cohort requirement, the profit for insurance services would not be recognised in the appropriate periods:

- the profitability of contracts written in Year 1 would be averaged with the lower profitability of contracts written in Year 2 and result in the blended profits being recognised over a longer time-frame (that is, over Years 1–5, rather than over Years 1–4).

- in Year 5, the averaging effect would result in a profit for insurance services of CU18m being recognised, despite the fact that the contracts in force (contracts written in Year 2) have an expected profit of only CU9m. In this case the earnings smoothing would overstate Year 5 profits by 100 per cent.

This example illustrates that the annual cohort requirement in IFRS 17 prevents profits outlasting contracts.

About disclosures

IFRS 17 introduces many new disclosure requirements, one of which is to require insurers to disclose the development of the expected profit of insurance contracts during the reporting period, for example, by major product lines, geographical area and reportable segment. This disclosure requirement in IFRS 17 will provide insight about the progression of profitability of insurance contracts that investors do not have today.

What will change when IFRS 17 is applied?

The existing IFRS Standard for insurance contracts—IFRS 4 *Insurance Contracts*—does not provide specific requirements concerning most aspects of the accounting for insurance contracts.

IFRS 4 substantially permits insurers to determine their own methodology in aggregating contracts. As a result, insurers use a wide range of insurance accounting practices based on local accounting requirements (some of which may have been applied prior to implementing IFRS Standards) or variations of those requirements for reporting on a key aspect of their business.

Although today most insurers do not specify whether and how insurance contracts are grouped together to recognise expected profits and losses, some insurers aggregate contracts at a high level to offset losses on onerous contracts against profitable contracts.

In addition, some insurers may recognise the expected profits from a group of contracts at inception if there are no restrictions. This may mask differences in the profitability of contracts written in different years.

IFRS 17 introduces a consistent framework for the accounting for insurance contracts, which will improve the transparency of the accounting policies applied by many companies and will enable investors to better analyse the profitability of insurance contracts by generation (or vintage) of contracts.

> Under IFRS 17, the mechanism for recognising profit from insurance services in the income statement will be less susceptible to distortion caused by artificial smoothing.

Educational material on IFRS 17 *Insurance Contracts*

Visit the IFRS 17 implementation page to see the wide range of material available to help you understand the requirements in IFRS 17 and the implications the Standard has for investors and others: go.ifrs.org/IFRS-17-implementation.

Watch the webinar How does IFRS 17 work and what does it mean for investors?

Get in touch

If you would like to discuss this topic or other areas of accounting, please contact:

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Follow @IFRSInvestors on Twitter to keep up to speed on changes in the world of IFRS Standards and how these changes may affect investors.

Appendix—Detailed calculations about the examples discussed in the article

Example 1—Timely recognition of losses

Amounts in currency units (CU)	Year 1	Year 2	Year 3	Year 4	Year 5	Total profit
Profit recognised in the income statement—with annual cohorts						
Contracts written in Year 1	30	30	(20)	0	–	40
Contracts written in Year 2	–	9	9	9	9	36
Profit or (loss)	**30**	**39**	**(11)**	**9**	**9**	**76**

Amounts in currency units (CU)	Year 1	Year 2	Year 3	Year 4	Year 5	Total profit
Profit recognised in the income statement—without annual cohorts						
Contracts written in Year 1 and in Year 2	30	36	4	4	2	76
Profit or (loss)	**30**	**36**	**4**	**4**	**2**	**76**
Unearned profit (beginning of year)	–	90	90	6	2	
New contracts	120	36	–	–	–	
Changes in expectations	–	–	(80)	–	–	
Allocation to the income statement	(30)	(36)	(4)	(4)	(2)	
Remaining unearned profit (end of year)	90	90	6	2	–	
Coverage units per year	1	2	2	2	1	
Cover provided / cover to provide	1/4	2/7	2/5	2/3	1/1	

The table above shows that without the annual cohort requirement:

- contracts issued in Year 1 and in Year 2 would be grouped together;

- in Year 2, the unearned profit for contracts written in Year 2 (CU36) would be grouped with the remaining unearned profit for contracts written in Year 1 (CU90) resulting in a cumulated remaining unearned profit of CU126;

- 2/7 of this unearned profit would be allocated to Year 2 resulting in a recognition of profit in the income statement of CU36 (CU126 / 7 x 2);

- in Year 3, the unearned profit would be adjusted for the changes in expectations of CU80 for contracts written in Year 1 (CU60 for the previously expected profit for Years 3–4 and CU20 for the new expected loss for those years); and

- in Year 3 the adjusted unearned profit of CU10 (CU90−CU80) would be allocated to Years 3–5 based on the coverage to be provided in Years 3–5 as follows: CU4 to Year 3 (CU10 / 5 x 2), CU4 to Year 4 (CU6 / 3 x 2) and CU2 to Year 5 (CU2 / 1 x 1).

Example 1—Assumptions

- In Year 1, an insurer writes four-year contracts with a total expected profit of CU120m—expected profit of CU30m for each year.

- In Year 2, the insurer writes four-year contracts with a total expected profit of CU36m—expected profit of CU9m for each year.

- In Year 3, due to changes in expectations, the group of contracts written in Year 1 is now onerous, with an expected loss of CU20m.

- All contracts provide the same level of cover per year. This means that, if contracts issued in Year 1 and in Year 2 are grouped together, there is one coverage unit in Year 1 (Year 1 contracts only) and in Year 5 (Year 2 contracts only) and there are two coverage units in Years 2–4 (Year 1 and Year 2 contracts).

- For simplicity, the time value of money is not reflected in this example.

Example 2—Recognition of profit when insurance coverage is provided

Amounts in currency units (CU)	Year 1	Year 2	Year 3	Year 4	Year 5	Total profit
Profit recognised in the income statement—with annual cohorts						
Contracts written in Year 1	30	30	30	30	–	120
Contracts written in Year 2	–	9	9	9	9	36
Profit or (loss)	**30**	**39**	**39**	**39**	**9**	**156**

Amounts in currency units (CU)	Year 1	Year 2	Year 3	Year 4	Year 5	Total profit
Profit recognised in the income statement—without annual cohorts						
Contracts written in Year 1 and in Year 2	30	36	36	36	18	**156**
Profit or (loss)	**30**	**36**	**36**	**36**	**18**	**156**
Unearned profit (beginning of year)	–	90	90	54	18	
New contracts	120	36	–	–	–	
Changes in expectations	–	–	–	–	–	
Allocation to the income statement	(30)	(36)	(36)	(36)	(18)	
Remaining unearned profit (end of year)	90	90	54	18	–	
Coverage units per year	1	2	2	2	1	
Cover provided / cover to provide	1/4	2/7	2/5	2/3	1/1	

The table above shows that without the annual cohort requirement:

- contracts issued in Year 1 and in Year 2 would be grouped together;

- in Year 2, the unearned profit for contracts written in Year 2 (CU36) would be grouped with the remaining unearned profit for contracts written in Year 1 (CU90) resulting in a cumulated remaining unearned profit of CU126;

- 2/7 of this unearned profit would be allocated to Year 2 resulting in a recognition of profit in the income statement of CU36 (CU126 / 7 x 2);

- in Year 3, 2/5 of the unearned profit of CU90 would be allocated to Year 3 resulting in a profit in the income statement of CU36 (CU90 / 5 x 2);

- in Year 4, 2/3 of the unearned profit of CU54 would be allocated to Year 4 resulting in a profit in the income statement of CU36 (CU54 / 3 x 2); and

- in Year 5, the unearned profit of CU18 would be totally allocated to Year 5 because no coverage will be provided after Year 5.

Example 2—Assumptions

- In Year 1, an insurer writes four-year contracts with a total expected profit of CU120m—expected profit of CU30m for each year.

- In Year 2, the insurer writes four-year contracts with a total expected profit of CU36m—expected profit of CU9m for each year.

- All contracts provide the same level of cover per year. This means that, if contracts issued in Year 1 and in Year 2 are grouped together, there is one coverage unit in Year 1 (Year 1 contracts only) and in Year 5 (Year 2 contracts only) and there are two coverage units in Years 2–4 (Year 1 and Year 2 contracts).

- For simplicity, the time value of money is not reflected in this example.