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IFRS® Standard 17 Insurance Contracts



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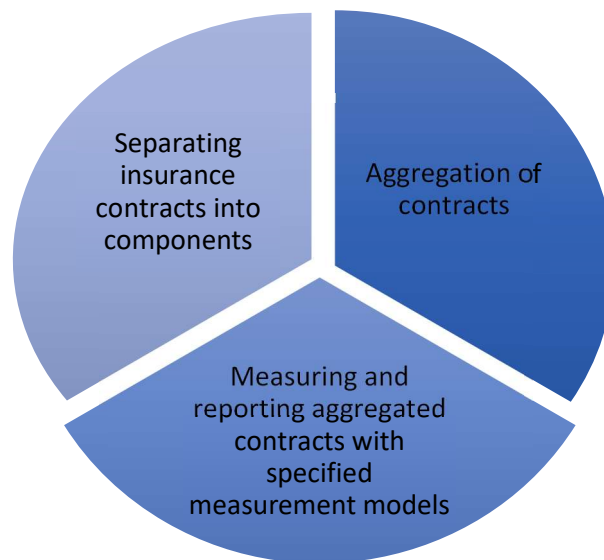
IFRS® Standard 17 Insurance Contracts

SCOPE

The IFRS 17 standard is effective for annual reporting periods beginning or after January 1st, 2023, and may be applied earlier, provided that “IFRS Standard 9 - Financial Instruments” is implemented.

Principles for recognition, measurement, presentation and disclosure of insurance contracts are established within the scope of IFRS 17. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity’s financial position, financial performance and cash flows (IFRS 17: 1). This standard consists of the process of separating, grouping and measuring insurance contracts with certain measurement models (see Figure 1).

Figure 1. Processes under IFRS 17



IFRS 17 combines the current measurement of future cash flows with the recognition of profit over the period in which services are provided under the insurance contract. The main purposes of the standard are summarized in Figure 2.

Figure 2. Main Purposes of IFRS 17



Considering the purpose and scope of IFRS 17, the contracts that should be reported and accounted for are listed as follows:

- All insurance contracts, including reinsurance contracts that are issued,
- Reinsurance contracts that are held,
- Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts

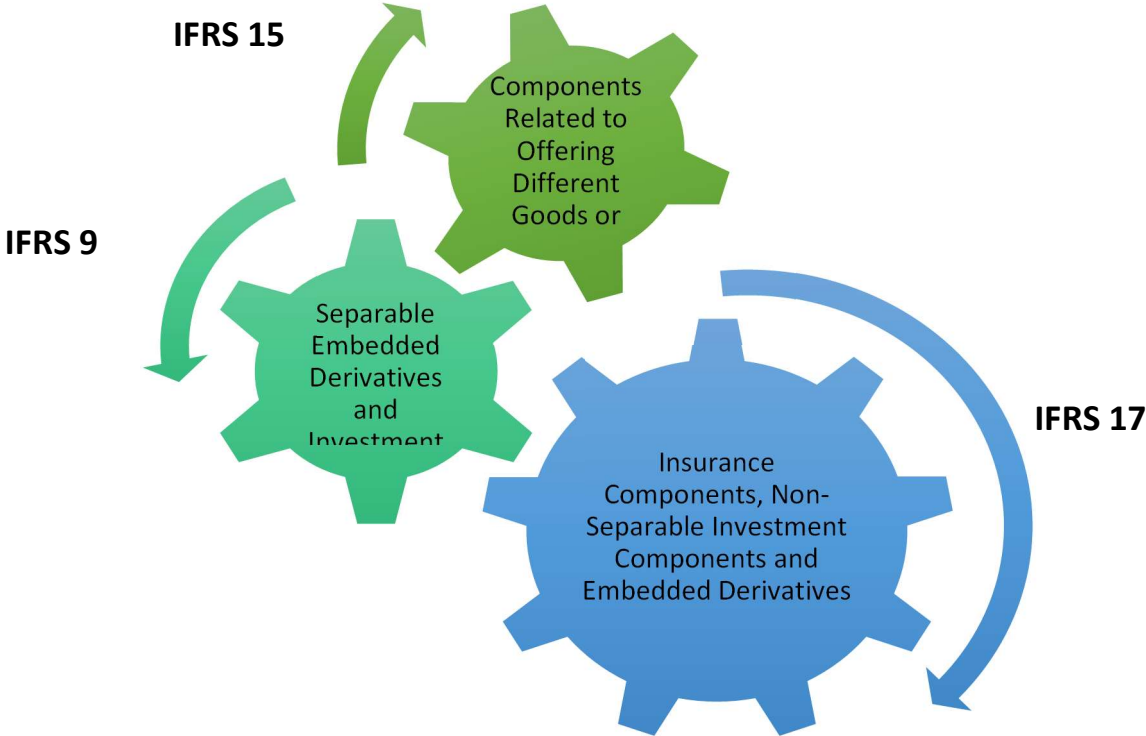
It is possible to combine two or more insurance contracts made by the insurance company within the scope of IFRS 17 at the same time or to be made in the near future, with the same insured or with the related parties of the insured and accounted for as a single insurance contract.

Cases related to different standards are accounted for within the scope of the relevant standard. For example, assets and liabilities arising from employee benefit plans are reported in accordance with “IAS Standard 19 Employee Benefits”.

Separation of Contract Components

Insurance contracts may consist of components related to the provision of services or investment components, or components that contain both, apart from the insurance component. According to the standard, components other than the insurance component should be separated from the insurance contract and included in the scope of the relevant standard (see Figure 3).

Figure 3. Components Covered in Other Standards



In order to be able to separate the investment component from the contract completely, exclude it from the scope of IFRS 17 and evaluate it within the scope of “IFRS Standard 9 Financial Instruments”, there should not be a high level of relationship between them. For example, if the insurance component cannot be measured without the investment component and the value of the insurance component affects the value of the investment component, then there is a high degree of correlation between them.

In addition, contracts with the investment component must be sold separately in the same market. Companies decide for themselves whether the investment component can be sold separately, by obtaining reasonable information. The separable investment component, on the other hand, should be separated from the contract and evaluated within the scope of “IFRS Standard 9 Financial Instruments”.

Different goods or services other than the insurance product that is provided to the insured should be separated from the articles of association and included in the scope of "IFRS Standard 15 Revenue from Contracts with Customers". However, if the cash flows related to the said goods or services and the insurance product are highly correlated, there is no need to separate them.

Combination of Insurance Contracts

After the components other than the insurance component which are separable from the contract are separated and included in the scope of the relevant accounting standards, the remaining elements of the contract should be grouped according to characteristics that are similar to each other in various respects.

Portfolios to be created under the IFRS 17 should consist of contracts with similar risks and be managed together. The company's portfolio should be divided into at least three groups: a group of economically onerous contracts, a group of contracts with no significant probability of subsequently becoming onerous, and a group of remaining contracts.

A combination of insurance contracts takes place at initial recognition and the composition of the groups is not re-evaluated later. For contracts to be consolidated within the same group, there must be supportable and reasonable information. Contracts to which the premium allocation approach is applied are assumed not to be onerous unless the circumstances indicate otherwise. In contracts which this approach is not applied, an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous. This assessment is based on the likelihood of changes in assumptions would result in the contracts becoming onerous and using information about estimates provided by the entity's internal reporting.

Example: A grouping can be done as follows:

	Group A	Group B
Onerous contracts	Contracts 3, 5	Contracts 1, 4
No possibility of becoming onerous	Contracts 8, 9, 10	Contracts 2, 6
Other profitable contracts	Contracts 7, 12	Contracts 11, 13, 14

KEY DEFINITIONS

In order to comprehend IFRS 17 more clearly and to apply it more accurately, the definitions in Table 1 should be understood:

Table 1: Key Definitions for IFRS 17

Contractual Service Margin (CSM)	A component of the carrying amount of the asset or liability for that group of contracts that represents the unearned profit that an entity will receive when it provides services under insurance contracts.
Coverage Period:	The period during which the insurer provides insurance contract services
Fulfilment Cash Flows	A weighted estimate of the difference between the present values of future cash inflows and outflows that will arise as insurance contracts are fulfilled, applying a risk adjustment for non-financial risk.
Insurance Contract	An agreement under which a customer (the policyholder) transfers significant insurance risk to an insurer
Insurance Risk	Risk, other than financial risk transferred from the policyholder to the insurer (for example, risk of death)
Investment Component	Amounts that the entity expects to reimburse the policyholder even if the insured event does not occur

Portfolio of Insurance Contracts	Insurance contracts that are subject to similar risks and managed together. Different product lines (for example, annuity contracts and car insurance) are expected to be in different portfolios
Reinsurance Contracts	An insurance contract in which an entity is involved to compensate for losses resulting from one or more insurance contracts issued by another insurance entity
Policyholder	A party entitled to compensation if an insured event occurs under an insurance contract

RECOGNITION

The IFRS 17 recognition framework establishes accounting principles in 2 main areas:

1. Profitability Recognition – the recognition of profit or loss at inception and over the lifetime of the insurance contract
2. Liability Measurement – the utilization of three different measurement models where insurance portfolios with similar risks and dates are managed together. This is accompanied by the CSM component, which represents the unearned profit the entity will recognize as it provides services in the future.

The timing of accounting for insurance contracts is also one of the issues included in IFRS 17. According to the standard, a group of insurance contracts issued by insurance companies should be recognized as of the earliest of the following dates:

- Starting date of the coverage period of the contract group
- The date on which the first payment to be made by the insured in the group is due
- The date the group became onerous for an economically onerous group of contracts.

In the absence of a contractual due date, the date on which the first payment is received from the policyholder is considered as the due date.

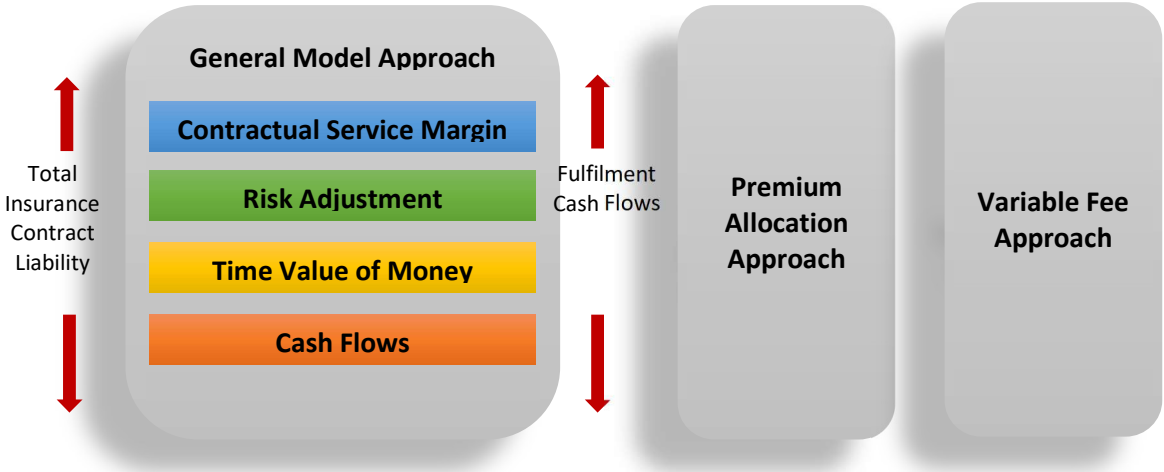
Cash flows related to a group of insurance contracts that are paid or received before recognition are recognized as assets or liabilities unless the entity chooses to recognize income or expenses for that group as expense or income. Assets or liabilities arising from the cash flows of such insurance acquisitions are derecognised after the group of insurance contracts is recognised.

At the end of each reporting period, the recoverability of an asset is evaluated for insurance acquisition cash flows if current conditions and circumstances indicate that the asset is significantly impaired. The carrying amount of the asset is adjusted for impairment and the impairment is recognized in profit or loss. If impairment conditions improve in subsequent periods, the carrying amount of the asset is increased. Thus, the impairment is cancelled.

MEASUREMENT

According to IFRS 17, there are three different measurement approaches that should be taken as a basis in the accounting and reporting of insurance contracts for the first time or in subsequent periods. It is envisaged that the most appropriate of these three approaches will be used in the valuation of an insurance contract as of the end of the period. These approaches are as seen in Figure 4.

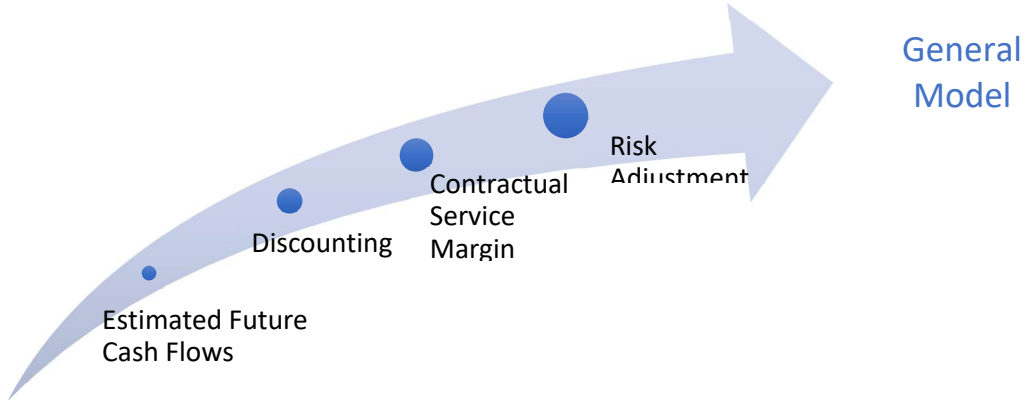
Figure 4. IFRS 17 Measurement Models



In practice, it is expected that the general model approach will be used in contracts with a term of more than one year, the premium allocation approach in contracts with a term of one year or less, and the variable fee approach in contracts with direct participation features.

General Model Approach: The general model is applied for all contracts and contract groups, with certain exceptions detailed in the standards. Figure 5 shows the factors of the general model.

Figure 5. General Model Approach



Initial Recognition and Measurement

- The CSM, which represents unearned contract profit and fulfilment cash flows, is the expected earnings as service is provided under the insurance contract. Under IFRS 17, this margin should not be recognized as a gain at initial recognition. Income should be recorded as the service is provided. At the same time, any losses that may arise should be recognized after they arise. The fulfilment cash flows within the boundaries of each of the contracts in the group should be measured with an estimate that is up-to-date, clear, unbiased, and based on information the company will obtain without undue effort.
- Future cash flow estimates should be discounted to reflect the time value of money and other financial risks. This discount rate should reflect the characteristics of cash flows, the time value of money, and the liquidity of insurance contracts. According to the standard, the discount is calculated in two ways. The first of these is the bottom-up approach, which is the calculation made by adding the differences between the liquidity characteristics of financial instruments in the market and the liquidity characteristics of the insurance contract group on a liquid and risk-free yield curve. The second calculation method is the top-down approach, and it is determined by adjusting the yield curve of the portfolio according to the liquidity characteristics of the insurance contract group and the liquidity characteristics of the reference portfolio in order to eliminate factors unrelated to the insurance contract group.
- Cash flows may not be as expected, both in terms of timing and amount. Therefore, risk adjustment for non-financial risks must be calculated. Risk adjustment is the compensation the insurer charges for uncertainties in the amount and timing of cash flows arising from non-financial risks. Risk adjustment is a highly complex process in which insurance companies combine uncertainty, diversification and risk aversion. IFRS 17 does not specify any method for calculating risk adjustment. An insurance company uses judgment in determining the appropriate estimation method for risk adjustment for non-financial risk.
- Cash flow forecasts can be made based on historical statistics. Cash flow estimates are based on claims reported by the insured, contractual features and historical data. All reasonable and supportable information available without undue cost or effort can be used for estimation. Market variables such as interest rates and exchange rates must be taken into account against financial risk in cash flow estimations. According to IFRS 17, a company's fulfilment cash flows must be updated.
- Estimates consistent with relevant market information are used at each reporting date.
- If the insurance contract is an onerous contract, the fulfilment cash flows will be negative. In this case, the entire loss must be accounted for in profit or loss for the period.

Example: Entity MD has drawn up a group of insurance contracts for 2 years with an expected premium of CU2,000 after initial recognition. Claims are estimated at CU1,000 and miscellaneous expenses at CU200, assuming that no contracts will expire before the end of the coverage period.

Insurance contract groups are measured at initial recognition as follows:

Estimates of future cash inflows	CU (2,000)
Estimates of future cash outflows:	
Claims	CU 1,000
Expenses	CU 200
Net fulfilment cash flows	CU (800)
Contractual service margin	CU 800
Insurance contract liability	---
Loss on initial recognition	----

Subsequent Measurement

Cash flow forecasts must be updated if conditions at the end of the reporting period differ. Current expectations about future events that may affect cash flow can be reflected in the forecast when estimating cash flow.

Insurance companies should include any changes in the book value of the remaining coverage liability in their financial statements. These changes can be listed as; decreases in the remaining coverage liability as a result of the services provided (insurance income), losses in the onerous contract groups and their cancellation (insurance service expenses) and the time value of money and the financial risk effect (insurance finance income/expenses).

Estimates apply to cash flows within the boundary of the contract and do not include cash flows outside the boundary of the contract.

The insurance company recognizes income and expenses related to changes in the carrying amount of the liability for incurred claims. These changes can be listed as follows:

- (a) Insurance service expenses for the increase in liability due to losses and expenses incurred during the period, excluding investment components.
- (b) Insurance service expenses for subsequent changes in fulfilment cash flows related to incurred claims and expenses incurred.
- (c) insurance finance income or expenses for the effect of the time value of money and the effect of financial risk.

Onerous Contracts

The concept of onerous contracts is used in the standard for economically disadvantageous contracts. Onerous contracts represent loss-making contracts and can be determined on a group or contract basis. Information can be requested from the pricing unit or other units to determine the contracts.

Pricing in insurance contracts is made according to the law of large numbers over risk groups that have similar and common characteristics. The risk premium is determined using statistical models, and the premium amount is created by adding additional premiums to the determined risk premium or by

subtracting discounts. With the standard, the information used in pricing will become important and can be used to determine whether the contract is onerous or not.

Used by companies during pricing, information such as historical damage data, status (private/legal) of the insured, gender, age, residence, city/district, amount of damage that occurred in previous contracts, damage frequency obtained from previous contracts, profession, etc. is expected to be used when finding onerous contracts. Apart from such information used in pricing, information such as economic conditions (purchasing power, unemployment, demand level), price sensitivity of customers, competitive situation in the market, companies' perspectives on risk, and the company's financial structure is also used.

Companies generally carry out pricing in a way that makes a profit from the contracts. However, unprofitable price planning can also be done for reasons such as the launch of a new product, competitive pressure or the desire to gain market share. In the case of non-profit pricing, the contract initially becomes onerous. Losses incurred on onerous contracts are required to be reported directly in profit or loss.

There are contract groups that make it difficult for companies to make decisions in determining the potential of contracts to be onerous. These contract groups can be listed as follows.

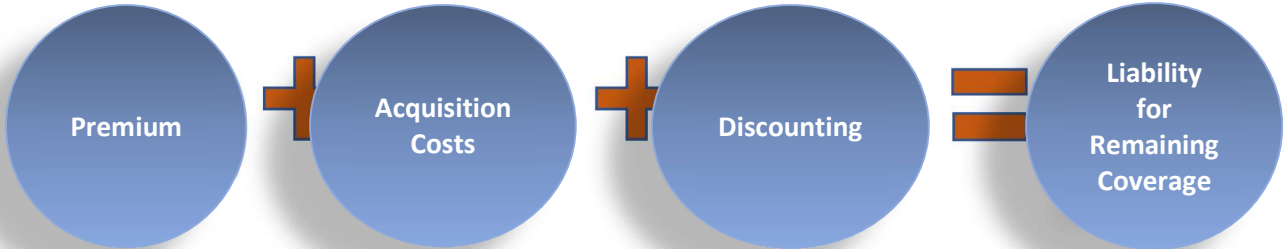
- Contracts priced differently from the standard tariff or pricing matrix used in contracts in the same portfolio.
- Contracts with different commitments that affect the profitability of the portfolio.
- Contracts with their own specific characteristics.
- Contracts marketed and sold through different distribution channels.

Premium Allocation Approach

Premium Allocation Approach is used when the contract term is one year or less or does not differ significantly from the measurement to be made with the general model. Essentially this model is a simplified version of the General Measurement Model.

Especially in life insurances, since the term is generally longer than one year, the mobility regarding the cash inflow and outflow during the term is higher, and cash flows are more affected by the changes in economic conditions. Therefore, this model is more suitable for insurance types other than life insurance. The premium allocation approach can be summarized in figure 6.

Figure 6. Premium Allocation Approach



In the premium allocation approach, at initial recognition, when determining the carrying amount of the liability for remaining coverage, premiums received at initial recognition are deducted from the insurance acquisition cash flows. And also, the amounts resulting from the derecognition of assets or liabilities related to the insurance acquisition are added to or deducted from the premium.

In the premium allocation approach, there is the possibility of recording the costs of any insurance acquisition directly as they occur. If the policy term is less than or equal to one year, the company may choose to expense the contractual direct costs directly.

At the end of each reporting period, when determining the carrying amount of the liability, the premiums received during the period, any adjustments made in a financing component and any amount recognized as expense within the reporting period are added to the carrying value at the beginning of the reporting period.

Example: AU Insurance Entity is an insurance company that produces health insurance contracts. The company produced 50 policies with a term of 1 year on 01.01.2022. These policies cover only inpatient treatment costs (excluding maternity). The premium amount per policy is CU 300. At the beginning of the contract, an acquisition cost of CU 100 has been accrued. If the insured receives inpatient treatment in private health institutions during the policy term, the amount of compensation to be paid will be covered up to CU 3,000. It is assumed that a guarantee of CU 8,000 will be paid at the time of the policy, according to available statistics. Calculation of discount and risk adjustment is not preferred. The company has chosen to apply the premium distribution model within the scope of IFRS 17.

At the beginning of the contract (January 1st, 2022):

Under IFRS 17, estimated cash flows must first be calculated.

Estimated cash inflows: CU 300 x 50 = CU 15,000

Estimated cash outflows: CU 8,000

Acquisition Cost: CU 100

In the premium distribution model, according to the standard, the use of risk adjustment and discount calculations is left to the discretion of the company, so the company has chosen not to apply these calculations. Accordingly, the Statement of Profit or Loss and Other Comprehensive Income of the entity will be as follows.

AU Insurance Entity	
“Statement of Profit or Loss and Other Comprehensive Income”	
December 31st, 2022	
Insurance Revenue	CU 15,000
Insurance Service Expenses	(CU 8,100)
Profit or Loss for the Period	CU 6,900
Comprehensive Income	CU 6,900

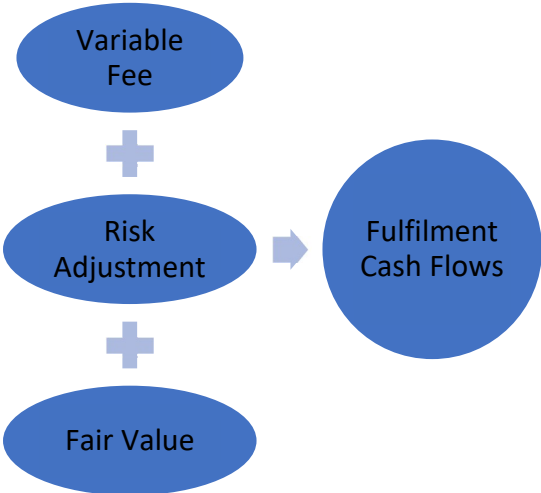
Variable Fee Approach

The variable fee approach is a variation of the general model and follows the principles of the general model but is modified to reflect the measurement of the return on investment that the insurance company can earn. This model is applied to insurance contracts with direct participation features. Insurance contracts with direct participation features should have the following characteristics:

- The insured participates in a clearly identifiable pool of underlying items.
- The insurance company expects to pay an amount equal to its share of the return on the underlying items.
- The amounts payable to the insured vary according to the changes in the fair value of the underlying items.

Variable Fee Approach can be summarized in figure 7.

Figure 7. Variable Fee Approach



The main difference between the variable fee model and the general model is evaluating the company's share over the return on assets. In the general model, interest is charged to the CSM at a fixed rate of return determined at the inception of the policy, and the difference between the rates of return in the market is accounted for as investment income or investment expense. In the variable fee model, on the other hand, the company's share of the return obtained from the asset pool in the contract is not considered as investment income but as a variable fee received in return for a service rendered.

The portion of the change in the value of the asset pool belonging to the insured is reflected in the cash flows. If a change in the return on assets is expected, it should be reflected in the CSM and the expected variable fee should be updated. The variable fee, which is the company's share of the return from its pool of assets, should be considered under IFRS 9.

Example: Entity UA has issued a portfolio of cumulative life insurance contracts. The premium amount for the portfolio is CU 50,000. The contracts are for 3 years and the starting date is January 1, 2022. At the end of the contract period, the insured are guaranteed to receive a sum equal to the premium they have paid at least. The portfolio has a total of 50 policies. If an insured dies within the term of the policy, the amount payable is CU4,000. An annual production cost of CU 40 is charged for each insurance policy from the insured. The fund, which consists of premiums related to cumulative life

insurance, is invested in bonds with an annual yield of 10%. The annual management fee charged on the portfolio return is 1%. All risks are assumed to be zero.

Total Premium:		CU 50,000
3-year sum of returns:	$(CU 50,000 \times 0.1) + (CU 55,000 \times 0.1) + (CU 60,500 \times 0.1) =$	CU 16,550
Agent commissions (for the insurance production costs):	$(CU 40 \times 50 \times 3) =$	<u>CU 6,000</u>
Estimated cash inflows:		CU 72,550
Total Guaranteed:	$[CU50,000 + (CU50,000 \times 0.1) + (CU55,000 \times 0.1) + (CU60,500 \times 0.1)] =$	CU 66,550
Entity's Share of the Return:	$(CU 5,000 \times 0.01) + (CU 5,500 \times 0.01) + (CU 6,050 \times 0.01) =$	<u>CU 165.5</u>
Estimated cash outflows:		<u>CU 66,715.5</u>
Estimated cash flow:		CU 5,834.5

DERECOGNITION

If the terms of an insurance contract are changed, the main contract is derecognised. The modified contract is accounted for as a new contract. In addition, the insurance contract is derecognised when the obligation specified in the insurance contract expires, is fulfilled or cancelled. When the insurance contract is terminated, there is no need to transfer any economic resources for the performance of the insurance contract, since the risk of the insurance company also ends.

The fulfilment cash flows allocated to the group are adjusted to remove the present value of the future cash flows and the risk adjustment for the non-financial risk associated with the rights and obligations removed from the group. In addition, the number of cover units for the time to contract expiration is adjusted to reflect the derecognised cover units. The CSM amount recognized in profit or loss during the period is also determined on the basis of this adjusted number.

DISCLOSURE

In accordance with IFRS 17, the following qualitative and quantitative information within the scope of this standard should be disclosed in order to evaluate the impact of insurance contracts on the financial position, financial performance and cash flows of the entity:

- Amounts recognized for contracts made,
- Significant judgments made in practice and changes in these judgments,
- The nature and extent of risks arising from contracts.

If such disclosures are insufficient, the entity should provide additional information. The entity aims to ensure that useful information is not lost in too many trivial details and is understandable when bringing together items with different characteristics.

Explanation of Recognised Amounts: Information disclosed about insurance contracts may be aggregated by contract type, geographic area, or reportable segment.

An entity shall separately disclose reconciliations showing how the net carrying amount of insurance contracts issued and reinsurance contracts held under IFRS 17 has changed due to recognized cash flows and income and expenses. An entity shall provide enough information in the reconciliations to identify changes in cash flows and amounts included in the financial performance statement.

Insurance Finance Income or Expenses: An entity discloses the total of insurance finance income or expenses in the current period. The relationship between such income and expenses and the return on investment in insurance finance assets is also disclosed in this context.

Transition Amounts: An entity shall make disclosures that enable users of financial statements to determine the effect on the CSM and insurance revenue in subsequent periods of groups of insurance contracts measured at the transition date by applying the modified retrospective or fair value approach. Therefore, the entity discloses a reconciliation of the CSM to the amount of insurance revenue.

EXAMPLE

DM Life Insurance Entity has issued 100 insurance policies for 2 years as of January 1, 2022. These policies cover payments to be made in the event of death. It is expected that a single premium of CU 10,000 will be received at the beginning of the contracts. At the beginning of the contract, an acquisition cost of CU 400 has been accrued. All of these expenses will be distributed throughout the coverage period. The amount of coverage per policy is CU 600. While estimating the cash outflows for each year, the company has assumed that it will repay 5 policies for each year by looking at the past statistics. During the contract period, the discount rate, including financial risk adjustment, is calculated as 3%. The risk adjustment ratio for non-financial risk has been determined as 5% of the estimated cash flows. Contracts will not be terminated until the end of the coverage period.

Solution: At the beginning of the contract (January 1, 2022):

Under IFRS 17, the present value of future cash flows must first be calculated. The insurance company estimated cash inflows of CU10,000. The company calculated the cash outflows as CU 3,000 based on the expected number of deaths (CU 600 x 5).

The net present value of the estimated cash outflows is calculated as CU 2,913 for the first year and CU 2,828 at a 3% discount rate.

$$1.\text{Year} \rightarrow \text{CU } 3,000 / (1 + 0.03) = \text{CU } 2,913$$

$$2.\text{Year} \rightarrow \text{CU } 3,000 / (1 + 0.03)^2 = \text{CU } 2,828$$

Also, the net present value of the acquisition cost is calculated as CU 388 for the first year and CU 377 at a 3% discount rate.

$$1.\text{Year} \rightarrow \text{CU } 400 / (1 + 0.03) = \text{CU } 388$$

$$2.\text{Year} \rightarrow \text{CU } 400 / (1 + 0.03)^2 = \text{CU } 377$$

Thus, the Present Value of Future Cash Flows has been estimated at **CU3,494** [CU10,000 – (CU 2,913 + CU 2,828) – (CU 388 + CU 377)]. It is calculated by subtracting the net present value of the estimated cash outflows and the net present value of the acquisition costs from estimated cash inflows.

The next step is to make a risk adjustment against non-financial risks. Risk adjustment based on assumptions is calculated as 5% of cash flows. Accordingly, the risk adjustment was calculated as CU 175 (CU 3,494 x 0.05). After risk adjustment, cash flows related to the fulfilment of the contract were determined (CU 3,494 - CU 175 = CU 3,319).

Under IFRS 17, an insurer is required to measure at initial recognition the fulfilment cash flows of a group of contracts at an amount that will not result in any profit or loss. Therefore, the CSM at initial recognition should be equal to zero when added to the fulfilment cash flows.

	January 1st, 2022
Present value of future cash inflows	(CU 10,000)
Present value of future cash outflows	CU 5,741
Present value of contract acquisition cost	CU 765
Present value of future cash flows	(CU 3,494)
Risk adjustment for non-financial risk	CU 175
Cash Flows Regarding the Fulfilment of the Contract	(CU 3,319)
Contractual Service Margin	CU 3,319
Insurance contract asset/liability at initial recognition	0

According to the standard, it is necessary to update the estimates of cash flows at the end of the year and recalculate the CSM as:

Present value of future cash outflows: $CU\ 3,000 / (1 + 0.03) = CU\ 2,913$

Present value of contract acquisition cost: $CU\ 400 / (1 + 0.03) = CU\ 388$

So the present value of future cash flows is calculated as CU 3,301 by adding the present value of future cash outflows and the present value of contract acquisition cost.

Also, the risk adjustment based on assumptions is calculated as CU 165 ($CU\ 3.301 \times 0,05$).

	January 1, 2022	December 31, 2022
Present Value of Future Cash Inflows	(CU 10,000)	-
Present Value of Future Cash Outflows	CU 5,741	CU 2,913
Present Value of Contract Acquisition Cost	CU 765	CU 388
Present Value of Future Cash Flows	(CU 3,494)	CU 3,301
Risk Adjustment for Non-Financial Risk	CU 175	CU 165
Cash Flows Regarding the Fulfilment of the Contract	(CU 3,319)	CU 3,466
Contractual Service Margin	CU 3,319	-
Insurance Contract Asset / Liability at Initial Recognition	0	