Article

Published in: The International Accountant – June 2019

Author

Dieter Van der Stock
Director, Product Manager

Contact Us

Americas
+1.212.553.1653

Europe
+44.20.7772.5454

Asia-Pacific
+852.3551.3077

Japan
+81.3.5408.4100

IFRS 17 calls for greater integration of actuarial and accounting systems

International Financial Reporting Standard (IFRS) 17 for insurance contracts becomes effective for insurers and reinsurers on January 1, 2022. An accounting-driven standard, IFRS 17 requires greater integration of actuarial and accounting systems, creating significant operational challenges related to data, processes, modeling, governance, and auditability.

Understanding the actuarial implications of IFRS 17 is a major challenge in its own right. Turning the calculations into a consistent accounting framework requires accountants who are familiar with the specific technical details of IFRS 17. This article examines one essential undertaking: designing an appropriate chart of accounts and posting logic.

That chart of accounts must either supplement a thick general ledger with the required accounts to produce a financial statement in accordance with IFRS 17, or be the cornerstone an IFRS 17 sub-ledger that will complement a thin general ledger. A suitable account numbering system should at the very least:

- Distinguish between portfolios and direct versus reinsurance business
- Classify insurance liabilities according to the IFRS 17 measurement approach
- Segregate accounting policy via PL or other comprehensive income (OCI)
- Isolate the different components of an insurance liability or asset, such as fulfilment cash flows, risk adjustment, and the contractual service margin (CSM)
- Group components belonging to the liability for remaining coverage and those belonging to liability for incurred claims
- Isolate the different types of movements (changed to a group of contracts induced by new business, experience variance, assumption changes, interest accretion, foreign exchange impact, and so on)

This design is not only a matter of classification, but also calls for decisions on how to meet all of the IFRS 17 disclosure requirements. For example, you could analyse movements through the net income statement and OCI, but how do you segregate movements that stay on the balance sheet, such as between the present value of fulfilment cash flows and the CSM?

A comprehensive chart of accounts is a good start, but the bigger challenge lies in the design of the posting logic, which must automate the translation of the actuarial calculations into the appropriate debit and credit journal entries. On the balance sheet, you need to account for the carrying amount of every group of insurance contracts into its distinct components: present value of cash flows, risk adjustment, and CSM. In addition, to meet IFRS 17 disclosure requirements, you must consider the same numbers from an alternative view, also breaking them down into the liability for remaining coverage, excluding the loss component, plus the loss component on one hand and the liability for incurred claims on the other hand.

At every reporting period, you must isolate changes to each of these components according to their origin. For example, new business in a non-onerous group increases the CSM, as you will be expecting additional premium cash flows out of it. After deducting expected claims and the risk adjustment, you need to keep the CSM largely on the balance sheet. Only across time will you gradually release tranches of the CSM into revenue, on par with the release of claims and expenses in each period. To make this happen, you must create journal entries to recognise the CSM as a liability and, subsequently, to amortize it into revenue.

Additionally, different types of changes will affect all the moving parts of your group at reporting time. For example, when you update the mortality tables for a group of life insurance policies, you require journal entries that separate the impact of these non-financial assumption changes on these elements:

» Present value of cash flows segregated across premiums, claims, and expenses

» Risk adjustment, which you may have to recalculate

» Ultimately, the CSM, because your expected profits will be affected

Another example is that you must recalibrate your insurance liability components with adjustments to your actuals and expected. But you cannot treat all such adjustments using the same accounting logic—that is, a change in financial assumptions will not affect the CSM. It does have an impact on current service but not future service; hence, you need to post it directly into income or expense. For current service movements, you also must identify the split between insurance service and insurance finance. The insurance finance components include interest accretion and changes in discount rates.

When a profitable group of contracts turns onerous, you need the posting logic to dissolve the CSM and recognize a loss component in expenses directly. Over time, you will not only account for the claims and expenses in the period, but will also gradually recognize some revenue as a reversal of previously posted losses.

Another area of complexity is the treatment of foreign currencies, which is where IAS 21 comes into play. IFRS 17 requires you to apply a discount rate whose characteristics are consistent with your insurance contracts, also in terms of currency. But how do you discount in a multicurrency group of insurance contracts? Splitting the group into subgroups per currency is not always desirable and also not possible if the group contains individual policies with cash flows in more than one currency.

One option to solve this issue would be to convert all cash flows of the group into a single currency. This might work where the FX impact is not very material, but for many businesses this is not the case. Thus, another option would be to apply, on a subgroup level, a discount rate on the cash flows per currency. This would be a more accurate approach but increases the complexity and introduces a number of important challenges. For example, at this subgroup level, you would have to remove the floor on the CSM and allow it to become negative. This is because onerousness is determined on a group level and not on a subgroup level.

You also need to produce posting logic for the ultimate release of revenue and expense out of other comprehensive income into profit or loss, related to your accounting policy with respect to treatment of foreign exchange, disaggregation, and reversals.

Next, acquisition expenses are embedded in your liabilities and CSM. Hence, the recovery of acquisition expenses over time will also be embedded in the release of CSM in income and expense. However, you also want to report the amortization and recovery of acquisition expenses separately in the income statement, which requires further calculations and accounting logic.

Another major challenge is the investment component (especially in the variable fee approach, but also elsewhere). While actuaries will take care of its definition and calculation, accountants need to design the logic to define the actual investment component on a paid claim, and remove and extract it from investment and service expense to enable IFRS 17-compliant disclosure.

A good practice would be to encapsulate the complexities of the IFRS 17 treatment of your insurance business in a sub-ledger solution, which inserts a journal into your general ledger and enables it to fill the IFRS 17 part of your financial reporting. In such a setup, you want a sub-ledger-level period closure process, which includes recognizing insurance profit or loss across the period, which you should do on the level of individual groups of insurance contracts. You should install controls and reconciliation checks to demonstrate that within the scope of your sub-ledger, your books balance and your disclosures reconcile.

To have all of your IFRS 17 calculations and accounting processes audit-ready, your solution must register all process steps—as well as manual interventions (if any)—meticulously.

CONTACT DETAILS

Visit us at **moodysanalytics.com** or contact us at a location below.

AMERICAS
+1.212.553.1653
clientservices@moodys.com

EMEA
+44.20.7772.5454
clientservices.emea@moodys.com

ASIA (EXCLUDING JAPAN)
+852.3551.3077
clientservices.asia@moodys.com

JAPAN
+81.3.5408.4100
clientservices.japan@moodys.com

BP57435