Effects of the implementation of IFRS 17 „Insurance Contracts“ in the accounting system of insurers

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Abstract: The article presents the main aspects of the new regulations in the accounting of insurance activity. The established financial reporting framework is being transformed on the basis of fundamental changes in regulatory and regulatory requirements. The basis of the started change is the transition to generally accepted rules for accounting for insurance contracts through the implementation of the new IFRS 17 "Insurance Contracts". The update creates conditions for increasing the opportunities for comparability of information from the accounting systems specific to individual countries and is directly related to the growing trend of globalization in the insurance sector.

Keywords: IFRS 17 Insurance Contracts, Insurers, accounting, accounting model

JEL: M41, M40

1. INTRODUCTION

The insurance activity as a form of social protection occupies a leading place in modern life, which clearly stands out in the current complex economic situation on a global scale. In line with this, there are processes of transformational changes in the regulatory and reporting requirements for insurers, which require updating the established accounting framework. The International Accounting Standards Board has come a long way in amending existing standards for financial reporting of insurers. The result is the adoption of a new International Financial Reporting Standard 17 "Insurance Contracts", which unifies and standardizes the diversity of national reporting practices in individual countries.

The aim of the study is to highlight some of the main challenges facing insurance companies as a result of the forthcoming changes in the accounting of insurance contracts. Basic statements are presented in the insurance accounting model, which is applied as in the transition to a unified accounting approach. The new moments in the recognition and subsequent evaluation of insurance contracts have been clarified. The studied features in the accounting of insurance activity will be limited in the field of non-life insurance.

The research methodology is based on a systematic approach with the application of the methods of analysis, summarization, graphical illustration of the achieved results.

2. MAIN PROVISIONS OF IFRS 17 „INSURANCE CONTRACTS“

IFRS 17 “Insurance Contracts” is the longest-developed financial reporting standard. In May 2017, the project for its creation was finalized and in a fully developed form it was published (IFRS Foundation, 2020). This marks the beginning of a new stage in the development of insurers' accounting. In March 2020, the International Accounting Standards Board (IASB) decided to enter into force IFRS 17 “Insurance Contracts” for annual periods beginning on or after January 1, 2023 (PwC, 2020). The change requires all insurers in Bulgaria to apply in their accounting IFRS 17 "Insurance Contracts" as of January 1, 2022 in order to achieve comparability of information in the financial statements as of December 31, 2023. The scope of the standard includes:

- All insurance contracts that insurers conclude;
- Reinsurance contracts issued;
- Purchased reinsurance contracts;
- Investment contracts that include additional non-guaranteed income.

IFRS 17 “Insurance Contracts” is the standard that characterizes the specifics of the accounting treatment of insurance contracts. The standard requires disclosures that indicate the amounts in the financial statements arising from insurance contracts.

One of the key changes is that the temporary exemption from the application of IFRS 9 Financial Instruments expires in 2021. The new regulations enabled insurers to defer the application of IFRS 9 Financial Instruments, which is why they continued to apply IAS 39 Financial Instruments: Recognition and Measurement. More insurers will now be able to move to IAS 17 “Insurance Contracts” and IFRS 9 Financial Instruments for the first time in 2023 at the same time. The two standards provide different benefits to help with the transition, and some market participants expect these differences to have significant effects on the usefulness of comparative information (IASB, 2021).

In order to determine whether a contract is within the scope of the standard, the insurance company should first answer the question whether the contract covers a specific future event that may adversely affect the insured person. In case it is covered, it is necessary to determine the type of risk. If not, it is necessary to assess which other IFRS is applicable.

The guidelines for the application of the standard make a clear distinction between insurance risk and its various risks, and in particular that insurance risk is anything but financial risk. If the risk is purely financial, it is necessary to determine which other IFRS is applicable. In the other case, the insurance contract falls within the scope of IFRS 17 “Insurance Contracts” and the insurance risk should be assessed.

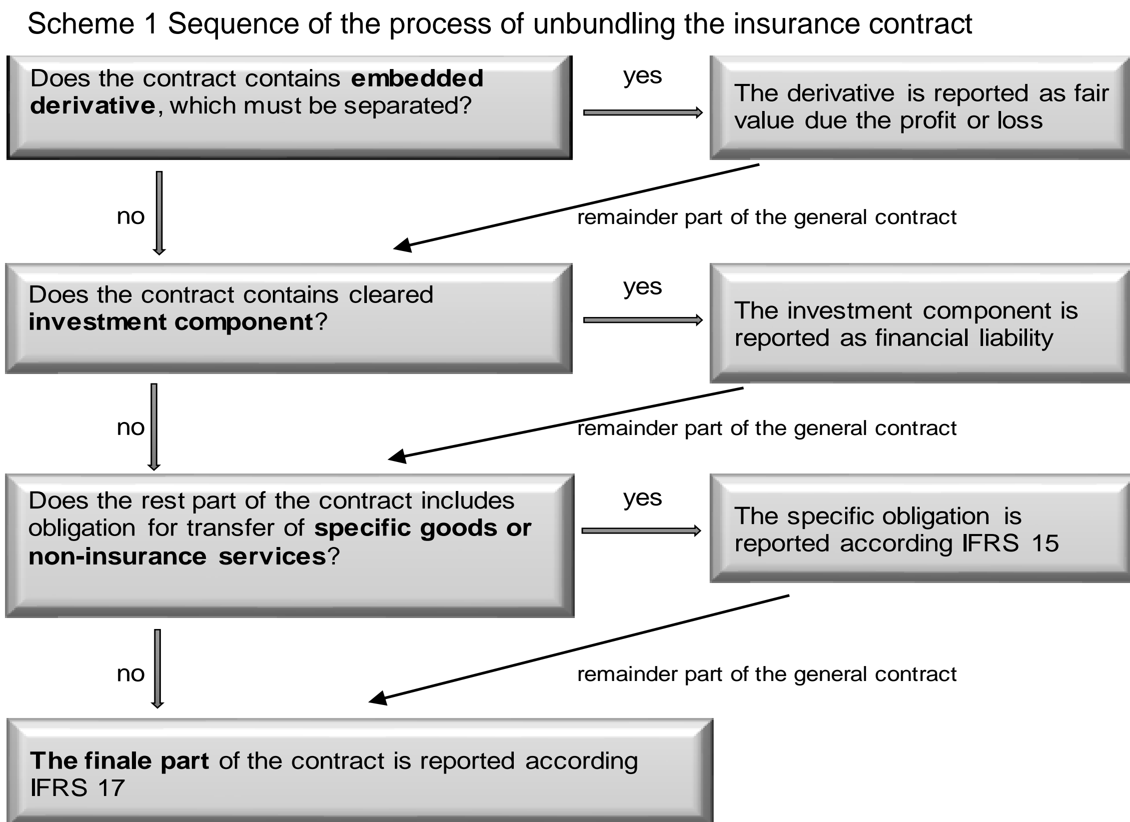
IFRS 17 “Insurance Contracts” sets out the definition of an insurance contract and provides additional guidance on how to assess whether insurance risk is significant. An insurance risk is significant only if there is a scenario according to which the occurrence of an insurance event leads to a result in which significant additional payments and losses are made under the contract. Based on the present value (Present value - PV), the insurance company must assess the probability of loss. In the event that there is a significant insurance risk, the contract falls within the scope of IFRS 17 “Insurance Contracts”. Otherwise, it is necessary to determine which other IFRS is applicable.

IFRS 17 “Insurance Contracts” distinguishes between the significance of insurance risk calculated on a discounted or undiscounted basis. The new standard specifies that the discount factor used to calculate the present value must reflect the time value of money, the characteristics of cash flows and the liquidity characteristics of the insurance contract. The significance of the insurance risk is assessed at the level of an individual contract, not a group of contracts.

Before an insurance contract is recognized, based on the requirements of IFRS 17 “Insurance Contracts”, it is necessary to thoroughly analyze whether the contract contains components to be separated. This requirement is a completely new moment.

IFRS 17 “Insurance Contracts” distinguishes three different components that need to be recognized separately based on specific criteria. Insurers are required to apply IFRS 17 “Insurance Contracts” to all other components of the contract. The standard does not allow voluntary separation of other non-insurance components. The structure of the process of unbundling the components of the insurance contract is presented in Figure 1 Sequence of the process of unbundling the insurance contract (Scheme 1).

Scheme 1 Sequence of the process of unbundling the insurance contract



Source: PwC, 2020

Insurers should follow the guidance in IFRS 9 Financial Instruments to assess whether an embedded derivative should be separated.

In addition to this, insurers should separate all investment components that are identifiable. The investment component is the amount that the insurer must pay to the insured person in the event that no insured event occurs. Such scenarios are typical mainly

for life insurance products, where upon the expiration of the insurance period the insured persons are paid amounts. In this regard, the investment component is not the subject of this study.

Following the unbundling of embedded derivatives and identifiable investment components, insurers should, as a last resort, make any commitment to transfer a distinguishable good or non-insurance service to policyholders. A promise of non-insurance service arises when the insured person can benefit from it alone or with another available resource. The insurer must also assess whether the cash flows and risks associated with the good or service are linked to the insurance component or to other components in the insurance contract.

It is appropriate to emphasize that the activities performed for the implementation of the insurance contract (for example, administrative services) are not differentiated and separated as a component. This is also valid for the activities for the processing of insurance claims, unless the service is performed as a separate service by an external contractor who does not provide insurance coverage. Cash flows from the various non-insurance commitments and the insurance component are presented separately.

The remainder of the insurance contract is included in the financial statements in compliance with the provisions of IFRS 17 “Insurers Contracts” for the recognition and measurement of insurance contracts.

3. CHARACTERISTICS OF THE UPCOMING ACCOUNTING MODEL OF INSURERS

The new standard contains circumstantial guidelines for the accounting treatment of insurance contracts. The requirements of IFRS 17 “Insurance Contracts” radically change existing accounting models. A key point, after the completion of the process of unbundling the components of the insurance contract, is the level of aggregation with a view to the initial recognition of insurance contracts.

A key requirement is that insurers should group contracts at their conclusion in order to recognize, evaluate, present and disclose them in the financial statements. Insurance companies initially identify portfolios of insurance contracts that are subject to similar risks and are managed jointly. Contracts in a specific portfolio are divided into three groups:

- Burdering (loses);
- Profitable, without significant risk of becoming burdensome;
- Profitable, not likely to become burdensome.

An insurance portfolio may include only some possible groups of contracts, and a group may include only one contract. The standard does not provide for contract groups to be reviewed after their initial classification. The ability of insurance contracts to generate profits needs to be assessed individually on initial recognition, if such information is available. The moment of initial recognition is the earliest of the following dates:

- Beginning of the coverage period;
- The first payment from the insured person is due or actually received;

- There are facts and circumstances that are indicative that the group of contracts is burdensome.

The insurance company should recognize all cash flows to the insurance liability if they have occurred during the time frame of the contract. In other words, this is the period during which insurance premiums are due by the insured person against the provision of insurance coverage by the insurer.

Within the accounting model, the standard provides for the possibility of applying three approaches to the valuation of insurance contracts. (Scheme 2)

Scheme 2 Approaches to the evaluation of insurance contracts

General model	Premium allocation approach	Variable fee approach
• The basic model of all insurance contracts; • Obligatory for implementation	• Simplified model of measurement for short term contracts with low level of changes before insurance accident; • Implemntation by choice	• Model of insurance contracts for business lines based on direct participation, in which the payments to the insured persons are involved with the basis assets; • Obligatory for implementation

Source: IFRS 17 Insurance Contracts

The general model applies to all insurance contracts, unless they contain direct participation arrangements or it is permissible for the insurer to choose to apply the premium allocation approach to the contract.

The premium allocation approach is a simplified model that can be applied optionally to estimate liabilities for residual coverage of short-term insurance contracts.

The variable fee approach should be applied to insurance contracts with direct participation arrangements. The approach is relevant for participating business lines, where payments to insured persons are contractually bound and vary significantly compared to underlying instruments. Insurance or investment contracts with unsecured returns in which the insurer shares the result of underlying instruments are classified as additional income contracts. All other contracts are classified as contracts without additional income.

A completely new aspect in the future application of IFRS 17 Insurance Contracts is the calculation of the Contractual Service Margin (CSM). The contractual service margin is a component of the carrying amount of an asset or liability for a group of insurance contracts and represents the unrealized gain that the insurance company will recognize by providing services under the insurance contracts in the group. The margin refers to services in the future and cannot be a negative value. Insurance companies will be required to define a methodology for depreciation (exemption) of the contractual margin (CSM) in which to determine the coverage units.

Any change in insurance contracts is treated as a modification or cancelation. In its essence, the modification is a change that should be registered, but in turn a change can lead to the cancelation or expiration of the insurance contract. Deregistration is available upon termination of the insurance contract. In all cases, however, the contractual service margin is adjusted and depends on the reason why the insurance contract has been modified or canceled.

Next in the outlined sequence in the implementation of the provisions of IFRS 17 are placed the presentation and disclosure of the results of activities in the financial statements. In this study we will mention the new regulatory requirements for insurers.

The main new circumstances relate to the amounts recognized in the financial reports. A completely new moment are the positions for separate presentation of insurance income and expenses and insurance financial income or expenses. Due to the high importance of the issue, the resulting changes deserve to be the subject of in-depth analysis in further research.

IFRS 17 will inevitably narrow the wide range of accounting practices. The benefits of this are in the direction of easier presentation to the management bodies of the data on the accounting treatment of insurance contracts.

The management and control departments of the insurer are responsible for the organization and functioning of the accounting records, which will ensure the accurate reflection of its results and financial condition (Insurance Code). In this sense, the accounting system is the main source of information about the results of insurance activities and its presentation in the financial reports.

The principles underlying the accounting approaches in IFRS 17 "Insurance Contracts" lead to a fundamental change in current practices, with an emphasis on market valuation. The requirements differ from most existing accounting models that will enrich the accounting processes. Some of the major improvements that the standard introduces compared to existing models are presented in Table 1 Major improvements to IFRS 17 compared to IFRS 4 (Tab. 1)

Tab.1 Major improvments of IFRS 17 compered to IFRS 4

Aspect	Improvements to IFRS 17 compared to IFRS 4
Relevance and accuracy	• The prime assessment in many IFRS 4 approaches is replaced by regular actualizations of the new assessment, established in IFRS 17; • The consumer will have access to more transparent information for the financial and property state of the insurer.
Profitability	• IFRS 17 establish accounting approach for revenue recognition that is more consistent with that of other industries. Revenue and profit are recognized over time when insurance services are provided, not when insurers receive premiums; • Insurers will use discount rates to reflect the effects of insurance cash flows.
Comparability	• According to IFRS 4, insurers report insurance contracts using different national practices; • IFRS 17 establish a consistent general framework for accounting for insurance contracts.

Source: Own data

Accounting information is a valuable tool for the proper functioning of the insurance company. Therefore, the tasks of the accounting system for creating and presenting timely, accurate and accurate reporting information should be consistent with the actual financial and financial condition of the insurance company, which serves to prepare the financial reports.

The dynamic development of the insurance market inevitably affects the way of organizing the processing and summarization of accounting data, the efficiency of obtaining and using accounting information.

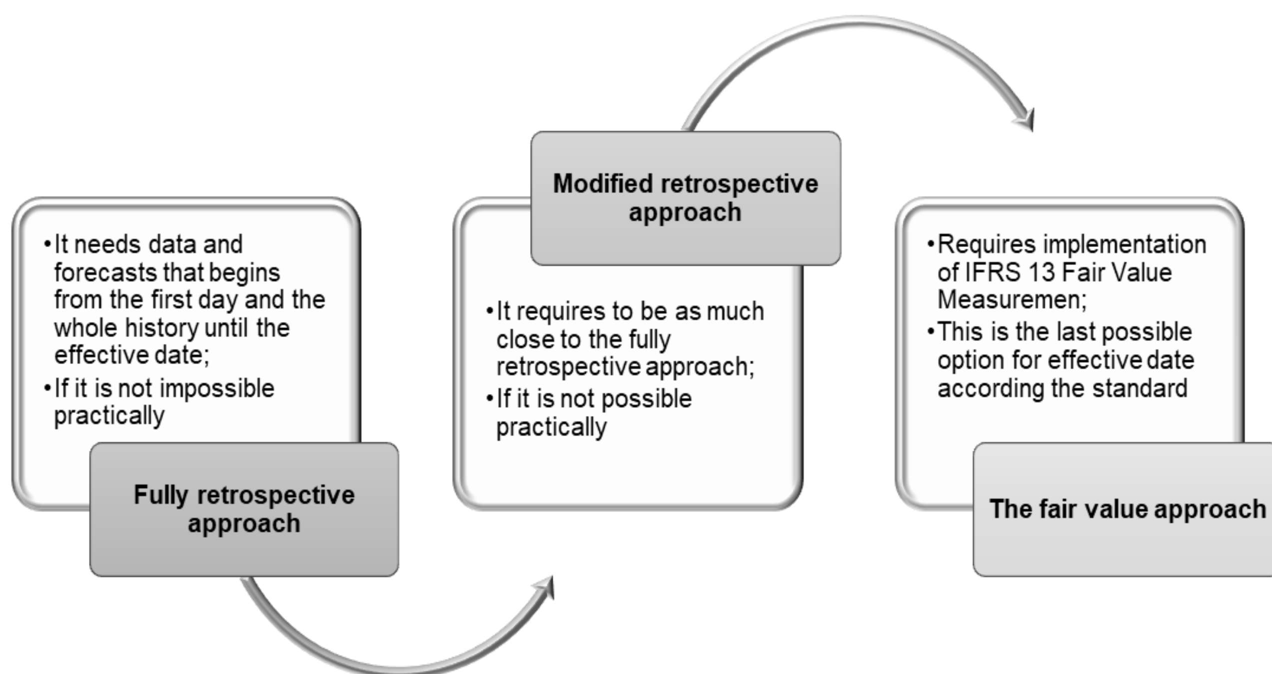
4. ACCOUNTING APPROACHES IN TRANSITION TO IFRS 17 “INSURANCE CONTRACTS“

Of interest is the process of transition to the new regulations. In this part of this statement, a brief emphasis should be placed on the transition to IFRS 17 “Insurance Contracts”. The introduction of the standard requires all insurers in Bulgaria to apply in their accounting IFRS 17 "Insurance contracts" in 2022. This is to achieve comparability of information in the financial statements as of December 31, 2023. Insurers must provide comparative information in accordance with the provisions of IAS 1 Presentation of Financial Statements. However, in 2022, insurance companies will prepare financial statements in accordance with IFRS 4. This standard is effective for 2022.

The new regulations call for new accounting policies. In order to systematically present the information in the financial statements and achieve comparability, the standard provides guidelines for the use of specific approaches. In the period of transition to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors requires insurers to retrospectively transition to the new accounting regulations. This is the baseline scenario for the transition to IFRS 17 “Insurance Contracts” and obliges insurers to apply a retrospective approach, unless there is a practical impossibility to do so. If it is not possible to apply a retrospective approach, the standard considers two other alternative approaches. In all cases, the application of one of the three approaches is mandatory.

According to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, it is practically impossible to assume that the effects of retrospective application cannot be determined, data on management's intentions in the past are not known and it is not possible to provide evidence for the past moment about what amounts should be recognized, valued, disclosed. The three possible approaches are presented in the following scheme 3 Approaches to the transition to IFRS 17 “Insurance Contracts” (Scheme 3).

Scheme 3 Approaches to transition to IFRS 17



Source: IFRS 17

With a ***retrospective approach***, the insurer is required to disclose an adjustment to each affected position in the financial statements. At the date of transition, each group of insurance contracts in force at that date should be recognized and measured and write off all existing amounts that would not have existed if IFRS 17 Insurance Contracts had always been in force. Another important aspect of the transition is the recognition in equity on a net basis of all differences between the amounts recognized under the two current standards for 2022 - IFRS 4 and IFRS 17.

Applying the ***modified retrospective approach***, the insurance company must achieve the closest possible result to the full retrospective approach, using sound information without undue effort or expense. The facilitations that the approach provides can be reduced to the following more important ones:

- Estimates at the date of initial recognition of groups of insurance contracts;
- Margin to contractual service for insurance contracts without direct additional income;
- Margin of contractual service for insurance contracts with direct additional income;
- Insurance financial revenue or expenses.

The third approach that the standard allows is the ***fair value approach***. It is applicable if the full retrospective approach and the modified retrospective approach are not applicable in practice. The benefits of the approach are as follows:

- The contractual service margin is calculated as the difference between the fair value of a group of insurance contracts calculated in accordance with IFRS 13 Fair Value Measurement, including its performance cash flows at the transition date;

- By the date of transition, the groups of insurance contracts should be known, it should be clarified whether the insurance contract meets the definition of insurance contract with direct additional income and that for contracts without direct additional income;
- Clarification of the cumulative amount recognized in other comprehensive income before the transfer date, if the insurer has chosen to recognize a large portion of insurance finance income and expenses in other comprehensive income.

From what has been stated so far, it is clear that the insurance contracts will be assessed differently in the transition compared to the assessment in future periods, unless a full retrospective approach is applied. This will affect the valuation of insurance contracts in the statement of financial position and the income statement until the transfer until the insurance contracts in effect are written off.

Greater homogeneity in contract aggregation will provide more relevant information on insurers' financial condition and financial performance, but will create more complexity in valuation models, data, systems and process requirements.

The new standard completely transforms the existing practice. Depending on the complexity of the different transition approaches, the costs of implementing the standard will be unpredictable.

A key aspect that is a costly effort is the reorganization of information systems. High priority is the change in financial systems and their adaptation in the direction of tracking portfolios and groups of contracts in order to recognize, evaluate, modify, present and disclose.

Another aspect that insurance companies should focus on is adult education. It is more than necessary for the governing bodies to allocate budgets for staff training. The qualification of the employees will inevitably contribute to the quality of data processing and their subsequent presentation in the financial reports.

We can summarize that the modernization of the insurance sector has undoubtedly become a means to achieve high results. New opportunities for improving accounting are to be increasingly used in the activities of insurers.

5. CONCLUSION

With the social development of the world and the changes in the economy, the need for research of the processes and the innovations in the insurance sector increases. Given the trend of harmonization of national reporting practices, there is a need to build a proper financial strategy, which in combination with a well-functioning accounting system helps to make the right strategic decisions.

The following conclusions can be formulated from the research on the new regulations in the accounting of insurers:

- The correct organization of the accounting is essential for the normal course of the processes in the insurance company. The accounting data are of paramount importance for the overall assessment of the insurance company's activity;

- As a result of the change, the Bulgarian legislation will be harmonized with the European one. As a result, greater transparency will be achieved in the public disclosure of information;
- IFRS 17 will have an impact not only on the presentation of information in the financial statements, but also on all aspects of the implementation of the activity. The standard defines clear and consistent rules that will significantly increase the comparability of financial reports.

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