

## FA Module 21: Insurance contracts: IFRS 17 general measurement approach (overview)

(The attached PDF file has better formatting.)

IFRS 17 governs insurance contracts in most countries (but not the United States). The readings on the discussion forum explain the accounting methods for both long duration life insurance contracts and short duration property-casualty insurance contracts. This module covers:

- ! Fulfilment cash flows
- ! Risk adjustment for non-financial risk
- ! Discount rates
- ! Insurance acquisition cash flows
- ! Contractual service margin

The exercises are heuristic, with insurance contracts lasting only two or three years and simplified cash flows. They help you understand the IFRS 17 principles, but they cover more than is needed for the final exam.

The practice exam questions for Module 24 show the types of final exam problems. You do not need to master all of IFRS 17 to answer these questions.

IFRS 17 has three approaches:

- ! The general measurement approach (building block approach) applies to most insurance contracts.
- ! The premium allocation approach is an alternative permitted for certain short duration contracts.
- ! The variable fee approach is used for contracts with discretionary participation features.

The “building block approach” is the IFRS 4 term; IFRS 17 refers to the “general requirements of IFRS 17.” The phrase “building block approach” is still common, though it is not used in IFRS 17.

This course covers the general measurement approach and the premium allocation approach. The variable fee approach applies to policies with direct participation features and is not covered in this course. The final exam problems test a two year contract with no reinsurance and no onerous features. The premium allocation approach, reinsurance, and onerous contracts are covered in the readings and exercises, but they are not tested on the final exam.

The general measurement approach (building block approach) has four pieces (“blocks”):

- ! Probability weighted mean of future cash flows
- ! Discount rate that depends on the maturity, currency, and liquidity of the cash flows
- ! Risk adjustment for non-financial risk
  - " the combination of the three items above is the fulfilment cash flows
- ! Contractual service margin that defers profit from initial recognition to the rest of the contract period

The discount rate is set by the insurer, using principles-based approaches, in contrast to the fixed rates for most statutory accounting, GAAP, and solvency regulation (Solvency II and risk-based capital). The accretion of interest is separate for future cash flows vs the contractual service margin. Final exam problems give you the discount rate; they do not ask you to compute it.

Risk is distinguished between financial risk and non-financial risk.

- ! Financial risk (time value of money, duration, and liquidity) affects the discount rate.
- ! The risk adjustment for non-financial risk is set by the insurer, remeasured at each valuation date, and reported separately.

IFRS 17 is principles-based: it explains what the item represents, but firms decide the appropriate techniques. Insurers determine the discount rate most appropriate for their contracts. Maturity and liquidity are influences on the discount rate, but IFRS does not prescribe specific methods. Similarly, IFRS 17 does not specify the method to determine the risk adjustment, though it requires disclosure of the confidence interval. Final exam problems give you the discrimination; they do not ask you to compute it.

The module explains the cost of capital method of setting the risk adjustment for non-financial risk in Solvency II and the Swiss Solvency Test, which is likely to be used by many insurers for IFRS 17 as well. Final exam problems give you the risk adjustment for non-financial risk; they do not ask you to compute it.

Acquisition costs that are directly attributable to the portfolio of insurance contracts are included in the fulfilment cash flows. Other acquisition costs are expensed when incurred. Final exam problems specify the acquisition costs that are directly attributable to the portfolio of insurance contracts and ask you to allocate them by policy year.

The postings on the discussion forum illustrate the accounting entries for the general measurement approach.

The module readings explain the IFRS 17 accounting principles tested on the final exam. For instance, the practice problem for measurement on initial recognition uses a non-onerous insurance contract issued on December 31, 20X0, with a coverage period of three years.

- ! Premiums are paid right after initial recognition.
- ! Claims of a constant amount each year occur on December 31, 20X1, 20X2, and 20X3.
- ! The risk adjustment for non-financial risk is the same for all claims and does not accrete interest.
- ! The discount rate for the fulfilment cash flows is constant and does not vary by duration.
- ! Directly attributable acquisition cash flows are zero.
- ! No contracts lapse before the end of the coverage period.

The final exam will use a two year insurance contract (to minimize the computations), and will ask you to compute

- A. The present value of the expected net cash flows
- B. The fulfilment cash flows
- C. The acquisition expenses allocated to year
- D. The contractual service margin
- E. The insurance contract liability
- F. The entry in the statement of profit and loss

The format of the final exam problem is shown in the practice exam questions for a two year coverage period in Module 24. Look over these practice exam questions before studying the four modules on IFRS 17. Once you know what you must learn, your exam preparation becomes much easier.

Study recommendation: IFRS 17 is enormous, and you are not expected to master the entire subject. Start by reviewing the practice exam questions for the two year coverage period in Module 24, so that you know what you will be tested on. Then work through the practice problems in the IFRS 17 modules; the arithmetic needed for the final exam is straight-forward. Onerous contracts, remeasurements of discount rates and of the risk adjustment for non-financial risk, complex allocations, and presentation issues are harder, but they are not tested on the final exam. Then read the explanations in each module, which justify the calculations.