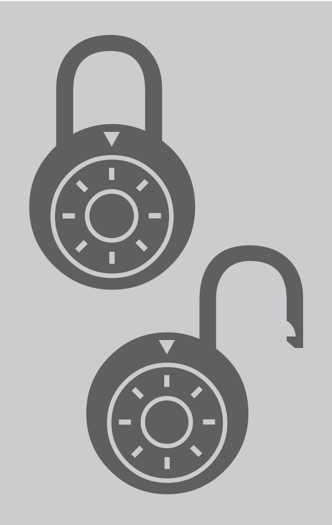
September 2017

IFRS® Standards
The Essentials—Issue No. 4

The Essentials—Busting insurance jargon



The insurance world uses some technical terms with a known meaning for insurers and their investors. For investors, navigating this world of jargon can be a challenge. IFRS 17 *Insurance Contracts* introduces fundamental changes to insurance accounting for some insurers. When IFRS 17 is applied in 2021, it will provide investors with consistent information for all insurance contracts as well as new metrics for evaluating the performance of insurers. Information that may already be available for some companies through non-GAAP measures will be available for all in a more comparable manner. To help investors adapt to the changes and better anticipate how the new Standard could affect their analyses, this issue of *The Essentials* translates existing terminology and metrics into the language of IFRS 17.

❶ Premiums

Earned premiums	
Equivalent IFRS 17 measure	**Insurance revenue**

Today—the proportion of premiums that relate to coverage provided in the period measured by reference to the risk that has expired. This metric is commonly presented for non-life insurance businesses but not for life (for example, Net Earned Premiums or NEP).

Impact of IFRS 17—insurance revenue under IFRS 17 will be similar to earned premiums for non-life business. However, insurance revenue will be provided for all contracts, including life and participating contracts.

Premiums due	
Equivalent IFRS 17 measure	**Premiums received**

Today—premiums paid in the period (or due to be paid in the period even if outstanding as a receivable at the end of that period). This metric is commonly presented as the top line for long-term contracts in a life business income statement (for example, Gross Written Premiums or GWP).

Impact of IFRS 17—premiums received will generally be similar to premiums due. Premiums received in the period will be disclosed in the notes as part of the roll forward of the insurance contract liability.

GWP is an important measure of volume and under IFRS 17 investors will still be able to analyse trends in this metric over multiple periods. GWP will not be presented in the income statement under IFRS 17, since, as a cash-based measure, it is inconsistent with the concept of 'revenue' in IFRS Standards.

Premiums written	
Equivalent IFRS 17 measure	**Present value of new business premiums—PVNBP**

Today—may be provided in addition to other premium metrics, but different interpretations apply. For life business, this metric generally equals premiums due. For non-life business, it generally refers to the total premiums expected in current and future periods for contracts written in the period, which could also be discounted. The present value of all premiums expected to be received as a result of new contracts written in the period is referred to as 'present value of new business premiums' and is a non-GAAP metric generally associated with embedded value reporting.

Impact of IFRS 17—premiums written is not a required IFRS 17 metric. However, the present value of new business premiums will be presented separately in the notes (as part of the insurance contract liability roll forward).

Annual premium equivalent—APE

Today—an alternative to the present value of new business premiums. Equals the premium due in the current period for new regular premium policies plus a portion (often 10 per cent) of the premium received in the period for single premium policies.

Impact of IFRS 17—APE is not required by IFRS 17. It might continue to be presented as an additional non-GAAP metric.

Gross and net premiums

Today—gross premiums are those charged to policyholders. Net premiums are often calculated by deducting any premiums 'ceded' to reinsurers (ie by deducting the premiums paid for reinsurance coverage) and brokerage and commission payments.

Impact of IFRS 17—insurance revenue will not include any deduction for 'ceded premiums' or acquisition costs. The effects of reinsurance will be separately presented in the balance sheet and in the income statement; a separate roll forward will be disclosed in the notes.

❷ Income statement

Underwriting profit	
Equivalent IFRS 17 measure	**Insurance service result**

Today—premium income less insurance claims and expenses. Generally, this metric is only applicable to non-life insurance, given that for life insurance companies a significant financial result means that the main focus is on measures of operating profit, which incorporate both the return from underwriting and from financial investments.

Impact of IFRS 17—an insurance service result subtotal will be required under IFRS 17 for all insurance contracts, and will exclude investment income and insurance finance expenses. The amount reported for the insurance service result may differ from underwriting profit under existing accounting due to differences in the measurement basis used.

Operating profit	
Equivalent IFRS 17 measure	**Insurance service result plus net financial result**

Today—this profit subtotal is commonly interpreted to include investment income on assets backing insurance liabilities. Companies may 'adjust' it to exclude some gains and losses related to insurance activities such as the component of the return on assets related to unexpected market movements.

Impact of IFRS 17—operating profit subtotals are not defined in IFRS 17 (or in other IFRS Standards), but are likely to refer to the sum of the insurance service result plus the net financial result (the return on assets backing the insurance business less the insurance finance expenses). The amounts presented in the net financial result will be affected by whether and to what extent a company presents gains and losses in Other Comprehensive Income. More generally, IAS 1 *Presentation of Financial Statements* provides some flexibility in presenting subtotals in the income statement.

New business profit	
Equivalent IFRS 17 measure	**Contractual service margin—CSM**

Today—the pattern of profit recognition varies by the products and by the accounting method chosen. A day one gain may be reported in the income statement when a new contract is written. The present value of future profits on new business is often provided as part of non-GAAP reporting or embedded value information.

Impact of IFRS 17—the CSM of new business determined under IFRS 17 represents the unearned profit on in-force business. The roll forward of the CSM will provide information about the amount of CSM added by new contracts written in the period. This will therefore give consistent information about the value added from new business, and is likely to resemble the 'new business profit' measures commonly presented in non-GAAP reporting or embedded value information.

Experience variances—life	
Equivalent IFRS 17 measure	Experience adjustments and change in estimates

Today—the difference between actual outcome in a period and prior expectations. Companies commonly provide this metric, but often only as part of non-GAAP embedded value disclosures. This metric may include both current period experience and the effect of changes in assumptions and may relate to non-financial variables only or to both non-financial and financial variables.

Impact of IFRS 17—experience variances will be separately disclosed as a component of the insurance contract liability roll forward, with further breakdowns—variances for current period coverage, adjustments to prior period coverage and for changes in assumptions related to future periods. This item will exclude the effect of changes in financial variables, which is instead presented as part of the insurance finance result.

Claims adjustments—non-life	
Equivalent IFRS 17 measure	Experience adjustments and change in estimates

Today—in non-life insurance business, adverse or positive reserve development includes prior-year claims adjustments.

Impact of IFRS 17—prior-year claims adjustments are required to be separately disclosed as a component of the insurance contract liability roll forward.

Change in insurance contract liability

Today—a gain or a loss reported as a line item in the income statement of life companies. The term incorporates several items, including the portion of premiums due reported in the 'top line' and not reflected in profit, the implicit accretion of the liability, the effect of changes in assumptions that impact profit, the effect of deposit components and the effect of the liability adequacy test. Companies may or may not provide a separate analysis of such components under existing accounting practices.

Impact of IFRS 17—this line item will no longer be presented under IFRS 17 since the components of this item, such as the interest accretion and the onerous contract adjustments, will either be reported separately, or will no longer be needed due to the way insurance revenue and expenses are measured.

❸ Balance sheet

Unearned premium reserves—UPR	
Equivalent IFRS 17 measure	Liability for remaining coverage—LRC

Today—a liability reported on the balance sheet representing the part of premiums received and receivable that is applicable to the unexpired portion of the policy.

Impact of IFRS 17—UPR will be included in the overall insurance liability in the balance sheet and be separately identified as the 'liability for remaining coverage' in the notes with a detailed roll forward provided. Investors will be able to analyse the LRC by components—present value of cash flows, adjustment for risk and CSM.

Claim or loss reserves	
Equivalent IFRS 17 measure	Liability for incurred claims—LIC

Today—a liability reported on the balance sheet for the estimated cost of outstanding insurance claims—claims incurred plus claims handling costs less amounts already paid. It includes specific reserves for individual claims plus claims estimated to have occurred, but for which no individual claims have been identified (claims incurred but not reported—IBNR). In practice, claim reserves may include different levels of 'conservatism' (ie reserve buffers), and may or may not be discounted.

Impact of IFRS 17—claim or loss reserves will be included in the overall insurance contract liability on the balance sheet, and separately identified as 'liability for incurred claims' in the notes, with a detailed roll forward. The liability equals the probability-weighted expected cash outflows plus explicit adjustment for risk. Discounting will be applied if material.

Deferred acquisition costs—DAC

Today—acquisition costs, including commissions and other initial expenses incurred in the course of obtaining business and issuing policies, are capitalised in the balance sheet, and amortised as an expense in subsequent periods. Accounting for acquisition costs varies, with some companies immediately expensing. If these costs are capitalised, they are included in the liability adequacy test.

Impact of IFRS 17—DAC will not be presented as an asset under IFRS 17. Contract acquisition costs are included in insurance contract fulfilment cash flows and are therefore reflected in the overall insurance contract liability without being identified as a separate component in the balance sheet (although the allocated acquisition cost expense is reported separately in the income statement).

Value in force—VIF	
Equivalent IFRS 17 measure	**Contractual service margin—CSM**

Today—the net present value of future profits from existing contracts. VIF equals the difference between the balance sheet liability and the risk-adjusted present value of future cash flows. Typically, this measure is presented in non-GAAP reporting or embedded value information packs.

Impact of IFRS 17—equivalent to the CSM portion of the liability under IFRS 17, although the measurement principles differ.

Liability adequacy test

Today—a test to ensure that the liability for insurance contracts, after deducting deferred acquisition costs and capitalised intangibles, is sufficient considering current estimates of cash flows and current discount rates. If the test determines that the balance sheet liability is 'inadequate', it leads to an increase in the liability and a loss in the income statement. The approaches used for this test vary; cash flow can be aggregated at a high level, and discounting may effectively take into account the benefit from forecast investment returns.

Impact of IFRS 17—this test will not be required under IFRS 17 because the fulfilment cash flows are always based on current assumptions including current market variables.

❹ Disclosures

Loss development table—ie reserve triangle

Today—companies disclose the development of claims or loss reserves between the date the loss is incurred and first recognised and the date the liability is settled. Investors frequently refer to these disclosures, usually presented in tables, as 'reserve triangles'. The tables show the changes in estimates and how current-period performance is influenced by the settlement of the liability. May be presented based on contract year or claims year.

Impact of IFRS 17—this same table will be available under IFRS 17, but will use a common basis of claims year.

❺ Ratios

Combined ratio

Today— this is a popular profitability ratio that analyses claims and expenses incurred divided by premiums earned. It provides a measure of the profitability of underwriting activities, and it may be split into a claims ratio and an expense ratio. Generally only applicable to non-life businesses.

Impact of IFRS 17—the same ratio will be available for all insurance activities under IFRS 17.

Contact us

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