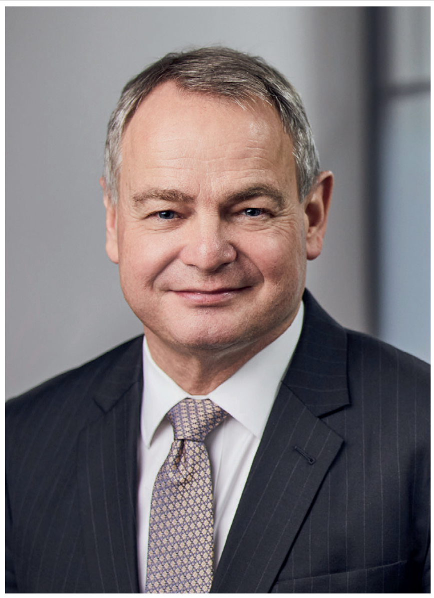
IFRS 17 *Insurance Contracts*—Why annual cohorts?



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This article explains why the International Accounting Standards Board (Board) has retained unchanged the annual cohort requirement in IFRS 17 *Insurance Contracts* for grouping insurance contracts to measure and recognise profit.
The Board has decided annual cohorts are necessary to provide useful information about an insurance company's financial performance, in particular about changes in profitability over time. Any exemption from the requirement, even if aimed at the very limited population of contracts for which the costs and benefits of the requirement might be open to question, runs too great a risk of an unacceptable loss of information.

The Board has concluded its redeliberations of the Exposure Draft of targeted amendments to IFRS 17.

The requirement to use annual cohorts as part of the process of accounting for the contractual service margin (CSM) has been the cause of much debate since IFRS 17 was issued.[1] In their responses to the Exposure Draft, some stakeholders advocated the removal or amendment of the annual cohort requirement for some or all insurance contracts. However, the Board took the decision in February 2020 to confirm again the requirements in IFRS 17 relating to annual cohorts.

In this article I explain the reasons for the Board's decision.

The Board sets Standards based on important principles, such as identifying useful information as having characteristics of relevance and faithful representation.

The Board is particularly concerned that financial reporting presents fairly the financial performance of businesses in each period and how profitability changes over time. As emphasised by the Board's Conceptual Framework, IFRS Standards must result in useful information about financial performance as well as financial position. Much of existing insurance contract accounting is founded on prudential regulation that has a primary focus on solvency. We believe the dual focus of IFRS Standards on financial performance and financial position greatly enriches the information provided in financial statements. The statements of financial performance often serve as a canary in the coal mine. An erosion of profits may be a foreboding of problems to come.

1 The annual cohort requirement relates to the timing of the recognition of the profit in the contract, the CSM, in profit or loss. The CSM is determined for groups of contracts and recognised in profit or loss when services are provided to the policyholders in that group. At a minimum, groups cannot include contracts that were issued more than 12 months apart.

To ensure a faithful representation of profit or loss, one of the central principles of accrual accounting is that income and expenses are recognised in the accounting period to which they relate. Profit should not be anticipated and recognised before it has been earned, nor should it be artificially deferred and recognised after a transaction has been completed. This is particularly important for insurance contracts where there is a significant timing difference between the cash flows and the provision of the related services, where the duration of contracts is long, and where features of contracts, such as financial guarantees, have different effects on contracts issued in different economic conditions.

Most financial reporting is applied at the individual contract level

In standard-setting many of the accounting requirements are driven by what we call the level of aggregation—whether accounting rules are applied to individual transactions, applied at a more granular level, such as components of transactions, or applied on a more aggregated basis. An appropriate level of aggregation is essential to prevent onerous contracts being obscured by profitable contracts or older, profitable contracts from masking the performance of newer contracts with lower profit margins.

In fact, for most purposes it is the individual contracts that drive financial reporting. Here are some examples:

- **Revenue recognition**—each contract with a customer is accounted for separately. Consideration paid is recognised as revenue only when goods or services are provided to the customer.
- **Bank loan loss provisions**—banks are required to calculate loan loss provisions on a loan-by-loan basis. If one borrower defaults (or shows increased risk of default) then that loan is written down and a loss recognised. This requirement applies even though banks, like insurance companies, often have voluminous contract portfolios and manage their businesses by pooling risks.
- **Fixed asset accounting**—the price paid for fixed assets is recognised as a depreciation expense over the useful life of the asset based upon how that asset contributes to the business. This calculation is done at an individual asset level to ensure that the appropriate depreciation expense is recognised in the appropriate accounting period.

In each of these situations, Standards that would have allowed the accounting requirements to be applied at a more aggregated basis might have been less costly to apply, but could have led to profit measures that would not faithfully represent performance. The Board and stakeholders accept that the cost of accounting for individual contracts (which in the case of banks, for example, can be very significant) is outweighed by the benefits of the resulting information.

Although in principle the accounting should be applied on a contract-by-contract basis, in practice this may not always be necessary to achieve an equivalent outcome. For example, if a group of fixed assets are similar in nature, have the same useful economic lives and are unlikely to become individually impaired, then accounting for this group as a single 'unit of account' may produce the same answer as accounting for each asset individually. When this is the case accounting for individual contracts may not be necessary. This also applies to annual cohorts, as I explain below.

So why not just account for individual insurance contracts?

The Board accepts that applying insurance accounting at the individual contract level would often not be appropriate for insurance contracts. The insurance business model is one of risk pooling and risk sharing. Some insurance contracts result in claims and others do not. In addition, the probability of a future claim may increase for some contracts during the coverage period but for others it declines. This means that some individual contracts may incur losses or become onerous even though the development of the group of contracts is as expected. Accounting for individual contracts may result in losses being recognised during the early stages of the development of a group, only to be offset by later profits. The Board decided that the best way to avoid this, and to present a fair development of the performance of insurance contracts, is to select a unit of account that is broader than the individual insurance contract, but not so broad as to make a faithful representation of an insurance company's financial performance impossible.

Annual cohorts essential for prudent accounting

The Board considered different approaches for the aggregation of insurance contracts into groups or portfolios, including segregation based on similar profitability. The Board concluded the best approach is one where insurance contracts are broadly grouped based on expected profitability at initial recognition, including the separation of any contracts that are onerous at initial recognition. To this we added the annual cohort requirement, meaning that all contracts in a group must have originated within a 12-month period. **The Board decided that the cohort approach is essential to ensure that aggregation is not so great as to render profit measures meaningless.**

If annual cohorts are not applied then it is likely that:

- there will be co-mingling of different generations of contracts with different profitability, or different changes in profitability, which could result in profit being anticipated or deferred rather than being recognised as it is earned.[2] These effects on the recognition of profit obscure the presentation of the effects of different pricing decisions at different times, resulting in a lack of accountability for such decisions and impaired ability for users of financial statements to model future profitability.
- the recognition of a loss arising from onerous insurance contracts would be delayed, potentially for many years. In every other industry, if transactions turn sour and become unprofitable then losses are recognised immediately this becomes apparent.

As a result, the absence of annual cohorts might lead to highly imprudent accounting, because of the failure to recognise profits or losses on contracts in the appropriate periods.

Objections to annual cohorts raised during the recent consultation

Many respondents to the recent Exposure Draft of targeted amendments to IFRS 17 commented on the Board's decision not to propose any changes to the annual cohort requirement. Some, including several users of financial statements and securities regulators, expressed support for the Board's decision not to amend the requirement and urged the Board to reaffirm that decision. Other respondents asked the Board to amend or delete the requirement.

The objections to annual cohorts focused on insurance contracts that share risks across generations of policyholders. Those objections are that annual cohorts fail to reflect that intergenerational sharing of risk or that CSM allocations between annual cohorts may be arbitrary. There were also concerns expressed over the implementation cost for these contracts.

2 Advanced recognition of profit would occur where newly issued contracts are more profitable than those issued previously. If all contracts are combined, then part of this higher profit is recognised earlier than it should be, considering the timing of services provided to each group of policyholders.

❶ Do annual cohorts fail to reflect intergenerational sharing of risk?

Some insurance contracts include provisions whereby different generations of policyholders share in a common pool of underlying assets, sometimes called mutualisation. Some stakeholders argue that, as a consequence of mutualisation, the profitability of each annual cohort is the same and that no individual annual cohort can become onerous without the whole portfolio being onerous. As a result, they said annual cohorts are not needed for these contracts.

The Board believes that intergenerational sharing of risk is not by itself sufficient to make annual cohorts unnecessary. The extent of mutualisation varies widely across different contracts—both in the type of risk being shared and in the extent to which the insurer retains some share of risk. Contracts that share all types of risks fully across policyholders with the insurer bearing no risk are very uncommon. Much more common are contracts under which either (i) some types of risk are not shared with policyholders or (ii) the insurer shares all types of risk with policyholders to some extent but retains some share itself, or (iii) a combination of both (i) and (ii). For these contracts, significant differences in financial performance can occur between different annual cohorts, particularly when contracts include minimum return guarantees.

Even if these guarantees are themselves mutualised—ie their effect is shared across generations of policyholders—the insurer will still bear its share of the effect unless the contracts are part of a mutual fund with no residual interest held by the insurer. The insurer's share of the effect could cause an individual annual cohort to become onerous.

This effect is one of the reasons why the Board thinks that the application of annual cohorts is so important—minimum return guarantees are prevalent in many jurisdictions in insurance products that participate in the returns on underlying items. Falling interest rates have resulted in many of these guarantees being 'in the money' and the contracts onerous for the insurer.

Of course, the smaller the insurer's share of the effect of the guarantee, the less likely it is that effect will make an annual cohort onerous. However, the global economy is in uncharted territory, with negative interest rates putting the insurance industry under severe stress. Rare events might occur, and it is very important that accounting standards perform well under such extreme stress and result in transparent information.

The application of annual cohorts is accordingly very important. A failure to account for CSM by annual cohort may result in financial statements that do not recognise losses on a timely basis and do not present meaningful trends in profitability.

❷ Do annual cohorts result in arbitrary allocations?

Intergenerational sharing of risk, coupled with discretion by the insurer over the sharing of returns on underlying items between the insurer and policyholders, requires adjustments to allow for changes in the fulfilment cash flows and, hence, the CSM of each annual cohort. Some stakeholders argued that these adjustments are, in effect, arbitrary and that consequently the separate CSM of each annual cohort is not meaningful.

The Board disagreed with this assessment and believes that, while judgement is required in these circumstances, the objective of the adjustments is clear, and the outcome should still provide relevant information about the profitability of each annual cohort. The adjustments depict the extent to which profits from existing contracts are expected to subsidise future contracts or vice versa. For example, an insurer may issue new contracts that would be onerous were they not to be subsidised by returns generated on invested premiums from previous contracts.

The Board agrees with stakeholders that argue such subsidisation is a fundamental principle for contracts with intergenerational sharing of risk. Accordingly, IFRS 17 requires the effect of that subsidisation to be included in the measurement of the annual cohorts.

The resulting measures of the expected profit (after the subsidisation is reflected) from new business are similar to those provided in many existing insurance accounting practices—what has been missing to date is any information on how that expected profit emerges or changes over time. Annual cohorts provide such information.

The Board concluded that tracking by annual cohort the information that results from the judgements an insurer makes in determining the adjustments for the subsidisation between contracts will provide useful insights about how management expects business to develop and could assist users of financial statements to hold management to account based on those expectations.

❸ Are annual cohorts too costly for contracts with intergenerational sharing of risks?

It is important that IFRS Standards provide good quality financial information to users of financial statements but at a reasonable cost to preparers. Some stakeholders thought that it would be burdensome to analyse CSM by annual cohort, in particular for contracts with intergenerational sharing of risk, and that consequently the requirement did not pass the 'cost-benefit' test.

The Board considered these arguments carefully and concluded that while the use of annual cohorts adds complexity to accounting systems, the requirement is still appropriate considering the significant benefit to users of financial statements. As explained above, the annual cohort requirement results in useful information even for insurance contracts that mutualise the returns on underlying items and related minimum return guarantees. There is only a very limited population of contracts with specific features for which the balance of the costs and benefits could be open to question. Further, it has proved impossible to identify robustly that limited population of contracts for which an exemption from the annual cohort requirement on cost-benefit grounds might be justifiable.

The Board concluded that any exemption would add further complexity to the Standard and would involve too great a risk of an unacceptable loss of useful information.

The Board also felt that some methods initially considered by insurers for applying annual cohorts were unnecessarily complex. Consequently, the Board considered that the cost is potentially not as high as some suggest and noted that this is becoming increasingly apparent as implementation of the Standard progresses. For example, although the CSM for each annual cohort should be kept separate for the purpose of determining when that profit is recognised, this requirement does not apply to other elements of an insurance contract liability. In particular, the measurement of fulfilment cash flows is not affected by the level of aggregation and may be done at a higher level, as long as changes in fulfilment cash flows can be allocated appropriately to the CSM balance of each annual cohort.

Finally, in practice annual cohorts may not always be necessary. The requirements in IFRS 17 specify the amounts to be reported, not the methodology to be used to arrive at those amounts. In some cases, applying the IFRS 17 requirements at a more aggregated level than envisaged by the annual cohort requirement may produce an outcome that is not materially different from the outcome applying the annual cohort requirement. For example, if all insurance contracts have the same profitability and changes in estimates affect them equally then annual cohorts may not be necessary. The same may be true for some participating contracts where returns are mutualised amongst policyholders, with no share of the returns being retained by the insurer.

This possibility—that applying the annual cohort requirement may not always be necessary—is explicitly acknowledged in IFRS 17 and explained in the Basis for Conclusions.[3]

3 Paragraph BC138 of the Basis for Conclusions on IFRS 17.

Deliberations (and redeliberations)

The Board has not taken the decision to retain annual cohorts lightly. The Board has debated and consulted on the issue on many occasions during the development of the Standard, during the implementation phase after IFRS 17 was issued, in the development of the targeted amendments to the Standard in the recent Exposure Draft, and finally in the subsequent redeliberations. As is always the practice with the Board, consultation with stakeholders has been extensive. All Board papers and Board meetings have been public, and stakeholders have been forthcoming with their advice and feedback. It is only after the most careful consideration that the Board has taken the decision to confirm that insurers should use annual cohorts when accounting for the CSM.[4]

The Board has demonstrated its willingness to consider and respond to the concerns of the insurance industry throughout the development of IFRS 17. In response to feedback, the Board made substantial changes to its proposals, for example the introduction of the variable fee approach and the option to use other comprehensive income. These changes have added to the complexity of the Standard and the costs for all involved, including investors. However, the Board was persuaded by the insurance industry that those costs were outweighed by the benefits of the resulting information.

On the question of annual cohorts, the Board again concluded that the costs of the requirement were outweighed by the benefits of the resulting information. In fact, the Board concluded that the **costs to investors of *any exemption* from the requirement would be excessive**, in terms of the risk of the loss of critical information and the difficulty in assessing the effect of the exemption.

It is now time to implement the Standard

One of the Board's objectives in this project is to demystify the financial statements of insurance companies. Many investors consider that insurance accounting is accessible only to specialists and even then does not satisfy their needs, as evidenced by the widespread use of alternative reporting methodologies, such as embedded value reporting. It has been acknowledged by many stakeholders that IFRS 17 will transform the quality of reporting, make the insurance sector more 'investible' and improve communication between insurers and their investors.[5] The targeted amendments to IFRS 17 will shortly be finalised; it is now time to focus on implementation.

4 More information about the Board's deliberations regarding annual cohorts, together with worked examples to demonstrate the effect of not applying the requirement, can be found in the Board paper Agenda Paper 2B *Level of aggregation—annual cohorts for insurance contracts with intergenerational sharing of risks between policyholders* of the February 2020 Board meeting.

5 Extract from an analyst report for investors commenting on IFRS 17: 'We think there will be a huge amount of information given to help investors understand the movement of value and cash components that are currently either ignored or wrapped into a single black box under IFRS 4.'
Extract from factsheet IFRS 17 prepared by an insurer implementing IFRS 17: 'As well as resulting in considerable implementation costs, this radical overhaul of external reporting will also create numerous opportunities for the insurance industry in the long term: (a) the more economical representation of insurance contracts, especially those in the life insurance business, will bring internal and external accounting closer together; (b) it may be possible to re-use the IFRS financial statements to calculate own funds as defined by Solvency II regulation, which use a similar measurement framework, eliminating duplication of effort; (c) all of this will create preconditions required to strengthen the transparency of the insurance industry.'