Cash versus accrual based accounting under IFRS 17

CONTENT AND BACKGROUND

In all industries, amounts to be received from debtors and amounts to be paid to creditors are accounted for as separate balance sheet items. This is currently also the case for the insurance industry under IFRS 4: premium debtors are recognised as premiums receivables when premiums are written and claims and expenses creditors are separately recognised as payables when incurred. This is changed with the introduction of IFRS 17 when it comes to accounting for insurance contracts.

In IFRS 17, cash flows and in particular expected future premiums and claims are to be accounted for in the insurance liability as part of the future fulfilment cash flows until they are actually received/ paid (i.e. on a cash basis) and not only until they are written or due (i.e. on an accrual basis). This means that elements that would today be separately accounted for as premiums receivables and claims and expenses payables are to be integrated with the insurance liability.

Insurers (a.o. via the European CFO Forum) have mentioned several times to the IASB (and EFRAG)[1] that this balance sheet presentation under IFRS 17 has non-desirable effects and requires significant efforts whilst it decreases information presented in the balance sheet. However, in December 2018 it became clear that the IASB wants to maintain this presentational requirement and provided only for a slight relief, which is maintained in the 2019 IFRS 17 Exposure Draft.[2]

In this article a solution is described by which the current accounting practice can continue while still materially complying with the IFRS 17 requirements.

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This article is written in a personal capacity.

POSSIBLE SOLUTION

Fulfilment cash flows in IFRS 17 include all the expected future cash flows within the boundary of each contract in the group. These include premiums due but not yet received until they are actually received. Also incurred but not yet paid claims and incurred but not yet paid insurance expenses are to be accounted for as part of the insurance liability until they are actually paid. However, this affects balance sheet presentation only as IFRS 17 still requires to account for insurance service expenses (claims and insurance expenses) in profit or loss when claims and expenses are incurred, which will be earlier than the actual payment.

In order to visualise this accounting process, the reconciliation of the insurance liability as required by IFRS 17.100 is shown in Table 1.

When claims or expenses are incurred, the liability for incurred claims is credited on the line item 'incurred claims and insurance expenses' highlighted in Table 1 in yellow. When claims or expenses are actually paid, the liability for incurred claims is debited on the line item 'claims and insurance expenses paid' as highlighted in green in Table 1. Premiums will only become visible in the required reconciliation after they have actually been received as highlighted in purple.

In order to materially comply with the principles of IFRS 17, but align to current processes as much as possible, a possible solution is as follows. Premiums receivables and claims and insurance expenses payables will be accounted for on an accrual basis, when premiums are written and claims and insurance expenses are incurred. This results in the creation of payables (claims/ expenses) and receivables (premiums). However, the outstanding amounts to be paid/ received at the end of a reporting period are transferred (or technically 'mapped') to the line items cash flows received/ paid in the in Table 1 recorded movement schedule of the insurance liability. Consequentially, the line items cash flows received/paid will only reflect the amounts actually received and paid.

REQUIRED DATA ENRICHMENT

IFRS 17 requires that opening and closing balances of insurance contracts that are in an asset position need to be presented separately from insurance contracts that are in a liability position. An insurance contract can be in an asset position if, for instance, more claims or (acquisition) expenses have been paid than premiums have been received for that contract or if the Contractual Service margin and Risk Adjustment would be released in profit or loss faster than the release of expected claims and expenses. IFRS 17 also requires a separate movement schedule for contracts accounted for under the Premium Allocation Approach.

This means the 'mapping' of outstanding premiums receivables and claims and insurance expenses payables at the end of a reporting period to the cash flows received/paid in the insurance liability needs to happen at the same level of granularity on which the asset/liability split is required. IFRS 17.78 (as amended in the 2019 Exposure Draft) prescribes this split should be done at the level of the portfolio.

Therefore, in order to make the above solution materially compliant with IFRS 17, data stored for insurance payables and receivables need to include references to the correct portfolio if there are or can be portfolio's in an asset position and simultaneously portfolio's in a liability position. Furthermore, if an insurer applies the Premium Allocation Approach and IFRS 17's General Model or Variable Fee Approach simultaneously, data stored for insurance payables and receivables need to, at least, include references to the correct measurement model.

	Net liability for remaining coverage		Liability for incurred claims and benefits	Total
	Remaining coverage (excluding loss component)	Loss component		
– opening balance presented as assets				
– opening balance presented as liabilities				
Net opening balance				
Insurance revenue				
Insurance service expenses:				
– incurred claims and insurance expenses				
– amortisation of insurance acquisition costs				
– changes in incurred claims and benefits previous periods				
– losses on onerous contracts and reversal of those losses				
Investment components excluded from insurance expenses and				
insurance income				
Finance expenses on insurance contracts				
Cash flows				
– premiums received				
– acquisition costs paid				
– claims and insurance expenses paid				
Net closing balance				
– closing balance presented as assets				
– closing balance presented as liabilities				

Table 1 Liabilities for remaining coverage and incurred claims and benefits

CASH VERSUS ACCRUAL ACCOUNTING FOR EXPERIENCE ADJUSTMENTS

IFRS 17 distinguishes experience adjustments on premiums (and premium related expenses) and experience adjustments on claims and other expenses. Experience adjustments on premiums need to be accounted for in the Contractual Service Margin if relating to future service and in profit or loss if not. Experience adjustments on claims and (non-premium related) insurance expenses are to be accounted for in profit or loss in full.

When the experience adjustments are to be accounted for in the Contractual Service Margin, a link between the expected amount (from the Actuarial system) and the actual amount (from the finance system) needs to be in place in order to account for the experience adjustment in the correct group of contracts. A group of contracts in IFRS 17 is a more granular level than portfolio level[3]. This link is not required for experience adjustments recorded in profit or loss. This means that only for premiums (and premium-related expenses) relating to future service the Actuarial system and finance system need to link.

Experience adjustment on claims and other, non-premium related, expenses is defined as the difference between the estimate at the beginning of the claims and expenses expected to be **incurred** in the period and the actual amounts **incurred** in the period. The experience adjustment on premiums and premium related expenses is in IFRS 17 defined as the difference between the estimated premiums for a reporting period and the actual premiums **received** in that period[4]. Although 'received' seems to suggest a cash based determination for this type of experience adjustment, the current common interpretation is that the experience adjustment on premiums and premium related expenses is defined as the difference between the estimated premiums for a reporting period and the actual premiums **written** in that period.

In line with this interpretation, under the solution as described above, experience adjustments will be recorded on an accrual basis (when premiums are written and claims and expenses are incurred) and not on a cash basis.

SUMMARY

In this article a solution is described whereby the current 'accrual' accounting practice for the accounting of premiums and claims under IFRS 17 can continue whilst still materially complying with the IFRS 17 requirements. It does require enrichment of data in premiums, claims and insurance expenses accruals in order to be able to 'map' the outstanding accruals to the correct portfolio when applicable. In this article also a required linkage between Finance and Actuarial systems is described in order to be able to correctly account for premium (related) experience adjustments. ■

1 – Comment letters send by the European CFO Forum to EFRAG and IASB

2 – IFRS 17.78

3 – IFRS 17.16-22: Each portfolio is subdivided into three levels of profitability and for each level having maximal annual cohorts

4 – IFRS 17 Appendix A Defined terms