Sudit K. Parekh & Co. LLP

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Ind AS 117 Insurance Contracts: An Overview

Introduction of Ind AS 117

Globally, International Financial Reporting Standards (IFRS) 17 replaced IFRS 4 as the primary accounting framework for insurance contracts. IFRS 4, introduced in 2004, was meant to be an interim standard on insurance accounting that guided on the matter while a holistic standard was developed. With the introduction of IFRS 17, the International Accounting Standards Board (IASB) has:

- Brought about comparability between insurance companies;
- Ensured one accounting policy for all insurance contracts;
- Updation on estimates for each reporting period;
- Transparency in key profit drivers;
- Implemented discount rates based on the cash flows of the insurance contract.

With the global insurance accounting landscape transitioning to IFRS 17, the Ministry of Corporate Affairs (MCA) introduced Indian Accounting Standards (Ind AS) 117 as the IFRS converged Indian accounting framework for insurance contracts. Here it must be pointed out that IFRS 17 has been under work with the IASB since IFRS was applied as a bridging mechanism to ensure guidance is available on the subject of insurance. The framework is a hybrid between financial instruments and insurance accounting, making its application judgment driven and complicated. The IASB deferred the application of IFRS 17 to 1 January 2023 after considering comments to its exposure draft in June 2020. In India too, the Insurance Regulatory and Development Authority has deferred the applicability of Ind AS 117. It is expected that Ind AS 117 will be applicable in India from 1 April 2023. Ind AS 117 brings about consistency resulting in better financial presentation for both insurers and investors. One stellar feature of Ind AS 117 is the separate presentation of income from underwriting and investment.

An Overview of Ind AS 117

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Core principles of Ind AS 117

1. Contract Identification:

The first step in applying Ind AS 117 is contract assessment and identification. Ind AS 117 applies to insurance contracts; hence the reporting entity is required to demarcate all relevant contracts as insurance and non-insurance contracts. The term 'insurance contract' refers to the agreement under which the reporting entity accepts significant insurance risk on behalf of the policyholder and agrees to compensate in the event of an uncertain future event.

2. Separation of contract components:

Ind AS 117 applies only to insurance contracts or to the insurance element/component of a contract. Hence, the standard requires that components like embedded derivatives, distinct investment components and distinct performance obligations be separated and valued on a stand-alone basis as per the applicable standard. This has been discussed in combination and separation of components from an insurance contract below.

3. Presentation:

Insurance revenue, service expenses, finance expense, or income are presented separately.

4. Contract Grouping:

Contracts are grouped as profitable and onerous on an annual basis for valuation. This is further discussed in the level of aggregation of insurance contracts.

5. Analytical disclosures:

Ind AS 117 discloses information to enable users of financial statements to assess the impact of insurance contracts on the financial position, financial performance, and cash flows.

6. Application of assumptions and management judgment:

Management assumptions and judgment are applied to the insurance cashflows by selecting appropriate discounting and risk adjustment factors. Unearned profits are arrived upon and treated as a liability until recognized.

7. Recognition of profit and release from risk:

Ind AS 117 recognizes profit from insurance contracts over the period the entity provides insurance coverage, and as the entity is released from risk. If insurance contracts become loss-making, the entity recognizes losses immediately.

Scope Inclusions and Exclusions

The reporting entity applies Ind AS 117 to:

a. Insurance contracts;
b. All reinsurance contracts held and issued;
c. Issued investment contracts with discretionary participation features provided the entity also gives insurance contracts.

The scope exclusions of Ind AS 117 are:

1. Warranties provided by a manufacturer, retailer, or dealer in connection with the sale of goods or services to a customer. Ind AS 115 Revenue from contracts with customers shall be applicable in such cases.
2. Employer's assets and liabilities from employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans. Ind AS 19 Employee Benefits and Ind 102 Share-based payments will be applicable to such cases.
3. Contractual rights or contractual obligations contingent on the future use of or the right to use, a non-financial item. Ind AS 115 Revenue from contracts with customers, Ind AS 38 Intangible assets, and Ind AS 116 Leases will be applicable to such cases.
4. Residual value guarantees are provided by a manufacturer, dealer, or retailer and a lessee's residual value guarantees when they are embedded in a lease. Ind AS 115 Revenue from contracts with customers and IND AS 116 Leases will be applicable to such cases.
5. Financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to them. The issuer shall choose to apply either Ind AS 117 or Ind AS 32 Financial instruments: Presentation, Ind AS 107: Financial instruments disclosures, and Ind AS 109 Financial instruments to such guaranteed contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.
6. Contingent consideration payable or receivable in a business combination. Ind AS 103 Business combinations shall be applicable here.
7. Insurance contracts in which the entity is the policyholder unless those contracts are reinsurance contracts.

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Combination and separation of components from an insurance contract

Imagine a large unit of machinery that encompasses several smaller specialized machines that work in tandem for the larger unit to function. Here, each smaller unit is a specialized machine that has a specialist engineer to maintain each unit individually. An insurance contract is like this machine we just described.

An insurance contract may comprise of individual contractual components that may fall within the scope of other standards if analyzed independently. Ind AS 117 has prescribed three examples where such individual contractual components would have to be accounted for separately, as per other standards, from the core insurance contract. These examples cover:

A. Embedded derivatives

B. Distinct investment component

C. Distinct goods or non-insurance services provided to a policyholder e.g.: Asset management services.

After demarcating and separately accounting for the above-mentioned components, the remainder of the insurance contract would have to be accounted for as per Ind AS 117.

Contract component	Applicable Standard
Insurance component	Ind AS 117
Non-distinct investment component	Ind AS 117 (Disaggregation)
Distinct goods or non-insurance service	Ind AS 115
Embedded derivative	Ind AS 109
Distinct investment component	Ind AS 109

An investment component is distinct from the core insurance contract if:

a. The investment component and the insurance component are not highly inter-related; and

b. A contract with comparable is/could be sold in the same market/jurisdiction.

Goods or non-insurance services are distinct from the core insurance contract if the policyholder can benefit from the goods or services either:

a. Individually (on its own); or

b. Together with other resources that are readily available to the policyholder.

Level of aggregation of insurance contracts

Ind AS 117 requires entities to identify portfolios of insurance contracts. Insurance contracts are grouped together in portfolios at commencement. Such grouping determines the level at which the insurer will apply guidance on recognition, measurement, presentation, and disclosure.

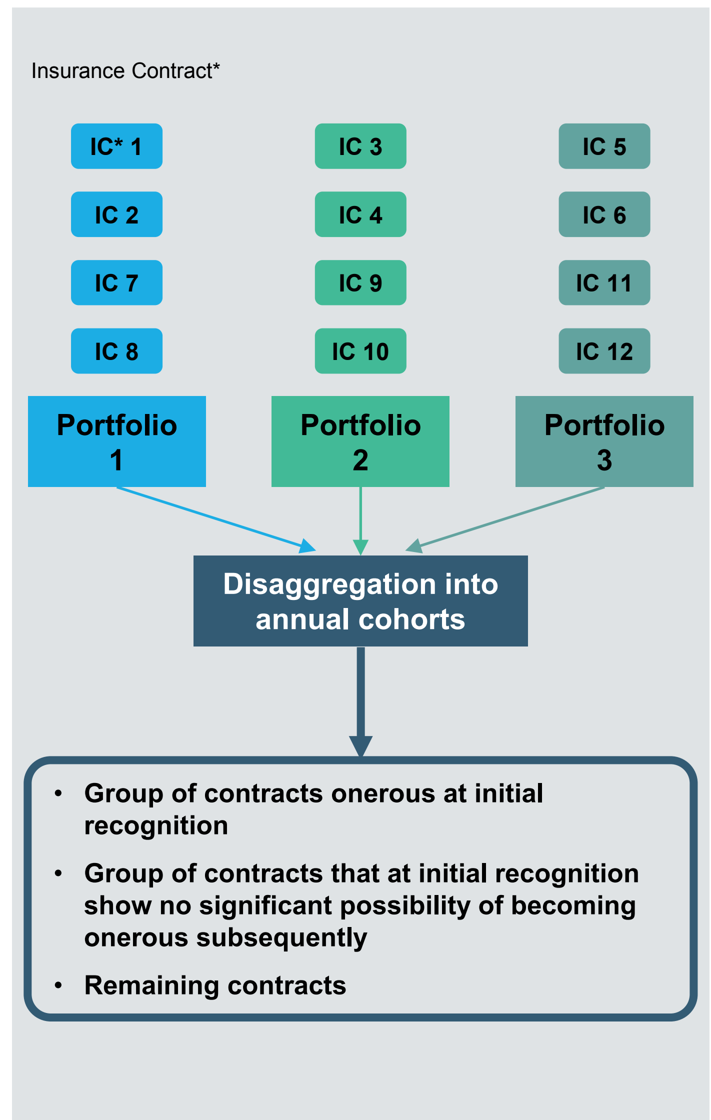
Insurance contracts are grouped together based on similarities in risk and that they need to be managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if managed together. For instance, single premium fixed annuities may be grouped together in a single portfolio.

Contracts in different product lines would not be expected to have similar risks and hence would be placed in different portfolios. For example, single premium fixed annuities and regular term life insurance would be placed in different portfolios.

Contracts with similarities in risk that can be managed together comprise of a portfolio of insurance contracts. Once all the contracts are grouped under distinct portfolios, each portfolio at contract inception is further divided into a minimum of:

1. Group of contracts onerous at initial recognition, if any;
2. Group of contracts that at initial recognition show no significant possibility of becoming onerous subsequently, if any;
3. Remaining contracts in the portfolio, if any.

The same group cannot include contracts issued more than one year apart. Hence, each portfolio is grouped into annual cohorts or units consisting of a period of less than a year.



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Initial recognition and timing of recognition

Initial Recognition

On initial recognition, the reporting entity recognizes groups of insurance contracts based on the above-mentioned grouping. The entity shall recognize a group of insurance contracts it issues from the earliest of the following:

a. The beginning of the coverage period of the group of contracts
b. The date when the first payment from a policyholder in the group becomes due
c. For a group of onerous contracts, when the group becomes onerous

For contracts with no contractual due date, the first payment from the policyholder is deemed to be due when it is received. A group of insurance contracts shall include only those contracts which are issued by the reporting date.

On initial recognition, the entity shall measure a group of insurance contracts at the total of:

a. Fulfillment cashflows (discussed below)
b. Contractual service margin (discussed below)

Timing of recognition

Timing of recognition plays a crucial role in insurance accounting. Determining the timing and initial recognition impacts the calculation of contractual service margin and the applicable discount rates and factors.

Contract Boundary

Ind AS 117 requires that all calculations of future cash flows for the contract be included in the measurement of a group of insurance contracts. Ind AS 117 refers to this as future cash flows within the "boundary" of each contract in the group. Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services.

The definition of contract boundaries enables the reporting entity to distinguish future cash flows that relate to existing contracts from future cash flows such as expected premiums and expected claims that relate to future contracts. Future cash flows that relate to future contracts are demarcated outside the contract boundaries of the existing insurance contract. This requirement of Ind AS 117 ensures that only those contractual cashflows which are binding on the company are included in the measurement of insurance contracts.

In cases where the entity reassesses the insurance risk of a given contract but is not in the position to reprice the contract based on the reassessed risk, the contract is still binding on the entity, and it shall be included in the existing contract's boundary.

Acquisition Costs

Insurance acquisition cash flows arise from the following sources:

a. Selling a group of insurance contracts
b. Underwriting a group of insurance contracts
c. Starting a group of insurance contracts

Under Ind AS 117, these cash flows are included in the insurance liability measurement and that results in the reduction of CSM on initial recognition.

Measurement Models

Ind AS 117 prescribes three measurement models for the measurement of insurance contracts. These are:

a. General model
b. Premium allocation approach
c. Variable fee approach

General Model

Under the General Model, the liability of a group of insurance contracts comprises:

a. Fulfillment cash flows
b. Contractual service margin

Fulfillment cash flows

Fulfillment cash flows are estimates of future cash flows that are discounted to their present value and further adjusted using a risk adjustment factor. These cash flows represent the risk-adjusted present value of the insurer's rights and obligations to policyholders. Fulfillment cash flows comprise three building blocks:

a. Estimates of future cash flows
b. Discounting factor
c. Risk adjustment for non-financial risk.

Estimates of future cash flows

Estimates of future cash flows are determined by simulating multiple scenarios with a range of possible outcomes specific to:

a. Amount of cash flows for a particular outcome
b. Timing of cash flows for a particular outcome
c. Estimated probability of cash flows for a particular outcome

The present value of cash flows from each simulated scenario is determined by applying a discount factor and weights based on the probability of an outcome. This exercise aims to incorporate all reasonable and supporting information in making cash flow estimates by avoiding unnecessary costs and bias. When the measurement result is within an acceptable range of precision, it is advisable to use a smaller number of parameters or simpler modeling techniques. However, in complicated scenarios such as estimating cash flows generated by derivative instruments like options related to insurance coverage, more refined, stochastic modeling techniques will have to be used.

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Discount factor

The discount factor plays a crucial role in estimating future cash flows that must reflect:

a. Appropriate impact of the time value of money
b. Considerations of all financial risks associated with cashflows
c. Consistency with current market trends and rates

Modes of determining the appropriate discount factor can be listed down for a few textbook scenarios:

Scenario	Applicable Discount rate
Cash flows that do not vary based on returns on any underlying financial items	Risk-free rate
Cash flows that vary based on returns on any underlying financial items	Rates that best reflect variability, such as the ongoing market rate of return or similar
Nominal cash flows	Inflation-adjusted discount rate
Real cash flows	Discount rate that excludes inflation

Risk adjustment factor for non-financial risk

Cash flow estimates and discount factors ensure that considerations for financial risk are embedded in the fulfillment cash flows. However, non-financial risk as well needs to be factored in. Ind AS 117 is silent on how risk adjustment factors should be arrived upon for factoring in non-financial risk. Hence, the factoring in of non-financial risk is driven by management judgment. The reporting entity shall adjust the estimate of the present value of future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk. The risk adjustment factor for non-financial risk should take into consideration:

a. Degree of risk aversion
This should reflect both favorable and unfavorable outcomes.

b. Degree of diversification benefit
This is the degree of benefit that the entity includes in estimates as compensation received for bearing risk.

Contractual Service Margin (CSM)

CSM is a component of the asset or liability for the group of insurance contracts representing the unearned profit the entity will recognize as it provides services in the future. At initial recognition, this unearned profit is defined by CSM for profitable groups of contracts or as a loss component for onerous contracts.

CSM relates to future services to be provided, and hence it relates to profit not yet recognized in the statement of profit and loss for groups of insurance contracts.

CSM is to be adjusted in each reporting period for several services provided under the group of insurance contracts for the said period. For this, CSM is adjusted in each reporting period for an amount recognized in the statement of profit and loss. The amount of adjustment is determined by:

a. Identification of coverage units (insurance contracts) in the group for which unearned profit must be factored in.
b. Allocating CSM to the identified coverage units in the current period.
c. Recognize profit and loss amounts for the identified coverage units.

Treatment of Acquisition costs under the general model:

Under this model, the reporting entity shall allocate part of the premium to recover acquisition costs so that both the costs and related revenue are recognized over the same period in the same pattern based on time.

Premium Allocation Approach (PAA)

PAA is a simplification of the General Model for certain insurance contracts to measure the liability for remaining coverage. Under PAA, recognition of the contract's premium over the coverage period provides similar information and profit patterns as would have been provided using the General Model.

PAA can be applied for the measurement of a group of insurance contracts at the inception of the group if:

a. The reporting entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the prescriptions of the General Model.
b. The coverage period of each contract in the group is one year or lesser.

Under PAA the total carrying amount of a group of insurance contracts is made up of:

a. Liability for remaining coverage

This includes:

The fulfillment of cash flows relating to future services that will be provided under the insurance contract in future periods; and

The CSM

Measurement of liability for remaining coverage under PAA is performed as under:

Particulars	Amount
Amount of premium received (net of acquisition cash flows paid)	XX
Less: Amount of premium and acquisition cash flows recognized in profit and loss over the expired portion of the coverage period based on the passage of time	(XX)
Liability for remaining coverage	**XX**

b. Liability for incurred claims

This is represented by fulfillment cash flows related to past service for claims and expenses already incurred.

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Variable Fee Approach (VFA)

VFA differs from the general model on two counts:

1. Treatment of changes in fulfillment cash flow arising from the time value of money and financial risks
2. Interest rate accreted to CSM

VFA modifies the treatment of CSM to include contracts with direct participating features. There is no difference in the initial recognition of contracts with direct participating features and those without direct participating features. The area of subsequent measurement is where the differences arise in the measurement of CSM. These differences reflect the specific nature of contracts with direct participating features.

	GM	VFA
Treatment of changes in fulfillment cash flow arising from the time value of money and financial risks	Recognized immediately in profit and loss as insurance finance income or expense	Treated as a part of the variability of fee for future services and recognized in CSM
Interest rate accreted to CSM	The interest rate is determined by initial recognition	Interest rate accretion is not required because the CSM is effectively remeasured when it is adjusted for changes in financial risk

Reinsurance

Reinsurance is the insurance cover that an insurer purchases to hedge its risk of major claims. It is defined as an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts.

Reinsurance held – the reporting entity that is an insurer hedges its insurance risk by purchasing a reinsurance contract from a reinsurance service provider.

Reinsurance issued – the reporting entity is the reinsurer issuing the reinsurance contract to an insurer looking to hedge its insurance risk.

Reinsurance contracts are recognized depending upon the coverage period.

Reinsurance held

Reinsurance held is accounted for separately from the underlying insurance contract to which it relates. This is because the holder of the reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by the amounts it expects to receive from the reinsurer.

The following shall be taken into consideration for the measurement of reinsurance contracts held:

1. The reporting entity shall include the effect of any non-performance risk by the issuer of reinsurance in the estimates of the present value of the future cash flows. This shall include the impact of collateral and losses from disputes.
2. Risk adjustment factor for the transfer of non-financial risk from the holder to the issuer.

Contractual Service Margin (CSM) related adjustments:

- CSM on initial recognition represents the net cost or net gain to be recognized on the purchase of a group of reinsurance contracts.
- Risk of non-performance by the reinsurance service provider will lead to changes in fulfillment cashflows. The same shall not be adjusted in CSM as they do not relate to future service.

CSM at reporting date shall be arrived upon as under:

Particulars	Amt
CSM at the previous reporting date (opening balance)	XX
Add: Impact of new contract added to the group	XX
Add/Less: Interest accreted on CSM during the reporting period	XX
Add/Less: Changes in fulfillment cash flows relating to future service	XX
Add/Less: Impact of foreign currency fluctuations on CSM	XX
Less: Amount of CSM recognized in profit and loss due to services received during the period	XX
CSM at the reporting date	**XX**

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Derecognition and Modification

The reporting entity shall derecognize an insurance contract only when:

a. It is extinguished; or

b. On contract modification.

Contract modification is said to occur when the contractual covenants are modified by an agreement between the insurer and the insured. The mere exercise of a contractual right or provision which is a part of the original contract does not amount to a contract modification.

If anyone of the following criteria is met due to contract modification, the modified insurance contract shall be derecognized:

a. Contract modification leads to the contract falling out of the scope of Ind AS 117.

b. Modification of the contract results in a substantially different contract boundary.

c. Premium allocation is no longer possible due to the modification.

d. The modification results in the contract not meeting the definition or substance of an insurance contract with discretionary participation features and hence has to be grouped in a different category of contracts.

e. The modification results in the separation of key components of the base insurance contract.

Where contract modification does not result in derecognition, the modification shall be accounted for change in the estimate of fulfillment cash flows.

Interaction with other Indian Accounting Standards

1. Interaction with Ind AS 109: Financial Instruments:

Select financial assets and liabilities of the insurer will be measured according to the principles of IND AS 109 which requires assets to be classified as:

a. Measured at amortized cost.

b. Measured at fair value through other comprehensive income.

c. Measured at fair value through profit and loss.

Ind AS 117 and Ind AS 109 have to be implemented in a manner that volatility in the reported numbers of assets and liabilities is reduced. The disaggregation of financial income and expense between profit and loss and other comprehensive income is an accounting policy choice. For hurdle-free reporting:

a. Insurers have to consider the classifications of Ind AS 109;

b. Insurers have to consider the impact of accounting mismatch and hence may choose to report volatility in other comprehensive income as opposed to profit and loss.

2. Interaction with Ind AS 115: Revenue from contracts with customers

The risk retained by manufacturers, dealers, and service providers in a fixed service fee contract meets the definition of an insurance contract. The reporting entity may choose to account for the same as per the principles of Ind AS 115 as opposed to applying Ind AS 117 if the following conditions are met:

a. The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer.

b. The contract compensates the customer by providing services rather than by making cash payments to the customer.

c. The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

The introduction of Ind AS 117 is to ease further the preparation of financial statements by the insurance companies. We have touched upon all the conceptual aspects covered by the standard. It is expected that the preparers of financial statements stay cognizant of the guidelines of this standard (Ind AS 117) to maintain standardization in insurance contracts with IFRS 17.

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