



IFRS 17 and Embedded Value Reporting

While the immediate challenge for many insurers around the globe is to determine accounting interpretations and methodologies for insurance contracts, and transition from existing frameworks before the effective date of 1/1/2021,¹ there are other areas indirectly impacted. One of those is Embedded Value (EV) reporting.

Overview

The long-awaited IFRS standard for insurance contracts, IFRS 17, was finally released in May 2017, replacing IFRS 4. Many companies routinely calculate and publish EV results. Despite having a collection of rules and practices, EV is not technically an accounting framework. Rather, it reports risk-adjusted performance, recognizing both economic principles and constraints posed by local statutory laws in distributing earnings. This article aims to discuss how the adoption of IFRS 17 will impact the future of EV reporting.

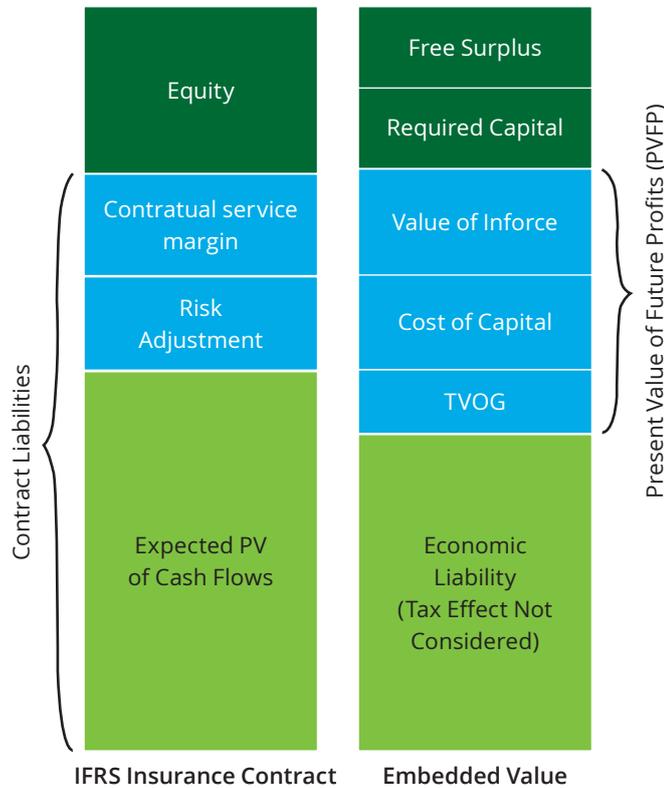
Comparison – IFRS 17 vs. EV

IFRS 17 is a current value framework which is intended to more consistently reflect economic reality than existing accounting frameworks under IFRS 4. Its adoption will align insurance accounting across the globe, and increase consistency, comparability and transparency.

As illustrated in Figure 1, under IFRS 17, insurance contract liabilities consist of three components under the general measurement model which is often referenced as the Building Blocks Approach (BBA) – probability-weighted mean present value of future cash flows (expected PV of cash flows), Risk Adjustment (RA) and Contractual Service Margin (CSM). There are variations to the general model such as the Premium Allocation Approach which is an option for certain short-term contracts, and the Variable Fee Approach which is applied to contracts with participating features that meet certain eligibility criteria. In this article, unless otherwise noted, we will focus on the general measurement model considering its broad applicability, and similarity to the EV framework.

1. The IASB Board voted on November 14, 2018 to propose one-year deferral of the effective date of the IFRS 17 to 2022.

Figure 1. Comparison of IFRS 17 and EV balance sheets – for illustration purpose only



Under the general measurement model, the expected PV of cash flows is akin to an economic liability. Discount rates are set based on a top-down or bottom-up approach, reflecting the risks and characteristics of the contracts' fulfilment cash flows. The risk adjustment is a component that recognizes the risks born by the insurer in light of the variability of cash flows. One potential approach to quantify the RA is the cost of capital (CoC) approach, although IFRS 17 does not prescribe any technique other than requiring a confidence level disclosure. Last of all, the CSM is similar to a deferred profit liability concept that is expected to release time zero profit into revenue over time.

In comparison, EV, as a supplemental reporting framework, has been widely used in Europe, Asia and other places of the world as an important measuring stick when comparing financial performance over time and against peers. It is based on economic principles, but also recognizes constraints posed by local statutory laws in insurers' ability to distribute earnings.

As illustrated, IFRS 17 has components that are very similar to those under the EV reporting. EV reporting does not set rules on how to calculate liabilities. By calculating the present value of future profits (PVFP), implicitly EV reporting recognizes the value embedded in the local statutory liability once the economic liability is removed (considering tax effect would add complication as PVFP is a post-tax calculation). Depending on whether Market Consistent EV or European EV principles are followed, the discount rates used for the PVFP calculation could be real world risk discount rates or market consistent rates with liquidity premiums. EV includes a CoC component that could be leveraged to modify into the IFRS 17 RA calculation. TVOG cannot be explicitly found from IFRS 17 requirements, but it is conceivable for insurers to quantify a TVOG as part of the expected PV of cash flows in order to capture the asymmetry of cash flows when optionalities exist in products.

In order to assess the equity position under IFRS reporting, there are other IFRS standards in play such as IFRS 9 for financial instruments. IFRS 17 is focused on the liability measurement and related presentation, while IFRS 9 provides guidance on asset valuation. The implementation of IFRS 9 can be deferred to 1/1/2021² for insurers to sync with the timing of IFRS 17. In contrast, EV reporting defines the Adjusted Net Worth (ANW) which is the sum of required capital and free surplus, and akin to an "equity" concept.

With the mandatory implementation of IFRS 17 for most global insurers, how will EV reporting be affected? Will IFRS 17 eliminate the need to report EV? If insurers expect to continue reporting EV on a supplemental basis, what changes will we foresee after the implementation of IFRS 17?

2. The IASB Board voted on November 14, 2018 to propose one-year deferral on the expiry date of the IFRS 9 deferral period to 2022.

Current State of EV Reporting

The European CFO Forum issued European EV Principles in May 2004, and Market Consistent EV Principles in June 2008. The intent of these principles was to improve the allowance for risk in reported results, and to increase the transparency, consistency and disclosures of EV reporting in Europe. They have been followed by global insurers elsewhere in the world too. While more European companies report EV under the Market Consistent EV principles in light of the solvency framework which is also market consistent, elsewhere in the world such as Asia, it is more prevalent for insurers to report European EV results which use real world scenarios.

As described earlier, EV is not an accounting framework. By design, EV reporting minimizes accounting biases in its calculation of distributable earnings. Its focus on value has gained popularity in the insurance industry, and EV-based measures have been utilized in both external investor analysis and internal business planning and management compensation. In particular, EV-based measures such as Value of New Business (VNB), new business margin (VNB over PV of new business premiums), EV operating earnings (part of EV analysis of change, or “income statement” with economic impact excluded), and return on EV (EV operating earnings as a % of EV) have been widely used.

In May 2016, the CFO Forum issued revised European EV and Market Consistent EV Principles and Guidance, updated for the Solvency II regime which came to effect on 1/1/2016. The revision recognized the similarities between Solvency II and EV in their methodologies and assumptions, and that components of Solvency II reporting could be leveraged for EV reporting.

Since then, some insurers, which previously reported Market Consistent EV, have discontinued EV reporting, because Solvency II is also a market consistent framework. Others have started using Solvency II-based measures with adjustments for EV reporting purposes. For example, Aviva reported VNB on both Market Consistent EV and adjusted Solvency II Own Funds basis as of 2016 year-end, stating that from 2017 onwards, the adjusted Solvency II VNB will replace EV VNB as a key performance indicator.



Future State – Impact of IFRS 17

Due to its wide applicability across the globe, it is expected that IFRS 17 will have a profound impact on the insurance industry, ranging from financial reporting and investor relations, to performance measurement and management compensation. Like any other accounting framework, IFRS 17, once implemented, will give rise to new accounting-based measures that will concern internal and external stakeholders. Will those measures eliminate the need to report under a value-based framework like European or Market Consistent EV? Is IFRS 17 going to be the last straw since the adoption of Solvency II to finally push insurers to move away from supplemental reporting like EV, and focus their resources on and completely leverage the primary reporting requirements?

Only time will tell how the future of EV reporting will exactly unfold, but here are a few angles that may help practitioners think through the potential impact of IFRS 17 on EV reporting:

1. Measurement Objectives

While being a principle-based current value approach, IFRS 17 has its own measurement objectives – designed for public reporting under a going concern, IFRS 17 allows for certain degree of matching of expenses and revenues, instead of immediate recognition. Similarly, an anticipation of changes in future cash flows may or may not impact current period income from an accounting perspective.

For example, the CSM is set up at time zero as a liability to capture the profit of the insurance contract, and is released into P&L as services are provided. It further functions as a shock absorber to the extent it is not depleted, meaning there is still profit to defer to the future, to offset any unfavorable changes in the expected PV of cash flows and the risk adjustments due to updates in non-economic assumptions related to future services, resulting in a zero impact to the income statement.

In comparison, should any future non-economic best estimate assumptions worsen, the impact would be reflected immediately on reported EV results, by flowing through the operating variance in the analysis of change (EV's "income statement").

Furthermore, IFRS reporting considers potential asset and liability mismatch, and has been designed in a way to mitigate such mismatch in order to provide relevant and consistent financial performance and cash flows to readers of financial statements. One example is the variable fee approach, which is a variation to the general measurement model when accounting for direct participation contracts that meet certain eligibility criteria. In comparison, EV as a value-reporting framework does not have such concern with asset and liability mismatch. In the analysis of change, the focus of the "income statement" components is merely on the value created or destroyed in an economic fashion during the reporting year.



2. Technical Components

As described earlier, certain technical components are similar under IFRS 17 and EV reporting. In particular:

- Pre-tax PVFP in the EV calculation, if removing the statutory reserve changes and investment incomes, would be comparable to the expected PV of cash flows in the IFRS 17 general measurement model;
- The TVOG component of EV, with some slight adjustments, could be viewed as an additional provision in the IFRS 17 expected PV of cash flows to account for the optionalities included in insurance contracts;
- The CoC component of EV would be comparable to the RA in the IFRS 17 general measurement model, though there are other ways to calculate the RA under IFRS 17;
- Value of Inforce (i.e., PVFP less TVOG less CoC) represents the value generated from the inforce business. It can be analogized to the CSM, which represents the profit generated from insurance contracts. Although changes in future non-economic assumptions do not impact income due to the CSM's shock-absorber nature, the CSM itself is adjusted for future favorable or unfavorable changes, thus it depicts a refined current picture of future profitability in each accounting period just like the EV Value of Inforce.

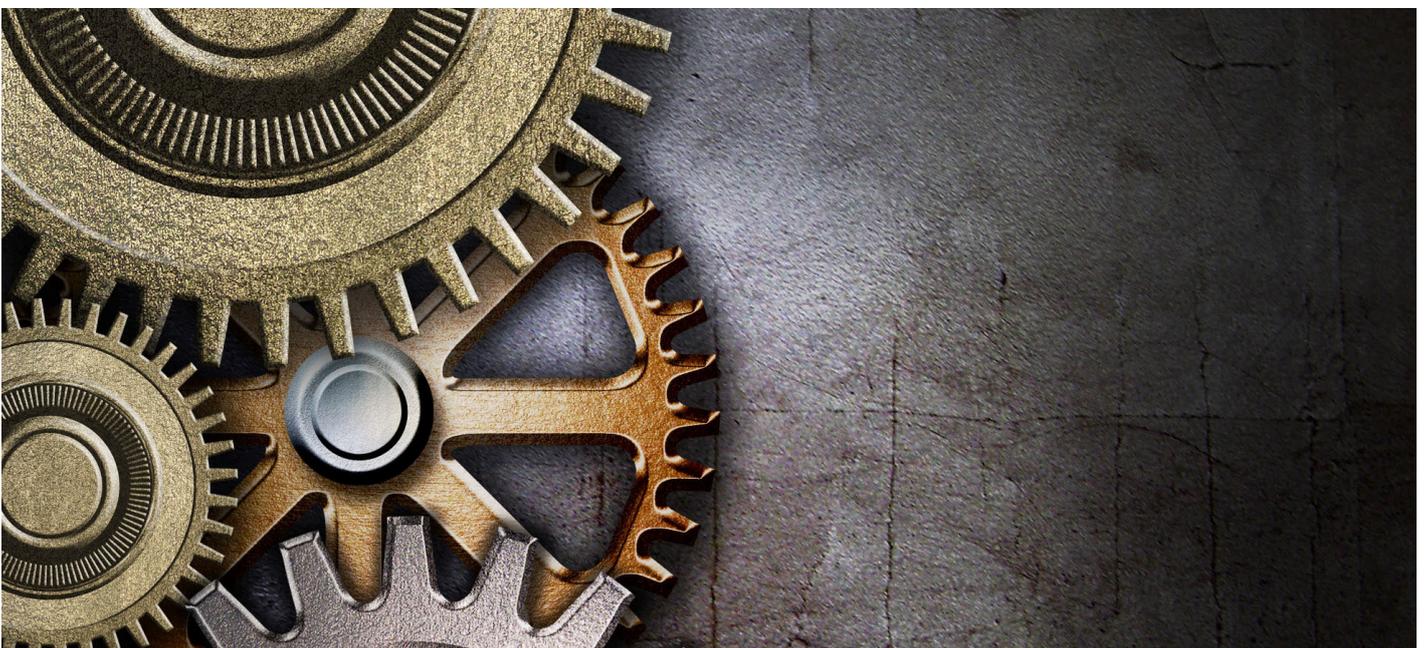
Of course there are various adjustments that need to be accounted for, such as choices of discount rates, definition of contract cash flows, inclusion of risks in the RA, tax effect, contract boundary,

and unit of account etc. However, both frameworks are based on current best estimate assumptions, and virtually all technical components can be analogized or compared closely to each other from a balance sheet perspective. It is not inconceivable that as insurers implement IFRS 17, they may leverage the same systems and processes used for EV. With some adjustments taken into consideration, stakeholders may gain additional insights by comparing the results from the two frameworks.

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3. Investor Appetite

In some economies, investors have become accustomed to review EV results to understand insurers' performance from an economic perspective. With the convergence of global accountings to be more principle-based, it is conceivable that investors that understand these shifts well, such as Solvency II and IFRS 17, will be more empowered with the new financial information driven by current assumptions. It is expected that certain insurance products, if currently accounted for under a "book value" type of reserving model that accretes the reserves over time, would be more inclined to become "onerous" once reported under IFRS 17 (i.e. loss-making in the terms of IFRS 17). This is one of the outcomes of adopting a current value framework. However, it is also likely that some investors still would like to hold on to the simple concept of value creation.



The impact of Solvency II is an example – useful EV data in Europe has been rapidly reduced since the adoption of Solvency II due to some insurers seeking alignment between EV and Solvency II and even discontinuing the reporting of EV. On the other hand, investors have not been thrilled by the amount of disclosures provided under the Solvency II framework, and how Solvency II components are assembled to measure profit performance and cash generation. IFRS 17, while having technical provisions that can be analogized to EV, may create similar issues for external users. For example, IFRS 17 requires a confidence level disclosure for the risk adjustment, but does not specify a calculation technique. The confidence level disclosure is meant to provide transparency and comparability amongst insurers, but from investors' perspective, it may have limited value because the RA needs to be reflective of entity's own view in quantifying the risks per IFRS 17 requirements.

Investor appetite will affect the continued existence of EV reporting, and how much value it still adds as a supplemental reporting framework. It is essential to have an "investor story" with a more coherent link between IFRS, EV and Solvency II.

4. Business Management

Insurers have historically used both accounting-based measures and EV metrics in business planning and management compensation. With the adoption of IFRS 17, the accounting-based measures, such as return on equity, operating income and profit margin etc. will all be affected and volatility is expected when comparing to historical values of these measures. Depending on business model and profit structures, insurers may experience varying degree of volatility in those measures, which may lead to redefining long-term targets or reconsidering key performance indicators that matter to insurers. In comparison, EV-based measures will not be impacted, and may continue to be seen as valid and effective in measuring insurers' performance.

It remains to be seen as to whether EV-based measures or accounting-based measures will be regarded by insurers as more relevant and effective in informing business decisions and performance measurement.

The Future will unfold

Undoubtedly, insurers will need to invest considerable amount of resources in order to comply with the detailed and complex IFRS reporting and disclosure requirements. We have observed insurers taking this compliance exercise as an opportunity to maximize the value of their investment by attempting to also modernize the operating model and reporting processes. It will be beneficial for insurers to also keep the EV reporting in mind as they progress further in that journey, as to whether there are potential synergies between IFRS 17 and EV from a production and reporting perspective, and whether a more coherent linkage can be presented between accounting figures and EV metrics. After all, EV is not limited by the measurement objectives inherent in the accounting models, and provides a more accurate view of insurer's cash generating capability. EV-based measures complement the accounting-based measures, and provide another angle to both internal and external stakeholders to inform their decision-making.

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