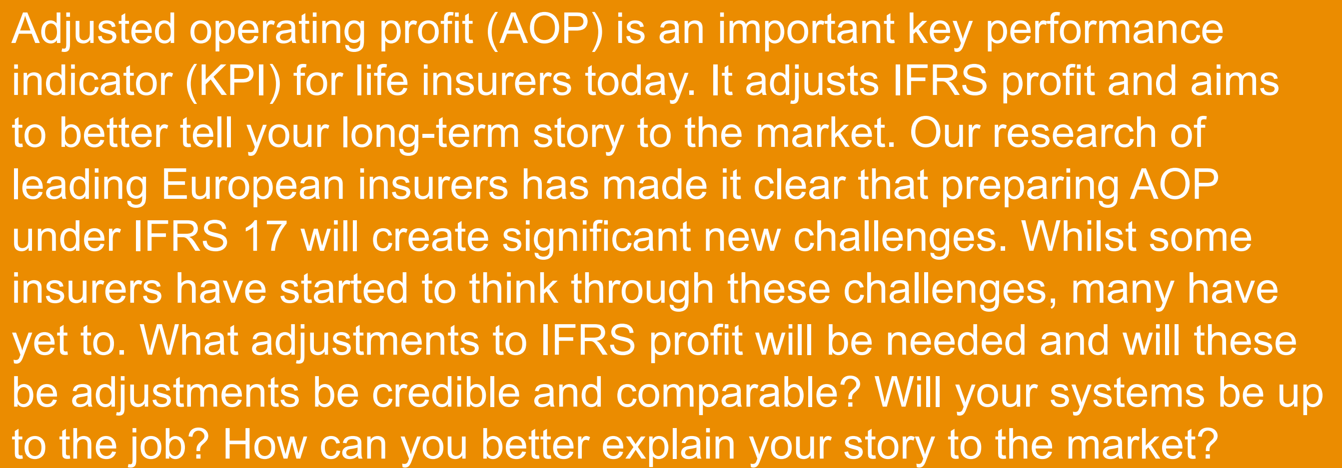
Implementing IFRS 17

Adjusted operating profit in an IFRS 17 world – telling your story with confidence

October 2019

pwc


Adjusted operating profit (AOP) is an important key performance indicator (KPI) for life insurers today. It adjusts IFRS profit and aims to better tell your long-term story to the market. Our research of leading European insurers has made it clear that preparing AOP under IFRS 17 will create significant new challenges. Whilst some insurers have started to think through these challenges, many have yet to. What adjustments to IFRS profit will be needed and will these be adjustments be credible and comparable? Will your systems be up to the job? How can you better explain your story to the market?

Introduction: Why AOP can't just be rolled over from current IFRS once IFRS 17 goes live

1. In New measures, new perspectives: The impact of IFRS 17 on insurance performance and reporting, we explored the impact of IFRS 17 on the Key Performance Indicators (KPIs) reported by European insurers including the key differences in revenue and profit measurement between IFRS 4 & IFRS 17. In this report, we build on our initial analysis by considering how AOP may change under IFRS 17

2. We begin by reviewing the adjustments currently made by insurers when moving from IFRS 4 profit to AOP, and then consider the further or new adjustments they may need to make to the new IFRS 17 profit measure. What comes through strongly from our analysis is that adjustments from the IFRS 17 measure are going to be far more complex than under current IFRS 4, especially when dealing with the changes in the timing and trajectory of earnings. Creating credible and comparable AOP measures requires a clear understanding of the advantages and disadvantages of various adjustment options. It could also demand investment in models, data, systems and processes.

Current market approach to calculating AOP

We've analysed the current adjustments applied to IFRS 4 profit when determining the AOP by five major European insurance companies at end 2018. The adjustments fall into three main categories:

1 Removal of short-term market volatility

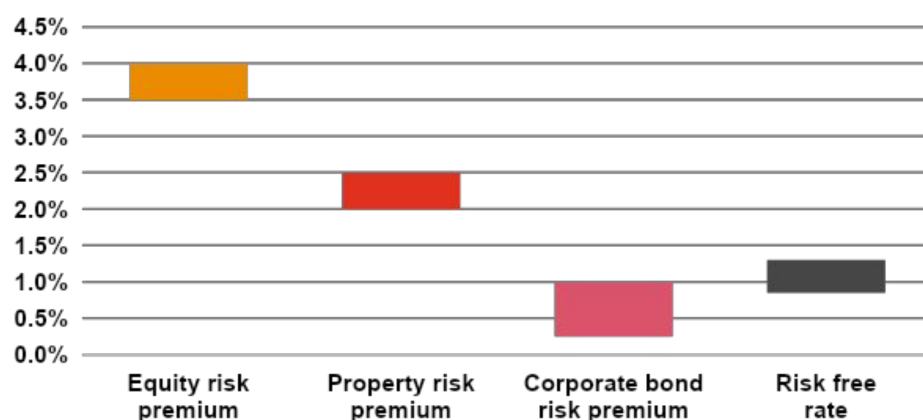
2 Exclusion of deal activity

3 Exclusion of items that are one-off in nature

1. Removal of short-term market volatility

All of the European insurers we analysed adjust for short-term market volatility. Figure 1 shows the ranges of expected long-term investment returns for different asset classes used within this adjustment. The range for each asset class is narrow, suggesting there is strong alignment across the industry at present. We see no reason why this level on industry consensus would not continue under the new measurement basis, in fact we believe it is desirable in order to add credibility.

Figure 1 – Variation in short-term volatility adjustment



Source: PwC analysis

2. Exclusion of deal activity

Of the insurers we benchmarked, all exclude certain impacts from acquisition or disposal activity (apart from bulk annuity transactions) from their AOP. For example, including impairment and amortisation of acquired intangibles and profit/loss on disposal. This deal activity would not be expected to recur year-on-year. We view that such adjustments, to the extent relevant, would be expected to continue.

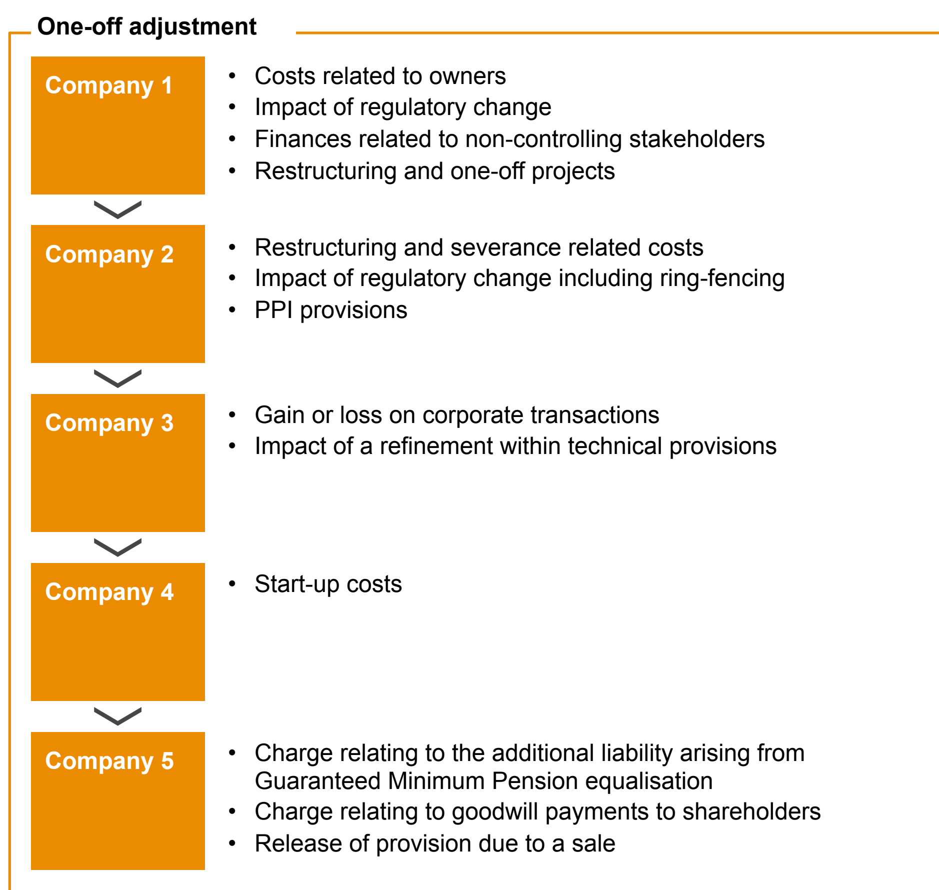
3. Exclusion of items that are one-off in nature

All of the insurers we reviewed adjust for one-off items, with consistent definitions: 'One-off items are those that, in the directors' view, should be separately disclosed due to them arising outside the normal course of business'.

The one-off adjustments made at end 2018 are outlined in Figure 2. These adjustments are obtained from publicly available information only, hence details are dependent on the level of disclosure provided.

The value of comparing relative profitability between insurers using AOP depends largely on consistency, from company-to-company, and from year-to-year. While there is a high degree of consistency in the treatment of short-term volatility and deal activity, variation in judgements over what is and isn't exceptional means that designation and removal of one-off items is less consistent. This can make it difficult for analysts and investors to compare insurers on a like-for-like basis.

Figure 2 – One-off item adjustments reported at year-end 2018



Source: PwC analysis

What might AOP look like under IFRS 17?

As the nature and timing of profits under IFRS 17 will be different to current IFRS 4, further adjustments may be needed to explain the performance story and provide further meaningful insights for analysts and investors.

We view that the main areas your business may consider adjusting for under IFRS 17 are:

1

Timing of profit release

Under IFRS 17, no profits are recognised when the contract is taken out. Instead, the contractual service margin (CSM) sets out the expected future profits for the contract, which are released, recognised and reported over its lifetime.

There may be a temptation to disclose an AOP that is consistent with the profile of cash emergence (and IFRS 4 is currently much closer to this than IFRS 17 will be). The pattern of profit release will be very different under IFRS 17, but an IFRS 17-derived AOP that reflects cash emergence may arguably be more meaningful to investors. However, it is a central objective of IFRS 17 to align release of profit with the coverage provided meaning any attempt to adjust profit through AOP may lack credibility. Changes in the trajectory of earnings should be communicated through clear disclosures to allow investors to understand the new approach. In addition, adjustments which deviate too far from the approach in IFRS 17 would lack consistency and not be credible.

2

Mismatches

Mismatches arise when there is inconsistent treatment between the measurement and presentation requirements for assets and liabilities, which impacts the amounts recognised in the income statement. Under IFRS 17 this can come about in a few ways. For example, between gross liabilities and reinsurance assets/liabilities, and if you're using derivatives to mitigate financial risks in some circumstances.

As current discount rates diverge from rates locked-in at inception under the general measurement model (GMM), there will be volatility in profits and shareholder equity as best estimate liability (BEL) is measured on current rates but the CSM uses locked-in rates. This introduces disclosure complexities as adjustments to CSM are measured on a different basis.

It may not be possible, or desirable, to avoid mismatches altogether, since some mismatches are economic and so should be reflected in P&L. As part of your evaluation and planning for KPI reporting under IFRS 17, it's important to choose whether to attempt to adjust AOP for these undesirable mismatches, incurring systems, data and process overheads to do so, or use your disclosures to explain why these mismatches occur.

3

Volatility

While the CSM should reduce current volatility by releasing profits throughout the lifetime of the contract, this doesn't mean profits will be predictable and stable. For example, when assumption changes are sufficiently extreme, the CSM is eliminated, the contract group becomes onerous and further variability is recognised immediately in P&L until a CSM is re-established. Similarly, the CSM under the variable fee approach (VFA) model absorbs all financial movements, meaning this is far from stable, and the amortisation will reflect this.

Potential adjustments to IFRS 17 profit when deriving the AOP

So, what can you do to take account of these timing, mismatch and volatility issues? In this table, we set out some specific adjustments that you might consider across the IFRS 17 balance sheet. Some of these possible adjustments might put strains on your systems, while others could raise questions about credibility as they go against central tenets of IFRS 17. We've included a red, amber and green rating to gauge credibility and operational difficulty.

Possible adjustments: Weighing up the advantages and disadvantages

Adjustment	Description	Advantages	Disadvantages	Operational difficulty	Credibility
Exclude CSM	Disclose without establishing the CSM as a liability on new business and recognise the profit up-front as part of AOP and adjust treatment of in force business accordingly.	Removes any profit deferral effects from IFRS 17. It may provide results which are closer to economic, cash or regulatory perspectives.	Difficult to justify as it may be too far removed from the objective of IFRS 17 where profit is earned over the period of cover.	🟠	🔴
Disclose alternative metrics, such as a combined equity and CSM	Equity plus CSM disclosed as a measure of the ‘true’ value in the business. Then AOP would be the movement in this metric.	Combined equity (released profit) and CSM (deferred profit) gives a view of the value of the business to shareholders, and reduces issues related to transition to IFRS 17 and CSM deferral.	This may lack consistency with peers if all insurers don’t adopt this adjustment and so it may be more difficult to explain to users.	🟠	🟠
Adjust reinsurance	Adjust for treatment of reinsurance by recalculating the reinsurance amounts on a consistent basis with the gross insurance contracts. For example, alignment in units of account, contract boundaries, no allowance for a negative CSM on reinsurance contracts and use consistent coverage period as for the gross business.	Removes any mismatches introduced by the reinsurance accounting model. A more economic view of the interactions between gross and reinsured cash flows.	Likely to require a number of additional model runs. Additional review and validation of model output will be required. Additional inputs will be needed. The results may not be sufficiently transparent and be too far removed from the IFRS 17 standard.	🔴	🔴
Different level of aggregation	Recalculate for a different level of aggregation of contracts in order to reflect the underlying performance. For example, you may want to allow for the way risks are managed together if you have a small number of onerous contracts in a portfolio.	Reflects the underlying performance such as the way risks are managed together.	Judgement is needed to determine the approach and appropriate level of any additional disclosure. Introduction of this judgement may remove consistency with peers. The changes may be complex to communicate effectively to users of the accounts and there is likely to be divergence of practice between insurers.	🟠	🟠
Recalculate VFA balances using long term (‘real world’) financial assumptions	Parallel BEL, Risk Adjustment and CSM closing balances and (roll forwards thereof) to be calculated using long-term financial assumption.	The difference between the long-term basis and IFRS 17 basis will be isolated, and taken to non-operating profit to reduce the short-term volatility.		🔴	🟠
Recalculate GMM balances using current market rates	For GMM business recalculate opening and closing BEL, RA & CSM using current market rates in order to remove the accounting mismatches introduced by the use of locked in rates.	Aligns movement in CSM with measurement of the underlying liabilities, reducing mismatches.		🟠	🟠

A further possibility includes presenting a parallel balance sheet that sets out your management's view and the IFRS position, although this will bring significant additional complexity.

Another consideration will be the extent of non-participating investment contracts that an insurer has. These contracts are not accounted for under IFRS 17 and so won't be changing. The AOP framework is unlikely to change for these, but how will this be explained relative to the new IFRS 17 adjustments?

More broadly, there will need to be external disclosure of the AOP framework which may impact the selection of certain adjustments.

In Europe, insurers will be familiar with the application of the European Security Market Authority (ESMA) Guidelines on Alternative Performance Measures since 2016. Complying with the Guidelines includes disclosing a clear definition of AOP, why it is relevant and a reconciliation to IFRS 17 profit.

In addition, the IASB is expected, later in 2019, to expose for comment proposals to improve transparency over non-IFRS measures such as AOP. In particular, to require that information explaining them is presented in a single note in the accounts. Today, this is often presented by insurers both in and outside their annual report.

Conclusion: An opportunity as well as a challenge

Deriving AOP from IFRS 17 is a far more complex exercise than under the relatively straightforward IFRS 4. There is a lot to weigh up as you look to create numbers that you believe give a fair picture of your long-term performance on the one side against the demands of market consistency and comparison on the other. And all of that needs to be achieved through a process that is operationally viable.

Judging what works best for you and putting in place any necessary systems upgrades and process changes is a time-consuming task. That in itself would underline the importance of getting evaluation and planning underway now. Crucially, early movers would also have an opportunity to develop and share with analysts and investors an AOP-adjustment framework that others would be under pressure to follow, or at least explain why they have deviated from.
The next posting in this series will begin to explore potential new KPIs under IFRS 17.

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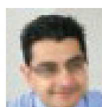

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