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Interaction between IFRS 17 and IFRS 9: accounting strategies and implications for investors

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Abstract

Interaction between IFRS 17 and IFRS 9: accounting strategies and implication for investors

Accounting Standards offer sometimes the possibility for an entity to choose between more viable options when reporting and accounting for items in their financial statements.

Furthermore, the conjunction between an insurance contract (IFRS 17) which is recognized as a financial instrument under IFRS 9 intertwines even more the scenarios that an insurer is going to face when both Standards will be mandatory.

After having introduced the Standards and how financial statements can be affected by their application, the focus will move on the impact that investors relations might have and how entities should manage this through ALM.

Keywords (up to four)

Accounting mismatches

ALM

Classification

Volatility

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Introduction

The objective of this paper is to understand and analyze how entities will deal with options regarding accounting items under IFRS 9 and IFRS 17 (effective from FY2022) and how these two standards intertwine and affect financial statements. Since the combined introduction of Other Comprehensive Income and Fair Value accounting, entities have to make choice and develop strategies when accounting for items in Profit and Loss or OCI and so impacting financial investors' behavior, who are seeking to maximize their value. Hence, the focus is to seize the different combinations and their impact on financial statements of insurance companies, that must comply with both the Standards.

In order to answer this question, a research approach has been applied, going through a brief description of the main topics of IFRS, the options that both Standards offer to insurers, and how Asset Liability Management (ALM) will be influenced. A picture of how investors read financial statements and are affected by the position of some accounting items has been drawn. In particular, the options here discussed focus on accounting mismatches between P&L and OCI that may arise when the two standards interact; to support this analysis in a quantitative way, an interactive data model about insurance contracts that are classified as financial instruments is proposed and explained.

Still, this technical paper opens points regarding the accounting strategies that are viable for insurers and how their choices will possibly impact the perception of investors and, implicitly, the valuation of the company itself. Here, volatility of net income and comprehensive income is investigated but there are no final answers that will enhance one choice more than another; instead, the different scenarios that have been tackled and simulations proposed will help insurers to pursue their ALM strategies and lead their investor relations.

IFRS 17: Insurance Contracts

Overview

IFRS 17 Insurance Contracts establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts issued. It also requires similar principles to be applied to reinsurance contracts held and investment contracts with discretionary participation features issued. The objective is to ensure that entities provide relevant information in a way that faithfully represents those contracts.

An entity shall apply IFRS 17 for annual reporting periods beginning on or after 1 January 2022.

Main features

In substance, the adoption of IFRS 17 does not change the classification of the companies' insurance contracts. However, this new Standard establishes specific principles for the recognition and measurement of insurance contracts issued and reinsurance contracts held by any company. The key principles are that an entity (IFRS 17.IN6):

- a) identifies as insurance contracts those contracts under which the entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder;
- b) separates specified embedded derivatives, distinct investment components and distinct performance obligations from the insurance contracts;
- c) divides the contracts into groups it will recognise and measure;
- d) recognises and measures groups of insurance contracts at:
 - i. a risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all the available information about the fulfilment cash flows in a way that is consistent with observable market information

- ii. an amount representing the unearned profit in the group of contracts (the contractual service margin);
- e) recognises the profit from a group of insurance contracts over the period the entity provides insurance coverage, and as the entity is released from risk. If a group of contracts is or becomes loss-making, an entity recognises the loss immediately;
- f) presents separately insurance revenue, insurance service expenses and insurance finance income or expenses;
- g) discloses information to enable users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of an entity. To do this, an entity discloses qualitative and quantitative information about:
 - i. the amounts recognised in its financial statements from insurance contracts;
 - ii. the significant judgements, and changes in those judgements, made when applying the Standard; and
 - iii. the nature and extent of the risks from contracts within the scope of this Standard.

Objective

IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the Standard. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents the insurance contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have the entity (IFRS 17.1).

Scope

The entity applies the IFRS 17 to contracts that meet the definition of an insurance contract, which generally include (IFRS 17.3):

- a) insurance contracts, including reinsurance contracts, it issues;
- b) reinsurance contracts it holds; and
- c) investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

The relationship between an insurer and the policyholder is established by a contract. A contract is an agreement between two or more parties that creates enforceable right and obligations (IFRS 17.2). enforceability is a matter of law. Contracts can be written, oral or implied by the entity's customary business practices.

Contracts that have the legal form of insurance contract but pass all significant risk back to the policyholder are not insurance contracts (IFRS 17, B27(b)): for example, some group of contracts also have similar features but these contracts are normally financial instruments or service contracts and are accounted for under IFRS 9 or IFRS 15, as applicable (IFRS 17. B28).

Variable Fee Approach (VFA)

Insurance contracts with direct participation feature apply a modified version of the General Model called the Variable Fee Approach (VFA). The application of VFA instead of GMM on insurance contracts with participation feature should reduce the artificial volatility in Profit and Loss due to mismatch between the accounting treatment of investment gains and losses on underlying items attributable to policyholders and the accounting treatment of the liability to those policyholders.

Insurance contracts with direct participation features are substantially related to investments service contracts (including an insurance component) where an entity promises an investment return based on some underlying items. Hence, they are defined as insurance contracts for which (IFRS 17. B101):

- a) The contractual terms of the contract specify that the policyholder is the owner of a share of a clearly identified pool of underlying items.

- b) The entity is expected to pay the policyholder an amount equal to a substantial share of the fair value returns from this pool of underlying items.
- c) The entity expects a substantial proportion of any change in the amounts paid to the policyholder to vary with the change in fair value of the underlying items.

In insurance contracts with direct participation features, the entity's obligation to the policyholders is expected to be net amount of (IFRS 17.B104):

- a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and
- b) a variable fee that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:
 - i. the entity's share of the fair value of the underlying items; less
 - ii. fulfilment cash flows that do not vary based on the returns on underlying items.

An investment contract with DPFs is a financial instrument that provides an investor with a contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts (IFRS 17 Appendix A):

- a) that are expected to be a significant portion of the total contractual benefits;
- b) the timing or amount of which are contractually paid at the discretion of the issuer; and
- c) that are contractually based on:
 - i. the returns from a specified pool of contracts or a specified type of contract;
 - ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
 - iii. the profit or loss of the entity or fund that issues the contract.

These contracts with Discretionary Participations Features (DPF) do not meet the definition of an insurance contract because they do not transfer insurance risk of an insurance contract but are accounted for under IFRS 17 if the entity also issues insurance contracts; if the entity does

not issue insurance contracts, it will apply IFRS 9 to account them.

IFRS 4 is currently required to be applied to every financial instrument with Direct Participation Features, without considering if the entity also issues insurance contracts. Instead, IFRS 17 scope is limited to investment contracts that meet the DPFs feature for entities that issue insurance contracts too. The goal of this amendment is to avoid the creation of possible contracts structured qualified to be accountable as insurance contracts and dodge scope crawl.

IFRS 9: Impact on insurers

Classification and measurement

Although the Classification and Measurement (C&M) requirements and conclusions under IFRS 9 may not be significantly different from those under the current financial instrument standard (IAS 39), the process of reaching these conclusions and the information required as well as the prescribed method of reporting are quite different. The C&M categories have been redefined in IFRS 9 and consideration is being given to whether the entity's business model is evaluated as one held to collect contractual cash flows, one where the intention is to hold to collect and sell or one where the intention is just sales. This assessment, combined with the assessment of the contractual cash flow characteristics, will impact the measurement option available to insurers. IFRS 9 introduces a situation where by satisfying both criteria, insurers can use the measurement options of amortized cost or fair value through other comprehensive income (FVOCI). The introduction of the FVOCI category to IFRS 9 is a positive development and significant improvement to the standard, in combination with the use of FVOCI in IFRS 17, for insurance companies. The FVOCI measurement category is a critical element of accounting for financial instruments by insurers as it will facilitate improved performance reporting for certain business models by removing volatility in profit and loss, particularly where insurance companies hold debt instruments.

Insurers' asset strategy is more complex than using simple financial assets, such as debt

instrument, to match the obligations assumed with policyholders: this involves the use of hedging derivatives to vary and expand their exposure to credit risk and manage interest risk. With the implementation of IFRS 9, each of the product types has one business purpose for the investment that has to be disclosed and under which classification and measurement might be different. The introduction of the SPPI test (Solely Payments of Principal and Interests) and the assessment of the business model adopted to verify the eligibility for a classification as amortized cost will probably result in a barrier to reach this category and therefore increase the number of financial instruments that will be classified as fair value through profit and loss (FVTPL).

When financial assets are measured at fair value, realized gains and losses are recognized either in profit or loss (FVTPL), or (when unrealized) in other comprehensive income (FVOCI).

Under IFRS 17, insurers are required to discount their insurance contract liabilities through current interest rates and have the chance to disclose and report these changes in P&L. In this way, income and expenses emerging as a result of changes in interest rates used to discount the relative financial instruments are expected to offset the volatility in P&L that may arise when accounting for at FVTPL.

Under IFRS 9, all entities, including insurers, are allowed to measure financial instruments at FVTPL where this tries to solve an accounting mismatch. Since insurers generally seek to minimize accounting mismatches, this option will be very useful when managing the effectiveness of financial statements.

Under IFRS 17, variations relating to insurance coverage of future periods are going to be recognized adjusting the CSM, while variations relating to insurance coverage of past periods will be reported in P&L. In this way, right after the recognition in P&L, the measurement of assets that back insurance contracts at fair value and the measurement of insurance liabilities using estimates that are consistent with market information decreases the generation of

accounting mismatches.

Profit and Loss (P&L) vs Other Comprehensive Income (OCI)

The liability-driven business model entities, such as insurance companies, invest in assets to meet long-term obligations accepted from policyholders. In order to reflect in the best way possible mismatches and offsets, measurement decisions should be made on a basis that is consistent from both the sides of the balance sheet (assets and liabilities) and provide significance to the reporting of the performance.

Whenever liabilities are backed up by assets or group of assets (i.e. there is correspondence between these liabilities and the assets they fund) and the entity's business model is to actively trade these financial instruments and gain sale proceeds, effects of changes in the fair value of these have to be reported every end-period in P&L.

If assets and liabilities are measured independently under a constant process, this might mislead information useful for the investors and wrongly express the very true business model of the company. This kind of information may affect the extent to which the entity is considered profitable by financial markets when the focus is put on the usefulness of predicting cash flows in the future.

P&L and OCI should provide different information to investors. While the first statement reports the economic performance of the entity, items of OCI should comprehend any financial reporting construct that may not have a strong link with the business model itself, but still representing useful information for readers, such as the recognition of incomplete transactions in profit and loss (e.g. derivatives) and the effects that multiple bases of measurement for financial instruments between balance sheet and profit and loss. For instance, this happens when items are recognized on a fair value basis in the balance sheet and on a historical cost basis when reported in profit and loss; this might be the case of insurance companies, whose business model, where gains in the fair value of items held would not be reflected in profit and loss until

they have been sold. Accounting for them in the profit and loss under a fair value basis would therefore increase the usefulness of information under market conditions from time to time and so the capacity of generating future cash flows.

Either the net amount recognized in OCI relating to a specific financial instrument will increase or decrease to zero over time (depending if it was a loss or a gain) or it will be recycled to P&L. This is the case when a financial asset is sold, and it was held in a business model with long-term investments.

The information provided through the recycling action is material and useful from the perspective of stewardship and vigilance and possibly with the business model chosen. Hence management is here assessed in its ability to produce gains from the latest cash inflow deriving from the proceed of the asset object of the transaction. Consistently, the change in OCI will provide information regarding the unrealized gains and losses.

Financial liabilities, which are generally measured at a fair value (the expected amount to be paid in a market transaction) to be valuable for appraising the financial position of an entity and its expected cash flows, will be weld by the transfer of some cash. Such measurement is also going to provide the most useful information in P&L when assessing the value of the company: similarly, the cash outflows' pattern has to be considered regarding management's decisions about the allocation of these expenses. To match the model proposed, changes in estimates of any financial liability should be equally reported for the underlying assets.

The effect on investors' behavior

Accounting researchers have investigated how comprehensive income (CI) and its various presentation formats influence users of financial statements. Early US-based research has investigated how the format or location of the information affect the way in which investors use information. Part of those studies relate to the long-standing recognition vs. disclosure debate, under which some researchers propose that investors process items differently depending on

whether they are disclosed in footnotes or recognized in the financial statements. For example, Hirshleifer and Teoh (2003) assume that due to the investors' limited attention and processing power, investors can more easily process and take in salient information compared to less salient information. Thus, due to limited attention ability, equivalent information disclosed in different format may have different impact on investors' perceptions. Because OCI items are transitory in nature, the increased OCI volatility makes firms' inherent risk more transparent to investors. As OCI and profit or loss are intertwined, the more salient presentation of OCI enables investors to better interpret earnings.

Value relevance of OCI and its components

Examining the value relevance of accounting items is important, because there is a need to evaluate the usefulness and relevance of accounting numbers for investors in their economic decision-making.

Dhaliwal *et al.* (1999), examining the relative usefulness of CI and net income (NI) among US investors, found that both NI and CI are value relevant. They also found that NI is a better performance indicator to predict stock returns, future NI, and future operating cash flows than CI with a total sample, comprising all industry sectors. Further, the results also indicate that CI does not explain returns better than NI for non-financial firms, but that CI for financial firms has incremental explanatory power for returns above and beyond NI. The authors suggest that this effect is likely driven by unrealized gains and losses on AFS securities but could also be caused by the magnitude of OCI relative to NI for financial firms vs. non-financial firms.

Mechelli and Cimini (2014) investigated the value relevance of NI and CI for the period 2006 to 2011 for a sample of European listed companies. They propose that OCI would be value-relevant, because it recognizes additional economic events that affect firm value, besides those that are disclosed in NI. Their findings show that NI is more value-relevant than CI, even though

the total OCI of the period adds relevant information to those items already disclosed in other accounting items such as NI and Book Value.

Overall, the evidence indicates that comprehensive income and OCI are less predictable than net income. According to Graham and Lin (2017), the information value of OCI relative to profit or loss (net income) is not well understood. While both OCI and profit or loss include similar components, such as gains (losses) that increase (decrease) shareholders' equity and indicate more (less) firm value, they are fundamentally different. For example, some unrealized gains and losses would be presented, at least temporarily, in shareholders' equity as OCI items, whereas realized gains and losses are presented on the income statement as components of profit or loss.

Preparers of financial statements claim that the 'excess' volatility of CI confuses financial statement users. Khan and Bradbury (2016), examining the volatility and risk relevance of CI, relative to net income, show that CI is more volatile than net income, and the volatility of CI will increase the perception of risk. These results hold when asset revaluations are excluded from OCI. These findings have relevant policy implications: (1) asset revaluation is the major component of OCI, which may increase volatility in CI compared to net income. This would indicate that the volatility of CI may be caused by the voluntary act of revaluation; (2) the finding supports the arguments of financial statement preparers that CI is, on average, more volatile than net income.

OCI and recycling

The IASB requires certain elements be recorded in OCI in several IFRS Standards. Generally, OCI items include current year unrealized gains and losses arising from:

- a) changes in the fair value of financial instruments classified as available-for-sale (as explained above, the available-for-sale category has been removed in IFRS 9);
- b) foreign currency translation adjustments;

- c) remeasurement of pension net defined benefit liability (asset); and
- d) changes in the fair value of derivative instruments classified as cash flow hedges.

Recycling of other comprehensive income items consists in the reclassification of amounts that were previously recognized in OCI to P&L in the current period. This means that, whenever some criteria regarding the realization of gains and losses are met, OCI components will be reclassified from equity (OCI reserve) to income (P&L).

Tarca *et al.* (2008) specify that recycling occurs when:

- a) an asset is sold for which the related fair value changes have previously been recognized directly into equity; and
- b) on sale of the asset, potential gains and losses are realized (released from risk), and a corresponding fair value gain (loss) is removed from equity and included in net income for the period but returned to equity through the recording of net income of the financial period.

Via recycling, the item will be reclassified from one subtotal (OCI/equity) to another subtotal (P&L). The effect of recycling on the aggregate number of CI is thus a zero-sum effect.

Further, the treatment of those items will vary in a later financial period, as they will either be recycled to profit or loss (such as foreign currency differences, revaluations, and cash flow hedges) or not recycled at all (e.g. actuarial gains and losses related to pension assets).

Dong *et al.* (2014), investigating gains or losses on AFS securities held by US commercial banks, found that realized gains or losses, which are being recycled from accumulated OCI to profit or loss, provide incremental information to the market, i.e. are value-relevant. Thus, they argue that the recycling of AFS gains and losses from accumulated OCI into profit or loss contributes to better predictive ability of future bank performance. In addition, their findings indicate a difference between realized and unrealized gains or losses from the users' point of view. Recycled gains or losses are valued in the same way as other earnings components with

high persistence, whereas unrealized gains or losses recognized in OCI are valued like earnings components with low persistence.

The results of the study by Frendy and Semba (2017) indicate that net income integrating recycling information shows higher relative value relevance compared to net income that excludes recycling, but these results only hold for financial firms, not for non-financial firms. Further, recycling disclosure by itself does not improve the incremental value relevance and the predictive power of operating cashflow and net income. The results also indicate that including recycling information into net income reduces the persistence and increases variability of net income due to the transitory nature of the realized OCI earnings reclassification.

Hodgson and Russell (2014) write that OCI recycling highlights issues related to the persistence of the OCI. The degree of persistence will be determined by the time that OCI is held in equity and whether gains are infrequent or not.

Further, Brouwer *et al.* (2014) question whether recycling adds any real value to investor decision-making. After illustrating recycling with an example of foreign currency translation adjustment, they conclude: “Recycling the amount can only be based on the idea that it should at some time be included in profit or loss, but the sales transaction and resulting realization in itself contains no information about the return an entity has made on its economic resources in this period. In our view, only when the distinction between profit or loss and OCI would be made based on the realized vs. unrealized attribute, could recycling be justified.”

In summary, scholars propose, based on their results of the positive effect of recycling, that investors of financial firms regard recycling disclosure value relevant and useful for improving their investment decision making process. Investors apparently take note of the type of gains or losses, i.e. the fact that gains or losses are realized or not (i.e. unrealized) appears to matter. This would support the current regulation, where realized and unrealized gains or losses are treated differently, and recycling is required.

Asset liability management (ALM)

The degree to which matching insurance liabilities and assets backing those liabilities can be successfully matched depends on a number of factors:

- a) The use of a dedicated fund of assets or a general fund of assets;
- b) The existence of accounting mismatches between the assets and the liabilities.

The use of a dedicated fund or a general fund of assets

Some insurers invest in a dedicated fund where a direct link exists between the assets and the liabilities whilst others make use of a general fund where there is no direct link between the assets backing the liabilities.

One of the conditions for applying the Variable Fee Approach (VFA) is that the contractual terms should specify that the policyholder participates in a share of a clearly identified pool of underlying items.

Using a dedicated fund of assets allows the insurer to align the characteristics of the assets more closely to the portfolio of insurance liabilities that it supports, thereby limiting the degree of mismatches. In contrast, when relying on a general fund of assets, the assets in such a general fund support several portfolios of insurance liabilities each with different characteristics. In such a case, there will be more mismatches between the assets and the insurance liabilities.

Accounting mismatches

Both IFRS 9 and IFRS 17 include options to reduce accounting mismatches. Whereas IFRS 9 allows entities to elect to measure financial assets at fair value through profit or loss where this addresses an accounting mismatch, IFRS 17 allows entities to make an accounting policy choice between:

- a) the incorporation of insurance finance income or expense for the period in P&L; or
- b) the disaggregation of finance income or expense between P&L and OCI.

Industry stakeholders expressed the view that the combined effect of applying IFRS 17 and

IFRS 9 may have an impact on asset allocation. For the income statement, when measuring the insurance liability in a way that is consistent with observable market information:

- a) For financial assets valued at amortized cost, the fair value option offered by IFRS 9 can be elected by the insurer to reduce accounting mismatches;
- b) For financial assets at FVTPL, changes relating to interest rates and therefore the creation of income/expenses and their reporting in P&L under IFRS 17 are expected to (partially) offset the volatility arising from the same measurement for the same assets under IFRS 9 (FVTPL)
- c) For financial assets at FVOCI, two options are available for the insurer:
 - i. To apply the FVO under IFRS 9 with the aim of reducing accounting mismatches; or
 - ii. To elect the option under IFRS 17 and disaggregate the financial result between P&L and OCI.

Still, the coupled application of IFRS 9 and IFRS 17 together could lead to the arising of accounting mismatches deriving from different measurement basis for insurance liabilities (measured at a present value which is risk-adjusted) and the assets backing the same liabilities. Some insurance contracts have returns based on the fair value of specified underlying items, such as bonds. The insurer and its policyholders share those returns, which are affected by market-driven changes in the fair value of the bonds.

If measurement at amortized cost or FVOCI would either create or increase a mismatch with the accounting valuation of liabilities, an entity can take the option to designate financial instruments at FVTPL. This is an important consideration for insurers, who will discount their insurance liabilities using current discount rates under IFRS 17.

IFRS 9 allows for equity instruments to be carried at fair value through OCI. However, the amount in OCI will never be recycled in profit or loss apart from dividends received. If these

instruments backing insurance liabilities an accounting mismatch can arise as over time the changes in the insurance liabilities will be recognized in profit or loss whereas the changes to any equity instruments backing those liabilities will never be recycled through profit or loss.

Furthermore, the option to measure equity instruments at fair value through OCI is an option and not a requirement under IFRS 9. The reason for exercising this choice is to mitigate the volatility of the effect of strategic investments within the income statement. Nonetheless, if those assets are backing insurance liabilities, entities could choose to measure such instruments at fair value through profit or loss as opposed to OCI to reduce any perceived opportunity for an accounting mismatch that could arise.

Insurers are expected to pick the option that reduces the most any accounting mismatch arising from the difference between the financial income deriving from financial income and the financial expenses of insurance contract liabilities. For this reason, P&L would be the expected position of the presentation of changes in financial assumptions for insurance contracts liabilities of an insurer who principally manages financial assets at FVTPL in its business model. Thus, these changes may impact assets and will then be, at least to some extent, offset by a comparable impact on insurance contract liabilities, generating an overall reduced result in P&L.

OCI Option under IFRS 17 for finance income and expenses

IFRS 17 allows insurers to decide whether the impact of changes in economic/financial assumptions will be accounted for through the insurance financial result, therefore impacting the P&L, or through OCI. This option can be taken at a portfolio level.

The various options and choices proposed by IFRS 17 in conjunction with those from IFRS 9 will allow insurers to manage the volatility of the CSM, the P&L and the OCI. Assets backing liabilities are currently not managed at a portfolio level as defined under IFRS 17, but at a more aggregated level, mutualizing the risks and returns of the underlying assets over large groups

of policyholders. In practice, in order to fully leverage the options provided by IFRS 9 and IFRS 17, insurers might have to at least notionally allocate their assets to their insurance contract portfolios. This exercise might create another layer of operational complexity.

Asset liability management adopted by insurers should be an important point to focus on when IFRS 17 and IFRS 9 are considered together and the business model comprises the pooled management of assets, liabilities, guarantees and derivatives. The insurer's strategy should be reflected by its accounting policies and the related financial performance may not be acceptably reflected by the usage of different accounting treatments that deal with isolated components in the financial statements.

The aim is to reflect changes in insurance liabilities and the associated backing assets in the same place, either in P&L or in OCI. If the related changes are reported in different places, performance reporting does not provide useful information. Currently, ALM analysis mostly focus on market consistent balance sheets and seek to optimize ALM under frameworks such as Solvency II, while not completely excluding the effects on IFRS and statutory balance sheets. Going forward, given that IFRS balance sheets will come closer to market consistency, they might also be included and analyzed in ALM studies.

Here are the main combinations available for an insurer regarding the options available:

a) Amortized cost (assets) and OCI option (liabilities)

- Value of liabilities change resulting from variations in the interest rate used to discount them and this difference is recognized in OCI
- Since assets have accounting value (historical cost), they're not affected by interest rate changes (only by impairment or amortization)

b) Fair value through P&L (assets) and OCI option (liabilities)

- Variation of assets' value to P&L resulting from changes in interest rates
- Variation of liabilities' value to OCI resulting from changes in discount rates

- Balance sheet impacts are offset, but P&L and OCI present mismatches

c) Fair value through OCI (assets) and OCI option (liabilities)

- Variation of assets' value to OCI resulting from changes in interest rates
- Variation of liabilities' value to OCI resulting from changes in discount rates
- Minimal mismatch in both OCI and balance sheet

d) Amortized cost (assets) and P&L option (liabilities)

- Value of liabilities change resulting from variations in the interest rate used to discount them and this difference is recognized in P&L
- Since assets have accounting value (historical cost), they're not affected by interest rate changes (only by impairment or amortization)

e) Fair value through P&L (assets) and P&L option (liabilities)

- Variation of assets' value to P&L resulting from changes in interest rates
- Variation of liabilities' value to P&L resulting from changes in discount rates
- Minimal mismatch in both P&L and balance sheet

f) Fair value through OCI (assets) and P&L option (liabilities)

- Variation of assets' value to OCI resulting from changes in interest rates
- Variation of liabilities' value to P&L resulting from changes in discount rates
- Balance sheet impacts are offset, but P&L and OCI present mismatches

When developing IFRS 17 the IASB was aware of this potential impediment to comparability and therefore sought to mitigate the effects. IFRS 17 requires:

- a) an entity to make the amounts recognized in OCI in any period clearly identifiable; and
- b) an entity that chooses to disaggregate insurance finance income or expenses between profit or loss and OCI to disclose an explanation of the methods used to determine the amounts recognized in profit or loss.

Thus, IFRS 17 allows entities to adjust the information provided in their financial statements, making them homogeneous and easier to compare. Nevertheless, some investors have vented that the implementation of the OCI option may add superfluous elaboration to their analysis regarding the information provided by insurers that apply IFRS 17.

Data Model

Objective

The data model tries to explain the development of the OCI Option under IFRS 17 and how different scenarios may affect several accounting items and so financial statements, together with the influence on investors. The goal is to analyze the possible accounting treatments for a group of insurance contracts valued under the Variable Fee Approach and the impacts that a different set of assumptions would have on Profit and Loss, OCI and Balance Sheet.

This objective follows the topics addressed in this paper, where several open points have been questioned about how accounting options are perceived under an Asset Liability Management point of view.

The model is not based on real data gathered from insurance companies' financial statements nor investment strategies, since the application of both IFRS 17 and IFRS 9 together has been postponed to 2022. Nonetheless, the model has been built following a precise structure that could be, even if simplified, replicable when insurance companies account for a group of contracts and the respective accounting items useful for this analysis under IFRS 17.

Structure

The model is based as follows:

- a) Assumptions;
- b) Different OCI development scenarios;
- c) Effects on accounting items.

Assumptions

The model is based on assumptions that together draw a set of characteristics of the group of insurance contracts object of analysis. In this case, the maturity of the contracts has been set equal to five years.

Different types of interest rates computed on different items outline the main outcomes of every step during the development of the subsequent sheets, interacting with margins and calculations. Furthermore, other assumptions typical of the insurance contracts (Lapse, Redemption Penalty, Insurance component) affect the main items of the Income Statement proposed under the IFRS 17 structure.

Different OCI development scenarios

The model is composed by several scenarios where both IFRS 9 and IFRS 17 options are taken in consideration:

- a) The evaluation of the financial asset at FVTPL or FVOCI (Fair Value Option – FVO);
- b) The choice of disaggregating finance income and expenses between profit and loss and OCI (OCI Option).

Every scenario is built as follows:

- a) Input Data – Asset
- b) Input Data – Liabilities
- c) PVFCF and CSM
- d) Income Statement
- e) Balance Sheet

Effects on accounting items

In the last sheet it is possible to have a view on the main accounting items as follows:

- a) Equity;
- b) P&L Result;

c) OCI Result; and

d) OCI Reserve,

depending on the choice to apply FVTPL or FVTOCI and, eventually, disaggregate finance income and expenses to OCI or not.

The main outcomes of the graphs want to define and underline how different accounting strategies would impact the above-mentioned accounting items, therefore affecting the financial statements of insurance companies and its financial investors.

Conclusions

To tackle the topic proposed, the interactions between IFRS 9 and IFRS 17 have been discussed and how financial investors perceive accounting items has been analyzed. Even though the implementation of these two Standards will be effective for most insurance companies from 2022 onwards and their transition has not happened yet, simulations are taking place to understand the possible impacts on financial statements.

To support the analysis about the possibilities offered by the two Standards, an excel-based data model has been presented, including its assumptions and its structure.

Finally, when considering the Fair Value Option and the OCI Option under the Variable Fee Approach, the main conclusions are the following.

Insurers that will likely lean towards a smaller volatility in P&L, are going to consider options that will shift this to OCI, considering the following options:

- a) the application of the disaggregation policy choice (OCI Option) for insurance finance income and expenses; and
- b) the non-election to designate debt instruments with the FVO under IFRS 9, accounting for them at FVOCI.

Insurers that prefer all changes of insurance liability and relating underlying assets to be recognized in P&L would consider:

- a) the non-application of the disaggregation policy choice (OCI Option) for insurance finance income and expenses; and
- b) the designation of financial assets as at FVTPL, in order to, at least to some extent, reduce an accounting mismatch that, otherwise, would emerge from the application of different measurement bases for assets or liabilities or the recognition of gains and losses related to them.

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