Employer Accounting for Pensions: Insurance Accounting vs. Employer Accounting under IFRS

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IFRS 17 "Insurance Contracts" for the accounting of insurers

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- IFRS 17 introduced in May 2017, applicable from 2021 onwards
- A new measurement approach for insurance contracts from insurer's perspective – not applicable for policyholders
- Further sophistication of valuation techniques in IFRS 9/13
- Yardstick is the fulfillment by the reporting entity

=> How does this new approach fit to the measurement of "insurance policies" in the employer's IFRS pension accounting?

Basic Features of IFRS 17

- Measurement attribute: Fulfillment value
  - Future cash flows considered as expected to arise when the entity fulfills the obligation rather than disposing by transfer
  - Discounted to represent the time value of money only
  - Financial risk measured assuming that the entity is subject to normal market conditions
  - Non-financial risks measured considering the risk attitude of the entity
  - Transfer of non-financial risk considered as a service and considerations to be distributed over the servicing period

IFRS 17: Valuation Technique

- "Fulfillment cash flows":
  Estimate of the risk-adjusted expected present value of future cash flows from the current substantive rights and obligations arising in fulfilling the contract by the entity
  - Estimate of future cash flows
  - Discounted with a risk-free illiquid rate depending on timing and currency
  - Adjusted for financial risk (market-based, implicit in discount rate or cash flows)
  - Adjusted for non-financial risk (entity-specific, explicit)
- A Contractual Service Margin (CSM) absorbs any initial excess of future cash inflows over cash outflows

IFRS 17: Subsequent Measurement

- Fulfillment cash flows are measured at current assumptions
- Any change in estimate subject to non-financial risk is off-set with a corresponding change of the CSM (CSM-adjustment)
- CSM distributes initial profit and any subsequent effect of change in estimates due to non-financial risk over the remaining coverage period in proportion to services provided

IFRS 17: Measurement Details

- Cash outflows include cost as far as directly attributable to the fulfillment of the contracts
- Principle-based approach to discount rates, no method for deriving rates prescribed
- Principle-based approach to risk adjustment, no method prescribed
- Changes subject to financial risk, e.g. discount rate changes, are presented immediately in P&L or OCI

IAS 19 for the accounting of employers: Insurance Policies funding Defined Benefit Plans

- Generally, insurance policies qualifying as plan assets or reimbursement rights are measured at their **fair value**

- IAS 19.115 and IAS 19.119: Where such policies <u>exactly</u> match the amount/timing of some or all of the plan benefits, the fair value of those policies is assumed to be equal to the related part of the defined benefit obligation (DBO)

- Typical approach in Germany: If the plan benefits depend exactly on the insurance policy benefits, the DBO is not measured by the projected unit credit method but equal with the fair value of the insurance policy

IFRSs Guidance for Fair Values

- IAS 19.8: "*Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm´s length transaction*", with reference to IFRS 13 "Fair Value Measurement"

- IFRS 13: When no market price is available, the fair value is estimated by a valuation technique, e.g. by an expected present value of future cash flows using a discount rate that reflects the risk associated with the cash flows

IAS 19: (Fair) Value for insurance policies

- German practice does not apply valuation techniques
- Based on German statutory requirements (tax and GAAP), the fair value is mostly identified as the statutory liability ("Aktivwert") of the insurance contract as determined by the insurer. This amount is assumed to reflect the fair value definition of an arm´s length transaction of transferring such contracts between insurers
- Insurance policies which are not plan assets or reimbursement rights are also measured with the same approach

Key Differences

	IAS 19/IFRS 13	IFRS 17
Cash flows	Policyholder‵s cash flows	Incl. insurer‵s cost
Discount rate	Risk-adjusted	Risk-free illiquid
Explicit margin	Not prescribed	Yes
Non-financial risk	Market-consistent	Entity‵s perspective
Initial profit	Possible, if no service margin	CSM
Deposit floor	Yes	No

Conclusion

The IFRS-measurement of insurance contracts/policies is different for

- the issuer (the insurer), applying a valuation technique according to IFRS 17, and for
- the policyholder (the employer), applying a valuation technique according to IFRS 13

Thank you very much for your attention!

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