IMPLICATIONS OF IFRS 17 FOR NON-INSURERS

INTERNATIONAL FINANCIAL REPORTING BULLETIN

2023/06

June 2023

BDO

BACKGROUND

IFRS 17 *Insurance Contracts* was issued in May 2017, replacing the interim standard IFRS 4, which permitted a variety of different accounting policies to be applied to insurance contracts worldwide.

IFRS 17 introduces a consistent measurement model for insurance contracts, including the requirements concerning the measurement of fulfilment cash flows, current discount rates, and the recognition of profit over the coverage period.

The new insurance standard has been complex to implement for insurance companies, with insurers 'going live' with IFRS 17 on 1 January 2023. This has required new information technology systems, charts of accounts and collaboration with actuarial expertise.

EFFECTIVE DATE

IFRS 17 *Insurance Contracts* is effective for annual reporting periods beginning on or after 1 January 2023 (i.e. 31 December 2023 year-ends and later).

ACCOUNTING IMPACT

IFRS 17 fundamentally changes how insurance contracts are accounted for by insurers. Non-insurers may be affected if they issue contracts that are within the scope of IFRS 17's requirements, which may not always be readily apparent.

While IFRS 17 has significantly affected insurance companies, the scope of IFRS 17's requirements apply to 'insurance contracts' (with some exceptions), and in some cases, corporate entities (i.e. non-insurers) may issue contracts in the scope of IFRS 17's requirements.

If non-insurers are affected by the transition to IFRS 17, the practical consequences should be identified as soon as possible, as accounting for contracts in accordance with the requirements of IFRS 17 may be complex and requirement significant changes to systems and processes.

SCOPE OF IFRS 17

IFRS 17 applies to insurance contracts, including reinsurance contracts issued by an entity (IFRS 17.3(a)). 'Insurance contracts' are defined as:

> *A contract under which one party (the issuer) 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.*

Insurance risk is defined as:

> *Risk, other than financial risk, transferred from the holder of a contract to the issuer.*

Therefore, a contract that transfers only financial risk would not meet the definition of an insurance contract. For example, an entity may enter into a contract to pay cash flows that vary with respect to movements in the market value of a public stock index. This contract may transfer significant risk, however, it would only transfer financial risk because the only risk relates to a possible future change in a financial instrument price index. Such a contract would likely be accounted for in accordance with IFRS 9 *Financial Instruments*.

Certain contracts may transfer significant insurance risk, but still not be within the scope of IFRS 17. This is because IFRS 17 includes a number of scope exclusions, which specifically require (or in some cases, permit as an accounting policy choice) other IFRS Accounting Standards to apply instead of IFRS 17 – see IFRS 17.7-8A.

This publication explores five scope exclusions that either require or permit other standards to be applied:

- Insurance contracts held;
- Warranty contracts;
- Fixed fee service contracts;
- Financial guarantee contracts issued; and
- Indemnifications issued by the seller in a business combination.

INSURANCE CONTRACTS HELD

Almost all entities hold some form of insurance to mitigate risk from general business operations. For example, insurance against property damage, corporate liability, errors and omissions, etc.

While these contracts will generally meet the definition of insurance contracts in IFRS 17, paragraph 7(g) specifically excludes from the scope of the standard:

> *Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held.*

Therefore, a policyholder of an insurance contract does not apply IFRS 17, and instead applies other applicable IFRS Accounting Standards. In many cases, entities will account for such contracts as an expense over the applicable coverage period.

This scope exclusion does not apply to reinsurance contracts held by an entity, meaning if the insurance contract held provides compensation to the entity for insurance contract that it issues itself (i.e. underlying contracts), the contract held is within the scope of IFRS 17.

WARRANTY CONTRACTS

Example 1
Entity A manufactures refrigerators. When it sells units to customers, Entity A includes a 5-year warranty, where Entity A will repair or replace the unit if it malfunctions due to normal ‘wear and tear’ during that period. Issue Does this warranty meet the definition of an insurance contract?

Assessment: The warranty issued by Entity A meets the definition of an insurance contract, because it transfers significant insurance risk, being the risk that the refrigerators will malfunction during the warranty period. However, IFRS 17.7(a) excludes from the scope of the standard:

> *Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see IFRS 15 Revenue from Contracts with Customers).*

Assuming that Entity A is a ‘manufacturer, dealer or retailer’ and the warranty is provided ‘in connection with the sale of its goods or services’, then the warranty provided by Entity A would be accounted for in accordance with IFRS 15 rather than IFRS 17.

Meaning of 'manufacturer, dealer or retailer'

'Manufacturer, dealer or retailer' are not defined in any IFRS Accounting Standard. The reason for the IASB introducing the scope exception on IFRS 17.7(a) is set out in IFRS 17.BC89-90:

BDO's Insight

Determining whether the scope exclusion in IFRS 17 for warranties offered by manufacturers, dealers or retailers is available to an entity may be challenging depending on the specific facts and circumstances, such as when the warranties are offered and the relationship between the entity offering the warranty and the entity supplying the good to the customer that is subject to the warranty.

BC89: IFRS 17 includes the scope exclusion previously included in IFRS 4 for warranties provided by the manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer. Such warranties might provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications, or they might provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

BC90: Such warranties meet the definition of an insurance contract. However, the Board decided to exclude them from the scope of IFRS 17. The Board noted that, if IFRS 17 were to apply, entities would generally apply the premium allocation approach to such contracts, which would result in accounting similar to that which would result from applying IFRS 15. Further, in the Board's view, accounting for such contracts in the same way as other contracts with customers would provide comparable information for the users of financial statements for the entities that issue such contracts. Hence, the Board concluded that changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.

Therefore, the intention of the IASB in retaining the scope exception from IFRS 4 is focused on cost vs. benefits as well as providing users of financial statements with consistent information compared to the other contracts that the entity enters into with customers.

In determining whether an entity is a 'manufacturer, dealer or retailer', entities should consider whether the entity issuing the warranties also routinely sells the associated goods or services to which the warranties relate. Entities should also consider the definitions of these terms (and the translated equivalent terms in IFRS Accounting Standards translated into languages other than English) in dictionaries.

An example of an entity that would not meet the scope exception in IFRS 17.7(a) would be an entity that offers warranties on the associated equipment sold to customers by other, unrelated third parties. Such an entity would consider whether such warranties may also be excluded from the scope of IFRS 17 if they meet the criteria in IFRS 17.8 for certain fixed fee service contracts.

Meaning of 'in connection with the sale of its goods or services to a customer'

IFRS 17 contains no guidance on how 'in connection with the sale of its goods or services to a customer' should be interpreted, therefore, entities must exercise judgement. Entities should consider the purpose of the scope exception and the entities applicable facts and circumstances in making this assessment.

The timing of when such warranties are purchased by customers may be an indicative factor, as well as when the warranties are priced.

For example, if an extended warranty for a period of 2 years is offered by a retailer to a customer for CU100 when a good is purchased, and the customer has a fixed period to decide whether to purchase the coverage (e.g. 3 months from the purchase date), it would generally be considered that this warranty would be 'in connection with the sale of its goods or services to a customer'.

In contrast, if an extended warranty is only priced after an initial, mandatory warranty period elapses (e.g. 1 year), it would be more challenging to conclude that the extended warranty is offered 'in connection with the sale of its goods or services to a customer'. This is because the contractual terms of the extended warranty would not be determined at the point when the good is provided to the customer.

This conclusion may differ in certain group scenarios. For example, if a parent entity sells goods to customers, and its subsidiary offers extended warranties on the goods sold, then in the consolidated financial statements of the parent, the group may apply the scope exception in IFRS 17.7(a). In the individual financial statements of the subsidiary offering the warranties, the subsidiary has not transferred any other goods or services, therefore, the scope exclusion in IFRS 17.7(a) would not apply because those warranties are not 'in connection with the sale of its goods or services to a customer.'

FIXED-FEE SERVICE CONTRACTS

Example 2
Entity G offers roadside assistance services to customers in exchange for CU100 per month. In the event that a customer requires roadside assistance, G stands ready to provide tyre repair, battery jumps, etc. Issue Are the roadside assistance service contracts offered by Entity G in the scope of IFRS 17?

Assessment: the roadside assistance service contracts meet the definition of insurance contracts because they transfer significant insurance risk from the customer to Entity G – the risk that the customer may suffer a loss due to tyre damage, a faulty battery, etc., in which Entity G will compensate the customer.

However, IFRS 17.8 permits entities an option for certain types of contracts. An entity may choose to apply IFRS 15 instead of IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The criteria and the evaluation of those criteria against the fact pattern in Example 2 is set out below (note that all three criteria must be met):

Criteria in IFRS 17.8	Assessment – Example 2
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;	The cost of the service is CU100 per month regardless of customer (i.e. G does not undertake significant underwriting of risk when it enters into contracts).
The contract compensates the customer by providing services, rather than by making cash payments to the customer; and	Entity G provides roadside assistance; it does not compensate customers with cash.
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.	Most of the uncertainty arises from whether a customer will need the roadside assistance; the cost of providing those services is relatively stable and known to Entity G.

Therefore, Entity G may choose to apply either IFRS 17 or IFRS 15 to its roadside assistance service contracts. Greater judgement may be required in assessing the criteria in IFRS 17.8 in different fact patterns.

FINANCIAL GUARANTEE CONTRACTS ISSUED

Financial guarantee contracts (FGCs) issued may be in the scope of IFRS 17 depending on the specific facts and circumstances.

IFRS 17.7(e) excludes from the scope of the standard ‘financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. The issuer shall choose to apply either IFRS 17 or IAS 32 *Financial Instruments: Presentation*, IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments* to such financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.’

The practical consequences of this scope exception may be demonstrated using several related examples, including an explanation of the requirements of IFRS 17’s predecessor standard, IFRS 4.

Example 2A - IFRS 4 (prior to the effective date of IFRS 17)	
▪ L is the parent of M. ▪ L owes CU50,000 to a bank. ▪ M issues a financial guarantee contract (FGC) to L’s lender. ▪ If L defaults on the bank loan, then M is contractually obligated under the FGC to pay any outstanding balance. ▪ L did not pay a premium to M in exchange for the FGC. Issue How should M account for the FGC issued?	L’s lender Parent L M issues FGC to L’s lender Subsidiary M

Assessment: prior to the effective date of IFRS 17, IFRS 4 was effective. The FGC issued by M meets the definition of an insurance contract because it exposes M to significant insurance risk (i.e. the risk that M may have to compensate the bank in the event that Parent L defaults). The credit risk of L is not ‘financial risk’, and is therefore not excluded from the scope of IFRS 17. This is because the risk is specific to an entity and is not a published credit index, which would be considered financial risk.

IFRS 4.4(d) permitted entities to make an accounting policy choice for FGCs issued, similar to IFRS 17.7(e) above. In practice, many corporate entities elected to apply IFRS 4 to such FGCs, and since IFRS 4 permitted entities to continue applying their existing accounting policies, entities may have continued to account for FGCs on an ‘incurred basis’ (i.e. in the example above, M would only recognise losses in the event that Parent L defaults).

<table>
<tr><th colspan="2">Example 2B - IFRS 17</th></tr>
<tr><td>The fact pattern is identical to example 2A, except M now applies IFRS 17 rather than IFRS 4.

▪ L is the parent of M.
▪ L owes CU50,000 to a bank.
▪ M issues a financial guarantee contract (FGC) to L's lender.
▪ If L defaults on the bank loan, then M is contractually obligated under the FGC to pay any outstanding balance.
▪ L did not pay a premium to M in exchange for the FGC.

Issue

How should M account for the FGC issued?</td><td></td></tr>
</table>

Assessment: as IFRS 17 is now effective, IFRS 17.7(e) must be applied, which requires M to apply either:

- IFRS 17; or
- IFRS 9, IFRS 7 and IAS 32

M may no longer account for the FGC issued to L's lender on an 'incurred basis' – it must apply the requirements of IFRS 17, which have significant complexity, or the requirements of IFRS 9, being the expected credit loss (ECL) model. In either case, the transition to IFRS 17 will affect M's accounting for the FGC issued.

These types of FGCs issued are common between related parties. While the effect of the FGC issued would eliminate in Parent L's consolidated financial statements, the FGC must be accounted for in M's separate financial statements.

Many corporate entities may prefer to apply the ECL model to FGCs issued, as entities may consider them less burdensome to apply than IFRS 17. However, in order to measure ECL, IFRS 9 still requires M to track whether a significant increase in credit risk has occurred since the FGC was issued, the probability of default of L, the loss given default, etc.

Transition to IFRS 17

In our view, if an entity had previously applied IFRS 4 to its FGCs prior to the effective date of IFRS 17, it is acceptable to 're-designate' on transition to IFRS 17 and apply IFRS 9 if an entity wishes to do so, rather than applying IFRS 17. The effect of this re-designation would be accounted for on transition to IFRS 17 (i.e. as at the first date of the comparative period, 1 January 2022 for entities with calendar year-ends).

INDEMNIFICATIONS ISSUED BY A SELLER IN A BUSINESS COMBINATION

In a business combination transaction, the selling entity may provide the buyer with an indemnification relating to contingent liabilities of the entity being sold. This indemnification states that the selling entity will reimburse the acquirer in the event that a contingency results in the acquirer being required to make a payment.

Example 3

Entity A is the parent of Entity B and A prepares consolidated financial statements. Entity B has several contingent liabilities relating to lawsuits where Entity B is being sued for damages. Entity B has not recognised any liability in its financial statements because the lawsuits do not meet the requirements in IAS 37 to be recognised (IAS 37.14).

Entity A agrees to sell Entity B to Entity C, with Entity B meeting the definition of a business. As part of the sale and purchase agreement (SPA), Entity A agrees to compensate Entity C if any of the lawsuits outstanding prior to the acquisition date result in Entity B being required to pay damages. Economically, Entity A remains exposed to the contingent liability subsequent to the sale of Entity B. Therefore, if Entity B were found liable in one of the lawsuits that arose prior to the business combination to pay CU1,000 of damages, Entity A would then be obligated to pay Entity C CU1,000.

For clarity, the indemnification issued by Entity A does not relate to any events or conditions that may give rise to a liability subsequent to the date that Entity C acquires Entity B (e.g. a lawsuit where Entity B is sued for circumstances arising subsequent to the acquisition of B by C).

Issues

1. Should the indemnification issued by Entity A be accounted for as an issued insurance contract in the scope of IFRS 17 *Insurance Contracts?*
2. If no to issue 1, how should Entity A account for the indemnification issued to Entity C?

Issue #1 - Is the indemnification an insurance contract in the scope of IFRS 17?

Assessment: IFRS 3.27-28 specifies requirements for how Entity C should account for the indemnification asset as the acquirer in the business combination. It is less clear how Entity A, as the issuer of the indemnification, should account for the effect of the indemnification.

In the event that a contingent future event occurs (e.g. Entity B is found guilty in a lawsuit and required to pay damages), Entity A is required to make a payment to Entity C, which appears to meet the definition of insurance risk; however, IFRS 17.B11 states (**emphasis added**):

*Insurance risk is the risk the entity accepts from the policyholder. This means the entity must accept, from the policyholder, **a risk to which the policyholder was already exposed**. Any new risk created by the contract for the entity or the policyholder is not insurance risk.*

Entity C (the acquirer of Entity B) was not exposed to the contingent liabilities prior to the SPA being executed. Therefore, the contract that creates the risk exposure from the perspective of Entity C (the SPA) cannot transfer insurance risk because Entity C was not 'already exposed' to that risk prior to entering into the SPA. As IFRS 17.B11 states: '*Any new risk created by the contract for the entity or the policyholder is not insurance risk.*'

Therefore, Entity A should not account for the indemnification issued to Entity C in the SPA as an issued insurance contract in the scope of IFRS 17 because it does not meet the definition of insurance contract, since the SPA does not transfer insurance risk from Entity C that it had prior to the SPA to Entity A.

Note that this conclusion would differ if Entity A were selling Entity B to Entity C, with A and C being insurance companies, and A subsequently sells a reinsurance contract to Entity C, with the reinsurance limiting the losses C will accept on the direct contracts B has issued to its policyholders. This is because in that case, the risks Entity C is transferring to Entity A are pre-existing risks on account of Entity C accepting insurance risk by acquiring Entity B's issued insurance contracts, and then purchasing the reinsurance contract from Entity A. The primary distinction is that the pre-existing risks in this case arise from the issued

insurance contracts of Entity B to individual policyholders, whereas in the corporate scenario above, there are no third-party policyholders outside of Entities A, B and C.

Issue #2 – How should Entity A account for the indemnification issued?

Assessment: As IFRS 17 does not apply to the indemnification agreement issued by Entity A, it must be determined which IFRS Accounting Standard applies.

Prior to the SPA, Entity A accounted for the potential liabilities relating to the lawsuits as contingent liabilities as being in the scope of IAS 37. That is because the potential outflow of economic resources did not arise from a contractual agreement and therefore were not in the scope of IFRS 9 (IAS 37.2), and the contingent liabilities did not meet the recognition criteria to be recorded as provisions.

Once the SPA is executed and Entity A has sold Entity B, Entity A is not directly responsible for the lawsuits as Entity A is no longer the parent of Entity B, however, the indemnification agreement has the effect of returning the risk to Entity A simultaneously.

There are two views as to how Entity A should account for the indemnification agreement:

View 1: One view is that Entity A is in the same economic position as it was in prior to the SPA, and therefore, there should be no accounting consequence from selling Entity B. Therefore, Entity A would continue to account for the lawsuits as contingent liabilities. This is supported by the fact that IAS 37 does not have derecognition or requirements as to when a potential liability should be allocated to a different accounting standard (e.g. IFRS 9). The SPA is simply a legal mechanism for Entity A to retain its own risk.

View 2: Another view is that IAS 37 does not apply to financial instruments in the scope of IFRS 9 (IAS 37.2), and once the SPA is executed, Entity A has a contractual liability to pay cash in the future. This differs from the facts and circumstances prior to the SPA being executed, because at that time, Entity A did not have a contractual obligation to pay cash; whether it had any obligation was uncertain pending the results of the legal proceedings. Therefore, Entity A should account for the indemnification as a financial instrument in the scope of IFRS 9.

In our view, either views 1 or 2 above are an acceptable application of the requirements of IFRS Accounting Standards. Entities should develop an accounting policy in accordance with IAS 8 and apply it consistently. Entities applying either view should consider the appropriate disclosure requirements relating to the potential liability that Entity A may be required to pay.

CONCLUSION

As demonstrated above, IFRS 17 may apply to corporate entities that do not issue contracts that are generally considered to be ‘insurance contracts’.

This publication is not exhaustive, as IFRS 17 also includes numerous other scope exclusions for the following:

- Employers’ assets and liabilities from employee benefit plans (IAS 19, IFRS 2) and retirement benefit obligations reported under defined retirement plans (IAS 26)
- Contractual rights and obligations contingent on the future use of, or the right to use, a non-financial item (license fees, royalties, variable and other contingent lease payments) (IFRS 15, IAS 38, IFRS 16)

- Residual value guarantees provided by a manufacturer, dealer or retailer and a lessee's residual value guarantees in leases (IFRS 15, IFRS 16)
- Contingent consideration payable or receivable in a business combination (IFRS 3)
- Certain credit card contracts

Non-insurers should carefully evaluate the effects of IFRS 17 in their first set of financial statements in which IFRS 17 is effective.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Neither BDO IFR Advisory Limited, and/or any other entity of BDO network, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

The BDO network (referred to as the 'BDO network' or the 'Network') is an international network of independent public accounting, tax and advisory firms which are members of BDO International Limited and perform professional services under the name and style of BDO (hereafter 'BDO member firms'). BDO International Limited is a UK company limited by guarantee. It is the governing entity of the BDO network.

Service provision within the BDO network in connection with corporate reporting and IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BV, a limited liability company incorporated in Belgium.

Each of BDO International Limited, Brussels Worldwide Services BV, BDO IFR Advisory Limited and the BDO member firms is a separate legal entity and has no liability for another entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BV, BDO IFR Advisory Limited and/or the BDO member firms. Neither BDO International Limited nor any other central entities of the BDO network provide services to clients.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2023 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

www.bdo.global