# Insurers' adjusted operating profit

## Historical and new challenges caused by the implementation of IFRS 17

Historically many UK insurers have widely disclosed adjusted operating profit ('AOP') as a management KPI to present their IFRS result cleared of any one-off effects and volatility. We have analysed the accounts of 10 largest UK insurers noting that all of them currently use the concept of adjusting operating profit in their IFRS accounts.

AOP has been a source of frustration amongst analysts needing to dissect a company's approach. Although widely used by insurers, AOP has never been regulated by accounting standards. The definition of a KPI has been tailored by each insurer, which makes the comparison between market participants challenging. Two subsidiaries of the same insurance group may present different methodology/approaches to AOP.

Today the importance of AOP for insurers rises significantly, and this is due to three reasons:

1. Firstly, insurers applying the new IFRS 17 need to consider their appetite for adjusting their IFRS operating profit to clear off any unwanted volatility, caused by some IFRS 17 measurement principles.
2. Secondly, the operating profit definition itself will become more rigorous due to the new Presentation and Disclosure standard that will replace IAS 1 (due to be issued by the IASB).

   These new IFRSs will pose thought-provoking challenges for insurers disclosing AOP, and in this publication we share our view on what are those challenges and how insurers can address them.
3. Thirdly, AOP as an alternative performance measure ('APM') is currently in the focus of the UK regulator, who recently published APMs thematic review (issued October 2021) calling for transparency and consistency of APMs disclosures, as well as regular review by the Audit committees.

### Part 1. How companies adjust IFRS 4 profit and their current challenges

The high level of investment in IFRS 17 implementation should be expected to deliver fixes to any AOP challenges.

Most of the adjustments insurers make to their operating profit result under IFRS 4 can be split into four main categories:

- Removal of short-term market volatility
- Assumptions changes
- Exclusion of deal activity, including amortisation of purchased business
- Exclusion of other items and items that are one-off in nature

There is consistency in the treatment of short-term market volatility and deal activity, but there is almost no comparability in one-off items presentation. Based on the analysis of disclosures of 10 UK insurers' financial statements, we provide examples of other adjustments insurers make to AOP:

- Investment projects and expenses
- Cost-saving initiatives
- Onerous contracts and discontinued operations
- Goodwill impairment
- Change in Ogden discount rate effect
- Reorganisation costs
- Certain bonuses
- Normalised weather claims
- Elimination of prior-year reserves movements

Regarding one-off items, we note that the Exposure draft of the new Presentation and Disclosure proposed standard (yet to be issued) includes a new definition of unusual items in order to increase consistency across the market. Based on the discussion process and feedback so far, this part of the proposal is not welcome. Moreover, with IFRS 17 to come into force, any inconsistencies will become more obvious as soon as insurers try to adjust the results of IFRS 17 to AOP (discussed later in the article). Without having a consistent and well-thought-through approach, the AOP measure risks becoming incomprehensible. To get the maximum value of the new AOP measure, insurers should develop a more unified approach to both new and existing adjustments.

## Part 2. The ABC of new AOP challenges caused by new IFRSs

The key challenges in interpreting the results of IFRS 17 are mainly caused by two reasons:

- New revenue release pattern different to IFRS 4 ones
- Various IFRS 17 measurement mismatches

### A. New revenue release pattern challenge

Understanding the pattern of future profit recognition and how it interacts with requirements for income and expenses arising from other standards, will be crucial in telling the new AOP story. Many UK insurers noted that IFRS 17 revenue recognition requirements and CSM release patterns will not reflect the economic substance of some insurance contracts. Some such contracts change their nature over time (from an accumulation phase to decumulation phases) and annuities – both types of contracts were largely discussed during the standard endorsement process in the UK.

Consider contracts that change their nature over time such as a with-profit contract that vests to an annuity. When applying IFRS 17 requirements insurers will need to apply measurement model eligibility test (general model or variable fee approach 'VFA') at the group of contracts inception date. Often contracts with a guarantee annuity option will be eligible for

VFA accounting as investment contracts with direct participation features, however, after the guarantee annuity option is exercised the contracts will enter the annuity phase changing the nature of the earning patterns. The economic substance of the annuity phase would be better reflected by applying general model accounting. However, IFRS 17 does not allow insurers to change the model after the contracts' inception date (unless modification criteria are met), and therefore the contracts will be accounted for when applying VFA requirements. This directly impacts the profit recognition as two measurement models have different requirements for the contractual service margin subsequent measurement. Using AOP adjustments might help insurers to reflect the economic substance of such contracts and artificially factor in the measurement model change in the earning patterns.

Another issue to consider is profit recognition for annuities. IFRS 17 contains no requirements or guidance specifically for annuities. Annuities contracts are accounted under the general model that requires insurers to spread the contractual service margin (unearned profit) over insurance coverage and investment return services periods. In comparison to IFRS 4 where annuities profit was largely recognised from the outset, once premium was paid, the IFRS 17 model leads to a significant deferral of revenue recognition.

However, the strict definition of investment-return service provision limits the ability of insurers to recognise unearned profit evenly over the insurance contract term often resulting in accelerated recognition, relative to that if the investment service element were properly considered. "...The fact that policyholders have no withdrawal rights once the pay-out phase starts, means that an investment-return service typically cannot be recognised in the annuity pay-out phase. An exception might arise when guarantee periods apply (i.e. when policyholders or their estate receive payments for the whole of the guaranteed period, irrespective of whether the policyholder dies in that period). In such cases the guaranteed amount may represent an investment component and an investment-return service may be recognised.

Similarly, in the case of deferred annuities, no insurance coverage can be recognised in the deferral period except to the extent of any death or disability benefit...[1]. Insurers might want to adjust the earning patterns of annuities when presenting their AOP figure. This can be achieved by using an alternative earning pattern and spreading investment service to the pay-out stage of annuities contracts.

The described profit release pattern issues may lead to the need to re-engineer AOP adjustments. The respective adjustments of revenue patterns when presenting AOP may help insurers to reflect the economical substance of the contracts more adequately.

### B. IFRS 17 measurement mismatches challenge

As mentioned earlier, most IFRS 17 measurement mismatches are caused by the new measurement requirements and inability to recognise correlated business elements.

The measurement of reinsurance contracts under IFRS 4 was largely linked to the measurement of underlying contracts. This link almost dissolves in an IFRS 17 world as the reinsurance contracts are measured separately from the underlying insurance contracts, reflecting the bundle of rights and obligations for reinsurance contracts only. Often, this segregated measurement principle can lead to a mismatch in contracts boundaries between reinsurance and underlying insurance contracts, making it almost impossible to explain the relationship between them to users of financial statements. Although those mismatches were actively debated during both IFRS 17 standard-setting and local endorsement in Europe and the UK, the treatment proposed by the IASB didn't change. From the accounting perspective, this can be logically supported, given that a similar approach is used in other IFRS standards[2].

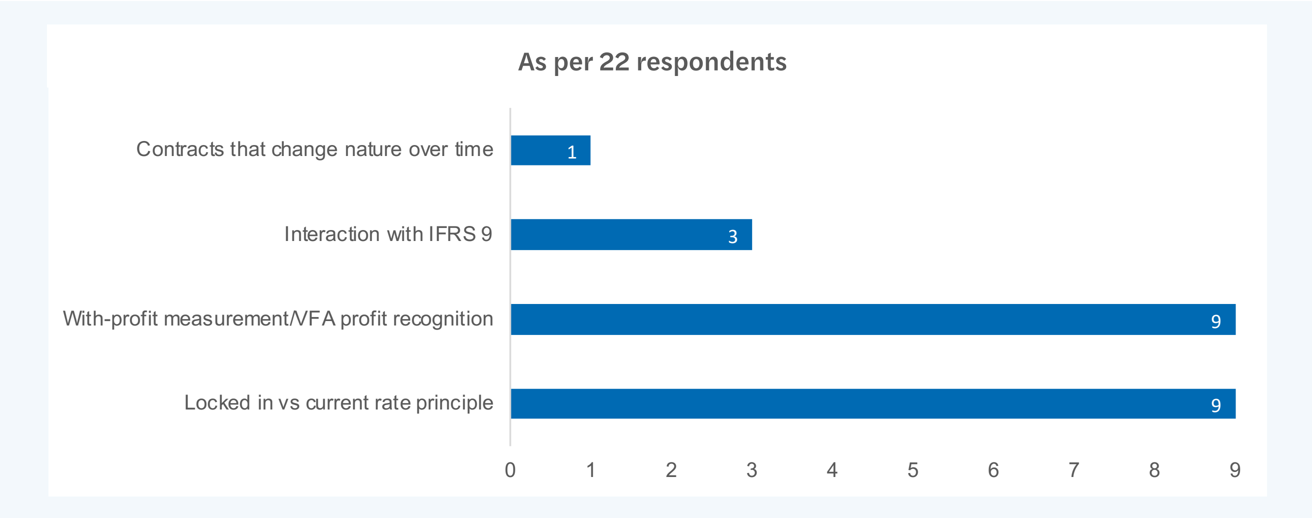
Interestingly, most of the mismatches are mainly relevant to long-term life insurance business, for life insurers. In summer 2021 we asked 22 life insurers in the UK what mismatches they will likely reflect in the AOP once IFRS 17 is adopted. More than 80% of respondents believe that the most important adjustments to AOP should address the 'mismatches' caused by:

- IFRS 17 locked in vs current rate principle for General model
- Measurement of with-profit contracts/VFA profit recognition

This is in line with what we observe in the UKEB endorsement process during which the two topics above were admitted as the areas of significant concern. Concerns around the first topic are caused by IFRS 17 requirement to apply inception date discount rates to the contractual service margin and at the same time requirements to re-measure future fulfillment cash flows at the current discount rate. Concerns around the second topic are related to the overall unpredictability of VFA profit recognition.

What can insurers do to alleviate the absence of business logic they used to apply historically and eliminate inconsistencies in business performance under IFRS 17? Reduction of mismatches via standard deliberation process and local endorsement was largely unsuccessful and now there is an urgency to develop a new approach to the business performance analysis, and particularly disclosure of AOP measures.

**Figure 1: Adjustments to AOP to be made by the UK life insurers**




1. Extracted from UEKB IFRS 17 Draft endorsement advice
2. IFRS 15 measurement principle also requires measuring a contract as one bundle of rights and obligations

### C. Presentation and disclosure challenge

A metric that will be required for disclosure by new IFRSs is operating profit. This requirement is currently included in the General Presentation and Disclosure Exposure Draft ('ED') that will replace the IAS 1 Presentation of Financial Statements. Although operating profit is currently used by many companies, the existing version of IAS 1 doesn't provide a comprehensive definition of the operating profit subtotal.

The ED proposes to include in the operating category income and expenses based on a residual method, i.e. everything which doesn't relate to financing and investing activity. Some insurers believe that this residual approach does not provide an adequate picture of business performance. This particularly applies to UK insurers who often use fair value through profit and loss ('FVTPL') category of financial instruments (and hence do not have OCI option to address PL volatility). To provide a fair view, insurers suggest disaggregating the fair value investment variances and economic assumption changes.

We think it is unlikely that the definition of operating profit under IFRS will be changed to address insurers comments in the final standard. And hence, companies will again face the challenge of how to present AOP adjustments in a way that reflects their business performance. Our view is that the new definition of operating profit will cause even more extensive use of AOP to address undesired volatility in the operating profit, arising for example from FVTPL investments valuation. This will widen the list of AOP adjustments creating the need to maintain a robust AOP framework.

What does it mean in practice for insurers? A wide range of AOP adjustments may require insurers to maintain a second set of figures, given the complexity of the adjustments measurement.

For example, to identify mismatches caused by with-profit contracts measurement there should be a robust management methodology in place, as well as an adequate tool to calculate the mismatch effect. In pursuing a more refined AOP, companies should make sure there are no manipulations and that the adjustments they make to operating profit are sufficiently explained and meet investors' expectations.

## Part 3. Step-by-step practical guidance to new AOP

When it comes to the actions insurers should take when making new adjustments, there are several steps to consider:

### Step 1. Determine key adjustments needed to AOP

The first step in creating a robust AOP framework is to identify the significant adjustments that tell your story. The effect of various mismatches will depend on the portfolio. An efficient approach includes a high-level assessment of all possible needs for AOP to determine the most significant ones that will impact business performance either on a one-off or recurring basis.

Following the challenges highlighted in Part 2 of this article, we provide a summary of possible solutions that insurers might use to generate new AOP adjustments. In this summary we describe the most discussed issues in the UK insurance market, however, we note that there might be other individual adjustments tailored to address the concerns of a particular company. In **Figure 2 Practical guidance to the new AOP adjustments,** we provide a breakdown of of the most discussed issues of the UK insurance market and the respective AOP adjustment.

**Figure 2: Practical guidance to the new AOP adjustments**

| Issue discussed in the market | How to address using AOP adjustment | Challenge insurers might face | Priority for UK insurers as per UKEB |
|---|---|---|---|
| **New revenue recognition pattern adjustments** | | | |
| **CSM allocation – lack of guidance coverage units and weighting, lack of economic substance in revenue release** | This is particularly important for the UK annuities business. As a part of AOP adjustments insurers might want to use alternative earning patterns reflecting the business nature of the contracts. For example, for annuities this can be achieved by using an alternative earning pattern and spreading investment service to the pay-out stage of described annuities contracts. | Hard to achieve consistency amongst insurers and increases complexity for the users of financial statements. | Material for UK annuities business. |
| **VFA mismatches** | To address mismatches caused by the application of the VFA model insurers might want to recalculate VFA results using long-term financial assumptions reflecting the real market. The difference between two bases could be presented as volatility adjustment in the reconciliation of adjusted operating profit. | Hard to achieve market consistency amongst insurers, rather complicated in terms of understanding by the users of financial statement. | Material for UK life insurers. |
| **Contracts that change their nature overtime – inability to change the model after inception** | To recalculate adjusted IFRS profit as if the measurement model change was allowed after contracts inception. For example, to apply to the group of contracts VFA model till the guarantee option is exercised and then change the model to the general one. | Necessity to run two models for one group of contracts, potential need to enhance IT solutions. | Material for some insurers running with-profit business. |
| **Accounting and economic mismatches adjustments** | | | |
| **Locked in discount rate – CSM interest accretion using inception rate while fulfilment cash flows are measured using current rate** | To recalculate the result under general measurement model using current market rates so that locked-in discount rate at initial recognition is updated to reflect recent market changes. Having this adjustment to AOP will allow to match the changes in CSM with the re-measurement of underlying investments, and hence to eliminate PL mismatch in the AOP. | A significant operational effort to re-measure CSM at current discount rate at each reporting date, potential need to enhance IT solutions. | Relevant to life insurers with significant GMM portfolio. |

| Issue discussed in the market | How to address using AOP adjustment | Challenge insurers might face | Priority for UK insurers as per UKEB |
|---|---|---|---|
| **Reinsurance – contract boundaries not matching with the underlying insurance contracts and other alignment matters** | Insurers to align the measurement of reinsurance contracts held with the underlying insurance contracts. A key area of alignment will include contract boundaries matching as well as coverage units alignment. Such adjustment will help to reflect the economic connection between reinsurance and gross book. | Requires a number of additional model runs to reflect revised aligned assumptions. An additional effort to assure accurate assumptions are used and adequate review of the model output is carried out. | ●●● (High)<br>Material for non-life insurers and reinsurers. |
| **With-profit contracts measurement – inherited estates/non-profit business in a with-profits fund** | There are a number of issues relating to profite emergence from with-profit contracts that arguably significantly increase the need for AOP:<br>• Non-profit contracts written within the WP fund may form part of the underlying items, and should be valued at fair value, in constast with the fulfilment value measurement of the non-profit contracts themselves.<br>• Profit from non-profit contracts may accrue to the estate, and only be earned by the shareholder through bonus transfer. Under IFRS 17 the non-profit contracts are not eligible for the VFA and will generate CSM despite only a portion being available to shareholders.<br>• Also, IFRS 17 profit will likely emerge in advance of the bonus declaration (and access to profit for shareholders – this will lead to recognition of equity that is unavailable to the shareholder until the bonuses are declared. | | ●● (Medium)<br>Limited to with-profit providers, but significant issues for those providers. |
| **Risk mitigation option – inability to apply retrospectively** | To apply risk mitigation option to the contracts with direct participation features retrospectively, ie pre-transition. A retrospective adjustment to the AOP pre-transition will effect the equity at transition and provide management information about an economic effect of hedging used prior to transition, making results more comparable. | An additional effort to assure accuracy and reliability of retrospective adjustments used without hindsight. | ● (Low)<br>Risk mitigation relevant to a narrow list of entities. |

**Key:** High ●●● Medium ●● Low ●

*Note: Issues discussed in the market are mainly aligned with the tentative conclusions provided in the Draft IFRS 17 UKEB endorsement advice issued in November 2021. In the table above we didn't include suggested solutions specifically for the with-profit funds accounting given the limited amount of companies exposed to the issue and covered it under a wider VFA mismatches topic. As for IFRS 9 interaction, we focused on risk mitigation options specifically given that other IFRS 9 interaction issues seem to be of less importance for the UK insurers.

### Step 2. Systems upgrade for parallel accounting and enhanced FP&A reporting

One of the biggest challenges of the new AOP adjustments is having a parallel management accounting system that will allow to perform all the required number of runs and factor in all new economic assumptions to create an output that will reflect the economic value and reduce IFRS 17 mismatches. 'Will your systems be up to the job?' – this is the question insurers should ask themselves once they decide on the adjustments they make. Historically insurers' adjustments to operating profit were quite easy to derive, as they mostly involved disaggregation of certain income and expenses components already included in IFRS result (e.g. separating of investments fair value variances of assumptions changes).

However, the majority of new adjustments we described in Figure 2 are far more complicated. To find out what is the adjustment, the new IFRS 17 calculations has to be made by insurers (e.g. to adjust initial recognition discount rate to the current rate). This is comparable to the efforts spent on parallel accounting. Insurers will need to think about automated ways of calculating that sort of adjustments. The solution could be enhanced FP&A tools that can be further used for financial planning. Incorporating IFRS 17 radialities into FP&A tools can bring more benefits than just having readily available AOP, at the desired level of granularity and with a frequency of reporting suitable for management analysis (e.g. monthly basis). Enhancing existing FP&A tools will help insurers to factor in IFRS 17 in their financial planning. In our view, this is a new emerging topic, and more granular and longer-term forecasting is within the scope of recent regulator's discussions[3].

### Step 3. Develop consistency across market

We've mentioned that the consistency across the market has always been sceptical when it comes to the AOP adjustments. To bring more value to the management and investors insurers should try to develop a robust market practice in approaching AOP adjustments. This consistency will serve the interest of the whole sector as well as the interest of each shareholder when benchmarking a company's performance against others.

### Step 4. Consider additional metrics to disclose in conjunction with AOP

It might be that AOP alone will not address all the needs of the stakeholders. Our view is insurers could benefit from disclosing an alternative KPI that would show retained earnings together with CSM. This KPI will effectively help stakeholders understand how much profit has been released (equity component) and how much profit is yet to be released going forward (CSM component as the deferred profit). To make this alternative measure meaningful a market practice has to be established to enable insurers comparison of the new KPIs across the market.

## Conclusion – benefits from having a proper AOP framework

In this article we provided an overview of how insurers can improve their AOP framework to reflect the pervasive upcoming IFRSs changes – including the adoption of IFRS 17, IFRS 9, and issuance of a new Presentation and Disclosure standard by the IASB. Timely revision of AOP framework will help insurers prepare for the adoption of new IFRSs, including:

- Understanding the impact of new standards on companies performance and the ability to present this impact to the shareholders clearly and concisely, telling the whole story of the business performance.
- Solving technical issues that have not been addressed as part of the IFRS 17 endorsement process in the management accounting.
- Tweaking any working assumptions and technical positions in the IFRS accounting to align it with the economic substance minimising the number of unnecessary AOP adjustments in the future.
- Assuring compliance with the new FRC pronouncements on alternative performance measures issued in October 2021.

3. This is based on the presentation of Sir Jon Thompson (FRC) delivered at the ILAG session for NEDs in October last year

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