Mazars' KPI and IFRS 17 report

For analysts and investors, insurance reporting can be obscure and considered somewhat selective in detail. For insurers, the current reporting frameworks do not fully tell the story of value creation; insurers feel they're valued at a discount. Under current accounting standards, few stakeholders are getting what they need.

A key objective of IFRS 17 adoption is to improve the quality of available financial information, ostensibly reducing the need for additional reporting. A lot of time and resource has been invested in moving to IFRS 17, yet initial impressions from analysts and investors are lukewarm. In this article we will look at how this gap can be bridged and how, in our opinion, the KPIs framework should be changed. We base our conclusions on the results of the poll that we asked at a recent presentation. What should companies do to ensure they get value from investing in their IFRS 17 implementation?

Education: IFRS impact on KPIs

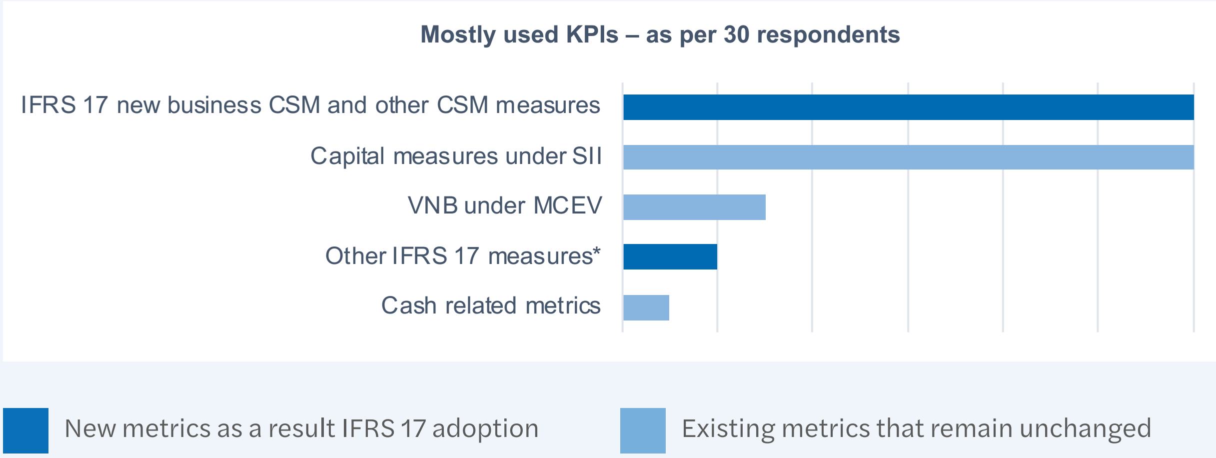
IFRS 17 impact overview

Why will IFRS 17 affect KPIs? IFRS 17 will significantly change the pattern of revenue recognition by introducing the contractual service margin concept – unearned profit under insurance contract released in line with service provision. IFRS 17 also ceases to use the concept of premium revenue. The number of insurance-related financial statement line items in the balance sheet and PL will reduce resulting in less KPIs being readily available on a company's financial statement (e.g. combined ratio or return on equity will disappear). New KPIs (e.g. CSM for new business) will emerge to reflect IFRS 17 measurement principles and some existing KPIs will remain valid, thus increasing the number of measures to be understood by stakeholders and considered by analysts (as can be seen from the **Figure 1 'Mostly used KPIs[1]'**). A number of so-called accounting mismatches are introduced by IFRS 17 measurement principles and interaction with other IFRSs, the new KPI measures will need to deal with these (as can be seen from **Figure 2 'Accounting 'mismatches' is the most important for the UK insurers[2]'**). All these changes inevitably mean UK insurers will use more supplementary reporting and non-GAAP measures[3] – the opposite of the initial goal of 'reducing additional reporting'.

1. We asked 30 respondents from various UK life insurance companies what will be the mostly used KPIs after IFRS 17 adoption. We excluded from the answers Adjusted operating profit as we think it will be used by the vast majority of the UK insurers.
2. We asked 22 respondents from various UK insurers what are accounting mismatches are the most significant and need to find reflection into the new KPIs framework (i.e. in the adjusted operating profit.
3. We asked 30 respondents from various UK insurance companies what they think is the impact of new IFRSs on the reporting. The majority of respondents (56%) think a more regulated approach to KPIs will require disclosing both mandatory KPIs along with the non-GAAP measures.

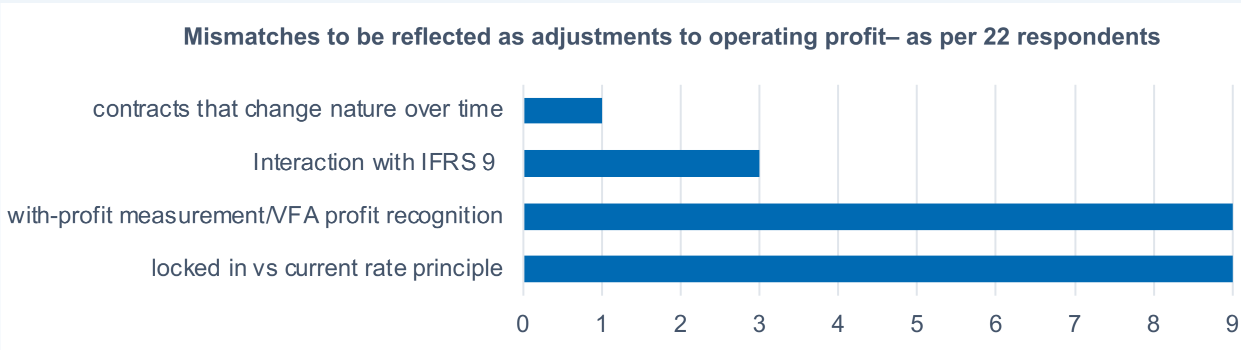
Any new KPI frameworks, aligned with the business strategy, financial targets and internal processes should form part of the implementation plans. The new framework should respond to the complexities of the new standard, but also provide an opportunity to tell the whole story to the investors and users of the financial statements – the story explaining value creation and how to interpret the accounting arising from IFRS 17 application. Please refer to our linked publication explaining how this can be achieved (link to AOP article).

Figure 1: Mostly used KPIs



*Respondents from the UK life Insurers presentation were asked to select the most important KPIs. If the response is capital measures under SII, the insurer should disclose the CSM roll forward, which is part of mandatory disclosures and represent KPIs.

Figure 2: Accounting 'mismatches' most important for the UK insurers



IFRS 17 impact: A potential narrowing of choice

We believe there are two factors that insurers should keep front of mind if they intend to increase KPIs:

1. Having both new and existing measures will not help to reduce user confusion without meaningful reconciliation between these KPIs (e.g. new business CSM and VNB/VIF) and evolving of existing KPIs formulas into new ones.

2. A more regulated approach to KPIs may be on the horizon. The exposure draft of the new Presentation and Disclosure IFRS standard (due to replace IAS 1) provides an explicit requirement for subtotals (e.g. operating profit) directly affecting KPIs and contains a proposal to disclose management performance measures in a separate footnote.

Solvency II measures will continue to be among the most important KPIs. Coverage ratios give a view of strength and risk exposure, and along with cash-related measures Solvency II KPIs provide an indicator of dividend expectations. Analysts have publicly called for improvement in profit performance & cash generation metrics. Those who can best help investors understand how SII free surplus and cash metrics relate to the disclosed IFRS 17 profit might benefit from investor confidence.

To create the link between IFRS 17 and cash-related measures, investors need to understand how the cash metrics and Solvency II constrained equity release relate to the disclosed IFRS 17 profit. Although this could partially be addressed by the statements of cash flows already presented in the accounts, the information presented in these is likely to be rather limited to create much value. Additional reconciliations might be needed to reflect different measurement principles, for example, treatment of insurance acquisition cash flows that can be deferred in IFRS 17 if paid before the group of insurance contracts is recognised. Creating this link will be technically difficult – decomposing the SII free surplus generation into analysis comparable to the IFRS 17 disclosures will require reconciliation of the of risk discount rates, risk quantification techniques, and units of account. It is unlikely this analysis will be conducted effectively or efficiently The calculation logic will likely need to be embedded as part of the implementation effort and as such the design needs to be happening now.

Historically there has been a certain amount of freedom when developing insurance KPIs. Insurers often had similarly labelled metrics based on different calculation bases. Changes to IFRSs will bring a more regulated approach to KPIs. Companies should be aware of upcoming IFRSs, for example, the new Presentation and Disclosure standard that will replace IAS 1. At the IASB meeting in March 2021 the Board tentatively agreed not only to disclose management performance metrics (that now include subtotals of income and expenses) in a separate disclosure note, but also to explore possible approaches to expanding the scope of the requirements for management performance measures to include other measures. In our view this direction in IFRSs standard setting creates a more unified basis for KPIs presentations. Some UK insurers opposed these Board suggestions primarily because of the new measurement principles of IFRS 17, which make subtotals like operating profit quite volatile. That again indicates the urgency in creating a meaningful KPIs framework that will address all the volatility concerns and other 'mismatches' arising from the application of new IFRSs.

Action plan: Steps to KPIs framework reengineering

Steps at a glance

Figure 3: Suggested step by step algorithm

1. Get accurate and high-quality data	2. Perform KPIs impact assessment and understand the scope of work	3. Identify most relevant new KPIs and link them to exisitng ones	4. Educate stakeholders by illustrating a complete story

Steps deep-dive

1. Get accurate and high-quality data

IFRS 17 requires greater data granularity, with existing groups split further into risk types, annual cohorts and levels of profitability. This has negative implications for data storage and manipulation – but when performed effectively, this will generate business value by providing granularity for analytics.

This new data enables robust interrogation of numbers , however, companies will need to make sure that KPIs are designed in such a way that they make sense when dissected. KPIs should also be forward-looking and linked to a strategy & plan which allows corrective management actions when necessary. Companies need to make sure that the right data is identified and tagged in such a way that it is accessible. Finally, infrastructure and processes need to be put in place to automate KPI production and to allow management to access with improved user experience

One of the biggest blockers to achieving this goal is related to data governance; cleaning, defining and manipulating data at more granular levels than previously required. Our view is that the minimum quality standards of the new IFRS 17 reporting and KPIs are best built on the foundation of improved data governance, as well as careful redesigning of internal controls and processes. Given that the internal control framework is very much linked to future external audit compliance, we think that insurers should ideally start implementing and testing the new IFRS 17 operating controls at the same time as systems parallel runs, and certainly before the external audit is conducted in 2024.

2. Perform KPIs impact assessment

Whilst companies[4] have already focused on PL and BS impact assessment, the impact on KPIs is less clear or prominent.

Currently, not many insurers explicitly include KPIs revision milestone in their implementation roadmaps, and even fewer have had conversations on KPIs at business leadership level.

It is time now for companies to carefully re-assess whether existing KPIs can be replaced with IFRS 17 new metrics in order to achieve greater synergy and reduce operational burden from management reporting. A combination of new and existing metrics will require a careful bridging of them. Being able to reconcile performance across bases – explaining differences – will enhance the external perception of management performance and control. Further in this report we provide examples of such links.

3. Identify most relevant new KPIs and bridge them to relevant existing ones

Assessments for change for non-life insurers

Gross premium written will not be presented in the IFRS 17 accounts; replaced by the IFRS 17 unearned profit and risk adjustment release, however non-life insurers are still likely to present it as an alternative performance measure ('APM') leading to several assessment points:

- How to calculate and present GWP
- How to reconcile GWP to IFRS 17 revenue
- What level of assurance is the expected by users of accounts
- What cost will auditors assign to this assurance (historically GWP audit has been considered a significant risk)

Unlike life insurers it is expected that non-life companies will be less focused on the new business CSM given that historically they were far less concerned about the new business profitability and more focused on loss ratios. It is expected that combined ratios will continue being the focus of attention of non-life insurers. Impact assessments will be needed to:

- Understand the optimum level of granularity at which combined ratio will be calculated
- Consider the change to the management accounting segments to align them with IFRS 17 level of aggregation
- Adjust the combined loss ratio metrics to accommodate the new way of claims measurement and presentation in IFRS 17
- On the one hand, the loss ratio will be linked to the insurance service result and insurance revenue, line items that IFRS 17 improved in terms of a more consistent presentation.

  On the other hand, these line items will largely depend on cash flows timing – so there is still a question of comparability of the loss ratio KPIs between market participants given different cash flows timing.

We recommend companies to perform KPI dry runs alongside IFRS 17 transition exercises. The results of these dry runs should be compared across lines of business as well as with existing benchmarks, based on that comparison companies should develop new benchmark goals for each line of business. The key difficulty in developing new benchmark goals will be factoring in IFRS 17 level of aggregation. This is due to the fact that currently management accounting is often based on separate risks that are included in one insurance contract. IFRS 17 minimum unit of account will not allow separating risks under one contract (unless unbundling requirements are met). Aligning management accounting lines of business with IFRS 17 levels of aggregation will allow to run KPI calculations more efficiently, however companies are rightly concerned about how understandable the new results will be. The purpose of new KPIs framework will be to improve on clarity and illustrate the appropriate story to the investors.

Finally, after dry runs are done, companies should start comparing the KPIs across market participants as early as possible to develop a more meaningful framework. It will take time to have an established market practice, and we envisage there could be a decreased comparability between the market participants in the first few years after the standard adoption. Companies that widely use combined ratio as an internal KPI metric should seek professional advice to get market insights in order to build a more consistent KPIs framework.

4. We asked five Non-executive directors from the UK insurers which area of focus is their current priority during IFRS 17 implementation process? Most of the respondents confirmed their focus have been on the Impact assessment of IFRS 17 adoption, ie changes in the revenue recognition pattern and impact on shareholder equity at transition whilst none of them included KPI as the area of focus.

Metrics that change for life insurers

Life insurers have provided additional disclosures such as Embedded Value ("EV") to supplement accounting bases for many years, feeling that current IFRS does not tell the full story of long-term value creation. The establishment of the CSM somewhat mirrors the objective of EV, and in an arguably more comparable way. This could undermine the desire to continue EV production, and at least one might expect a clear bridge to articulate any differences between the bases. Any such bridge would rely on a more standardised and consistent framework provided by IFRS 17 and at the same time emphasise the business specifics allowed by EV which brings more flexibility and includes a wider scope of contracts (e.g. investment contracts along with insurance ones). Parallel reporting of such bases will add to already complicated processes, and we believe the 'smart implementation money' should be selectively re-directed to invest in the standardisation, rationalisation and digitisation of finance and actuarial processes and models. Teams can use consistent tools to simplify and automate processes and deploy with the broader system development work (general ledger, CSM etc.). In a world where efficiency is key, this will pay off in the years to come.

One of the market concerns at the moment is CSM sustainability which reflects a company's ability to achieve a sustainable growth of operating profit. Companies should assess the transition CSM and compare it to the forecasted new business CSM to gain insight around its future sustainability. This will allow adequate messaging to the market and potential design of other growth metrics to tell the story.

4. Educate stakeholders by illustrating a complete story

For a long time, knowledge about IFRS 17 has been kept within the team of dedicated experts. The time has come for insurers to talk to those charged with governance and investors not only to get them up to speed with IFRS 17 basics, but also to showcase the effect of the news standard on KPIs. To get management and investors 'buy in' companies should simplify reporting so that it is easy to explain from a business and 'interaction with other standards' perspective. They should also focus on neutralising mismatches and volatility discussed in this report earlier. Companies can achieve this with a two-dimensional plan: one dimension is financial optimisation of PL using the right estimates and earning patterns compliant with IFRS 17; another dimension is neutralising volatility by introducing various KPIs e.g. meaningful AOP and keeping a focus on CSM sustainability metrics.

Another aspect of stakeholders' education is "Business as usual" transition process. In this report we've already mentioned that whilst IFRS 17 implementation programme is often handled by the team of dedicated experts, certain aspects of implementation (such as internal control redesigning or KPIs framework revision) are excluded from the implementation programme and remain the responsibility of the financial accounting and FP&A teams. These teams should start interacting with each other without further delay to ensure that they effectively deign new IFRS 17 controls and appropriately revise KPIs framework. This becomes particularly important when IFRS 17 implementation projects are staffed with temporary contract roles that will not be part of the business as usual team when the projects end.

Conclusions

In this report we described the main challenges for the future KPI framework. In order to overcome these challenges and create an adding value KPIs framework, insurers that adopt IFRS 17 should:

- Use high-quality data that needs to be available in order to perform KPIs impact assessment.
- Design KPI framework timely and perform KPIs dry runs at the same time as systems parallel runs.
- Simplify reporting that is easy to explain from a business perspective. Maintain a P&L which reflects operational performance and neutralises volatility in financial markets.
- Maintain the level of Shareholder's Equity during and after the transition and achieve a sustainable growth of operating profit.
- Manage the investors focus on dividend paying capacity driven primarily by free capital (by creating KPIs to link IFRS 17 and SII for the external market stakeholders).
- Manage stakeholder expectations by presenting a bigger picture and bridging new KPIs with some existing KPIs.

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