KPMG

Insurance contracts

IFRS 4 Phase I and overview Proposed changes in Phase II

August 2016

Agenda

Overview of the insurance contract project

IFRS 4 Phase I – Accounting for Insurance Contracts

Phase II – IFRS 17 - Proposed Approach to Insurance Contracts Accounting

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Why the need for a standard on insurance contracts?

Diversity in accounting practices for insurance contracts across the world

Other IFRSs do not address accounting for insurance contracts

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Overview of the insurance contract project

Phase I: objective was to:

- **make limited improvements to accounting for insurance contracts**

- **provide disclosures that identify and explain amounts in an insurer's financial statements arising from insurance contracts and provide information about the amount, timing and uncertainty of future cash flows from insurance contracts until the Board completes phase II**

- **Resulted in IFRS 4 *Insurance Contracts*, an interim standard that permits a wide variety of accounting practices for insurance contracts**

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Overview of insurance contract project (cont'd)

Phase II

- **Currently ongoing**

- **Objective is to develop a standard to replace IFRS 4 - interim insurance standard and to provide a basis for consistent accounting for insurance contracts in the longer term**

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IFRS 4 – Phase I – Scope

The standard applies to all contracts classified as insurance contracts excluding the following;

- Product warranties issued directly by a manufacturer, dealer or retailer (IAS 18)
- Employers' assets and liabilities under employee benefit plans (IFRS 2, IAS 19 and IAS 26)
- Contractual rights or obligations contingent on future use or right to use a non-financial item (e.g. some royalties)
- Lessee's residual value guarantee embedded in a finance lease
- Financial guarantee contracts (if not previously accounted for as insurance contracts
- Contingent consideration payable or receivable in a business combination
- Direct insurance contracts held by a policyholder

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IFRS 4 – Phase I – Classification

A contract that exposes the issuer to financial risk without significant insurance risk would not be an insurance contract under the proposals. The specified uncertain future event that is covered by an insurance contract creates insurance risk. ‘Insurance risk’ is any risk, other than financial risk, transferred from the holder to the issuer of a contract. The following table includes examples of insurance risk and financial risk.

Insurance risk

Risks to the holder, such as:

- death
- illness
- disability
- loss of property due to damage or theft
- failure of a debtor to make payment when due.

Financial risk

The risk of a potential future change in one or more of:

- interest rates
- financial instrument prices
- commodity prices
- foreign exchange rates
- indices of prices or rates
- credit ratings or credit indices
- any other variable, except for a non-financial variable that is specific to a party to the contract.

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IFRS 4 – Phase I – Classification (Cont'd)

Separating non-insurance components

Unbundling of a deposit component is <u>prohibited</u> if the deposit component cannot be measured separately

Unbundling of a deposit component is <u>required</u> if the deposit component can be measured separately and the obligations and rights arising from the deposit component need not be recognized per the insurer's accounting policy

Unbundling of a deposit component is <u>permitted</u> if the deposit component can be measured separately and the obligations and rights arising from the deposit component need to be recognized per the Insurer's accounting policy

To unbundle a hybrid contract, an insurer should:

- **apply IFRS 4 to the insurance component**
- **apply IAS 39 to the deposit component**

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IFRS 4 – Phase I – Recognition and Measurement

IFRS 4 exempts an insurer from applying the requirements of IAS 8.10-12 to its insurance contracts (including reinsurance contracts held). Specifically, an insurer;

- **shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period**
- **shall carry out the *liability adequacy test***
- **shall remove an insurance liability from its statement of financial position when, and only when, it is extinguished**
- **shall consider whether its reinsurance assets are impaired (IAS 39)**
- **shall not offset *reinsurance assets* against the related insurance liabilities (including income and expenses)**

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IFRS 4 – Phase I – Recognition and Measurement

Insurers may continue with their existing accounting policies to eliminate excessive prudence

- An insurer may continue with the following practices, but introduction of any of them is not allowed;
- measuring insurance liabilities on an undiscounted basis
- Measuring contractual rights to future investment management fees at an amount that exceeds their fair value (i.e. current fees charged by others)
- using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries
- Eliminates excessive prudence

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IFRS 4 – Phase I – Liability Adequacy Test

- **An insurer should assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts**

- **IFRS 4 only specifies minimum requirements for conducting the liability adequacy test**
  - **the test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees**
  - **if liability is inadequate, entire deficiency is recognised in profit or loss immediately.**

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IFRS 4 – Phase I - Disclosures

- **Disclosures comprise**
  - explanation of recognised amounts
  - nature and extent of risks arising from insurance contracts

Explanation of recognised amounts

- accounting policies for insurance contracts and related assets, liabilities, income and expense
- amounts of recognised assets, liabilities, income and expense arising from insurance contracts, as well as gains/ losses recognised on reinsurance by the cedant

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IFRS 4 – Phase I - Disclosures (cont'd)

- the process used to determine the most significant assumptions used to measure recognised amounts, and if practicable, quantified disclosure of assumptions
- effect of changes in assumptions used to measure insurance assets and liabilities
- Reconciliation of changes in insurance liabilities, reinsurance assets

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IFRS 4 – Phase I - Disclosures

Nature and extent of risks

- risk management objectives, policies and processes, and methods used for managing risk from insurance contracts
- sensitivity to insurance risk
- concentrations of insurance risk
- actual claims compared with previous estimates, i.e.
  - claims development
- information about credit risk, liquidity risk and market risk that IFRS 7 would require if the insurance contracts were within the scope of IFRS 7, with certain exceptions

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IFRS 17 – Phase II

Phase II – Proposed Approach to Accounting for Insurance Contracts

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Why the need for a revised standard on Insurance?

IFRS 4 *Insurance Contracts* is an interim Standard

- Permits continuation of diverse practice
- 'Temporary exemption' from the general requirement that accounting policies should be relevant and reliable

No transparent information for effects on financial statements

New Standard must be transparent on:

- Effects on financial performance / The nature and extent of risks
- Profits or losses through underwriting activity and investing premiums

Comparisons are difficult on products companies and jurisdictions

New Standard:

- Replaces a variety of treatments that depend on the contract and companies
- Will be easier to compare insurance with other types of contracts

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Phase II – Project history

- **1997** – Start of the project on insurance contract
- **Mar 2004** – IFRS 4 Phase I issued Interim Standard on Insurance Contracts
- **Mid 2004** – Phase II Project started
- **May 2007** – Discussion Paper – 162 comment letters received
- **Jul 2010** – Exposure Draft – 253 comments letters received
- **Jun 2013** – Revised Exposure Draft – 194 comments letters received
- **Dec 2016 ??** – Dec 2015 – Amendments to transitional requirements / Expected publication of IFRS 17

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Phase II – Proposed amendments – Scope

- The scope of the proposed standard is very similar to the current IFRS 4 Insurance Contracts.
- However, the proposal provides guidance on how investment contracts with discretionary participation feature (DPF) should be accounted for as insurance contracts, provided the entity also issues insurance contracts.
- The scope exclusion has been extended to include
  - Some certain fixed fee contracts, which should now be accounted for under IFRS 15.

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Phase II – Proposed amendments – Classification

- **The classification criteria of the proposed standard is very similar to the current IFRS 4 Insurance Contracts.**
- **However, the proposal includes guidance on**
  - **How insurance contracts entered into at or near the same time with the same policyholder (or related policyholders) may be combined and accounted for as a single contract**
  - **How insurance contracts with more components may be separated into an investment component (IFRS 9) or/and a service component (IFRS 15)**

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Phase II – Proposed amendments – Classification (cont'd)

- **Changed the term 'unbundling' to separation; consistent with the requirements of IAS 39/IFRS 9**
- **The principles for identifying and separating components are now more closely related to those of IFRS 9 and IFRS 15.**

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Phase II – Proposed amendments – Recognition and Measurement

- The proposed standard introduces fundamental changes and a single approach to the recognition and measurement of insurance contracts
- It provides clarity on the recognition criteria for an insurance by introducing *<u>coverage period</u>* and *<u>cash flows within the boundary of a contract.</u>*

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Phase II – Proposed amendments – Recognition and Measurement

- The proposal also introduces clear principles on accounting for
  - Modification of an insurance contract
    - Modifications that meet the derecognition criteria
    - Modifications that do not meet the derecognition criteria
  - Derecognition of an insurance contract
  - Gains and losses on modification or derecognition
  - Insurance contracts acquired in a portfolio transfer or a business combination

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Overview of the accounting model for insurance contracts

Step 1

- Identify and recognise the contract

Step 2

- Measure the contract at initial recognition

Step 3

- Re-measure in subsequent periods

Step 4

- Present results in financial statements

Step 5

- Provide the disclosures

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Phase II – Proposed amendments – Recognition and Measurement (Cont'd)

Initial measurement of an insurance contract is based on

Contractual service margin → Difference between the risk-adjusted present value of expected inflows and outflows at inception

'Fulfilment cash flows'

Future cash flows → Expected cash flows from premiums and claims and benefits

Risk adjustment → Uncertainty assessment about the future cash flows and its costs

Discounting → An adjustment that converts future cash flows into current amounts

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Phase II – Proposed amendments – Recognition and Measurement (Cont'd)

Subsequent measurement of an insurance contracts is based on

Contractual service

- Adjusted by changes in estimates relating to the future
- Allocated to profit or loss on the basis of provision of insurance contracts (ie the passage of time)

'Fulfilment cash flows'

Future cash flows

Risk adjustment

Discounting

In each reporting period, an entity remeasures the **fulfilment cash flows** using current assumptions

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Phase II – Proposed amendments – Recognition and Measurement (Cont'd)

The proposal introduces the Premium Allocation Approach, used to simplify the measurement of insurance contract liabilities for the remaining coverage period.

- Useful for short term insurance contracts
- Need not adjust future cash flows for the time value of money
- Applies when the coverage period is 12 months or less

Does not require the Liability Adequacy Test

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Phase II – Proposed amendments – Recognition and Measurement (Cont'd)

Presentation of insurance amounts on the financial statements:

- **The proposed standard provides detailed guidance on amounts to be presented on the statement of financial position and the statements of profit or loss and other comprehensive income**
- **It requires the following to be presented;**
  - **Carrying amounts of portfolios of insurance contracts including reinsurance contracts held**
  - **Revenue and expenses**

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Phase II – Proposed amendments – Recognition and Measurement (Cont'd)

- **Insurance contract revenue should depict the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.**

- **Insurance contract revenue and incurred claims should exclude any investment components.**

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Phase II – Proposed amendments – Disclosure

Amounts Recognised

- ✓ Expected PV of future payments-receipts
- ✓ Risk and the contractual service margin
- ✓ New contracts written in the period
- ✓ Time value of money (insurance investment expense)

Significant Judgements

- ✓ Estimating inputs and methods
- ✓ Effects of changes in the methods and inputs used
- ✓ Reason for change, identifying the type of contracts affected

Nature and extent of Risk

- ✓ Nature and extent of risks arising
- ✓ Extent of mitigation of risks arises from reinsurance and participation
- ✓ Quantitative data about exposure to credit, market and liquidity risk

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Thank you!

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