FINANCIAL REPORTING WORKSHOP

1. IFRS 13: FAIR VALUE MEASUREMENT
2. IFRS 17: INSURANCE CONTRACTS

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Agenda

- ❑ Fair Value
- ❑ Fair Value Inputs
- ❑ Disclosure Requirements
- ❑ IFRS 17: Insurance Contracts

IFRS 13 - Objective

IFRS 13:

- defines fair value
- sets out in a single IFRS a framework for measuring fair value
- requires disclosures about fair value measurements.

Out of scope:

- share-based payment transactions within the scope of IFRS 2 *Share-based Payment*
- leasing transactions within the scope of IAS 17/IFRS 16 *Leases*
- measurements that have some similarities to fair value but that are not fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets*.

IFRS 13 - Considerations

1: What is the unit of account?

2. Are there other markets for the item?

3. Who are the other market participants? What use would they put the item to?

4. Current use of the asset? Any better alternative?

5. Calculate the price

6. Fair value disclosures

Terminologies

Fair value - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Active market - A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Exit price - The price that would be received to sell an asset or paid to transfer a liability.

Principal market - The market with the greatest volume and level of activity for the asset or liability.

Terminologies

Highest and best use - The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

Factors to consider in determining HBU:

- *Physically possible; Legally permitted; Financially viable.*

Most advantageous market - The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Inputs

Level	Inputs
1	Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. *(A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available)* *E.g., treasury bills, securities on national exchange*
2	Quoted prices are not available but fair value is based on observable market data. *E.g., corporate bonds, derivatives such as currency and interest rate swaps*
3	Unobservable inputs for the asset or liability *(An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available).* *E.g., private equity investments, residential and commercial mortgage related assets*

Transaction price vs fair value

Transaction price is usually the fair value unless;

- The transaction is between related parties
- The transaction is not orderly/forced
- The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.
- The market in which the transaction takes place is different from the principal (or most advantageous) market.

Valuation techniques

Market approach

- uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business)
- e.g. equity securities

Cost approach

- reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost)
- e.g., factory plant and equipment

Income approach

- converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts
- e.g., unlisted equity instruments, intangible assets like brands

Disclosure objective

IFRS 13 requires an entity to disclose information that helps users of its financial statements assess both of the following:

- for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
- for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

Basis of measurement

RFVM

(Recurring Fair Value Measurement)

Fair value measurement is required at reporting date by other IFRSs (e.g. investment property, biological assets etc.)

NRFVM

(Non-Recurring Fair Value Measurement)

Fair value measurement is triggered by particular events/circumstances (e.g. assets held for sale under IFRS 5 etc.)

Disclosures

The following minimum disclosures are required for each class of assets and liabilities measured at fair value in the statement of financial position after initial recognition:

- the fair value measurement at the end of the reporting period
- for non-recurring fair value measurements, the reasons for the measurement
- the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3)
- for assets and liabilities held at the reporting date that are measured at fair value on a recurring basis, the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred, separately disclosing and discussing transfers into and out of each level.

Disclosures

- for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement, any change in the valuation techniques and the reason(s) for making such change (with some exceptions)
- for fair value measurements categorised within Level 3 of the fair value hierarchy, quantitative information about the significant unobservable inputs used in the fair value measurement
- for fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity

Disclosures

For recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:

- total gains or losses for the period recognised in profit or loss, and the line item(s) in profit or loss in which those gains or losses are recognised
- total gains or losses for the period recognised in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognised
- purchases, sales, issues and settlements (each of those types of changes disclosed separately)
- the amounts of any transfers into or out of Level 3 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred.

Disclosures

- For recurring fair value measurements categorized within Level 3 of the fair value hierarchy:
  - a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.
  - for financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated
- If the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its HBU.

Disclosures - Summary

Disclosure requirement	RFVM	NRFVM	FV Disclosed
Fair value at reporting date	X	X	
Reasons for fair value measurement		X	
Fair value hierarchy level – i.e., 1, 2 and 3	X	X	X
Transfers between Level 1 and 2 (Including reasons for transfer and the entity's policy for transfer)	X		
Valuation techniques, inputs, changes, reasons for changes - Level 2 and 3	X	X	X
Level 3 valuation processes/policies	X	X	
Level 3 unobservable inputs	X	X	
Level 3 reconciliations of total gains or losses in P&L and OCI, purchases, sales issues, settlements and transfers	X		
Level 3 unrealized gains/losses recognised in P&L	X		
Level 3 sensitivity to changes in unobservable inputs (qualitative for non-financial instruments, quantitative for financial instruments)	X		
Reasons if HBU differs from current use	X	X	X

Disclosures - Example

Amounts in KES	**Level 1**	**Level 2**	**Level 3**	**Total**
Biological assets	-	-	X	XX
Real estate for rental (IP)	-	-	X	XX

The entity recognises transfers out of Level 3 as of the date of the event or change in circumstances that caused the transfer

The following table shows reconciliation from the beginning balances to the ending balances for Level 3 fair value measurements

Amounts in KES	**Biological assets**	**Investment property**
Balance at 01.01.x1	X	X
Acquisitions	X	X
Sales	(X)	(X)
Reclassification from PPE	-	X
Gains and losses for the period		
Changes in fair value - Realised	X	-
Income - unrealised	X	-
Change in fair value recognised in OCI		
Effect of movements in exchange rate	X	-
Balance at 31.12.x1	**XX**	**XX**

Discussion

1. How are transportation and transaction costs treated in the determination of fair value?
2. What are some of the characteristics of a transaction that is forced or not orderly?
3. Does the HBU concept apply to financial assets?
4. Does an entity consider its own risk of non-performance in measuring the fair value of its liabilities?
5. Is there need for an organisation to specifically identify market participants? Can the participant(s) be a related party?

IFRS 17 – Insurance Contracts

- IFRS 17 establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the standard.
- The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts
- IFRS 17 was issued in May 2017 and applies to annual reporting periods beginning on or after 1 January 2021*.

Scope

An entity shall apply IFRS 17 Insurance Contracts to:

1. Insurance contracts, including reinsurance contracts, it issues;
2. Reinsurance contracts it holds; and
3. Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

Key concepts

Insurance contract - 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.

Contractual service margin (CSM) - A component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned profit the entity will recognize as it provides services under the insurance contracts in the group.

Fulfilment cash flows (FCF) - An explicit, unbiased and probability-weighted estimate (i.e. expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk.

Risk adjustment for non-financial risk - The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows arising from non-financial risk as the entity fulfils insurance contracts.

Separating components from an insurance contract

An insurance contract may contain one or more components that would be within the scope of another standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both).

An entity shall:

(a) Apply IFRS 9 Financial Instruments to determine whether there is an embedded derivative to be separated and, if there is, how to account for such a derivative.

(b) Separate from a host insurance contract an investment component if, and only if, that investment component is distinct. The entity shall apply IFRS 9 to account for the separated investment component.

(c) After performing the above steps, separate any promises to transfer distinct non-insurance goods or services. Such promises are accounted under IFRS 15 Revenue from Contracts with Customers.

Aggregation

- IFRS 17 requires entities to identify portfolios of insurance contracts, which comprises contracts that are subject to similar risks and managed together.
- Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together.
- Each portfolio of insurance contracts issues shall be divided into a minimum of:
  a) A group of contracts that are onerous at initial recognition, if any;
  b) A group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
  c) A group of the remaining contracts in the portfolio, if any.
- An entity is not permitted to include contracts issued more than one year apart in the same group.

Recognition

An entity shall recognise a group of insurance contracts it issues from the earliest of the following:

(a) the beginning of the coverage period of the group of contracts;

(b) the date when the first payment from a policyholder in the group becomes due; and

(c) for a group of onerous contracts, when the group becomes onerous.

Measurement – General Model

On initial recognition, an entity shall measure a group of insurance contracts at the total of:

(a) the fulfilment cash flows ("FCF"), which comprise:

   (i) estimates of *future cash flows*;

   (ii) an adjustment to reflect the *time value of money* ("TVM") and the financial risks associated with the future cash flows; and

   (iii) a risk adjustment for *non-financial risk*

(b) the contractual service margin ("CSM").

Measurement

Key components

Fulfilment cash flows

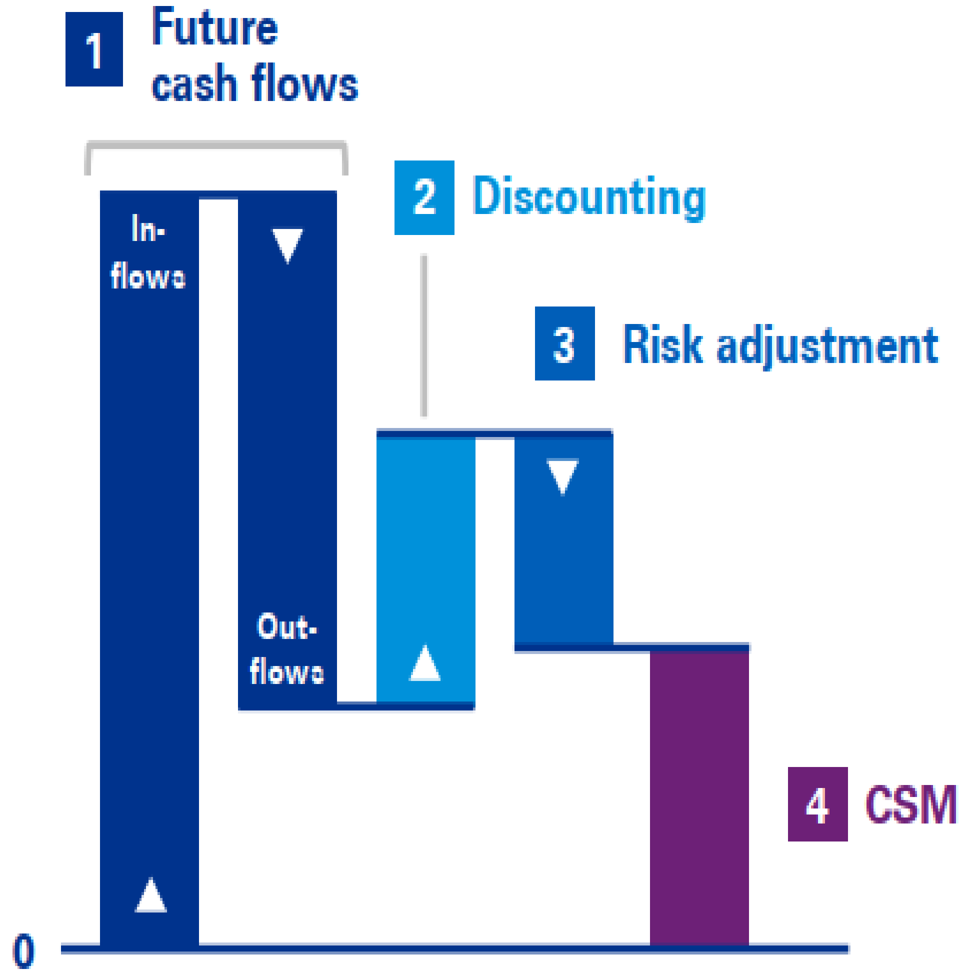
Risk-adjusted present value of future cash flows – e.g. premiums, claims

1
2
3

Contractual service margin (CSM)

Represents unearned profit – results in no gain on initial recognition

4



Subsequent measurement

On subsequent measurement, the carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:

(a) the liability for remaining coverage comprising:

(i) the FCF related to future services and;

(ii) the CSM of the group at that date;

(b) the liability for incurred claims, comprising the FCF related to past service allocated to the group at that date.

Onerous contracts

- An insurance contract is onerous at initial recognition if the total of the FCF, any previously recognised acquisition cash flows and any cash flows arising from the contract at that date is a net outflow.
- An entity shall recognise a loss in profit or loss for the net outflow, resulting in the carrying amount of the liability for the group being equal to the FCF and the CSM of the group being zero.
- On subsequent measurement, if a group of insurance contracts becomes onerous (or more onerous), that excess shall be recognised in profit or loss.
- Additionally, the CSM cannot increase and no revenue can be recognised, *until the onerous amount previously recognised has been reversed in profit or loss* as part of a service expense.

Premium Allocation Approach

An entity may simplify the measurement of the liability for remaining coverage of a group of insurance contracts using the Premium Allocation Approach (PAA) on the condition that, at the inception of the group:

a) the entity reasonably expects that this will be a reasonable approximation of the general model, or
b) the coverage period of each contract in the group is one year or less.

Where, at the inception of the group, an entity expects significant variances in the FCF during the period before a claim is incurred, such contracts are not eligible to apply the PAA

Premium Allocation Approach

Using the PAA, the liability for remaining coverage shall be initially recognised as the premiums, if any, received at initial recognition, minus any insurance acquisition cash flows.

Subsequently the carrying amount of the liability is;

a) the *carrying amount at the start* of the reporting period plus
b) the *premiums received* in the period, minus
c) insurance *acquisition cash flows*, plus
d) *amortisation* of acquisition cash flows, minus
e) the amount recognised as *insurance revenue* for coverage provided in that period, and minus
f) any *investment component paid* or *transferred to the liability for incurred claims*

Premium Allocation Approach

The PAA is an optional, simplified model for measuring the LRC

Total liability of a group of insurance contracts

Liability for remaining coverage (LRC)

PAA replaces the GMM for short-duration contracts

+

Liability for incurred claims (LIC)

May need to be discounted

Premium is recognised over time as revenue unless release of risk follows a different pattern

While unearned premium is a familiar concept, the revenue recognition pattern could differ

Insurance finance income or expenses

- Insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:
  a) the effect of the time value of money and changes in the time value of money; and
  b) the effect of changes in assumptions that relate to financial risk; but
  c) excluding any such changes for groups of insurance contracts with direct participating insurance contracts that would instead adjust the CSM.
- An entity has an accounting policy choice between including all of insurance finance income or expense for the period in profit or loss, or disaggregating it between an amount presented in profit or loss and an amount presented in other comprehensive income ("OCI").

Presentation in the statement of financial position

An entity shall present separately in the statement of financial position the carrying amount of groups of:

- *insurance contracts issued that are assets;*
- *insurance contracts issued that are liabilities;*
- *reinsurance contracts held that are assets; and*
- *reinsurance contracts held that are liabilities.*

Presentation in Income Statement

- An entity shall disaggregate the amounts recognised in the statement(s) of financial performance into:
  a) an insurance service result, comprising insurance revenue and insurance service expenses; and
  b) insurance finance income or expenses.
- Income or expenses from *reinsurance contracts held* shall be presented separately from the expenses or income from *insurance contracts issued.*

Disclosures

An entity shall disclose qualitative and quantitative information about:

- the amounts recognised in its financial statements that arise from insurance contracts;
- the significant judgements, and changes in those judgements, made when applying IFRS 17; and
- the nature and extent of the risks that arise from insurance contracts.

Discussion

What, in your opinion, do you think is the potential impact of this standard on insurance firms and the financial sector at large?

Interactive Session