LAST CHANCE TO INFLUENCE THE SHAPE OF INSURANCE ACCOUNTING

The revised exposure draft on insurance accounting remains open for comment until 25 October 2013. **Glenn Gillard** and **Bilal Qamar** explain some of the more significant proposed modifications.

The International Accounting Standard Board (IASB) has always intended to replace IFRS 4 phase 1 ('the interim standard') as soon as possible. The interim standard was a stop gap to allow transition to IFRS for EU listed groups in 2005 and permits a wide range of practices. In particular, the interim standard allows a 'temporary exemption' that explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision making needs of the users of financial statements or that such accounting policies are reliable. As a result, there has been a significant diversity in the financial reporting of insurance contracts across insurers/reinsurers applying IFRS and IFRS as adopted by the EU.

The revised exposure draft (ED) is the latest step in the development of a comprehensive IFRS containing measurement and presentation requirements for insurance (including reinsurance) contracts. The revised ED confirms the key features of the ED published by the IASB during 2010, most notably the building block approach (BBA). However, there are some important modifications which are introduced by the revised ED and, it is fair to say, these revisions add significantly to the complexity of the proposed standard and will present significant conceptual and operational issues for preparers and users.

The revised ED extends the comment period to 25 October 2013, however it has limited the areas of comment to five specific areas (as discussed below), thus most parts of the ED should be treated as nearly final.

> "THE REVISED ED CONFIRMS THE KEY FEATURES OF THE ED PUBLISHED BY THE IASB DURING 2010, MOST NOTABLY THE BUILDING BLOCK APPROACH (BBA). HOWEVER, THERE ARE SOME IMPORTANT MODIFICATIONS TO THE ORIGINAL ED"

The revised ED proposes to allow a timeframe of three years from the date of the final standard being published to the date of mandatory implementation resulting in a likely earliest mandatory implementation for periods beginning on or after 1 January 2017.

KEY FEATURES OF THE REVISED ED

Unearned profit estimate

Under the revised ED, the residual margin established on initial recognition has been renamed the contractual service margin (CSM). This unearned profit portion of the insurance contract, rather than being amortised over the contract with no adjustment for changes in expected profitability of the contract, will now be adjusted for changes in future expected cash flows relating to the future coverage period. Effectively, changes in expected future cash flows on the contract will be offset against the CSM. The IASB considers this treatment to provide a more faithful representation of the unearned profit. Adjustments for positive changes in the future cash flows (that is, greater expected future profit on the contract) can be added to the contractual service margin (CSM) with no limit and subsequently earned in line with the insurer fulfilling the contract. Negative changes in the expected future cash flows (that is, reductions in expected profit on the contract) cannot result in a contractual service margin asset (at portfolio level). This results in an onerous contract liability that is immediately recorded in profit or loss. It should be noted that changes in estimates of incurred claims would always be recognised immediately in profit or loss and do not form part of this CSM unlocking mechanism.

Discount rate

The estimate of the insurance contract liability is required to be discounted (unless the effect of discounting is not material). The discount rate to be applied is, therefore, one of the most material estimation factors. Given the significant level of insurance liabilities and financial assets backing them that are sensitive to market interest rates, the IASB has proposed the following solution:

- Interest expense based on historical discount rates i.e. the rate at the initial recognition of the Insurance Contract Liability (ICL) will be recognised in the profit and loss account.
- The effect of difference between historical discount rates and current interest rates on the measurement of ICL will be reported through Other Comprehensive Income (OCI).

In parallel with this 'OCI solution' the IASB has also published a proposed amendment to IFRS 9 on classification and measurement of financial instruments which introduces a new financial asset measurement category: debt instruments at fair value through other comprehensive income (FVOCI). This category requires the fair value changes in certain debt instruments to be accounted for within OCI with amortised cost accounting being required for the profit or loss.

The combination of these decisions on financial assets and liabilities aims at segregating the effects of underwriting performance from the effects of changes in the discount rate. This is intended to eliminate material accounting mismatches that would have been created under the original ED, however the proposals may not always be sufficient to eliminate mismatch issues.

The ED also provides an option on the determination of the discount rate allowing for a 'top-down' approach which would remove credit risk spreads from debt instruments in determining the discount rate.

These proposals, while generally welcomed, do require effectively two balance sheets to be maintained: one to feed the unwinding of the discount rate locked in at inception and one to feed the change in current discount rate presented through OCI. This introduces significant operational complexity in recording these amounts.

Participating contracts

Insurance contracts with participating features (both discretionary and non-discretionary) had been a significant area of comment and concern in the original ED. The revised ED looks to address this with specific proposals for contracts 'with a contractual link to underlying items'. A completely different measurement approach, the mirroring approach, is proposed to that of the BBA which is aimed at eliminating the key accounting mismatches that had concerned respondents to the original ED. With this approach, however, comes significant complexity and the required valuation and actuarial models needed to implement the approach will present a material operational challenge.

Insurance contract revenue and expense

The 2010 ED proposed a margin approach to presenting income for an insurer effectively presenting the movements arising from the BBA. Most respondents criticised this approach as it did not include the volume of an insurer's activity as prominent information in the income statement. The 2013 ED attempts to address this by requiring entities to decompose the result of the calculations under the BBA such that a gross presentation of revenue is achieved. Revenue determined as above will still, however, be significantly different than the traditional gross and earned premium model as currently reported by insurers/reinsurers. In addition, the ED prohibits the recognition of premium collected from insurance contracts as revenue when it contains a payment of cash that would be returned to the policyholder irrespective of the occurrence of an insured event (i.e. all bundled deposit components of an insurance contract).

The requirement to decompose the BBA result significantly complicates the reporting model particularly for long duration contracts.

Transition requirements

Moving from existing insurance contract accounting to the new ED will be complex. The 2010 ED sought to simplify transition by requiring the CSM on in-force business to be set at zero on transition. However, respondents had concerns that this approach would mean that profits deferred on contracts in-force at the date of transition would never be recognised in the income statement. The new transitional provisions call for full retrospective restatement of the CSM (with some latitude for simplifications). The IASB has particularly sought comment on the transitional provisions. Significant areas of complexity will be encountered on transition including:

- Restatement of OCI to reflect the OCI solution discussed above for the in-force portfolio;
- Treatment of insurance contracts acquired through a business combination or portfolio transfer;
- Re-designation of financial assets including making use of the new fair value through other comprehensive income (FVOCI) category for debt instruments;
- Determination of the CSM on in-force policies as noted above.

"THE IASB HAS ALSO PUBLISHED A PROPOSED AMENDMENT TO IFRS 9 ON CLASSIFICATION AND MEASUREMENT OF FINANCIAL INSTRUMENTS WHICH INTRODUCES A NEW FINANCIAL ASSET MEASUREMENT CATEGORY: DEBT INSTRUMENTS AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME (FVOCI)."

IMPLEMENTATION CONSIDERATIONS

Implementing the changes that the new IFRS insurance standard will require is a major regulatory-driven transformation which is likely to span several years. Insurers have a strategic choice to make in determining what their IFRS transformation programmes should deliver. This is particularly critical against the significant investment already spent on Solvency II that must be safeguarded and ideally leveraged to minimise the IFRS insurance implementation costs.

Understandably, there may be reluctance within insurers to set off too far down the track on an implementation plan given the various false starts we have seen with the IFRS insurance project (and the very recent experience of the stop start nature of Solvency II implementation), however, there are steps that should be taken at a minimum:

- Understand the current shape of the proposals in the ED and engage with industry bodies and other interested parties in ensuring a meaningful response to the proposals is made to the IASB;
- Actively track the developments at IASB level as responses are received and the ED moves closer to becoming an approved standard;
- Recognise that this is not an accounting issue and not limited to the finance function and therefore engage the wider organisation in considering the detailed impacts of the proposals to create a strategic view of how best to build the IFRS implementation programme into wider transformation programmes under way or due to start;
- Data is a key element for the successful implementation of the IFRS. The data requirements per the new insurance ED and IFRS 9 are very comprehensive and a successful data governance and data reconciliation process needs to be implemented by the insurers to deliver a quality set of data. This is already a priority under Solvency II and a general business imperative therefore IFRS considerations should form part of the strategic plans in place.

While 2017 may appear a distant implementation date, given the nature of the transformation required, early engagement at a strategic level in insurers is required.

Glenn Gillard, FCA is a partner and Bilal Qamar is a manager in the audit department of Deloitte.