Straight away

IFRS bulletin from PwC

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Revised proposals for insurance contracts will have a significant impact

Background

Following the 2010 exposure draft (ED), the IASB has published a targeted revised ED that will fundamentally change the accounting by all entities that issue insurance contracts. The IASB has attempted to address concerns expressed by stakeholders regarding perceived 'artificial' volatility resulting from the proposals in the previous ED. The revised ED will replace IFRS 4, which currently permits a wide variety of practices in accounting for insurance contracts. While this is not a joint project, the IASB and FASB have been working together in their deliberations. However, the EDs will have a number of differences. The FASB expects to publish its comprehensive ED on insurance contracts in the near future.

The proposal

Scope

The revised ED will apply to all insurance contracts and investment contracts with discretionary participating features issued by insurers. Fixed-fee service contracts whose primary purpose is the provision of services will not be within the scope of the revised ED. Financial guarantee contracts are allowed to be in scope if the entity previously asserted them to be insurance contracts. Similar to IFRS 4, the revised ED does not address the accounting by holders of insurance contracts (other than reinsurance).

The measurement model

Consistent with the previous ED, a current measurement model is proposed, where estimates are re-measured each reporting period. The measurement of the insurance contract liability continues to be based on the building blocks of discounted, probability-weighted cash flows, a risk adjustment and a contractual service margin (previously known as a residual margin) representing the unearned profit of the contract. A simplified approach is permitted if it provides a reasonable approximation to the building block model or if the coverage period is one year or less.

The IASB is seeking comments on the five key areas that have significantly changed since the previous ED (as set out below). In addition, the IASB is asking whether it has appropriately balanced costs and benefits in developing the proposed changes.

1. The use of other comprehensive income (OCI)

The previous ED proposed recognition of all the effects of updating the discount rate in profit or loss. Under the revised ED, the difference between discounted cash flows using current market rates and the discount rates at initial recognition is recognised in OCI for cash flows that do not depend on returns on the underlying assets. This reduces some of the income statement volatility for insurers where debt securities are measured at amortised cost or fair value through OCI, as proposed in the limited amendments to classification and measurement under IFRS 9. But it will increase volatility where assets are measured at fair value through profit or loss.

2. Unlocking the contractual service margin

The revised ED requires changes in cash flows related to future services to be recognised against the contractual service margin included within the balance sheet amount, rather than through profit or loss (as proposed in the previous ED). The contractual service margin cannot be negative, so changes in future cash flows that are greater than the remaining contractual service margin are recognised in profit or loss.

3. Contracts that require an entity to hold underlying items and specify a link to the returns on those items

Some insurance contracts specify a link between payments to the policyholder and the returns on underlying items that the entity is required to hold, such as some 'participating', 'with profits' and 'unit linked' contracts. The revised ED requires the contract cash flows to be decomposed into those that are expected to vary directly with returns on underlying items and those that are not. The portion of the liability where cash flows vary directly with underlying items will mirror the carrying value of the underlying items in both measurement and presentation. Other cash flows, such as specified fixed payments, options and guarantees, are measured in accordance with the building block model.

4. Presentation of insurance contract revenue and expenses

The revised ED moves away from the previous summarised margin approach, in response to the request for volume information, and strives to align the presentation of revenue with other industries. Premiums are allocated to periods in proportion to the value of expected coverage and other services that the insurer provides in the period, and claims are presented when incurred. Investment components (that is, amounts repaid to policyholders even if the insured event does not occur) are excluded from revenue. In the simplified approach, premiums are recognised in a systematic way that best reflects the transfer of services under the contract.

5. Transition

The previous ED did not allow for a contractual service margin on existing insurance contracts on transition to the new standard. The revised ED requires retrospective application for insurance contracts in force at transition, but also provides for a number of simplifications to determine the building blocks. Additionally, it will allow entities to revisit, at transition, their fair value options under IFRS 9.

Am I affected?

The revised ED will significantly affect all entities that issue insurance contracts, including recognition of profits and presentation in the statement of comprehensive income. Compared to the previous ED, income statement volatility will be reduced to some extent. But the new proposals add significant complexity and create extra demands on resources, data and modelling systems, and stakeholders need to understand the changes. The impact of the proposals will vary from one territory to another, depending on current accounting and regulatory requirements.

What do I need to do?

Given the likely significant impact of this revised ED, management should assess the implications and consider commenting on the new proposals to ensure its views are taken into account. The comment period ends on 25 October 2013, and the effective date is expected to be approximately three years from the date of publication of the final standard.