

ACCOUNTING POLICY IFRS IMPLICATIONS

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IFRS 4: INSURANCE CONTRACTS

Objectives

- IFRS 4 Insurance Contracts was issued by the International Accounting Standards Board (IASB) on 31 March 2004 as the **first step** in the IASB's project **to achieve convergence** of widely varying accounting practices in insurance industries around the world.

Objectives (Contd.)

- The objective of IFRS 4 is to:
 - achieve **limited improvements** in accounting for insurance contracts by insurers; and
 - introduce **appropriate disclosure** to identify and explain amounts in insurers' financial statements arising from insurance contracts and
 - help users understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Definition of Insurance

- An insurance contract is a contract under which one party (the insurer) 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**.

Definition of Insurance (Contd.)

- The conceptual basis of an insurance contract is the presence of significant insurance risk.
- Insurance risk is defined as a transferred risk other than financial risk
- Financial risk is defined in terms of changes in the same variables used in the definition of a derivative in IAS 39.

Definition of Insurance (Contd.)

- With the introduction of IFRS 4, the definition of financial risk was amended in IFRSs to include **non-financial variables which are not specific to one of the parties** of the contract.

Embedded Derivatives

- Exemption from the applicability of IAS 39: A policyholder's **option to surrender** an insurance contract for a fixed amount, even if the exercise price differs from the carrying amount of the host insurance liability

Example

- Death benefit linked to equity or equity index
 - payable on death or annuitisation
 - Insurance contract
- Death benefit higher of unit value of an investment fund and guaranteed minimum
 - Insurance contract
- Option to take life-contingent annuity at guaranteed rate
 - Insurance contract

Example (Contd.)

- Equity linked return available on surrender or maturity
 - Not an insurance contract; Measure at fair value
- Embedded guarantee of minimum equity return on surrender or maturity
 - Not an insurance contract; Measure at fair value

Example (Contd.)

- Embedded guarantee of minimum equity return- if the policy holder elects to take life contingent annuity
 - An insurance contract

Unbundling of Deposit components

- Unbundling is mandatory if, both the following conditions are met:
 - The insurer can measure the deposit component separately; and
 - The insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component

Unbundling of Deposit components (Contd.)

- Unbundling is permitted, but not mandatory if, both the following conditions are met:
 - The insurer can measure the deposit component separately; and
 - The insurer's accounting policies require it to recognise all obligations and rights arising from the deposit component regardless of the basis used to measure those rights and obligations

Unbundling of Deposit components (Contd.)

- Unbundling is prohibited if the insurer cannot measure the deposit component separately
- If unbundled, the insurance component is accounted for under IFRS 4 and the deposit component under IAS 39 *Financial instruments: recognition and measurement*.

Example

- A reinsurance contract
 - Premium CU 10 every year
 - Experience Account – 90 % of cumulative premium less 90% of cumulative claims
 - If balance negative – additional premium allocated over the remaining period
 - At the end – if it is credit balance – it is refunded
 - No cancellation
 - Maximum loss covered CU 200

Example (Contd.)

- Situation 1: No claim
 - Refund of CU 45 at the end of the fifth year
 - In effect cedant has made a loan
 - If reinsurer's accounting policy requires it to recognise its contractual liability – unbundling is permitted but not required

Example (Contd.)

- Situation 2: Claim CU 150 in year 1
- Additional premium:
 - Year 2: 39; Year 3: 36; Year 4: 31; Year 5: 0
- Refund: Year 5: 6
- PV of additional premium (Discount rate 10%)
Case 1 and 2 combined:
 - Year 2: 35; Year 3: 30; Year 4: 23; Year 5: 27; Total : 115

Example (Contd.)

- In effect the reinsurer in year 1 paid a claim of 35 and made a loan of 115

Temporary Exemption From Some IFRSs

- IFRS 4 exempts an insurer from applying IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, in respect to criteria for formulating accounting policies, for:
 - Insurance contracts that it issues
 - Reinsurance contracts that it holds

Temporary Exemption From Some IFRSs (Contd.)

- Nevertheless, IFRS 4 does not exempt an insurer from some implications from applying those criteria
- Specifically, an insurer:
 - Should not recognise as a liability any provision for possible future claims (e.g., catastrophe provisions and equalisation provisions)
 - Should carry out the **liability adequacy test**

Temporary Exemption From Some IFRSs (Contd.)

- Should remove an insurance liability from the balance sheet only when it is extinguished
- Should not **offset** reinsurance assets against the related insurance liabilities
- Should not **offset** income or expense from reinsurance contracts against the expense or income from the related insurance contracts
- Should consider whether its **reinsurance assets** are **impaired**

Capital Inadequacy 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
- If, there is deficiency, the entire deficiency should be recognised in profit or loss

Change in Accounting Policy

- An insurer may change accounting policies for insurance contracts only if the change adds to the relevance to users for economic decision-making needs without loss of reliability.

Change in Accounting Policy (Contd.)

- Examples of specific issues where accounting policy changes for insurance contracts are or are not permitted include:
 - An insurer is **permitted but not required** to change its policies to remeasure designated insurance liabilities (including deferred acquisition costs and related intangible assets) to reflect **current market interest rates** and recognises changes in those liabilities in profit or loss

Change in Accounting Policy (Contd.)

- an insurer can continue, **but not introduce**:
 - measuring liabilities on an undiscounted basis
 - measuring contractual rights to future investment management fees at an amount exceeding their fair value as implied by comparison with current fees for similar services charged by other market participants
 - using non-uniform accounting policies for the insurance contracts of subsidiaries, unless specifically permitted

Change in Accounting Policy (Contd.)

- Accounting policies do not need to be changed to eliminate excessive prudence or to eliminate future investment margins

Change in Accounting Policy (Contd.)

- An insurer is permitted to change its policies such that a recognised but **unrealised gain or loss** on an asset affects the measurement of some or all of its insurance liabilities, related deferred acquisition costs and related intangible assets in the same way that a realised gain or loss does

Discretionary Participation Feature

- The issuer of an insurance contract with a discretionary participation feature and a guaranteed element **may but need not** choose to recognise the elements separately with the following consequences:
- if not recognised separately, the whole contract is classified as a liability

Discretionary Participation Feature

- If recognised separately:
 - the guaranteed element is classified as a liability
 - the discretionary participation feature can be classified as either a liability or a separate component of equity
- All premiums may be recognised as revenue without separating any portion applying to an equity component

Disclosures

- Accounting policies for insurance contracts and related assets, liabilities, income and expense recognised assets, liabilities, income and expense
- Cash flows, if presenting the cash flow statement using the direct method
- Specific disclosures for an insurer who is a cedant

Disclosures (Contd.)

- Specific disclosures on the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts
- The effect of changes in assumptions used to measure insurance assets and insurance liabilities

Disclosures (Contd.)

- Reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs
- Other required disclosures also include information that enables users to evaluate the nature and extent of risks arising from insurance contracts.

Disclosures (Contd.)

- The disclosures shall include:
 - the objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks
 - Information about insurance risk including sensitivity of risk, concentration of risk and claims development

Disclosures (Contd.)

- Information about credit risk, liquidity risk and market risk that IFRS 7 *Financial instruments: disclosures would require if the insurance contracts were within the scope of IFRS 7*
- Information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the embedded derivatives are not measured at fair value

INDIAN GAAP INSURANCE

Indian GAAP: Life Insurance Business

- Premium
 - Recognise when due [No specific requirement in IFRS 4]
- Acquisition cost
 - Recognise as expense for the period in which it is incurred [No specific requirement in IFRS 4]
- Liability
 - Actuarial valuation [IFRS 4 compliant]

Indian GAAP: General Insurance Business

- Premium
 - Recognise as income over the contract period or the period of risk [No specific requirement in IFRS 4]
- Reserve for unexpired risk
 - [No specific requirement in IFRS 4]
- Premium deficiency
 - Recognise in the profit and loss account [Confirms to requirements in IFRS 4]
- Acquisition cost
 - Recognise as expense in the period in which it is incurred [No specific requirement in IFRS 4]

Indian GAAP: General Insurance Business (Contd.)

- Liability
 - Recognise liability for unpaid reported claims
 - Recognise liability for claims incurred but not reported
 - Actuarial valuation is required if, the claim payment period exceeds four year
 - [Confirms to requirements in IFRS 4]

Indian GAAP: General Insurance Business (Contd.)

- Catastrophe Reserve
 - An insurer may create catastrophe reserve in accordance with the norms prescribed by the Authority
 - [Does not violate the IFRS 4 requirements if the Reserve is considered as a part of equity created through appropriation of profit]

Indian GAAP: Measurement Of Investments

- Real estate
 - Historical cost measurement; Revaluation at least once every three years for Life-insurance companies [IAS 40 gives a choice between the fair value model and cost model]
- Debt securities and preference shares
 - Historical cost subject to amortization [Conforms to accounting for held to maturity investment under IAS 39]

Indian GAAP: Measurement Of Investments (Contd.)

- Equity securities and derivative instruments traded in active markets
 - Fair value; Change to 'Fair Value Change Account' in equity; Recycle to profit and loss account on sale
- [IAS 39 gives a choice to take the change to profit and loss account or to equity in case of available for sale securities; derivatives is considered as financial instruments held for trading; change in fair value to be taken to profit or loss]

Indian GAAP: Measurement Of Investments (Contd.)

- Equity securities and derivative instruments not traded in active markets
 - Historical cost; Provision for diminution in value [IAS 39 allows use of historical cost only if the fair value cannot be determined reliably]
- Loans
 - Historical cost subject to impairment test [Conforms to IAS 39 requirements]

IMPORTANT DIFFERENCES BETWEEN INDIAN GAAP AND IFRS

Property, Plant and Equipment

- Indian GAAP:
 - Cost model; Revaluation is permitted
- IFRS:
 - Choose between cost model and revaluation model
 - Principle of component accounting should be followed strictly

Intangible Assets

- Indian GAAP:
 - Rebuttable presumption that the useful life cannot exceed ten year
- IFRS:
 - No rebuttable presumption; Assets with indefinite useful life (e.g., brand) not to be amortised, but should be tested for impairment, at least annually

Provisions

- Indian GAAP
 - No concept of constructive obligation
 - Time value of money should not be considered
- IFRS
 - Constructive obligations should be recognised as liability if recognition criteria are met
 - Time value of money, if material should be considered

THANKS