KPMG

IASBriefing

This special issue of IASB*riefing* summarises the key points of IFRS 4 *Insurance Contracts*.

April 2004

Issue 23

Overview

On 31 March 2004, the International Accounting Standards Board (IASB) published IFRS 4. This standard is phase I of the IASB's work on insurance contract liabilities. It is intended to fill a gap that otherwise would have existed in the body of standards required to be adopted by many European Union, Australian and other entities from 1 January 2005. Before the issuance of IFRS 4 no guidance on the accounting for insurance contracts existed within IFRSs. IFRS 4 allows insurers to continue many of their current practices under national accounting principles. This approach was taken to avoid requiring entities to change their accounting policies twice, once upon adoption of IFRSs and then again upon the finalisation of phase II of the IASB's project on insurance contracts.

This standard is applicable primarily to insurers, but also applies to other entities reporting under IFRSs that issue insurance contracts. However, the standard does not apply to certain types of transactions including product warranties issued directly by a manufacturer, dealer or retailer.

IFRS 4 is effective for annual reporting periods beginning on or after **1 January 2005**. Earlier application is encouraged.

Summary

The main requirements of IFRS 4 are summarised below.

- The term 'insurance contract' is defined and distinguished from financial instruments. An insurer will be required to account for its financial instruments under IAS 39 *Financial Instruments: Recognition and Measurement*.

- The standard, in most cases, permits an entity to continue its existing accounting practices with respect to insurance contracts, including reinsurance contracts held by an insurer. Changes in current practices are permitted if the new policy, or a combination of policies, results in information that is *more* relevant or reliable. An entity could not change its accounting policy to one that resulted in less relevant and reliable information in relation to the *Framework*,

KPMG's bi-monthly update on International Financial Reporting Standards (IFRSs)

© 2004 KPMG International. KPMG International is a Swiss cooperative of which all KPMG firms are members. KPMG International provides no services to clients. Each member firm is a separate and independent legal entity and each describes itself as such. All rights reserved.

even if the desired policy was eligible for 'grandfathering' by another entity.

- In limited cases, a deposit element is required to be 'unbundled' from an insurance contract and accounted for separately under IAS 39. IFRS 4 also requires some embedded derivatives within insurance contracts to be separated and accounted for under IAS 39.

- An insurer is prohibited from recognising provisions for possible claims under contracts not yet in existence (e.g., some catastrophe and equalisation provisions).

- The offsetting of insurance assets and liabilities is prohibited.

- A liability adequacy test has been introduced to ensure that the measurement of an entity's insurance liabilities considers all expected contractual cash flows, including amounts payable under guarantees and other derivatives.

- The standard permits contracts that include discretionary participation features (sometimes described as 'with profits' contracts) to be accounted for as insurance contracts, even when the contract contains no insurance risk. It also permits some or all of the discretionary component in such contracts to be classified as equity.

- IFRS 4 permits an expanded presentation of purchased insurance contracts to include an asset for the present value of the premiums under existing contracts (sometimes referred to as present value of future profits (PVFP), value of business acquired (VOBA), or present value of in force business (PVIF)).

- Reinsurance assets are required to be tested for impairment.

- IAS 18 *Revenue* is amended to include guidance on the accounting for asset management fees. The amendment permits direct, incremental transaction costs incurred in establishing an investment management contract to be recognised as an asset (usually referred to as deferred acquisition costs (DAC)).

- New disclosures are required for insurance contracts.

Definition of an insurance contract

An important requirement for insurers applying IFRSs is the ability to determine which contracts are insurance contracts and which (or which parts) are financial instruments that should be accounted for under IAS 39.

IFRS 4 defines an insurance contract as "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".

Insurance risk is any risk, other than financial risk, transferred from the holder to the issuer of a contract. Financial risk is the risk of change in a specified interest rate, commodity or equity price, foreign exchange rate, credit index or in a non-financial variable that is not specific to a party to the contract. It follows that risks such as death, illness, disability, loss of property due to damage, theft, etc., are insurance risk. Credit default risk also is a form of insurance risk, as it is residual value risk to the extent that the value of an asset is specific to the policyholder and not market-price based.

Insurance risk is significant when there is at least one loss event scenario that has substance. A loss event has substance if it affects the economics of the transaction, so that the insurer would be required to pay *additional benefits* to the policyholder beyond those that would be paid if the insured event does not occur. It does not matter that the insured event is extremely unlikely, as long as it would have an effect on the economics of the transaction.

Insurance risk is assessed on a contract-by-contract basis, and so insurance risk may be significant even if material losses are not expected in a portfolio of contracts. The 'additional benefits' referred to above can include a requirement to pay a benefit earlier (e.g., upon death) than if the policyholder survives for a longer period.

Examples of contracts that are likely to qualify as insurance contracts are:

- investment contracts with a guaranteed death benefit that significantly exceeds the amount payable if the policyholder survives until the maturity of the contract; and

- deferred annuities, where the policyholder has a right to convert an investment contract into a life-contingent annuity at a pre-determined or guaranteed annuity rate.

Accounting policies for insurance contracts

In order to allow an insurer to continue using its existing accounting practices for insurance contracts as much as possible, IFRS 4 exempts an entity from applying the 'GAAP hierarchy' in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to insurance contracts in the absence of specific requirements in other standards. It also provides an exemption from certain other requirements. For example, under IFRS 4 an entity is not required to eliminate excessive prudence in accounting for insurance contracts nor, on consolidation, to apply consistent accounting principles to insurance contracts held by each entity within a group. There also is no requirement to use discounting in the measurement of insurance liabilities.

An insurer is permitted to make changes in accounting policies as long as it can demonstrate that the change, or a combination of changes implemented together, improves either the relevance or the

© 2004 KPMG International. KPMG International is a Swiss cooperative of which all KPMG firms are members. KPMG International provides no services to clients.
Each member firm is a separate and independent legal entity and each describes itself as such. All rights reserved.

reliability of its financial statements without reducing either. It is permitted, for example, to change a policy in order to:

- remeasure some insurance liabilities (but not necessarily all of them) to reflect changes in interest rates or other current market assumptions;
- switch to a comprehensive, investor-oriented model for insurance policy liabilities such as US GAAP; or
- apply 'shadow accounting' to remeasure insurance liabilities to reflect unrealised gains and losses on directly related assets. If unrealised gains and losses on the related assets are recognised in equity (as will be the case where related assets are classified as available-for-sale under IAS 39), corresponding unrealised losses and gains on the insurance liability also may be recognised directly in equity.

Deposit components and embedded derivatives in insurance contracts

Some insurance contracts contain a deposit component, which is a component that would, if it were a stand-alone instrument, be within the scope of IAS 39. An example is certain reinsurance contracts where any claims received from a reinsurer are reimbursed to the reinsurer by increases in future premiums paid to the reinsurer. Under IFRS 4 the deposit component is required to be unbundled and accounted for under IAS 39 if the deposit component can be measured separately, without considering the insurance component, and if all obligations and rights under the deposit component would not otherwise be recognised under the insurer's accounting policies.

IFRS 4 provides three significant exceptions to the requirement of IAS 39 to separate embedded derivatives. IAS 39 requires a derivative embedded in another contract, including a host insurance contract, to be separated and marked-to-market when its economics are not closely related to those of the host contract. Generally, an embedded derivative linked to interest rates would be considered closely related to a host insurance contract, as long as it is not leveraged.

The three exemptions provided in IFRS 4 regarding embedded derivatives are described below.

- An embedded derivative that meets the definition of an insurance contract need not be separated. For example, an option to take a life-contingent annuity contract would not be separated from a host insurance contract.
- An insurer need not separate a fixed-price surrender option from a host insurance liability, or a surrender option linked to an interest rate.
- Liabilities under unit-linked contracts may be measured at their unit values without the need to separate a host deposit contract and embedded derivative.

The liability adequacy test

An insurer must assess at each balance sheet date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under insurance contracts. Any adjustment is recognised in profit or loss.

The minimum requirement for the test is that it considers all contractual cash flows as well as cash flows resulting from embedded options and guarantees. If an insurer's existing accounting policies include a test that meets this requirement, no further test is required. If it does not, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* must be applied to determine whether the recognised liabilities are adequate. This requirement creates a powerful incentive for an insurer to introduce the minimum test before the date at which IFRS 4 is first applied.

Contracts with discretionary participation features

A discretionary participation feature is a contractual right of the investor or policyholder to receive, in addition to guaranteed benefits, significant additional benefits based on the performance of a pool of assets. The amount or timing of the policyholder's participation is at the discretion of the issuer. Such contracts may be insurance contracts or investment contracts, and often are described as 'with profits' contracts.

The guaranteed amount, to which the policyholder has an unconditional right, is classified as a liability. The discretionary amount may be classified as a liability or equity. IFRS 4 allows either presentation as long as the basis used is applied consistently. All premiums received may be recognised as revenue.

When the contract (i) is classified as an investment contract because it does not contain significant insurance risk, and (ii) some or all of the discretionary feature is classified as equity, then the liability amount must include, at a minimum, the amount that would be recognised for the guaranteed element under IAS 39.

Investment assets

With the exception of DAC on insurance contracts, VOBA and reinsurance assets, an insurer's accounting on the asset side will follow other applicable standards within IFRSs. An insurer's financial assets will be accounted for under IAS 39. Most of an insurer's investments are likely to be classified as available-for-sale and measured at fair value, generally with fair value changes recognised directly in equity. In some cases, fair value changes will, or may, be recognised directly in profit or loss.

Investments generally will be measured at amortised cost under IAS 39 only if the strict requirements for held-to-maturity classification can be met. This may apply to some, but is unlikely to apply to all, of an insurer's investment portfolios.

© 2004 KPMG International. KPMG International is a Swiss cooperative of which all KPMG firms are members. KPMG International provides no services to clients. Each member firm is a separate and independent legal entity and each describes itself as such. All rights reserved.

Disclosure

An insurer is required to disclose information that explains the amounts in the balance sheet and income statement arising from insurance contracts. Disclosure of information on the likely amounts, timing and uncertainty of future cash flows arising from insurance contracts also is required.

In addition to disclosing its accounting policies for insurance contracts, the amounts recognised in the financial statements, and reconciliations of those amounts, an insurer is required to disclose:

- how significant actuarial assumptions are determined, if practicable, the assumptions themselves, and the impact of changes in the assumptions;
- its risk management objectives and policies for insurance risk;
- the sensitivity of profit or loss and equity to changes in insurance risk, and concentrations of insurance risk; and
- claims development information, covering all periods for which material claims (for which uncertainty remains) are outstanding, up to a maximum of 10 years.

Financial guarantee contracts

Financial guarantee contracts that meet the definition of an insurance contract are within the scope of IFRS 4. The IASB intends to issue an exposure draft shortly, proposing that these contracts be accounted for initially at their fair value and subsequently at the higher of this amount and the provision (if any) required under IAS 37. Meanwhile, the similar requirement in IAS 39 (revised December 2003) has been withdrawn temporarily.

Transitional provisions

An existing IFRS reporter must apply the requirements of IFRS 4 retrospectively. Opening retained earnings at the beginning of the earliest reporting period presented should be adjusted. Comparative income statements, balance sheets and statements of changes in equity also should be restated. The only exception to this requirement is when it is impracticable to apply the liability adequacy test in the comparative periods.

However, an amendment to IFRS 1 *First-time Adoption of IFRSs* provides an exemption from applying IFRS 4 to comparative information for a first-time adopter of IFRSs. This is consistent with the exemption for first-time adopters in respect of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39.

An entity, whether a first-time adopter or an existing reporter under IFRSs, is not required to apply some of the disclosure requirements to its comparative periods. For example, actuarial assumptions, sensitivity analysis and insurance risk management policies are not required disclosures in an entity's comparative information for 2004 and earlier periods. Claims development disclosure also is not required in respect of reporting periods more than five years before an insurer's first IFRSs reporting date.

As IFRS 4 largely allows entities to continue using their national GAAP accounting policies upon adoption of IFRSs, entities may wish to consider adopting new accounting policies (e.g., the minimum loss recognition test), to the extent possible under national GAAP, prior to adoption of IFRSs.

If you would like further information on any of the matters discussed in this IASB*riefing*, please talk to your usual local KPMG contact or call any of our member firm offices.

www.kpmg.com

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

KPMG International, a Swiss cooperative, is a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

IASB*riefing* – Issue 23 April 2004

This publication is prepared by KPMG's International Financial Reporting Group.

© 2004 KPMG International. KPMG International is a Swiss cooperative of which all KPMG firms are members. KPMG International provides no services to clients. Each member firm is a separate and independent legal entity and each describes itself as such. All rights reserved.