KPMG

# IFRS Notes

## The implementation group in the insurance sector submits its report on Ind AS to IRDAI

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## Introduction

On 30 December 2016, the Insurance Regulatory and Development Authority of India (IRDAI) released the 'Report of the Implementation Group (IG) on Indian Accounting Standards (Ind AS) in the insurance sector in India' (the report).

The report includes the recommendations of the IG, which was constituted to examine the implications of implementing Ind AS, address the implementation issues and facilitate the formulation of operational guidelines to converge with Ind AS in the Indian insurance sector.

### Important developments

**17 November 2015**
IRDAI recommended a road map for insurance companies and constituted the IG

**7 December 2015**
IRDAI issued a discussion paper on convergence with Ind AS

**30 March 2016**
MCA notified Ind AS implementation road map for insurance companies from 1 April 2018

**30 December 2016**
Report by the IG on implementation of Ind AS in the insurance sector released

(Source: KPMG in India's analysis, 2017)

## Background

The IRDAI through its order dated 17 November 2015 stated that the insurance sector in India would converge with International Financial Reporting Standards (IFRS) after the issuance of the revised standard on insurance contracts i.e. IFRS 4, *Insurance Contracts* by the International Accounting Standards Board (IASB). IFRS 4 is currently under deliberation by the IASB. However, in order to prepare the Indian insurance sector towards convergence with Ind AS, the IRDAI constituted an IG under the Chairmanship of Smt. V.R Iyer.

Further, the Ministry of Corporate Affairs (MCA) on 30 March 2016 notified the road map for implementation of Ind AS for Scheduled Commercial Banks, insurance companies and Non-banking Financial Companies (NBFCs) from 1 April 2018 onwards.

Recently, the IG submitted its report to the IRDAI, highlighting the potential Ind AS implementation issues for insurers in India along with its recommendations to ease out the implementation process.

In formulating its recommendations, the IG adopted a consultative approach and held outreach meetings with insurers and other stakeholders. The IG also reviewed several extant stipulations and guidelines as well as the Ind AS notified by the MCA to identify potential implementation issues. The recommendations in the report are generic in nature and are applicable to the insurance industry as a whole. However, the report does not deal with the impact on taxation arising due to transition to Ind AS.

The recommendations in the report are divided into the following key areas with a focus on standards relating to insurance contracts and financial instruments:

i. Ind AS 101, *First-time adoption of Indian Accounting Standards*

ii. Ind AS 104, *Insurance Contracts*

iii. Ind AS 109, *Financial Instruments*

iv. All other Ind AS

v. Presentation of financial statements.

Additionally, the IG has recommended Ind AS compliant formats for preparation of financial statements of insurers.

This edition of IFRS Notes provides an overview of the key recommendations in the report.

## Overview of the report

The following sections highlight significant Ind AS implementation issues deliberated by the IG and the related recommendations.

### I. Ind AS 101, *First-time adoption of Indian Accounting Standards* - Transitional provisions

- Ind AS 40, *Investment Property* requires entities to follow a cost based measurement model for all investment property with disclosures of fair value.
- However, life insurance companies are mandated to revalue investment property every three years under IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 (the Regulations). Accordingly, these companies would be permitted to either:
    a) Consider the carrying amount of their investment property under the previous GAAP as deemed cost under paragraph D7AA of Ind AS 101, or
    b) Remeasure the cost of investment property on the date of transition by retrospectively following the cost model.

*Recommendations*

- The existing stipulations should continue, i.e., life companies to revalue investment property at a minimum every three years and general insurance companies to continue with cost-based measurement.
- IRDAI may provide a regulatory override requiring life insurance companies to continue the existing practice of revaluing investment property, unless Ind AS 40 is amended to permit a fair value option.

### II. Ind AS 104, *Insurance Contracts*

The recommendations of the IG are based on Ind AS 104 which is consistent with the current IFRS 4 (Phase I). However, IFRS 4 Phase II is expected to be issued by the IASB with a likely application date of January 2020. Consequently, the following recommendations are expected to apply for a limited implementation period, until the Ind AS equivalent of IFRS 4 Phase II is notified and becomes applicable.

#### Determination of an insurance contract

- The sole definition that needs to be applied in determining whether a contract is an insurance contract is the existence of *significant* insurance risk.
- As per Ind AS 104, *significant* risk exists when an insured event causes an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.
- Analysis based on information obtained by the IG indicates that all products currently offered by general insurers meet the definition of an insurance contract under Ind AS. While some diversity in practice exists for life insurers, the new product regulations stipulate minimum death benefit of 105 per cent of premiums paid. This may be considered as significant risk cover, which is expected to meet the definition of an insurance contract.

*Recommendation*

IRDAI may consider specifying a minimum threshold for death benefits based on one of the three criteria recommended in the report, to ensure that these products meet the definition of an insurance contract.

#### Unbundling of deposit component

- As per paragraph 10(a) of Ind AS 104, unbundling of an insurance contract (comprising an insurance component and a deposit component) is *required* if both the given conditions are met:
    a) The insurer can measure the deposit component (including any embedded surrender options) separately (i.e. without considering the insurance component) and
    b) The insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
- As per paragraph 10(b) of Ind AS 104, unbundling is permitted, but *not required*, if the insurer can measure the deposit component separately as in (a) above but its 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.

*Recommendation*

- The present regulations require that all obligations and rights of an insurance contract are recognised on the balance sheet in separate line items either as liabilities, insurance reserves, etc. Therefore, paragraph 10(a) of Ind AS 104 would not apply to Indian insurance companies.
- Hence, all linked products (unit linked products and variable insurance products) and all non-linked products (including variable insurance products classified as non-linked products) are recommended not to be unbundled, as permitted by paragraph 10(b) of Ind AS 104.

## Overview of the report (cont.)

### Liability adequacy test

Ind AS 104 requires an insurer to assess, at the end of each reporting period, whether its recognised insurance liabilities are adequate using current estimates of future contractual cash flows and related cash flows such as claims handling costs, embedded options and guarantees. If the liability is inadequate, the entire deficiency is recognised in profit or loss.

*Recommendations*

- In accordance with existing regulations, life insurers are expected to be largely compliant with the minimum requirements of the liability adequacy test with changes being required to regulations relating to:
  a) Separate creation of an equalisation reserve which reflects the undeclared bonus and is a part of the insurance liabilities, and
  b) Discontinuing the current practice of showing the lapsed provisions for non-linked policies under the funds for future appropriation and recognising the entire liability until the end of the revival period for policies that have lapsed.
- For general, health and reinsurers, the existing practice of estimating the reserve for unexpired risk and the premium deficiency reserve may require modification to reflect the current estimates of all contractual cash flows and related cash flows.

### Disclosure requirements

Paragraphs 36 to 39A of Ind AS 104 prescribe disclosures that are required pertaining to explanation of recognised amounts and nature and extents of risks arising from insurance contracts.

*Recommendations*

- In order to ensure compliance with the disclosure requirements, an insurance company would need to determine the data available with it and then would need to collate it suitably.
- In case the information required to be disclosed is not available then it is suggested that insurance companies embark on the task of collating the same and then vetting it for completeness, accuracy and appropriateness.

### Others

Following are some of the other areas identified and clarified with respect to implementation of Ind AS 104:

- **Applicability of Companies Act, 2013 (2013 Act) to deposit components:** The requirements of the 2013 Act relating to acceptance of deposits would not apply to any amount identified for recognition as a deposit component as the purpose of Ind AS is only to provide a reporting framework for financial statements. The operational matters and business environment are governed by the Insurance Act, 1938 and IRDAI Act, 1999 respectively.
- **Discretionary participation feature:** Under unit linked products, some products are offered with discretionary participation feature. However, the assets supporting the guaranteed element and the discretionary participating feature are part of one fund and cannot be separated. Hence, the whole contract should be classified as a liability.
- **Shadow accounting:** Paragraph 30 of Ind AS 104 permits a preparer to adjust the insurance liability (net of deferred acquisition costs or the intangible asset), to be recognised in Other Comprehensive Income (OCI), if and only if, unrealised gains or losses on an asset affect the measurement of the insurance liability and are recognised in OCI. This is called 'shadow accounting' and would not apply to insurance companies in India.

## III. Ind AS 109, *Financial Instruments*

### Accounting for unquoted equity instruments

- Ind AS 27, *Separate financial statements* permits measurement of investments in subsidiaries, associates and joint ventures either at cost or in accordance with Ind AS 109 in separate financial statements of the parent entity.
- Investments in equity instruments are measured at fair value as per Ind AS 109.

*Recommendations*

- The IG recommended that cost may be mandated by the IRDAI as the basis for the accounting for investments in subsidiaries, associates and joint ventures in separate financial statements of the parent.
- Fair value would be more relevant as a measure even for unquoted equity instruments. IRDAI may consider providing guidance on the treatment of unrealised gains or losses on such unquoted equity instruments for solvency/dividend distribution purposes.

### Initial recognition at trade date

- Ind AS 109 allows the option to use either trade date or settlement date accounting in case of regular purchase or sale of a financial asset.
- Trade date refers to the date that an entity commits itself to purchase or sell an asset.

*Recommendation*

Trade date accounting may be prescribed as the uniform basis of initial recognition of securities by all insurers.

## Overview of the report (cont.)

### Fair value measurement

- As per Ind AS 109, when an entity first recognises a financial asset, it should measure it at its fair value plus or minus, in the case of a financial asset not at Fair Value Through Profit and Loss (FVTPL), transaction costs that are directly attributable to the acquisition or issue of the financial asset.
- Transition to fair value seems difficult on account of the absence of active markets for corporate bonds and loans, differences with current IRDAI stipulation of valuation under the Regulations, absence of an established body of accredited valuers and lack of adequate historical experience in the use of fair value by insurers.

*Recommendations*

- In cases where quoted prices are available on active markets, fair value measurement may be carried out on this basis without the need for any regulatory guidance on the matter.
- In cases where quoted prices are not available but there are sufficient market observable inputs available, an independent agency such as Fixed Income Money Market and Derivatives Association of India (FIMMDA) may develop the mechanisms to provide valuations for various instruments, taking into account the requirements of Ind AS 113, *Fair Value*. The use of an independent agency specifying the valuation would provide guidance to market participants as well as facilitate consistent application across the insurance industry. In order to improve credibility of such a methodology, the assumptions and basis for the unobservable inputs should be published in a transparent manner.
- In certain cases involving complex and highly illiquid instruments, it may be necessary to have valuations certified by an external valuer/expert.
- IRDAI may consider providing specific guidance on the treatment of reserves created in OCI (relating to unrealised gains or losses) as 'free reserves' for distribution of dividend or consideration of solvency.
- IRDAI may also consider reviewing limits on investments in unlisted securities.

### Hedge accounting and derivatives

- Ind AS 109 requires the recognition and initial measurement of all derivatives on the balance sheet at fair value.
- The identification of embedded derivatives in insurance or investment contracts and subsequent measurement at fair value may pose a significant challenge.

*Recommendation*

The IRDAI may consider permitting insurance companies to hedge their Fair Value Through Other Comprehensive Income (FVTOCI) investments (debt and equity) to mitigate accounting and economic volatility.

### Impairment and Expected Credit Losses (ECL)

- Ind AS 109 has a single impairment model that applies to all financial assets classified as at amortised cost and as at FVTOCI, as well as lease receivables, trade receivables, commitments to lend money and financial guarantee contracts.
- It is not necessary for a loss event to occur before an impairment loss is recognised. Hence, all financial assets in scope are expected to carry a loss allowance.

*Recommendation*

For Indian rupee denominated Government of India securities, the practical application of ECL rules would lead to a zero loss provision being established.

## IV. All other Ind AS

The IG considered the following Ind AS as specifically not applicable to the insurance sector in India:

a) Ind AS 2, *Inventories*

b) Ind AS 29, *Financial Reporting in Hyperinflationary Economies*

c) Ind AS 106, *Exploration for and Evaluation of Mineral Resources*

d) Ind AS 114, *Regulatory deferral accounts*

e) Ind AS 41, *Agriculture.*

### Ind AS 7, *Statement of Cash Flows*

- Ind AS 7 permits entities to provide cash flow statements under both direct as well as indirect method.
- The present Regulations, mandate that only direct method be followed for insurance companies.

*Recommendations*

- Cash flow statements to be prepared as per the direct method as mandated by the Regulations, even though the option of preparing cash flow statements as per indirect method is available under Ind AS 7.
- IRDAI may consider allowing the option of the indirect method to reinsurance companies.

## Overview of the report (cont.)

### V. Presentation of financial statements

- A complete set of financial statements compliant with Ind AS as well as the Regulations should comprise the following:

  a) Balance sheet (including statement of changes in equity), in accordance with Ind AS 1, *Presentation of Financial Statements*

  b) Statement of profit and loss for the period, in accordance with Ind AS 1

  c) Revenue account (policyholders' account) and profit and loss account (shareholders' account), as required by the Insurance Act, 1938

  d) Receipts and payments account (Cash flow statement as per the direct method in accordance with Ind AS 7)

  e) Notes including:
     – Summary of significant accounting policies
     – Other explanatory notes annexed to, or forming part of, any document referred above.

  f) Comparative information in respect of the preceding period.

- Additionally, following draft regulations have been prescribed by the IG:

  a) Draft notification containing short title of commencement, definitions and preparation of financial statements as per Schedule A and Schedule B.

  b) Schedule A (for life insurance business) and Schedule B (for general insurance business including health and reinsurance business) comprises following:
     i. Part I: Accounting principles for preparation of financial statements
     ii. Part II: General instructions for preparation of financial statements
     iii. Part III: Balance sheet including statement of changes in equity
     iv. Part IV: Statement of profit and loss, revenue (policyholders) and profit and loss (shareholders) account
     v. Part V: Other disclosures.

## Our comments

Insurance companies should take note of the issues and recommendations considered in the report as they are expected to reduce the complexities involved during implementation of Ind AS. With Ind AS being applicable to insurance companies from 1 April 2018 onwards, the report provides timely guidance on the application of significant standards, including Ind AS 104 and Ind AS 109.

However, the following aspects may be considered further:

- Internationally, the difference in the application dates of IFRS 9 (1 January 2018) and the new standard on insurance contracts (expected application date of 1 January 2020) is likely to have a significant impact on insurers, leading to concerns regarding temporary accounting mismatches and volatility. In September 2016 the IASB issued an amendment to IFRS 4 that provided the following two optional approaches for such entities:

  - **Temporary exemption from IFRS 9:** Companies with activities that are predominantly connected with insurance are permitted to continue applying IAS 39, *Financial Instruments: Recognition and Measurement* rather than implementing IFRS 9.
  - **Overlay approach**: This is a presentation approach that alleviates temporary accounting mismatches and volatility by permitting a company to reclassify from the statement of profit and loss to OCI, the difference between amounts that are recognised in profit or loss under IFRS 9 and those that would have been recognised under IAS 39.

  The report of the IG does not consider or comment on the applicability of these exemptions to insurance companies in India. A similar exemption has not been included in the current version of Ind AS 104. Since Ind AS 109 would apply to Indian insurers before the new standard on insurance contracts, similar concerns on volatility and accounting mismatches are likely to arise. The IG and the IRDAI may consider providing further guidance or clarification on this aspect.

- The recommendations in the report broadly indicate that current accounting practices followed by Indian insurance companies (based on current regulation) are generally in accordance with the requirements of Ind AS, with minor changes. However, the new standard on insurance contracts (IFRS 4 Phase II) is expected to be issued shortly and be applied internationally from 2020 onwards. Therefore, the applicability of this new standard to Indian insurers assumes greater relevance as the current standard is expected to apply only for the first two years of Ind AS implementation.

## Our comments (cont.)

- The report identifies certain areas where changes to regulation may be required or further guidance is required from IRDAI. Some of these areas are of significance, such as the impact on solvency, 'free reserves' for distribution as dividend and measurement of investment property by life insurers. Hence, insurance companies in India should continue to track further steps taken by IRDAI based on the recommendations in the report to determine their impact on Ind AS implementation.

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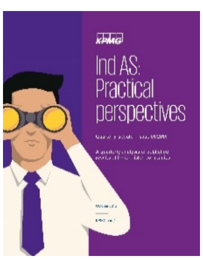
The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

## Ind AS - Practical perspectives



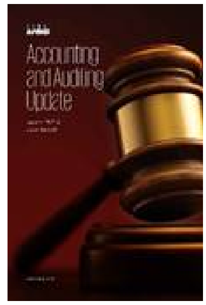

**KPMG in India's Ind AS - Practical perspectives through aims to put a finger on the pulse of India Inc's adoption of Ind AS and capture emerging trends and practices.**

Our impact assessment is based on Nifty 50 companies which would be the first group of companies to report Ind AS results. The Nifty 50 companies have started reporting their financial results for the quarter ended 30 September 2016.

Out of the companies comprising Nifty 50 index, eight companies are banks, one is a Non-Banking Financial Company (NBFC) and two companies follow a different date of transition to Ind AS. Therefore, our analysis would comprise the remaining 39 companies.

This can be accessed on KPMG in India website - 'Ind AS- Practical perspectives' webpage

## Missed an issue of our Accounting and Auditing Update or First Notes




**Issue no. 5/2016 – December 2016**

This month the Accounting and Auditing Update focusses on the recent updates from the regulators in India and emerging new trends in the field of accounting and auditing. This edition includes a detailed analysis on the recently notified sections of the Companies Act, 2013 relating to restructuring, amalgamation and winding-up of companies. The notification of these sections was much awaited and our article discusses the key provisions of the recently notified sections along with our comments.

This publication also carries an article on the revised guidance note on reports or certificates for special purposes issued by the Institute of Chartered Accountants of India. The article provides an overview of the key elements of the guidance note and highlights additional considerations for management of entities and practitioners.

Ind AS 110, *Consolidated Financial Statements* provides wider definition of control in comparison to Accounting Standards. The revised definition is expected to impact the current structures and give rise to certain practical issues while preparing consolidated financial statements. Our article highlights some of these issues and explains the accounting under Ind AS with the help of examples.

Additionally, this publication carries an article on low-interest and interest-free loans under Ind AS 109, *Financial Instruments.* The article on this topic explains the accounting with the help of detailed illustrative examples and a detailed flowchart. Our publication also carries a regular synopsis of regulatory updates.


**Provisions relating to merger, amalgamation and winding-up, etc. are notified under the Companies Act, 2013**

**12 December 2016**

On 7 December 2016, the Ministry of Corporate Affairs (MCA) issued a notification, whereby certain sections of the Companies Act, 2013 (2013 Act) were notified to come into force. These sections amongst others, relate to:

- reduction of capital and variations of shareholders' right;
- compromises, arrangements and amalgamations.

In addition to the above, certain winding-up sections were also notified by MCA. The notification states that the aforementioned sections would come into force on 15 December 2016.

MCA has also on 7 December 2016 notified the Companies (Transfer of Pending Proceedings), Rules 2016 (Transfer Rules) and also issued the Companies (Removal of Difficulties) Fourth Order, 2016 (Difficulties Order) to facilitate a smooth transition of the proceedings initiated under the Companies Act, 1956 (1956 Act) and pending before any district court or high courts to the National Company Law Tribunal (NCLT).

This issue of First Notes aims to provide an overview of these notifications.

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