Insurance Contracts
A new world for insurance

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IN THE HEADLINES

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The IASB has made great efforts to improve the proposals by addressing the key concerns of constituents while retaining the objective of a current value basis for measuring insurance liabilities – bringing a final IFRS standard for insurance a great deal closer.

– Frank Ellenbürger, KPMG’s global Head of Insurance

A new world for insurance

The new accounting and reporting model for insurance contracts proposed by the IASB on 20 June 2013 would completely overhaul the way an insurer’s financial statements look. The re-exposure draft would go some of the way towards addressing concerns that the changes to insurance and financial instruments accounting would create volatility in profit or loss. It would also provide a consistent reporting framework for use across and within entities.

The new proposals apply to all insurance contracts, including certain financial guarantees, rather than insurance entities, and to investment contracts with a discretionary participation feature (DPF) issued by insurance companies.

They introduce a number of significant changes in key areas that have been at the heart of the debate since the initial proposals were released in 2010, including:

- the use of other comprehensive income (OCI) to present changes in the measurement of insurance liabilities arising from changes in discount rates; and
- a new presentation approach for both the statement of profit or loss and OCI and the statement of financial position, which would significantly change the way insurers – in particular, life insurers – report performance.

Other major changes in the proposals include:

- an unlocked contractual service margin, which would change the timing of profit recognition;
- a mirroring approach, which would reduce accounting mismatches by better aligning the measurement of contracts whose cash flows vary with underlying items – e.g. participating or with-profits contracts and unit-linked contracts – with the measurement of those underlying items; and
- a retrospective approach for the transition to the new standard, with practical expedients.

There continues to be a simplified (or ‘premium-allocation’) measurement approach, which would be expected to reduce the operational complexity of applying the measurement model to short-duration contracts.

Increased volatility possible in profit or loss and equity

The proposals would be likely to result in an overall increase in volatility in profit or loss and equity for most insurers, as a result of having to remeasure insurance contract liabilities at a current value each period, rather than on an historical cost basis – i.e. rather than using locked-in assumptions.

One key issue relates to volatility arising when the measurement of insurance liabilities and the measurement of the assets that an insurer holds to back those liabilities respond in different ways to changes in interest rates. The re-exposure draft, in combination with proposed amendments to IFRS 9 Financial Instruments, aims to reduce this volatility in profit or loss. The effects of changes in discount rates on the valuation of an insurer’s liabilities and some of its financial assets would be stripped out of the income statement and presented in OCI. The discount rate determined at the insurance contract’s inception would be used for calculating interest expense in profit or loss, contributing to a more steady profit or loss result.

However, for some insurers this requirement might lead to accounting mismatches if the corresponding financial assets are classified under IFRS 9 as fair value through profit or loss (FVTPL) or amortised cost, rather than as fair value through OCI (FVOCI). The degree of volatility in profit or loss would depend heavily on how the assets are classified and measured. Even if financial assets are classified as FVOCI, accounting mismatches may result if those assets are sold.

In addition, those insurers writing long-term life business with options and guarantees may need to report changes in the value of these items in profit or loss. This is likely to spark debate as to whether further changes in the insurance liability should also be presented in OCI, and about the residual volatility expected in both profit or loss and equity.
Impact on reporting of operational performance

Measurement requirements

The proposed measurement model focuses on the drivers of an insurance contract’s profitability, and uses current estimates of cash flows discounted to reflect the time value of money. Changes in estimates of the present value of a contract’s future cash flows would be reflected in either profit or loss or OCI, or in some cases offset against the contractual service margin, depending on their nature. The aim of this presentation would be to clearly segregate the effects of the underwriting performance from the effects of changes in discount rates, and to include an amortised-cost based interest expense in profit or loss.

The overall impact on operating performance would be expected to be significant for most entities. In particular, life insurers issuing long-duration insurance contracts who currently use locked-in estimates of cash flows in measuring their contracts would be likely to experience shifts in earnings patterns. Non-life insurers would discount claims provisions at a current discount rate, and would recognise the unwind of a locked-in discount rate in profit or loss over the settlement period of the contract, resulting in a significant change in practice for many insurers.

Presentation requirements

A new earned-premium approach would apply in the statement of profit or loss and OCI, which would be unlike presentations used today for long-duration contracts. Insurance contract revenue (‘earned premiums’) would be based on the initial expected pattern of claims and benefits, revised to reflect revisions in estimates. This approach for estimating insurance contract revenue would be drastically different from presenting premiums when they are due.

For short-duration contracts using the simplified approach, premiums would be allocated over the coverage period in a way that best reflects the transfer of services.

Claims and expenses would be presented on the face of the statement of profit or loss and OCI as and when incurred. In addition, the amounts recognised for insurance contract revenue and incurred claims would exclude amounts that the insurer is obliged to pay to the policyholder or a beneficiary regardless of whether an insured event occurs – i.e. any ‘investment’ component.

As a result, the way in which performance is communicated would be likely to change. Traditional performance and volume metrics would be less familiar, and multi-line business may become more complex to explain. Non-GAAP measures may be used to explain financial performance, while greater emphasis would be placed on the entire statement of profit or loss and OCI.

Impact on users of the financial statements

Although the proposals would require premiums and claims to be reported in profit or loss, they would take on a whole new meaning for analysts and users. The ‘top line’ revenue number and some of the other line items presented in the statement of profit or loss and OCI could not be taken straight from the current chart of accounts and may not be straightforward to derive under the proposals. The proposals also include extensive new disclosure requirements.

Educating both preparers and stakeholders about the new basis of reporting may take significant time and effort.

Capital management and regulatory requirements may be affected in some jurisdictions

For entities using insurance liabilities based on IFRS financial statements to calculate regulatory capital requirements, volatility in IFRS equity could have a direct effect on regulatory capital and may affect decisions on capital management.

Some entities might be able to reduce the effort of implementing the insurance proposals by leveraging the work needed to enhance systems and processes for ongoing regulatory initiatives – e.g. Solvency II and Solvency Modernization.

“This would be the biggest ever financial reporting change for most insurers – far surpassing the adoption of IFRS. The extent of change would be far-reaching and there is no question that insurers’ financial statements would look very different compared to today.”

– Joachim Kölschbach
KPMG’s global IFRS insurance leader
If insurers start planning now, the wave of change could open up opportunities for synergies in areas such as data collection, modelling capability and investment in systems and resources. The bottom line is that the technical aspects of the proposals would need to be made operational.

– Gary Reader
KPMG’s global insurance advisory leader

**Impact on asset-liability management**

The insurance proposals provide a limited ability to redesignate some financial assets on initial application. As a result, entities may consider whether it is appropriate to redesignate some financial assets on initial application of the insurance proposals.

The effective date of IFRS 9 is currently 1 January 2015, and although it is expected to be deferred, the requirements of IFRS 9 may come into effect before the insurance proposals. Therefore, the need for entities to consider the implications for asset-liability management would be accelerated.

**Broad business impacts expected**

The proposed requirements may change an entity’s decisions on product design, features and pricing. In applying the proposed measurement model, profit profiles of certain products may change, and more volatile products may become less desirable – e.g. long-tailed products (annuities, workers compensation), spread-business products (universal life, fixed annuities) and investment-orientated products with guarantees (variable annuities).

**Significant impacts expected on systems, processes and people**

The new measurement model and the transition requirements would require entities to retain large amounts of historic and current data, which may necessitate systems upgrades. Most insurers are likely to be affected, and would need to develop, test and implement any new processes and systems for collecting and presenting financial information before the new standard’s effective date. The proposals’ complexity may also place more pressure on timelines for preparing this information.

Implementing the proposals would also be expected to create a heavy demand for resources, with additional resources potentially needed to manage transition, actuarial and reporting processes, and system upgrades.

Accountants and actuaries would need to understand the impacts on their own, and each other’s, roles. Meanwhile, senior management and investor relations personnel would need training on how to explain the financial results – particularly the new financial statement presentation and the potential for increased volatility – to shareholders and external analysts.

In addition, the proposed presentation requirements may lead entities to change their traditional performance measures, resulting in changes to compensation arrangements and performance targets.

**A profound impact on financial statements and your organisation**

Preparing for the far-reaching impacts of these changes may take considerable effort, so companies may wish to start proactively assessing and managing the whole transition process now.

**Comments are due to the IASB by 25 October 2013.**
Basic facts

Building-block approach

The proposed measurement model is based on a current fulfilment value, and comprises four building blocks:

- explicit, unbiased and probability-weighted estimates of future cash flows;
- discounting to reflect the time value of money;
- an explicit risk adjustment; and
- a contractual service margin to eliminate any gain at inception.

An entity would be required to update estimates of its insurance liabilities each reporting period using current market-consistent information.

Premium-allocation approach

A simplified premium-allocation approach for measuring the insurance contract liability would be available for contracts that:

- have a coverage period of one year or less; or
- would produce measurements that are a reasonable approximation to those that would be produced when applying the building-block approach.

Under this simplified approach, the insurance liability would be split into two components.

- A pre-claims liability (liability for remaining coverage), measured at the value of the premium received at the contract’s inception less directly attributable acquisition costs that are not expensed as incurred (plus any onerous contract liability if applicable). The pre-claims liability would subsequently be released over the coverage period.
- A liability for incurred claims, measured at the present value of fulfilment cash flows in line with the building-block approach.

The measurement and recognition of the pre-claims liability would be very similar to current practice for non-life insurers. However, both the pre-claims liability and the liability for incurred claims would reflect the time value of money if significant.

To reduce some of the complexities in applying the premium-allocation approach, the revised proposals include a number of practical expedients for discounting, which are closely aligned with the revenue recognition proposals.
Convergence between IASB and FASB models

The IASB developed the proposals in the re-exposure draft jointly with the FASB. The IASB and the FASB reached the same conclusions in many areas, but reached different conclusions on some limited aspects – e.g. scope and certain aspects of the measurement model. To the extent that the IASB and FASB models do not further converge, there may be additional complexity for entities that will need to prepare financial data under both sets of standards – e.g. US subsidiaries of entities reporting under IFRS and foreign subsidiaries of US entities.

The FASB is expected to publish its exposure draft shortly, and its comment period is expected to follow a similar timeline to that of the IASB’s proposals.

Find out more

For more information on the proposals, please go to the IASB press release, or speak to your usual KPMG contact.

Timeline

20 June 2013:
Re-exposure draft published

25 October 2013:
Comment period ends

1 January 2017:
Earliest possible effective date

1 The IASB has estimated that the effective date will be approximately three years from the date of publication of the final standard, and has stated that it expects that the earliest possible mandatory effective date will be 1 January 2017.