IFRS Notes

The IASB issues IFRS 17, *Insurance Contracts*

25 May 2017

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Introduction

On 18 May 2017, the International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS) 17, *Insurance Contracts.* IFRS 17 is the first comprehensive international standard which provides guidance on accounting for insurance contracts.

IFRS 17 replaces IFRS 4, *Insurance Contracts,* which was in the nature of an interim standard pending the completion of the project on insurance contracts by the IASB.

Background

IFRS 4 was issued by the IASB as an interim standard in 2004. This standard was meant to limit changes to existing insurance accounting practices. Hence, it gave companies dispensation to continue accounting for insurance contracts using national accounting standards which resulted in a multitude of different approaches. This made it difficult for investors to compare and contrast the financial performance of otherwise similar companies.

The IASB completed its project of replacing IFRS 4 with a new comprehensive standard and issued IFRS 17 on 18 May 2017.

IFRS 17 is expected to resolve the comparison problems created by IFRS 4 by requiring all insurance contracts to be accounted for in a consistent manner, and is expected to benefit both investors and insurance companies.

This issue of IFRS Notes provides an overview of the requirements prescribed in IFRS 17.

Overview of IFRS 17

Accounting for insurance contracts

As stated in IASB's Project Summary on IFRS 17, insurance contracts generally have the following features:

a) They often cover difficult-to-measure long-term and complex risks, with uncertain outcomes

b) They are not typically traded in markets and

c) They may include a significant deposit component - the amount the insurer is obligated to pay the policyholder regardless of whether the insured event occurs.

A new, comprehensive accounting model - General measurement model

IFRS 17 has introduced a new and comprehensive model (general measurement model) which has the following features:

- Based on a fulfillment objective and uses current assumptions
- Establishes a single, revenue recognition principle to reflect services provided
- Is modified for certain contracts.

The approach has been discussed in detail in the following section.

General measurement model

IFRS 17 requires a company that issues insurance contracts to initially recognise and report them on the balance sheet as the total of the following components:

a) The fulfilment cash flows: The current estimates of amounts that the insurer expects to collect from premiums and pay out for claims, benefits and expenses, including an adjustment for the timing and risk of those cash flows.

Measurement of the fulfilment cash flows would reflect the current value of any interest-rate guarantees and financial options included in the insurance contracts. IFRS 17 requires a company to update the fulfilment cash flows at each reporting date, using current estimates that are consistent with relevant market information.

b) The Contractual Service Margin (CSM): The expected profit for providing future insurance coverage (i.e. unearned profit).

The total liability for a group of insurance contracts is to be subsequently measured as the aggregate of the following components:

a) Liability for remaining coverage (LRC): The sum of the fulfilment cash flows related to future services and the CSM remaining.

b) Liability for incurred claims (LIC): The fulfilment cash flows for claims incurred, but not yet paid.

Overview of IFRS 17 (cont.)

Insurance revenue

Insurance revenue is derived from the changes in the LRC for each reporting period which covers the following:

a) Expected insurance claims and expenses
b) Risk adjustment
c) CSM allocation
d) Acquisition cash flows.

These items represent a company's consideration for providing services. IFRS 17 excludes from insurance revenue, those deposits that represent the investment of the policyholder rather than an amount charged for services.

IFRS 17 prescribes the following treatment for recognition of revenue:

- **Timing of revenue recognition**: IFRS 17 requires a company to report the amount charged for insurance coverage as insurance revenue when it is earned, rather than when the company receives premiums.
- **Level of aggregation:** The CSM is determined for groups of insurance contracts. Insurers are required to recognise in the statement of profit and loss, the expected profit for providing coverage for a group of contracts as the coverage is provided over time. Expected losses for a group of contracts are to be recognised in the statement of profit and loss as soon as a company determines that they are expected.

  In order to do so, an insurer is required to aggregate their contracts first into portfolios (contracts subject to similar risks and managed together), which are further divided into groups considering the differences in expected profitability. Specifically, contracts that are expected to be onerous are grouped separately since expected losses are to be recognised immediately and cannot be offset against profits from other contracts. This means that insurers are required to account for their business performance at a more granular level.

Modification to the general measurement model

IFRS 17 introduces the following two modified approaches to the general measurement model.

a) *Premium Allocation Approach:* When applying IFRS 17, a company may use this optional simplified approach to measure the LRC for short duration insurance contracts – i.e. contracts for which the company does not expect significant changes in estimates before the claims are incurred, or for which the coverage period is less than a year.

   Under this approach, the total liability of a group of insurance contracts would comprise the LRC and LIC. The liability for incurred claims may need to be discounted. The premium relating to the remaining coverage is recognised over time as revenue unless release of risk follows a different pattern in this approach. Therefore, under this approach the pattern of revenue recognition could differ from the general measurement model.

b) *Variable Fee Approach:* 'Insurance contracts with direct participation features' are those which have returns based on the fair value of certain underlying items. The insurer and its policyholders share those returns, which are affected by market-driven changes in the fair value of the underlying, e.g., shares.

   IFRS 17 introduces a specific approach - the variable fee approach - wherein, it considers the variable fee associated with direct participating features. Such a variable fee has to be reduced from the obligation to pay fair value of underlying items to arrive at the obligation to policy holder.

   This approach is expected to reduce the volatility of net results reported by the insurer.

Insurance performance

- **Classification of profits**: IFRS 17 requires a company to provide information that distinguishes the two ways in which an insurer earn profits from the insurance contracts:

  a) *Insurance service result:* It should depict the profit earned from providing insurance coverage, and

  b) *Financial result:* It should cover the following:

     i. Investment income from managing financial assets, and

     ii. Insurance finance expenses from insurance obligations - the effects of discount rates and other financial variables on the value of insurance obligations.

- **Accounting for change in estimates**: On application of IFRS 17, changes in the estimates of the expected premiums and payments that relate to future insurance coverage would adjust the expected profit - i.e. the CSM for a group of insurance contracts would be increased or decreased by the effect of those changes.

  The effect of such changes in estimates would be recognised in the statement of profit and loss over the remaining coverage period as the CSM is earned by providing insurance coverage.

Overview of IFRS 17 (cont.)

If the amounts that the insurer expects to pay out for claims, benefits and expenses exceed the amounts that the insurer expects to collect from premiums, either at the inception of the contracts or subsequently, the contracts are then regarded as loss making and the difference would be recognised immediately in the statement of profit and loss.

Accounting for reinsurance contracts

In case of reinsurance contracts, the general measurement and premium allocation approaches would continue to apply with the following modifications:

- The reinsurance contract would be accounted for separately from the underlying direct contract
- Reinsurance gain or loss would be recognised as reinsurance services are received.

Presentation

- **Investment components are excluded from insurance revenue and service expenses**: IFRS 17 requires that insurance revenue should exclude those deposits that represent the investment of the policyholder, rather than an amount charged for services.

  Additionally, companies are required to present deposit repayments as settlements of liabilities instead of insurance expenses.

- **Change in discount rates:** Companies could opt to present the effect of changes in financial assumptions such as discount rates and other financial variables for each portfolio of insurance contracts in the statement of profit and loss or Other Comprehensive Income (OCI) to reduce volatility and minimise any accounting mismatches.

Disclosures

IFRS 17 requires disclosure of information at a level of granularity that would help users assess the effects the contracts would have on the following:

- Financial position
- Financial performance
- Cash flows.

These disclosures relate to expected profitability and attributes of a new business.

Effective date

IFRS 17 is effective from 1 January 2021. Early application of the standard is permitted only if the company also applies IFRS 9, *Financial Instruments* and IFRS 15, *Revenue from Contracts with Customers.*

Transitional provisions

IFRS 17 prescribes a full retrospective approach. However, companies can use either of the following expedients, in case it is impracticable to use a full retrospective approach:

- Modified retrospective approach, or
- Fair value approach.

Additionally, IFRS 17 permits a company that had applied IFRS 9 at an earlier date to reassess classifications of financial assets (i.e. how they are being measured) as per IFRS 9 based on the facts and circumstances that exist at the date of initial application of IFRS 17.

Our comments

With the issue of IFRS 17 (replacing IFRS 4), the IASB has introduced a consistent accounting framework for insurance companies across jurisdictions. However, the changes introduced by IFRS 17 are expected to affect the insurance companies operating in various jurisdictions differently, depending on the accounting practices being currently followed by them.

Some of the key changes introduced by the IFRS 17 and their impacts on insurance companies in India are summarised as below:

Non-life insurance contracts

- **Simplified approach for measurement of liabilities (less than one year)**: IFRS 17 provides an option to use a simplified approach (Premium Allocation Approach) for measurement of liabilities with a duration of less than one year in comparison to current methodology of measuring liability using the unearned premium method. Insurance contracts would be valued as pre-claims coverage liability and an incurred claims liability. Applying this approach may require companies to account for losses on insurance business at a more granular level and accounting for incurred claims may be more transparent but complex.

Our comments (cont.)

Non-life and life insurance contracts

- **Use of current market information while determining insurance obligations**: IFRS 17 requires that a company should update the measurement of insurance obligations at each reporting date, using current estimates of the amount, timing and uncertainty of cash flows and of discount rates, instead of historical information. Using updated assumptions about probability-weighted cash flows, discount rates and risk at each reporting date is expected to better reflect the manner in which a company expects to settle its insurance contract liabilities. It will also make visible any economic mismatch between the current value of assets and liabilities. Companies would have an option to reduce the volatility in the statement of profit and loss by recognising the change in fair value on account of movement in the discount rates in OCI.
- **Reporting period-end adjustment**: The overall adjustment at the end of the reporting period would include a contractual service margin, which represents the unearned profit on the insurance contracts. This would not have a significant impact for short duration non-life insurance contracts which are for less than one year.
- **Unbundling of embedded derivatives, investment and service components**: Insurance companies would need to unbundle any embedded derivatives, investment and service components in an insurance contract. Overall, revenue would now be recognised in line with the period over which the insurer provides its services. Further, reported revenue would represent insurance related services and exclude any investment components.
- **Incremental presentation and measurement requirements**: Insurers are required to track and recognise revenue relating to the CSM by grouping insurance contracts based on shared risks and characteristics and their year of issue. Further, contracts that are onerous at inception, contracts with no significant risk of becoming onerous and other contracts are to be identified for recognition of expected losses. This may give rise to some operational complexities. In addition, the new standard prescribes enhanced disclosures on areas where management judgement is exercised. Overall, the disclosure requirements are more extensive than applicable under the existing standard.

Impact under Ind AS

The Insurance Regulatory Development Authority of India (IRDAI) through its order dated 17 November 2015 stated that the insurance sector in India would converge with IFRS after the issuance of the revised standard on insurance contracts by the IASB. Subsequently, the Ministry of Corporate Affairs (MCA) on 30 March 2016 notified the road map for implementation of Indian Accounting Standards (Ind AS) for Scheduled Commercial Banks, insurance companies and Non-Banking Financial Companies (NBFCs) from 1 April 2018 onwards.

IRDAI also constituted an Implementation Group (IG) on 17 November 2015 to facilitate Ind AS convergence for the Indian insurance sector. On 30 December 2016, 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. However, the report is based on IFRS 4/Ind AS 104, *Insurance Contracts* and does not addresses the areas which have been identified as key changes in IFRS 17 vis-à-vis IFRS 4.

With Ind AS being applicable to the insurance companies from 1 April 2018, Indian insurance companies would have to apply Ind AS 104 (converged with IFRS 4) on transition to Ind AS. The requirements of IFRS 17 would apply to Indian insurance companies only when a converged standard is issued and notified by MCA and IRDAI. Further, IRDAI would need to assess the impact of the new standard and provide implementation guidance for Indian insurers.

However, insurance companies should commence assessing the requirements of the newly issued standard to determine the likely impact on their life and non-life businesses. Additionally, companies should also take note of the requirements of IFRS 17 and, review their contracts, plan their accounting policy decisions and determine their need for any change in the existing systems, processes and resources. This would assist them in preparing for this significant change when it becomes applicable in India.

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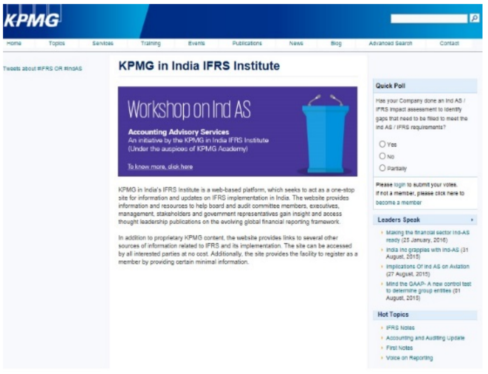
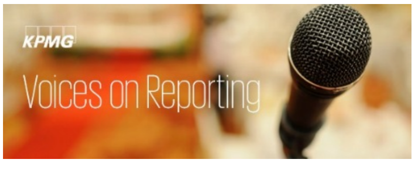


Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

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.

Voices on Reporting

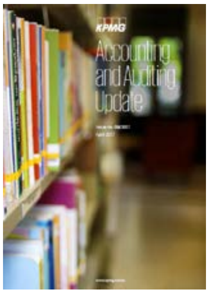


KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In our recent call held on 5 April 2017, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders for the quarter ended 31 March 2017.

Our call included updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc.

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



Issue no. 9/2017 – April 2017

This edition of Accounting and Auditing Update (AAU) covers an article on accounting of prior period errors and explains the guidance with the help of illustrative examples. Ind AS 8, *Accounting policies, Changes in Accounting Estimates and Errors* covers guidance on accounting for accounting of changes in accounting policies, estimates and prior period errors. The guidance on accounting of errors under Ind AS is wider than current Indian GAAP (Accounting Standards) and requires an entity to adjust material prior period errors retrospectively by restating the comparative amounts and opening retained earnings at the beginning of the earliest period presented in the balance sheet.

In this edition of AAU, we explain the accounting treatment of FCTR in various scenarios e.g. on first-time adoption of Ind AS, disposal, impairment, restructuring, etc. of a foreign operation.

Under the Companies Act, 2013 section of AAU, we highlight the regulatory requirements with regard to acceptance of deposits. This article captures the amendments and updates on the topic 'acceptance of deposits' by the Ministry of Corporate Affairs.

The IASB proposed certain amendments to IFRS 8. Our article summarises the amendments proposed by the IASB.

As is the case each month, we also cover a regular round-up of some recent regulatory updates in India.

CBDT issues draft ICDS on real estate transactions

15 May 2017

The Finance Minister constituted a Committee (the Committee) comprising of experts from accounting, departmental officers and representatives from the Institute of Chartered Accountants of India (ICAI) to recommend the areas in respect of which further ICDS may be notified under the IT Act.

The Committee vide a press release dated 11 May 2017 has issued the draft ICDS on real estate transactions (draft ICDS). The draft ICDS is based on the Guidance Note issued on *Real Estate Transactions* (ICAI GN) issued by ICAI in 2012. For the purposes of providing uniformity, certainty and harmonising the same with provisions of the IT Act, the Committee suggested certain changes in draft ICDS in comparison to the ICAI GN.

The draft ICDS is open for comments from stakeholders till 26 May 2017.

This issue of First Notes provides an overview of the draft ICDS issued by the MoF.

Previous editions are available to download from: www.kpmg.com/in