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INSURANCE DISPATCH

INSURANCE ACCOUNTING NEWSLETTER

Welcome to Insurance Dispatch.

In this edition we provide you with our insights into a number of accounting topics relevant to the insurance industry at the moment and we recap on some developments in areas we have previously discussed:

- IFRS 15 and its impact on insurance companies
- Further delay expected on IASB's standard on insurance contracts
- European insurers table alternative proposals for participating contracts
- IASB considering further transition relief on initial application of IFRS 4 in light of project delays
- Taking some pain out of IFRS 4: Harnessing Solvency II to create efficiencies

In the previous edition, we looked at FRS 103 Insurance Contracts, which was published by the FRC in March 2014, and considered some of the practical implementation issues when transitioning to the new UK GAAP framework. Now that the full suite of new UK GAAP standards is in effect, we expect insurers to be progressing with their implementation plan ahead of the 31 December 2015 year end reporting cycle. To help you navigate your way through the new requirements, we have a dedicated site with links to all our publications to date on the subject as well as external links to the full standards themselves. This site can be accessed by clicking here.

We also looked at IFRS 9 Financial Instruments, which becomes effective for 1 January 2018 and considered some of the features around the measurement and classification of financial assets which may have an impact on insurers. In this issue, we look at the transition relief proposed by the IASB to help insurers applying IFRS 9 and the new standard on insurance contracts within a potentially short space of time.

With a final accounting standard for insurance contracts now in sight, the industry is looking at the most effective way to implement IFRS with as little disruption to reporting as possible. Our podcast, Harnessing Solvency II to create efficiencies with IFRS 4 Phase II, covers key considerations for CFOs.

Within this issue, we take a look at the new revenue recognition standard, IFRS 15 Revenue from Contracts with Customers, and consider its potential impact on insurers. We also consider the alternative proposals for the treatment of participating contracts under IFRS 4 Phase 2, as issued by the European CFO Forum.

As always we value your thoughts and comments, so please do contact me or your usual KPMG contact, if you wish to discuss any of the issues highlighted in this edition.

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IFRS 15 and its impact on insurance companies

How could your business be affected?

Insurers should not underestimate the potential impact of IFRS 15, the new revenue standard that was published jointly by the IASB and FASB in May 2014. Although IFRS 15 does not apply directly to insurance contracts, it may apply to other arrangements which the insurer may have such as asset management, insurance broking, pension administration, claims handling or custody services.

Assessing the impact of IFRS 15 requires both an understanding of the new revenue recognition model and an analysis of how this new model applies to particular transactions that fall in the scope of the new standard.

IFRS 15 takes effect in January 2017, although IFRS preparers can choose to apply it earlier. While the effective date may seem a long way off, decisions need to be made soon – namely, when and how to transition to the new standard. An early decision will allow you to develop an efficient implementation plan and inform your key stakeholders.

Determining the impact

Area	Potential impact	Actions to consider
Contracts that are wholly, or partially, in the scope of IFRS 15	• Insurance contracts or contractual rights and obligations in the scope of the financial instruments guidance are fully, or partially, scoped out of IFRS 15. This is largely	• Determine which contracts fall entirely, or partially, in the scope of IFRS 15 through a comprehensive review of contracts with customers.

	consistent with current practice. • Non-insurance service contracts (such as asset management, insurance broking, pension administration, claims handling or custody services) may fall entirely in the scope of the new standard. • Contracts that are partially in the scope of another standard – e.g. investment management contracts that originate one or more financial instruments – are first subject to the requirements of the other standard if that standard specifies how to separate and/or initially measure one or more parts of the contract.	• Analyse at a high level the impact on the amount and timing of revenue recognition. • Identify data ‘gaps’ between what is presently available and what is necessary to meet the new requirements.

Bundled service contracts	• Non-insurance service contracts may integrate different services into a single package – e.g. administrative services, asset management and custody services. IFRS 15 includes new guidance for such arrangements, including:
	  • New separation criteria that may affect which services are bundled or unbundled; and
	  • New guidance on determining and allocating the transaction price for each performance obligation.
		• Evaluate bundled non-insurance service contracts against the new separation criteria.
		• Consider changes necessary for existing systems, processes and internal controls to facilitate new estimates and judgements.
		• Consider whether any contract terms should be modified for the impact of IFRS 15.

Non-refundable up-front fees	• Accounting for non-refundable up-front fees received at or near inception – e.g. front-end loaded fees received for investment management contracts – will depend on whether the fee: • Relates to a specific good or service transferred to the customer; or	• Assess the impact of new guidance on the timing of revenue recognition for any non-refundable up-front fees. • Determine whether the timing of the receipt of a non-refundable up-front fee creates a significant financing component in a contract.

	- Represents an advance payment for future goods and services in the contract, including future contract periods. - The new requirements may cause differences from current practice. - The timing of the receipt of an up-front fee in comparison to the transfer of services it relates to, may give rise to a significant financing component. In this case, the transaction price may need to be adjusted to reflect the time value of money, unless the practical expedient not to adjust for the time value of money when the time between receipt of cash and delivery of services is applicable and elected by the company.	
Contracts with variable consideration	- Insurers may earn performance-based incentive fees for investment management services, which are subject to the revenue 'constraint' under IFRS 15. - When determining the transaction price, a company estimates the amount of variable consideration using either the 'expected value' or 'most likely amount' method. - The estimated variable consideration is included in the transaction price to the extent it is highly probable that a significant revenue reversal will not subsequently occur.	- Consider whether new models or processes are needed to determine the transaction price. - Evaluate the impact of the new standard on internal management reporting and key performance indicators.
Costs related to in-scope contracts	Under IFRS 15, a company is required to capitalise certain costs incurred in obtaining and fulfilling a contract, if specified criteria are met. This may include capitalisation of broker commissions payable when an investment contract is	- Assess whether the current capitalisation policy is consistent with the new requirements. - Make changes to existing systems to capture the costs that will be capitalised and/or to reflect amortisation periods.

	obtained, unless the practical expedient not to capitalise fees that would be amortised within a year or less is applicable and elected by the company. • Capitalised costs are amortised on a systematic basis consistent with the transfer of the associated goods and services. • Judgement will be needed to determine the appropriate period and pattern of amortisation – e.g. whether the amortisation period should include anticipated future contract periods. These may differ from the amortisation period of similar costs incurred to obtain insurance contracts.	• Develop a policy for evaluating the asset for impairment.
A clear plan for transition to the new standard	• Developing an implementation plan that considers the requirements of the recent financial instruments standard (IFRS 9) and forthcoming insurance contracts standard (IFRS 4) may not be straightforward. • IFRS 15 may be adopted retrospectively, by restating comparatives and adjusting retained earnings at the beginning of the earliest comparative period. • Alternatively, IFRS 15 may be adopted as of the application date, by adjusting retained earnings at the beginning of the first reporting period and disclosing the effect of adoption on each line of profit or loss for the first period of application.	• Perform a high-level gap analysis to identify potential drivers of changes in accounting for revenue and certain contracts. • Develop an overall strategy for transition that incorporates all accounting changes expected in the near future – i.e. IFRS 9 and IFRS 4 – and capitalises on any available synergies.

Interaction between IFRS 15 and the forthcoming insurance contracts standard (IFRS 4)

Given the expected three-year lead time from publication to implementation, the effective date of the forthcoming insurance contracts standard is expected to fall well after that of IFRS 15, which is 1 January 2017.

Where the proposed scoping requirements of the forthcoming insurance contracts standards differ from current practice, implementation of the forthcoming insurance contracts standard may cause some contracts currently accounted for under IFRS 4 Insurance Contracts to fall wholly, or partially, in the scope of IFRS 15. Such contracts may include:

- Certain fixed-fee service contracts – e.g. roadside assistance programmes, capitation and fixed-fee medical service arrangements in the healthcare sector, and equipment and maintenance costs – which are permitted, but not required, to be excluded from the scope of the forthcoming insurance contracts standard; and
- Service components – i.e. performance obligations to provide goods or non-insurance services – embedded within some insurance contracts which are distinct and required to be separated from the insurance contract.

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Finalisation and effective date may slip, transition method modified

Deliberations on the IASB's insurance contracts project look set to extend further into 2015, following an October meeting in which the Board did not discuss its model for participating contracts.

With the European CFO Forum expected to set out its proposals for an alternative model during an education session in November, it no longer appears likely that a final standard will be issued in mid-2015. Given an expected three-year lead time from publication to implementation, the new standard's effective date is likely to fall after that of IFRS 9 *Financial Instruments* – i.e. 1 January 2018.

"Companies may end up applying IFRS 9 before the forthcoming insurance contracts standard. They will need to prepare for this scenario, and consider the impacts on project management, accounting policies, the use of options available under IFRS 9 and stakeholder communications."

Joachim Kölschbach,
KPMG's global IFRS insurance leader

However, the October meeting did see the IASB modify its initial application proposals in the 2013 exposure draft for contracts with no participating features.

Initial application	Summary of decisions
Retrospective application	The Board confirmed that the forthcoming insurance contracts standard would be applied retrospectively, unless this is 'impracticable' as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
Simplified approach (modified)	The Board confirmed the simplified approach to retrospective application proposed in the 2013 ED for cases where full retrospective application is 'impracticable' – i.e. practical expedients for determining

	the contractual service margin at transition and the discount rate at initial recognition. However, it made a modification to this approach. The risk adjustment at the date of initial recognition would be estimated by modifying the risk adjustment at the beginning of the earliest period presented by the expected release of risk before the beginning of the earliest period presented.
Fair value approach (new)	The Board introduced the fair value approach to retrospective application for cases where both full retrospective application and the simplified approach are 'impracticable'. A company would determine: • the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date; and • interest expense in profit or loss, and the related amount of OCI in accumulated equity, by estimating the discount rate at the date of initial recognition using the method outlined in paragraphs C6(c)–(d) of the 2013 ED – i.e. the same method as the simplified approach. A company would disclose the information proposed in paragraph C8 of the 2013 ED separately for contracts measured using the fair value approach.

Our *IFRS Newsletter: Insurance* will continue to report on significant developments in the insurance contracts project. Watch out for the next issue.

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European insurers table alternative proposals for participating contracts

The European CFO Forum, which represents 21 of Europe's largest insurance companies, has presented alternative proposals for participating contracts to the IASB.

The Forum believes that the IASB's 2013 exposure draft and current redeliberations do not provide an appropriate basis to explain the performance of an insurance business to investors or adequately reflect the nature of long-term insurance contracts, particularly participating contracts.

"We believe the Board needs to clearly define an overall principle for accounting for contracts with participating features, and would support a measurement and presentation approach that is more aligned with the principles of the building-block model and with the new revenue recognition standard."

Joachim Kölschbach,
KPMG's global IFRS insurance leader

The proposals were presented at an education session and, although the Board asked the representatives from the Forum a number of questions about the alternative proposals, no decisions were taken and no direction was given to the IASB staff. The IASB is expected to make decisions on accounting for contracts with participating features as a whole in a future meeting.

The alternative proposals include the following key principles, which the Forum believes are interconnected and should be considered together as an integrated package.

Initial application	Summary of decisions
Scope	Applicable to all participating contracts – i.e. contracts that give policyholders a right to receive, as a supplement to the guaranteed benefits, a variable return either contractually or at the discretion of the issuer.
Full unlocking of the contractual service margin	• Unlocked for all assumption changes that impact expected future profits and that relate to future services, including reinvestment assumptions. • Disclosure of the components of the CSM and how the CSM develops over the reporting period.
Release of the CSM	• Represents unearned profit, including projected future allocation of asset returns, at initial recognition and throughout the life of the contract. • Released in accordance with fulfilment of the contract as services are provided. • Service driver(s) depend on the nature of services provided by the contract.
Single measurement basis	• Cash flows from options and guarantees treated consistently with all other elements of the insurance contract liability. • Single yield curve applied to all cash flows – i.e. no need to bifurcate cash flows.
Non-mandatory use of OCI	Accounting policy choice to present the effect of changes in the discount rate in OCI or in profit or loss.

More detail on the Forum's alternative proposals is available on the IASB's webpage.

Our *IFRS Newsletter: Insurance* will continue to report on significant developments and further decisions by the IASB in the insurance contracts project. Watch out for the next issue.

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Further transition relief considered in light of project delays

With discussions on participating contracts continuing into the first half of 2015, the forthcoming insurance contracts standard will not be published before late 2015 at the earliest.

Because the IASB plans to allow approximately three years between publishing the final standard and having it come into effect, the earliest possible mandatory effective date will now be later than that for IFRS 9 *Financial Instruments* (which is 1 January 2018).

"Preparers are concerned about implementing two major standards in a short period of time; but even more important would be the challenge to users posed by successive changes in financial reporting."

Joachim Kölschbach,
KPMG's global IFRS insurance leader

Stakeholders have raised concerns about applying the classification and measurement requirements of IFRS 9 without being able to fully evaluate the implications of the forthcoming insurance contracts standard. In response, the IASB has confirmed:

- the limited fair value option redesignations for financial assets on initial application of the insurance contracts standard that were included in the 2013 exposure draft; and
- that it will consider providing further transition relief to permit, or require, a company to reassess the business model for financial assets at the date of initial application of the forthcoming insurance contracts standard.

Two Board members suggested that deferring the mandatory effective date of IFRS 9 for companies that are significantly impacted by the forthcoming insurance contracts standard would allay insurers' concerns – both about implementing IFRS 9 without fully evaluating the forthcoming insurance requirements, and over the practical issues associated with two substantial rounds of accounting changes. The Board discussed the merits and demerits of this proposal, and decided not to pursue it.

The staff will consider consequential issues arising from further transition relief at a future meeting, and the mandatory effective date for the new insurance contracts standard after deliberations on the model for participating contracts have been completed.

Our *IFRS Newsletter: Insurance* will continue to report on significant developments and further decisions by the IASB in the insurance contracts project. Watch out for the next issue.

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Taking some pain out of IFRS 4: Harnessing Solvency II to create efficiencies

European insurance CFOs have a number of significant reporting changes to navigate over the coming years. They are facing some of the most stringent regulatory changes ever to be unleashed on the insurance sector in Solvency II, which is due to come into force in 2016. They are also shifting their financial reporting to a new insurance accounting standard (known as IFRS 4 Phase II), which could be in force by 2018. At the same time, a new accounting standard for financial instruments (IFRS 9) is also expected to become mandatory by 2018. The next few years may not be easy.

Not surprising, then, that insurance CFOs are looking for opportunities to reduce the cost, effort and resources needed to achieve compliance across both mandates. “We can see that managing both programs of work separately is going to put significant strain on our existing resources and, potentially, could result in two very different views of our group’s financials,” Danny Clark, Global Accounting Change Lead, KPMG in the UK as heard from a client. “After all that we have done to prepare for Solvency II, we simply don’t have the resources or the time to kick off another equally complex finance transformation project.”

Overlaps and opportunities

What many insurance executives are finding is that there are significant similarities between Solvency II and the new insurance accounting proposals. Both require similar balance sheets which, while some differences certainly exist, in turn require similar processes, data, assumptions and modeling. There is little difference, for example, between the calculations non-life insurers would use to value their claims liabilities under the two methods.

Most insurers will find the overlap considerable. In fact, our experience suggests that insurers may be able to cut their IFRS 4 Phase II implementation effort by almost half if they combine their Solvency II and IFRS 4 programs; similar efficiencies could be brought to bear in the management of ongoing post-implementation reporting. And, it’s not just in Europe that insurers have an advantage. A number of other countries have introduced (or are in the process of introducing) capital regimes based on current valuations of assets and liabilities. In many cases, these will also provide a springboard for the valuation of insurance contract liabilities under IFRS.

But saving costs and reducing duplication are not the only reasons for insurance CFOs to consider combining their implementation programs. The reality is that stakeholders – investors, regulators, customers and media – will be carefully scrutinizing both balance sheets and any difference will need to be quickly and adequately explained. This is not easy when so many of the regulations are changing (solvency, assets and liabilities) – there are interdependencies between how insurers account for their assets and liabilities that are essential to manage in order to avoid unwanted volatility in the accounting results.

Having a single governance process that looks at the entity’s reporting under both frameworks together and uses a single set of analytical reviews and a single set of approvals will ensure that any inconsistencies are identified, discussed and thoroughly understood by management before being published.

Time for action

While the benefits of combining the programs are clear, our experience suggests that few insurers have yet to start working towards reaping those synergies. In large part, this is because significant uncertainty still surrounds the final insurance contracts standard. However, with redeliberations progressing and the final standard expected in the first half of 2015, any remaining uncertainty should quickly disappear.

Others are taking more of a ‘first things first’ attitude and focusing all of their efforts on becoming compliant with Solvency II – which becomes effective as of January 1st 2016 – rather than IFRS 4 Phase II which may not come into effect until 2018 at the earliest.

This, in our opinion, may not be the wisest strategy: there is already more than enough clarity in the current insurance contract proposals to allow insurers to properly identify the synergies;

any Solvency II work that takes place without – at the very least – incorporating the future requirements of IFRS could result in wasted or duplicative effort.

Preparing for advantage

There are a number of insurers, however, that are making significant headway. Many are using this time ahead of the announcement of the final standard to conduct high level assessments of how they are going to use their Solvency II data and processes to meet their future IFRS 4 requirements. Others are looking carefully at the current insurance contract proposals to see how different interpretations allowed within the proposals may be applied in order to maximize the reuse of Solvency II data.

We believe insurers should also be taking this time to consider how IFRS 4 Phase II may impact their operating models within finance and actuarial services. Indeed, the implementation of both Solvency II and IFRS 4 phase II will bring about new demands on data, additional requirements for actuarial modeling, and potentially hundreds of new processes to run, all of which will put strain on existing resources and require new ways of working. Some may even decide (if they haven't already) to fold their actuarial and finance departments into a single business unit to enhance efficiencies after implementation of the new requirements.

There will be advantages for some; aligning accounting for insurance globally makes the business case for managing financial reporting centrally stronger for example.

Seeing the way forward

Once insurers are able to conceptualize their new target operating models, we believe a prudent next step is to develop a well-understood roadmap to coordinated implementation that not only identifies the tactical implications such as the production of data, but also the wider effects including the impact on dividend paying capability, product pricing, investor relations and capital market communication.

Those that are able to integrate their planning should then be well prepared to reap the efficiencies offered by the overlaps between IFRS 4 Phase II and Solvency II. Those that do not will find the next four years to be an unnecessary struggle.

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