IFRS NEWSLETTER
INSURANCE

Issue 47, July 2015

cutting through complexity

> Amending IFRS 4 will allow insurers to address much of the temporary volatility and accounting mismatches in profit or loss when implementing IFRS 9. However, other issues still exist.

Joachim Kölschbach, KPMG's global IFRS insurance leader

MOVING TOWARDS INTERNATIONAL INSURANCE ACCOUNTING

This edition of *IFRS Newsletter: Insurance* highlights the IASB's discussions in July 2015 on its insurance contracts project.

Highlights

Addressing the consequences of different effective dates

- The IASB discussed the accounting consequences of the different effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts standard.
- The discussion focused on temporary volatility and accounting mismatches in profit or loss.
- The IASB considered the following three options to address these consequences:
  - using the existing options under IFRS 4 *Insurance Contracts*;
  - amending IFRS 4; or
  - deferring the effective date of IFRS 9 in some circumstances.
- The IASB tentatively decided to amend IFRS 4 to permit an entity to remove the impact of applying IFRS 9 from profit or loss, subject to certain limitations.
- The IASB will discuss further details of the decision, and whether to allow a deferral of the effective date of IFRS 9, in September.

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RESPONDING TO CONCERNS OVER ACCOUNTING CONSEQUENCES

The story so far ...

The current phase of the insurance project was launched in May 2007, when the IASB published a discussion paper, *Preliminary Views on Insurance Contracts*. More recently, the IASB re-exposed its revised insurance contracts proposals for public comment by publishing the exposure draft ED/2013/7 *Insurance Contracts* (the ED) in June 2013.

Since January 2014, the Board has been redeliberating issues raised through the ED. It initially focused on the model for non-participating contracts and has now turned its focus to modifications for participating contracts.

Interaction with other standards

Throughout its redeliberations, the Board has considered whether the accounting for insurance contracts would be consistent with other existing or future standards, including the new revenue recognition standard – IFRS 15 *Revenue from Contracts with Customers*[1]. Much of the guidance contained in the ED was designed to align with the IASB's and the FASB's joint standard on revenue recognition.

The Board has also considered many of the decisions made in the new financial instruments standard, IFRS 9 *Financial Instruments*[2] – including the way in which IFRS 9 might interact with the final insurance contracts standard – because IFRS 9 will cover a large majority of an insurer's investments. Additionally, the Board is examining how best to address the consequences of the different effective dates of IFRS 9 and the forthcoming insurance contracts standard.

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What happened in July 2015?

After several months of discussions, the IASB reached an important decision on the interaction between IFRS 4 and IFRS 9 in July.

During its previous meeting in June 2015, the IASB discussed the accounting consequences that could arise from an insurer implementing the forthcoming insurance contracts standard with an effective date after that of IFRS 9, including temporary volatility and accounting mismatches.

The Board also discussed potential options available to alleviate these consequences. It considered the extent to which IFRS 4 already allows an entity to reduce temporary volatility and accounting mismatches, and whether IFRS 4 should be amended.

During its July 2015 meeting, the IASB decided to amend IFRS 4 to permit an entity to exclude from profit or loss, and recognise in other comprehensive income (OCI), the difference between the amounts recognised in profit or loss under IFRS 9 and under IAS 39 *Financial Instruments: Recognition and Measurement* for specified assets relating to insurance activities.

This accounting treatment would only apply:

- if the entity issues contracts that are accounted for under IFRS 4, and applies IFRS 9 in conjunction with IFRS 4; and
- to financial assets that are classified at fair value through profit or loss (FVTPL) under IFRS 9 when those assets were previously, or would have been, measured at amortised cost or as available-for-sale under IAS 39.

The staff continue to explore other approaches to address the accounting consequences of applying IFRS 9 in advance of the forthcoming insurance contracts standard, including options to defer the effective date of IFRS 9. The staff recognised that more than one permitted approach may need to be considered, and will favour options that provide users of financial statements with useful financial information during the period between the effective dates of the two standards.

The staff expect to ask the IASB for technical decisions on the outstanding issues during the remainder of 2015. The effective date of the final standard will be discussed after the IASB has concluded its redeliberations on other topics. A final standard is not expected in 2015.

1. See our Issues In-Depth: Revenue from Contracts with Customers (September 2014). In February 2015, the IASB started discussing targeted amendments to the new standard; for more detail, see our IFRS Newsletter: Revenue.
2. See our First Impressions: Financial instruments – The complete standard (September 2014).

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ADDRESSING THE CONSEQUENCES OF DIFFERENT EFFECTIVE DATES

Different effective dates of IFRS 9 and the forthcoming insurance contracts standard could have accounting consequences.

What's the issue?

Stakeholders are concerned about temporary increases in accounting mismatches and other sources of volatility in profit or loss and equity created by changes in the classification and measurement of financial assets if IFRS 9 is applied in advance of the forthcoming insurance contracts standard.

In particular, some insurers are concerned that there are circumstances in which financial assets currently measured at amortised cost or classified as available-for-sale under IAS 39 would be classified at FVTPL under IFRS 9. The following consequences are possible.

- Accounting mismatches could arise in profit or loss and equity if insurance contract liabilities are measured on a cost basis – e.g. using a locked-in discount rate.
- Volatility relating to the shareholder's interest in financial assets classified at FVTPL that underlie contracts with direct participation features could arise in profit or loss and equity – some of this volatility would not exist once the forthcoming insurance contracts standard is effective.

The staff considered the following three options to address these consequences.

Option		Where to find further information
1	Use existing options under IFRS 4	For more details on the options available to entities under existing IFRS 4, read our IFRS Newsletter: Insurance – Issue 46.
2	Amend IFRS 4	This is discussed in the section below.
3	Defer the effective date of IFRS 9 in some circumstances	The staff plan to provide the Board with an agenda paper discussing possible options for deferring the effective date of IFRS 9 at the September meeting.

What possible amendments to IFRS 4 did the staff consider?

The staff considered the following possible amendments to IFRS 4 to address accounting mismatches and temporary volatility.

How the amendment would work	Effect of application	Impact on entities
A. Shadow adjustment for shareholders' interest in underlying assets		
Entity makes a shadow adjustment for all unrealised gains and losses on underlying assets that are attributable to the shareholders of the entity.	Reduces temporary volatility in profit or loss for the shareholders' interest only.	• Could remove non-temporary volatility in profit or loss that would persist after the forthcoming insurance contracts standard is applied, and which should rightly appear in the financial statements. • No significant implementation effort for entities that already apply shadow accounting.

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How the amendment would work	Effect of application	Impact on entities
B. Shadow adjustment for assets backing non-participating insurance contracts		
Entity makes a shadow adjustment for the unrealised gains and losses on assets designated as backing insurance contracts, including those where there is no direct relationship between the contract and the assets.	Reduces accounting mismatches in profit or loss between assets classified at FVTPL and liabilities valued on a cost basis only.	• Could obscure the effect of any economic mismatches between non-participating insurance contracts and related assets. • Entities would be required to begin linking and tracking assets to non-participating insurance contracts.
C. Apply IFRS 9 with an adjustment that offsets the effect of IFRS 9 on profit or loss		
Entity recognises an adjustment to profit or loss to offset the effect on profit or loss of applying IFRS 9.	Reduces temporary volatility in profit or loss for shareholder's interest and reduces accounting mismatches in profit or loss between assets classified at FVTPL and liabilities valued on a cost basis.	• Consistent application of IFRS 9 to all assets for all entities. • Adjustment to profit or loss could be taken against OCI or insurance contract liabilities. The staff believe that adjusting against OCI would be easier to explain to users, and would result in a similar presentation to IAS 39. • Adjustment would apply to some or all assets classified at FVTPL under IFRS 9 that would not have been under IAS 39. • Entities would be required to perform a parallel run of IFRS 9 and IAS 39 during the period between the effective dates of IFRS 9 and IFRS 4.

The staff considered that Amendment C would address both accounting mismatches and temporary volatility, would not require extensive operational change and could be easily understood by users of financial statements.

What did the staff recommend?

Based on the above considerations, the staff recommended that IFRS 4 be amended to permit an entity to exclude from profit or loss, and recognise in OCI, the difference between the amounts that would be recognised in profit or loss under IFRS 9 and under IAS 39.

This accounting treatment would only be used if the entity:

- issues contracts that are accounted for under IFRS 4[3];
- applies IFRS 9; and

3. The staff noted that this option should be restricted to entities that issue contracts in the scope of IFRS 4, but will consider in future meetings whether the scope should be restricted further.

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- holds financial assets that are classified at FVTPL under IFRS 9 when those assets were previously measured at amortised cost or classified as available-for-sale under IAS 39.

Before the Board voted, the staff presented two additional recommendations – namely that the amendment would be limited to financial assets:

- that relate to insurance activities; and
- that are mandatorily classified at FVTPL under IFRS 9, and that were previously measured at amortised cost or classified as available-for-sale under IAS 39.

What did the IASB discuss?

Most Board members supported the staff's recommendation as a simple and transparent solution that could result in minimal investment for entities. They believed that this approach would directly address the issue that was brought to the IASB by stakeholders – i.e. temporary volatility in profit or loss – and would result in comparability between the insurance industry and other industries, as all entities would be applying IFRS 9 at the same time.

One Board member expressed concern that the staff's recommendation would not provide a solution for temporary volatility in equity. However, the staff noted that entities would end up with the same or similar volatility in equity as they experienced under IAS 39 for underlying assets classified as available-for-sale, and that this issue was limited to underlying assets that would have been measured at amortised cost under IAS 39.

Another Board member was not concerned by volatility in equity under IFRS, as the insurance industry relies on other regulatory capital standards – e.g. Solvency II.

Two Board members preferred that the Board do nothing to address this issue, other than to require additional disclosures for insurers. Some other Board members suggested that the adjustment should be made to the insurance liabilities, rather than OCI, given that the amendment is to IFRS 4.

The Board tentatively decided to amend IFRS 4 to permit an entity to remove the impact of applying IFRS 9 from profit or loss, subject to certain limitations.

What did the IASB decide?

The Board tentatively decided to amend IFRS 4. For specified assets, an entity would be permitted to remove from profit or loss, and recognise in OCI, the difference between:

- the amounts that would be recognised in profit or loss under IFRS 9; and
- the amounts recognised in profit or loss under IAS 39.

In doing this, an entity would apply IFRS 9 in full but would make the adjustments described above in profit or loss, and OCI, for assets that:

- were previously, or would have been, measured at amortised cost or classified as available-for-sale under IAS 39;
- are classified at FVTPL under IFRS 9; and
- relate to insurance activities.

The adjustments could only be applied if the entity:

- issues contracts that are accounted for under IFRS 4; and
- applies IFRS 9 in conjunction with IFRS 4.

Consequently, the net effect on profit or loss would reflect the IAS 39 accounting for those specified assets.

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The Board asked the staff to consider the following issues which the Board will discuss at a future meeting.

- The scope of the amendment, including the definition of an insurance activity.
- How to address transfers between activities – e.g. between insurance-related and non-insurance-related activities.
- Required disclosures.

The staff will continue to analyse the accounting consequences that could arise from the application of IFRS 9 for entities applying IFRS 4 before the forthcoming insurance contracts standard. To quickly address any possible issues, the staff will continue to explore several approaches to addressing accounting consequences, including approaches based on a deferral of IFRS 9.

The staff noted that there may be a need to consider whether a single approach, or a variety of approaches – e.g. a combination of asset- and liability-based approaches – is necessary. This is because of the difficulties in precisely targeting any approaches and the different circumstances affecting reporting entities.

KPMG insight

The Board's decision focuses on addressing volatility in profit or loss, and does not address:

- increased volatility in equity, which may arise for non-participating contracts; and
- the shareholders' share of assets supporting participating contracts

if assets are measured at amortised cost under IAS 39 – e.g. loans and receivables. On applying IFRS 9, some of these assets may be mandatorily measured at fair value.

Users would face two significant accounting changes in a short period of time – IFRS 9 and the forthcoming insurance contracts standard – and the Board's decision suggests that it is focused on creating a transition period between the effective dates of IFRS 4 and IFRS 9 that would be easily understood by users. However, the full impact of the interaction of these two standards will remain unknown until redeliberations on the forthcoming insurance contracts standard are complete.

Insurers would need to change their financial reporting processes and systems in order to run IAS 39 and IFRS 9 in parallel for relevant financial assets. While any changes made to systems and processes to implement IFRS 9 would remain in effect after the forthcoming insurance contracts standard is applied, incremental effort would be needed to develop the processes necessary to permit the timely preparation of accounts and temporary disclosures.

In addition, entities would have to consider the complexities of how the proposed amendment interacts with their current accounting for insurance contract liabilities – e.g. participating contracts and shadow accounting adjustments.

Insurers applying the proposed amendment would still face operational challenges. For example, additional controls would be required to:

- identify financial assets classified at FVTPL under IFRS 9 as relating to insurance activities; and
- determine whether these assets would have a different classification under IAS 39.

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APPENDIX: SUMMARY OF IASB'S REDELIBERATIONS

What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the ED?
Targeted issues		
Unlocking the contractual service margin (CSM)	• Favourable changes in estimates that arise after losses have previously been recognised in profit or loss would be recognised in profit or loss to the extent that they reverse losses that relate to coverage and other services in the future.	Yes
	• Differences between the current and previous estimates of the risk adjustment that relate to coverage and other services for future periods would be added to, or deducted from, the CSM, subject to the condition that the CSM would not be negative. Consequently, changes in the risk adjustment that relate to coverage and other services provided in the current and past periods would be recognised immediately in profit or loss.	Yes
	• For non-participating contracts, the locked-in rate at inception of the contract would be used for: – accreting interest on the CSM; and – calculating the change in the present value of expected cash flows that adjust the CSM.	No
Presenting the effects of changes in the discount rate in OCI	• An entity could choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI, and apply that accounting policy to all contracts within a portfolio.	Yes
	• Application guidance would be added to clarify that, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity would select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted for.	Yes
	• The requirements in IAS 8 would be applied without modification to changes in accounting policy relating to the presentation of the effects of changes in discount rates.	Yes
	• If an entity chooses to present the effects of changes in discount rates in OCI, then it would recognise: – *in profit or loss:* the interest expense determined using the discount rates that applied at the date on which the contract was initially recognised; and – *in OCI:* the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the amount of the insurance contract measured using the discount rates that applied at the date on which the contract was initially recognised.	Yes

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What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the ED?
Presenting the effects of changes in the discount rate in OCI (continued)	• An entity would disclose the following information. – *For all portfolios of insurance contracts:* An analysis of total interest expense included in total comprehensive income disaggregated at a minimum into: - the amount of interest accretion determined using current discount rates; - the effects on the measurement of the insurance contract of changes in discount rates in the period; and - the difference between the present value of changes in expected cash flows that adjust the CSM in a reporting period measured using the discount rates that applied on initial recognition of insurance contracts and current discount rates. – *In addition, for portfolios of insurance contracts for which the effects of changes in discount rates are presented in OCI:* An analysis of total interest expense included in total comprehensive income disaggregated at a minimum into: - interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and - the movement in OCI for the period.	Yes
	• For non-participating contracts accounted for under the premium allocation approach (PAA), when an entity presents the effects of changes in discount rates in OCI, the discount rate that is used to determine the interest expense for the liability for incurred claims would be the rate locked in at the date the claim was incurred. This would also apply if a liability for onerous contracts is established under the PAA, in which case the locked-in discount rate would be the rate on the date the liability is recognised.	Yes
Insurance contract revenue	• An entity would be prohibited from presenting premium information in profit or loss if that information is not consistent with commonly understood notions of revenue.	No
	• An entity would present insurance contract revenue in profit or loss, as proposed in paragraphs 56–59 and B88–B91 of the ED.	No
	• An entity would disclose the following: – a reconciliation that separately reconciles the opening and closing balances of the components of the insurance contract asset or liability; – a reconciliation from the premiums received in the period to the insurance contract revenue in the period; – the inputs used when determining the insurance contract revenue that is recognised in the period; and – the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position.	No
	• For contracts accounted for under the PAA, insurance contract revenue would be recognised on the basis of the passage of time. However, if the expected pattern of release of risk differs significantly from the passage of time, then it would be recognised on the basis of the expected timing of incurred claims and benefits.	Yes

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What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the ED?
Transition	• An entity would apply the forthcoming insurance contracts standard retrospectively in accordance with IAS 8, unless this is impracticable.	No
	• For the simplified retrospective approach, instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity would estimate it by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of the risk before the beginning of the earliest period presented. The expected release of risk would be determined with reference to the release of risk for similar insurance contracts that the entity issued at the beginning of the earliest period presented.	Yes
	• If the simplified retrospective approach is impracticable, then an entity would apply a fair value approach. The entity would determine the: – CSM at the beginning of the earliest period presented as the difference between the fair value of the insurance contract and the fulfilment cash flows measured at that date; and – interest expense in profit or loss, and the related amount of OCI accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified retrospective approach proposed in the ED.	Yes
	• For each period presented for which there are contracts measured in accordance with the simplified retrospective approach or the fair value approach, an entity would disclose the information proposed in paragraph C8 of the ED separately for contracts measured using the: – simplified retrospective approach; and – fair value approach.	Yes
Participating contracts		
The variable fee approach	• For direct participating contracts – i.e. those that meet the following criteria – the CSM would be unlocked for changes in the estimate of the variable fee for service that the entity expects to earn: – the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items; – the entity expects to pay to the policyholder an amount equal to a substantial share of returns from the underlying items; and – a substantial portion of the cash flows that the entity expects to pay to the policyholder is expected to vary with the cash flows from the underlying items.	Yes
Recognising the CSM in profit or loss	• An entity would recognise the CSM in profit or loss on the basis of the passage of time.	Yes

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What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the ED?
Non-targeted issues		
Recognising the CSM in profit or loss	• The remaining CSM would be recognised in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services under the insurance contract.	No
	• For non-participating contracts, the service represented by the CSM would be insurance coverage that: – is provided on the basis of the passage of time; and – reflects the expected number of contracts in force.	Yes
Fixed-fee service contracts	• Entities would be permitted, but not required, to apply the revenue recognition standard to fixed-fee service contracts that meet the criteria stated in paragraph 7(e) of the ED.	Yes
Significant insurance risk	• The ED's guidance will be adjusted to clarify that significant insurance risk occurs only when there is a possibility that an issuer will incur a loss on a present-value basis.	Yes
Portfolio transfers and business combinations	• Paragraphs 43–45 of the ED will be amended to clarify that contracts acquired through a portfolio transfer or a business combination would be accounted for as if they had been issued by the entity at the date of the portfolio transfer or the business combination.	Yes
Determining discount rates when there is a lack of observable data	• The discount rates used to adjust the cash flows of an insurance contract for the time value of money would be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract.	No
	• In determining those discount rates, an entity would use judgement to: – ensure that appropriate adjustments are made to observable inputs, to accommodate any differences between observed transactions and the insurance contracts being measured; and – develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting the way market participants assess those inputs – accordingly, any unobservable inputs should not contradict any available and relevant market data.	Yes
Asymmetrical treatment of gains from reinsurance contracts	• After inception, entities would recognise in profit or loss any changes in estimates of cash flows for a reinsurance contract that arise as a result of changes in estimates of cash flows that are recognised immediately in profit or loss for an underlying insurance contract.	Yes

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What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the ED?
Level of aggregation	• The objective of the proposed insurance standard is to provide principles for measuring an individual insurance contract; but in applying the standard, an entity could aggregate insurance contracts, provided that the aggregation would meet that objective.	No[4]
	• The definition of a portfolio of insurance contracts would be amended to "insurance contracts that provide coverage for similar risks and are managed together as a single pool".	Yes
	• Guidance would be added to explain that, in determining the CSM or loss at initial recognition, an entity would not aggregate onerous contracts with profit-making contracts. An entity would consider the facts and circumstances to determine whether a contract is onerous at initial recognition.	Yes
	• Examples would be provided of how an entity could aggregate contracts but nevertheless satisfy the objective of the proposed insurance standard when determining the CSM on subsequent measurement.	Yes
Additional considerations		
Interim amendment to existing IFRS 4	• IFRS 4 would be amended. For specified assets, an entity would be permitted to remove from profit or loss, and recognise in OCI, the difference between: – the amounts that would be recognised in profit or loss under IFRS 9; and – the amounts recognised in profit or loss under IAS 39. • In doing this, an entity would apply IFRS 9 in full but would make the adjustments described above in profit or loss, and OCI, for assets that: – were previously, or would have been, measured at amortised cost or classified as available-for-sale under IAS 39 – are classified at FVTPL under IFRS 9; and – relate to insurance activities. • The adjustments could only be applied if the entity: – issues contracts that are accounted for under IFRS 4; and – applies IFRS 9 in conjunction with IFRS 4.	N/A

4. In the staff's view, this decision represents a clarification of the principle already included in the ED. However, many respondents to the ED noted that they were unsure how to apply the different levels of aggregation. Consequently, this clarification may result in a change in the application of the principle.

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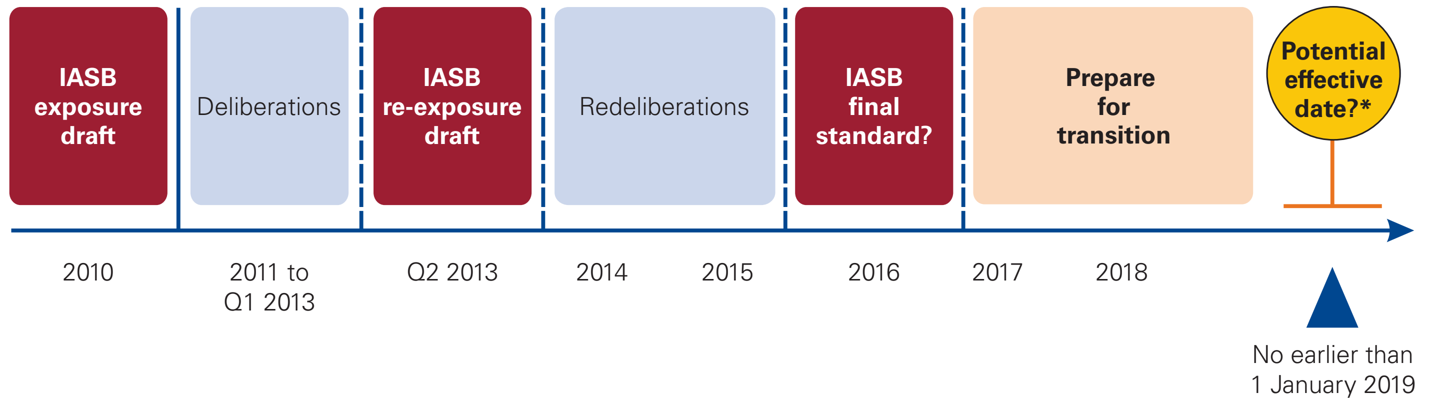
PROJECT MILESTONES AND TIMELINE FOR COMPLETION

The IASB re-exposed its insurance contracts proposals and issued ED/2013/7 *Insurance Contracts* in June 2013. A final standard is no longer expected during 2015.



* The effective date of the final standard is expected to be approximately three years after the standard is issued. The IASB staff do not expect the final standard to be published before the end of 2015. The mandatory effective date will be considered after the redeliberations on the model for participating contracts have been completed.

Our suite of publications considers the different aspects of the project.

	KPMG publications
1	IFRS Newsletter: Insurance (issued after IASB deliberations)
2	New on the Horizon: Insurance contracts (July 2013)
3	Challenges posed to insurers by IFRS 9's classification and measurement requirements
4	Evolving Insurance Regulation: The journey begins (March 2015)

For more information on the project, including our publications on the IASB's insurance proposals, see our website. You can also find, in the same place, information about the FASB's insurance contracts project before February 2014, when this newsletter stopped following that project. For information on the FASB's project subsequent to February 2014, see KPMG's Issues & Trends in Insurance.

The IASB's website and the FASB's website contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

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FIND OUT MORE

For more information on the insurance project, please speak to your usual KPMG contact or visit the IFRS – insurance hot topics page.

You can also go to the insurance pages on the IASB website.

Visit our Global IFRS Institute to access KPMG's most recent publications on the IASB's major projects and other activities.

Insights into IFRS: Volume 3 – IFRS 9 (2014)

Builds on previous publications to bring you our first complete work of interpretative guidance based on IFRS 9 (2014).

April 2015

First Impressions: IFRS 9 *Financial Instruments*

Provides our detailed analysis on the complete version of IFRS 9 *Financial Instruments*.

September 2014

IFRS Newsletter: IFRS 9 Impairment – Issue 1

Highlights the discussions of the IFRS Transition Group for Impairment of Financial Instruments on the impairment requirements of IFRS 9.

April 2015

IFRS Newsletter: Revenue – Issue 13

Examines the latest developments on the new revenue standard.

March 2015

IFRS Newsletter: Leases – Issue 17

Highlights the recent discussions of the IASB and the FASB on their lease accounting proposals published in 2013.

March 2015

Breaking News

Brings you the latest need-to-know information on international standards in the accounting, audit and regulatory space.

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