



The impact of accounting changes on regulation

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The International Association of Insurance Supervisors (IAIS) continues its move towards a market consistent basis of valuation for both assets and liabilities to underpin the determination of regulatory capital for the group capital and solvency assessments. One of the most significant challenges it has faced has been the lack of a consistent basis of accounting applied across jurisdictions – either for regulatory or financial reporting purposes. Application of a harmonized financial reporting framework would have significant advantages for both the IAIS's work and the practical application of the final requirements.

In this chapter, we provide a general overview of the forthcoming international financial reporting standard (IFRS) for insurance contracts, outlining the key aspects of the standard. We also provide KPMG professionals' perspectives regarding the efforts to create a globally consistent accounting framework for insurance contracts and discuss how this may interact with the IAIS's work.

The current IFRS 4 *Insurance Contracts* enables only limited comparability between peers within the insurance industry because it allows insurance contract liabilities to be measured in accordance with accounting policies grandfathered from local accounting regimes. Non-uniform accounting policies may be used in consolidated IFRS financial statements if this was permitted under the group's previous accounting policies, such as in financial statements prepared in accordance with European Union (EU) Directives.

During 2015, the International Accounting Standards Board (IASB) made significant progress in its Insurance Contracts project to deliver a standard that will provide comparability within the insurance industry. It has now completed planned technical deliberations and has begun drafting the forthcoming insurance contracts standard. It expects to issue the final standard around the end of 2016, meaning an expected mandatory effective date of 1 January 2020 or 2021, with early adoption permitted. A final decision regarding an effective date will be taken by the IASB later this year.

Regardless of the timing of the practical application of the standard, it is clear that the IAIS cannot wait for its issuance to meet its own challenging timeline for progressing towards a final insurance capital standard (ICS). However, now that the technical decision-making has been completed, the IAIS could revise its proposals and potentially incorporate some of the key requirements of the standard, where meaningful to do so, to ensure greater harmonization between accounting and regulatory valuation bases at a later date. For this reason, it is important to recognize that the changes to be introduced to the IFRS may also have regulatory impacts. The main accounting perspectives are discussed on the following pages.



The Financial Accounting Standards Board, which establishes generally accepted accounting principles within the United States, is also proposing changes to disclosure about short-duration insurance contracts and targeted changes to the accounting for long-duration contracts that are outside the scope of this chapter.

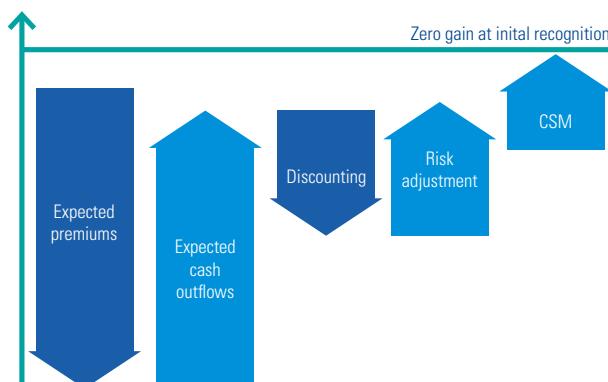
Measurement basis

The forthcoming insurance contracts standard will include a comprehensive measurement model for all types of insurance contracts issued by entities. However, a simplified form of the model, the premium-allocation approach, may be used for some short-duration contracts, and modifications will be made to the model for direct participating contracts.

The measurement model is based on the current 'fulfilment' objective which reflects the fact that an entity generally expects to fulfill its liabilities over time as claims become due. Accordingly, the starting point for measuring an insurance contract liability will be the expected future cash flows for fulfilling the contract. The fulfilment of the obligation is based on the entity's perspective (not exit value or fair value).

In measuring an insurance contract liability, the expected future cash outflows less inflows (building block 1) are discounted to reflect the time value of money (building block 2). A risk adjustment that reflects the uncertainty about the amount and timing of the cash flows when fulfilling an obligation to the policyholder (building block 3) is added to the expected discounted future cash flows. These three 'building-blocks' are re-measured at each reporting date using current information. If the sum of the three building blocks is negative at the inception of the contract (i.e. the present value of cash outflows plus the risk adjustment is less than the expected present value of cash inflows), a contractual service margin (CSM) is added to remove any day one gains.

Title: Figure 1: General measurement model



Source: KPMG International, 2016

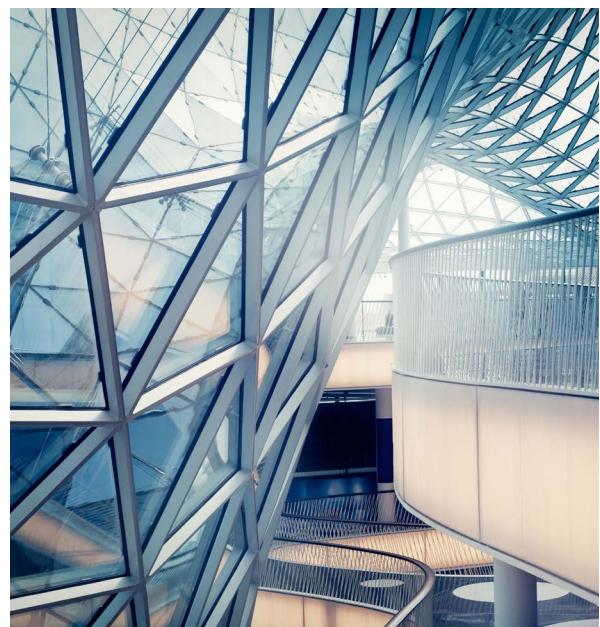
The CSM represents the unearned profit at the inception of the contract. It is recognized evenly over the coverage period. The subsequent claims settlement period is not included.

At subsequent measurement, the CSM is adjusted for changes in future cash flows and changes to the risk adjustment that relates to future coverage and other future services, provided that the CSM does not become negative. Consequently, there is no impact on net income or equity for these changes.

Discounting the future cash flows reflects the time value of money. Due to the long durations of some insurance contracts, the determination of the discount rate and changes in the discount rate can have a major impact on equity and net income.

The forthcoming insurance contracts standard will not prescribe how to determine the discount rate, but rather provide a broad principle of being consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contracts in terms of timing, currency and liquidity. Hence the rate will conceptually be risk-free and illiquid. Depending on the currency and type of insurance contracts issued, and the methodology adopted to determine the appropriate discount rate (or rates), a number of different discount rates might be applied. The disclosure requirements for discount rates, or ranges of discount rates, are intended to achieve comparability, transparency, and market discipline.

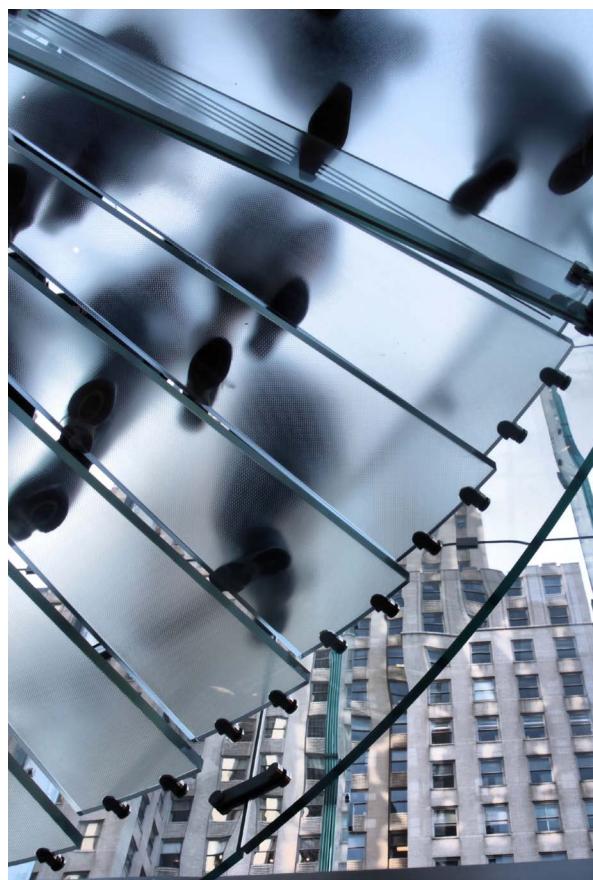
"The disclosure requirements for discount rates... are intended to achieve comparability, transparency, and market discipline."



Simplified approach

As stated previously, the standard will permit the application of a simplified 'premium-allocation' approach to measure the liability for remaining coverage for certain short-duration contracts – in particular, those with a coverage period of one year or less. The approach is broadly consistent with current unearned premium accounting practices applied in most jurisdictions for non-life, short-duration contracts.

Incurred claims liabilities will be measured using the building block approach, meaning that (with certain exceptions) cash flows will be discounted. Profit will be recognized earlier than under most current accounting models, because incurred claims liabilities are generally not currently discounted, although if the risk adjustment exceeds the effect of discounting, which may be the case, in particular for liability insurance, profit will be recognized later.



Participating contracts

A direct participating contract is defined as a contract for which:

- the policyholder participates in a defined share of a clearly identified pool of underlying items
- the entity expects to pay the policyholder a substantial share of the returns from those underlying items and
- the cash flows the entity expects to pay the policyholder are expected to vary significantly with the performance of the underlying items.

For direct participating contracts, the CSM is adjusted for changes in the shareholders' share of the returns on underlying items in the current period (the variable fee approach). The general measurement model is modified in two primary areas to accommodate direct participating contracts, as set out in Table 1.

Table 1: Amendments to building block approach for participating contracts

Area	General measurement model	Variable fee approach
Recognition of the effects of changes in market variables on guarantees embedded in insurance contracts	Recognised in the statement of comprehensive income	Regarded as part of the variability of the fee for future service, and recognised: – in the CSM or – in profit or loss if a company uses a derivative measured at fair value through profit or loss (FVTPL) to mitigate the financial market risk from the guarantee.
Interest rate applied on the CSM	Locked-in rate	Current rate through the remeasurement of the CSM.

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Key aspects of the forthcoming insurance contracts standard

Presenting discount rate effects

For all insurance contracts the forthcoming standard will provide an option to present changes in insurance liabilities arising from changes in discount rates and other market variables either in other comprehensive income (OCI) or in profit or loss. Except for contracts with no economic mismatches (see below), if the OCI accounting policy option is adopted, the effect of unwinding the discount would be presented as an "*insurance finance income or expense*" in profit or loss using the rate locked in at inception (cost measurement basis). Accordingly, the difference between an insurance finance income or expense using a cost measurement basis and a current measurement basis would be recognized in OCI.

Many investments held by insurers will not meet the criteria for classification as fair value through OCI (FVOCI) (for example, equity securities, derivatives, structured products or those with participating rights), and even if it were possible to classify all financial assets as FVOCI it would still not be possible to remove all sources of volatility arising from accounting mismatches.

Due to the possibility that accounting mismatches may still arise, the objective of disaggregating changes in market variables between profit or loss and OCI was modified for direct participating contracts with no economic mismatches. For such contracts the insurance finance income or expense in profit or loss would be equal and opposite in amount to the gain or losses presented in profit or loss for the underlying items held. Any difference between the insurance finance income or expense presented in profit or loss and the change in the contracts arising from market variables (being the change in the fair value of the corresponding underlying items) would be presented in OCI.

This approach would effectively eliminate accounting mismatches in profit or loss. By providing an option to present volatility resulting from interest rate fluctuations in OCI, the IASB will allow entities to present profit or loss on a basis that is consistent with the long-term nature of their insurance business.

Level of aggregation

The IASB has prescribed characteristics for contracts that may be aggregated for the purpose of determining whether a loss for onerous contracts needs to be recognized at inception in profit or loss, and for

measuring the CSM after initial recognition. One of these characteristics is that contracts must have similar expected profitability (i.e. similar CSM as a percentage of the total expected revenue) at inception to be included in the same contract grouping. The other is that expected cash flows respond in similar ways to changes in the amount and timing of key assumptions. Judgment will be required to interpret and apply these principles.

Differing effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts standard

The differing effective dates (2018 for IFRS 9, and probably 2020 or 2021 for the forthcoming insurance contracts standard) means two consecutive major accounting changes occurring in a short period of time, requiring insurers to apply the IFRS 9 classification and measurement requirements before the adoption of the forthcoming insurance contracts standard. Required changes in the classification of financial assets would temporarily increased accounting mismatches and created volatility in profit or loss and OCI. These consequences would have resulted in added costs and complexity for both preparers and users of insurers' financial statements.

In December 2015, the IASB responded to these potential issues by proposing amendments to the existing IFRS 4. The exposure draft ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* proposed:

- temporary exemption from applying IFRS 9 for certain entities that issue contracts in the scope of IFRS 4 (the deferral approach)
- exclusion from profit or loss of the difference between the amounts recognised under *IFRS 9 and IAS 39 Financial Instruments: Recognition and Measurement* for specified assets relating to insurance activities (the overlay approach).

The overlay approach aims to address insurers' concerns about temporary accounting mismatches and volatility in profit or loss, but would not address the concern of implementing two significant accounting changes within a short period of time. The deferral approach addresses this concern for eligible entities.

Entities will be permitted to defer the application of IFRS 9 for annual reporting periods beginning before 1 January 2021 (or application of the new

insurance contracts standard if earlier) if its activities are predominantly related to insurance and it has not previously applied IFRS 9. These activities include issuing investment contracts measured at FVTPL under IAS 39 and issuing contracts in the scope of IFRS 4. An entity will be required to assess the eligibility based on the ratio of liabilities arising from these activities plus 'other' liabilities that are connected to those activities compared to the entity's total liabilities. An entity's activities would be deemed predominantly related to insurance only if the ratio is greater than 90%; or if the ratio is above 80% but less than or equal to 90% and the entity can offer evidence that they do not have a significant activity that is unrelated to insurance.

These amendments are currently in the drafting phase. The IASB expects to issue the final amendments in September 2016.

KPMG perspectives

For the first time, the forthcoming insurance contracts standard will require consistent accounting for insurance contracts, providing the ability to analyze results more meaningfully across entities and jurisdictions. The standard will be one of the most complex standards issued by the IASB and its implementation will reflect this, particularly for those insurers that issue long-duration insurance contracts.

Some of the related impacts include:

- The measurement model will change the way insurance liabilities are measured and presented:
 - due to the even release of the CSM, earnings patterns may change especially for long-duration contracts. For many contracts, earnings (and hence the creation of capital) will arise later compared to both Solvency II and market consistent embedded values. However, for other contracts such as regular premium contracts with participation features, the recognition of earnings may be accelerated

- the level of aggregation used for measuring the CSM and for determining when contracts are onerous will influence an entity's profit profile (and hence the creation of capital)
- a reduction in equity may occur on transition and in subsequent periods, impacting reported capital.
- Volatility may increase for entities that have not previously measured their insurance contracts using current information and assumptions. Although various accounting options are expected in the forthcoming insurance contracts standard, it remains unclear precisely what effect these options will have on reducing volatility in profit or loss.
- Calculating and releasing the CSM, both at transition, and subsequently, will present a new operational challenge.
- The new measure of insurance contract revenue and the presentation of OCI will represent a significant change to current practices and the metrics utilized by analysts and other users of financial statements, such as regulators and supervisors.
- Significant effort and investment may be needed to develop, test and operationalize new processes and controls to implement the forthcoming insurance contracts standard. Systems may need upgrading, for example to ensure that they can handle the new requirements to collect and store data and track the CSM.

The forthcoming standard will require significant changes on the part of both preparers and users of insurers' financial statements.

“The standard will be one of the most complex standards issued by the IASB and its implementation will reflect this, particularly for those insurers that issue long-duration insurance contracts.”

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