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IFRS 17[1] challenges in the South African Market

At the heart of any implementation project is the accounting solution. Although many implementation projects re-evaluate systems, processes and resource requirements, changes are often dictated by the accounting requirements.

In South Africa, insurers have experienced many accounting challenges. Some of these are locally specific, while others have global relevance.

We will be exploring these challenges ….

Cash-back – long or short-term insurance product?

Cash-back products are unique to South Africa. The big question for the short-term industry is whether these products could qualify as short duration contracts. It is an important consideration as it will impact the decision on the measurement model. If the contracts are short duration contracts, insurers may[2] apply the simplified premium allocation approach which is more closely aligned to their current accounting model.

Example

An insurer issued a motor policy in terms of which cash will be paid to the policyholder if the policyholder does not claim for three consecutive years. The policyholder will receive 10% of all premiums paid within this period (three years).

The insurer re-prices the insurance policy annually, on the policy's anniversary as if it was a new policy. The policyholder or the insurer may cancel the policy on each anniversary date.

In considering whether the cash-back product is a short-duration contract, the IFRS 17 definition of contract boundary has to be evaluated:

Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services.

A substantive obligation to provide services ends when the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks[3].

We have applied the definition of contract boundary to the above example:

The insurer's substantive obligation to provide services ends after 12 months when the insurer has the ability to reassess the risks of the policyholder.

Consequently the contract boundary of the cash-back product (in the example) is 12 months and the insurer may apply the premium allocation approach.

Sources

[1] IFRS 17 Insurance Contracts, effective for year-ends commencing on or after 1 January 2021

[2] IFRS 17 par 53: Application of the premium allocation approach

An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach if, and only if, at the inception of the group:

(a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or

(b) the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

[3] IFRS 17 par 34

Back to cash accounting for short-term insurers?

Many short-term insurers may elect to apply the premium allocation approach and may believe that the impact of IFRS 17 would therefore be limited.

However, IFRS 17 requires that an insurer, when applying the premium allocation approach to measure the liability for remaining coverage includes premiums ***received***[4]. It should be noted that "received" in this case refers to "received in cash".

This however does not apply to insurance revenue – the measurement requirements are different to that for the liability. Insurance revenue for the period is the amount of ***expected*** premium receipts, adjusted to reflect the time value of money and the effect of financial risk[5]. As revenue is recognised based on expected premium receipts, revenue could still be recognised even if the cash has not been received.

What impact would this have on an insurer's accounting? We will illustrate this by way of an example.

Example

- Insurance contract with a contract boundary of 12 months, i.e. 1 January to 31 December 2019, was issued by new insurer.
- The insurer's year-end is 28 February 2019.
- The annual premium due is CU 1 200. The premium net of commission of 20% was received on 3 March 2019.
- Assume no claims and bad debts as at the reporting date and this contract is the only contract in the group.
- The expected pattern of release of risk is not significantly different from the passage of time.

What is the impact on the statement of financial position and statement of profit or loss for the year ended 28 February 2019?

Statement of profit or loss for the 2 months ended 28 February 2019	
	CU
Insurance revenue (1 200 x 2/12)	200
Insurance service expenses (20% x 1 200 x 2/12)	(40)
Insurance service result	**160**
Statement of financial position as at 28 February 2018	
	CU
Insurance asset	**160**
Retained earnings	**(160)**

The above example illustrates that in the measurement of the liability for remaining coverage, "cash accounting" is applied. The premium is only included in this liability once the cash has been received.

We have illustrated the impact when cash has been received below:

Liability for remaining coverage as at 31 March 2019	
	CU
Insurance asset as at 28 Feb 2019	160
Cash received (1 200 * 80%)	(960)
Insurance revenue for March	100
Insurance service expense for March	(20)
Closing balance – liability	**(720)**

Once the cash has been received, the asset becomes a liability for remaining coverage as the insurer has the obligation to provide future services.

Impact on insurers

As illustrated in the above example, there will no longer be any insurance receivables, although there may be an asset for remaining coverage before the cash has been received. This may create a significant challenge for existing systems and processes. The bookkeeping system should keep track of outstanding premiums, however these premiums receivable would not be recorded in the IFRS 17 measurement model.

Why does it make sense to include premiums only when the cash is received?

The premium allocation approach was included in IFRS 17 to be a proxy for the general measurement model. If IFRS 17 referred to premiums receivable, the premium allocation approach would no longer meet its objective of approximating the general model. The insurance contract liability under the premium allocation approach would be grossed up for the premiums receivable, unlike insurance contract liabilities under the general model which include all future cash flows at their carrying amount[6].

What is the issue with tax cash flows?

In South Africa the trustee principle is applied when taxing policyholder income that is accounted for in the applicable policyholder fund of a long-term insurance company. This is on the basis that insurers are deemed to hold and administer certain of their assets on behalf of various categories of policyholders while the balance of their assets represents shareholders' equity.

[4] IFRS 17 par 55
[5] IFRS 17 par B126
[6] ED/2019/4 Amendments to IFRS 17, issued June 2019, par BC 98.

Policyholder tax is withheld in each policyholder fund in respect of certain types/categories of income and paid to the South African Revenue Service (SARS) by the long-term insurer on behalf of the policyholder. The long-term insurer is liable to pay the tax. SARS will not try to recover the tax from the policyholder. The long-term insurer on-charges the tax to the policyholder, although the amount on-charged may not be exactly equal the proportionate amount of tax paid by the insurer.

Currently the taxes (calculated per policyholder fund) are included in the tax expense of the insurer (in its IFRS financial statements). There has been no change in the tax law which could challenge the inclusion of the taxes in the insurer's tax expense.

Insurers are arguing that the taxes paid on certain contracts, for example investment contracts with discretionary participation features (DPF), should be part of fulfilment cash flows as the tax is charged back to the policyholder.

The accounting challenge is that IFRS 17 differentiates between tax paid in a fiduciary capacity or not in a fiduciary capacity. If the insurer pays the tax in a fiduciary capacity, the tax is included in the fulfilment cash flows (when applying the general measurement model). If the insurer is not paying tax in a fiduciary capacity, the tax is not included in the fulfilment cash flows. The tax is then included in the tax line in the insurer's financial statements.

The relevant paragraphs in IFRS 17 are as follows:

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts[7].

The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

(f) *income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity*. Such payments and receipts are recognised, measured and presented separately applying IAS 12 Income Taxes[8].

What does fiduciary mean?

The definition of "fiduciary" refers to a trustee relationship – "when a party knowingly accepts the fiduciary duty on behalf of another party, they are required to act in the best interest of the principal, the party whose assets they are managing"[9].

The question is whether in a South African tax regime, the insurer is withholding the tax and paying it over to SARS on behalf of the policyholder.

We have explored the different views below.

Payments by the insurer in a fiduciary capacity: Included in fulfilment cash flows and never accounted for as IAS 12 income tax

Based on the fact that the trustee principle is applied when taxing a long-term insurance company, the expected tax expense should be included in the fulfilment cash flows when measuring the investment contracts with DPF and insurance contracts.

Current, deferred and future taxes "specifically chargeable to the policyholder" are generally accounted for under IAS 12[10] by most large life insurers. This view will challenge the accounting applied in current and prior years – i.e. to recognise the taxes in the tax line in the financial statements.

If argued that the tax cash flows are in essence payments made in a fiduciary capacity, they should be included in the fulfilment cash flows and as the insurance contract liability unwinds, the actual tax payable is an insurance service expense.

Some insurers reject this view on the basis that IFRS 17 should not change the previous view that the tax is within the scope of IAS 12 tax and paragraph B66(f) of IFRS 17 excludes taxes not paid in a fiduciary capacity.

Payments by insurer not made in a fiduciary capacity – not included as fulfilment cash flows, but as IAS 12 income taxes

This view argues that the insurer is legally the taxpayer. The tax amounts are not paid by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, but are tax obligations incurred by the insurer itself. If such amounts meet the definition of an income tax, then the tax paid should be recognised and presented in terms of IAS 12 as is currently done.

The impact of this view is that future taxes "specifically chargeable to the policyholder" are not taken into account to accurately measure the fulfilment cash flows (as explicit cash flows). As and when the insurance contract liability unwinds the actual tax is accounted for under IAS 12.

[7] IFRS 17 par B65
[8] IFRS 17 par B66
[9] https://www.investopedia.com/terms/f/fiduciary.asp
[10] IAS 12 Income Taxes

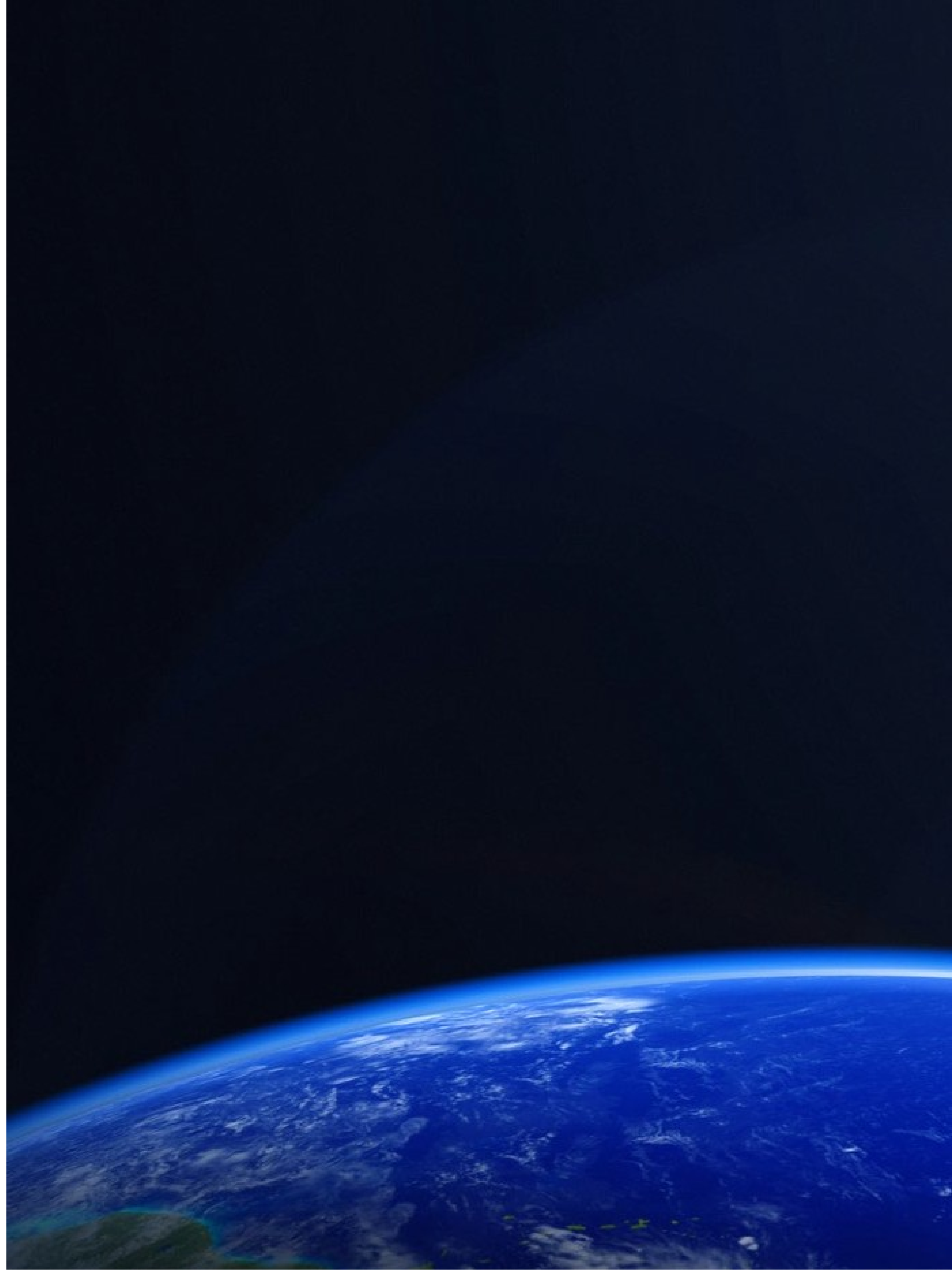
Insurers in South Africa agree that the impact of this view is not desirable. If the tax is excluded from the fulfilment cash flows, then the insurance liabilities will be too low by the required allowance for tax expected to be paid over the term of the contract. Consequently the contractual service margin will be inflated by the same amount.

One of the previous staff papers of the International Accounting Standards Board (IASB), included the following:

"Some respondents suggested that the fulfilment cash flows should include the amounts that insurers pay in some jurisdictions as a proxy for investment returns being taxed in the hands of policyholders. *The IASB decided to clarify that the cash flows excluded from the fulfilment cash flows are the income tax payments and receipts attributable to policyholders that do not arise directly as the insurer fulfils the contracts"* [11].

Insurers are arguing that the taxation arises as they fulfil the insurance contracts. We will wait to see if the IASB acknowledge their concerns and relooks at the IFRS 17 paragraphs. Currently it may be difficult to support that long-term insurers are paying the tax in a fiduciary capacity...

[11] 18 February – 22February 2013 IASB Agenda Ref 2C – Staff Paper - Comparison of the IASB's tentative decisions to the comment letter summary par 58



IFRS 17

Considerable accounting changes for insurers on the way

The new insurance contracts standard, IFRS 17, aims to increase transparency and to reduce diversity in the accounting for insurance contracts.

Responding to stakeholders' concerns and implementation challenges, the International Accounting Standards Board has proposed an effective date of 1 January 2022 for IFRS 17 – a one-year deferral – and amendments in seven important areas of the standard.

The magnitude of evolving insurance accounting change should not be underestimated. Even with the extra year, many insurers need to step up the pace of their implementation. There is much that needs to be done in what is still a relatively short time.

Our materials will help you understand the evolving proposals and assess the potential impact on your company.

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