IAS PLUS

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ED 5, INSURANCE CONTRACTS: DETAILED SUMMARY

On 31 July 2003, the IASB issued ED 5, Insurance Contracts, setting out the Board's proposals in Phase I of a two-part project. ED 5 provides guidance on applying existing IFRS to accounting insurance contracts and requires additional disclosures. This publication summarises the proposals in ED 5.

Background

When the IASB took over from the IASC in April 2001, it inherited a comprehensive project on accounting for insurance contracts that the IASC started in April 1997. The IASC had published an issues paper in November 1999.

The IASB continued the work that the IASC had begun but realised that it was not feasible to complete the comprehensive project in time for the adoption of IFRS by European listed companies in 2005. Nonetheless the IASB recognised that some guidance is needed before 2005 because accounting for insurance contracts under IFRS at the moment is diverse and quite unique relative to other industries. Also, the existing IFRS that are most relevant to accounting for insurance contracts (IAS 32, 37, 38, and 39) exclude insurance contracts from their scopes.

So in May 2002 the IASB split its insurance contracts project into two phases. Phase I, from which ED 5 emanates, will provide guidance in time for the 2005 changeover to IFRS in Europe. Phase II will be the comprehensive project. The comment deadline on ED 5 is 31 October 2003.

Proposed effective date

Periods beginning on or after 1 January 2005, except the fair value disclosure requirement would be deferred until 31 December 2006 (and comparative 31 December 2005 fair value disclosures would not be required).

Definitions

An insurance contract is a contract under which an insurer accepts significant insurance risk by agreeing to compensate the policyholder or other beneficiary for the adverse effect of a specified uncertain future event. An insurance risk is a risk other than a financial risk. A financial risk is a risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

Scope of ED 5

- Applies to all insurance contracts, including reinsurance contracts. That is, this standard does not relate just to insurance companies.
- Does not apply to other assets and liabilities of issuers of insurance contracts, although other IFRS would apply.

Recognition and measurement of insurance liabilities

Catastrophe and equalisation provisions. These are prohibited because they do not reflect loss events that have already occurred and, therefore, are inconsistent with IAS 37.

Loss recognition testing. An insurer is required to carry out a loss recognition test relating to losses already incurred at each balance sheet date. If the test shows that the measurement of its insurance liabilities (net of related deferred acquisition costs and intangible assets) is insufficient, adjustment of the liabilities is recognised in net profit or loss. While the ED would require that current estimates of future cash flows be used in the loss recognition test, it does not specify which cash flows should be included and whether and how to discount them:

- If the insurer's existing accounting policies use this type of loss recognition test, ED 5 won't change the policies.
- However, if the insurer's existing accounting policies have not required this type of loss recognition test, then the ED would require that the principles of IAS 37 be followed. Guidance for doing so is included.

Applying IAS 39

- *Embedded derivatives.* IAS 39 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract. ED 5 would not change that. However, ED 5 expressly provides an exception that an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount. That exception does not apply if the surrender value varies based on the change in an equity or commodity price or index.

- *Unbundling deposit components of insurance contracts.* If an insurance contract contains both an insurance component and a deposit (investment) component, the deposit component must be treated as a financial liability or financial asset under IAS 39. As a result, the insurer would not recognise premium receipts for the deposit component as revenue. ED 5 clarifies that the measurement at fair value of a demand feature (such as a demand deposit) is no less than the amount payable on demand and that cash surrender and maturity values of many traditional insurance contracts would not generally be classified as a deposit component.
- *Derecognition.* The derecognition provisions of IAS 39 should be applied to insurance liabilities. Therefore such liabilities cannot be removed from the entity's balance sheet until discharge, cancellation, or expiry.

Applying the requirements on offsetting in IAS 1 and IAS 32

- Assets under reinsurance contracts cannot be offset against related insurance liabilities.
- Income and expense from reinsurance contracts cannot be netted against related expense or income from the underlying insurance contracts.

Accounting policies: issues relating to IAS 8 (as proposed to be revised in the Improvements Project)

One purpose of the IFRS that will result from ED 5 is to lay some groundwork that will help insurers in their future transition to a Phase II standard (see last section of this newsletter) and, at the same time, discourage accounting changes that may need to be reversed when Phase II is completed. With those objectives in mind, ED 5 would:

- Suspend until 2007 the hierarchy of authoritative guidance on IFRS that will be added to IAS 8. The reason for the suspension is that, given the diversity of existing accounting practices for insurance contacts and the inconsistency of those practices with accounting in other sectors, the Board feared that the hierarchy might impose unintended and potentially undesirable changes in insurance accounting before Phase II is finished.
- Prohibit changes in accounting policies for insurance contracts unless the change clearly makes the financial statements more understandable, relevant, reliable, and comparable as judged by the criteria in IAS 8.

Other things ED 5 does not do Does not require discounting or prohibit the use of a discount rate that reflects the estimated return on the insurer's assets to measure the insurer's liabilities.

- Does not try to eliminate excessive prudence (the existing result of influence of regulatory reporting on GAAP).
- Does not prohibit or require deferral of policy acquisition costs.
- Does not require all insurance subsidiaries of a single parent to use same accounting policies.

An insurer cannot change the measurement basis for its insurance liabilities simply by the purchase of reinsurance.

Disclosure

ED 5 proposes the following disclosures, among others:

- Accounting policies for insurance contracts and related assets, liabilities, income, and expense.
- Amounts and other details of assets, liabilities, income, expense, and cash flows relating to insurance contracts.
- Fair values of insurance assets and insurance liabilities (starting 1 January 2006).
- Significant assumptions and changes in them.
- Risk management policies.
- Those terms and conditions of insurance contracts that have the most significant effect on cash flows.
- Information about insurance risk, including the sensitivity of reported profit or loss and equity to changes in key variables, significant risk concentrations, and actual claims compared to previous estimates.
- Information about interest risk and credit risk, including risks related to embedded derivatives.

What is the Board's leaning in Phase II?

The Board favours an asset and liability model that requires an entity to identify and measure directly individual assets and liabilities arising from insurance contracts, rather than deferrals of inflows and outflows. Under that model, insurance contract assets and liabilities would be measured at fair value (which involves discounting), except that:

- entity-specific assumptions and information may be used to determine fair value if market-based information is not available; and
- the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical terms and remaining term from new policyholders.

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