

Need to know

Financial Reporting Council issues FRED 49 Draft FRS 103 Insurance Contracts

In a nutshell

- The Financial Reporting Council (FRC) has issued Financial Reporting Exposure Draft (FRED) 49: 'Draft FRS 103 Insurance Contracts'. The proposed FRS 103 is based on IFRS 4, and broadly allows entities to continue with their current accounting for insurance contracts if they wish, or to make certain improvements. Nevertheless, given some of the requirements of this standard and of FRS 102, insurance contract accounting may change for many insurers.
- The FRC has also published draft implementation guidance to assist in the application of FRS 103, the application of FRS 102 to insurance companies, and the accounting requirements of the Companies Act for insurance companies.
- Once approved, the new standard would apply for periods commencing on or after 1 January 2015, with early adoption permitted (but not required) if FRS 102 is also adopted. Once FRS 103 is adopted, FRS 27 and the ABI SORP will cease to apply. The deadline for comments to the FRC is 31 October 2013.

Background to FRED 49

FRED 49 was developed following the 2012 Discussion Paper *Insurance Accounting – Mind the GAAP* and will apply to entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* that:

- issue insurance contracts (including reinsurance contracts) or hold reinsurance contracts; and/or
- issue financial instruments (other than insurance contracts) that have a discretionary participation feature.

Draft FRS 103 is based largely on IFRS 4, amended to reflect the requirements of company law. The proposed standard and its implementation guidance draws on FRS 27 *Life Assurance* and the ABI SORP, both of which will be withdrawn when FRS 103 becomes effective.

The FRC anticipate that the proposed standard will have a limited life and expects to revise the standard once the IASB has issued its updated standard on insurance contracts (IFRS 4 Phase 2) and changes in the regulatory regime for insurers (Solvency II) have been finalised.



Will draft FRS 103 be applicable to me?

The standard will be applicable to entities that apply FRS 102 and issue insurance contracts (including reinsurance contracts), hold reinsurance contracts and/or that issue financial instruments with a discretionary participation feature. This will include life and general insurers (including mutuals), as well as entities that are not legally constituted as insurance companies.

Companies adopting IFRS 4 (for example, listed groups) will not need to apply FRS 103.

The question of whether Draft FRS 103 will apply to warranties depends on the company giving the warranty:

- there is a scope exclusion for product warranties issued by manufacturers, dealers or retailers, which will be accounted for under Sections 21 *Provisions and Contingencies* and 23 *Revenue* of FRS 102;
- insurance companies will, as a matter of law, be accounting for warranties as insurance contracts; and
- for other companies, there will be the choice as to whether to maintain their existing accounting policy (which might be either of the above approaches) – or, if they are currently accounting for the contract in line with FRS 12 and FRS 5 Application Note G, to move to account for them as an insurance contract.

Draft FRS 103 also contains a list of scope exclusions which includes product warranties, which will be accounted for under Sections 21 *Provisions and Contingencies* and 23 *Revenue* of FRS 102. The Accounting Council's advice to the FRC suggests that entities may be given the choice to apply FRS 103 to warranties.

What is an insurance contract?

Entities that apply FRS 26 will be familiar with the definition of an insurance contract.

Definition of an insurance contract:

A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policy holder.

In this definition, insurance risk means risk, other than financial risk, transferred from the holder of a contract to the issuer.

Contracts which do not meet the definition of "insurance contracts" will fall within the scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues* of FRS 102. Appendix II of Draft FRS 103 provides helpful examples of contracts that are, and are not, insurance contracts. Additionally the standard provides guidance (based on IFRS 4) on unbundling of deposit components, specifying when unbundling is required, permitted or prohibited. A deposit component is defined as a contractual element that is not accounted for as a derivative under Sections 11 and 12 of FRS 102 and would be within the scope of those Sections of FRS 102 if it were a separate instrument. Where a deposit component is required to be unbundled it would be accounted for as a financial instrument. Unbundling is only required when the entity can measure the deposit component reliably and its accounting policies do not otherwise require it to recognise all the rights and obligations arising from the deposit component.

What will change in accounting for insurance contracts?

As with IFRS 4, Draft FRS 103 largely permits entities to continue with existing accounting policies for insurance contracts. Again, like IFRS 4, Draft FRS 103 permits entities the same flexibility to make improvements in their accounting policies, provided that the 'improved' accounting policies continue to comply with existing legal and regulatory requirements. Where an entity makes such an 'improvement', it need not apply the material in the proposed FRS which derives from FRS 27 or the ABI SORP where these are inconsistent with the new policy. The improvements that are permitted, but not required, include:

- allowing remeasurement of designated insurance liabilities to reflect current market interest rates through profit and loss; and

Entities that have not applied FRS 26 may see a significant change in their accounting as they account separately for deposit and insurance components of a contract. Insurers that have not previously applied FRS 26 will need to consider the categorisation of their contracts and whether their systems can collect the necessary data to account under FRS 102 or FRS 103 as applicable.

- where realised gains and losses on assets affect the valuation of insurance liabilities (and related deferred acquisition costs and intangible assets), entities may allow remeasurement of liabilities for recognised but unrealised gains and losses. The related adjustment to the insurance liability will be recognised through other comprehensive income (OCI) if, and only if, the unrealised gains or losses on the asset are recognised through OCI.

Existing practices can be continued but certain practices may not be adopted by an existing insurer:

- measuring insurance liabilities on an undiscounted basis (unless required to do so by law or regulation);
- measuring contractual rights to future investment fees at a value that exceeds their fair value when compared with current fees charged by other market participants for similar services;
- using non-uniform accounting policies for insurance contracts (and related deferred acquisition costs and intangible assets) of subsidiaries;
- including future investment margins in the measurement of contracts other than long-term business, except where (a) the contractual payments are affected by those margins or (b) the presumption that such information is less relevant can be rebutted.

New entrants to the insurance market will, of course, not have any existing policies, and therefore will be permitted to start with those derived from FRS 27 and/or the ABI SORP (as applicable) before deciding whether to 'improve' on those policies.

Excessive prudence

The ABI SORP explains that claims provisions should be set so that there is no adverse run-off deviation – in other words, so that the likely outcome as time passes is that reserves are released rather than new reserves being required. The FRC's proposals, in line with IFRS 4, note that this may result in excessive prudence. Existing accounting policies can be continued, but 'improved' policies must not require excessive prudence.

Embedded derivatives in insurance contracts

Where an insurance contract contains a separable embedded derivative (using the guidance in IAS 39 and IFRS 4), Draft FRS 103 requires that separable embedded derivatives should be accounted for separately in accordance with Sections 11 and/or 12 of FRS 102 (or, if they have chosen to apply IAS 39 or IFRS 9, that standard). The only exception to this requirement is where the embedded derivative is itself an insurance contract and for certain policyholder options to surrender contracts. This is in contrast to the general requirement of FRS 102 to fair value non-insurance contracts containing non-typical features as a whole rather than separating into two elements.

Entities that do not currently adopt FRS 26 will need to check whether any features of their contract are embedded derivatives.

Differences from IFRS 4

The FRC is keen to minimise differences from IFRS 4, and therefore the only differences are those arising from the law:

- equalisation provisions may be required by law, but are prohibited by IFRS 4. This issue also affects insurers applying FRS 101 and a consequential amendment to FRS 101 is also proposed;
- Draft FRS 103 is consistent with IFRS 4.34(b) and 4.35(b), permitting discretionary participation features to be accounted for as equity or as a liability. However, for an insurance company, the law requires presentation as a liability; and
- the law has specific requirements which permit and prohibit discounting. IFRS 4 requires new accounting policies to be on a discounted basis.

What additional disclosures will be required?

IFRS 4 requires certain disclosures of claims development over a ten year period, which are replicated in draft FRS 103. This goes above and beyond the requirements of the law. A transitional provision allows this information not to be presented for periods more than five years before the first application of draft FRS 103.

IFRS 4 does not require some disclosures around credit risk, liquidity risk, and market risk because these are included in IFRS 7 for an IFRS reporting entity. Draft FRS 103 instead cross-refers to the equivalent sections of FRS 102.

Additional disclosures of risks and uncertainties may require effort to collect the necessary information.

What about disclosures of capital?

Entities that did not previously apply either FRS 26 or FRS 27 will not have had to make disclosures in the notes to the financial statements about their capital. The FRC is consulting as to whether insurers without long-term business should make such disclosures.

The draft FRS preserves the requirement in FRS 27 for long-term insurance business capital disclosures. It does not propose extending these to other insurance companies, although it asks whether this should be recommended as best practice. Long-term insurers that are 90%+ subsidiaries of another entity that provides disclosures will now have to make capital disclosures; previously they were exempt.

Looking beyond the debits and credits

Insurance companies that apply existing UK GAAP will have a choice whether to apply full IFRS, FRS 101 (if they are a qualifying subsidiary), or FRS 102 with FRS 103. In making their choice, entities will want to consider a range of factors including:

Systems – can systems produce the necessary information?	Wider change – are plans to change accounting framework integrated with wider planning for Solvency II and further IFRS changes for insurance?
Management incentives – are targets set based on a specific profit measure?	Regulatory – will any of these changes affect regulatory returns?
Loan covenants – are these based on defined profit or asset measures?	Communications – how will any changes be communicated to investors? Members of a mutual? Other stakeholders?

Making these capital disclosures should not be overly burdensome as the necessary information will already be available in Prudential Regulatory Authority regulatory returns.

Much else is changing in the world of insurance with Solvency II and the IASB's insurance project likely to be finalised over the next few years. Proper planning will avoid duplication of effort.

How can Deloitte help?

Deloitte can assist you in understanding how the technical accounting aspects of the proposed standard will impact your financial statements and its potential impacts to your income profile and balance sheet. In addition we can also help you to:

- Assess your current systems to assess whether the information is available to support the required accounting and disclosures.
- Provide training on the proposed accounting standards to your finance team.
- Update your accounting policy documentation and prepare the required journals and changes to your financial statements to reflect the transition to the proposed standard.
- Assist you in communicating the impact of the changes from Draft FRS 103 to your stakeholders.
- Provide project management support to your transition project in preparation for the implementation of a new UK GAAP insurance standard.

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