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The forthcoming IFRS® insurance contracts Standard

WHY CHANGE INSURANCE CONTRACTS ACCOUNTING?

The International Accounting Standards Board (the Board) is close to finalising new accounting requirements for insurance contracts. The Board expects to publish a new IFRS Standard for insurance contracts in early 2017, called IFRS 17 *Insurance Contracts*. The new Standard will replace IFRS 4 *Insurance Contracts* from 1 January 2021.

What is an insurance contract?

An insurance contract (or policy) provides a promise from a company to a policyholder to assume the financial consequences of uncertain future events (insured event). The outcome of the contract for the company is uncertain and the profit or loss is not known for many years. This, in itself, means that accounting for insurance contracts is heavily reliant on assumptions. In addition, insurance contracts may include a significant saving component (ie an amount the company is obligated to pay to the policyholder regardless of whether the insured event occurs). Insurance contracts are not typically traded in markets. These factors pose challenges for measuring insurance contracts and reporting their performance.

This article provides an overview of the criticisms of existing insurance accounting practices and the reasons why the Board and many stakeholders think that an urgent change is needed.

Insurance contracts accounting today is fragmented

Today, IFRS Standards do not have a comprehensive Standard for insurance contracts. IFRS 4 was issued in 2004 as an interim IFRS Standard that (a) permitted companies to continue their accounting practices and (b) focused on enhanced disclosure on the amount, timing and uncertainty of future cash flows from insurance contracts.

Applying IFRS 4, companies use a wide range of accounting practices for insurance contracts, largely based on the accounting requirements in each jurisdiction before it adopted IFRS Standards. Different accounting models have evolved according to the circumstances and the types of insurance products in each jurisdiction, often independent of accounting for other transactions in that jurisdiction. This leads to a significant diversity in those insurance contracts accounting practices.

Get in touch

If you would like to discuss this topic or other areas of insurance contracts accounting, please contact:
insurancecontracts@ifrs.org

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In addition, some existing insurance contracts accounting practices reflect an incomplete view of the insurance contracts' effect on a company's underlying financial position and performance. For example, the accounting practices may:

(a) use information that reflects only the company's expectations when it entered into the insurance contracts, possibly decades previously, without subsequently updating those expectations; and

(b) require the company to report only incomplete information about the value of insurance contracts with complex features, such as financial options and interest-rate guarantees.

To accommodate some of these accounting practices, IFRS 4 states explicitly that a company is not required to ensure that its accounting policies for insurance contracts are reliable or relevant to the economic decision-making needs of users of its financial statements, such as investors and analysts.

Thus, IFRS 4 has caused problems, particularly for investors and analysts in comparing and understanding insurance contracts across jurisdictions. Limited information in the financial statements can lead, in turn, to narrow investments, ambiguity in reporting and ultimately defective decision-making.

Users of financial statements, regulators and preparers have told the Board these problems need to be addressed. For example, the Financial Stability Board (FSB) Plenary issued a statement in September 2015 underlining the high priority of the insurance contracts project.

To address these problems, the Board started a project to harmonise insurance accounting practices across jurisdictions and to improve the relevance and transparency of companies' financial reports. The forthcoming insurance contracts Standard will complete this project.

The need for greater transparency

A company generally invests in assets the premiums it receives to meet its promise to pay cash to the policyholder if a specified, uncertain event happens, sometimes many years in the future. The investment strategy seeks to match the expected future cash flows to and from insurance contracts, as well as generally attempting to match the returns inherent in the promise to policyholders, and seeks to accommodate the uncertainty of those cash flows. However, because of limited availability of suitable assets, the cash flows arising from the assets and insurance contract liabilities are frequently exposed to different risks that need to be reflected in companies' financial statements. This information helps investors and analysts to understand the timing, amount and uncertainty of those cash flows.

The new accounting requirements will provide more relevant, comparable information

The forthcoming insurance contracts Standard will require all companies that issue insurance contracts to account for all insurance contracts in a way that provides:

(a) current estimates at each reporting date of the obligation created by the insurance contracts, reflecting up-to-date information about cash flows arising from insurance contracts, and the timing and risk associated with those cash flows.

(b) information about (i) the sources of profit or losses through underwriting activity and investing premiums from customers; and (ii) the extent and nature of risks arising from insurance contracts.

This is expected to provide users of financial statements with more relevant information about the company's financial position and performance, and better transparency. In addition, as a result of consistent accounting requirements, the Board expects significantly improved comparability.

Further information about how the Board has addressed existing problems in insurance contracts accounting and the expected benefits of the forthcoming insurance contracts Standard is provided in the tables below.

Today—a lack of comparability	Tomorrow—a consistent framework
Comparability among companies	
Accounting for insurance contracts varies significantly between companies operating in different jurisdictions. For example: • Some companies recognise as revenue all premiums received; others exclude from their reported revenue any saving components received through premiums. • Some companies capitalise and amortise over years the costs incurred in issuing new insurance contracts; others expense these costs when incurred. • Some companies use updated discount rates to measure their insurance contracts; others use historical discount rates. These differences prevent meaningful comparisons between companies.	**Companies will apply a consistent accounting framework for all insurance contracts.** Many insurance accounting differences will be removed, enabling investors and analysts to properly identify economic and risk similarities and differences between companies issuing insurance contracts.
Comparability among insurance contracts	
A multi-national group is allowed to consolidate subsidiaries using non-uniform accounting policies as insurance contracts can be measured applying the relevant local accounting requirements of each jurisdiction. This results in a lack of comparability between insurance contracts issued by the same group in different jurisdictions.	**A multi-national group will measure insurance contracts in a consistent way within the group**, increasing the comparability of its results by product and geographical area.
Comparability among industries	
Some companies present cash or deposits received as revenue. This is contrary to the accounting applied in other industries, and in particular the banking and investment-management industries.	**Revenue will reflect the insurance coverage provided, excluding saving components**, like any other industry, increasing comparability and understanding of the income statement of companies issuing insurance contracts.

Today—a lack of transparent and relevant information	Tomorrow—clear and useful information available for all
Value of insurance contracts	
Use of out-of-date assumptions does not provide useful financial information. Some companies measure insurance contracts using assumptions at the time that the contracts were issued that are not subsequently updated to reflect economic changes.	**Insurance contracts will be measured at current value**, using updated assumptions about cash flows, discount rate and risk at each reporting date. This will better reflect the way a company expects to extinguish its insurance contract liabilities.
Some companies use the 'expected return on assets held' as the discount rate to measure insurance contracts, distorting the value of the insurance contract liabilities as these liabilities may not be directly linked to assets and may have a different duration.	**Companies will use a discount rate that reflects the characteristics of the insurance cash flows** to measure their insurance contracts. Companies' financial statements will reflect the risks relating to insurance contracts that are not economically matched by assets of equivalent risk and duration.
Some companies do not consider the time value of money when measuring liabilities for claims incurred. Misleading results may arise for insurance contracts for which the settlement of a claim may take some years.	**Companies will report estimated future payments to settle incurred claims on a discounted basis.** Because the time value of money will be taken into consideration, the reported expense for claims will better reflect the economic expense.
Some companies include an 'implicit allowance for risk' in the measurement of their insurance contract liabilities. The extent of the implicit margin is typically not disclosed in the notes to the financial statements.	**Companies will calculate and disclose an explicit risk margin.** This will provide transparent information about uncertainty of the amount and timing of cash flows arising from insurance contracts issued by the company.
Information about profitability of insurance contracts	
There is a lack of transparency about the sources of profit recognised from insurance contracts, especially when revenue is reported on a cash basis.	**Companies will provide information about current and future profitability** arising from insurance contracts. Companies will recognise revenue as the insurance coverage is delivered and will provide information about different profit components.
Obligations arising from insurance contracts are highly uncertain. The assessment of the timing, amount and uncertainty of cash flows arising from insurance contracts is difficult to perform.	**Companies will provide additional information about estimates and judgements used to measure insurance contracts**, enabling investors and analysts to better assess the timing, amount and uncertainty of cash flows arising from insurance contracts.
Many companies provide non-GAAP information, usually about future profitability of long-term insurance contracts. This information, which has been defined independently of IFRS requirements, is not presented on a consistent basis and by all companies issuing insurance contracts.	**Limited need to produce non-GAAP information.** Improved accounting for insurance contracts will reduce the need for companies and analysts to use non-GAAP performance measures.