XIV GENERAL INSURANCE SEMINAR

IFRS – an update

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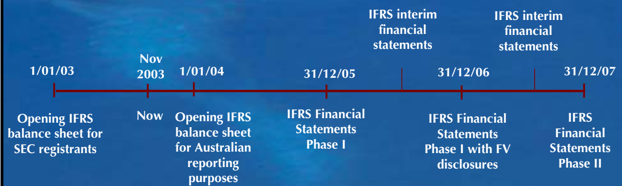
Agenda

- Introduction
- IFRS timing
- Accounting issues
  - Insurance Phase I – ED 5
  - Insurance Phase II
  - Other accounting issues
- Strategic issues
- Discussion

International Accounting Standards Board (IASB)

- privately funded organisation based in London
- restructured independent board 2001
- 14 members
- EU 2005 adoption, Aust 2005
- USA position

Timetable



IFRS context for Australian insurers

IFRS to be "foundation" standards – Australian equivalents to be issued

- AASB ED 122 equivalent to IASB ED 5 – draft
- Insurance IFRS in two phases:
  - Phase I: amendments to AASB 1023 and new standard arising from ED 122
  - Phase II: replace AASB 1023 with insurance standard

Phase I: key issues

- ED5 covers insurance contracts not insurance companies
- Distinguishing insurance contracts from investment contracts
- Loss recognition test for insurers
- Enhanced insurance disclosure requirements

Definition of insurance contract

ED 5 states that an insurance contract is:

"a contract under which one party (the** insurer**) accepts significant** insurance risk **from another party (the** policyholder**) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the** insured event**) adversely affects the policyholder or other beneficiary."

What is insurance risk?

- Uncertainty or risk is the essence of an insurance contract
  - Whether a specified future event in the contract will occur
  - When the specified event will occur
  - How much will the insurer need to pay if the specified event occurs

What is significant?

Significant if….

"reasonable possibility … causes significant change in the present value of cash flows…"

- Consider both probability and magnitude hence:
  - Significant if high probability but limited potential payment (loss of contact lenses)
  - Significant if low probability but high potential payment (earthquake)
  - Not significant if event not plausible
- Issue over how level of insurance risk will be measured

ED 5 loss recognition

- ED 5 requires:
  - Loss recognition testing at each reporting date
  - Use of current estimates of future cash flows
  - If deficiency exists, must recognise *entire* amount in income statement
- Under ED 5, insurer would first write off any applicable deferred acquisition costs or other intangibles and then record additional liability for any remaining deficiency

ED 122 loss recognition

- AASB 1023 does not currently meet all the loss recognition requirements of ED 5
- AASB is proposing two options for amending AASB 1023 to require:
  - a write-down of DAC and any intangible assets and then to recognise an additional liability when necessary – same as ED 5, OR
  - premium revenue and insurance liabilities to be recognised at the outset of insurance contract. Would require recognition of premium liabilities as in APRA GPS 210. However, would not allow for profit on inception of a GI contract, but earned over period of risk.

Three Disclosure Principles

ED 5 disclosure requirements follow three core principles:

1. Information to *identify and explain* insurance contract related amounts in balance sheet, income statement and cash flow statement
2. To help users *understand* the estimated amount, timing and uncertainty of future cash flows
3. *Disclose the fair value* of its insurance assets and insurance liabilities from 31 December 2006

Explanation of reported amounts

- Amounts and significant accounting policies
- Process used to determine assumptions with greatest effect on the amounts
- Quantified disclosures of assumptions
- Effect of changes in assumptions
- Material changes in insurance liabilities, reinsurance assets and DAC

Amount, timing and uncertainty of cash flows

ED 5 requirements:

- Objectives and policies for managing and mitigating risks
- Significant contract terms and conditions
- Information about insurance risk:
  - Sensitivity analysis for changes in variables
  - Claims development
  - Concentration of risk
  - Interest and credit risk

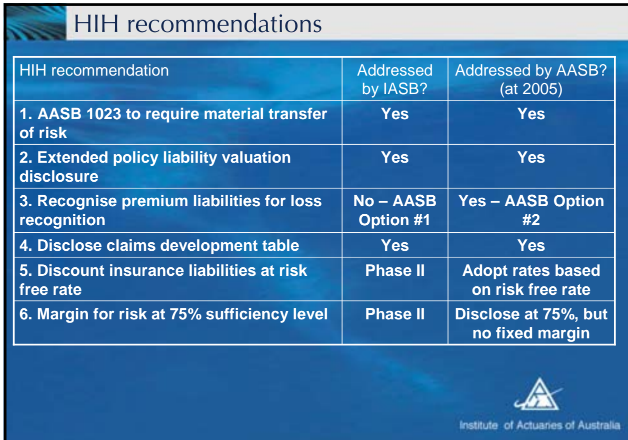
Claims development table example

Underwriting year	20X1	20X2	20X3	20X4	20X5	Total
Estimate of cumulative claims:						
At end of U/W year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	(702)	(689)	(570)	(350)	(217)	
	0	82	275	553	751	1,661
Effect of discounting	0	(14)	(68)	(175)	(285)	(542)
Present value recognised in the balance sheet	0	68	207	378	466	1,119

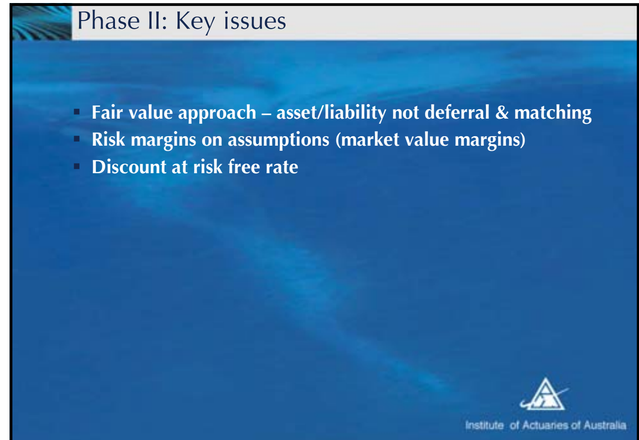
Amount, timing and uncertainty of cash flows

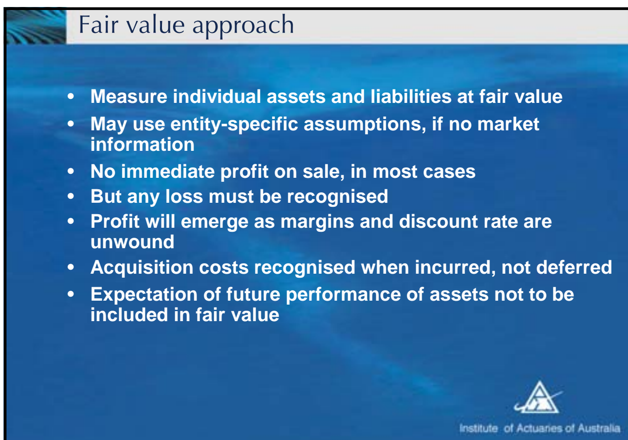
Additional AASB requirements:

- Valuation of liabilities at:
  - Central estimate
  - 75% probability of sufficiency
  - Margin ultimately adopted by the entity



HIH recommendation	Addressed by IASB?	Addressed by AASB? (at 2005)
1. AASB 1023 to require material transfer of risk	Yes	Yes
2. Extended policy liability valuation disclosure	Yes	Yes
3. Recognise premium liabilities for loss recognition	No – AASB Option #1	Yes – AASB Option #2
4. Disclose claims development table	Yes	Yes
5. Discount insurance liabilities at risk free rate	Phase II	Adopt rates based on risk free rate
6. Margin for risk at 75% sufficiency level	Phase II	Disclose at 75%, but no fixed margin





Key other accounting issues

- IAS 39
  - Classification of investments
  - Hedge accounting and fair values
  - Securities - Mark to market and impairment
  - Debt / Equity classification
- Deferred taxes
- Pensions and share based payments
- Defined benefit funds surplus/deficit on balance sheet
- Goodwill no longer amortised

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Some strategic issues for insurance companies

- Understanding pattern of profit emergence for all contracts
- Future pricing will be really important for profit emergence
- Product design and distribution
- System needs and requirement for better integration
- Impact of new disclosure items
- Managing stakeholders – APRA, S&P, etc
- Impact of 2 phased approach

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