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In this supplementary issue of Financial Reporting Matters, we discuss the recently issued accounting standard on insurance contracts and highlight some of the more challenging issues on implementation.

FRS 104 *Insurance Contracts*

This first standard on insurance accounting aims to introduce limited improvements in accounting for insurance contracts and improved disclosure for insurance contracts, without requiring extensive changes that might need to be reversed when the International Accounting Standards Board (IASB) issues a new standard upon completion of Phase II of the project.

In short, FRS 104 permits entities in most cases to continue their existing accounting practices for insurance contracts, although certain industry wide practices are now prohibited. Of particular importance, FRS 104:

- introduces a definition for an insurance contract;
- prohibits provisions for possible claims under contracts that are not in existence at the reporting date, such as catastrophe and equalisation provisions;
- requires a liability adequacy test to ensure that the measurement of an entity's insurance liabilities considers all expected cash flows, using current estimates; and
- requires an insurer to keep insurance liabilities on its balance sheet until the liabilities are discharged, cancelled or expired.

Insurers also need to implement the new Valuation and Risk-Based Capital requirements introduced by the Monetary Authority of Singapore in the Insurance (Valuation and Capital) Regulations 2004, and revised MAS Notice 307 (Notice on Investment-Linked Life Insurance Policies), both also effective from 1 January 2005. Hence, it is important to focus resources and time to cope with the major reporting and regulatory changes.

FRS 104 is effective for annual financial periods beginning on or after **1 January 2005**. It is based on, without modifications, IFRS 4 *Insurance Contracts,* which was issued on 31 March 2004 by the IASB. The IASB decided to develop IFRS 4 primarily because there was no IFRS on insurance contracts and accounting practices for insurance contracts are diverse.

Scope and definition

FRS 104 applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other FRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of FRS 39 *Financial Instruments: Recognition and Measurement.*

It is important to determine which contracts are insurance contracts and which (or which parts) are financial instruments or service contracts. The definition of an insurance contract in FRS 104 provides a basis for identifying insurance and non-insurance contracts and therefore the appropriate accounting treatment.

What is an insurance contract?

Insurance risk distinguished from financial risk

FRS 104 defines an insurance contract as "*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 policyholder.*"

Importantly, the scope of the insurance contract definition is restricted by the definition of insurance risk, which is *"risk other than financial risk"*. This definition of insurance risk excludes many financial instruments, including most derivatives from the scope of the standard.

Assessment of significance of insurance risk

Significant insurance risk exists only if an insured event could cause an insurer to pay *significant additional benefits* in any scenario (excluding scenarios lacking commercial substance) on an individual contract basis.

When assessing the significance of insurance risk, the following two factors should be considered:

- the insured event should have sufficient probability of occurring; and ·
- the insured event should have a significant magnitude of effect.

These two factors are assessed independently.

The occurrence of an event is viewed as sufficiently probable if the occurrence thereof has commercial substance. Any event which market participants see as a threat to their economic targets for which they are willing to pay to cover against, has commercial substance and therefore sufficient probability of occurrence.

In addition, the magnitude of the effect is considered sufficient if the effect on the policyholder is significant when compared to the minimum amount payable in a scenario of commercial substance. For example, if a contract pays a death benefit (death being the insured event) exceeding the amount payable on survival ('non occurrence' event) the contract is an insurance contract unless the excess death benefit is insignificant.

When to assess?

Insurance risk should be assessed at the inception of the contract. Once the contract is classified as an insurance contract it remains so until the ultimate settlement of all rights and obligations under the contract.

Other factors in considering the appropriate accounting treatment

If there is no significant insurance risk, the contract should be examined to establish the appropriate accounting treatment. Contracts will either be accounted for under FRS 39 as 'investment' contracts or under FRS 18 *Revenue* as service contracts if there is no financial risk. Investment contracts may include the provision for investment management services. However, an investment contract that contains a discretionary participation feature will be accounted for under FRS 104 and will therefore be permitted to be recognised and measured under existing accounting policies.

Implications of definition

Certain contracts issued by non-insurers may now meet the definition of an insurance contract. Some such contracts, however, are excluded from the scope of FRS 104, for example: product warranties, certain financial guarantees and contingent consideration payable or receivable in a business combination.

Insurers and non-insurers need to undertake a formal review of contracts to determine the appropriate accounting under FRSs.

Scope and the embedded derivative

What is an embedded derivative?

An embedded derivative is a component of a contract that includes both the derivative and a host contract, with the effect that some of the cash flows of the contract vary in a similar way to a stand-alone-derivative.

Implications

FRS 39 requires an embedded derivative in another contract, including a host insurance contract, to be separated and marked to market when its economics are not closely related to those of the host contract. The determination of whether the derivative is closely related involves understanding the economic characteristics and risks of the host contract and the embedded derivative, analysing and understanding the cash flows, economic characteristics and risks of the combined contract and comparing the cash flows of the combined contract with those of the host contract.

Generally, an embedded derivative linked to interest rates would be considered closely related to a host insurance contract, as long as it is not leveraged.

Embedded derivatives should be separated from the host contract where the host contract is measured at amortised cost or at fair value but the changes in fair value are recognised in equity, as may be the case with some financial instruments with discretionary participation features.

Separation under FRS 39 applies to a put or cash surrender option in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index) or a non-financial variable that is not specific to a party to the contract.

Examples of embedded derivatives

Examples of embedded derivatives requiring separation include:

- non-insurance options embedded in the host insurance contract which are priced inadequately and this can be demonstrated at the inception of the contract;
- equity or commodity indexed non contingent benefit payments; and
- additional contractual terms that do not fall under the definition of an insurance contract (for example a persistency bonus paid only at maturity in cash unless the persistency bonus is life contingent to a significant extent).

Exceptions to the requirement to separate embedded derivatives

FRS 104 provides exceptions to the requirement of FRS 39 to separate embedded derivatives:

- An embedded derivative that meets the definition of an insurance contract need not be separated. For example, an option to take a life-contingent annuity contract would not be separated from a host insurance contract.
- An insurer need not separate and measure at fair value, an option to surrender for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability.

In addition, since liabilities under unit-linked contacts are generally measured at their unit values, there is no need to separate a host deposit contract and an embedded derivative for such contracts.

Scope and the unbundling of deposit components

In limited cases, FRS 104 requires the deposit element to be 'unbundled' from an insurance contract and accounted for separately under FRS 39.

Many financial products contain an insurance contract and an investment component, often referred to as a deposit component.

Rules relating to unbundling:

- Unbundling is required when the deposit component can be measured separately, and not all of the obligations and rights arising from the deposit component would be recognised under the insurer's existing accounting policies.
- Unbundling is permitted but not required where the deposit component is separately measurable, but all obligations and rights are recognised.
- Unbundling is prohibited where the deposit component cannot be measured separately.

Implications

Unbundling the deposit component leads to the separate recognition and measurement of the financial asset or financial liability and the host insurance contract. If unbundling is required:

- the financial assets or liabilities arising from the deposit component are accounted for under FRS 39;
- receipts and payments relating to the deposit component are not recognised in the income statement but as assets and liabilities; and
- receipts and payments relating to the insurance element are recognised in the income statement.

Recognition and measurement

FRS 8 hierarchy specifies criteria that entities should use in the absence of an FRS or an Interpretation that specifically applies to a transaction

FRS 104 exempts an insurer from applying the FRS 8 hierarchy to insurance contracts it issues and reinsurance contracts that it holds. This means that insurers can continue to use, in general, existing accounting policies. Changes to accounting policies are permitted only if, as a result, the financial statements are more reliable and no less relevant or more relevant and no less reliable.

Implications of exemptions

- Insurers may continue using the following accounting practices, but may not introduce any of them:
  - Measuring liabilities on an undiscounted basis.
  - Measuring contractual rights to future investment management fees at an amount in excess of fair values as implied by a comparison to current fees charged by other market participants.
  - Using non uniform accounting policies for the insurance liabilities of subsidiaries.
- Insurers need not eliminate excessive prudence, but may not introduce additional prudence. In addition, an insurer need not change its accounting policy to eliminate future investment margins. However there is a rebuttable presumption that financial statements will be less relevant and reliable if an accounting policy is introduced, which reflects future investment margins in the measurement of insurance contracts.
- Insurers however are no longer allowed to hold equalisation or catastrophe provisions as a liability in the balance sheet.
- Insurers should also consider whether reinsurance assets are impaired.

Liability adequacy test

FRS 104 requires insurers at each balance sheet date to assess whether its recognised insurance liabilities (less related deferred acquisition costs and related intangible assets) are adequate, using current estimates of future cash flows. Any deficiency should be recognised in the profit and loss account. To the extent that an insurer already has procedures in place that consider current estimates of all cash flows (including claims handling costs and cash flows arising from options and guarantees), and so long as any deficiency arising from such procedures is already booked in the profit and loss account, FRS 104 imposes no further requirements.

Discretionary participation features in financial instruments

What is a discretionary participation feature?

Life insurance contracts often include a discretionary participation feature as well as a guaranteed feature

FRS 104 defines a discretionary participation feature as a contractual right held by an investor or policyholder to receive, as a supplement to guaranteed minimum payments, additional payments:

- that are likely to be a significant portion of the total contractual payments;
- whose amounts or timing is contractually at the discretion of the issuer; and
- that are contractually based on:
  - the performance of a specified pool of contracts or a specified type of contract;
  - realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - the profit or loss of the entity, fund or other entity that issues the contract.

Other characteristics of discretionary participation features:

- Discretionary distributions are generally funded from accumulated surpluses, (sometimes referred to as the fund for future appropriations).
- Constructive obligations only form part of the discretionary participation feature if they are a direct consequence of the contractual obligation to establish the discretionary participation feature.

Payments made that are not a consequence of the contractual rights are not covered under the discretionary participation feature.

What are the rules relating to classification?

FRS 104 sets out rules relating to the classification on the balance sheet of discretionary participation and guaranteed features

An insurer may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If a combined presentation is adopted this must be classified as a liability, rather than a component of equity.

If an insurer recognises the features separately, the insurer must recognise the guaranteed element as a liability. FRS 104 does not address whether the discretionary portion of the available surplus should be accounted for as a liability on the basis that distributions will be made to policyholders in the future or a component of equity. However, the classification of the feature as an intermediate category that is neither a liability nor equity is prohibited since there is no intermediate category available on the balance sheet.

- For an insurance contract with discretionary participation features, the liability recognised is subject to the liability adequacy test.

- For discretionary participation features in financial instruments, if the discretionary participation feature is reported as a liability the liability adequacy test should be applied to the whole contract.

- If part or the entire discretionary participation feature for financial instruments is classified as equity, the liability recognised for the whole contract cannot be less than the result of applying FRS 39 to the guaranteed amount. If the carrying amount of the total liability is clearly higher, there is no requirement to determine the minimum amount.

- All premiums received on contracts with discretionary participation features (including investment contracts) may be recognised as revenue. However, to the extent that profits or losses arise that relate to a discretionary participation feature classified in equity, those profits or losses should be accounted for as an allocation of profit or loss rather than as income or expenses.

Investment contracts

Under FRS 39 a financial liability may be categorised as either 'fair value through profit or loss' or as 'other liabilities', which is the default category.

- Financial liabilities categorised as 'fair value through profit or loss' are measured at fair value.
- 'Other liabilities' are measured at amortised cost.

When a financial liability is recognised initially, it should be at fair value, which is considered to be the transaction price.

It is important to distinguish between costs relating to the financial instrument from the costs of securing the right to provide management services, as the accounting treatment is different.

Transaction costs

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial liability or asset. Such costs will include fees and commissions but will exclude financing, internal administrative or holding costs.

Transaction costs should be included in the initial measurement of financial liabilities and assets other than those at fair value through profit and loss, where transaction costs are not added to the fair value measurement at initial recognition.

For financial liabilities, directly related costs are deducted from the amount of liability originally recognised.

Transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through the profit and loss over the life of the instrument.

Management fees

Investment contracts may provide for the provision of investment management services. Fees from such services should be accounted for under FRS 18.

Incremental costs

Incremental costs that are directly attributable to securing an investment contract are deferred if they can be identified separately and measured reliably, and if it is probable that that they will be recovered. The asset is amortised as the entity recognises the related revenue.

Offsetting

FRS 104 does not provide any exemptions to the offsetting rules contained in FRS 1 and FRS 32. Specifically, FRS 104 prohibits the offsetting of reinsurance assets and related insurance liabilities or income and expense from reinsurance contracts against the expense or income from related insurance contracts.

Disclosures

FRS 104 requires fairly significant disclosures for insurance contracts. The objectives are to enable users of financial statements to identify and explain the amounts in the insurer's financial statements arising from insurance contracts; and to assist users to understand the amount, timing, and uncertainty of future cash flows from insurance contracts.

The requirements relating to disclosure are principles-based, giving insurers flexibility in how information is presented. It is anticipated that systems and reports will need amendments in order to provide the appropriate information.

Key new disclosures include:

- the process used to determine the assumptions that have the greatest effect on the measurement of recognised assets, liabilities, income and expenses;
- the effect of changes in assumptions used;
- the insurer's objectives in managing risks arising from insurance contracts and policies for mitigating those risks;
- the terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows; and
- information about insurance risk, both before and after reinsurance, including concentrations of risk and details of actual claims development compared with previous estimates.

If the insurer is a cedant, it should also disclose:

- gains and losses from the acquisition of reinsurance which are recognised in the profit and loss account; and
- gains and losses arising from the acquisition of reinsurance, which are deferred and amortised, the amortisation for the period and the amount remaining unamortised at the beginning and end of the period.

Effective date and transition arrangements

Effective date

FRS 104 is applicable for years beginning on or after 1 January 2005. Earlier application is encouraged. It should be noted that Singapore entities would not be applying FRSs for the first time. The transition requirements provide only limited relief from applying the standard retrospectively.

Exemption relating to comparative information

Disclosures in respect of annual periods beginning before 1 January 2005 are not required, except for disclosures relating to accounting policies and recognised assets, liabilities income and expenses (and cash flows if the direct method is used).

The effect of the exemption will be that entities will not need to provide detailed disclosure of comparative information. For example comparative information relating to:

- the process used to determine the assumptions that have the greatest effect on the measurement of recognised amounts and
- the effect of changes in assumptions to measure the recognised amounts and reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, deferred acquisition costs.

Hence, actuarial assumptions, sensitivity analysis and insurance risk management policies are not required disclosures for an entity's comparative information for 2004 and earlier periods.

As insurers are generally able to continue to use existing accounting policies, this will not affect the recognition and measurement of assets, liabilities, income and expenses and cash flows, only the presentation and level of disclosure.

Unbundling of deposit component

Where an entity is not able to apply the requirements of FRS 104 relating to unbundling of deposit components, recognition and measurement, acquired insurance portfolios and discretionary participation features to the comparatives that relates to periods beginning prior to 1 January 2005, this fact should be disclosed. Under FRS 8, an insurer need not apply these requirements only if it is impracticable to do so.

Claims development disclosure

With respect to claims development disclosures, no disclosure is required about claims development occurring earlier than 31 December 2000. In addition, if it is impracticable, on first time application of FRS 104, to prepare information about claims development that occurred before the beginning of the earliest period for which full comparative information that complies with FRS 104, this fact should be disclosed.

Changes in accounting policies

FRS 104 permits changes in accounting policies for insurance contracts if the new policy results in information that is more relevant or reliable without reducing either relevance or reliability.

New accounting policies

Where an entity decides to apply new accounting policies for its insurance contracts, FRS 8 would require that this should be done retrospectively.

What you need to do to be ready for FRS 104

- ☐ Understand your products and classify them according to the relevant accounting standard. Identify the appropriate accounting treatment and assess whether this departs from current practice. Products under development should also be subject to the same review and classification process.
- ☐ Identify embedded derivatives and assess if the embedded derivatives need to accounted for under FRS 39 or FRS 104.
- ☐ Review current accounting practice with respect to the discretionary participation feature and establish practices and policies to comply with available classification options.
- ☐ Assess if current practices to set aside premium and claims liabilities are sufficient to meet the liability adequacy requirements.
- ☐ Assess impact of reversing equalisation or catastrophe provisions on 1 January 2005.
- ☐ Establish procedures to stop offsetting reinsurance balances with related insurance balances.
- ☐ Review current systems and reports to establish action plans necessary to produce the necessary information for disclosure purposes. System changes may need to be made.
- ☐ Consider whether comparative figures need to be presented.

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