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FRS 103 Insurance Contracts – The Key Issues

Following the FRC's recent issue of FRS 103, Insurance Contracts, Professor Robert Kirk CPA outlines the new FRS applying to insurance contracts.

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The Financial Reporting Council (FRC) issued FRS 103, Insurance contracts, in March 2014. FRS 103 was developed following feedback after the publication of the exposure draft FRED 49 Insurance contracts.

Overall, there are not many amendments to the exposure draft's proposals. FRS 103 provides a single source of financial reporting requirements for insurance contracts.

FRS 103 applies to all reporting entities adopting FRS 102, The financial reporting standard applicable in the UK and Republic of Ireland, that issue insurance contracts. This will include life and general insurers (including mutuals), as well as entities that are not legally constituted as insurance companies. This is the main change from current Irish GAAP where accounting guidance was designed to cover entities with insurance business only.

Scope

FRS 103 applies to insurance contracts (including reinsurance contracts) issued and reinsurance contracts held. The definition of 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 if a specified uncertain future event (the insured event) adversely affects the policyholder."

Contracts falling within this definition are within the scope of FRS 103, regardless of whether they are regarded as insurance contracts for legal or regulatory purposes. Examples (provided in the Appendix to FRS 103) of insurance contracts include contracts where the transfer of insurance risk is significant such as:

(a) insurance against theft or damage to property.
(b) insurance against product liability, professional liability, civil liability or legal expenses.
(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).
(d) life-contingent annuities and pensions (i.e. contracts that provide compensation for the uncertain future event – the survival of the annuitant or pensioner – to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

However, some specific types of contract falling within the definition of an insurance contract (such as product warranties issued directly by a manufacturer, dealer or retailer) are excluded from the scope of FRS 103 and are accounted for under the relevant sections of FRS 102.

FRS 103 also applies to issued financial instruments with discretionary participation features (DPF).

Background to the development of the standard

FRS 103 is relevant to entities applying FRS 102 that have insurance contracts that fall within the standard and so is not for general application. The FRC states in the standard that the FRS consolidates the existing requirements for insurance contracts. They highlight the fact that the standard is primarily based on IFRS 4 *Insurance Contracts* as amended by IFRS 13 *Fair Value Measurement*. The main body of the standard also includes FRS 27 *Life*

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Assurance's recognition and measurement requirements in respect of with-profits funds measured on a 'realistic' basis for regulatory purposes. There are also "elements of the Association of British Insurers" – *Statement of Recommended Practice on Accounting for Insurance Business* SORP. Some of FRS 27's disclosure requirements are also included as guidance in the Implementation Guidance (IG). FRS 27 itself will be withdrawn on the implementation of FRS 103.

Because there is likely to be a long term replacement for IFRS 4 in the not too distant future FRS 103 may have a short life. It therefore permits entities to continue with their current accounting practices for insurance contracts, "but permits entities the same flexibility to make improvements (subject to legal and regulatory requirements) as entities in the UK and Republic of Ireland applying IFRS 4 have, because the FRC does not want the standard to be more onerous to apply than IFRS 4." However, it is also highlighted that some of the requirements of FRS 102 and of the FRS in relation to financial instruments will lead to changes for insurers. All entities will therefore need to consider the impact of the standard.

Content

FRS 103 generally allows management to continue with current accounting practices for insurance contracts. This is subject to meeting some minimum requirements (for example, in respect of a liability adequacy test). In general, it is expected that 'old' Irish GAAP for regulated insurance contracts will meet these minimum requirements.

FRS 103 provides the ability, as under IFRS 4, to make improvements (subject to legal and regulatory requirements) to existing accounting policies. That is, an accounting policy can be changed if the new policy makes the financial statements either more reliable and no less relevant, or more relevant and no less reliable.

The improvements that are permitted, but not required, include:

- permitting remeasurement of designated insurance liabilities to reflect current market interest rates through profit and loss; and
- where realised gains and losses on assets affect the valuation of insurance liabilities (and related deferred acquisition costs and intangible assets), entities are permitted to also 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.

Although current accounting practices can still be continued there are certain applications that may not be adopted by an existing insurer. These are:

- 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; and
- 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.

One point, however, that the FRC are concerned about is the use of excessive prudence when introducing improved policies so any changes must be considered in that light.

Where an insurance contract contains a separable embedded derivative FRS 103 requires that these should be accounted for separately in accordance with Sections 11 and 12 of FRS 102. 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 contradicts 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.

FRS 103 requires, for the purposes of applying the requirements of Section 30 *Foreign Currency Translation*, of FRS 102, that all assets and liabilities arising from an insurance contract be reported as monetary items. This eliminates the accounting mismatches that would have arisen otherwise for insurance contracts not held by an overseas subsidiary, where some assets and liabilities arising from the insurance contract would have been treated as monetary items and others as non-monetary.

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Disclosures

The disclosure requirements are also emphasised in FRS 103, with the standard setting out both the broad aim of disclosure and specific requirements. The broad aim is for disclosure that:

(i) identifies and explains the amounts in an insurer's financial statements arising from the insurance contracts (including reinsurance contracts) it issues and reinsurance contracts that it holds;
(ii) relate to the financial strength of entities carrying on long-term insurance business; and
(iii) helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from those insurance contracts.

FRS 103's disclosure requirements are largely based on those in IFRS 4. More disclosures are likely to be required, compared to previous practice under 'old' Irish GAAP, including IFRS 4 disclosure requirements such as claims development tables and risk disclosures.

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

Reporting 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. FRS 103 preserves the requirement in FRS 27 for long-term insurance business capital disclosures.

Long-term (life) insurers that are 90%+ subsidiaries of another entity providing disclosures will now have to make capital disclosures; previously they were exempt. The FRC did consider extending the capital disclosure requirements to all insurers. However, based on the feedback received on FRED 49 it decided against it on the grounds of being too onerous for general insurers.

What is status of the implementation guidance?

The FRC published the IG mainly for life insurers, based on FRS 27, on capital disclosures. These disclosures go beyond FRS 102's minimum requirements. However, the guidance is consistent with current practice for life insurers, so following the guidance is unlikely to be unduly burdensome. In addition, FRS 103 clarifies that the Implementation Guidance accompanying FRS 103 is not mandatory

Who is most affected?

All entities that apply FRS 102 and issue insurance contracts or financial instruments with DPF are affected. Entities that have not previously adopted FRS 26 will be applying the definition of an insurance contract for the first time. Management will therefore need to perform a 'contract classification' exercise to determine which of their contracts fall within FRS 103's scope and which contracts need to be accounted for as financial instruments under section 11 or 12 of FRS 102. This is likely to affect life insurers who might issue contracts without significant insurance risk.

For most regulated insurance entities currently reporting under Irish GAAP, FRS 103 will generally permit existing practice to continue for those contracts falling within its scope, but additional disclosures are likely to be required.

Entities that are not regulated insurers are required to apply FRS 103 to contracts issued by them that meet the definition of insurance contracts. While the ability to continue existing practices means that the recognition and measurement of contracts such as product warranties (issued by third parties) might not change, such contracts are subject to FRS 103's disclosure requirements.

Statement of compliance

An entity whose financial statements comply with this FRS must, in addition to its statement of compliance with FRS 102, make an explicit and unreserved statement of compliance with this FRS as well in the notes to the financial statements.

Effective date

FRS 103 applies to accounting periods beginning on or after 1 January 2015. However, early adoption is permitted.

FRS 27 and the ABI SORP will be withdrawn once FRS 103 becomes effective. The FRC anticipates that FRS 103 will have a limited life, and expects to review it when the IASB has issued its updated standard on insurance contracts. In addition, the FRC might make interim amendments to FRS 103 once changes in the regulatory regime for insurers (Solvency II) come into force.

Conclusion

FRS 103 is unlikely to require significant changes to the way in which entities currently measure insurance contracts. However those companies who have not previously applied FRS 26 will have to go through a 'contract classification' exercise to determine which contracts are within FRS 103's scope and there will undoubtedly be additional disclosures for most insurance entities.

It must be remembered that this is merely a stop gap measure whilst the IASB consider a major revision to IFRS 4 which will ultimately result in FRS 103 being revised in due course as well.