

Insurance accounting undergoing a major revamp

The new International Financial Reporting Standards (IFRS) Insurance Contracts Standard (IFRS 17 - Insurance Contracts) will impact insurance companies in South Africa including those offering motor vehicle insurance, life insurance and medical schemes. The manner in which these companies recognise, measure, present and disclose insurance contracts and reinsurance contracts will change.



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It has been over a year now since IFRS 17 was published. It replaces an interim standard (IFRS 4 – Insurance Contracts) which has been in place for over a decade, which allowed companies to use a wide variety of accounting practices for insurance contracts, reflecting national accounting requirements and variations of those requirements.

The differences in the accounting treatment across jurisdictions and products made it difficult for investors and analysts to understand and compare financial results of insurance companies. IFRS 17 addresses these inconsistencies and thus enhancing comparability in addition to making the financial statements of insurance companies more useful. Globally around 450 listed insurers using (IFRSs) will be affected by this standard.

“Insurance companies should be considering the impact of the new requirements on its financial performance, including budgetary implications e.g. reviews of the IT systems, key leverage ratios, the contracting process, debt covenants, employee performance incentives - applicable where performance incentives are based on the IFRS numbers - and human resource capacity to implement the new requirements,” says Bongeka Nodada, South African Institute for Chartered Accountants (Saica) project director: financial reporting.

Asking the tough questions

The governing bodies of insurance companies and in particular the audit committees should be asking the tough questions now to understand the effect of IFRS 17 and assess the company’s readiness to adopt the new standard. In its assessment, insurance companies should consider the extent to which the impact of IFRS could be passed onto the policyholder.

Nodada notes that IFRS 17 is applicable to insurance contracts that fall within its scope. An insurance contract is a contract under which the insurance company accepts significant insurance risk from a policyholder by agreeing to compensate the policyholder if a specified uncertain event affects the policyholder. Examples include those contracts that will compensate a policyholder against theft or damage (for example, damages made to the policyholder's motor vehicle), professional liability insurance, insurance against civil liability or legal expenses, life insurance, disability and medical insurance and some product warranties.

IFRS 17 also provides detailed guidance on the measurement of insurance contracts such that it is clear what considerations an insurance companies should take into account in determining the IFRS insurance liability or asset. Insurance companies will be required to recognise and measure groups of insurance contracts at a risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all of the available information about the fulfilment cash flows in a way that is consistent with observable market information; plus (if this value is a liability) or minus (if this value is an asset) an amount representing the unearned profit in the group of contracts (the contractual service margin).

Risk

An insurance company is required to recognise the profit from a group of insurance contracts over the period it provides insurance coverage, and as it is released from risk. If a group of contracts is or becomes loss-making, an entity recognises the loss immediately.

Furthermore, an insurance company may apply a simplified measurement approach (the premium allocation approach) to some insurance contracts. The simplified measurement approach allows an insurance company to measure the amount relating to the remaining service by allocating the premium over the coverage period.

IFRS 17 will require insurance companies to disclose information to enable users of financial statements (existing and potential investors, lenders, creditors) to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of a company.

IFRS 17 is effective for annual periods beginning on or after 1 January 2021 and early application is permitted.