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ukGAAP: Beyond the detail

# Need to know
# Financial Reporting Council issues FRS 103 Insurance Contracts

**In a nutshell**

- The Financial Reporting Council (FRC) has issued FRS 103 *Insurance Contracts.* The standard consolidates existing financial reporting requirements and guidance for insurance contracts.
- FRS 103 is based on IFRS 4, FRS 27 *Life Assurance* (now withdrawn by FRS 103) and elements of the ABI SORP. It broadly allows entities to continue with their current accounting for insurance contracts if they wish, or to make certain improvements. Nevertheless, given some of the requirements of this standard and of FRS 102, insurance contract accounting may change for many insurers.
- The FRC has also published non-mandatory implementation guidance to assist in the application of FRS 103, the application of FRS 102 to insurance companies, and the accounting requirements of the Companies Act for insurance companies (Schedule 3 of the Accounting Regulations).
- The new standard applies for periods commencing on or after 1 January 2015, with early adoption permitted (but not required) if FRS 102 is also adopted. The ABI has confirmed that it will withdraw the ABI SORP when FRS 103 is effective.

## Background to FRS 103

FRS 103 was developed following the publication of the exposure draft FRED 49. Overall, there are not many amendments to the exposure draft's proposals. Any significant changes are discussed further below. The standard will apply to entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* that:

- issue insurance contracts (including reinsurance contracts) or hold reinsurance contracts; and/or
- issue financial instruments (other than insurance contracts) that have a discretionary participation feature.

FRS 103 is based largely on IFRS 4 *Insurance Contracts*, amended to reflect the requirements of company law and, to the extent compatible, with FRS 102. The standard and its implementation guidance draw on FRS 27 *Life Assurance* and the ABI SORP, both of which will be withdrawn when FRS 103 becomes effective.

The FRC anticipates that the standard will have a limited life and expects to revise the standard once the IASB has issued its updated standard on insurance contracts (IFRS 4 Phase 2) and the regulations supporting the changes in the Solvency II directive (the new framework for insurance regulation and supervision in the EU) have been finalised.

## Will FRS 103 be applicable to me?

The standard will be applicable to entities that apply FRS 102 and issue insurance contracts (including reinsurance contracts), hold reinsurance contracts and/or that issue financial instruments with a discretionary participation feature. 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 UK GAAP where accounting guidance was designed to cover entities with insurance business.

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The question of whether FRS 103 will apply to warranties depends on the company giving the warranty:

- there is a scope exclusion for product warranties issued by manufacturers, dealers or retailers, which will be accounted for under Sections 21 *Provisions and Contingencies* and 23 *Revenue* of FRS 102;

- insurance companies will, as a matter of law, be accounting for warranties as insurance contracts;

- for other entities that are not legally constituted as insurers, issuing warranties or appliance servicing agreements, the contracts will fall within the scope of FRS 103 if they meet the definition of insurance contract. For recognition and measurement, the entities will have a choice to continue with their previous practice of applying an accounting policy based on FRS 12 (or some other method) using a similar accounting policy based on Section 21 *Provisions and Contingencies* of FRS 102. Alternatively, they can apply the recognition and measurement requirements of FRS 103. Although on first time application of FRS 103 an entity with such contracts will not need to change its accounting policies for those contracts, it will need to consider other requirements of FRS 103, for example the liability adequacy test, and may need to provide additional disclosures, such as a claims development history.

### What is an insurance contract?

Entities that apply FRS 26 will be familiar with the definition of an insurance contract:

> Definition of an insurance contract:
> 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 policy holder.
>
> In this definition, insurance risk means risk, other than financial risk, transferred from the holder of a contract to the issuer.

*Entities that have not applied FRS 26 may see a significant change in their accounting as they account separately for contracts that do not meet the definition of an insurance contract and for unbundled deposit components of an insurance contract. Insurers that have not previously applied FRS 26 will need to consider the categorisation of their contracts and whether their systems can collect the necessary data to account under FRS 102 or FRS 103 as applicable.*

Appendix II of FRS 103 provides guidance on the definition of an insurance contract and helpful examples of those contracts that do and do not meet the definition. Contracts which do not meet the definition of "insurance contracts" may be financial non-insurance instruments or service contracts. Service contracts would be accounted under the section 23 *Revenue* of FRS 102 and non-insurance financial instruments without discretionary participating features will fall within the scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues* of FRS 102. Additionally, the standard provides guidance (based on IFRS 4) on unbundling of deposit components, specifying when unbundling is required, permitted or prohibited. A deposit component is defined as "a contractual element that is not accounted for as a derivative under sections 11 and 12 of FRS 102 and would be with the scope of [those sections of] FRS 102 if it were a separate instrument." Where a deposit component is required to be unbundled it would be accounted for as a financial instrument. Unbundling is only required when the entity can measure the deposit component reliably and its accounting policies do not otherwise require it to recognise all the rights and obligations arising from the deposit component.

### What will change in accounting for insurance contracts?

As with IFRS 4, FRS 103 largely permits entities to continue with existing accounting policies for insurance contracts. Again, like IFRS 4, FRS 103 permits entities the same flexibility to make improvements in their accounting policies, provided that the 'improved' accounting policies continue to comply with existing legal and regulatory requirements and are either more relevant to the users' economic decision making and no less reliable or more reliable and not less relevant. Where an entity makes such an 'improvement', it need not apply the material in the FRS which derives from FRS 27 or the ABI SORP where these are inconsistent with the new policy. The improvements that are permitted, but not required, include:

- allowing 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 allowed 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.

*Once any deposit component and embedded derivative have been separated out of an insurance contract, no further changes are necessarily required. However, entities that are part of a larger group reporting under IFRS may wish to consider making changes, where permitted, if this will align them more closely with their parent's accounting policies.*

Existing practices can be continued but certain practices may not be adopted by an existing insurer:

- 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.

New entrants to the insurance market will, of course, not have any existing policies, and therefore are advised to start with FRS 103 guidance derived from FRS 27 and/or the ABI SORP (as applicable) before deciding whether to 'improve' on those policies.

#### Excessive prudence

The ABI SORP explains that claims provisions should be set so that there is no adverse run-off deviation – in other words, so that the likely outcome as time passes is that reserves are released rather than new reserves being required. The FRC's proposals, in line with IFRS 4, note that this may result in excessive prudence. Existing accounting policies can be continued, but 'improved' policies must not require excessive prudence.

#### Embedded derivatives in insurance contracts

Where an insurance contract contains a separable embedded derivative (using the guidance in IAS 39 and IFRS 4), FRS 103 requires that separable embedded derivatives should be accounted for separately in accordance with Sections 11 and/or 12 of FRS 102 (or, if they have chosen to apply IAS 39 or IFRS 9, that standard). 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 is in contrast to 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.

*Entities that do not currently adopt FRS 26 will need to check whether any features of their insurance contract are embedded derivatives.*

#### Insurance contracts denominated in foreign currencies

FRS 103 requires, for the purposes of applying the requirements of Section 30 *Foreign Currency Translation*, of FRS 102, to treat all assets and liabilities arising from an insurance contract as monetary items. This is a welcome change from the proposal in FRED 49. It eliminates the accounting mismatches that would have arisen otherwise for insurance contracts not held by an overseas subsidiary, where some assets and liabilities stemming from the insurance contract would have been treated as monetary items and other as non-monetary.

*Entities with insurance contracts denominated in foreign currencies will need to consider the requirements of section 30 of FRS 102.*

### Differences from IFRS 4

The FRC is keen to minimise differences from IFRS 4, and therefore the only differences are those arising from the law:

- equalisation provisions may be required by law, but are prohibited by IFRS 4. This issue also affects insurers applying FRS 101 and a consequential amendment to FRS 101 has also been made;
- FRS 103 is consistent with IFRS 4.34(b) and 4.35(b), permitting discretionary participation features to be accounted for as equity or as a liability. However, for an insurance company, the law requires presentation as a liability; and
- the law has specific requirements which permit and prohibit discounting. IFRS 4 requires new accounting policies to be on a discounted basis.

### What additional disclosures will be required?

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

*Additional disclosures of risks and uncertainties may require effort to collect the necessary information.*

IFRS 4 does not require some disclosures around credit risk, liquidity risk, and market risk because these are included in IFRS 7 for an IFRS reporting entity. FRS 103 instead cross-refers to the equivalent sections of FRS 102.

The FRC has considered and decided against disclosure exemptions for captive insurers. A captive insurer provides insurance cover for other entities in the group to which it belongs, and only a small part, if any, of its risk exposure relates to entities outside the group. The FRC decided that such entities meet the definition of financial institutions and insurance risk forms significant part of their business that needs to be disclosed in the individual accounts.

### What is status of the implementation guidance?

One of the amendments in the final text of FRS 103 clarifies that the Implementation Guidance accompanying FRS 103 is not mandatory. Section 2 of the Implementation Guidance contains material originating from the ABI SORP providing useful guidance on the application of the requirements of FRS 102, FRS 103 and company law.

*The implementation guidance, while not mandatory, provides useful guidance.*

#### Fund for future appropriations

The Implementation Guidance clarifies among other things the appropriateness of establishing a Fund for Future Appropriations (FFA) account for long term business in applying the requirements of note 19 of the Notes to the Balance Sheet format in Schedule 3 to the Regulations. Where there is reasonable certainty over the allocation of technical account balances between policyholders and equity owners establishing an FFA account would not be appropriate. The Implementation Guidance has been amended from FRED 49 to add to the examples of entities with unclear allocation (and where establishing an FFA account is appropriate) some mutual insurers.

### What about disclosures of capital?

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. The FRS preserves the requirement in FRS 27 for long-term insurance business capital disclosures. Long-term insurers that are 90%+ subsidiaries of another entity providing disclosures will now have to make capital disclosures; previously they were exempt. The FRC has considered extending the capital disclosure requirements to all insurers. However, based on the feedback received on FRED 49 it decided against it. Such disclosures were viewed as too onerous for general insurers. Further, in deciding whether to recommend such disclosures as best practice for other financial institutions the FRC has decided to wait and consider this issue in the first three-yearly review of FRS 102.

*Making these capital disclosures should not be overly burdensome as the necessary information will already be available in the Prudential Regulatory Authority regulatory returns.*

### Looking beyond the debits and credits

Insurance companies that apply existing UK GAAP will have a choice whether to apply full IFRS, FRS 101 (if they are a qualifying subsidiary), or FRS 102 with FRS 103. In making their choice, entities will want to consider a range of factors including:

**Systems** – can systems produce the necessary information?

**Management incentives** – are targets set based on a specific profit measure?

**Loan covenants** – are these based on defined profit or asset measures?

**Wider change** – are plans to change accounting framework integrated with wider planning for Solvency II and further IFRS changes for insurance?

**Regulatory** – will any of these changes affect regulatory capital?

**Communications** – how will any changes be communicated to investors? Members of a mutual? Other stakeholders?

*Much else is changing in the world of insurance with Solvency II and the IASB's insurance project likely to be finalised over the next few years. Proper planning will avoid duplication of effort.*

## How can Deloitte help?

Deloitte can assist you in understanding how the technical accounting aspects of the proposed standard will impact your financial statements and its potential impacts to your income profile and balance sheet. In addition we can also help you to:

- Assess your current systems to assess whether they are capable of producing the information to support the required accounting and disclosures

- Provide training on the proposed accounting standards to your finance team

- Update your accounting policy documentation and prepare the required journals and changes to your financial statements to reflect the transition to the new standard

- Assist you in communicating the impact of the changes from FRS 103 to your stakeholders

- Provide project management support to your transition project in preparation for the implementation of the new UK GAAP insurance standard.

Our integrated team of accounting, systems and taxation specialists can assist you in managing the impact of the changes to UK financial reporting. Information about the services we offer can be found at www.deloitte.co.uk/futureofukgaap.

More information on the new UK financial reporting regime, as well as other UK accounting, reporting and corporate governance news and publications can be found at www.ukaccountingplus.co.uk.

## Contacts

If you would like further, more detailed information on FRS 103, please contact your local Deloitte partner or:


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