KPMG
cutting through complexity

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Accounting for financial instruments is changing

What's the impact on insurance companies?

Have you considered the:

- significant judgements required?
- profit or loss and equity implications?
- operational challenges?
- transition options?

How could your business be affected?

Now that the IASB has published a completed standard on financial instruments accounting – IFRS 9 *Financial Instruments* (2014) – the real work for insurance companies is just beginning. The new standard includes revised guidance on the classification and measurement of financial assets, including a new expected credit loss model for calculating impairment, and supplements the new general hedge accounting requirements published in 2013.

Insurers can expect a sea-change in financial reporting over the next few years as they plan for adoption of new standards on both financial instruments and insurance contracts. Before insurers reach any conclusions about how they apply IFRS 9, they will want to consider its interaction with the forthcoming insurance contracts standard.

Although the permissible measurement bases for financial assets – amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL) – are similar to IAS 39 *Financial Instruments: Recognition and Measurement*, the criteria for classification into the appropriate measurement category are significantly different. IFRS 9 also replaces the 'incurred loss' model in IAS 39 with an 'expected credit loss' approach.

IFRS 9 will take effect from 1 January 2018, but preparers can choose to apply it earlier. While the effective date may seem a long way off, insurance companies may benefit from early decisions regarding when and how to transition to IFRS 9 – particularly in terms of evaluating its interaction with the forthcoming insurance contracts standard. An early decision will allow companies to develop an efficient implementation plan and inform their key stakeholders.

Determining the impact

	Potential impact	Actions to consider
Significant judgements required	• Ensuring financial assets are classified appropriately under IFRS 9 will require insurers to: – determine the objective of the business model in which financial assets are managed; and – where relevant, analyse the contractual cash flow characteristics of financial assets (e.g. whether the contractual cash flows give rise, on specified dates, to cash flows that are solely payments of principal and interest). • Applying the expected credit loss model to calculate impairment for debt instruments measured at amortised cost or FVOCI and certain financial guarantees and loan commitments will require: – robust estimates of expected credit losses; – identification of the point at which there is a significant increase in credit risk since initial recognition of an asset; and – decisions as to how key terms will be defined in the context of their financial assets.	• Perform a comprehensive review of financial assets to ensure that they are appropriately classified and measured. • Decide how to apply the expected credit loss model to different financial assets. • Develop impairment methodologies and controls to ensure judgement is exercised consistently and supported by appropriate evidence. • Update accounting policies to incorporate the new requirements.
Profit or loss and equity implications[1]	• Volatility in profit or loss and equity may arise as a result of mismatches between the measurement bases for financial assets and insurance contract liabilities and from the presentation of gains and losses in the statement of profit or loss and OCI. These mismatches may be caused by: – the effects of changes in discount rates; – changes in other market factors (e.g. equity prices); or – timing or accounting differences between the settlement or disposal of assets and liabilities. • The expected credit loss model is likely to lead to larger and more volatile charges for credit losses on financial assets, but an insurer's own credit risk is not intended to be reflected in the measurement of insurance contract liabilities under the forthcoming standard – limiting any significant offsetting impact. • For insurers with significant portfolios of financial assets measured at amortised cost, initial application of the expected credit loss model may result in a potentially large negative impact on equity, as equity will incorporate not only incurred credit losses but also expected credit losses. • Where regulatory capital resources and requirements are based on an entity's IFRS financial statements, the classification of an insurer's financial assets under IFRS 9 may affect those calculations.	• Identify options and elections available under IFRS 9 and the forthcoming insurance contracts standard to minimise mismatches between the accounting for insurance contract liabilities and the financial assets held to back them. • Evaluate the impact of accounting change on regulatory capital resources and requirements, corporate taxes, management compensation metrics and key performance indicators. • Develop communication plans for shareholders, analysts and employees who may be affected – e.g. finance and compliance teams. • Keep up-to-date with developments on the IASB's model for participating insurance contracts through KPMG's publications and newsletters.
Operational challenges	• Systems and processes may need to be modified to collect new data and perform new calculations to: – capture fair value, amortised cost and other information needed for classification and measurement; – estimate 12-month and lifetime expected credit losses to calculate impairment; and – satisfy new disclosure requirements. • Changes to systems and processes may necessitate changes to key internal controls over financial and regulatory reporting or impact the way in which work is performed by relevant personnel. • Depending on the scope of the project, designing and executing a successful accounting change programme can be a complex and time-consuming process, requiring careful management and appropriate resources.	• Develop a co-ordinated response to implementation that incorporates system and process changes driven by regulation – e.g. Solvency II – and the forthcoming insurance contracts standard. • Upgrade accounting systems to capture necessary information and perform required calculations. • Identify whether there is a need for additional staff with appropriate expertise or to engage external help. • Develop and execute training plans for employees across functions and locations.

	Potential impact	Actions to consider
Transition options	• If an insurer wants to adopt both IFRS 9 and the forthcoming insurance contracts standard at the same time, it will need to plan for adoption of the forthcoming insurance contracts standard from 1 January 2018 – assuming that timing is permitted by the forthcoming insurance standard. • An insurer can elect not to restate comparative information to reflect adoption of IFRS 9. However, the forthcoming insurance contracts standard is likely to require retrospective restatement of comparative information on insurance contracts.	• Quantify and evaluate the effects of different transition options. • Evaluate different approaches to reporting comparative information. • Develop a communication plan to minimise surprises for stakeholders.

1 For many insurers, the treatment of gains and losses on participating insurance contracts will be critical to understanding the interaction between IFRS 9 and the forthcoming insurance contracts standard. The IASB is expected to make tentative decisions on participating insurance contracts during 2014.

Interaction between IFRS 9 and the forthcoming insurance contracts standard

Before insurers make final decisions about how they will apply IFRS 9, they will want to consider how measurements of insurance contract liabilities – together with the presentation of related gains and losses – will respond to changes in interest rates and market risks under the forthcoming insurance contracts standard.

The effects may be less radical for insurers who already have financial assets measured at FVTPL and record insurance contract liabilities using current assumptions with changes also presented in profit or loss. For other insurers, the overall impacts may be more profound – in particular, many insurers are concerned about possible accounting mismatches and transition issues arising from the interaction between IFRS 9 and the forthcoming insurance contracts standard. Once the final insurance contracts standard becomes available, we will explore this interaction more fully.

Find out more

Visit our Global IFRS Institute for access to KPMG's most recent publications on the IASB's major projects and other activities, including our IFRS – financial instruments and IFRS – insurance hot topics pages.

Our financial instruments publications discuss how insurers will be affected.

In the Headlines (July 2014) brings you up to speed fast, with a high-level summary of the new standard and the impacts for your business

First Impressions (due in September 2014) will consider the requirements of the standard and highlight the areas that may result in a change in practice

How we can help

KPMG's Insurance practice

KPMG's insurance practice is a global network of professionals, offering skills, insights and knowledge based on substantial experience. KPMG can identify the issues early and can share leading practices to help avoid the many pitfalls of such projects.

For those affected by the new financial instrument requirements, our global network of professionals can advise you on your transition to the new standards, including designing an approach to implementation that incorporates fast-approaching regulatory changes. The following are just a few examples of how our cross-functional team of experts can help you with the accounting and operational challenges, subject to independence limitations.

- Performing a comprehensive review of financial assets to ensure that they are appropriately classified and measured.
- Developing impairment methodologies and controls to ensure that judgement is exercised consistently and supported by appropriate evidence.
- Identifying system and process changes necessary to collect new data and perform new calculations, taking into consideration regulatory requirements and internal controls over financial and regulatory reporting.
- Evaluating the impact of accounting change on management compensation metrics, performance targets and KPIs.
- Developing a communication plan to minimise surprises for stakeholders.
- Developing and executing training plans for employees across functions and locations.
- Setting up a project team with representatives from risk management, accounting, tax, regulatory and IT teams, with an appropriate governance structure, realistic timescales and clear accountabilities.

Starting now will allow you to assess the impact and design an appropriate implementation plan that allows time for unanticipated complexity.

Contact us

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