ASSURANCE GAZETTE

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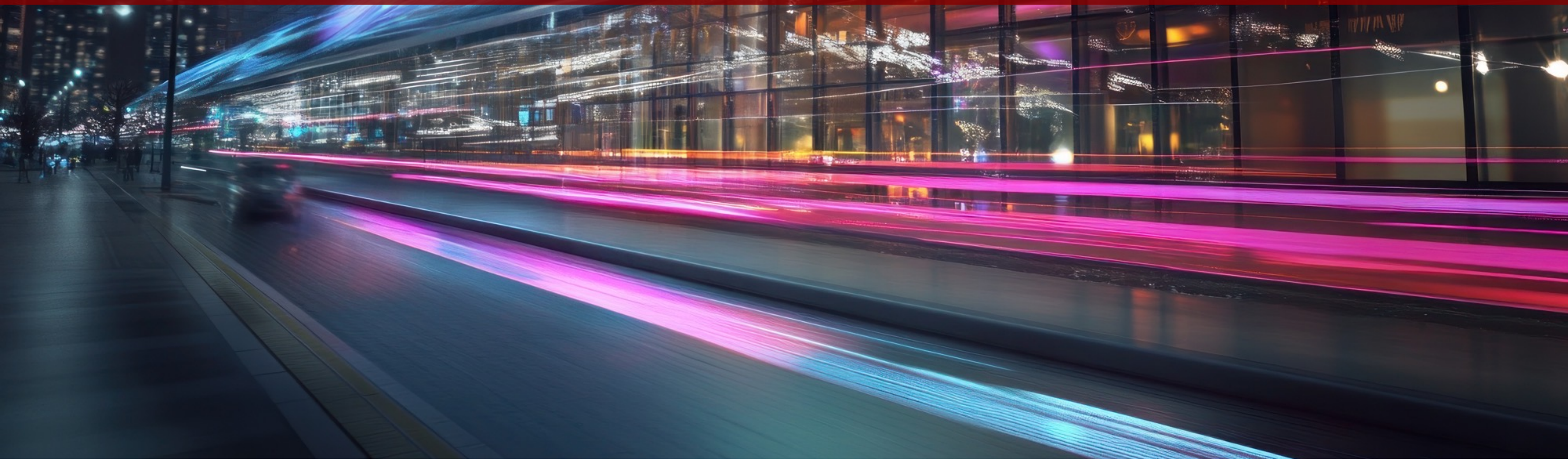
NANGIA & CO LLP
CHARTERED ACCOUNTANTS

Contents

Foreword

We are thrilled to present the September 2024 edition of the Assurance Gazette. This edition delve into a significant development in Indian accounting standard for Insurance Contracts. We hope this edition provides valuable insights and helps you navigate the complexities of Ind AS 117. While its applicability for Indian insurers annual financial statements is currently pending IRDAI notification, understanding this new standard is essential for all professionals in the field. This foresight will enable a smooth transition when Ind AS 117 eventually comes into effect. In this edition of the Gazette, we would like to highlight the proposed illustrations included in the Exposure Draft of IFRS on Climate-related and Other Uncertainties in Financial Statements. This aims to enhance materiality judgments and disclosures, thereby improving the clarity and relevance of financial reporting on such uncertainties.



Decoding Ind AS 117: What It Means for the Indian Insurance Industry

The Ministry of Corporate Affairs has issued the Companies (Indian Accounting Standards) Amendment Rules, 2024, introducing Ind AS 117, Insurance Contracts. This new standard will replace Ind AS 104 and is effective for annual reporting periods beginning on or after April 1, 2024.

This standard applies to insurance contracts (including reinsurance contracts) reinsurance contracts held by insurance companies and investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

Key Features and Impact of Ind AS 117

1. New Measurement Models

Ind AS 117 introduces three measurement models for insurance contracts:

a. **General Model (Building Block Approach)**: This is the default model for measuring insurance contracts. It requires entities to measure a group of insurance contracts as:

- Fulfilment cash flows (probability-weighted estimate of future cash flows, adjusted for time value of money and financial risks)
- Contractual Service Margin (unearned profit)

2. Understanding Contractual Service Margin (CSM):

- **Definition:** CSM represents the unearned profit embedded in a group of insurance contracts. It's the profit that an insurer expects to earn over the remaining coverage period as it fulfils its obligations under those contracts.
- **Initial Recognition:** CSM is initially recognized in a way that avoids immediate profit or loss recognition upon issuing the contracts. It is calculated as the difference between the present value of future cash inflows and outflows associated with the contract group, minus any recognized insurance acquisition cash flows.
- **Subsequent Measurement:** CSM is gradually released into profit or loss over the coverage period as the insurer provides services to its policyholders. This release is known as insurance revenue.

b. **Premium Allocation Approach:** A simplified model for contracts with coverage periods of one year or less or where the measurement is not expected to differ materially from the General Model.

c. **Variable Fee Approach:** For contracts with direct participation features, where the entity's obligation to policyholders is based on the fair value of underlying items.

3. Changes in Revenue Recognition with Ind AS 117

- **Focus on Service Provision:** Ind AS 117 shifts the focus from premium recognition to revenue recognition based on the actual provision of services over time. This is a significant departure from previous practices that often-recognized revenue upfront upon receiving premiums.
- **Amortization of CSM:** Instead of recognizing the entire premium as revenue upfront, Ind AS 117 mandates the amortization of CSM over the coverage period. This amortization pattern reflects the gradual fulfilment of the insurer's obligations and the proportionate earning of profit.
- **Variable Consideration:** The standard addresses variable consideration, which is common in insurance contracts. The CSM is adjusted to reflect changes in the estimates of future cash flows, including changes arising from experience adjustments, changes in assumptions, and the effect of risk mitigation.
- **Onerous Contracts:** When a contract group becomes onerous (meaning the expected costs exceed the expected benefits), immediate loss recognition is required, and the CSM is reduced to zero. Thus, this would require regular assessments to identify whether groups of contracts are onerous, and actuaries need to develop models to perform these tests efficiently and frequently.
- **Disclosure Requirements:** Ind AS 117 introduces detailed disclosure requirements to provide transparency on the amount and timing of revenue recognition. Entities need to disclose information about their CSM, how it's calculated, and how it's being amortized.

4. Disaggregation of Results

Ind AS 117 requires a granular approach to presenting the results of insurance contracts, emphasizing the disaggregation of income and expenses into distinct components. This disaggregation aims to provide a clearer picture of an insurer's performance and the various sources of its profits and losses.

The key elements of result disaggregation under Ind AS 117 are:

a. Insurance Service Result:

- **Insurance Revenue:** Reflects the consideration received for providing insurance coverage services. It's recognized as the CSM is amortized over the coverage period.
- **Insurance Service Expenses:** These include incurred claims (excluding investment components), other incurred insurance service expenses (like underwriting and policy administration costs), and losses on onerous contracts.

The insurance service result is the difference between insurance revenue and insurance service expenses. It essentially represents the insurer's core underwriting performance, isolating the profitability of providing insurance coverage.

Options for Presenting Insurance Finance Income/Expenses:

Ind AS 117 offers two options for presenting insurance finance income/expenses:

- **Option 1: Full Recognition in Profit or Loss:** All insurance finance income/expenses are directly recognized in profit or loss each period.
- **Option 2: Disaggregation between Profit or Loss and Other Comprehensive Income (OCI):** This involves a systematic allocation of expected total insurance finance income/expenses over the contract group's duration. A portion is recognized in profit or loss, while the remainder is recognized in OCI.

The choice between these options depends on factors like the nature of the contracts, the underlying assets held, and the insurer's accounting policies.

5. Transition Requirements

Ind AS 117 provides three approaches for transition through **Full Retrospective Approach, Modified Retrospective Approach or Fair Value Approach**

Entities are required to use the full retrospective approach unless it is impracticable, in which case they can choose between the modified retrospective approach and the fair value approach.

6. Implementation Challenges

Entities implementing Ind AS 117 may face challenges related to:

- **Systems and process changes:** Insurers may need to significantly modify their existing IT systems and accounting processes to accommodate the new requirements for data collection, measurement, and reporting.
- **Data requirements:** Ind AS 117 requires a significant amount of data to be collected and analyzed, including detailed information on cash flows, discount rates, and risk adjustments.
- **Impact on key performance indicators:** The new measurement and revenue recognition models may have a significant impact on insurers' key performance indicators, such as profitability, return on equity, and solvency ratios.
- **Resource and training needs:** Insurers will need to invest in training and development to ensure that their staff have the necessary skills and knowledge to implement and comply with the new standard.

Nangia’s Take

The notification of Ind AS 117 marks a watershed moment in Indian insurance accounting, bringing it into closer alignment with global best practices enshrined in IFRS 17. However, While the Ministry of Corporate Affairs has formally notified Ind AS 117, its practical applicability and significance within the insurance sector remain subject to a clear roadmap and notification from IRDAI.

Furthermore, the tax implications arising from changes in accounting practices and actuarial reserving methodologies necessitate careful evaluation. Given the magnitude of the shift, the insurance industry may not yet be fully prepared to adapt to such significant changes and could seek a deferment of Ind AS 117's application until the industry reaches a greater level of maturity and preparedness. Until IRDAI explicitly mandates the adoption of Ind as 117 for insurance companies, the impact of this sweeping amendment will remain limited in scope.

Exposure Draft IFRS Accounting Standard: Climate-related and Other Uncertainties in the Financial Statements:-Proposed illustrative examples

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Introduction

The International Accounting Standards Board (IASB) has launched a project to enhance the reporting of climate-related risks and other uncertainties in financial statements, highlighting inconsistencies between the information provided in financial statements and other general purpose financial reports.

In response, the IASB conducted research and decided to broaden the project's scope to include all uncertainties, not just climate-related risks. The goal is to improve the transparency and consistency of how these risks are reported in financial statements.

The IASB has collaborated with the International Sustainability Standards Board (ISSB) to align financial statements with sustainability disclosures. An Exposure Draft has been issued, containing eight illustrative examples demonstrating how entities can apply IFRS standards to report climate-related and other uncertainties. While these examples focus primarily on climate risks, they are intended to apply to various uncertainties.

The IASB is accepting comments on this Exposure Draft until 28 November 2024, after which it will decide whether to implement the proposed examples.

Example 1: Materiality Judgements Leading to Additional Disclosures (IAS 1/IFRS 18)

This example demonstrates how a manufacturer facing climate-related transition risks evaluates materiality in its financial statements. The company has implemented a plan to reduce greenhouse gas emissions over the next ten years by investing in energy-efficient technology. Although this plan does not directly impact the recognition or valuation of its assets and liabilities, the company concludes that omitting the plan’s implications could mislead users about its financial standing. As a result, it provides additional disclosures to clarify that the transition plan does not negatively affect its financial performance, improving users' understanding of the company’s position.

Example 2: Materiality Judgements Not Leading to Additional Disclosures (IAS 1/IFRS 18)

In this case, a service provider in an industry with limited climate-related transition risks evaluates its greenhouse gas emissions policy. Although the company publicly shares its low emissions levels and commitment to renewable energy, it finds that this policy does not affect the recognition or measurement of items in its financial statements. Given that current IFRS requirements do not mandate additional disclosures, the company concludes that providing extra information would not significantly impact users’ decisions. Consequently, it decides not to offer any additional disclosures beyond what is required by the standard.

Example 3: Disclosure of Assumptions: Specific Requirements (IAS 36)

This example illustrates how an entity applies IAS 36 when disclosing the assumptions used in impairment testing for assets impacted by climate-related risks. The entity is required to assess whether its cash-generating units are vulnerable to impairment due to climate-related factors. If the entity concludes that climate-related uncertainties may significantly affect future cash flows, it must disclose the key assumptions behind its impairment assessments, along with the reasoning for those assumptions. Such transparency is essential for users to fully grasp the potential risks to the entity's asset values.

Example 4: Disclosure of Assumptions: General Requirements (IAS 1/IAS 8)

In this example, the entity is required to disclose key accounting assumptions under IAS 1 and IAS 8, especially when those assumptions are affected by climate-related uncertainties. The entity must assess whether the assumptions used in its financial statements appropriately account for the potential effects of climate change. If these assumptions are considered significant, the entity should offer detailed explanations to help users understand the rationale behind them and their possible impact on the entity's financial outcomes.

Example 5: Disclosure of Assumptions: Additional Disclosures (IAS 1/IFRS 18)

This example highlights the need for extra disclosures when the information required by IFRS standards is insufficient. After assessing its climate-related risks, the entity identifies certain assumptions about future market conditions as crucial for users' understanding. To offer a clearer view of how climate uncertainties might impact its financial performance and position, the entity voluntarily discloses these assumptions, even though they are not specifically required by IFRS.

Example 6: Disclosure About Credit Risk (IFRS 7)

This example centers on how an entity discloses climate-related credit risk under IFRS 7. The entity must evaluate whether climate risks could impact the creditworthiness of its customers or counterparties. If a significant risk is identified, the entity must disclose this, including its potential effect on expected credit losses. Such disclosure enables users to understand how climate risks may affect the entity's financial stability and credit risk exposure.

Example 7: Disclosure About Decommissioning and Restoration Provisions (IAS 37)

This example outlines the disclosure requirements for provisions related to decommissioning and restoration costs under IAS 37, influenced by climate-related factors. The entity must assess whether climate change impacts the costs of decommissioning its facilities. If so, it must disclose details about these provisions, including the expected timing of cash outflows and any uncertainties in the estimates. Providing this information is crucial for users to evaluate the entity's potential future liabilities arising from climate-related regulations or environmental concerns.

Example 8: Disclosure of Disaggregated Information (IFRS 18)

The example highlights the need to break down information about climate uncertainties in line with IFRS 18. The entity is encouraged to provide detailed insights into how climate risks affect different parts of its operations. This disaggregation helps users better understand the specific impacts on various business segments, improving transparency and relevance in the financial statements. This approach supports users in making more informed decisions by clarifying the distinct risks tied to each segment.

Nangia's Take

The IASB has decided to include examples as illustrative materials accompanying IFRS Accounting Standards, rather than as separate educational documents. These examples are not part of the Standards and may not be translated in all jurisdictions, but they are accessible, useful for preparers, auditors, and regulators, and provide flexibility. They are designed to aid in making materiality judgments, applying disclosure requirements, and improving financial statement reporting on climate-related and other uncertainties. Entities should reassess materiality at each reporting date and implement any necessary changes to disclosures promptly. The Exposure Draft supports this approach to enhance the clarity and relevance of financial reporting.

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