SULLIVAN & CROMWELL LLP

July 24, 2017

New Insurance Accounting Standard IFRS 17

FSB Endorses New Accounting Standard for Insurance Contracts – IFRS 17

SUMMARY

On July 17, 2017, the Financial Stability Board ("FSB") issued a statement endorsing the final publication of International Financial Reporting Standards (IFRS) 17.[1] Previously, on May 18, 2017, the International Accounting Standards Board (the "IASB") issued the final version of IFRS 17, finalizing a long-standing project of the IASB to develop a single, consistent approach to the accounting for insurance contracts in jurisdictions that apply IFRS.[2] IFRS 17 will replace IFRS 4, which currently allows entities to use a wide variety of accounting practices for insurance contracts, reflecting different national accounting requirements. Development and finalization of a new IFRS standard for insurance contracts was identified as a high priority at the FSB Plenary meeting of September 25, 2015. Subject to the applicable adoption procedures in IFRS jurisdictions, the new standard will become effective for annual periods beginning on or after January 1, 2021, although earlier application is permitted.

BACKGROUND

The IASB, and its predecessor organization, the International Accounting Standards Committee, have been working on a project for the accounting of insurance contracts since 1997. As it was not feasible for the IASB to complete that project in time for the many entities that would adopt IFRS Standards in 2005, the IASB issued IFRS 4 in 2004, but with the intention to eventually replace it with a standard that would "make insurers' financial statements more useful and insurance accounting practices consistent across jurisdictions."[3] IFRS 4 made limited improvements to existing accounting practices for insurance contracts, resulting in a wide diversity in the financial reporting of insurance contracts across entities applying IFRS. According to the IASB, the differences in accounting treatment across IFRS jurisdictions has made the comparison and understanding of insurers' financial results difficult for investors and other stakeholders.

IFRS 17 is the culmination of proposals set out in various consultation documents published by the IASB. The IASB published a Discussion Paper in 2007 setting out its preliminary views on the main components of an accounting model for insurance contracts. This was followed by revised and more detailed proposals set forth in a 2010 Exposure Draft and a 2013 Exposure Draft. The IASB received many comment letters on these consultation documents, and conducted four rounds of field work relating to its proposals in 2009, 2011, 2013 and 2016. The IASB considered, but rejected, applying generally applicable IFRS Standards as an approach to accounting for insurance contracts, and applying an approach that would be based on existing models of insurance accounting (e.g., existing U.S. generally accepted accounting principles (GAAP) relating to insurance contracts, or national regulatory insurance accounting models such as statutory accounting practices in the United States).

IFRS 17

Scope

IFRS 17 applies to insurance contracts issued by entities (but not to insurance contracts held by an entity, i.e., where the entity is the policyholder), all reinsurance contracts (whether issued or held), and to investment contracts with discretionary participating features if the entity also issues insurance contracts. For fixed-fee service contracts whose primary purpose is the provision of services, an entity has the choice to account for them in accordance with either IFRS 17 or IFRS 15 (*Revenue from Contracts with Customers*). Financial guarantee contracts are permitted to be accounted for within the scope of IFRS 17 if the entity has asserted explicitly that it regards them as insurance contracts.

IFRS 17 identifies insurance contracts as those contracts under which the entity 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.

Under IFRS 17, an entity must separate, or "unbundle," specified embedded derivatives and distinct investment and service components from insurance contracts and account for them in accordance with other applicable IFRS Standards.

Main Features

IFRS 17 reflects the IASB's view that an insurance contract combines features of both a financial instrument and a service contract, and that many insurance contracts generate cash flows with substantial variability over a long period. In light of those views, IFRS 17 combines current measurement of future cash flows with the recognition of profit over the period services are provided under the contract; presents insurance service results separately from insurance finance income or expenses; and requires entities to make a choice, portfolio by portfolio, of whether to recognize all insurance finance income or expenses for the reporting period in profit or loss or to recognize some of that income or expenses in other comprehensive income (OCI).

IFRS 17 recognizes and measures groups of insurance contracts at: (1) "a risk-adjusted present value of the future cash flows (the fulfillment cash flows) that incorporates all of the available information about the fulfillment cash flows in a way that is consistent with observable market information," and (2) an amount referred to as the "contractual service margin," representing the unearned profit of the group of contracts. Profits from a group of insurance contracts are recognized over the period the entity provides insurance coverage, and as the entity is released from risk. If a group of insurance contracts becomes loss-making, the entity must recognize the loss immediately.

The disclosure requirements under IFRS 17 are more detailed than the disclosures currently required under IFRS 4. Under IFRS 17, an entity must disclose qualitative and quantitative information about the amounts recognized in its financial statements from insurance contracts; the significant judgments, and changes in those judgments, made when applying IFRS 17; and the nature and extent of the risks from contracts within the scope of IFRS 17.

An entity may apply a simplified premium allocation approach to some insurance contracts, which allows the entity to measure the amount relating to remaining service by allocating the premium over the coverage period.

APPLICATION

IFRS 17 applies to annual periods beginning on or after January 1, 2021, with earlier application permitted if IFRS 15 (*Revenue from Contracts with Customers*) and IFRS 9 (*Financial Instruments*) are also applied. Once effective, an entity must apply IFRS 17 retrospectively to groups of insurance contracts, unless that is impracticable, in which case the entity may choose between a modified retrospective approach and a fair value approach.

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ENDNOTES

[1] FSB, Press Release: *FSB welcomes new insurance accounting standard*, July 17, 2017, available at http://www.fsb.org/2017/07/fsb-welcomes-new-insurance-accounting-standard/.

[2] IASB, IFRS Standards – IFRS 17 Insurance Contracts, May 2017.

[3] IASB, IFRS Standards – IFRS 17 Insurance Contracts, *Basis for Conclusions*, May 2017. The IASB also has released IFRS Standards – IFRS 17 Insurance Contracts, *Illustrative Examples*, May 2017.

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