Corporates, do not be caught out by IFRS 17

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There is a common misconception that the International Financial Reporting Standards 17 (IFRS17): Insurance Contracts accounting standard applies exclusively to insurers. This standard, however, provides guidance for insurance contracts and not for insurance companies. It is therefore possible for an entity, which is not in the insurance business, to issue contracts with characteristics of an insurance contract as defined by IFRS 17.

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It is thus imperative to understand what IFRS 17 defines as an insurance contract to avoid an accounting crisis.

Common insurance contract pitfalls

An insurance contract is defined as a “contract under which one party (the issuer) 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”. One critical element in the definition of an insurance contract is the transfer of significant insurance risk.

Most corporate entities have insurance contracts where they are the policyholders and pay premiums. These premium payments will continue to be accounted for as expenses in profit or loss as incurred and are not in the scope of IFRS 17.

Sometimes, corporates also issue insurance contracts. These are the contracts that are sometimes overlooked and are explored in more detail here.

Insurance risk is any risk other than financial risk. Significant refers to the amount of additional benefits that would be payable, in any scenario with commercial substance, that exceed those that would be payable if no insured event occurred. There is no numerical threshold prescribed in the standard and judgement is required. Some examples of insurance contracts that are missed by corporate entities are:

- Performance guarantees/surety bonds, which are guarantees that are dependent on an entity's ability to perform a service. These arrangements usually involve an entity guaranteeing to pay out if a contractor defaults in its performance. These guarantees are commonly seen in the construction and mining industry.
- Hotel management services companies guaranteeing to pay out a minimum return to hotel owners/investors.
- Retail or transport companies committing to compensate the customer in the event of loss/damage of goods during transportation.
- Health capitation providers (for example, a physician, hospital, or ambulance service) guaranteeing certain medical services to a pool of patients in return for a fixed fee.
- A bank guaranteeing its customer a full reimbursement in the case where the customer's account is misappropriated.

Some tricky scope exclusions

The standard scopes out several contracts that meet the definition of an insurance contract. Warranties and fixed fee service contracts are two scope exemptions that we would like to highlight, as these would be most applicable to corporates.

Warranties could be provided by the manufacturer, dealer, or retailer in connection with the sale of its goods or services to a customer. Such warranties might provide a customer with assurance that the related product will function as the parties intended. These are within the scope of IFRS 15 and IAS 37. However, when a warranty is provided separately or as an extension, it will fall within the scope of IFRS 17.

A contract might meet the definition of an insurance contract, but its primary purpose is the provision of services to a customer for a fixed fee. Under these fixed fee service contracts, the customer pays a fixed fee to receive certain services over a fixed period when needed.

Examples of fixed fee service contracts are maintenance contracts under which the service provider is obliged to repair specified equipment after a malfunction, or car breakdown services in which the provider is obliged to provide roadside assistance or tow the car to a nearby garage. Since the level of service and the obligation of the service provider depend on an uncertain future event, these kinds of contracts might meet the definition of an insurance contract.

An entity can make an irrevocable choice to apply IFRS 15 instead of IFRS 17 to these contracts if it meets the requirements prescribed in the standard. The conditions consist of the following: the risk associated with individual customer is not reflected in setting the price of the contract with that customer; the customer receives services as compensation, rather than cash payments; and the insurance risk transferred by the contract arises primarily from the customer’s use of services rather than from uncertainty over the cost of providing the services to the customer. It is important to note that this assessment would have to be performed on a contract per contract basis and that the decision for each contract is irrevocable.

Cell captive arrangements

There are fronting structures available where corporate entities without insurance licenses can use their client base to sell insurance policies. These arrangements are referred to as third-party cell captives. This is a mechanism where a corporate entity, without an insurance license, can issue insurance products (which are underwritten by the registered insurer) to its customers and then share in the profits and risks from these insurance contracts. These are typically sold at the same time and complementary to the products that the entity sells.

A typical example of a corporate entity entering a third-party cell arrangement, is a mobile phone company offering handset or funeral insurance policies to its cell phone contract customers. The entity does not have a license to offer insurance policies and therefore makes use of a cell captive insurer. These arrangements can, however, be structured in different ways and this would impact the accounting treatment. Simply put, if the corporate shares in both the profit and the loss of such arrangements, then this would result in an insurance contract as there is a transfer of insurance risk.

With arrangements like this it can become very complex to assess whether there has been a transfer of significant insurance risk, and careful consideration needs to be given to the appropriate accounting treatment.

Key takeaways

Currently, IFRS 4 is the accounting standard applicable to insurance contracts and it does not provide for specific measurement requirements. This allows corporates to continue with their existing accounting policies if they comply with minimum requirements. IFRS 4, however, will be replaced by IFRS 17 from 1 January 2023 with a retrospective application. The new standard is complex, and very prescriptive on how to account for insurance contracts.

Corporates may have contracts that fall within the scope of IFRS 17 and the measurement of insurance contracts and/or structures will be different. Identifying these changes is the first step on the journey of implementation of IFRS 17. There is, however, still time for corporates to catch up with this complex standard before its effective date, so do not be caught out.

ABOUT THE AUTHOR

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