

Corporations can take on insurance risk - NZ IFRS 17

March 2022

The landscape of the world is changing more rapidly than ever before due to changes in our climate, safety, food supplies, and government policies. With so much uncertainty in this world and management seeking new risk management strategies, arrangements that mitigate non-financial risks come in many forms.

In this publication, we highlight the accounting challenges by clarifying what is non-financial risk and when an arrangement designed to mitigate a non-financial risk for a customer may be an insurance contract for the provider under accounting standards.

1. What is non-financial risk?

'Risks' exist for all entities and come in different forms.

Financial risks may impact an entity through changes in market prices, including changes in interest rates, foreign exchange rates, credit ratings, equity prices or commodity prices. Whereas **non-financial risks** are other risks not driven from financial risks, and are specific to a party to the arrangement.

Examples of non-financial risks include obsolescence or damage to inventory, death of an individual, motor vehicle accidents causing property damage or loss of life, and failure of a good or service to be fit for purpose.

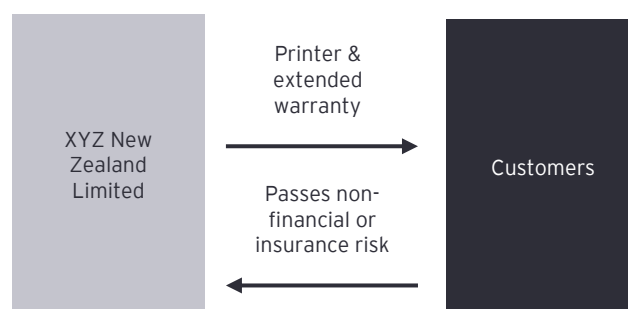
To mitigate non-financial risk, for example, the risk of a storm causing damage to a manufacturing plant, a manufacturer may consider diversifying its manufacturing locations, entering into a joint ownership arrangement or entering into a contractual arrangement that compensates for any storm damages that may occur.

The following are some examples of arrangements that are designed to address the impact of non-financial risks (mitigate for a customer; create risk for the provider of protection):

- ▶ Life and general insurance policies
- ▶ Warranty arrangements
- ▶ Residual value guarantee contracts
- ▶ Rent guarantees
- ▶ Financial guarantee contracts
- ▶ Performance bonds
- ▶ Contingent consideration agreed in a business combination

Non-financial risk becomes **insurance risk** when one party accepts this risk from a counterparty. For example, when a manufacturer provides warranties for goods it sells to customers, it is effectively accepting the insurance risk that the product may be defective by promising to compensate or make good with the customer.

Example 1: Sale of printers and warranties



XYZ New Zealand Limited ("XYZ New Zealand") sells printers and extended warranties for 'XYZ branded printers'.

Its extended warranty covers uncertain future events specific to the printer, including defective software and hardware. The extended warranty may be purchased online, and the customer can choose a term of 1 year, 3 years or 5 years.

Effectively, XYZ New Zealand is accepting non-financial/insurance risk from its customers through the sale of these warranties.

Therefore, while XYZ New Zealand is not held out as an insurer regulated by the Reserve Bank of New Zealand, it does provide cover designed to mitigate insurance risk for its customers.

2. What is an insurance contract?

In what circumstances can the acceptance of non-financial risk within an arrangement result in accounting as an insurance contract under NZ IFRS 17 *Insurance Contracts*? It's when an issuing party **accepts significant insurance risk** from another party by agreeing to **compensate** them if a **specified uncertain future event** adversely affects them. The event could be uncertain in its probability, the timing of its occurrence or in the amount of compensation.

Common misunderstandings

It is common for management to assume they are 'not engaging in insurance activity', simply because the entity is not a financial institution or regulated insurer. New Zealand accounting standards are written with a focus on transaction neutrality and the **substance of the arrangement**. For this reason, it is important to assess potential arrangements with an unbiased mindset.

A key factor in determining whether a contract is an insurance contract is the existence of *significant* insurance risk. 'Significance' is assessed by whether an insured event could cause the issuer to pay *significant additional amounts* in any scenario, excluding scenarios that lack commercial substance. So, the scenario does not have to be *probable* but only needs to be *possible*.

The existence of significant insurance risk may drive the need to apply insurance accounting to the arrangement.

Do you have any of these?

The following are common arrangements likely to be accounted for as insurance contracts (if material) by the provider:

- ▶ Warranties issued on products not sold by the entity
- ▶ Performance bonds
- ▶ Indemnity issued by a vendor in a sale of its business
- ▶ Loans or mortgages issued with a waiver for job loss
- ▶ Guarantees of minimum profit
- ▶ Contracts that guarantee minimum output (e.g., electricity generation by a solar plant)

Now that we understand the definition of an insurance contract, we will explore how this applies in the context of the new insurance accounting standard, NZ IFRS 17.

3. NZ IFRS 17 Insurance Contracts

NZ IFRS 17 incorporates the same standard as that issued by the International Accounting Standards Board, and for the first time, there will be a globally consistent insurance accounting standard bringing uniformity. The definition of an insurance contract (as described above) is unchanged from the current New Zealand insurance standard.

NZ IFRS 17 measures the progress of an insurance contract by recognising the premium received as insurance revenue over the coverage period, which is broadly consistent with the principle of recognising revenue for performance obligations for services provided over-time under NZ IFRS 15 *Revenue from Contracts with Customers*.

To understand whether NZ IFRS 17 applies to certain arrangements, we will now explore the arrangements specifically excluded from the scope of NZ IFRS 17.

4. Arrangements excluded from NZ IFRS 17

NZ IFRS 17 excludes certain arrangements and instead directs the accounting to follow other accounting standards such as NZ IFRS 15 *Revenue from Contracts with Customers*, NZ IFRS 9 *Financial Instruments* or NZ IFRS 3 *Business Combinations*. The following arrangements meet the definition of an insurance contract, but are specifically **excluded** from insurance accounting to avoid conflicts with other accounting standards:

Insurance contract as policyholder, unless it is a reinsurance contract

Warranties issued directly by the manufacturer, dealer or retailer in connection with the sale of the underlying item

Employers' assets and liabilities from employee benefit plans

Contractual rights or obligations contingent on future use of, or the right to use a non-financial item (for example, future lease payments made only when COVID-19 restrictions are lifted)

Residual value guarantees provided by the manufacturer, dealer or retailer of goods it sells, and those provided by a lessee when embedded in the lease

Financial guarantee contracts (unless the issuer asserted it's an insurance contract and accounts for it as insurance)

Contingent consideration payable or receivable on business combinations

Certain credit card contracts that provide insurance coverage without assessing the insurance risk of the individual involved

It pays to focus on the scope of the standard.

For certain arrangements where the primary purpose is providing services for a fixed fee, management can choose whether to apply NZ IFRS 17 or NZ IFRS 15. This is illustrated below.

Example 2: Provision of service for fixed fee

XYZ New Zealand, in addition to the sale of warranties, also sells 'repair and maintenance services' for a fixed annual fee. The service is provided by XYZ New Zealand on an as-needed basis (does not involve making cash payments to the customer), and the company does not assess the risk of the individual customer in setting the price. As a consequence, XYZ New Zealand has the choice to account for the repair and maintenance services by applying either NZ IFRS 15 or NZ IFRS 17.

In example 2 above, if XYZ New Zealand assessed the risk associated with the individual in setting the price, or could make a cash payment instead of providing the repair service, then it must apply NZ IFRS 17.

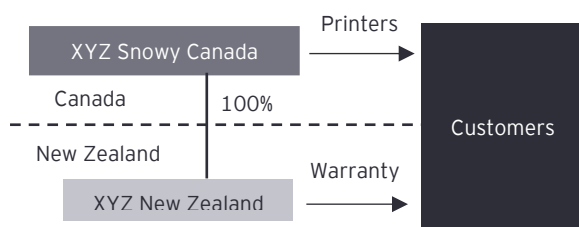
While warranties provided by manufacturers, dealers and retailers of items they sell are excluded, any entity that provides warranties (including extended warranties) over products that they do not sell will need to apply insurance accounting. Warranties sold in Example 1 above would not constitute an insurance contract given XYZ New Zealand is also the retailer of the printer. However, we see in Example 3 below that slight changes in the underlying circumstance may result in an insurance contract falling within the scope of NZ IFRS 17.

Example 3 below illustrates complexities that may arise due to the structure of an entity's business activities with its consumer sales channels. An arrangement can be excluded from insurance accounting for a group's consolidated financial statements, but be required to apply insurance accounting in the separate entity financial statements.

Example 3: Scoping

In Example 1, XYZ New Zealand sold printers and extended warranties to customers.

Now, assume that printers are only sold directly by its ultimate parent, XYZ Snowy Canada. XYZ New Zealand is not a retailer of the product itself.



For XYZ Snowy group's consolidated financial statements (which includes both Canada and New Zealand), the extended warranties are not accounted for as insurance contracts since the warranty were provided for goods the group sells.

However, in the separate financial statements of XYZ New Zealand, XYZ New Zealand is **not** considered a manufacturer, dealer or retailer of the printer. As a result, the warranties it sells will be included in XYZ New Zealand's separate entity financial statements and accounted for as an insurance contract.

Similar to NZ IFRS 15 and NZ IFRS 9, insurance accounting under NZ IFRS 17 requires the existence of an 'enforceable contract'. So, arrangements that do not create contractually enforceable rights and obligations *with an external party* are not accounted for as insurance contracts - another standard, such as NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or NZ IAS 19 *Employee Benefits* may need to be applied. Such examples are self-insurance and government protections established by consumer law.

5. Accounting under NZ IFRS 17

Once an arrangement is considered an insurance contract within the scope of NZ IFRS 17, then such contracts are grouped together for measurement when they share similar risk characteristics. There are three ways to measure such groups of insurance contracts - the General Model, the Premium Allocation Approach (PAA), and the Variable Fee Approach (VFA).

The three models have similar objectives in that they provide a mechanism to release the premium received as insurance revenue over the coverage period that insurance service is provided to the counterparty. This results in a liability representing the compensation for promising to fulfil future claims and service costs, and earn a profit margin (contractual service margin).

In addition, all three models require entities to separately recognise and provide for claims when incurred. This is then remeasured subsequently for changes in expectations of future cash outflows (claims, service costs, etc).

The general model is the default model for accounting for insurance contracts, whereby the liability is constantly reassessed to reflect the experiences and current expectations of future claims.

For contracts with a coverage period of one year or less, the PAA may be elected to simplify the accounting to allocate the premium over the coverage period on the basis of either the passage of time or the expected release from risk. When the coverage period is more than one year, if it is reasonably expected that the liability recognised under the PAA would be materially the same as the general model, then this simplified approach can be applied.

The VFA is a tailored version of the general model, which is to be applied to contracts with direct participation features. Direct participation features exist where the payout under the insurance contract is substantially linked to the return of an identified pool of underlying items (usually investments).

Each of these models can be complex and has its own detailed measurement and disclosure requirements. For further information regarding the accounting for insurance contracts under NZ IFRS 17, refer to EY publication '*Applying IFRS: A closer look at IFRS 17 Insurance Contracts*'.

6. Next steps

Management should consider the following:

1. What are the non-financial / insurance risks that the entity has accepted in its contracts?
2. Are such contracts excluded from NZ IFRS 17?
3. Are these risks 'significant'?
4. Does the acceptance of these risks result in an 'insurance contract'? (i.e., there is a specified uncertain future event, compensation mechanism, etc.)

The requirement to apply NZ IFRS 17 is just around the corner and is mandatory for annual periods beginning on or after 1 January 2023. Prior year comparatives must be restated, such that the transition date is the beginning of annual periods commencing on or after 1 January 2022.

Therefore, do not delay in understanding whether insurance accounting under NZ IFRS 17 may apply to your arrangements.

For our illustrative financial statements applying NZ IFRS 17, refer to '*Good General Insurance (International) Limited*' or '*Good Life Insurance (International) Limited*'.

To discuss further, please contact your local EY adviser.

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