

## Indonesia: Proposed updates to PSAK 74 in response to amendments to IFRS 17 (Part II - making results easier to explain)

### Introduction

This e-Alert is Part II in a series of three e-alerts we have prepared to discuss the changes to IFRS 17 and the Institute of Indonesian Chartered Accountants' (IAI) proposed changes to PSAK 74, an adaptation of IFRS 17 issued by the International Accounting Standards Board (IASB). Each e-Alert focuses on one of the IASB's three criteria for deciding to change IFRS 17:

- To reduce the implementation and system development costs of IFRS 17
- To make results easier to explain
- To make transition to IFRS 17 easier.

If you would like to read Part I which covers the IASB's criterion of reducing costs and also provides the background behind these updates, you can download it [here](#).

In this second e-Alert, we discuss the amendments to IFRS 17 in order to make results easier to explain and attempts to reduce accounting mismatches, their impact on insurers and likely impact on PSAK 74. Part III will cover the third criterion - easing the transition to IFRS 17 will be released shortly.

The amendments to IFRS 17 aimed at making results easier to explain cover the following areas:

- Recovery of acquisition cashflows from expected renewals
- Accounting mismatches on reinsurance treaties held
- Recognising profit on General Model contracts with an investment component
- Applying the risk mitigation option

### Amendment 1: Acquisition cashflows

IFRS 17 requires an insurer to consider acquisition costs when determining the expected profit of insurance contracts.

Acquisition costs are recognised as an asset until the group of insurance contracts is recognised or included in the contracts' fulfilment cashflows at the time of initial recognition. IFRS 17

required an entity to allocate the acquisition costs directly attributable to a group of contracts fully and immediately, even when part of the acquisition costs related to future renewals are not within the contract boundary. Insurers are now allowed to allocate part of the acquisition costs to expected renewals and to recognise those costs as an asset until they recognise the corresponding renewal.

For example, an insurer pays USD 300 commission for a three-year contract. Policyholders pay USD 150 premium each year, but because the insurer has the right to re-price the contract before each premium, the contract boundary under IFRS 17 in this example is assumed to be one year. Before the amendments, the profit and loss recognises strain in year one.

|  | Before June 2020 Amendments |        |        | After June 2020 Amendments |        |        |
|--|-----------------------------|--------|--------|----------------------------|--------|--------|
|  | Year 1                      | Year 2 | Year 3 | Year 1                     | Year 2 | Year 3 |
| Premiums                                   | 150                         | 150    | 150    | 150                        | 150    | 150    |
| Claims                                     | 20                          | 20     | 20     | 20                         | 20     | 20     |
| Commissions                                | (300)                       | -      | -      | (100)                      | (100)  | (100)  |
| Profit/(Loss)                              | (130)                       | 130    | 130    | 30                         | 30     | 30     |
| Asset for Insurance Acquisition cash flows | -                           | -      | -      | 200                        | 100    | -      |

The insurer must assess the recoverability of the asset for acquisition cashflows at each period before the renewed contracts are recognised if facts and circumstances indicate the asset may be impaired. If the asset is impaired, then the insurer must recognise the impairment loss in profit and loss when the insurer no longer expects the renewals supporting the assets to happen. Additional disclosures about assets for acquisition cashflows are now required because these assets will be larger and of longer duration than before as they increase by the acquisition costs of future renewals.

IFRS 17 leaves insurers free to apply this amendment to contracts using the General Model (GM) or Variable Fee Approach (VFA) if required. An example would be when the contract boundary is shorter than the term of the contract. However, the proposed amendments to PSAK 74 stipulate this amendment can only be applied to contracts using the Premium Allocation Approach. Potentially, this is another difference between the standards, which companies required to report under IFRS 17 and PSAK 74 should be aware of when calculating results. However, given the desired convergence between PSAK and IFRS, we may expect additional amendments to PSAK 74 in line with IFRS 17 during the amendment process.

## Amendment 2: Mismatch on reinsurance contracts

IFRS 17 requires an insurer to recognise losses from onerous contracts immediately in profit or loss at initial recognition. However, any net cost or net gain by purchasing reinsurance is recognised in profit or loss over time as services are received from the reinsurer. Where insurers purchase reinsurance to mitigate the losses on onerous contracts, then this results in an accounting mismatch. The losses on the onerous underlying contracts may appear overstated on initial recognition and then understated in future periods from this mismatch

IFRS 17 now requires insurers to recognise an amount for loss recoveries from reinsurance when they recognise losses on underlying insurance contracts at initial recognition. The adjusted net cost or net gain is then recognised over time. The loss on the underlying insurance contract is treated as early recognition of a proportion of claims while the loss recovery from reinsurance is treated as early recognition of a proportion of claim recoveries. Reinsurance must be bought before, or at the same time as, the loss on the underlying insurance contracts is recognised. An insurer must recognise a reinsurance treaty when the insurer recognises the onerous underlying insurance contracts if that is earlier than when they otherwise would recognise the reinsurance treaty held. The amendment to IFRS 17 applies regardless of whether the reinsurance is quota share or excess-of-loss.

Losses and loss recoveries are presented as separate line items in profit and loss and are disclosed separately in the notes to the financial statements. The accounting for the underlying insurance contracts, before reinsurance, is unchanged by this amendment.

## Amendment 3: Profit recognition

In IFRS 17, the GM applies to insurance contracts without direct participation features with profits being recognised as the insurer provides insurance coverage through the operation of “coverage units”. However, the GM does not allow any investment services which may be provided by the contract to be considered when determining the coverage units. Insurers that issue contracts

without direct participation features must now recognise profit when they provide insurance coverage or any service related to investment activities (“investment-return services”). A contract may provide an investment-return service if and only if:

- An investment component exists or the policyholder has the right to withdraw an amount
- The entity expects the investment component or the amount the policyholder has the right to withdraw to include an investment return
- The entity expects to perform investment activities to generate that investment return

If all the conditions are met, then an insurer may still decide that no investment-return service exists because the conditions are not definitive. This is a matter of judgement for the insurer.

Costs related to investment activities are included in the measurement of the fulfilment cashflows within the contract boundary to the extent they enhance benefits from insurance coverage to policyholders. Coverage units are determined by considering both the insurance coverage and any investment-return service. As a result, an insurer will recognise profit as it provides both insurance coverage and investment-return services.

The disclosure requirements of IFRS 17 are enhanced so that:

- Insurers will provide quantitative information about when Contractual Service Margin is recognised in profit and loss
- The judgements applied in determining the relative weightings of the benefits provided by insurance coverage and investment-return service for the GM, and insurance coverage and investment related service for contracts covered by VFA

## Amendment 4: Application of the risk mitigation option

The risk mitigation option allows insurers to reduce income volatility from insurance contracts with direct participation features. Changes in the effect of financial risk can be recognised in the profit or loss instead of adjusting the Contractual Service Margin as is normally required by the VFA. The option was included in IFRS 17 to mitigate an accounting mismatch between VFA contracts and any derivatives used to mitigate financial risk from those contracts. Insurers now have the choice to use the risk mitigation option when using reinsurance or non-derivative financial instruments to mitigate financial risk. Reinsurance and non-derivative financial instruments are measured at fair value through profit or loss.

The risk mitigation option is more restricted for non-derivative financial instruments because it applies only when the insurer uses those non-derivatives to mitigate financial risk in the fulfilment cashflows. No risk mitigation option exists for insurance contracts without direct participation features because the option resolves a specific accounting mismatch from the VFA.

## Feedback in response to proposed changes to PSAK 74

The IAI has requested feedback from the industry on the proposed changes to PSAK 74. The PSAK 74 Amendments Exposure Draft is available on the IAI's website [here](#). The IAI has asked to receive written feedback to the exposure draft by 30 October 2020 at the latest. Insurers can provide their responses using the online form on the IAI's website or by sending them to:

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