AASB 17 *Insurance Contracts*

Why non-insurers shouldn't overlook the standard

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INTRODUCTION

Contracts entered into by entities that are not insurers may fall within the scope of the new insurance standard.

AASB 17 *Insurance Contracts* is the most significant new accounting standard to become effective since the last major new standard, AASB 16 *Leases*. It supersedes AASB 4 *Insurance Contracts* and fundamentally changes the way insurance contracts are accounted for. The new standard applies to annual reporting periods beginning on or after 1 January 2023.

Understandably, **non-insurers** may have given the new insurance standard very little thought on the basis that it will not apply to them. While this may be true in many cases, AASB 17 should not be completely ignored as some contracts that non-insurers enter into on a regular basis may fall within the scope of this complex new standard. This is because AASB 17 applies to insurance contracts regardless of the entity that issues them.

In this four-part series, we will explore the scope of AASB 17 with non-insurers in mind. The focus will be on key definitions and concepts, transactions that are explicitly carved out of the scope of the standard, and optional exemptions that allow certain contracts that meet the definition of an insurance contract to be accounted for under another accounting standard.

CONTENTS

What is an insurance contract?

Key definitions

AASB 17 defines an insurance contract as a **contract** under which one party (the insurer) 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.

Insurance risk is defined as being any risk other than financial risk transferred from the holder of a contract to the issuer.

Financial risk is explicitly defined in AASB 17 as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Existence of a contract

For an insurance contract to exist, there must be an enforceable contractual arrangement between two or more parties that creates substantive rights and obligations. Such contracts can be written, verbal or implied by an entity's customary business practices. Implied terms include those imposed by law or regulation.

Compensation for a specified uncertain future event

An insurance contract requires there to be compensation for a specified uncertain future event (the insured event). Compensation can be in cash or in kind (i.e., repairing or replacing a damaged item).

Uncertainty is at the core of an insurance contract. At least one of the following must be uncertain at inception of the contract:

- Probability of the insured event occurring
- Timing of the insured event
- How much will need to be paid if the insured event occurs.

Adverse effect on policyholder

An adverse effect on a policyholder means that the policyholder suffers a loss as a result of the occurrence of the insured event. This is important because contracts which pay the counterparty when an event occurs, regardless of whether the counterparty is adversely affected or not, are not insurance contracts.

Non-financial risk

Non-financial risk is a risk that is specific to a party to the contract e.g., the occurrence or non-occurrence of a flood that damages a party's asset. Consequently, insurance risk is the non-financial risk the issuer accepts from the policyholder.

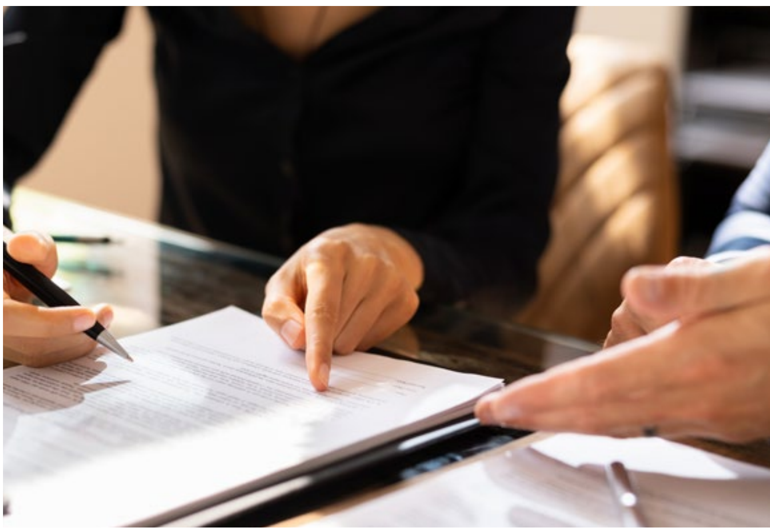
The policyholder must be exposed to the risk before entering the insurance contract. Risk that is created by a contract is not a pre-existing risk and therefore is not insurance risk.

Significant insurance risk

For insurance risk to be significant, it must require the issuer to pay significant additional amounts beyond what it would pay if the insured event did not occur, and it could suffer a loss as a result.

Key concepts regarding the assessment of significance in the context of insurance risk:

- It is done from the issuer's perspective at the individual contract level
- Time value of money is taken into account
- The likelihood of the insured event occurring is ignored
- Scenarios that have no commercial substance are excluded



Mandatory scope exclusions

Where a contract meets the definition of an insurance contract but is a type of contract specifically excluded from the scope of AASB 17, it will not be accounted for applying the requirements of AASB 17. Instead, the requirements of another accounting standard must be applied to that contract.

Non-insurers often enter into the types of contracts covered by the mandatory scope exclusions referred to above. It is therefore helpful to be aware of these exclusions to avoid having to do any further detailed assessment under AASB 17, and instead immediately refer to the other standard applicable in the circumstance.

AASB 17 generally applies to the issuer of an insurance contract, not the holder. An entity that owns a fleet of vehicles and takes out insurance over this fleet is the holder and does not apply AASB 17 to this purchased insurance contract. However, an entity that holds a reinsurance contract to transfer the insurance risk arising from an underlying insurance contract that it has issued will have to apply AASB 17.

The table below lists the mandatory scope exclusions as well as the other accounting standard(s) that applies in the circumstance:

Type of contract	Other applicable accounting standard(s)
Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see below)	AASB 15 *Revenue from Contracts with Customers* AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
Employers' assets and liabilities from employee benefit plans	AASB 119 *Employee Benefits* AASB 2 *Share Based Payment*
Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item	AASB 15 *Revenue from Contracts with Customers* AASB 16 *Leases* AASB 138 *Intangible Assets*
Residual value guarantees provided by a manufacturer, dealer or retailer	AASB 15 *Revenue from Contracts with Customers*
Residual value guarantees for lessees embedded in a lease	AASB 16 *Leases*
Contingent consideration payable on a business combination	AASB 3 *Business Combinations*
Credit card contracts (or similar contracts that provide credit or payment arrangements) that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer	AASB 9 *Financial Instruments*

PART 3

Product warranties

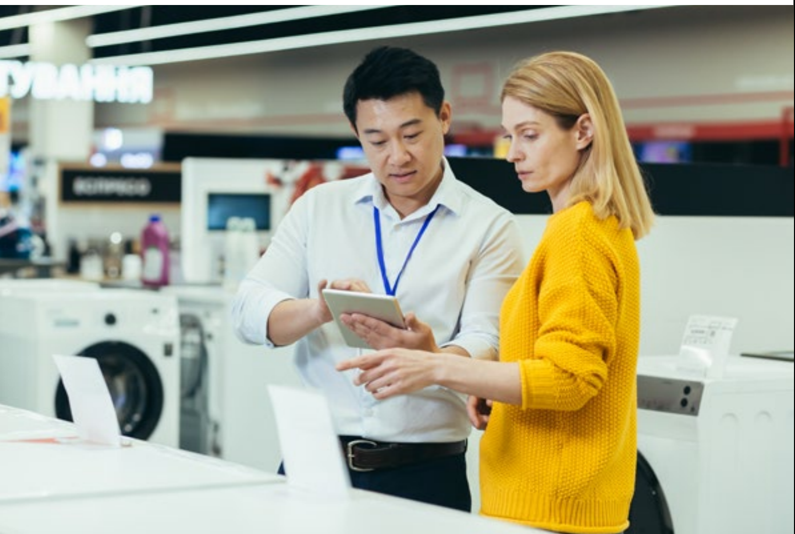
Warranties are promises an entity makes about the quality of a product or service, or how it will fix any problems with a product or service, that it sells.

Insurance risk exists in product warranties because either the number of services to be performed or the nature of those services, or both, is uncertain. They protect the customer against an 'uncertain future event', and the risk may be significant. Consequently, product warranties normally meet the definition of an insurance contract and would therefore be caught by AASB 17.

The mandatory scope exclusion ensures extended warranties offered to customers by manufacturers, dealers or retailers at the time of sale of the goods or services are not subject to insurance accounting.

Judgement may be needed to determine whether a warranty is provided 'in connection with' the sale of goods or services to a customer as there is no guidance on this. Factors such as when the warranty is purchased by the customer and when the warranty is priced will need to be considered.

In a group situation where the parent entity sells the goods or services while a subsidiary offers the warranty, the scope exclusion would apply in the consolidated financial statements. However, in the subsidiary's individual financial statements it would not apply because the warranty is provided by a party other than the manufacturer, retailer or dealer. The fixed fee contract criteria may apply in this case which means the subsidiary could choose to account for the warranties under AASB 15 *Revenue from Contracts with Customers* instead of AASB 17.



Example:

A white goods retailer provides its customers with a free two-year warranty to cover repairs due to manufacturing defects. In addition, for a fixed price, customers can purchase an additional one-year extended repair warranty. Both warranties are provided/offered at the time of sale of an appliance.

Question: Are the two warranties insurance contracts within scope of AASB 17?

No, as they meet the scope exclusion for warranties. Both warranties are available at the time of the sale and are provided by the retailer that sells the appliance.

Question: How would the assessment change if the one-year extended repair warranty is offered at a later date?

If the extended repair warranty is provided at a later date and not concurrently with the sale (i.e., the original sale terms did not allow for the subsequent purchase of the warranty at a fixed price), it is unlikely that the extended repair warranty will meet the scope exclusion for warranties. This is because it fails the 'in connection with the sale' test.

Question: How would the assessment change if the one-year extended repair warranty is provided by a subsidiary in the same group and not by the entity that sells the appliances?

In this case, the warranty is provided by a party other than the manufacturer, dealer or retailer which means the scope exclusion for warranties would not apply in the individual financial statements of the subsidiary. That is, AASB 17 would need to be applied in the subsidiary's financial statements (unless the fixed fee contract criteria are met). From a group perspective, however, the appliances and both warranties are provided by the same reporting entity therefore the scope exclusion for warranties would apply in the consolidated financial statements.

Optional scope exemptions

If a non-insurer issues a contract that meets the definition of an insurance contract (i.e., it transfers significant insurance risk), the mandatory scope exclusions should be considered first. If none of these apply, it does not necessarily mean the contract is within the scope of AASB 17; there may be an option to account for the contract under another accounting standard if certain conditions are met.

Fixed-fee contracts

Non-insurers may issue fixed-fee service contracts that they currently account for under AASB 15 *Revenue from Contracts with Customers*. The primary purpose of these contracts is the provision of services for a fixed fee. The level of service to be provided by the service provider under the contract depends on an uncertain future event.

Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a breakdown. Such contracts meet the definition of an insurance contract because:

- It is uncertain whether, or when, assistance or a repair will be needed;
- The owner is adversely affected by the occurrence; and
- The service provider compensates the owner if assistance or repair is needed.

Even where a fixed-fee service contract meets the definition of an insurance contract, there is a choice to apply AASB 15, but only if all the following conditions are met:

- The price of the contract is not based on an individual customer's risk assessment (i.e., all customers are charged a similar price for a similar service contract);
- Compensation to the customer is in the form of a service rather than a cash payment; and
- Insurance risk in the contract arises mainly from the customer's use of services rather than from uncertainty over the cost those services.

The irrevocable accounting policy choice to apply AASB 15 instead of AASB 17 is made on a contract-by-contract basis.

Financial guarantee contracts

Financial guarantee contracts may or may not be within scope of AASB 17.

Under a financial guarantee contract, the issuer grants the counterparty the right to be reimbursed for a loss that the counterparty incurs when a specified debtor fails to make a payment when due under the terms of a debt instrument. These types of financial guarantees are common in groups (e.g., between a parent and a subsidiary) and usually meet the definition of an insurance contract.

An entity can elect to apply AASB 17 to its existing issued financial guarantees if, and only if, it has previously explicitly asserted that it considers such contracts to be insurance contracts and has accounted for them on that basis. The choice is available on a contract-by-contract basis but once the choice is made, it is irrevocable for that contract.

If AASB 17 is not applied, then financial guarantee contracts are accounted for under the financial instruments standards, namely AASB 7 *Financial Instruments: Disclosures,* AASB 9 *Financial Instruments*, and AASB 132 *Financial Instruments: Presentation*.

Loan contracts with limited compensation

Certain loan contracts may meet the definition of an insurance contract if they transfer significant insurance risk. An example includes a loan with a death waiver.

If a contract limits the compensation for an insured event to the amount otherwise required to settle the counterparty's obligation created by the contract, the issuer can elect to apply AASB 9 instead of AASB 17 (provided no other scope exclusions apply). This choice is made irrevocably on a portfolio-by-portfolio basis.

"Even where a fixed-fee service contract meets the definition of an insurance contract, there is a choice to apply AASB 15, but only if all the certain conditions are met."

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