

**First Time Adoption on Accounting Issues in Insurance Industry on
Implementation of New Standards based on IFRS.**

	Matters discussed	Decision
1	SLFRS 4 on Insurance Contracts requires a liability adequacy test to consider current estimates of all contractual cash flows, and of related cash flows such as claims handling costs. It's been raised as a concern that the IBSL rules permit a net premium method and hence if the regulation is <u>not</u> amended a conflict will occur.	As the financial statements should be prepared based on SLFRSs the actuaries will have to use gross cash flows to perform the liability adequacy test. The IBSL will not treat this as a conflict in preparing the general purpose financial statements. The liability adequacy test will only be a disclosure.
2	An Insurer is permitted, but not required, to change its accounting policies so that a recognized but unrealized gain or loss on an asset affects those measurements in the same way that a realized gain or loss does. (SLFRS 4, Para. 30) In terms of Shadow Accounting (SLFRS 4), the current market fair value will be used for the valuation and whatever life policy holder unrealized gains / losses will be recorded through the other comprehensive income (OCI) to the policy liability (life fund valuation).	In principle, gains & losses on an asset should not influence the measurement of an insurance liability (unless the gains or losses on the asset alter the amounts payable to policyholders). The Actuaries clarify that they exclude unrealized gains / losses in determining adequacy of liability and only consider the realized gains / losses, at present. However, market values used in accordance with SLFRS 4 will result in a reserve being created in the life balance sheet, through OCI.
3	SLFRS 4 Para. 14 (d), requires that reinsurance assets shall not be offset against related insurance liabilities.	The sub-committee recommends that reinsurance assets be shown as Gross on the Balance Sheet. Any reinsurance asset could be taken as admissible to the extent it satisfies the current norms of admissibility specified in the Solvency Margin rules, according to the IBSL.

4	<p>One of the underlying assumptions in the Framework is that financial statements are prepared on the accrual basis of accounting. Currently, companies are accounting for life insurance premiums on cash basis, as practiced and recommended by the SoRP on Insurance.</p>	<p>In the absence of a Standard, the SoRP on Insurance mentioned cash basis of accounting for life premiums. However, as Sri Lanka is converging with IFRS under a new Framework accrual of premiums method is recommended. Treatment of this receivable (up to a limited period relating to the grace period allowed in policy terms and conditions) for solvency purposes could be considered by the IBSL, provided the corresponding liabilities and policy reserves are also recognized by the company, subject to the necessary approval of the IBSL. However, this may not be applicable for Unit linked policies as the policyholder liability on unit price has to be created. Normally, units are created on receipt of premiums/cash.</p>
5	<p>The SRCC & TC premium in terms of accounting standards is treated on a gross basis resulting in the premium ceded to NITF being treated as reinsurance. However, there is a legal view that NITF has indicated that they are acting as a principal insurer in relation to SRCC & TC supported by a gazette.</p>	<p>Substance over legal form is a qualitative characteristic of financial statements and therefore the information is presented in accordance with their substance and economic reality and not merely their legal form. These premiums should be accounted on gross basis as the company is acting as a principal in the eyes of the customer. All administrative activities from underwriting to claims settlements are also carried out by the insurance company. However, the IBSL requires the outflow to NITF to be classified in a separate heading and not part of reinsurance premiums, to overcome any legal disputes. E.g. it could be termed “compulsory cession to NITF”.</p>

6	The sub-committee has a consensus that fronting arrangements should be treated on a gross basis resulting in the premium ceded to NITF being treated as reinsurance.	According to IBSL, companies could be recording remittance of fronting premium as reinsurance, provided that the transactions occur on the basis of a treaty or a facultative arrangement with reinsurers acceptable to the board and the relevant NITF portion has been ceded by the company.
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Guidance on Accounting Issues given to the Banking sector that are relevant to the Insurance Industry.

	Matters Discussed	Decision
1	<p>Measurement Criteria for comparative figures</p> <p>Valuation of Bills & Bonds Eg: Treasury Bills & Bonds Development Bonds Sovereign Bonds</p>	<p>The committee recognized three options available for classification of treasury bills and bonds as at 31.12.2011.</p> <ul style="list-style-type: none"> ➤ Continue to recognize as Held to Maturity Bills and bonds existed on 31.12.2011, with the intention of held to maturity has the option to record it as HTM instruments under LKAS 32& 39. ➤ Reclassification of HTM instruments as Available for Sale. (AFS) The entity has the option to reclassify HTM instruments as available for Sale (AFS) and any fair value difference should be recognized under equity. According to the LKAS 39, at the time of reclassification of HTM to AFS, it should be re-measured at fair value, and the difference between its carrying amount and fair value shall be recognized directly in equity. ➤ Reclassification of Available for Sale(AFS) instruments to Held to Maturity (HTM) In the application of the new GAAP, entity has the option to reclassify Available for Sale instruments to HTM. Under this option the entity should refer to the original date of the transaction and roll forward under amortized cost. In the application of the above three options, it was agreed to be based on the information published by CBSL, for any measurement at the time of reclassification

2	Measurement of Listed & Unlisted Debt	<p>The entity has the option to reclassify as HTM.</p> <p>Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market can be classified as Loans and receivables.</p>
3	Measurement of Listed Equity	<p>The entity has the option to classify it under suitable category, and should be valued at fair value. Based on the category where the instruments are falling, necessary fair value adjustments should be charged to income statement or to the equity.</p> <p>According to the LKAS 39, any fair value gains and losses arising from trading instruments are recognized in the income statement where as these gains and losses are directly recognized in equity for AFS (Available for Sale) instruments.</p>
4	Measurement of Unlisted Equity(This excludes any subsidiary/ associates/ joint ventures)	<p>LKAS 39 excludes from its scope, the interests in subsidiaries, associates and joint ventures that are accounted for under LKAS 27, 28 and 31.</p> <p>It was agreed that the valuation model will be decided by the investee while ensuring that it will not be less than the net asset value of the investee (as a minimum threshold).</p> <p>However, investee should use the cost for valuation of unlisted equity only if the entity is unable to get the required information to fair value the said equity using established valuation methodologies.</p>
5	Measurement of Unit Trust	Valuation will be done based on the information published by the Unit Trust Manager.
6	Measurement of Derivatives	<p>➤ Currency SWAPS</p> <ul style="list-style-type: none"> • Funding SWAP In evaluating the currency SWAP, if the transaction fulfills the following criteria, it should be recognized as a funding arrangement or a REPO transaction. <ul style="list-style-type: none"> a) Counterparties are same b) Tenor/Period of the transaction is same c) Principal amount is same • Currency SWAP If a transaction does not satisfy the above three criteria, that will be treated as a normal currency SWAP.

		<p>The exchange gain or loss and the fair value adjustments of the Funding SWAPS are accounted as one line item in the income statement, whereas this will be accounted as two separate line items in normal currency SWAPS.</p> <p>➤ Interest Rate SWAP</p> <p>It was agreed that the Interest Rate SWAPS should be measured at its fair value.</p> <p>However, when there is no active market to determine the fair value, it was agreed that the entity should derive its fair value either through a valuation model developed by the entity or through a counterparty pricing.</p> <p>Further, it was agreed that the counterparty pricing would be the better option in arriving at the fair value which is a more observable method compared to entity specific valuation models. However, the methodology and its effect will be decided by the entity after considering the materiality.</p> <p>It was further agreed that any fair value adjustments on these SWAPS should immediately be recognized, without amortizing over the tenor of the transaction as required by the standard.</p>
7	Employee Loan	<p>Employee loan should be treated as a financial instrument according to LKAS 32, since there is a contractual right to receive cash.</p> <p>Accordingly, these loans should be measured at its fair value as per LKAS 39 using the comparable market rate. It was agreed that the rate that the entity will offer to its best customer as at the loan granting date could be treated as a yardstick to derive the fair value, and this rate will differ from entity to entity based on the loan rates offered by each entity.</p> <p>It was agreed that the fair value loss can be amortized over the employee service period as an employee cost.</p> <p>It was understood that there won't be any impact either to the income statement or the balance sheet although there will be a classification difference between line items. (i.e. the increase in interest income would be set off against the increase in the employee cost in the income statement, and</p>

		<p>the loan balance would decrease with a simultaneous increase in prepayments in the statement of financial position)</p> <p>For the valuation of employee loans which were granted on or before 31.12.2011, the standard requires to go to the date the loan was granted and to adjust the interest rate differential.</p> <p>However, a suggestion was made to simplify the valuation process: to consider that all employee loans granted before 01.01.2011 will be fully settled on 01.01.2011 and new loans will be granted on the same date for the same amount.</p> <p>It was further agreed that the concession was given for the fair value measurement of the loans granted before 01.01.2011, if the entity is unable to get the fair value of each loan as at the loan granting date as required by the standard.</p>
8	Share Issue Expenses	<p>It was noted that although the LKASs allow setting off the share issue expenses against the proceeds on share issue, the Companies Act does not allow any deduction to stated capital. It was further noted that other effects of discrepancies between the Companies Act and the LKAS reporting requirements exist.(E.g.: Classification of Redeemable Preference shares & Solvency Testing etc)</p> <p>However, it was finally agreed that the entity will comply with the LKAS's in financial reporting and accordingly the entity may set off any share issue expenses from "Equity" instead of "Stated Capital. Stated Capital may be explained in a note to comply with the Companies Act requirements.</p>
9	ESOPS	<p>It was noted that there could be two categories of Employee Share Ownership Schemes based on whether there has been transfer of risks and rewards of the shares allotted.</p> <p>a) Risks & Rewards Transfer through the Trust Where money advanced by the company for purchase of shares represents a complete transfer of risks and rewards of the shares through the trust, such amounts shall be reflected in the books of the company as a loan.</p>

		<p>Since the risk & rewards have been transferred no fair value adjustments are needed for change in share prices.</p> <p>However, if the loan repayment is below the market terms any resulting impairment less any security held by way of shares pledged shall be debited to employee cost.</p> <p><i>b) Risks & Rewards Held with the Company</i> Where such transfer of funds to purchase its own shares to a trust does not reflect complete transfer of risks and rewards of shares, any balance outstanding shall be reflected in the financials as a deduction of equity, and not as a separate asset and any fair value adjustments reflected therein accordingly.</p>
10	Share Options	Share options need to be valued at fair value, only for those where the grant date is on or after 01.01.2012. Therefore, no changes in comparatives are required, where the grant date is before 01.01.2012.