Financial Services

Insurance Accounting:

The Implications

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Insurers will face unprecedented change in the way they report their business under International Financial Reporting Standards (IFRS) and U.S. GAAP. But how useful will the information be?

Around mid-2010, the IASB and FASB plan to issue a draft standard on accounting for insurance contracts, with the objective of issuing a final version in the first half of 2011. The publication of this draft is a major milestone in a process that started more than a decade ago to develop a standard for the measurement of insurance liabilities. Both boards have made considerable progress over the past year, despite distractions arising from the financial crisis, and the project is now moving forward with a real sense of urgency for several reasons:

- A number of major economies — including Brazil, Canada, India, Japan, Korea and Mexico — have announced plans to adopt IFRS or move their reporting standards to IFRS between 2010 and 2012.
- Due to internal rotation rules, the IASB chair and all board members who have participated in the project over many years will complete their terms by 2011. It would be unrealistic to expect a new board to get acquainted with the specifics of the insurance business and finalize the project quickly.
- The new insurance contract standard will affect more than just those companies subject to IFRS. Given FASB involvement in the insurance contract project, current insurance-related U.S. GAAP standards will likely be replaced by a similar standard in a similar time frame, leading to significant changes in U.S. GAAP insurance accounting.

The insurance contract standard is not the only change that will affect reporting by insurance entities. Following comments received during the financial crisis about the existing reporting standards for financial instruments, the IASB and FASB are working vigorously to revise them. As a result, on the IFRS side, IFRS 9: *Financial Instruments* was published in November 2009. This new standard for financial instruments, which so far contains new classification and measurement rules for financial assets, will replace IAS 39, the previous standard. It allows fair-value and amortized cost measurement models for financial assets, where an entity's business model and the contractual terms of its assets determine classification. Subject to adoption procedures in certain jurisdictions, these rules will become mandatory for reporting periods beginning January 1, 2013, with the possibility of early adoption. In addition, the classification and measurement of financial liabilities, the impairment model for assets measured under amortized cost and the principles for hedge accounting are also being reviewed. The outstanding final IFRS and U.S. GAAP standards are expected to be published by the end of 2010.

A number of other IASB projects in progress will lead to further changes that need to be understood and implemented. Among these are the fair-value project, which aims to clarify the definition of fair value and establish a single source of guidance for all fair-value measurements, and the revenue recognition project, which will prescribe the accounting for contracts with customers in general, including pure service contracts.

Within the next few years, insurance companies preparing their financial statements under IFRS and U.S. GAAP will face unprecedented change. This is expected to lead to significant differences in the way that companies measure and communicate their performance, and manage their business and the products they sell. It is imperative that insurers follow these developments closely, quantify the impact of proposed changes and understand the business model implications before implementation.

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Why a New Standard?

For a long time, analysts and other users of insurance companies' financial statements have expressed dissatisfaction with the information they receive. Because of the wide variety of insurance product designs within and across jurisdictions, the various risk and profit-sharing arrangements between policyholders and shareholders, and the variation in local reporting and regulatory practices, it is often not obvious how insurance business works, shareholder value is generated, or performance is assessed and compared. Therefore, for many years, life insurance companies in Europe, Canada, South Africa and parts of Asia have been publishing supplementary information in the form of embedded-value disclosures, in addition to their primary financial accounts, to better communicate their business performance.

Primary insurance company accounts, including current IFRS information, are not perceived as useful for a number of reasons, including:

- Different treatment of contracts classified as "insurance" or "investment" (those with insignificant insurance risk)
- Different prevailing practices for the measurement of insurance contract liabilities across jurisdictions and companies due to the application of local liability measurement practices, different types of liability adequacy tests and different interpretations of unbundling rules
- Mismatches between the valuations of assets and liabilities
- Implicit conservatism often included in the calculation of liabilities
- Inadequate allowance, in some circumstances, for the time value of money or the cost of embedded guarantees

What Is Currently Proposed?

Although a draft of the insurance contract standard is not yet available, some tentative decisions have been made by the IASB, often but not always mirrored in tentative decisions by the FASB.

Measurement approach

As proposed by the IASB, the measurement approach for an insurance contract liability should portray a current assessment of the insurer's obligation, using the following building blocks:

- The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfills the obligation
- The time value of money
- A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows
- An additional amount, referred to as a residual margin

The purpose of the residual margin is to prevent a profit from being recognized at inception (also referred to as a "positive day-one difference"). However, if the initial measurement results in a negative day-one difference, the entity should recognize this amount in profit and loss.

Future cash flows, the time value of money and risk adjustment are to be remeasured at each subsequent reporting date. The residual margin should be released over the coverage period in a systematic way that best reflects the exposure from providing insurance cover and should not be adjusted in subsequent reporting periods for changes in estimates.

The FASB measurement approach uses a similar building-block approach with the exception that the risk adjustment and residual margin are combined into one composite margin. Guidance on how the composite margin should be released into profit and loss will be developed later.

Acquisition costs

Under the FASB model, acquisition costs should be expensed rather than deferred, and the recognition of revenue to offset those costs is prohibited. Also, such costs will not form part of the cash flow within the composite margin calibration. This results in a loss at inception at least equal to acquisition costs.

The IASB has recently decided that a proportion of acquisition costs referred to as "incremental" (the marginal cost incurred when selling an insurance contract) should be taken into account within the residual margin calibration, reducing the loss at inception.

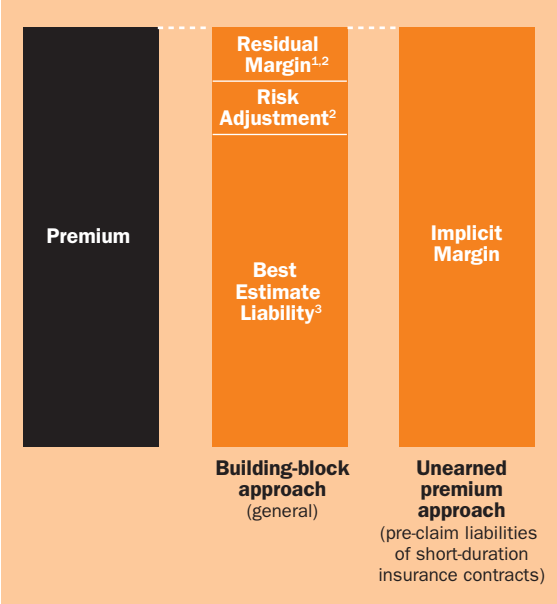
Nonperformance risk

The measurement of an insurance contract liability should not be updated for changes in the risk of nonperformance by the insurer.

Discount rates

The discount rate for an insurance contract liability should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability. It should not be based on the expected returns on actual assets backing those liabilities unless those returns affect the determination of policyholder benefits. The IASB has stated that the standard should not give detailed guidance on how to determine the discount rate, for example, whether the rate should be based on corporate bond, government bond or swap rates, and what adjustment, if any, should be made for credit risk or liquidity premium.

Figure 1. Initial measurement of insurance contract liability



[1] Under the IASB measurement approach, excludes an amount equal to the incremental acquisition costs

[2] Under the FASB measurement model, the residual margin and risk adjustment are combined into one composite margin

[3] Combines the unbiased probability weighted average of future cash flows and the time value of money

Short-duration insurance contracts

For short-duration insurance contracts, such as most property & casualty contracts and certain pure-risk life insurance contracts, an unearned premium approach, already commonly used, is likely to be mandatory for pre-claim liabilities. The building-block approach, contrary to current general practice, will be required for claim provisions.

Participation features

The IASB tentatively decided that payments arising from a participation feature should be included in the measurement of insurance contracts in the same way as any other contractual cash flows, whereas the FASB requires a liability for participating benefits to the extent that the insurer has a legal or constructive obligation to pay those benefits.

Outstanding decisions

A number of important decisions remain outstanding, such as the presentation of the income statement and the treatment of embedded derivatives, unbundling, and unit-linked and index-linked contracts.

Figure 1 illustrates the initial measurement of an insurance contract liability under building-block and unearned premium approaches.

How Useful Will the Proposed Reporting Basis Be?

The usefulness of financial reporting information is often judged according to two main criteria: relevance and reliability. *Figure 2* on page 16 shows the desirable attributes for an insurance business financial reporting framework that is to provide relevant information.

The currently proposed IASB measurement framework for insurance contracts, together with the new rules for classification and measurement of financial assets, will have a number of these attributes. The building blocks for the measurement of insurance contract liabilities reflect best estimate, nonfinancial assumptions and the use of market-consistent financial assumptions. Furthermore, worldwide convergence may be achieved if the FASB adopts similar principles for U.S. GAAP.

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On the other hand, a number of the IASB proposals risk compromising the relevance of the new standard. The potential lack of detailed guidance in a number of areas — such as future cash flows, allowance for the time value of money and risk adjustment — may lead to a continued proliferation of approaches, which would not be helpful. It is hoped that the IASB will propose detailed guidance or that some other credible international body will assume responsibility for doing so.

The combination of an amortized cost asset measurement and a market-based liability discount rate may lead to significant mismatches in the measurement of assets and liabilities, and an inability to compare results across the insurance sector. Insurers may wish to apply the fair-value option described in IFRS 9 to avoid such accounting mismatches.

Figure 2. Desired characteristics of a financial reporting framework

1.	Reflects the economic characteristics and features of insurance contracts, for example, through consideration of all relevant cash flows attributable to a contract
2.	Reflects the underlying insurer's business model, for example, through assessing the allowance for risk consistently across liabilities and their backing assets
3.	Uses market prices to measure insurance cash flows, where available, and market-consistent valuation techniques otherwise
4.	Reflects the costs of all inherent risks
5.	Is broadly consistent with the economic balance sheets underlying risk-based statutory and regulatory reporting frameworks
6.	Clearly defines the functions of liabilities and capital: Liabilities reflect the expected average outcome of future cash flows with no prudence margin, while regulatory capital ensures that future obligations to policyholders and other creditors can be fulfilled with a defined probability
7.	Clearly attributes performance to different areas of the business and provides feedback to users by monitoring key assumptions and risks
8.	Applies consistently across jurisdictions without being influenced by local regulatory requirements

While we acknowledge some of the arguments for not recognizing profits up front, we note that the prevention of positive day-one differences through the inclusion of a residual or composite margin, with subsequent release of the margin, does not reflect economic reality and makes a comparison of insurers' new business strategies more difficult.

The recognition of initial acquisition costs as an expense when incurred, without reflecting some or all of these costs in the measurement under the building-block approach, will lead to accounting losses being reported during the period of sale of new business, even if such business is expected to be profitable. One of the most controversial aspects of the current proposals, this is likely to generate considerable criticism.

Another issue is that since the current dividing line between insurance and investment contracts remains, different accounting treatments will be applied to the two, even though the contracts may have similar economic characteristics. Finally, the treatment of participating features in life insurance contracts might not reflect economic reality.

Depending on the responses received during the exposure period, some of the tentative decisions may need to be reconsidered. To the extent that proposed features of the measurement basis undermine the relevance of insurers' financial statements, the need for additional disclosure — either in notes to the primary financial statements or through supplementary information such as embedded value — will continue. The table shown in *Figure 3* has been designed to complement such additional disclosures. This table combines an embedded-value-style analysis of earnings with a reconciliation between IFRS equity, some form of "economic equity" and solvency capital requirements.

What Will Be the Impact on Insurance Companies?

It is likely that insurance companies will need to implement the new standard on classification and measurement of financial assets, and the proposals for measurement of insurance contract liabilities, at the same time that substantial changes are being made to regulatory solvency rules in many jurisdictions. This will affect insurance companies in a number of ways:

- Companies should reconsider the way they assess and communicate the performance of their business. Companies may wish to prioritize which measures to target — for example, IFRS earnings, increase in IFRS equity or increase in economic equity.
- The expected profit profile of new business may change materially compared with that under existing primary accounts. Insurers may wish to review pricing and product design to minimize the likely effect of being forced to recognize an acquisition cost loss on day one. This may lead to the increased use of "trail" rather than "acquisition" commissions.
- The volatility within the balance sheet and income statement may change to better reflect real asset/liability mismatch risks and remove accounting volatility. Consequently, companies may wish to review their risk appetites, asset/liability management practices and hedging strategies.
- Appropriate systems and processes need to be developed to generate the required information in a timely, secure and fully auditable manner. Where not already in place, implementation projects need to be established. Experience suggests that the implementation task is nontrivial, and needs to be appropriately resourced and initiated as early as possible. In jurisdictions where risk-based capital frameworks are being implemented simultaneously, such as Solvency II in Europe, close coordination between the various implementation projects is critical.

An Economic, Risk-Based Global Standard for Accounting

Financial reporting for insurance companies is at a crossroads. The current IASB and FASB proposals for the measurement of insurance contract liabilities will overhaul existing standards and lead to significant changes. They will, for the first time, provide a global standard for insurance accounting, which will in part reflect economic and risk-based measurement characteristics. However, in their present form, the proposals raise some serious concerns that require further consideration if the resulting financial statements are to be relevant to users.

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Figure 3. Analysis and reconciliation of earnings

	IFRS Equity	Asset Adjustments	Liability Adjustments				Economic Equity	Split of Economic Equity	
		Fair Value of Assets	Investment Contracts	Residual Margin	Participating Features	Others		Solvency Requirements	Free Surplus
Equity (start of period)									
New business sales									
Movement in existing business • Expected returns • Transfer to free surplus • Experience variances • Assumption changes									
Operating earnings									
Economic variances									
Total earnings									
Capital movements									
Equity (end of period)									