Insurance contracts accounting: Are we there yet?

Steve Cooper, a member of the IASB, provides an update for investors on the IASB's insurance contracts project

Improvements to accounting for insurance contracts have taken longer than planned—but we are nearly there.

Many investors find the financial statements of insurance companies difficult to understand. Many are also aware that our promise to deliver improvements to the accounting for insurance contracts has taken longer than we initially thought.

I am sure I don't need to explain the complexity and variety of insurance contracts. But this complexity and variety, combined with the existing diversity in accounting practices under IFRS (which currently permits the continuation of many pre-IFRS insurance-related accounting practices), has created a complex financial reporting challenge for the IASB. Furthermore, like most issues in accounting, views on many insurance-related topics vary, so these challenges have been compounded by significant differences in thinking among our various stakeholders. Such differences are often a direct result of the existing accounting that both investors and preparers are used to. That is particularly true for both the reporting of performance for such contracts and the relevance of changes in the value of insurance assets and liabilities to current period performance.

Despite these differences in thinking, almost all the users of financial statements that I have spoken to have encouraged the IASB to find a common approach that removes the diversity in accounting for insurance contracts, and improves the usefulness of the financial statements of insurance companies. And we are nearly there—apart, that is, from some tricky issues mainly related to profit recognition for 'participating contracts' that promise policyholders a combination of insurance coverage and investment returns.

Consequently, although we have not yet completed our deliberations, I thought this was a good opportunity to provide an update to investors on some of the enormous progress we have made on this project. I would also like to highlight a few of the changes that I believe will particularly benefit you.

Key advance no. 1: a current, updated measure of insurance contract liabilities

Problem: today *s*ome jurisdictions allow for the use of out-of-date or 'locked-in' assumptions in calculating insurance contract liabilities.

Insurance contract liabilities will no longer be reported using out-of-date assumptions.

Proposed solution: insurance contract liabilities will no longer be reported using out-of-date assumptions. Instead, the insurance contract liability will always be adjusted to reflect current estimates of cash flows to be paid to policyholders. This will mean taking current market factors, including an updated current discount rate, into account.

Our decision to measure the basic insurance contract liability using the present value of net cash flows to policyholders (the so-called 'best estimate liability') is widely supported by our stakeholders. A particular benefit of this approach is that the current value of minimum return guarantees and other complex features will be measured as part of the insurance contract liability. At present it is common for such features to be reflected in the insurance liability only when they become onerous, and even then only at an amount that does not reflect their true economic value. As a result, the deterioration that might arise beforehand is often not visible today.

Key advance no. 2: using an asset-based discount rate only where relevant

A discount rate appropriate to the insurance contract liability will significantly improve the relevance of financial statements.

Problem: although this relates to **Key advance no. 1**, it is worth highlighting separately. Currently some insurance accounting practices permit companies to use the 'expected return on assets held' as the discount rate to measure insurance contract liabilities. This may occur even when the insurance contract liability cash flows are unrelated to the cash flows on the assets. Discounting insurance contract liabilities using such rates can hide true economic exposures and can misstate liabilities.

Proposed solution: our proposal is to require the use of a discount rate that is appropriate for the liability. This means that a risky asset return premium should only be included in the discount rate if, and to the extent that, the liability cash flows are themselves linked to those risky assets. An example of this would be in participating contracts in which the insurance liability cash flows depend on the asset returns. These proposals will significantly improve the relevance of information that you receive in the financial statements.

Key advance no. 3: recognising profit as services are delivered

Problem: there is currently little consistency in the way in which profits from an insurance contract are recognised, with many companies recognising profits on a cash basis.

Proposed solution: we believe that profits are earned as the issuer provides insurance coverage and related services. In the proposed IASB approach, expected or 'unearned' profits are represented by the difference between the best estimate liability (the present value of the net payments to the policyholder) and the premium received and receivable, and are referred to as the 'contractual service margin' (CSM). A portion of the CSM would be recognised as a gain in the statement of profit or loss in each

A roll-forward of 'unearned profit' will significantly improve the transparency of reporting for insurance contract liabilities.

period as insurance coverage and related services are delivered, in the same way that revenue is recognised when a performance obligation[1] is satisfied under our new revenue recognition Standard.

However, unlike the revenue recognition requirements for other contracts, the contractual service margin inherent in an insurance contract will be clearly disclosed. The notes to the financial statements will identify a company's total insurance contract liabilities (analysed by type of business), split between the best estimate liability and the remaining CSM, and will identify the changes to the CSM each period.

While the changes in the contractual service margin primarily represent provision of insurance coverage and related services, they may also arise for a number of other reasons. For example, the CSM may increase as a result of new contracts being written (the value of new business), or decrease as the profitability of existing contracts falls because of, say, worsening mortality expectations. Consequently, we will require that companies provide a roll-forward of the contractual service margin, in addition to a roll-forward of the other components of the overall insurance contract liability. I expect this information to significantly improve the transparency of reporting for insurance contract liabilities, and that it will also provide you with additional metrics that could be used to evaluate performance.

Of course, some of this information may already be available to you today, for example through non-GAAP measures such as embedded value disclosures. Nonetheless, the anticipated changes should make this available to all, and in a more comparable manner.

Key advance no. 4: recognising that in many respects insurance is not that different from other industries

Problem: in the many years that I have worked on this project I have often been told that insurance is 'special' and that it is therefore acceptable to have accounting requirements that are unlike those in other industries. I have never entirely accepted this argument. In fact, I feel that the perceived highly specialised nature of insurance company financial statements has been a significant barrier to many non-specialist investors in understanding this industry.

One area that has proved particularly controversial is in *how* revenue (and consequently expenses) related to insurance contracts should be presented in the statement of profit and loss. Again, there is a variety of practice at present, but a common approach is to present all premiums received (or due) in the period as 'revenue'. There are two problems with this. Firstly, it results in cash (or close to cash) accounting for revenue.

[1] A performance obligation is an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer.

Insurance contract revenue must reflect the service provided, as for any other industry.

Recognising the premium for, say, a single-premium life contract as 'revenue' on Day One when there is ten years' worth of service to be provided does not seem to reflect the economics of the transaction. In contrast, in other transactions for the provision of a service, the cash received from customers is recognised as revenue only when it has been earned through the delivery of that service.

Secondly, many insurance premiums contain a deposit component because the product combines investment with insurance protection. Recognising all deposits received as revenue (and the return of these investment amounts as expenses) would also be contrary to the accounting applied in other industries, including other financial services.

Proposed solution: the IASB will require that insurance contract revenue must reflect the services provided. While this may add some complexity for preparers compared to using the premiums written or due, I believe this complexity to be outweighed by the significant benefits in terms of the resulting understandability of insurance sector financial statements.

Some of you might now be worried that we are eliminating an important metric that you use when looking at the insurance sector—namely, premiums received. This is not the case, because there will still be disclosures related to premiums received.

In summary

I have chosen to highlight only four areas in which I feel that the IASB, helped by the support and advice of many of our stakeholders, has developed solutions to existing issues in the accounting for insurance contracts. These are summarised in the table below.

These four key advances will make financial statements of companies that issue insurance contracts less 'special'.

Issue today	Proposed solution
Use of old or outdated assumptions does not provide useful financial information	A current, updated measure of insurance contract liabilities provides more relevant and useful information
Using the 'expected return on assets held' as the discount rate to measure unrelated insurance contract liabilities does not reflect the risks relating to insurance contracts	Using an asset-based discount rate only where applicable improves the relevance of the information received
There is diversity in practice and a lack of transparency about profit recognition patterns from insurance contracts	The unearned profit arising from a contract will be recognised as the insurance coverage and related services are delivered, significantly improving transparency, and providing additional metrics to evaluate performance
Reporting revenues on a cash or near-cash basis is inconsistent with all other industries	Revenue will reflect the services provided, and exclude deposits, like any other industry, increasing comparability and understanding

I am pleased that many aspects of our proposals will make financial statements of companies that issue insurance contracts both more understandable and less 'special'. Clearly there are still features that are specific to insurance that need to be captured. And I appreciate that the nature of insurance contracts is sufficiently different to justify a separate accounting Standard. However, basic issues related to liability measurement, reporting the delivery of services, and the recognition and measurement of financial assets are still very similar to those in other industries and transactions. Those similarities will be made more apparent by the four key advances highlighted in this article, and will significantly benefit users of financial statements.

There remain some diverse views about the merits of a few of the IASB proposals among industry commentators, such as the measurement of insurance contract revenue and the aggregation basis for dealing with the CSM, some of which are still the subject of discussion. Nevertheless, I believe there is generally significant support for this project and a real desire to complete this much-needed insurance contracts Standard.

So what is there left to do?

One major issue remains to be resolved, which is the pattern of profit recognition for participating contracts. Participating contracts are complicated by the fact that they provide both insurance protection and a return on underlying financial assets. Consequently, views differ on how the profits of these two components should be recognised. A related question is how much of that profit should be recognised in 'other comprehensive income' (OCI), and under what circumstances.

The proposals we put forward in 2013 related to participating contracts were not well supported by some insurance industry groups. Many criticised the exception that we proposed for the measurement of participating contracts as being unnecessary and excessively complex to apply. The IASB is currently considering further analysis of participating contracts, working closely with interested parties. We will make decisions about these in the coming months. I am confident that we can provide a solution to this particular problem that has both the support of the insurance industry and provides the relevant and transparent information required by investors.

Get involved

We welcome investors' views on information needs related to participating contracts. Please contact Barbara Davidson (bdavidson@ifrs.org) to set up a call or meeting. Alternatively, you can email me directly to simply provide your views on the proposed accounting for insurance contracts. I look forward to hearing from you.

Respond to the author

Steve Cooper is a member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB or the IFRS Foundation. The IASB/IFRS Foundation encourages its members and staff to express their individual views. This article has been developed by the author as an individual. It is has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

If you would like to discuss this topic or other areas of accounting, please contact Steve Cooper at scooper@ifrs.org or Barbara Davidson, IASB Investor Liaison, at bdavidson@ifrs.org