The long and winding road: the IASB's project on insurance contracts

Patrick Finnegan, a member of the IASB, provides his perspectives on the IASB's proposals for the accounting for insurance contracts.

The objective of the IASB's proposals is financial reporting that better portrays the economics of insurance contracts and that provides insight into the drivers of earnings and cash flows.

Existing accounting for insurance contracts is a patchwork quilt that leaves investors struggling to understand the economics of the business.

On 20 June 2013, the IASB published a revised set of proposals dealing with the accounting for insurance contracts (the 'revised Exposure Draft'). It will be important to all entities and investors to make sure that they understand the scope of the new proposals, because they may apply to entities that do not consider themselves insurance companies. In addition, investors will want to pay close attention to the way in which the proposed changes will affect reported patterns of profit or loss and the presentation of insurance contract revenue and expenses.

The revised Exposure Draft refines the IASB's previous proposals that were published in July 2010, and establishes a comprehensive framework for preparing and presenting information about insurance contracts in the financial statements of entities (not just for insurance companies). The objective of creating such a framework is primarily to create financial reporting that better portrays the economics of insurance contracts and to provide investors with better insights into the drivers of earnings and cash flows for entities that issue insurance contracts. This insight will, in turn, hopefully lead to better investment decisions.

The revised Exposure Draft responds to many recommendations to modify our proposals. This article focuses on three principal areas that represent the potential for the most change and complexity for both preparers and investors. These include:

1. how to report discount rate changes.
2. how to present insurance contract revenue and expenses.
3. how to report changes in estimates of contract cash flows.

Why is the IASB developing a comprehensive model for accounting for insurance contracts?

Many global developments have occurred in the design and complexity of insurance contracts over the past several decades. Those developments were a response to changing demographics, declining interest rates, increasing competition and expanding regulation. Yet, accounting for insurance contracts has not kept pace with such changes in many markets. Also to the extent that accounting practices have changed, it has become more difficult for users to understand the financial statements of entities that issue insurance contracts because such changes have not been uniform across markets, producing an overall view of insurance contracts that is somewhat of a patchwork quilt. As a result, investors struggle to understand clearly the business as portrayed by current reporting.

The existing Standard was not intended to be a long-term solution.

The IASB's current Standard that deals with insurance, IFRS 4 *Insurance Contracts*, was issued in 2004 and was designed principally as an interim Standard to improve disclosures about the accounting for insurance contracts. It provided limited guidance about measurement and presentation of insurance contracts; most significantly, as an interim Standard, it did not create a comprehensive framework that reduced the variety of measurement and presentation models in use.

The IASB has been working to develop a comprehensive framework for insurance contracts that would replace IFRS 4. The development of a current value accounting standard for insurance contracts has proved to be complex and, thus, has slowed the completion of the project. However, we believe the revised proposals offer sound and reasonable alternatives to the concerns of many stakeholders and will deliver much needed improvements in this area of financial reporting.

A current value approach to measuring insurance contracts

The July 2010 Exposure Draft proposed a current value approach to measure insurance contract liabilities. That approach required all changes in the measurement of insurance contracts to be reported in profit or loss. However, because current accounting guidance requires financial assets to be reported at either amortised cost or fair value, many insurers complained that a current value approach for insurance contracts would create a measurement mismatch leading to ''accounting volatility'' in reported profit or loss and shareholders' equity.

The revised Exposure Draft balances two key issues: understandability and complexity.

The revised Exposure Draft retains a current value approach to measure insurance contract liabilities, but proposes alternative ways to deal with its effects. These alternatives have the potential to create greater complexity in the accounting for insurance contracts and, ultimately, the reporting. We welcome your views about whether the IASB has reached the right balance between making it easier for investors to understand how insurance contracts affect an entity's financial position, financial performance and cash flows and the complexity of the resulting accounting.

Key proposals

1. Reporting discount rate changes

One of the main criticisms of current accounting in many jurisdictions is that the interest rate used to discount an insurance contract is set at contract inception and is not updated unless there is evidence of loss.

The first major proposal that investors and entities that issue insurance contracts need to understand is the presentation of the effects of using a current interest rate to discount the cash flows of an insurance contract.

One of the main criticisms of current accounting in many jurisdictions is that the interest rate used to discount an insurance contract is set at contract inception and is not updated unless there is evidence of loss. We propose that an insurance contract would be discounted using a current rate at the end of every reporting period. However, the effects of using a current value measure for the balance sheet would be separated into two elements for presentation in the statement of comprehensive income.

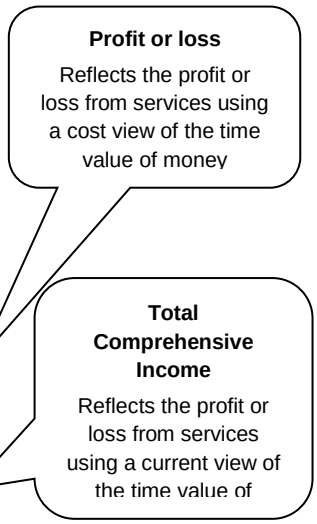
- The first element, which would be presented in profit or loss, represents the rate applied to discount the insurance contract liability at the date that a contract is initially recognised (the original rate).

- The second element would be presented in other comprehensive income (OCI). It represents the difference between the effects of discounting the insurance contract using a current rate in the balance sheet and the effects of discounting the insurance contract using the original rate in profit or loss.

Table 1 below illustrates the ‘‘OCI approach’’ for presenting interest expense.

TABLE 1: STATEMENT OF COMPREHENSIVE INCOME

	20XX
Operating (underwriting) result	**X**
Investment income	X
Interest expense (on insurance liability)	(X)
Investment result	**X**
Profit or loss	**X**
Effect of discount rate changes on insurance liability	(X)
Total comprehensive income	**XX**



Proposals for reporting discount rate changes give investors a baseline measure to understand profit or loss.

The benefit of this approach is that investors can observe a cost-based view of insurance contracts in profit or loss that would be stable and provide a baseline for understanding part of an insurer’s performance from period to period. At the same time, investors would be able to observe how the effects of changes in interest rates are affecting the value of insurance contracts reported in the balance sheet.

Some may argue that separating the effects of interest rate changes between profit or loss and OCI creates additional accounting complexity. However, if all such effects were reported in profit or loss, we anticipate that investors would inevitably ask for the effects of movements in interest rates to be disaggregated from other elements of profit or loss. Thus, that alternative would involve a similar level of complexity.

2. Presenting insurance contract revenue and expense

Proposals retain traditional volume measures while presenting economics in a more insightful manner.

The second major proposal deals with the presentation of revenue and expenses in the statement of comprehensive income. The question for investors is whether it is useful for an insurer to present information about revenues and expenses (gross performance metrics) and, if so, whether the presentation of revenue from insurance contracts should be consistent with the way revenue is presented for other kinds of businesses.

Investors may recall that the 2010 Exposure Draft proposed a summarised margin approach in the statement of comprehensive income. This meant that premiums were not shown separately on the face of that statement and, hence, there was no top-line or insurance contract revenue reported. Our modifications to the presentation of the

Revenue reflects the underlying economics of service delivery.

statement of comprehensive income respond to feedback from the investor community.

The revised proposals would require that an insurer present insurance contract revenue in the statement of comprehensive income. This reporting is likely to differ materially from what investors are accustomed to seeing today for entities that issue life insurance or other long-term insurance contracts.

The concept underpinning our proposal is that, at any balance-sheet date, when an insurer determines its liability for remaining coverage, it represents the value of the obligation to provide coverage and services. Therefore, we believe that the reduction in that liability is a reasonable representation of the value of coverage and services provided in a period, and hence revenue should be recognised on that basis. Most significantly, the revenue measure would reflect the value of services provided in each period, not the amount of cash collected or the amount of cash due from a customer.

A principal advantage of this approach is that it aligns the reporting of revenue by insurers with the principal concepts that the IASB and the FASB (the national accounting standard setting body in the US) have adopted for recognising revenue in other kinds of contracts with customers.

Another advantage of the proposed presentation is that insurance contract revenue would be shown consistently across all kinds of insurance contracts, life and non-life alike.

Table 2 below shows how a statement of comprehensive income would report the operating result with information about insurance revenue and incurred claims. In contrast, Table 3 illustrates how an insurer might report revenues, claims and expenses related to insurance contracts under current IFRS.

TABLE 2: PROPOSED PRESENTATION

	20XX
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Operating (underwriting) result	**X**

TABLE 3: CURRENT PRESENTATION

	20XX
Premiums and fee income	X
Investment return	X
Total revenue	**X**
Insurance and investment contract benefits	(X)
Net insurance and investment contract benefits	**XX**

Proposals will give a clearer attribution of value drivers, reflecting the latest estimates of profit from services.

We believe that the information that is required to disclose revenue in this manner will be derived from the systems required to develop a current value measure of insurance contracts and, as a result, reporting insurance contract revenue as proposed will require limited additional costs.

Many investors would continue to find current measures of gross performance, such as written premiums or premiums due, to be useful indicators of growth and use of capital. As a result, we propose to require the disclosure of these measures in the notes.

3. Changes in estimates of contract cash flows: adjusting the contractual service margin

The third major proposal that will be of interest to investors deals with the accounting for the margins embedded in the measurement of the insurance contract liability. To understand this accounting, an illustration is presented below to show how we propose the insurance contract liability to be estimated.

The current value measurement approach identifies two components to the measurement of an insurance contract. The first component, known as the 'fulfilment cash flows', is determined by estimating the future cash inflows (premiums) and the future cash outflows (benefits, claims, expenses) that the insurer expects the contract to generate as it is fulfilled, adjusted for risk (also known as a ''risk margin'') and the time value of money.

The second component, known as the 'contractual service margin', is recognised to eliminate any day 1 gain and is essentially the unearned profit in a contract. If the initial estimate (or subsequent estimates) of the expected present value of cash outflows exceeds the estimate of the expected present value of cash inflows, an immediate loss would be recognised.

A simple illustration may help to show how the above principles are used to estimate an insurance contract liability at contract inception and subsequently.

Assume an insurer estimates the amounts shown in Table 4 ('EPV' refers to the expected present value or discounted values):

TABLE 4: CALCULATING THE CONTRACTUAL SERVICE MARGIN

	CU
EPV of future cash flows (premiums)	(900)
EPV of future cash outflows (claims, expenses and acquisition costs)	690
Risk margin	30
Fulfilment cash flows	(180)
Contractual service margin	180
Insurance contract liability at initial recognition	**0**

In this example, the fulfilment cash flows are less than zero; therefore, a contractual service margin is added to the liability to eliminate any day 1 gain.

Let's further assume the following:

- the coverage period of the contract is three years.
- Immediately after initial recognition, the first instalment of premiums is received (CU300) and acquisition costs are paid (CU90);
- the future cash outflows are expected to be CU200 each year (CU600 in total).

There were no differences between actual and expected cash flows over the three years.

Immediately following receipt of the first instalment the insurance contract liability would be re-measured as shown in Table 5:

TABLE 5: REMEASUREMENT OF THE INSURANCE CONTRACT LIABILITY

	CU
EPV of future cash flows (premiums)	(600)
EPV of future cash outflows (claims, expenses)	600
Risk margin	30
Fulfilment cash flows	30
Contractual service margin	180
Insurance contract liability immediately after initial recognition	**210**

In accordance with the revised proposals, the earnings of an insurer would have two drivers: the risk margin and the contractual service margin. The recognition patterns of these two items would differ. Changes in the amount of the risk margin would be recognised directly in profit or loss as estimates of risk decline. Changes in the contractual service margin would be recognised in a systematic way that reflects the other services in the contract over the remaining life of the contract. Both these changes are recognised as an adjustment to the insurance contract liability.

In this example, assuming the actual cash flows emerge as expected, the pattern of recognition for the contractual service margin that best reflects the transfer of services (payment of claims) would be CU60 each year.

A key change in the revised Exposure Draft is to require the contractual service margin to be updated at the end of each reporting period.

A key change that the IASB adopted in the revised Exposure Draft is to require the contractual service margin to be updated at the end of each reporting period. Previously, the board decided to 'lock-in' the contractual service margin from contract inception. Consequently, in the example above, the contractual service margin would not have changed when estimates of future cash flows increase or decrease. The revised proposals state that if there are changes in estimates of the future cash flows to be incurred for future service (coverage), then

those changes should be accounted for as an update of the contractual service margin (in the balance sheet), not as a charge or credit to profit or loss in the current period. The charge would be recognised in profit or loss only if the contractual service margin is insufficient to absorb it.

Referring to the example again, let's assume that the actual cash flows are equal to the expected cash flows for year 1 (i.e. CU200), but at the end of year 1, the remaining expected cash outflows for years 2 and 3 change from CU400 to CU450. The increase in the liability for future cash outflows of CU50 would be offset in the contractual service margin. The remaining contractual service margin at the end of year 1 of CU70 (CU120—CU50) would then be recognised over the remaining two years in a systematic way.

The IASB amended this proposal principally because it is consistent with the notion that the initial estimate of the contractual service margin is deferred (included in the measurement of the liability) and not recognised through profit or loss. This revision is also expected to reduce the effect of earnings volatility as a result of changes in estimates of cash flows.

To help investors understand the pattern of these drivers, the IASB is proposing that an insurer provide reconciliations from the opening to closing balances of the risk margin and the contractual service margin. Also, accompanying that disclosure would be an explanation of the methods and inputs used to estimate the risk margin and the pattern of recognition of the contractual service margin and, if applicable, any changes in those methods or inputs over time.

Concluding remarks

Compared to our 2010 Exposure Draft, our revised proposals deal with the effects of current value measurement by providing greater disaggregation of the changes in insurance contracts and how those changes affect income and expense. A consequence of these proposals is the introduction of greater complexity in the preparation and presentation of financial statements, and, ultimately, the reporting to investors. We are interested in whether you believe we have reached the right balance between complexity and usefulness, and any alternatives you would propose to deal with either or both.

Respond to the author

Patrick Finnegan 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.

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