Staff Paper

Topic **Presentation of volatile information**

Purpose of this paper

1. This paper considers how to present information about changes in insurance contract liabilities in a way that is most useful to users of financial statements. In particular, we consider whether insurers should report separately:

   (a) changes that provide useful information about the likely amount and timing of future cash flows.

   (b) changes that provide useful information mainly about the uncertainty and risk of future cash flows, rather than about the amount and timing of those cash flows.

   Some fluctuations arising from market-based inputs might fall into this second category.

2. This paper does not consider the summarised margin approach for insurance contracts, or whether the Board should permit or require volume information to be presented in the statement of comprehensive income. This paper does not consider any issues relating to measurement of insurance contract liabilities.

Background

Response from comment letters and outreach

3. Many are concerned that the measurement model for insurance contracts proposed in the Exposure Draft *Insurance Contracts* (the ED) would report

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

volatility that they view as not being a faithful representation of the economics of insurers' business when considered in conjunction with related assets.

4. Many were concerned that the discount rate proposed in the ED would cause volatility in the financial statements:

   (a) Some insurers state that this volatility results from a failure to reflect the asset-liability management inherent to the insurance business model.

   (b) Some users question whether volatility might mask important information, such as key performance indicators might be overshadowed by short-term market volatility.

   (c) Most believe that this volatility would result in financial statements that will be difficult to explain, lack comparability and be neither relevant nor a faithful representation of the economics of insurance.

5. One consequence of a current measurement of insurance contract liabilities and the assets backing them is volatility. Some believe this volatility is necessary and inevitable and comment that it is unrealistic to expect investors to ignore market movements even if assets and liabilities were to be measured at cost. However, some suggest that, to present the effects of volatility in a way useful to users of financial statements, the IASB should permit or require insurers:

   (a) to include an 'operating profit' figure within profit or loss to counteract the focus on a volatile net income figure

   (b) to present some components of economic volatility in other comprehensive income (OCI).

6. Those that suggest an 'operating profit' notion are concerned that what they regard as a subjective and assumption-laden model would impair comparability of financial statements. Accordingly, they propose that an 'operating profit' measure of performance should comprise close-to-cash items.

Non-GAAP measures and management commentary

7. Many preparers provide non-GAAP measures and other information in an attempt to explain their underlying performance to investors. Such information is often displayed outside financial statements, for example in a management commentary or similar document. As noted in paragraph 13 of IAS 1 *Presentation of Financial Statements*:

   > "Many entities present, outside the financial statements, a financial review by management that describes and explains the main features of the entity's financial performance and financial position, and the principal uncertainties it faces. Such a report may include a review of:
   >
   > (a) the main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and the entity's policy for investment to maintain and enhance financial performance, including its dividend policy.
   >
   > ...."

8. Although some have stated that a measure of success for the IASB's insurance contracts project is the elimination of the use of non-GAAP measures, we do not believe this to be feasible. Insurers will always want to interpret their results in the way that they believe best portrays their business. Regulators will always demand more detailed information than is needed for general purpose financial statements and users will inevitably find some of that detailed information useful.

9. A key non-GAAP measure for many is the notion of 'operating profit', which is often described in ways intended to convey that it represents the profit earned from an entity's normal, core business activities.

Operating profit

10. We examined financial statements and press announcements of some insurers to assess the items that they excluded from operating profit. We noted that the rationale or principles applied in deriving operating profit were not always clearly disclosed. However, insurers generally adjusted income from investments to exclude some investment returns and financial assumption changes. A few also adjusted expense from insurance contract liabilities. We did not consider any non-insurance related adjustments, because addressing the classification of such items is beyond the scope of this project.

11. The adjustments made are consistent with our view, based on the reading of the comment letters and other outreach, that insurers wish to exclude from their operating results the volatility that arises through short-term changes in financial market variables. Those variables relate predominantly to changes in the discount rate and changes in the fair value of financial assets held to back the insurance contracts.

12. We note that income and expense arising from non-financial assumptions, such as assumptions about mortality and morbidity, are generally included within operating profit. We think that this reflects that such changes are regarded as part of an insurer's operations, and affected by management decisions and to an extent manageable, for instance through pricing.

13. We draw from this analysis two points:

    (a) Insurers have a desire to adjust profit or loss to report some kind of "normalised" result[1].

    (b) Those normalised results typically exclude the effects of changes in financial market variables.

14. We note that a definition of 'operating profit' is well beyond the scope of this project. Operating profit generally considers all of an entity's operations, and

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[1] We also believe that insurers generally attempted to report separately some changes in the fair value of assets to eliminate the accounting mismatches that arise when insurance contracts are measured on a cost basis and the assets backing them are measured on a current basis. This would no longer be relevant under the proposals in the ED.

entities often define it in a way that excludes the effects of restructurings, amortisation of intangible assets acquired in business combinations etc. (We also note that operating profit generally excludes investing activities, but observe that investing is a core business activity of many insurers.)

15. Furthermore, as noted in paragraph BC55 of the Basis for Conclusions to IAS 1, "'operating activities' are not defined in IAS 1, and the Board decided not to require disclosure of an undefined item."

16. However, the primary purpose of an operating profit measure appears to be to provide information with predictive value, and believe that this notion can be applied to the reporting of changes to insurance contract liabilities.

Information about predictive value

17. QC8 of the IASB and FASB's Conceptual Framework for Financial Reporting (the *Framework*) states that:

> Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

18. Furthermore, when describing the objective, usefulness and limitations of general purpose financial reporting, the *Framework* states in paragraph OB3 that:

> Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity

19. Some note that information about volatile components of changes in insurance contract liabilities provides an indication of the **uncertainty** of future cash

flows, but conveys little information about their **likely amount and timing**. Accordingly some believe that separation of those volatile components from other changes would improve the predictive value of information about changes in insurance contract liabilities. This view is consistent with the IASB's forthcoming amendments to IAS 19 *Employee Benefits*. In those amendments, the IASB concluded that it is useful to present separately components of changes in a liability that have different predictive implications.

20. We believe that the components of changes in insurance contract liabilities that insurers would regard as having different predictive implications compared to 'core' earnings would depend on how the assets backing the insurance contract are measured. Thus, an insurer might want to exclude the following components of change in the liability from normalised earnings:

    (a) the effect of discount rate changes, if the assets are carried at amortised cost. Some might also argue that the effect of guarantees of, for example, minimum interest rates or minimum equity returns, should be excluded.

    (b) part of the effect of discount rate changes, being the difference between measurement of the liability using an asset-based rate and a rate that reflects only the characteristics of the liability, if the assets are carried at fair value through profit or loss.

    (c) the effect of discount rate changes on the part of an insurance liability that is not matched by backing assets that are carried at fair value through profit or loss.

Presentation

21. If an insurer were to present normalized results in the statement of comprehensive income, the following questions arise:

    (a) Should the difference between actual results and normalized results be presented in other comprehensive income (OCI)?

(b) Would IAS 1 permit the presentation of normalized results within profit or loss?

OCI

22. Some suggest that some or all of the items listed in paragraph 20 should be presented in OCI.

23. Some have suggested using two different discount rates, and reporting in OCI the difference between the results of the two rates. . Because of the tentative decision that the discount rate should reflect the characteristics of the liability, the question remains which second rate could be used as an alternative rate to determine the split.

    (a) Some have suggested, in effect, locking in the discount rate at inception and reporting the unwind of the locked-in rate in profit or loss (some would pair this with a liability adequacy test).

    (b) Others have suggested a pricing or long-term expected earnings rate.

24. In the staff's view, any discount rates should reflect a consistent measurement of all building blocks. The liability in the statement of financial position should be reported based on the current market consistent discount rate that reflects the characteristics of the liability.

25. Furthermore, some suggest OCI might be helpful to eliminate a potential mismatch for participating contracts. IFRS 9 permits an entity to designate some or all equity investments as at fair value through OCI. An entity would present dividends on such investments in profit or loss, and present realised and unrealised gains and losses in OCI, with no recycling. However, under the proposals in the ED, an insurer could not use OCI to report policyholder participation in realised and unrealised gains and losses on those equity investments. Thus, presenting the policyholder's participation in the realised

and unrealized gains and losses from these investments would mitigate such a mismatch.

26. We note that any presentation approach would be developed on the assumption that the financial assets backing the insurance contracts would be measured in accordance with IFRS 9 *Financial Instruments*. The IASB has no current plans to change the classification and measurement requirements in IFRS 9.

Application of IAS 1

27. Paragraph 85 of IAS 1 requires an entity to present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial statements.

28. However, some believe that IAS 1 would not permit an insurer to provide a subtotal that divides the effects of changes in financial market variables from other changes in insurance contracts liabilities and that creates a similar division for assets backing those liabilities. Those with this view interpret the requirement in paragraph 82 of IAS 1 that "the statement of comprehensive income shall include **line items** that present … finance costs" to mean that all finance costs must be presented in a single line item in the profit or loss. Accordingly, in their view, it would not be possible to present changes in financial market variables, such as discount rate, separately from other finance costs.

29. One possibility would be for the IASB to amend IAS 1 to permit insurers to present a subtotal in the statement of comprehensive income that identifies changes in financial variables (such as interest rates or equity prices) separately from other gains and losses. We believe that changing IAS 1 in this way would be consistent with the principle in paragraph 85 of IAS 1 that an entity should present additional line items when such presentation is relevant to an understanding of the entity's financial statements.

30. The following example illustrates how an entity might separate information about changes in financial market information from other changes within profit or loss.

	'000m
Risk margin	26
Residual margin	3
Underwriting margin	29
Changes in non-market estimates	0
Investment income	37
Interest on insurance liability	(23)
Net interest and investment	14
Profit before tax and changes in financial market estimates	**43**
Changes in financial market estimates	(5)
Profit before tax	**38**

Discussion question
1. Would be useful to users of financial statements for insurers to present separately changes in financial market variables? Why or why not? 2. Should such changes in financial market variables apply to: (a) insurance contract liabilities? (b) assets backing insurance contracts? (c) all financial assets? (d) some or all financial liabilities? 3. Should such changes in financial market variables be presented under a subtotal within profit or loss, or should OCI be used? Why? 4. Should a change to IAS 1 apply to entities that issue insurance contracts or to all entities? Why?

Appendix A: Relevant extracts of IAS 1

85 An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance.

86 Because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity includes additional line items in the statement of comprehensive income and in the separate income statement (if presented), and it amends the descriptions used and the ordering of items when this is necessary to explain the elements of financial performance. An entity considers factors including materiality and the nature and function of the items of income and expense. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. An entity does not offset income and expense items unless the criteria in paragraph 32 are met.

87 An entity shall not present any items of income or expense as extraordinary items, in the statement of comprehensive income or the separate income statement (if presented), or in the notes.

Profit or loss for the period

88 An entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.

89 Some IFRSs specify circumstances when an entity recognises particular items outside profit or loss in the current period. IAS 8 specifies two such circumstances: the correction of errors and the effect of changes in accounting policies. Other IFRSs require or permit components of other comprehensive income that meet the *Framework*'s definition of income or expense to be excluded from profit or loss (see paragraph 7).