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Investor Perspectives

Patrick Finnegan: Making sense of Insurance contracts

On 30 July 2010, the IASB published an exposure draft, Insurance Contracts that would improve significantly the accounting for insurance contracts. The principal objective of the proposals is to provide users of financial statements with more transparent information about the performance and financial position of entities writing insurance contracts. The improvements come in several areas, including: (a) a comprehensive framework for measuring insurance contracts, (b) presentation principles that reveal sources of earnings from insurance contracts and (c) disclosure requirements to help users bridge the 'gap' between, on the one hand, amounts reported in the balance sheet and statement of comprehensive income, and, on the other hand, cash flows arising from insurance contracts. You might say that an accounting standard that can do all of the above is too good to be true. I will plead my case and let you be the judge.

Advantages of the proposed model

Today, many users describe the accounting for insurance contracts (particularly life insurance contracts) as a 'black box' because they feel that its principles are not easy to understand and that it is difficult to use. There are many reasons for this, ranging from the complexity of such contracts to the wide variety of accounting practices for them. The current standard, IFRS 4 *Insurance Contracts*, was adopted as an interim standard. It permits insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years. The new proposals would apply to all types of insurance contracts, although there is a modified measurement approach (see below) for certain short-duration contracts (ie contracts for which the coverage period is approximately one year or less and which do not contain any embedded derivatives). The proposals would

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eliminate the inconsistencies and weaknesses in existing practices by laying a foundation for a comprehensive measurement approach, which would provide comparability across entities, jurisdictions and capital markets. The measurement model would facilitate the presentation of information about the main drivers of insurance contract profitability for all periods reported. This is one of the most significant improvements in the proposed standard. Let's take a deeper look.

The margin-based approach

We have developed a presentation model for the income statement and the balance sheet arising from insurance contracts. This model is derived from the proposed measurement of insurance contracts and changes in such contracts. The proposed measurement model uses the notion of building blocks to make the measurement process transparent. Those blocks comprise: (a) **estimates of cash flows** (required to be explicit, unbiased, market-consistent, probability weighted estimates), (b) **current market discount rates** (to capture the time value of money) and (c) **a risk adjustment** (representing an explicit and unbiased estimate of the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract). In addition, the measurement model recognises at the origination of a contract the positive difference between: (i) the expected value produced from the three building blocks and (ii) the initial premium collected from a customer as a residual margin.

As discussed above, the presentation model rests on the foundation of the three building blocks by showing a measure of insurance liabilities at each balance sheet date and the key changes (drivers) in those liabilities across periods. By doing so, the effects on cash and profit and loss caused by changes in the building blocks are made clear. Such a presentation method provides users with information about important performance factors. For example, the income statement will illustrate information about:

- changes in the risk adjustment
- release of the residual margin
- differences between the actual cash flows for the current period and previous estimates of those cash flows
- changes in estimates during the period, and
- changes in discount rates.

Two illustrations appear below that highlight the presentation and disclosure proposals. The first presents a hypothetical income statement showing the sources of earnings and the second presents a hypothetical reconciliation of the changes in insurance liabilities showing the effects of changes caused by cash and accrual transactions.

Income statement	Year 20X2	Year 20X1
Risk adjustment	3	2
Residual margin	1	1
Underwriting margin	4	3
Experience adjustment	(0.5)	1
Changes in estimates	(0.5)	0
Underwriting result	3	4
Investment income	5	3
Interest on insurance liability	(2)	(1.5)
Net interest and investment	3	1.5
Profit	**6**	**5.5**

Liability at start of year	Changes in the liability					Liability at end of year
	Cash	Items in profit or loss				
	expected cash flows	change in risk adjustment	release of residual margin	interest on liability	unexpected cash flows	
20	- 5	- 3	- 1	+ 2	+ 1	14
Effect on profit or loss		+3	+1	-2	-1	= +1

As shown in the two illustrations, the margin approach provides a transparent picture of performance by separately reporting:

- underwriting income as the entity is released from risk (decrease in risk adjustment) and as it provides insurance coverage (release of the residual margin).
- changes in circumstances as they occur, and differences between estimates and actual outcomes.
- interest expense on insurance liabilities, presented or disclosed in a way that highlights the relationship between the changes in discount rates and the changes in the investment return on the assets that back those liabilities.

The margin approach differs markedly from what investors are accustomed to seeing in the income statement of insurers. However, today's reporting fails to provide an investor with clear and direct signals about whether an insurer is underwriting profitably, managing expenses efficiently and realising returns on its investments. In contrast, the margin approach has the following advantages:

- It provides a clear link with the measurement approach for insurance liabilities. Failure to illustrate such linkages is a significant defect of many existing models, particularly for long-duration contracts.
- It makes it unnecessary to unbundle deposit receipts from premiums, because it treats premiums in the same way as deposits. Many long-term life insurance contracts contain deposit components. Drawing a line between the deposits and premiums is arbitrary for some contracts.

However, the margin approach does not provide information in the statement of comprehensive income about premiums and claims. It depicts as income only part of the total consideration receivable from the policyholder, namely the risk adjustment at initial recognition, and the residual margin. In the Board's view, information about premiums, claims and expenses is relevant to users of financial statements. Consequently, the Board proposes to require disclosure of such information in the notes. As a result, the data to perform traditional loss and expense ratios, as well as combined ratios, would still be available.

Modified measurement approach for short-duration contracts

The Board has also developed a modified measurement model for short-duration contracts, which is also known as the unearned premium model. This model is required for all short-duration contracts, provided the contracts do not contain significant embedded derivatives. The rationale for requiring such a model (when specified conditions are met) is to ensure comparability between insurers and to avoid requiring entities to bear the costs of implementing a margin model when the modified model provides a reasonable approximation of the full measurement model.

Conclusion

In summary, we believe that a presentation approach that can be applied to all kinds of insurance contracts, and that highlights the main drivers of profitability, would help investors to gain a better understanding of an insurer's performance.

Please tell us what you think.

Patrick Finnegan is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.