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**INTERNATIONAL FINANCIAL REPORTING  
STANDARD 4 CHANGING PROJECT**

Master's thesis

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## **ABSTRACT**

Everyone is exposed to risks. In order to diminish the potentially negative effects when risk materializes, people and companies seek to obtain insurance coverage from insurance companies. Currently, there is no universal financial reporting standard for insurance companies; therefore, the reports they provide are neither transparent nor comparable. The International Accounting Standards Board (IASB) is developing an international standard. The IASB issued the Exposure Draft 2013 to outline proposed changes to the preliminary standard. The purpose of the master's thesis is to find out life insurance companies' point of view related to the proposed changes and to provide improvement recommendations. Therefore, the author evaluates the feedback provided by 25 life insurance companies by applying Likert's scale approach. The author addresses the following items: presenting contractual service margin, revenue and interest expense; measuring cash flows depending on the link to returns of underlying items, transitioning the standard; transparency and clarity of the standard and costs related to implanting the standard. As a result of the analysis the author recommends to the IASB to revise the proposal by making the following changes before issuing the final standard: do not apply contractual service margin for life insurance contracts; do not decompose cash flows nor investment components from contracts and interest expenses should be measured at current value.

**Keywords:** IFRS 4, life insurance companies, financial reports, transparency, comparability, revenue, cash flows

## **INTRODUCTION**

Everyone is exposed to risks. Risks impact individuals as well as businesses. Unexpected events can damage a person's financial disposition or worse, their health or their family's health. Similarly, businesses can be negatively impacted by various events that can cause short and long term damage. Some major events can even result in bankruptcy for both individuals and businesses.

In order to reduce the impact of the inherent risks in life and business, people and businesses seek to obtain insurance coverage. Individuals usually focus on property insurance, health insurance, and life insurance. Companies also insure property as well as company operations and employees.

Insurance companies issue insurance contracts to help individuals and businesses manage risk. Insurers collect revenue from individuals and businesses in the form of premium, and payback event based insurance claims according to the contract. Like all companies, insurance provides are required to report the profits or losses associated with their business contracts. However, there are currently different rules and practices for financial reporting across countries. As a result, the financial statements used by investors are not comparable. The IASB recognized the need to improve transparency and comparability. In response to this need, the IASB developed an interim International Financial Reporting Standard (IFRS) 4 in 2004, specifically for insurance companies. This standard was a first step to standardize reporting, but more work was needed. In 2010, the IASB issued the preliminary version of the final standard (Exposure Draft 2010). The board sought for the feedback, from preparers and users of financial reports, for the proposed draft. Based on the feedback received, in summer 2013 the IASB issued a revised Exposure Draft

2013, with the proposed changes. The biggest impact of these changes will be on life insurance companies.

As the IASB has not extensively tested the proposed changes in the Exposure Draft 2013 the rationale and practicality of the changes are in question. The aim of the master's thesis is to find out the point of view of life insurance companies related to the proposed changes in the Exposure Draft 2013 and to suggest improvement possibilities. Therefore, the author set two hypotheses:

*Hypothesis 1:* Life insurance companies believe that the changes proposed in the Exposure Draft 2013 are irrational and not practical for implementation.

*Hypothesis 2:* The expected costs associated with implementing the proposed standard outweigh the expected benefits.

In the first part of the master's thesis the author provides an overview of the changes introduced in the Exposure Draft 2013. The chapter consists of five main questions related to the proposed changes:

- 1) contractual service margin – adjusting the future expected profit;
- 2) underlying items – decomposing cash flows based on the link between returns and underlying items;
- 3) insurance contract revenue – decomposing investment component;
- 4) interest expense – discounting liability;
- 5) transition – making previously reported financial results comparable with the reports prepared after the transition.

In addition the author presents two extra questions related to the transparency and clarity of the wording of the draft and the associated costs.

Secondly, the author analyses and evaluates the feedback provided by the life insurance companies by applying the Likert's scale method. Lastly, the author summarizes the feedback and presents the results with improvement recommendations.

The author would like to express sincere gratitude to professor Lehte Alver for assisting and guiding the writing of the master's thesis.

# **1. DESCRIPTION OF IFRS 4 CHANGING PROJECT**

## **1.1. Methodology applied in evaluation of IFRS 4 changing project**

The chapter methodology describes methods used by the author to collect, interpret and analyze data related to the revised Exposure Draft 2013 issued by the IASB.

### **Research purpose and approach**

The main purpose of the master's thesis is to find out which changes the IASB proposed in response to the comment letters they received to Exposure Draft 2010. Also, the author will analyze the opinions of life insurance companies about the proposed changes and implementation approaches. Lastly, the analysis will suggest some alternative approaches to the changes, if necessary.

The research started by collecting information to understand the IASB's objectives in developing the Exposure Draft 2013. The process continued with collecting information about the proposed changes and the implementation approached. As a next step, the author collected feedback from the interested parties of the proposal (e.g. insurance companies, banks, auditors, actuaries, individuals etc.). Then, the author analyzed the responses of the commentators based on the Likert scale. Lastly, the author summarized the respondents' opinions, stated her own and provided improvement possibilities.

### **Data collection method**

The majority of data used in preparing the master's thesis was taken from the IFRS webpage (www.ifrs.org). The IFRS kept the webpage updated with the revised Exposure Draft, related appendixes, and minutes of the IASB meetings. In addition, they uploaded all the comment letters sent by the respondents to the web page. Therefore, the author was able to receive most of the information from one source.

In order to obtain a better understanding of the topic the author reviewed the newsletters and training videos prepared by the following international consulting companies: PricewaterhouseCoopers, Deloitte, KPMG, and Ernst & Young.

### **Sample selection**

The author analyzed the respondents feedback related to the changes proposed in the Exposure Draft 2013. All together there were 196 comment letters sent by the commentators. The length of comment letters varied from a couple of pages to 60 pages depending on the respondent. As the profile of respondents varied, the author decided to concentrate on a certain group of respondents in order to reduce the variation caused by different business objectives. The author subjectively decided to analyze only the feedback sent by life insurance companies. Due do the significant number of respondents the author selected a sample of companies based on the line of insurance and relevance of responses.

### **Data analysis**

The IASB wanted to receive feedback whether the respondents agreed with the proposed changes in the Exposure Draft 2013. Therefore, the author believed that the most appropriate approach to measure the level of agreement or disagreement would be by applying the Likert's scale.

Likert scale is commonly used to measure the degree of agreement. Where the respondents are asked to provide their opinion related to a The level of agreement is indicated on a scale. Usually the scale is divided into 5 possible response categories. The division could be modified to more or less categories. The below scale is most commonly used (Naresh K. M. Questionnaire):

*1 – strongly disagree*



2 – *disagree*

3 – *neither agree or disagree*

4 – *agree*

5 – *strongly agree*

On one side of the scale usually indicates “strong agreement” which reflects the most favorable response. The other side of the scale indicates “strong disagreement” which reflects the most unfavorable response.

### **Data presentation**

In the master’s thesis, the author presents the ideas and statements of others only in *italic* font (e.g. questions posed by the IASB) and refers to the source of the data. However, the statements and opinions in the text which do have references are summarized and modified by the author.

## **1.2. Background of IFRS 4 changing project**

In 1973 the International Accounting Standards Committee was formed. The main purpose of the committee was to increase the transparency of accounting standards. (Camfferman, Zeff 2007, 1) Subsequently, the Steering Committee was formed in 1997 (Figure 1) to develop a standard to start regulating the financial reporting of insurance companies who issue insurance contracts. The insurance

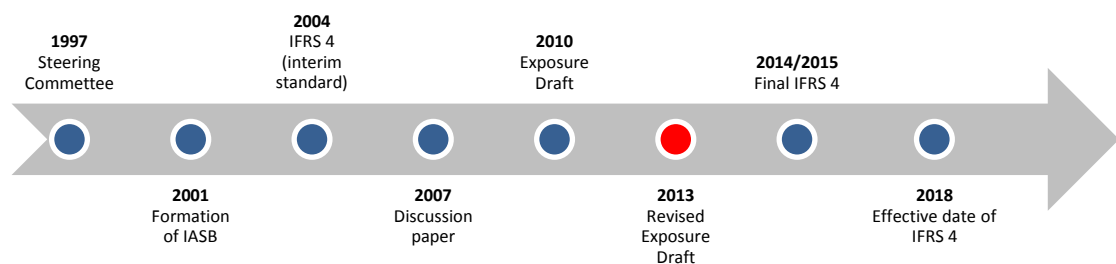


Figure 1. Evolution of IFRS 4

Source: (Deloitte; modified by Author)

contract is an agreement between the insurer and policy holder, where the insurer

accepts the insurance risk of the policy holder. If the insured event occurs, then the insurer compensates the insured amount to the policy holder. (Mirza, Holt, Knorr, Orrell, Holt 2006, 350) This year was considered to be the start of developing the IFRS 4. Four years later, in 2001 the IASB was founded, and it took over the responsibilities of the Steering Committee. Based on the development of the preliminary standard, the board issued an interim IFRS 4 in 2004. After issuing the documents, the board sought for the feedback to the preliminary standard by issuing the discussion paper in 2007. Based on the feedback received, the IASB issued the Exposure Draft in 2010 which was the first phase of issuing the draft, and in summer 2013 the board issued phase two, the revised Exposure Draft 2013. The Exposure Drafts apply to all insurance contracts with the following exclusions: product warranties issued directly by manufacturers, dealers, and retailers, employer's assets and liabilities under employer's benefit and retirement plan, and the lessee's guarantees of financial lease (Chamboko, Coetsee, Colyvas, Hanekom, Mackenzie, Njikizana 2013, 845).

After publishing the revised draft in 2013, the IASB waited to receive the feedback related to the proposed changes from preparers and users of financial statements of insurance companies. The deadline for providing the feedback was the end of 2013.

Currently the board is analyzing the received feedback and they are aiming to issue the final version of the standard in the end of 2014 or in the beginning of 2015. As the standard would result in significant changes in reporting, the effective date of the final standard is considered to be in 2018.

The IASB proposed in the Exposure Draft 2013 five significant changes compared to the previous Exposure Draft 2010. These five changes are: adjusting the contractual service margin, decomposing cash flows dependent on the link of return of the underlying items, presenting insurance contract revenue, interest expense, and transition of the standard.

### **1.3. Contractual service margin**

#### **1.3.1. Proposal 2010**

The Exposure Draft 2010, the IASB proposed to capture any changes in the present value of future expected cash flows in the profit and loss. According to this approach gains or losses are recognized immediately in the profit and loss as an expense. At the same time, the future expected cash flows should remain at the same level as they were before a gain or a loss occurred. The IASB received comment letters indicating concern that this approach would not accurately reflect the expected future profitability of insurance contracts.

#### **1.3.2. Proposal 2013**

In response, the board introduced a new methodology in the Exposure Draft 2013 to the wider public in the middle of the summer of 2013 (IASB, Exposure Draft).

*Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:*

- 1) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and*
- 2) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognized immediately in profit or loss?*

*Why or why not? If not, what would you recommend and why?*

According to the IASB, companies initially measure an insurance contract as the sum of the fulfillment cash flows (adjusted with the discount rate) and the contractual service margin. This method is called standard or Building Blocks

Approach. The fulfilment cash flows are calculated based on the amount of the liability of the remaining coverage period and the liability of incurred claims. The incurred claims include both the claims that have already occurred and have been reported as well as the claims which have occurred but have not been reported.

The IASB proposed that entities could use a simplified Building Blocks Approach (shown on Figure 2.) to measure the liability of the remaining coverage. The simplified method is called Premium Allocation Approach (Figure 2.) and by applying this it would reduce the complexity of measuring liabilities. However, the approach has limitations and only applies if the result is close to the result achieved by summing the fulfillment cash flows and contractual service margin and/or if the coverage period of the contract is up to one year (IASB, Exposure Draft).

*Premium Allocation Approach where an entity may measure the liability for the remaining coverage as follows:*

- 1) *at initial recognition, the carrying amount of the liability for the remaining coverage is:*
  - a) *premium received at initial recognition (if applicable);*
  - b) *minus any payments that relate to acquisition costs, as an exception an entity could recognize these costs as an expense if the contract period is up to one year;*
  - c) *plus (or minus) any pre-coverage cash flows;*
  - d) *plus any onerous contract liability (where expected liabilities are higher than expected return and the liability will be measured as difference between the carrying amount of the liability for the remaining coverage and the fulfilment cash flows)*
- 2) *at the end of each subsequent reporting period, the carrying amount of the liability for the remaining coverage is the previous carrying amount:*
  - a) *plus the premiums received in the period;*
  - b) *minus the amount recognized as insurance contract revenue for coverage that was provided in that period (the period is determined as the amount of the expected premium receipts allocated in the period.*

The entity shall allocate the expected premium receipts as insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract.);

- c) plus any onerous contract liability (which expected liabilities are higher than expected return and the liability will be measured as difference between the carrying amount of the liability for the remaining coverage and the fulfilment cash flows);
- d) plus (or minus) the effect of any changes in estimates that relate to any onerous contract liability recognized in previous periods;
- e) plus any adjustment to reflect the time value of money (if the contract contains significant financial instruments then an entity should adjust the liability for the remaining coverage to reflect the time value of money using the discount as determined at initial recognition).

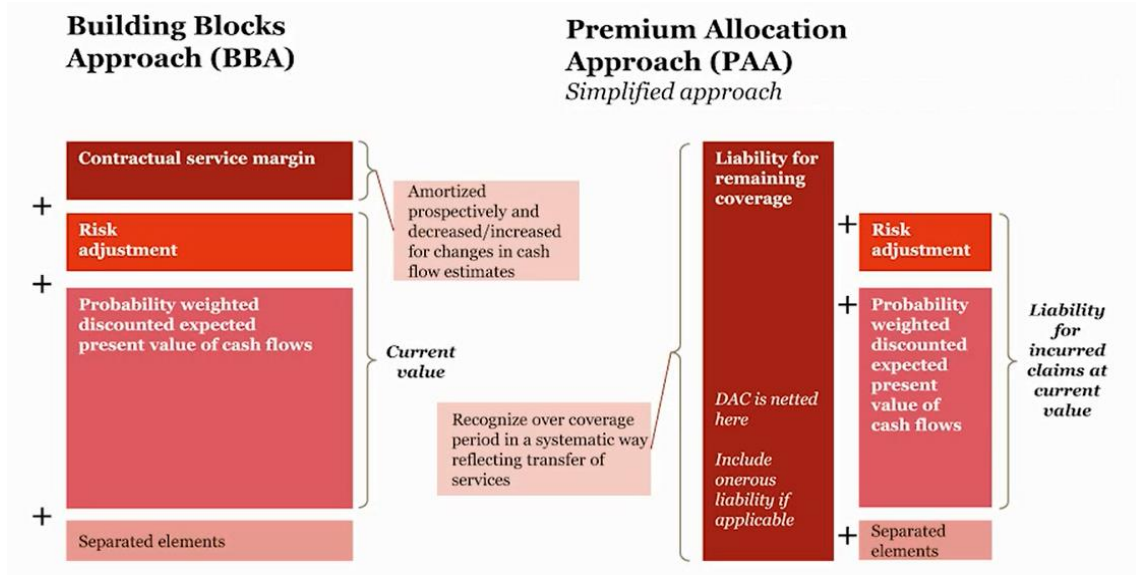


Figure 2. Building Blocks Approach vs. Premium Allocation Approach

Source: (PricewaterhouseCoopers)

Future estimated cash flows must be determined by fulfillment cash flows which are directly related to the contracts in a portfolio. Entities must estimate the cash flows separately from the estimates of the discount rate and the risk adjustment. The IASB asks entities that the estimates are in accordance with relevant market variables and that they will enclose available and reliable information about the timing, the amount and the uncertainty of cash flows related to the portfolio. As the contractual service margin compares the cash flows with previous estimates, the estimates must reflect the available information on the date of the measurement. Companies should measure an insurance contract initially as the sum of the fulfillment cash flows and contractual service margin. This should be calculated as the liability of the coverage during the remaining coverage period and the liability of incurred claims. The incurred claims include both the claims that have already occurred and have been reported, but as well as the claims which have occurred but have not been reported.

The new approach presents the effect of changes in the expected profitability of future cash flows relating to the future services in the periods when the future services will be provided. The changes to expected profitability should be reflected by adjusting the contractual service margin (previously known as a residual margin in the Exposure Draft 2010 or as “unlocking” the contractual service margin). Contractual service margin represents the expected contract profit which depends on the expected premium amounts an entity expects to receive less the claims, benefits and expenses which will be adjusted for risk (the uncertainty of the future cash flows) and time value of money. (IASB, Exposure Draft)

The revised Exposure Draft requires adjusting the contractual service margin for the difference between the current estimates of the present value of future cash flows with the previous estimates. It applies only to the cash flows which will be produced by the future coverage and other future services. The new approach requires measuring the contractual service margin for both favorable and unfavorable difference only between current and previous estimates of the present value of the future cash flows which are related to the future coverage and services. As the

contractual service margin could not be negative, the change could not result in negative expected future cash flows. If the difference will absorb all the expected future cash flows up to zero then the remaining negative amount will be recognized in the profit and loss as an expense. This means that all the losses exceeding the expected future cash flows will be recognized immediately in the profit and loss while the gains of the future cash flows will be recognized over the coverage period of the insurance contract.

The carrying amount at the start of the reporting period is equal to the remaining amount of the contractual service margin (excluding the fulfillment cash flows) at the end of the reporting period. The criteria for adjusting the remaining amount of the contractual service margin for a difference between the current and previous estimates of the cash flows that relate to future coverage and other future services are (IASB, Exposure Draft):

- 1) *the contractual service margin is not adjusted for changes in estimates of incurred claims, because these claims relate to past coverage. Such changes are recognized immediately in profit or loss.*
- 2) *the contractual service margin is adjusted for experience differences that relate to future coverage; for example, if they relate to premiums for future coverage. The entity adjusts the margin for both the change in premiums and any resulting changes in future outflows.*
- 3) *the contractual service margin is not adjusted for a delay or acceleration of repayments of investment components if the change in timing did not affect the cash flows relating to future services. For example, if an entity estimates that there will be a lower repayment in one period because of a corresponding higher repayment in a future period, the change in timing does not affect the cash flows relating to future periods. The contractual service margin is adjusted only for any net effect on the contractual service margin of the delay or acceleration.*
- 4) *the contractual service margin is not adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of*

*changes in the value of the underlying items. Such changes do not relate to services provided under the contract.*

- 5) *the contractual service margin is adjusted for changes in estimates of cash flows that are expected to vary directly with returns on underlying items only if those cash flows relate to future services under the insurance contract. For example, changes in cash flows relating to asset management services that are provided under a contract relate to future services under the insurance contract. Gains or losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognized in accordance with the Standards Relevant to the underlying items. (IASB, Exposure Draft; Author’s summarization)*

The contractual service margin will be adjusted prospectively which means that there is no need to adjust previously recognized gains and losses. Only future change will be reflected. The main reason why it is not required for entities to adjust the gains and losses retrospectively is due to its high complexity which would result in increased costs.

The Figure 3. compares effect of the two different approaches of the expected future cash flows through the contractual service margin. The red line represents the approach described in the Exposure Draft 2010 where profits and losses were immediately recognized in the profit and loss (the sharp decline in Year 5). The blue line shows the approach suggested in the Exposure Draft 2013, where the impact of

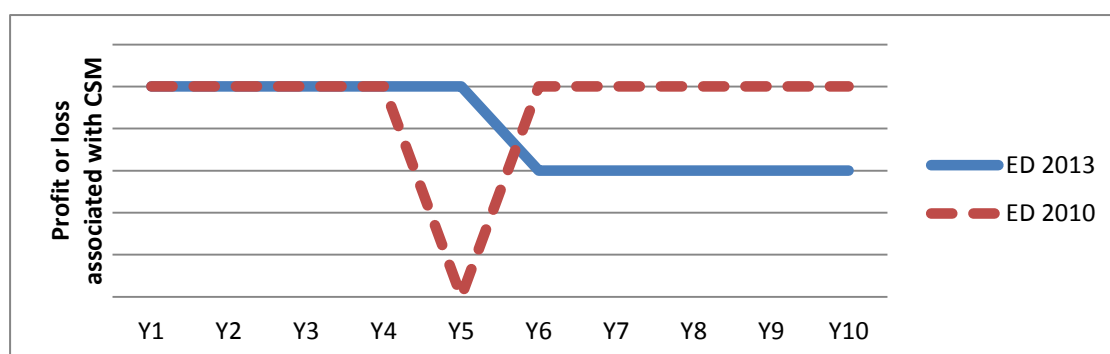


Figure 3. Changes in the expected future cash flows

Source: (Pryde, Ruta)



the profits or losses in the future expected cash flows has been incorporated in the contractual service margin.

## **1.4. Underlying items**

The insurance industry has different kinds of insurance contracts. Some of the contracts offer policyholders a contractual arrangement. The arrangement awards policyholders with a return based on financial assets that the insurance company hold. These kinds of contracts are called participating contracts or unit-linked contracts. The participating contracts have cash flows that vary with the return on underlying items.

Participating contracts are very common in life insurance industry. These contracts are used to fund pension plans, and they represent the material liability for the life insurance industry with portfolios of assets backing them. Even though insurance liabilities are tightly connected with the financial assets backing them, there is still a different approach to account for them.

### **1.4.1. Proposal 2010**

The IASB proposed in the Exposure Draft 2010 in case when amount, timing and/or uncertainty of cash flows depend on the returns from specific assets, a company should reflect that dependence in the discount rate used to measure the insurance contract. However, this approach was widely rejected by the respondents as it resulted in an accounting mismatch. The mismatch arises when applying different measurement approaches for calculating the liability based on the fair value through the profit and loss vs. calculating the underlying item based on the fair value through other comprehensive income. In addition, the proposed approach would not have recognized some financial assets such as goodwill.

### 1.4.2. Proposal 2013

As a response to the feedback received for the Exposure Draft 2010, the IASB revised their initial approach and proposed an updated accounting method. The IASB described the updated proposal below and sought for feedback from preparers and users of financial reports for the following questions (IASB, Exposure Draft):

*If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:*

*1) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?*

*2) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?*

*3) recognizes changes in the fulfilment cash flows as follows:*

*a) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognized in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;*

*b) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognized in profit or loss; and*

*c) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognized in profit or loss and in other comprehensive income in accordance with the general requirements of the Standard?*

*Why or why not? If not, what would you recommend and why?*

As there was not one single definition how to identify an underlying item, the board presented a short description:

- 1. The returns from a specified pool of insurance contracts or a specified type of insurance contract; or*
- 2. Realized and/or unrealized investment returns on a specified pool of assets held by the issuer; or*
- 3. The profit or loss of the entity or fund that issues the contract.*

### **Mirroring approach**

One of the changes in the revised Exposure Draft 2013 is that the measurement and presentation of the changes in the cash flows is based on the carrying amount of the underlying items (Yeoh, Pryde). Since the change in cash flow varies directly with the underlying items, the board sought to eliminate this accounting mismatch where the cash flows and the underlying items are economically matched. This requirement has been called the mirroring approach because the measurement and presentation of the liability cash flows is a mirror image of the accounting of the underlying item. This means that the amount of liability equals to the asset it is backing. The mirroring approach applies only to the cash flows where the insurance company does not bear the risk of the return on underlying items.

### **Decomposing principle**

The biggest challenge of applying the mirroring approach is related to decomposing the cash flows. Therefore, the IASB proposed in the Exposure Draft

2013 that the cash flows must be decomposed to meet two main requirements. First, the cash flow decomposition should maximize the illustration of how the cash flows are expected to vary with returns on underlying items. Second, the cash flow decomposition should maximize the minimum fixed payment that the policyholder will receive. (IASB, Exposure Draft)

**Measurement and presentation of cash flows dependent on underlying items**

According to the Exposure Draft 2013 the cash flows that vary directly with the underlying items will be measured and presented using the mirroring approach (Figure 4.). The mirroring approach is completely different from the other

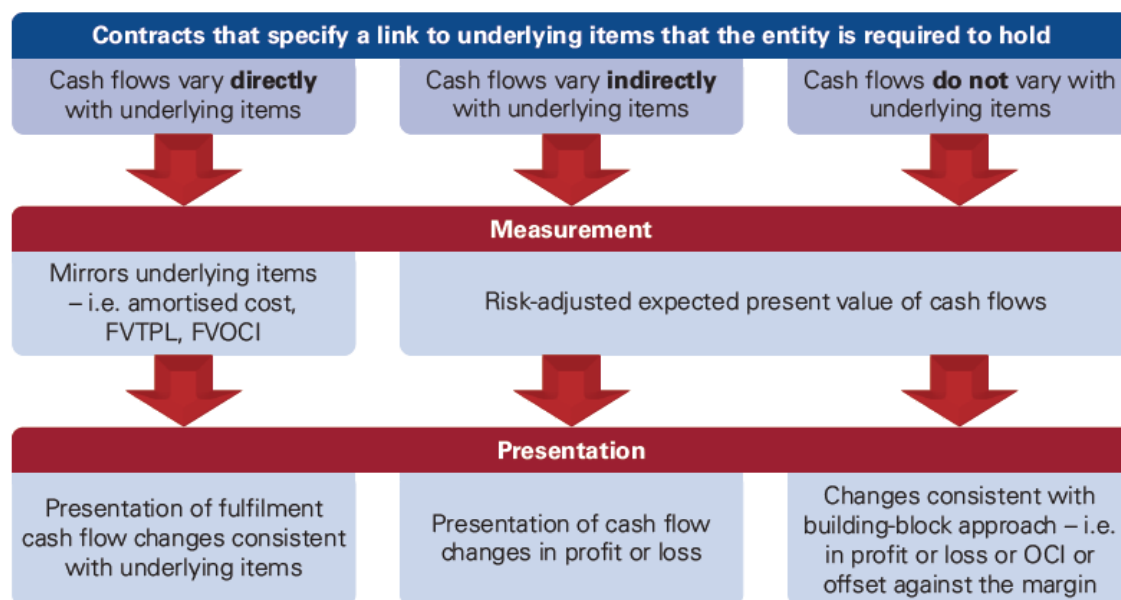


Figure 4. Cash flows depending on underlying items

Source: (KPMG, IFRS Newsletter)

measurement approaches applied for all other types of insurance contracts (e.g. a risk weighted present value of future cash flows or Building Blocks Approach), the Exposure Draft 2013 will over rule all other requirements including the other comprehensive income solution and the unlocking of the contractual service margin approach.

Secondly, the cash flows that vary indirectly with the underlying items (e.g. unbundled options and guarantees) will be accounted for by using the Building Blocks Approach. In this approach, the changes in the cash flows will impact the profit or loss except all those changes must go through profit or loss except the benefit of the other comprehensive income solution and the unlocking of the contractual service margin approach. Lastly, the cash flows that do not vary with the underlying item will be accounted by using the Building Blocks Approach. This time the approach will be inclusive of the other comprehensive income solution and the unlocking of the contractual service margin approach.

## **1.5. Insurance contract revenue**

### **1.5.1. Proposal 2010**

In the Exposure Draft 2010 the IASB addresses the issue of aligning the presentation of the performance statement of insurance contracts with other industry reports. In that draft, the board presented the summarized margin presentation approach which focuses on changes in the margins. This approach highlights: underwriting margin, experience adjustment, changes in insurance contract liability estimates, and changes in interests estimates. As part of the summarized margin presentation the board raised a question whether the deposit amount of the premium should be considered as part of the revenue. (IASB, Minutes of Meeting)

In 2010, many respondents did not support the summarized margin approach because it eliminates information about premiums, benefits, and claim's expenses from the statement of comprehensive income. In addition, respondents believe that the deposit is part of the insurance contract, and therefore; it should not be unbundled from the contract.

### 1.5.2. Current practice

Today, there is no standardized way to measure premium in a certain period. As a result, some insurance companies present their premium as the entire premium they expect to receive in the future for all the contracts they have written in the period. Investment component is another example of inconsistent premium measurement where insurers sometimes invest on behalf of the insured and return premium to insured even in cases where no insured event occurs. Presenting investment component in revenue contradicts the IFRS requirement for revenue measurement. As an example from the banking sector: banks do not report the deposits they receive from their account holders as revenue; instead, they remove the deposit amounts from their revenue amount.

The second discrepancy lies in presenting the revenue for the services which have not yet been provided. This approach is most common in life insurance products and portfolios. Some insurers collect fixed payment amounts over the policy period. In life insurance policies, the probability that the claim occurs is higher at the end of the policy period. Therefore, in the early years of the contract period, the policy holder pays a higher premium (Figure 5.) relative to the probability of the estimated

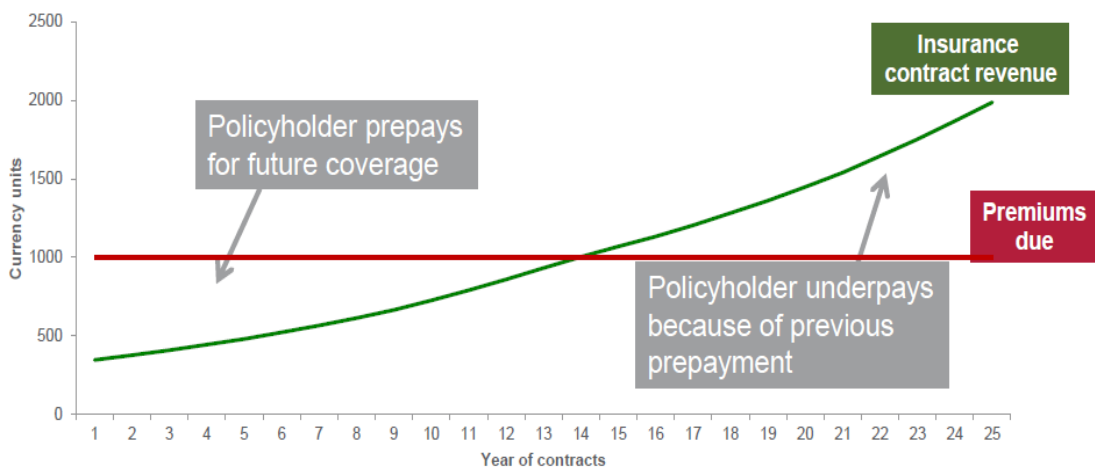


Figure 5. Insurance contract revenue: fixed payments

Source: (Cooper S., Brown J)

claims. This applies if the contract is issued on an annual basis, and therefore the premium is also calculated on an annual basis. Therefore, part of the premium paid by the insurer should be counted as a prepayment; however, some insurers recognize it as the premium for the current period. The reverse affect occurs in the end of the coverage period where insurers show fewer premiums than the expected expenses and costs. In this approach, it follows that the prepayments received in the earlier years are meant to cover part of the incurred claims in the later years of the coverage period. If the insurer would have priced each period separately it would have charged more in the later years.

In the case of annuity contracts, insurers receive the whole premium amount in the beginning of the policy period (Figure 6.). Due to the nature of the annuity contract which depends on mortality rate, the annuity payments to policy holders will decrease over time after the policy holders die. Insurers are usually showing the full

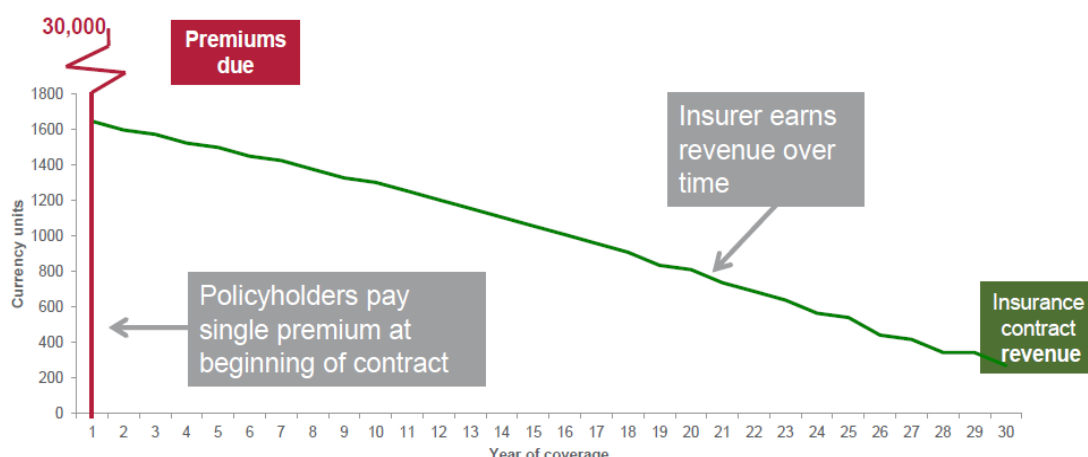


Figure 6. Insurance contract revenue: annuity payments

Source: (Cooper S., Brown J)

premium amount received at the inception of the contract as revenue for the current period. Sometimes the insurers are spreading the premium amount over period of time which is usually around 10 years.

As both approaches do not accurately reflect performance of the insurance contract, the insurers are presenting the estimated expenses in the profit and loss.

However, estimating the future costs and expenses is in contradiction with IFRS. In response to the discrepancies presented above, the IASB aims to implement an approach of measurement for revenue and expenses which is more consistent with entities in other sectors.

### **1.5.3. Proposal 2013**

The IASB revised their revenue recognition approach in the Exposure Draft 2010 and modified based on the feedback they received. In the revised draft the board is proposing to recognize and present insurance revenue and expense instead of margin changes. The board asked the interested parties to provide their feedback to the following question (IASB, Exposure Draft):

*Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?*

*Why or why not? If not, what would you recommend and why?*

The proposed change will mainly impact the contracts which provide coverage for a long period of time (e.g. life insurance contracts). According to the updated approach from 2013, the insurers need to divide premium received into two amounts:

- 1) amounts related to the investment (amount which will be returned to the policy holder);
- 2) amounts related to the insurance coverage and any other services provided by insurer.

Insurance companies' revenue must exclude the income related to the aforementioned investment activities and include only the premium received relating to the insurance coverage and other services. If the premium payments received are not reflecting the nature and extent of expected claims, then the company must proportionally adjust the received premium with the expected claims.



Insurers will measure the revenue depending on whether they are applying Premium Allocation Approach or Building Blocks Approach (simplified approach) for measuring the insurance contract's liability. In the simplified approach, the insurance contract revenue for each period is simply the premium allocated to the period. While in the standard measurement, the insurance contract revenue is determined by the changes in the insurance contract liability between the start and the end of the period. This is measured by the sum of: expected present value of future cash flows, risk adjustment, and contractual service margin. The total revenue over the duration of the contract cannot be higher than the premium received and it must be adjusted to the time value of money. If the contract seems to be loss making, in the remaining periods where the expenses are exceeding the premium, then the insurers who are applying the standard measurement approach need to separate total insurance contract liability into three:

- 1) liability of remaining coverage up to the premium amount received for that coverage;
- 2) any liability of the remaining coverage in excess of the premium received (only in cases when it is expected that the portfolio will be loss making);
- 3) liability of incurred claims.

The excess liability will be recognized in the profit and loss.

## **1.6. Interest expense**

### **1.6.1. Proposal 2010**

The IASB proposed in the Exposure Draft 2010 to recognize and present all the changes in the insurance contract liability arising from the changes in the discount rate in the profit and loss. The board's objective in implementing this approach was to:

- 1) provide transparent information about the economic gains and losses;
- 2) avoid reporting complexity;

3) reduce the possibility of accounting mismatches.

As part of the proposal, the board suggested to use current updated information for measuring cash flows, risk adjustment and discount rates. After issuing the proposal, the board received many comment letters from the respondents indicating that the proposed approach did not faithfully reflect the performance of insurance companies. One of the concerns was that presenting the changes in the profit and loss would not correctly reflect the underwriting performance.

### **1.6.2. Proposal 2013**

Based on the feedback received in the comment letters, the board analyzed alternatives to capture the interest expenses. As a result, the IASB developed an approach which separates results from the underwriting and investing activities from the effect of changes in the discount rates. The board posed the following question and sought feedback from the insurance sector (IASB, Exposure Draft):

*Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:*

*1) recognizing, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognized. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and*

*2) recognizing, in other comprehensive income, the difference between:*

*a) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and*

*b) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the*

*contract was initially recognized. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?*

*Why or why not? If not, what would you recommend and why?*

The author addresses the above stated questions under analysis chapter of the master's thesis.

### **1.6.3. Current practice and future implications**

This proposal would have significant impact for both life and non-life insurance contracts as insurance companies would be required to change their current accounting practice. As a current practice in many countries, life insurance entities measure and present interest expense adjusted by the discount rate at the inception. This methodology of discounting is also known as the cost view approach. The change for these companies will be that they must measure the liability on the balance sheet based on the discount rate as of the reporting date. This methodology is known as current view approach. The difference between the discount rates must be reconciled on the other comprehensive income statement. Those life insurance companies which are currently recognizing the interest expenses based on the current discount rate would need to recognize the change in the profit and loss statement.

Today, in many jurisdictions it is not required to discount claim liabilities, and if discounting is required, then it applies only to certain products. In order to reflect the impact of time value of money, insurance companies must discount the claims liabilities. There will be a change for insurance contracts where claim liabilities are currently discounted; in the future, interest expense will be recognized on a cost basis at the contract inception date. The changes in discount rates will be reflected in the other comprehensive income statement. Finally, companies who are currently discounting claims liabilities, the change for them would be to recognize the interest

expense on the cost basis and unwind the changes in the other comprehensive income statement.

## **1.7. Transition**

### **1.7.1. Proposal 2010**

The IASB proposed in the Exposure Draft 2010 that insurance companies must apply the new IFRS 4 standard retrospectively where the insurance contracts would be measured based on fulfillment cash flows. As part of the proposal, the board wanted the insurance entities not to recognize the contractual service margins (recognize at the level of zero) for contracts which were written before the transition date. Therefore, in the period before the transition, the profit amounts of these contracts would not be presented in the profit and loss statement, and instead recognized immediately in the retained earnings. The board received wide feedback for this proposal where almost all respondents disagreed with the approach. Two main reasons for the disagreement were that the proposed standard would not faithfully present the performance of insurance companies, and the financial statements would not be comparable.

### **1.7.2. Proposal 2013**

The board reviewed the comments they received, and they revised their proposal accordingly. While updating the standard, the board's objective was to balance the benefits with the associated costs and complexity of implementation for both insurance companies and for the final users. As a result, in 2013 the IASB issued an updated standard related to the effective date and transition of the IFRS 4. The Exposure Draft 2013 proposes that insurance companies should apply the standard in compliance with the IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors when* it is practicable. However, if it is not practicable, the board proposes a modified retrospective application, which simplifies the transition requirements

while maximizing the use of objective information. In addition, the board changed their initial standpoint by adding the contractual service margin to the proposal. As a next step in finishing the standard the board posed a question:

*Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?*

*Why or why not? If not, what do you suggest and why?*

In order to assess whether the board met the objectives, the IASB sought feedback from preparers and users of financial statements of insurance business.

### **Standard implementation retrospectively**

The revised exposure draft will include a proposal to indicate the residual margin in the measurement of insurance contracts at the transition date. The measurements will be applied retrospectively as the measurements had always been applied. As a result, insurance companies will be obliged to measure the insurance contract's revenue, liability and effects of discount rate changes at the transition date and continuously in the future at the end of each reporting period.

#### ***Measuring insurance contract revenue***

To measure the insurance contract revenue after the transition date, an entity must estimate the carrying amount of the expected losses which had been recognized in the profit and loss for the periods prior to the transition date. The purpose is to ensure the entity does not recognize more revenue than was charged for the contract. The amount of losses cannot be measured directly on the transition date, as the expected future losses will depend on the total premiums charged for the contracts in relation to the expected costs. Therefore, the entity must estimate the expected gains or losses, and any subsequent changes related to those expectation. In order to estimate those gains and losses an entity has to estimate the fulfillment cash flows at the inception of a contract and any subsequent changes.

#### ***Measuring insurance contract liability***

In order to calculate an insurance contract liability an entity must measure the contractual service margin and fulfillment cash flows as follows:

- 1) contractual service margin – the expected future profit. The contractual service margin could not be accurately calculated on the transition date as it depends on premium amounts related to total amount of expected cost for the contract;
- 2) fulfillment cash flows – the expected cash flows at the transition date. These cash flows will be adjusted for the current time value of money, and also for current measure of risk. Fulfillment cash flows will be measured by using only current and forward looking information.

### **Measuring discount rate changes**

Finally, the IASB proposes that insurance entities should present the effect of discount rate changes related to the insurance contract liability in the other comprehensive income statement. In addition, they have to recognize interest expense in the profit and loss by using discount rate as of the inception date of the contract.

In order to apply the proposed changes for the first time, an entity needs to calculate profits and losses retrospectively, and treat the financial activity as if the changes have been in place for the whole reporting period. Therefore, insurance company will estimate the fulfillment cash flows, and determine whether there is a contractual service margin or expected loss at the inception of the contract. As a second step, insurance companies must estimate all subsequent changes of fulfillment cash flows, including changes that revise expected future profit for the contract. However, it would not be practical to apply the retrospective approach to long term contracts, mainly life insurance products. The main reason is that the required information would not be available, and this would force entities to make rough estimations. To address the issue, the board proposed a simplified standard implementation approach.

### Simplified standard implementation

The retrospective transition approach is not applicable for long term contracts. Therefore, the board suggested a different approach which provides a simplified method to calculate every item in the fulfillment cash flows at the contract inception

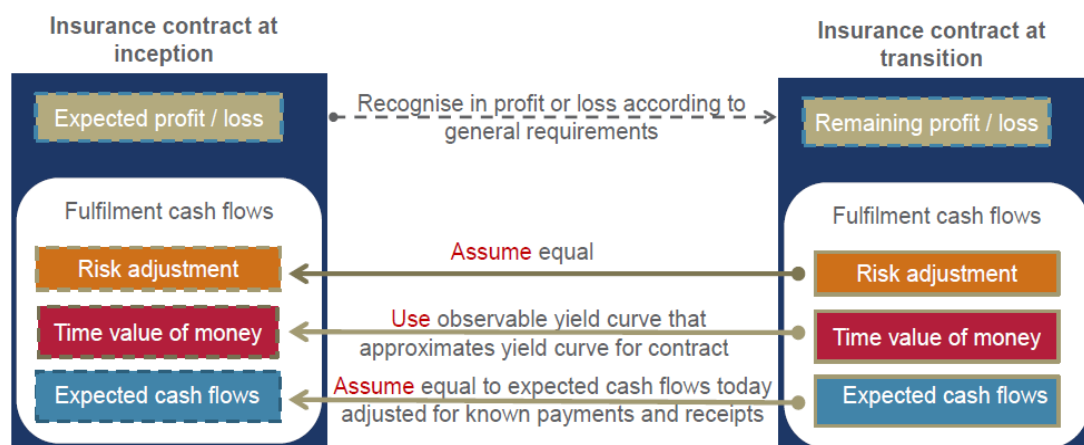


Figure 7. Simplified standard implementation

Source: (Jaworek, Ruta)

date. In order to estimate expected cash flows at the inception of a contract, insurance company could use expected future cash flows at the transition date, and adjust it for the cash flows that happened before the transition (Figure 7.). In cases where there are changes between the inception date and transition date, this approach could result in different amounts when compared to the retrospective approach.

As part of the transition process, companies must estimate the adjustment of the time value of money at the inception of a contract. Therefore, an entity has to know the discount rate or yield curve at the inception. The discount rate will be used to adjust the expected cash flows at the inception. Moreover, the yield curve will be used to calculate:

- 1) the effect of change in the discount rate in the insurance contract liability which is presented in the other comprehensive income statement;
- 2) the interest rate for the contract presented in the profit and loss at the transition date.

To estimate the yield curve at the inception, the insurance company could use the observable yield curve. In order to ensure the observable yield curve is an appropriate approximation for the contract, the company must use data at least 3-years prior to the transition date. In cases when the yield curve does not exist, the company must choose a yield curve that provides the best estimation at least 3 years prior to transition. This yield curve should be adjusted to the observable yield curve at the inception of the contract for the average spread observed between both those yield curves during the required 3 year period.

The IASB simplified estimating the risk adjustment at inception by using the same amount of risk adjustment as calculated at the transition date. Moreover, the amount of risk will not be adjusted to changes between the date of initial recognition and the previous period. As a result, at the inception of the contract, the expected profit could be slightly overstated, and the expected loss could be understated. However, the advantage of this approach is that it is easier to implement.

Even though implementing the Exposure Draft 2013 will be complex and costly, the users will be able to compare the contracts written before and after the transition date. In addition, insurance companies will be able to comply with the presentation requirements for revenue and discount rate changes for contracts written before transition in a comparable way to the contracts written after transition. In addition, these changes to revenue and discount rate change presentation provide a means for comparing contracts before and after the transition date.

## **1.8.Effects of Standard**

The IASB received wide feedback to the Exposure Draft 2010 and based on the recommendations sent by insurance companies the board revised the proposal. The IASB's objective was to create a standard that provides guidance on how to measure and present relevant information about insurance companies in a timely manner.



While developing the proposal, the board aimed to balance the benefits with the costs arising from implementing the standard. The IASB acknowledges that both preparers and users of financial statements will bear costs related to implementing and using the proposed Exposure Draft 2013.

The costs associated with implementing the Exposure Draft 2013 will begin with the initial implementation and continue post implementation. The IASB is seeking for feedback to understand whether the proposed draft will provide transparency and comparability across the insurance industry and other industries. In addition, they would like to know whether the benefits related to implementing the updated proposals are outweighing the associated costs in the following areas:

- 1) adjusting the contractual service margin;
- 2) contracts that require the entity to hold underlying items and specify a link to returns on those underlying items;
- 3) presentation of insurance contract revenue and expenses;
- 4) interest expense in profit or loss;
- 5) effective date and transition.

Therefore, the board posed the following question hoping to receive feedback from the insurance industry participants (IASB, Exposure Draft):

*Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?*

*How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?*

*Please describe the likely effect of the proposed Standard as a whole on:*

- 1) *the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and*
- 2) *the compliance costs for preparers and the costs for users of financial statements to understand the?*

The author addresses the above stated questions under analysis chapter of the master's thesis.

### **1.9. Clarity of proposal**

The last question the IASB posed in the Exposure Draft 2013 was related to the clarity of the draft. The board asked feedback from the preparers and users of the financial statements, to understand whether the proposal was drafted clearly and if it reflected the board's intentions. The board asked respondents to offer suggestions to reduce any ambiguity found in the draft. Therefore the board posed following question (IASB, Exposure Draft):

*Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?*

*If not, please describe any proposal that is not clear. How would you clarify it?*

The IASB believes that the proposed changes in the Exposure Draft 2013 will help to achieve a reporting practice with higher transparency and comparability across industries.

## **2. ANALYSIS OF RESPONCES TO IFRS 4 CHANGING PROJECT**

The second part of the master's thesis provides a short overview of the sample group of respondents. Also, it explains how the Likert's scale was implemented to measure their degree of agreement related to the proposed Exposure Draft 2013. Finally it provides the summarized overview of the feedback received from the respondents and the author's opinion and suggestions.

### **Sample group selection**

Insurance business is divided into two main categories based on the nature of insurance products: non-life (property and casualty insurance) and life insurance products. Since these products are very different, the business is managed differently in order to achieve the best results for insurance companies. In order to ensure responses did not vary due to differing business objectives in non-life vs. life insurance products, the author decided to analyze only the feedback received from life insurance companies. As the IASB received 196 comment letters in total the author selected 25 life insurance companies (Appendix 1) based on the relevance of the responses which represent about 13% of all the respondents.

The sample group includes life insurance companies from all over the world (USA, Europe, Africa, Asia, etc.). Some of these companies have international operations while the others are operating locally.

### **Likert's scale implementation**

For measuring the respondents' degree of agreement with the proposed changes in the Exposure Draft 2013 the author used a modified Likert scale. The scale was modified due to the nature of responses, and below are the 4 categories selected:

- 1- strongly disagree with the statement;
- 2- disagree with the statement;
- 3- agree with the statement;
- 4- strongly agree with the statement;

In addition the author added a category “No comments,” as some of the respondents did not provide responses to some of the questions (Appendix 2). The results of the analyses are provided in following paragraphs.

## 2.1.Contractual service margin

The Exposure Draft 2013 proposal to unlock contractual service margin received wide feedback from the insurance companies where 22 companies out of 25 provided their point of view which represents 88% of total responses (Figure 8.). The

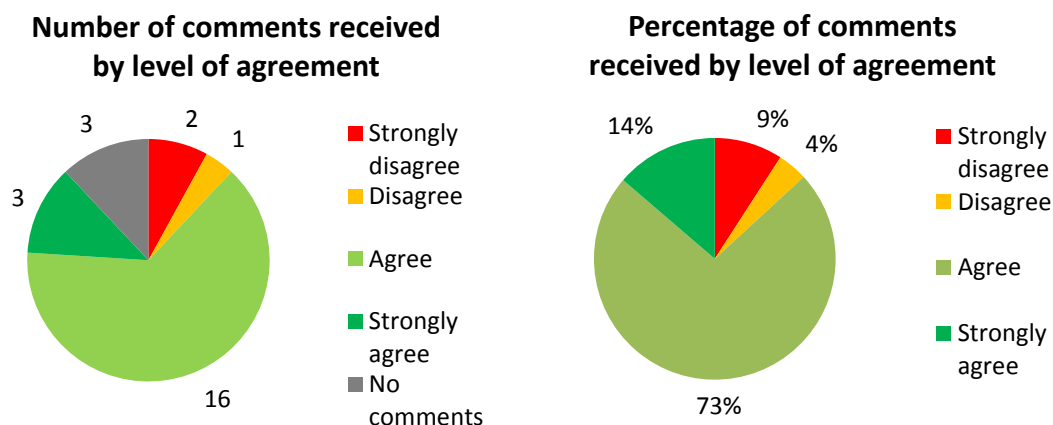


Figure 8. Contractual service margin adjustment feedback

Source: (Author)

purpose of this change was to reflect the changes between the current expected future cash flows and previous estimates. The majority of companies (about 87%) agree to the new approach. Unium, China Life Insurance and Fubon Life (which represents 14% of all the responses) strongly agree that unlocking the service margin will more

accurately reflect the financial situation of the insurance companies, and they agree the proposed approach is more useful to the final users of the reports. Unium also indicates that it should be possible to disaggregate the changes in the risk adjustment between the changes related to incurred claims, expiration of risk and changes related to future coverage. (Unum, 25 2696) In addition, Fubon Life has indicated the benefits in the proposed changes to unearned profits which will reflect a more gradual impact to the profit and loss. It would reduce volatility in the profit and loss and it makes easier to see trends and make management decisions. (Fubon Life, 25 2868)

Most respondents (16 out of 25) generally agreed with the approach, but they did point out several weak points and discrepancies. Allstate supports the idea of unlocking the contractual service margin with the exception of proposed changes to discount rates as this could cause volatility of the contractual service margin. This impact to contractual service margin would not provide insightful information to the financial statement users. (Allstate, 25 2804) AIA expressed concern that the discount rates would be determined on the portfolio level in the contractual service margin which is not consistent with the company's operating structure. (AIA, 25 3002) The current proposal suggests that the risk adjustment and the contractual service margin should be measured as two different margins. AIG is of the opinion that these should be measured as a single margin as it would be nearly impossible to calculate the risk adjustment on a comparable basis between different insurers. This reduces comparability, relevance and reliability of the produced information. The same point of view is also shared by Financial Accounting Standard Board (FASB) and Cathay Life Insurance. (AIG, 25 2746; Cathay Life Insurance, 25 2924) HSBS believes that adjusting the contractual service margin to reflect changes in the risk adjustment related to future coverage and services is consistent with the initial measurement of the contractual service margin. Therefore, HSBC does not understand the board's reason for showing the changes in the income statement. (HSBC, 25 2769) Mercuries Life Insurance indicates that the changes in the risk adjustment could be reflected in the contractual service margin as most insurers will use cost of capital or confidence level technique to determine the required risk adjustment. (Mercuries Life Insurance,

25 2923) The IASB proposed to release the contractual service margin only over the period of coverage. However, since the cash flows from the handling period could still change, BNP Paribas suggested releasing the contractual service margin over the insurance coverage period as well as over the claims handling period. (BNP Paribas, 25 2871)

Many commentators shared the opinion that the contractual service margin should not be negative. Liberty also shared this opinion; however, they suggested that the negative changes should be tracked, and then offset with positive changes until the negatives are exhausted over a period of time. (Liberty, 25 2780) This position is held due to the unpredictable nature of the insurance business; estimates could change tremendously from year to year. Losses are recognized immediately in other comprehensive income, and gains are recognized over the contract period. This mismatch could lead to misstating the true financial situation. It was unclear to OldMutual whether the negative changes which have been previously recognized in the profit and loss should be reversed before re-establishing the contractual service margin, as their approach would be to recognize the contractual service margin on the net value of the favorable change without reversing the previously recognized loss. (OldMutual, 25 2862)

Several commentators emphasized the importance in the difference between property and casualty contract (P&C are non-life contracts) versus life contracts. The accounting and measuring of life contracts is significantly different compared to non-life contracts. As an example, the duration of life contracts could be for many decades; therefore, it is much more complicated to calculate the future estimated cash flows, risk adjustment, and discount rate for those contracts compared to P&C contracts. Allstate indicated that they currently use an approach for accounting for the P&C contracts which does not allow them to account for the contractual service margin. (Allstate, 25 2804)

The IASB received three comment letters, representing 14% of all the responses, where the respondents strongly did not agree or did not agree with the suggested updated contractual service margin recognition approach. CNA and Sun

Life Financial of Canada (Sun Life) both strongly disagreed with implementing the Exposure Draft 2013. CNA strongly disagreed with the proposal's suggestion to re-measure the margin. In their opinion, it would create opportunity to manipulate or re-establish the margins earned during previous periods based on changes in the variability of cash flows. (CNA, 25 2788) However, Sun Life's comment is more general. In their view, the approach is not going to provide accurate performance overview of the insurance entity. (Sun Life Financial, 25 2766) Another concern raised by Prudential was that the contractual service margin principle was not completely developed and as a result it excludes the assets return which is earned as part of companies' fees from the contractual service margin. (Prudential, 25 2937)

Companies did agree to immediately recognize profit and loss impacts based on the differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services. Also they agreed that the contractual service margin should not be negative, as it is designed to show the future profitability of an insurance contract or portfolio.

The overall opinion of the commentators was that unlocking the contractual service margin would provide better transparency and comparability of the performance of insurance companies. However, before implementing the new methodology the IASB was requested to clarify and reconsider the following items:

- 1) clarify how to identify which cash flows should be measured;
- 2) consider of implementing the single margin approach for measuring risk adjustment and the contractual service margin;
- 3) adjusting the contractual service margin retrospectively;
- 4) the contractual service margin should be released the coverage and claims handling period.

Three companies which did not address the question related to presenting the effect of changes in the expected future cash flows were PartnerRe, RSA and Shin Kong Life Insurance.

### **Author's opinion**

The author is of the opinion that the financial statements must faithfully present insurance company's performance, and this should not be compromised. The author agrees with the IASB that it would be more informative for the users of financial statements to show the changes in the expected future cash flows by adjusting the contractual service margin rather than indicating this in the profit and loss. This can be accomplished as long as the contractual service margin is not negative. The author suggests that this approach should be applied to life insurance contracts which coverage period is up to ten years. Life insurance contracts which coverage period is longer than ten years, their changes in cash flows should be recognized in profit and loss in current period. The changes in cash flows which are related to future coverage must be recognized in the profit and loss. Also, the contractual service margin and risk adjustment should be measured as a single margin. In addition, the author recommends to the IASB to describe the methodology how to measure these cash flows in order to make sure that the requirement will be implemented correctly.

### **2.2.Underlying items**

The IASB proposed in the Exposure Draft 2013 that insurance companies must measure the insurance contracts based on the expected cash flows generated by the insurance contract. All the cash flows will be discounted based on the time value of money and adjusted for a risk. When the cash flows of insurance contract are dependent on the underlying items, and the policy holders have contractual right to receive returns of the underlying item, then changes in the measurement of these kinds of contracts will be reported on the profit and loss. When there is no economic mismatch, the board's objective is to reduce and eliminate accounting mismatch between the cash flows generated by insurance contracts and the underlying items.



The board believes this will be achieved when the underlying items are measured at fair value through the profit and loss statement.

The IASB received the least comments related to the approach of how to measure and report the cash flows which vary or do not vary with the returns of the underlying items. Seven life insurance companies which present 32% of the total sample group did not provide their opinion related to the proposal. However some of them did indicate that they do not hold contracts where the approach would apply. However, they did feel that the proposal was unclear and could create additional mismatches.

Only 5 insurance companies, representing 28% of respondent that provided feedback, agreed with the proposed approach to capture the information related to the cash flows dependent on underlying items (Figure 9.). They support the boards attempt to eliminate the accounting mismatches. Also some of them believe that

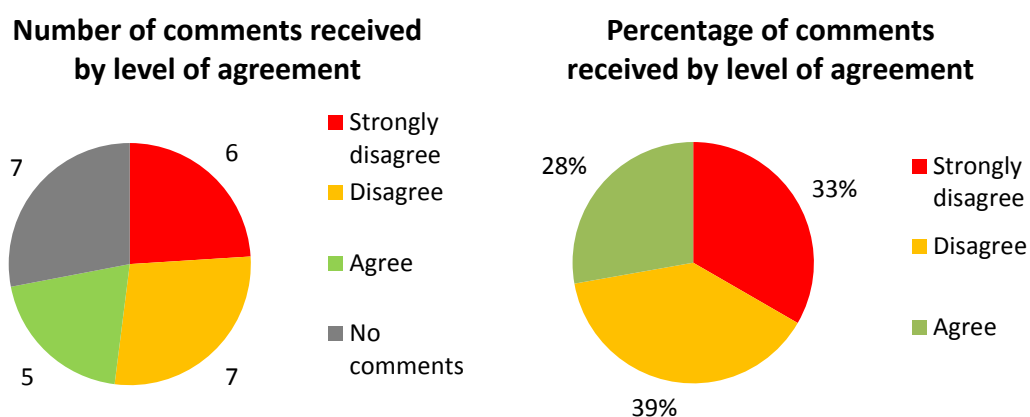


Figure 9. Link to returns of underlying items feedback  
Source: (Author)

decomposing the cash flows and applying the mirroring approach could theoretically provide faithful presentation of insurance company's performance. However, some of them were concerned about the complexity and costs related to implementing the proposal. Additionally, they would like to receive more practical examples on how to implement.

The majority of commentators, 72% of respondents, disagreed with the proposal. However, some of them did acknowledge and appreciate the board's intention to try to faithfully present the performance of participating contracts, but in their opinion this would cause additional accounting mismatch and would not add additional value to anyone. The main objections to the approach came from the belief that there will not be a visible benefit from decomposing the cash flows and applying the mirroring approach.

### **2.2.1. Decomposing cash flows**

Many respondents did agree with the IASB proposal that assets must be recognized in the financial statements for insurance contracts that are dependent on cash flows. However, some of the commentators indicated that decomposing the cash flows is arbitrary and without any conceptual basis. (HSBC, 25 2769) Also by implementing the approach it is in conflict with the nature that insurance contracts are priced managed and sold including the rights and obligations of the contracts. (BNP Paribas, 25 2871) Moreover, all the decomposed cash flows do interact with one another. Besides the practical complexities of decomposing and measuring the cash flows separately, is it not consistent with how the business is managed and how they evaluate the contracts. (Prudential, 25 2937) Also, Credit Agricole indicated that decomposing cash flows of participating contracts in order to isolate the embedded options and guarantees is not aligned with how the company constructs and prices the insurance contracts. (Credit Agricole, 25 2913) China Life Insurance commented that it is very difficult to recognize the cash flows that are directly linked to returns on underlying items. As an insurance entity from developing markets, they do not have historic data to calculate the value of embedded options and guarantees. (China Life Insurance, 25 2721)

Massachusetts Mutual Life Insurance emphasizes the importance that all elements of insurance contract that specify a link to an underlying item should be accounted for together by using the value of the underlying item. This approach would reflect the economics of a contract, and decreases the accounting volatility.

Additionally, this would reduce cost and complexity of measuring the insurance contracts. The changes of insurance liability must be presented as the performance of the linked assets as this reflects the nature of a contract. The changes should be presented in either the profit and loss or in the other comprehensive income statement. (Massachusetts Mutual Life Insurance, 25 2995)

AIA mentioned that it would be extremely difficult to decompose the cash flows as described in the Exposure Draft 2013. Moreover it will involve arbitrary allocations that could have a material impact on results, and lead to results that are not consistent with the underlying economics of the contracts. (AIA, 25 3002) BNP Paribas also agreed that the mirroring approach requires artificially separating the cash flows of insurance contract. (BNP Paribas, 25 2871) According to Metlife the contractual cash flows may vary from period to period based on how fees are incorporated into the insurance contract. In some situations it would be inappropriate to eliminate the accounting mismatches between the underlying items and the insurance contract. This will result in a situation where directly related cash flows are not contractually linked anymore. This approach can create very different accounting results for very similar contracts. (MetLife, 25 2807)

MetLife disagrees with decomposing the non-contractually linked cash flows. They believe that all the non-contractually linked cash flows, including fixed, directly, and indirectly related to underlying items, should be treated consistently. By applying the same approach for measuring all the non-contractually linked cash flows, it will create consistency with how similar cash flows in contracts would be reported. Also, it will significantly simplify the implementation of the measurement. (MetLife, 25 2807)

### **2.2.2. Mirroring approach**

It is a widely shared opinion that applying the mirroring approach will be overly complicated and impractical. Prudential believes that the freedom to choose the accounting approach will lead to arbitrary results which will reduce the comparability across companies. Also, there is no relevant reason to separate underwriting

components from the returns. (Prudential, 25 2937) HSBC disagrees with the mirroring approach as well, because based on the introduced approach the insurance contracts will be treated as financial instruments instead of being contracts with performance obligations. (HSBC, 25 2769)

Among others, Prudential HSBC and CNA support the idea of replacing the mirroring approach with a single model. Prudential suggests that a single model should consider contractual service margin, estimate cash flows, discount rates, and their dependency on the applicable backing assets. In addition, the cash flows generated by the non-participating contracts should be measured using a building block approach where the discount rates are reflecting the extent to which the cash flows depend on the returns of underlying items. (Prudential, 25 2937) HSBC believes that the proposed methodology should present gains and losses in accordance with the fulfillment of participating contracts and unit linked contracts. The contractual service margin should be adjusted to reflect the changes in financial and non-financial assumptions affecting future cash flows. Also, HSBC, China Life Insurance, and CNA recommend applying the building block approach. This approach will reduce the complexity of measuring liabilities, and provide consistency in measuring the contracts. (CNA, 25 2788; China Life Insurance, 25 2721; HSBC, 25 2769)

### **2.2.3. Comparability**

Different countries in the world have different laws and regulations linking returns to specific underlying items. As there is no internationally recognized approach, insurance companies in different countries use different methodologies where applicable. Using this approach, companies will end up with different results for economically similar contracts when representing different types of cash flows using the same methodology. This will cause additional accounting mismatch even if there is no economic mismatch. (HSBC, 25 2769)

Decomposing cash flows represents another area of mismatch since insurance companies are allowed to use a wide variety of accounting methodologies to measure the assets which are backing the liabilities. (Suncorp, 25 2654) According to Suncorp

this will reduce the comparability of insurance contracts which is contrary to what the IASB is trying to achieve.

#### **2.2.4. Implementation and benefits**

Some insurance companies indicated that the proposal is not clear for them. They are waiting to receive guidance from the IASB on practical application on identifying the link between the underlying items and returns from these items. . Additionally, more clarity is needed on how to differentiate direct cash flows and indirect cash flows. (Fubon Life, 25 2868; Ping An Insurance, 25 2678) Almost all life insurance companies indicated that implementing the proposed approach would be overly complex, and the costs would weigh the estimated benefits (Credit Agricole, 25 2913; Massachusetts Mutual Life Insurance, 25 2995).

#### **2.2.5. Author's opinion**

The author shares the opinion with the IASB that the financial statements should clearly link the cash flows related to the asset backing the liabilities. However, the author does not agree to decomposing cash flows where it contradicts how the business is really conducted and managed. Also, the author believes the proposed decomposition approach will reduce comparability of financial statements across the insurance sector, as the proposal leaves several options on how to measure the cash flows. The author agrees with the life insurance companies who suggested applying the building block approach as this would provide faithful overview of insurance company's performance, significantly reduce implementation complexity, and reduce associated implementation costs.

### **2.3. Insurance contract revenue**

The revenue presentation approach suggests presenting insurance contract revenue and expenses in the profit and loss, or presenting information about the

changes of the components of insurance contracts. The majority of respondent (88% on Figure 10.) provided feedback to help answer the question whether the revenue presentation approach provides the most relevant information to faithfully represent a company’s financial performance. Only MunichRE and Sun Life Financial of Canada did not provide their view on that matter. In total, there were four companies who agreed with the proposal. Unum and SunCorp Group agreed with the proposal completely without providing any further comments. (MunichRe, 25 2992; Sun Life Financial, 25 2766) Shin Kong Life Insurance and RSA did agree with the proposal.

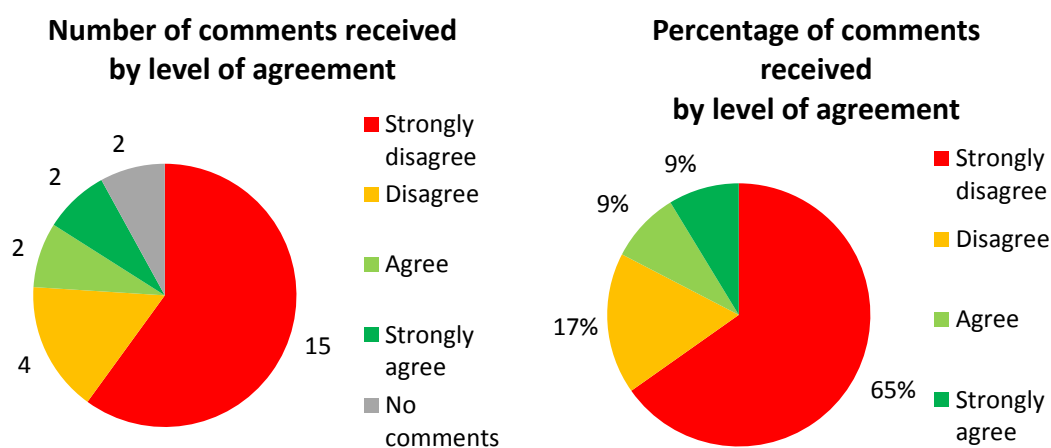


Figure 10. Insurance contract revenue measurement feedback

Source: (Author)

However, Shin Kong Life Insurance Co indicated that it would be complicated to implement in Taiwan as the proposal is completely different from the current reporting practice and it would require significant resources to administer. They suggested that the IASB should consider developing a simplified approach to avoid the need to maintain duplicate accounting systems in Taiwan which would also be required to comply with local reporting requirements. (Shin Kong Life, 25 2903) RSA agreed that there may be additional need for developing metrics for companies who are also providing non-insurance services to the policy holders (e.g. investment services). However, they strongly disagreed with going back and adopting the summarized margin approach.

The highest disagreement from respondents was related to applying the revenue presentation approach where 65% of all the commentators strongly disagreed with the approach and 17% generally disagreed. There were several different reasons why commentators did not agree or strongly disagree with the revenue presentation approach.

The main disagreement is that the revenue presentation approach does not take into consideration the economics of insurance business. The insurance industry is fundamentally different than other industries, and therefore they use different reporting approaches for accounting. Life insurance companies pointed out that there are even significant differences between life and non-life insurance businesses due to the duration of the contracts. Revenues generated by life insurance contracts which reflect mortality risks, other indistinct options, and embedded guarantees cannot be faithfully presented by applying the revenue presentation approach. (Massachusetts Mutual Life Insurance, 25 2995)

As part of the revised proposal, the board asks to unbundle the deposit investment amount from the insurance contract premium. Many respondents strongly disagree with the approach because it contradicts the concept of accounting for portfolios of insurance contracts as a bundle of rights and obligations. (Credit Agricole, 25 2913) The proposed revenue approach unbundles the deposit component from the premium which differs from the measurement of the liability which contains the deposit component. (Barclays, 25 3024) Disaggregating the deposit component from the revenue would not reflect the amount of new business, and it would not correspond to the premium amount received in a specific period. In addition, it would result in significantly decreasing life insurance companies' revenue, influence the ranking of listed company on the global stock exchange, and shrink the market share of the insurance industry as it would be based on income. (Ping An Insurance, 25 2678)

Another disadvantage of the revenue presentation approach according to Barclays is that it would make it possible to present increasing insurance contract revenue in a period when actually no new business was written. (Barclays, 25 3024)

Therefore, the reliability and comparability of the financial reports between companies would be reduced. It would not provide useful information for management or for external users of financial reports do make decisions. Users of the reports consider premium volume (i.e. gross premium) to be the most objective measure to assess growth in the underlying business. (PartnerRe, 25 2799)

Unbundling the investment component would be very complex and costly. The general consensus is that it would pose large operational difficulties to separate investment components in the incurred claims which are reflecting the proportional amount in the deposit amount of the respective premium.

Some of the respondents did acknowledge that the revenue presentation approach was a step forward compared to the summarized margin approach presented in the Exposure Draft 2010, but it was still not meeting the requirements of faithful presentation of insurance contracts. However, there was another group of insurers who thought that the summarized margin approach was reflecting the performance of insurance companies more accurately than the revenue presentation approach. Moreover, some of them who were previously against the summarized margin approach revised their opinion. HSBC believes that the summarized margin approach would reflect the drivers of profitability of the insurance contracts based on how they expect to earn income and investment return. (HSBC, 25 2769)

Four life insurance companies, representing 17% of total comments received, disagreed with the revenue presentation approach. These companies disagreed with the same elements as the companies who strongly disagreed. In addition, Mercuries Life Insurance indicated that according to the Taiwan jurisdiction, insurance companies must announce their profit and loss by the 10<sup>th</sup> day of every month. However, under the proposed model it would be impossible for the insurance companies to meet the deadline.

The majority of the respondents were concerned that applying the revenue presentation approach will result in a completely different performance presentation than the current practice. Also, it would not reflect the essence and dynamics of insurance business, especially life insurance. Additionally, it would provide



misleading information which would make the comparison across industries and companies impossible. Therefore, commentators emphasized the importance of developing a unique recognition and measurement model for insurance companies. This model must include the investment component in order to faithfully reflect the performance of insurance companies, and the model must be extensively tested before implementation.

#### **Author's opinion**

The author believes that the financial statements should accurately reflect how insurance business is conducted and managed. Therefore, the author shares the opinion of the IASB and many life insurance companies that presenting contract revenue in the period when it is earned. This approach would faithfully reflect the dynamics of the business; otherwise, the insurance companies would be able to manipulate the revenue.

However, the author does not agree with the idea to separate the investment component from the life insurance products. This would contradict how the business is written. Secondly, this would cause accounting mismatch, because the assets must be backing the liabilities. Therefore, the author recommends including the investment components to the revenue calculation. By doing so, this would provide more accurate presentation of the performance of life insurance companies.

#### **2.4. Interest expense**

The financial statement should provide understandable, transparent, comparable, and reliable information about entity's financial condition and performance. The IASB's aim is to meet these objectives by creating accounting standards which are consistent with insurance companies' business models and reflect the way businesses are managed. Twenty five companies were asked to provide their opinion about whether the board managed to achieve the aforementioned objectives. The board wanted to know that if insurance companies segregate the effects of the

underwriting performance from the effects of the changes in the discount rates, whether this approach would provide relevant information to the users of the financial statements.

In total, 92% (23 companies) of the sample group companies provided their point of view (Figure 11.). Moreover, these companies expressed their opinion about recognizing changes of discount rates in the other comprehensive income statement. Only Shin Kong Life Insurance and Munich RE did not provide their comments. In general companies did not share one opinion related to the usefulness and applicability of this approach.

Over 40% (10 commentators in total) of respondents believe that segregating the underwriting performance from the effects of discount rates provides useful

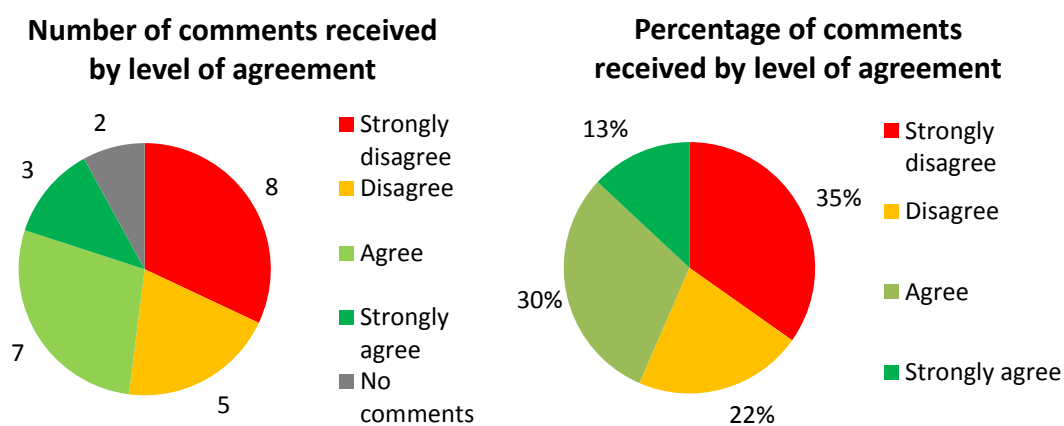


Figure 11. Interest expense recognition feedback

Source: (Author)

information to companies' management and investors. Three companies out of ten, including China Life Insurance Company, agreed with this approach completely, and they did not suggest modifications or changes. (China Life Insurance, 25 2721) The other seven companies, who mainly agreed with the proposal, had some concerns related to the methodology of segregating the performance elements and presenting these in the profit and loss and other comprehensive income statements. These

concerns matched with the concerns raised by the companies who principally did not agree with implementing the proposal as presented in the Exposure Draft 2013.

The majority of entities, representing 57% of respondents, disagreed with the proposal, and 8 companies, representing 35% of respondents, expressed their strong disagreement with the interest expense recognition approach. The four main areas of disagreement were:

- 1) accounting mismatch;
- 2) interest expense measurement and presentation;
- 3) discount rates;
- 4) complexity of implementation and increased costs.

Many companies have emphasized the difference between life insurance products and non-life insurance products, explaining that the economics of these contracts are significantly different. Allstate believes that recognizing changes in the interest rates in the other comprehensive income would be reasonable only for life insurance contracts and for non-life insurance contracts which have long-tail claims. (Allstate, 25 2804) Companies believe that it too complicated with little to no value to implement this concept for non-life insurance companies with a short settlement period.

#### **2.4.1. Accounting mismatch**

Several insurance companies expressed their concern that the IASB proposal would create a mismatch between financial assets and claims liabilities which are not related to the economics of business. Liberty pointed out that segregating the underwriting performance from the effects of changes in discount rates will reduce the usefulness of financial statements. Also, this will increase the risk that users of financial statements do not fully understand the insurers' risks. It is essential to understand that taking risks in insurance business is one of the core business components. Various risks will be divided between the performance of investment markets including the time value of money and the uncertainty of claim events. (Liberty, 25 2780) According to BNP Paribas financial assets and insurance liabilities

should be measured on a consistent basis. (BNP Paribas, 25 2871) The reason for mismatch is that currently most of the assets backing the insurance liabilities are counted on fair value basis through profit and loss. (OldMutual, 25 2862) However, the changes in the discount rates would be recognized in the other comprehensive income statement.

### **Interest expense measurement and presentation**

OldMutual is of the opinion that entities' management must measure future cash flows on a current value basis as this would reflect the effectiveness of management. They believe that the interest expense should be calculated based on the discount rate at the reporting date not the date of inception of a contract as this is in accordance with the economics of insurance business. As a result they disagree with the statement that reporting interest gains or losses in profit and loss based on the original values at the inception of the contract is a better reflection of performance than adjusting to current prevailing interest rates. (OldMutual, 25 2862) The same idea is shared by Partner RE who believes that the insurance accounting model should be based on the current value model as this reflects the present value of the cash flows which are coming from the fulfillment of insurance contracts. Another contradiction is related to recognizing the interest expense in profit and loss based on the initial discount rate at the contract inception date. According to the model's concept, the changes in profit and loss should be presented based on the fair value, and should not be presented based on the amortized cost basis. (PartnerRe, 25 2799)

### **Discount rates**

The IASB proposes in the Exposure Draft 2013 that the insurance companies should recognize the difference between the discount rates at the inception and reporting date. This means that throughout the duration of an insurance contract, insurance companies must monitor at least two discount rates. (AIG, 25 2746) For life insurance contracts, this monitoring could last several decades. The first discount rate is measured at the inception of the insurance contract, and this discount rate does not change over time. The second discount rate does change over time as it depends on

future reporting dates. The requirement to monitor two different discount rates would significantly increase complexity in the models.

#### **2.4.2. Complexity of implementation and increase costs**

Companies shared the opinion that implementing the proposed changes will be extremely complicated. As an example RSA indicated that some outstanding claims may relate to policies written more than eight years ago. The problem with measuring older contracts is that, at the time, there were no investments available. Therefore the companies must estimate the discount rates. (RSA, 25 2947)

Monitoring two discount rates will require modifying and enhancing the information technology systems and processes in order to capture the required information. Suncorp Group is of the opinion that the cost of implementing the change outweighs the benefit. (Suncorp, 25 2654)

As a response to the aforementioned disadvantages of the proposed methodology, the commentators have widely recommended making it optional to use the other comprehensive income approach. Among others, this opinion was shared by Barclays and Credit Agricole. (Barclays, 25 3024; Credit Agricole, 25 2913) AIA also indicated that this approach could be suitable if it would be optional by portfolio as this would reduce the volatility and accounting mismatches (AIA, 25 3002).

#### **2.4.3. Author's opinion**

The author believes that the primary purpose of the financial statements is to provide truthful and useful information about a company's performance to management and investors. However, the proposed method of segregating the underwriting performance from the effects of changes in discount rates did not meet this purpose. Due to the nature of insurance business, the risks related to the changes in discount rates should be recognized in the profit and loss, and should not be recognized in the other comprehensive income statement. In addition, the interest expense should not be recognized on the cost value. Instead, the interest expense should be recognized at the current value at the reporting date as this shows

management’s operational effectiveness. Also, the author believes that if the IASB decides to proceed with the current proposal, then the expected costs of implementing the changes will heavily outweigh the resulting benefits. The author’s recommendation to the board is to review the comments received, and implement the changes by recognizing the changes in the discount rates in the profit and loss statement, or by making it optional to recognize the changes in the other comprehensive income.

## 2.5. Transition

The question about comparability and verifiability of financial statements had the highest response activity from the sample group of insurance companies. The response rate on this topic was 96% of all the commentators (Figure 12.). Only

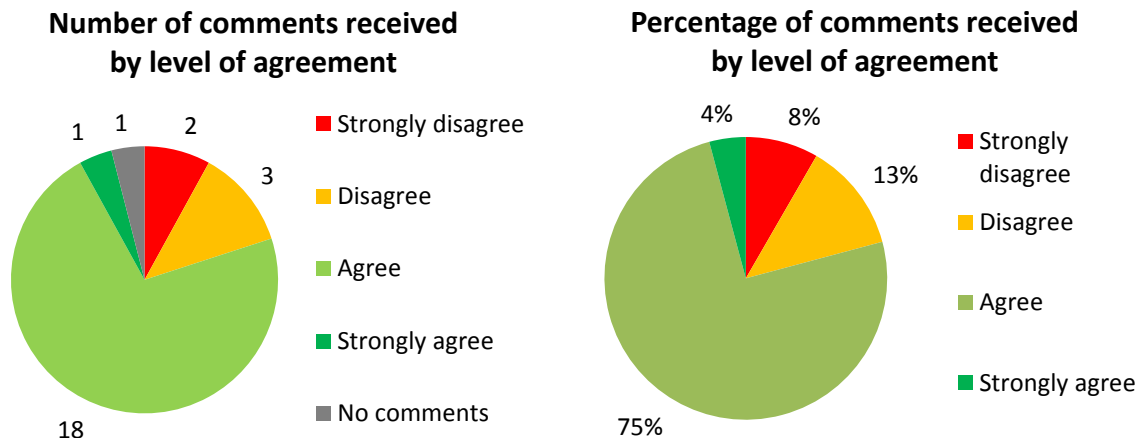


Figure 12. Transition feedback

Source: (Author)

MunichRe representing 4% of total respondents did not provide their comment. In 79% of respondents, commentators confirmed that the proposed approach in the Exposure Draft 2013 was a significant improvement compared to the Exposure Draft

2010. The insurance companies were pleased that the contractual service margin was introduced in the transition approach including a simplified transition method. In general, companies believe that implementing the new standard will come with a significant cost. Fortunately, the insurance companies also believe the benefits will outweigh these costs. Despite the expected long term benefits, companies remain concerned about the short term implementation costs. These items are further described in the following paragraphs.

Approximately 21% of all the respondents did not agree with the suggested approach. Four companies out of five were from Asia. Therefore, their disagreements were mainly related to the limitations of local jurisdictions. The specific concerns were: recognizing the historical discount rate, estimating the contractual service margin, aligning the IFRS 4 with the IFRS 9, and the proposed implementation period.

#### **2.5.1. Historical discount rates**

Even though the IASB proposed a simplified approach for implementing the new standard, some life insurance companies, especially from Taiwan, expressed their concern that implementing the simplified approach would be impossible. Shin Kong Life indicated that in Taiwan the long-term insurance contracts have prevailed in the market; therefore, the coverage period could be as long as 40 years or longer. It would be almost impossible to apply the modified retrospective approach to these contracts due to the lack of historical information about the yield curves, as the bond market had not developed. (Shin Kong Life, 25 2903) The same concern was shared by Old Mutual from South Africa, they mentioned that the historic cash flows information will be available only up to 10 years. Moreover, the information would not be at the level of detail needed to calculate the retrospective contractual service margins for portfolios. (OldMutual, 25 2862) Commentators pointed out that the current information technology systems were not collecting data with the necessary granularity to implement the proposal. Some insurance companies, including Liberty specified that their information technology systems were built with a fully prospective

valuation in mind, and thus do not store all the information required for a retrospective application. Therefore, they believe that they will not be able to provide the historical cash flows for some long term insurance contracts at the level of granularity that will be required to calculate retrospective contractual service margins for portfolios. (Liberty, 25 2780) In addition, RSA drew the board's attention to the need for additional guidance to determine the appropriate yield curves to apply for currencies that no longer exist (e.g. Estonian kroon which was replaced with Euro). (RSA, 25 2947)

### **2.5.2. Contractual service margin estimation**

Several life insurance companies indicated that they do not agree with the approach to calculate the contractual service margin on the portfolio level as described in the Exposure Draft 2013. The proposal indicates that the portfolio must be created with insurance contracts with the following criteria: contracts provide similar coverage for similar risks, contracts priced similarly relative to the risk taken, and contracts are managed together as a single pool. (IASB, Exposure Draft) CNA and AIA both indicated that they disagree with the board's proposal to determine the contractual service margin at transition in accordance with the proposed definition of portfolio. One of the main reasons is that the historical data and experience is not consistently maintained at the level with the new portfolio definitions. Instead this information is maintained in the same manner which insurance companies have historically managed their businesses. (AIA, 25 3002) Moreover, it would be complicated to meet the requirement to regroup contracts at transition based on reasonably available objective information which is needed to determine the margin at transition. Therefore, the insurers should be allowed to use the information as currently tracked to determine the estimate of the contractual service margin of the portfolios prior to the transition date. In this case, the insurance contracts written prior to the transition date may be grouped into separate portfolios from contracts written or substantially modified after the transition date. Insurance companies will make this determination depending on if the portfolio differs from what the portfolio would be



under this proposed guidance. (CNA, 25 2788) Using the existing portfolio definition is considered a more appropriate approach as it will allow the use of historical information to establish the opening contractual service margin balance. This approach avoids the need to convert the data into the new portfolio definition before it's actually been used.

Fubon, believes the current proposal would be very complicated to implement, so they suggested an alternative. Their idea is to calculate the contractual service margin as the difference between the carry amount and the present value of fulfillment cash flows at the transition date. (Fubon Life, 25 2868) Some entities indicated that the current proposal was unclear to them, and that they would like to see some examples in the final version of the IFRS 4.

### **2.5.3. Aligning standards**

More than half of the respondents emphasized the importance of aligning the effective dates of the IFRS 4 with the IFRS 9. According to Sun Life Financial of Canada, the effective dates of those standards must be aligned for life insurance contracts as asset liability management is fundamental for the life insurance business model. (Sun Life Financial, 25 2766) Also, as the proposed standard presents a comprehensive change to insurance contract accounting, an insurer may review its asset-liability management strategy upon adoption, taking into consideration potential accounting mismatch with the IFRS 9. (AIA, 25 3002) If the effective dates of the standards are not aligned, this could cause three significant risks:

- 1) the information provided in different financial statements will be incoherent, and this will confuse the users of the financial statement;
- 2) requirement to produce two sets of retrospectively adjusted results within a short time frame; (Prudential, 25 2937)
- 3) result in reporting two significant changes (one on each side of its balance sheet) in different accounting periods. (RSA, 25 2947)

Ping An recommends synchronizing the standards in order to avoid the possible mismatch that could occur from the time difference between the forced effective date

of the new standards of financial instruments. If these standards are not aligned, it will significantly increase insurance companies' implementation costs. (Ping An Insurance, 25 2678)

All the companies agreed that the proposed standard is a significant change from current accounting practices. Therefore, they believe that an extended implementation period would be required. Most companies agree that the proposed 3 year period for implementation is achievable – beginning 3 years from the publication date. However, they did mention that the timeframe for implementation is very tight. Only Partner RE proposed that they would need at least eight years to implement the standard, since the publication date. According to their calculations they need: Three years to assess, plan and execute the reconfiguration of information systems. The process would include identifying and capturing additional and new data requirements, changing systems, setting new policies, and resolving implementation issues and testing systems for accuracy; Afterwards, and additional five years to prepare, analyze, educate, and understand the impacts of all of the changes in the accounting (PartnerRe, 25 2799).

#### **2.5.4. Author's opinion**

The author is of the opinion that most of all, the financial reports must faithfully present insurance companies performance and financial health. Also, it is important that the financial reports would be comparable between companies, and preferably also between industries. Therefore, the author agrees with the retrospective approach to determine the amount of contractual service margin and the accumulated amount in the other comprehensive income caused by the changes in the discount rate since the inception of insurance contract. In cases when applying the retrospective approach is impractical, the author agreed with the IASB's decision to suggest a simplified approach. However, there is a need to further clarify implementing the standard when there is no historic information about the yield curve or if the currency has changed.

As mentioned before, the author shared the opinion that the contractual service margin should be calculated based on the current portfolio structure for the contracts written before the transition date as this reflects the economics of the business. The author is concerned that if the board will not align the IFRS 4 with the IFRS 9 this will cause accounting mismatches and significantly more work for the insurance companies. The author strongly believes that the IASB should address this issue, and find a solution before publishing the final standard.

The author shares the opinion, that three years, beginning from the date of publication, is a sufficient time to implement the new standard. However, this time period is sufficient only if it is supported with extensive testing prior to implementation. The results of the tests must be presented to insurance companies with further clarification on how to overcome the implementation challenges discovered during the testing.

## 2.6. Effects of Standard

Due to the unique nature of the insurance industry, several companies emphasize the usefulness of having a dedicated accounting board that can focus on creating standards which are internationally applicable for all types of insurance products. This would provide comparability across the insurance industry.

The majority of life insurance companies (Figure 13.) in the sample provided

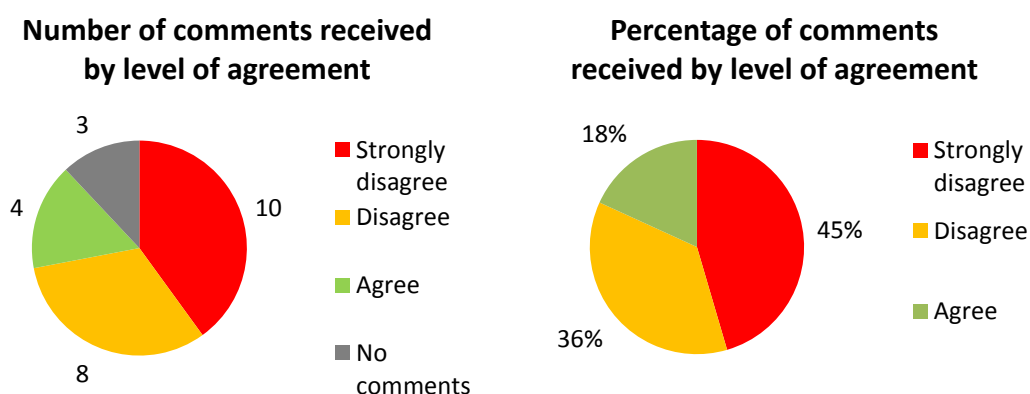


Figure 13. Effects of implementing the Exposure Draft 2013 feedback

Source: (Author)

their feedback (Figure 13.) about the effects of applying the revised Exposure Draft 2013. Over 80% were concerned that implementing the proposal as it was introduced will cause a significant financial burden to insurance companies and to the users of financial statements. Moreover, they emphasized that the related costs will heavily outweigh the expected benefits.

In addition, they specified that in some cases, implementing the draft will reduce the transparency and comparability of the statements. The most common concern related to transparency was the economic mismatch caused by not presenting the information in the same way that the insurance business is conducted and managed.

Four companies, representing almost 20% of all the respondents, think that the proposal is generally useful; however, they do not believe it will fulfill its primary objectives of providing transparency and comparability of the financial statements. They also indicated that implementation will require extensive resources in time and money.

### **2.6.1. Transparency and comparability**

The proposed approach suggests reflecting the present value of the following three financial measures: expected future cash flows, risk adjustment, and residual margin. Some companies, including HSBC, agree that this approach will provide significant insight regarding company performance. These companies do believe that the IASB fulfills their objective in achieving transparency. (HSBC, 25 2769) However, there were many more companies that expressed concerns that applying the Exposure Draft 2013 will reduce the transparency and comparability of financial statements. AIG and Metlife indicated that insurance companies in different countries apply different subjective judgments and methodologies to identify cash flows, discount rates, and calculate acquisition costs. (AIG, 25 2746; MetLife, 25 2807) As a result it creates discrepancy and reduces comparability of the performance figures presented by insurance entities in the financial statements. (Prudential, 25 2937) As an example Ping An highlighted that acquisition costs are measured differently in

different parts of the world. Therefore, they suggested that the IASB define an updated standard on how to measure acquisition costs and other items which could be calculated differently due to local regulations. (Ping An Insurance, 25 2678)

Credit Agricole and Allstate expressed their concern that the proposed Exposure Draft 2013 does not consider the unique characteristics of different types of insurance products; these companies believe that the IASB is taking an overly unified approach for all insurance lines. (Allstate, 25 2804; Credit Agricole, 25 2913) For example, this would cause an economic mismatch as the proposal would not reflect how the life insurance business is conducted and managed. (Credit Agricole, 25 2913) In addition, AIA indicated that the proposal is applicable only for certain insurance products. Therefore, this would not provide the expected transparency throughout the industry and throughout all insurance products. (AIA, 25 3002) Another opinion related to economic mismatch was expressed by OldMutual. They believe it is not economically justified to separately present the impact of discount rate changes from the other insurance liability movements, and presenting these changes separately will not provide the required transparency. (OldMutual, 25 2862)

Several life insurance companies disagreed that the Exposure Draft 2013 would provide a faithful presentation of insurance companies' financial performance due to the lack of clarity of the risk adjustment methodology. This view was shared by Massachusetts Mutual Life Insurance as they believe it will result in reduced reliability and understandability of the financial statements. In addition, they believe that the earned earnings approach does not provide transparency of the financial statements as the model is in contradiction with the economics of the business. According to the proposed approach, the earned premium represents the combination of acquisition costs, benefits, and expenses instead of real earnings of the insurers. (Massachusetts Mutual Life Insurance, 25 2995) Barclays did acknowledge that the proposed way to measure revenue and expenses does not align with the current structure of how the business is managed.

### **2.6.2. Costs and benefits**

The majority of the respondents indicated that implementing the changes proposed in the Exposure Draft 2013 will cause significant costs to the insurance companies and to the users of financial statements. The entities confirmed that there will be two different kinds of costs. Firstly, the costs associated with the first time implementation of the proposed standard. These costs are considered to be onetime costs and will be mainly related to developing the data systems and educating internal and external preparers and users of the financial statements. Secondly there will be costs related to ongoing operations.

Most of the companies indicated that the highest expenses will be caused by developing and replacing the existing accounting and actuarial systems. The current systems are only providing claims handling functions and measuring the insurance contracts. The proposed requirements represent significant changes to the systems which will have to support the following functions: modeling of the unlocked contractual service margin, changing future cash flows across periods, and changes to discount rates across periods. (Massachusetts Mutual Life Insurance, 25 2995) SunCorp expressed their concern that the proposed approach to calculate interest expense based on the discount rates at the inception of insurance contract will cause significant, unnecessary costs. Therefore, they believe that the costs will outweigh the expected benefits. (Suncorp, 25 2654)

The proposed Exposure Draft 2013 would cause significant changes in the accounting practice compared to the existing practice. Therefore, it is considered that the second biggest cause of costs will be related to educating the preparers and users of financial statements. The trainings will be provided to employees (e.g. accountants and actuaries) and the management of insurance companies. In addition, insurance companies would also have to educate the external users of financial statements (e.g. investors and auditors).

The biggest ongoing expense is considered to be the costs for maintaining the data systems. OldMutual is of the opinion that implementing and maintaining the proposed contractual service model will be very costly, but they believe that the

benefits of the implementation will justify the investments in long run. (OldMutual, 25 2862)

Due to the increased granularity and complexity of financial reporting, the insurance companies will be forced to hire new employees. As a result, CNA indicated that in order to meet the requirements stated in the proposed standard, they have to increase the number of actuaries significantly (CNA, 25 2788). Also, other companies mentioned that they would have to hire additional accountants and IT engineers to manage the data systems.

### **2.6.3. Author's opinion**

The author shares the opinion with the IASB and life insurance companies that implementing universal financial reporting standards would increase the transparency and comparability between companies. The author believes that the highest purpose of the financial statements must be to provide faithful and accurate information about a company's performance. As mentioned in the previous sections, the author does not agree that the proposed changes in the Exposure Draft 2013 take into account the differences between different insurance products and local practices. As an example the IASB proposed measuring life insurance contracts based on the discount rate at the inception. Some countries, like Taiwan, do not have this information. Also, the board leaves freedom to decide which methodologies insurance entities could apply to measure cash flows. In practice, this would lead to situations where companies are applying different methodologies which will result in significantly different figures even for similar contracts. Due to these reasons, the author does not believe that the revised Exposure Draft 2013 would provide transparency and comparability across industries and not even among insurance companies.

As specified above, the author does not believe that the IASB would meet the objectives they aimed to achieve by implementing the draft. Therefore, the author is on the opinion that the costs related to implementing the changes significantly outweigh the expected benefits. The author suggests the IASB prepare the standard based on the economics of the insurance industry product lines.

## 2.7. Clarity of proposal

The majority (76%) of the respondent group provided their opinion related to clarity of the Exposure Draft 2013 (Figure 14.). All of the 19 insurance companies

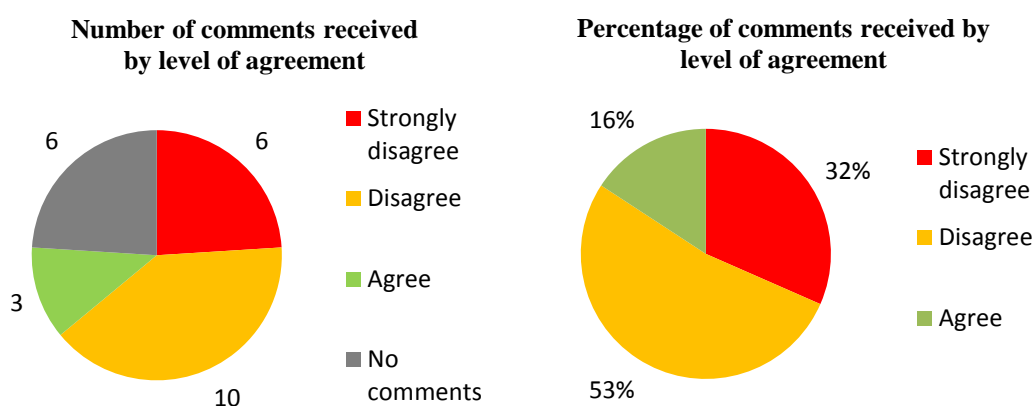


Figure 14. Clarity of Exposure Draft 2013 wording feedback

Source: (Author)

believe, to some degree, that the draft needs additional clarifications in order to achieve consistent application and comparability of the financial statements. This is necessary for the users of financial statements to be able to make appropriate decisions. Sixteen out of nineteen commentators expressed their disagreement about the clarity of the proposal. They indicated that the examples provided in the draft are too simplified and do not represent real life situations experience in the industry. In practice, leaving companies the option to apply different approaches during implementation will lead to many subjective judgments.

Therefore, the life insurance entities recommended the IASB to incorporate additional guidance and illustrative examples of how to implement the Exposure Draft 2013. This would help to achieve consistency in interpretation and application of the standard in the future



### Author's opinion

The author shared the opinion of life insurance companies that the IASB should clarify some of the proposed approaches (e.g. measuring the contractual service margin, decomposing cash flows for mirroring purposes, and applying the Premium Allocation Approach). In order to achieve consistency, it would be useful to those preparing financial statements if the board would provide illustrative example which are reflecting real life situation.

## 2.8. General summary of analysis

The IASB aimed to increase transparency and to reduce diversity in the accounting for insurance contracts by issuing the revised Exposure Draft 2013. The draft was open for a public discussion, where the board invited prepares and users of insurance company's financial statements to provide their feedback about the proposed changes. As a result the IASB received 196 comment letters where the author analyzed the feedback provided by 25 life insurance companies, representing 13% of total respondents. The general opinion of the proposed changes is divided into two similar sized categories (Figure 15). The respondent rather agreed with some

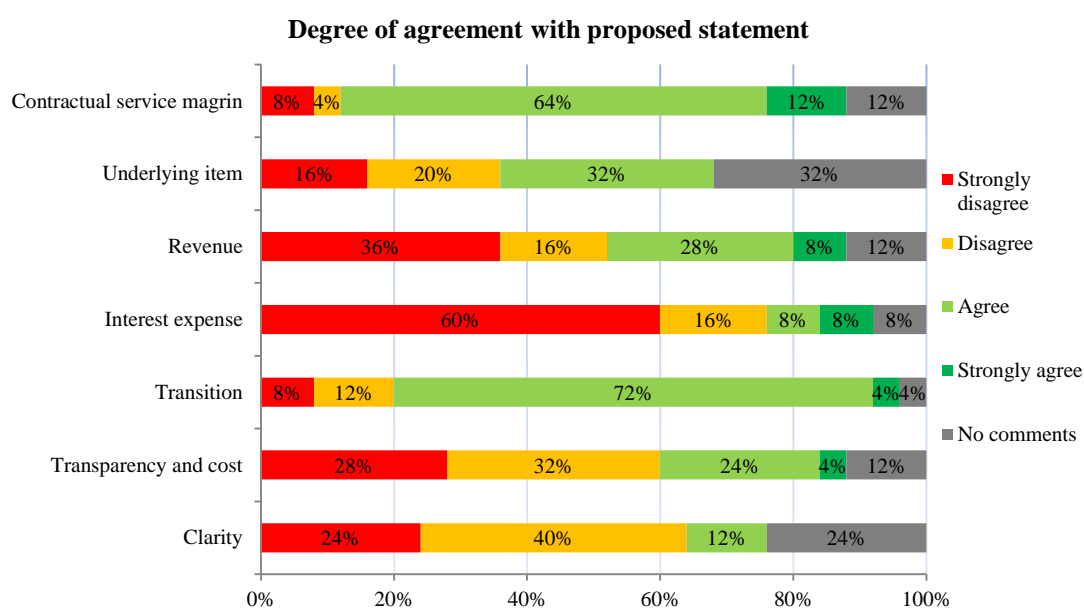


Figure 15. Degree of agreement with Exposure Draft 2013 proposed changes feedback  
Source: (Author)

proposed changes and for some other proposals they disagreed. In total, 52% of the responses agree with the proposed changes and 48% disagree. The group who agrees with the proposed changes, they only agree if the standard will be further clarified and simplified. The ones that disagree believe that the proposed changes are not sufficient to be implemented in the way these were presented. Also the majority of the respondents do not agree that proposed changes will increase the transparency of financial reporting. In addition it is a widely shared opinion that the expected cost related to implementing the changes will outweigh the expected benefits. Therefore, the author recommends to the IASB consider the alternatives proposed in the master's thesis before issuing the final version of the standard.

## **CONCLUSION**

Everyone is exposed to different kinds of risks. When risks become reality, the impact can significantly reduce the capabilities and assets of people and companies. In order to minimize risk, people and businesses obtain insurance policies which provide coverage for insured event.

The policies are issued by insurance companies which have an obligation to demonstrate and report their financial performance. Currently there is no one universal financial reporting standard. To address the lack of consistency, the IASB has worked on developing a standard for over a decade. At the moment, the IASB is reviewing the feedback they received from preparers and users of financial reports to their latest Exposure Draft 2013. After considering the comments, and revising the draft, the board will issue the final standard.

All insurance companies will be impacted by these changes. Not all insurance companies operate in the same countries, nor do they have the same business objectives due to varying types of insurances offered. As the proposed changes impact life insurance companies the most, the author chose to focus on these companies. The purpose of the master's thesis was to obtain the point of view of life insurance companies about the proposed changes in the Exposure Draft 2013 and to provide improvement recommendations. The author analyzed and evaluated the feedback provided by 25 life insurance companies which were selected based on the relevance of the feedback they provided. The author analyzed the opinion of the life insurance companies to all five proposed changes. In addition, the author analyzed the comments to identify whether applying the changes will make financial reporting more transparent, and whether the expected benefits will exceed the costs.

The author applied the Likert's scale to evaluate life insurance companies' level of agreement with the proposed changes. The scale was divided into four opinions where on one side of the scale the insurance companies *strongly agreed* with the proposal and on the other side *strongly disagreed*. Not all companies provided comments for all questions, and the author incorporated a fifth category, *no comments*, to account for the unanswered questions.

The author is of the opinion that the financial statements must faithfully present the insurance company's performance. The accounting method must be able to illustrate how the life insurance business is conducted and managed, and this reporting should not be compromised by implementing accounting methods used in different industries.

The author, the IASB, and the majority of respondents did agree with the proposed approach to implement contractual service margin, and to reflect the changes in the future expected cash flows over the remaining period for non-life insurance products. However, due to the length of life insurance contracts, it would be impractical to measure future expected cash flows throughout the life of the contract, and it is recommended to recognize the changes in the profit and loss in the current period.

The IASB's idea to show the link between returns and the underlying items was widely rejected. The author does not agree with the idea of decomposing life insurance contracts cash flows based on the link between returns and underlying items as insurance contracts were conducted as a bundle of rights and obligations. Moreover, in some countries it was not required to specify the link between the underlying items. Therefore, it is recommended not to decompose these cash flows and to apply the Building Block Approach to measure the cash flows.

Also, the majority of commentators disagreed with decomposing investment component from the insurance contract revenue. The investment component is an essential part of insurance contracts, and it is taken into account in the pricing of a contract. Therefore, author recommended keeping the investment component in the revenue calculation.

The IASB proposed segregating the underwriting performance from the effects of changes in discount rates did not meet this purpose. Due to the nature of insurance business, the risks related to the changes in discount rates should be recognized in the profit and loss. Therefore, the author believes that if the IASB decides to proceed with the current proposal, then the expected costs of implementing the changes will heavily outweigh the resulting benefits. The author recommended recognizing the changes in the discount rates in the profit and loss statement, or by making it optional to recognize the changes in the other comprehensive income.

According to the proposed changes, the insurance companies are required to apply the standard as if it had always been in place. There are two methods to apply the standard: retrospective or simplified standard. Both approaches will provide comparability of the financial reports before and after the transition. Even though, the majority of the companies agreed with the proposal, further simplifications are needed for measuring historical cash flows for life insurance contracts which may have been written 40 years ago.

The proposed standard allows the freedom to use subjective measurement options which could cause different results for similar contracts. As a result, commentators expressed their concern that, in some cases, applying the proposed changes could reduce the comparability across the insurance industry. Also, the costs associated with implementing the changes will significantly outweigh the expected benefits.

The author proved the first hypothesis that the life insurance companies believe that the changes proposed in the Exposure Draft 2013 are irrational and not practical to be implemented as currently proposed. Also the second hypothesis was proved that the costs associated with implementing the proposed standard will outweigh the expected benefits.

Therefore, it is strongly recommended that the IASB revise the proposed changes in the Exposure Draft 2013 based on the recommended alternatives suggested by the author and life insurance companies before issuing the final standard.

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# RESÜMEE

## RAHVUSHAVELISE FINANTARUANDLUSSTANDARDI 4 MUUDATUSPROJEKT

Annika Härma

Kõiki inimesi ja ettevõtteid ümbritsevad riskid ja neid riske on erinevat liiki. Inimesi ohustavad riskid on seotud inimese tervise ja varaga ning ettevõtteid ohustavad riskid on seotud firma vara, protsesside ja töötajatega. Riskide realiseerumine võib kaasa tuua olulise kahju. Eesmärgiga vähendada või vältida riski realiseerumisest tulenevaid tagajärgi, omavad inimesed ja ettevõtted kindlustuskaitset ehk kindlustuslepingut. Kindlustuslepingu kohaselt hüvitab kindlustusettevõtte kindlustusjuhtumi kahjud kindlustuse omanikule.

Kõik kindlustusettevõtted peavad esitama finantsaruandeid. Täna on päeval ei ole aga ühtset rahvusvaheliselt tunnustatud toimivat finantsaruandlusstandardit ja seetõttu loodi 2001. aastal *International Accounting Standard Board* (IASB), mille ülesandeks on välja töötada rahvusvaheline finantsaruandlusstandard. 2004. aastal andis IASB välja ajutise standardi, millele järgnes lõpliku standardi kavandi (Exposure Draft 2010) välja andmine 2010. aastal. IASB ootas väljastatud kavandi kohta tagasisidet kindlustusettevõtetest, kes peavad tulevikus seda standardit rakendama, ja finantsaruannete kasutajatelt. Saadud tagasiside põhjal koostas IASB muudatus-ettepanekud (Exposure Draft 2013), mis esitati avalikkusele 2013. aasta suvel. Kuna neid muudatusettepanekuid ei ole põhjalikult testitud, soovis IASB ka seekord saada tagasisidet finantsaruannete koostajatelt ja kasutajatelt.

Magistritöö eesmärk on välja selgitada elukindlustusettevõtete arvamus tehtud muudatusettepanekute kohta ning selle põhjal välja pakkuda parendusettepanekuid. Autor koostas magistritöö „Rahvusvahelise finantsaruandlusstandard 4 muudatusprojekt“. Antud magistritöös seadis autor kaks hüpoteesi. Esimese hüpoteesi kohaselt

usuvad elukindlustusettevõtted, et välja pakutud muudatusettepanekud on antud kujul rakendamiseks irratsionaalsed ja ebapraktilised. Teine hüpotees väidab, et standardi rakendamisega seotud kulud ületavad rakendamisest saadavad eeldatavad tulud.

Antud magistritöö esimeses osas annab autor ülevaate standardi kavandis tehtud muudatusettepanekutest. Standardi kavandis esitati viis põhilist muudatust. Esimese muudatusettepaneku kohaselt tuleb kajastada muutus praeguse ja eelmise prognoositud rahavoogude vahe tulevaste perioodide kasumis (kasum mis tekib tulevikus lepingu järgsete teenuste pakkumise eest; *contractual service margin*). Tulevaste perioodide kasum ei saa olla negatiivne. Rahavood, mille teke ei ole seotud tulevaste teenuste pakkumisega, kajastatakse sama perioodi kasumiaruandes.

Teise muudatusettepaneku kohaselt tuleb rahavood eraldada sõltuvalt alusvarast (*underlying item*). See ettepanek kehtib ainult ettevõtete puhul, mis on kohustatud näitama ühendust alusvara ja sellest saadava tulu väljamakse kohustust kindlustusvõtjale. Sellisel juhul tuleb mõõta rahavooge, mis sõltuvad otseselt alusvara bilansilisest väärtusest või rahavooge, mis sõltuvad sellest kaudselt. Lisaks sellele tuleb kajastada muutusi rahavoogudes, sõltuvalt seoses alusvaraga. Juhul kui rahavood sõltuvad otseselt alusvarast või ei sõltu üldse, siis nende muutused tuleb kajastada kasumiaruandes või koondkasumiaruandes. Muutused rahavoogudes, mis sõltuvad kaudselt alusvarast, tuleb kajastada kasumiaruandes.

Kolmanda ettepaneku kohaselt tuleb esitada kõikide kindlustuslepingute tulu ja kulu, mitte nende muutused. Sellele lisaks tuleb kindlustusettevõtetal jagada tulu kaheks: tulu, mis on teenitud kindlustusettevõtte põhitegevusena ning tulu, mis on teenitud investeerimis-tegevusena ja mis makstakse kindlustusvõtjale edasi.

Neljandas muudatusettepanekus käsitleb IASB intressikulu kajastamist. Sellekohaselt peab ettevõtte eraldama põhitegevuse tulemusest diskontomäära muutuste mõju. Selleks tuleb intressikulu kajastada kasumiaruandes lepingu jõustumispäeva seisuga. Firmad on kohustatud uuendama nende rahavoogude diskontomäärasid, mis otseselt sõltuvad alusvarast. Kindlustuslepingu bilansilise väärtuse vahe aruandlusperioodil, võrreldes väärtusega lepingu jõustumise hetkel, tuleb kajastada koondkasumiaruandes.

Viimane sisuline muudatusettepanek on seotud standardi rakendamisega. IASB tegi ettepaneku rakendada uut standardit tagasiulatuvalt, et oleks võimalik võrrelda käesolevat perioodi eelmiste perioodidega.

Lisaks eelpool mainitud muudatusettepanekutele, soovis IASB teada saada, kas Exposure Draft 2013 rakendamine toob kaasa finantsaruannete arusaadavuse ja võrreldavuse, ning millised on eeldatavad rakendamiskulud. Täiendavalt oodati tagasisidet standardi selguse kohta.

Kuna muudatusettepanekud mõjutavad kõige rohkem elukindlustusettevõtteid, siis magistritöö teises osas analüüsib autor 25 elukindlustusettevõtte arvamust. Arvamuste analüüsimiseks rakendab autor *Likert*-i skaalat, kus elukindlustusettevõtete arvamused jaotuvad vastavalt: *täielikult nõustub, pigem nõustub, pigem ei nõustu, üldse ei nõustu*. Kuna osad ettevõtted ei vastanud kõikidele küsimustele, siis autor lisas täiendava kategooria: *kommentaari puudub*. Saadud tulemuste põhjal esitab magistritöö autor parandusettepanekud.

88% vastanutest oli nõus, et praeguse ja eelmise prognoositud rahavoogude vahe kajastamine tulevaste perioodide kasumis, võimaldab paremini võrrelda kindlustusettevõtete finantsaruandeid. Ollakse ka nõus, et tulevaste perioodide kasum ei saa olla negatiivne. Rahavood, mille teke ei ole seotud tulevaste teenuste pakkumisega, kajastatakse sama perioodi kasumiaruandes. Selle lähenemise rakendamise puhul tõstatati järgmised probleemid: rahavoogude hindamismeetod ei ole selge, riski täpsustust ja diskontomäära hinnatakse erinevalt ning ebapraktiline on arvutada tulevaste perioodide rahavooge elukindlustuslepingutele. Seetõttu soovib autor IASB-l täpsustada rahavoogude mõõtmise meetodikat, kasutada ühte diskontomäära ning pikkade elukindlustuslepingute puhul tuleb rahavoogude vahe kajastada kasumiaruandes.

Suurem enamus (72%) oli vastu rahavoogude eraldi kajastamisele sõltuvalt alusvarast. Peamised vastuolud olid tingitud vähesest arusaamast, kuidas eraldada rahavooge, üldisest vastuolust, eraldada rahavood, mis ei ole otseselt seotud alusvaraga, kuna tegemist on kindlustuslepingu kui tervikuga ning väga kõrgete meetodi rakendamise kuludega. Seetõttu autor soovib IASB-s kasutada rahavoogude

eraldamise meetodikat ning rakendada rahavoogude mõõtmiseks standard meetodit (*building block approach*). See lihtsustaks finantsaruannete koostamist, suurendaks võrreldavust ja vähendaks oluliselt selleks tehtavaid kulutusi.

Enamus elukindlustusettevõtteid oli täiesti vastu tulu kajastamisele, kust eemaldatakse tulu, mis saadakse investeerimistegevust. Peamine vastuoluallikas on investeerimiskomponendi eemaldamise puhul see, et lepingulised tulud ja kohustused ei ole enam tasakaalus ning see on vastuolus kindlustussektori dünaamikaga. Lisaks sellele, ei oleks osades riikides võimalik seda igakuisele aruandluskohustusele rakendada. Seetõttu soovib autor arvestada investeerimiskomponendist saadav tulu kogutulu sisse, see vähendab aruandluse keerukust ning vähendab rakendamisega seotud kulusid.

IASB eesmärk, eraldada ettevõtte põhitegevuse tulemusest diskontomäära muutuste mõju, jääb paljudele arusaamatuks. Selle muudatusettepaneku rakendamine läheks osade elukindlustusettevõtete arvates vastuollu kindlustussektori praktikaga ning põhjustaks ebarealistlikku finantsolukorra kajastamist. See omakorda vahendab finantsaruannete võrreldavust teiste sektorite aruannetega. Lisaks nõuaks see kahe diskontomäära jälgimist, mis oleks väga kulukas. Autor soovib IASB-l rakendada ainult aruandluspäeva diskontomäära ning kajastada seda kulude kasumiaruandes või teha kahe diskontomäära rakendamine ja diskontomäära muutuste vahe kajastamine koondkasumiaruandes valikuliseks.

Enamust vastanutest (79%) olid nõus finantstulemuste tagasiulatava esitamisega, kuna see tõstab finantsaruannete arusaadavust ja võrreldavust erinevate äri sektorite vahel. Enamus elukindlustusettevõtteid, kes selle muudatuse vastu olid, asuvad Aasiast. Nende vastuolek oli tingitud nõudest kasutada diskontomäära. Kuna Aasias on riike, kus pole aastakümnete pikkust diskontomäära, siis seetõttu neil ei ole võimalik seda rakendada. Autor soovib siinkohal kehtestada üldine diskontomäär, mida kõik rakendavad või keskmine diskontomäär ainult nendele riikidele, kellel see informatsioon puudub.

Üldiselt olid elukindlustusettevõtted arvamusel, et tehtud muudatusettepanekud on suuremas osas head, kuid siiski vajavad täiendavaid

täpsustusi ja lihtsustusi. Magistritööst selgus, et elukindlustusettevõtted olid arvamusel, et tehtud muudatusettepanekute rakendamine sellisel kujul, nagu need on Exposure Draft 2013 esitatud, on irratsionaalsed ning ebapraktilised. Lisaks kaasneksid nende rakendamisega suured kulutused, mis ületaksid eeldatava tulu. Seetõttu soovib magistritöö autor IASB-l rakendada eelpool soovitatud parendusettepanekuid enne lõpliku standardi kehtestamist.

## APPENDIXES

### Appendix 1 List of companies

No.	Name	Country
1	AIA	World
2	Allstate	US
3	AIG	World
4	Barclays	World
5	BNP Paribas	World
6	Cathay Life Insurance	Asia
7	China Life Insurance	China
8	CN A	World
9	Credit Agricole	World
10	Fubon Life	Asia
11	HSBC	World
12	Liberty	World
13	Massachusetts Mutual Life Insurance	USA
14	Mercuries Life Insurance	Taiwan
15	MetLife	World
16	MunichRE	World
17	OldMutual	World
18	PartnerRe	World
19	Ping An Insurance	China
20	Prudential	World
21	RSA	World
22	Shin Kong Life	Taiwan
23	Sun Life Financial	US, EU, Asia
24	Suncorp	AU/NZ
25	Unum	US/UK

## Appendix 2 Evaluation matrix

Name	Contractual service margin					Underlying items					Revenue					Interest expense					Transition					Transparency & cost					Clarity				
	Strongly disagree	Disagree	Agree	Strongly agree	No comments	Strongly disagree	Disagree	Agree	Strongly agree	No comments	Strongly disagree	Disagree	Agree	Strongly agree	No comments	Strongly disagree	Disagree	Agree	Strongly agree	No comments	Strongly disagree	Disagree	Agree	Strongly agree	No comments	Strongly disagree	Disagree	Agree	Strongly agree	No comments					
AIA			x					x			x							x														x			
Allstate			x																													x			
AIG			x																													x			
Barclays			x						x																							x			
BNP Paribas			x			x																										x			
Cathay Life Insurance			x					x																								x			
China Life Insurance					x																											x			
CN A	x							x																								x			
Credit Agricole			x					x																								x			
Fubon Life					x																											x			
HSBC			x			x																										x			
Liberty			x						x																							x			
Massachusetts Mutual Life Insurance			x					x																								x			
Mercuries Life Insurance			x						x																							x			
MetLife			x			x																										x			
MunichRE			x																													x			
OldMutual			x						x																							x			
PartnerRe					x																											x			
Ping An Insurance			x						x																							x			
Prudential			x			x																										x			
RSA					x																											x			
Shin Kong Life					x																											x			
Sun Life Financial	x					x																										x			
Suncorp			x																													x			
Unum					x																											x			
Total count	2	1	16	3	3	6	7	5	0	7	15	4	2	2	2	8	5	7	3	2	2	3	18	1	1	10	8	4	0	3	6	10	3	0	6