Insurance

The future of insurance reporting

PricewaterhouseCoopers' views on the latest IASB and FASB proposals

December 2007

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01 Introduction

'The primary focus of financial reporting is to meet the needs of current and potential capital market investors and lenders. Consequently any proposed accounting solution should be assessed against that benchmark.'

From PricewaterhouseCoopers' response to IASB discussion paper

This paper summarises PricewaterhouseCoopers'[1] comment letter on the latest proposals for the future of insurance reporting published by the International Accounting Standards Board (IASB) in May 2007. It also outlines our response to the 'agenda proposal' published by the US Financial Accounting Standards Board (FASB) in August 2007, seeking views on the extent of US involvement in the insurance contract project. Our comment letters include our proposals for a modified reporting framework that builds on the blueprint set out in the IASB discussion paper, while providing what we believe would be a more relevant, reliable and user-friendly approach to accounting and financial reporting for insurance contracts. In developing our responses, we have taken account of the increasing use of IFRS around the world, which means that the proposals need to be relevant in a wide range of companies in very diverse economies.

'The development of a comprehensive standard for insurance contracts is essential…'

From PricewaterhouseCoopers' response to IASB discussion paper

On 16 November 2007, PricewaterhouseCoopers responded to the IASB's invitation to comment on its latest proposals for a future International Financial Reporting Standard for insurance contracts (IFRS Phase II).[2, 3] We also sent a comment letter to the FASB, setting out our support for a joint project between the FASB and the IASB, aimed at producing a revised US reporting standard that is in line with the eventual IASB's IFRS Phase II.[4, 5]

Our responses drew on an in-depth survey of analysts specialising in the sector,[6] along with discussions with our clients from around the world. Although the opinions of different preparers and users of accounts can vary quite markedly, their perspectives have provided valuable insights that have helped us to formulate what we believe is a balanced and coherent approach to future financial reporting.

1 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

2 'Discussion paper: Preliminary views on insurance contracts', published by the IASB for comment in May 2007 (www.iasb.org).

3 Copies of all responses including PricewaterhouseCoopers (No 92 in the IASB record and No 31 in the FASB record) are available on the IASB and FASB websites, respectively: http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Discussion+Paper+Preliminary+Views+on+Insurance+Contracts/Comment+Letters/CL92.htm and http://www.fasb.org/ocl/1540-100/51725.pdf.

4 'Agenda proposal: Accounting for insurance contracts and insurers and policyholders, published by the FASB for comment in August 2007 (www.fasb.org).

5 A copy of the PricewaterhouseCoopers' response letter is posted on the FASB website (www.fasb.org).

6 The results of PricewaterhouseCoopers' survey of insurance analysts are set out in 'Insurance reporting at the crossroads: What do analysts think?', which is available for download or order (copies are free) by visiting www.pwc.com/insurance.

We believe that the development of a comprehensive IFRS Phase II is an urgent priority and welcome the IASB's work in this respect.

As our survey of insurance analysts confirmed, the current transitional arrangements (IFRS 4) do not provide the level of transparency and comparability necessary for the users of financial statements. Improving the quality, clarity and consistency of financial reporting could help insurers to meet the expectations of users of their accounts and ensure that their share prices reflect the true performance and prospects of their business.

We also feel that US insurers and standard setters should play an active role in the formulation of IFRS Phase II as part of the development of a harmonised US/IFRS insurance contract standard. Insurance is a global industry that demands a universally comparable framework for accounting and financial reporting. While many constituents may disagree with certain aspects of the IASB proposals, the discussion paper could help to initiate a timely debate about some of the key issues facing reporting in the sector. This includes how to simplify some of the overly complex elements of US GAAP. Ultimately, failure to engage at this critical stage of the IASB project can only heighten the disparities between US GAAP and the eventual IFRS Phase II, and make convergence far harder to achieve thereafter.

'…investment analysts specialising in this sector lack confidence in the accounting information currently provided under IFRS 4…'

From PricewaterhouseCoopers' response to IASB discussion paper

'The use of a single set of accounting principles for similar transactions across all jurisdictions will increase comparability and users' understanding of the financial statements.'

From PricewaterhouseCoopers' response to IASB discussion paper

‘The use of unobservable data to support profit recognition may cast doubt on the robustness of the income statement…’

From PricewaterhouseCoopers’ response to IASB discussion paper

‘Insurers do not transfer insurance contracts in the normal course of business and therefore any assessment of the amount an insurer would expect to pay in those circumstances is hypothetical.’

From PricewaterhouseCoopers’ response to IASB discussion paper

‘Cash flows with commercial substance are those that an insurer can expect to receive or pay during the period of the contract when it is in the policyholders’ interests to continue to make payments.’

From PricewaterhouseCoopers’ response to IASB discussion paper

Balanced approach

We support a single model for life and non-life contracts, viewing any division as potentially arbitrary. For example, it is not clear what would be the classification of some health insurance contracts. We also believe that a common standard applicable to all types of insurance risks would aid comparability because it will reflect consistently all the relevant economic characteristics (e.g. time value of money) of insurance businesses. A single accounting basis would also in our view simplify the understanding of insurers’ financial statements.

In principle, we also endorse the IASB’s proposed ‘building blocks’ for a new measurement model: the current estimate, the margin for risk and services, and the discount rate. However, we feel that market consistency envisaged by the IASB through its ‘current exit value’ approach would be hypothetical and, therefore, ultimately unreliable and unverifiable as there is no actual transfer market for insurance contracts.

We have therefore adapted the three building blocks to create a model that we believe provides a better balance between economic relevance and verifiable reliability. This includes the use of entity-specific estimates, which are in keeping with the way insurers manage their business and which can be validated against actual experience. Our approach also seeks to recognise the commercial substance of the contract and the interdependence of rights and obligations by measuring the contract as a whole.

Broadening the agenda

We are keen to ensure that a number of critical components of a future IFRS, which have yet to be addressed, are brought onto the agenda. In particular, we believe that the IASB needs to look at how to remodel the income statement and disclosure principles to bring them into line with users' expectations and the changes to other aspects of financial reporting set out in the discussion paper. Dealing with the presentation issues is often a necessary step to develop a comprehensive answer to some of the questions the IASB has posed.

We also believe that key elements of the IASB's insurance discussion paper, many of which break new ground, could have a far-reaching impact on parallel IFRS projects and hence accounting and disclosure within other industries. For example, proposed measures to address potential inconsistencies between IFRS Phase II and IAS 18/IAS 39 could impinge on revenue recognition and accounting for financial instruments. Proposals on accounting and financial reporting for participating contracts could have important ramifications for the ongoing debate over the classification of instruments as liability or equity. It is therefore essential that the implications of these issues are assessed and addressed by all relevant constituents, not just insurers.

'...the Board's deliberations on this topic (participating contracts) should be incorporated into their consideration of the liability/equity project.'

From PricewaterhouseCoopers' response to IASB discussion paper

Work in progress

We hope that our proposed model will contribute to the ongoing debate on a future IFRS Phase II, though naturally we recognise that this is only one of dozens of responses to the IASB discussion paper and that many different viewpoints exist. Alongside the continuing deliberations, we believe that it will be important to conduct extensive field testing to help gain a better insight into the practical impact of the evolving proposals.

'It is important that the Board and the insurance industry develop a common understanding of the implications of the model before it is finalised.'

From PricewaterhouseCoopers' response to IASB discussion paper

02 Our proposed model

'…the data used should be current, unbiased and probability-weighted. However, it also needs to be reliable and supported by observable data'.

From PricewaterhouseCoopers' response to IASB discussion paper

We support a single model of accounting and disclosure for life and non-life insurance. In our opinion, payment to policyholders as a result of an insured event is common to both life and non-life insurance and therefore any separation is likely to be arbitrary and could impede comparability. Similar economic characteristics within insurance contracts should be accounted for similarly (e.g. to reflect time value of money) and a single accounting model achieves this key objective.

In principle, we also endorse the three building blocks for measuring contractual liabilities. However, in the absence of a transfer market for insurance contracts, any attempt at market consistency would be no more than hypothetical and certainly not sufficiently relevant or reliable. In particular, it would be difficult for users of accounts to compare and validate estimates against actual performance on a like-for-like basis, a key expectation highlighted in our survey of insurance analysts.

'This model recognises the interrelationship of the cash inflows and outflows and the nature of the contractual relationship with the policyholder.'

From PricewaterhouseCoopers' response to IASB discussion paper

We therefore believe that the estimate should reflect entity-specific rather than hypothetical cash flows when there are no directly observable market-based inputs. This is particularly important in the estimation of cash flows that depend on insurance risk and future expenses. Measurements would be equated to the company's own view of the outcome that would arise from its current strategy and level of efficiency. Measurements would also focus on the whole contract rather than its separate rights and obligations to capture its economic essence.

The current estimates that form the first building block will always be subjective – no accounting model can eliminate this fact. However, the estimation of insurance risks and the level of future expenses, based on an entity-specific approach, would be more reliable than the IASB alternative, by allowing projections to be subsequently judged through a direct like-for-like comparison with the entity's actual performance.

Investor judgement and market comparability would need to be underpinned by appropriate explanation about managements' underlying assumptions and their impact on valuation. We therefore believe that the IASB should develop fresh disclosure principles that reflect, supplement and help validate the data emanating from the three building blocks. This might include an explanation of the assumptions relating to, and impact of, diversification benefits, for example.

In keeping with insurance analysts' strong focus on the income statement, we also feel that the IASB needs to look more closely at how to enhance this critical element of financial reporting. This includes developing presentation principles that reflect how the building blocks might affect the insurer's reported performance and information that would help users to judge the

margins that an insurer is able to earn. In addition, as we explain below, a direct approach to cash-flow reporting would complement the margins analysis with the provision of gross cash inflow and outflow data.

We believe that premiums should be presented as deposits rather than revenue. Although there is an element of a service obligation within many insurance contracts, we believe that the acceptance of insurance risk is dependent on whether or not the insured event will occur. This key characteristic of insurance business makes it a contingent activity closer to writing options than providing a service.

As we explain in the next section, the deposit-accounting approach would also make redundant the IASB's proposals to unbundle the deposit component.

However, we believe that premiums are an important indicator of an insurer's cash-flow performance and the feedback from users is that this is important to them. We would therefore recommend that premiums be clearly reported as inflows in a modified cash-flow statement. In particular, written premium is an important measure of volume for many property and casualty products so should be disclosed whether in the cash flow statement or elsewhere.

'…we recommend that the Board consider new disclosure principles that reflect the key characteristics of the new reporting model'.

From PricewaterhouseCoopers' response to IASB discussion paper

Building block: Current estimates

We believe that measurement should concentrate on how an insurer's contractual obligations are actually met in practice, which is rarely through transfer.

The discussion paper would only recognise future premiums if they pass the narrow 'guaranteed insurability' test. In practice, however, insurers and investors tend to look at the net value of the cash inflows and outflows that make up the commercial and hence economic substance of the contract. They would also take account of the full impact of policyholder behaviour. We believe that all such elements of the commercial substance of the contract should be included in its measurement.

The discussion paper indicates that separate deposit and service components may need to be unbundled and valued separately. While we would agree that similar economic transactions should have the same accounting treatment, we are concerned that any move to unbundling may pre-empt the outcome of the critical revenue recognition and performance reporting projects. We would therefore suggest that reporting for insurers could be made more comparable with other financial institutions without the need for unbundling or the risk of forestalling decisions in other areas by presenting premiums as deposits, as outlined earlier.

'The measurement of an insurance contract should be based on how an issuer can, in practice, extinguish the contractual obligations…'

From PricewaterhouseCoopers' response to IASB discussion paper

‘We believe that an insurer should reflect the expected net economic benefits arising from beneficial policyholder behaviour under existing contracts…’

From PricewaterhouseCoopers’ response to IASB discussion paper

We agree with the IASB on the need to take some account of credit characteristics in the valuation of an insurance contract. This is because the possibility of an insurer not paying is part of the overall risk a policyholder faces and ignoring these characteristics would be inconsistent with the approach for fair valuing financial liabilities used elsewhere. However, the risk of an insurance contract’s default is limited, especially if it carries the security of guarantees provided by policyholder protection schemes. Under our model, the risk of the contract’s default would be included with all the other risks in the probability-weighted estimate of liabilities with the resulting uncertainty reflected in the margin. In most cases, we would expect this to have only a small impact on liability measurement. However, we emphasised the need for appropriate disclosure of any material impact on profit or loss from changes in credit standing, especially as there could be a ‘gain’ when credit quality declines.

Building block: Margins

‘The Board could achieve its objective of comparability using a more pragmatic approach.’

From PricewaterhouseCoopers’ response to IASB discussion paper

We believe that the risk margin should be current, unbiased and explicitly disclosed. However, we feel that it would be impractical for the margin to be market-consistent when there is no market upon which to draw such estimates. Instead, we believe that insurers should base the evaluation on the estimated reward an independent third party would demand to take on the entity-specific uncertainties and nature of future services arising from the contract.

We recognise that an unbiased risk margin implies that after acquisition costs are taken into account, there may be a profit or loss at the inception of the contract. For example, a day-one gain might arise if an insurer has been able to generate diversification benefits from assembling portfolios of contracts that are not fully reflected in a lower price charged to the policyholder. Conversely, a day-one loss might arise if a company chooses to market new policies at an attractively low premium to help attract new policyholders who will generate business with better margins in the future.

‘…the selection of an unbiased risk margin will be challenging in the absence of objective evidence to support it’.

From PricewaterhouseCoopers’ response to IASB discussion paper

Estimating the margin is likely to be one of the biggest practical difficulties. In particular, the development of an approach that would deliver consistency among companies and year-on-year is one of the key requirements from users. We believe this is a key area for the IASB to include in its field testing programme with insurance companies.

If the estimation of the margin is difficult, determining the appropriate unit of measurement for such an estimate may make it harder. We are not convinced that the IASB has put forward compelling arguments in favour of a portfolio-specific unit of measurement that would exclude the viability of alternative

routes (e.g. an entity-specific unit of measurement that incorporates cross-portfolio diversification benefits). We believe that much more consideration is needed in this area to ensure that what could be the most subjective of the building blocks is grounded in reliable and comparable practice.

We agree that reinsurance should be incorporated into margin evaluations, especially as it can curtail the variability and therefore reduce the uncertainty of the estimated cash flows.

Finally, we would not favour separate risk and service margins as this is contrary to the economics of the transaction. We believe that there should be a single margin that represents the reward for the uncertainty of bearing risk and for providing future services to the policyholders.

Building block: Discount rate

We agree with the IASB that current interest rates and the duration of the contractual cash flows represent appropriate bases for the evaluation of the discount rate. In our opinion, the discount rate should be independent of the expected asset returns, unless there is a direct link between the benefits and these returns, for example in a unit-linked contract. We believe that, absent a contractual link with invested assets, the discount rate should adjust the estimated contractual cash flows for the time value of money rather than reflect the insurer's investment strategy. In contrast to the discussion paper, we believe that liquidity risk should already have been accounted for in the current estimate and margin and therefore adjusting the discount rate would only lead to double-counting.

'In our view the arguments presented in the discussion paper are insufficient to support a conclusion on the appropriate unit of measurement.'

From PricewaterhouseCoopers' response to IASB discussion paper

'In view of the impact of the risk margin on profit recognition, the availability of different actuarial models to determine it and the lack of clarity surrounding the unit of measurement, we recommend that the Board arrange selective testing…'

From PricewaterhouseCoopers' response to IASB discussion paper

'In our view, the risk that the counterparty will demand payment at an earlier date is captured in defining the scenarios used to estimate the cash flows.'

From PricewaterhouseCoopers' response to IASB discussion paper

03 Other issues

'Both our proposal of accounting for the contract as a whole and the Board's proposal to use a constructive obligation approach would introduce new models for the classification of debt and equity.'

From PricewaterhouseCoopers' response to IASB discussion paper

Participating contracts

We welcome the IASB's commitment to addressing participating contracts, even if they do not contain insurance risk, though we note that the discussion paper only goes so far. In line with our overall model, we would favour treating a participating contract as a single unit to reflect the underlying economics of the transaction.

In keeping with our proposals for insurance contracts we believe that all cash flows with commercial substance, which arise from the contract, should be taken into account in its measurement. This approach does not need to rely on the concept of 'constructive obligation'. However, we recognise that both the IASB's and our own more holistic view would have important implications for the classification of instruments as liabilities or equity, and should be considered by all relevant parties involved in the liability-equity project.

'Any changes to IAS 39 will have significant implications for other entities, particularly banks, which issue similar products and such changes should not be implemented without wider consultation.'

From PricewaterhouseCoopers' response to IASB discussion paper

Implications for IAS 18 and IAS 39

We recognise that contracts with similar economic substance should be accounted for in similar ways. However, any attempt to eliminate the inconsistencies between the discussion paper and the revenue recognition principles of IAS 18 and the measurement principles of IAS 39 should follow proper due process.

In relation to IAS 39, we have drawn the IASB's attention to the fact that the presence of two measurement bases for financial instruments (fair value and amortised cost) would prevent the elimination of all differences. The absence of a fair value option for the recognition of service revenue would make it even more difficult to eliminate the differences with IAS 18.

'The key decision is where to draw the line in this project…'

From PricewaterhouseCoopers' response to IASB discussion paper

We would therefore recommend that the IASB avoids introducing major revisions to IAS 18 and IAS 39, which draw on amendments from the finalisation of the insurance contract project. Instead, the IASB should provide separate opportunities for consultation over proposals to amend other IFRS where any changes would affect other sectors. This should be carried out without delaying the finalisation of the new IFRS Phase II.

Policyholder accounting

The development of an accounting standard for insurance contracts would logically require that it also covers policyholder accounting. However, we have recommended that the IASB includes the accounting for policyholders, only if this can be done without causing delays in what is already a complex project.

Assets backing liabilities

We recognise the importance of avoiding an accounting mismatch between liabilities and any assets directly held to back them. While we believe that moving to a current valuation of liabilities that makes use of market inputs when observable will help to minimise any artificial inconsistencies, we recognise that it may not eliminate the problem altogether. Nonetheless, we would be reluctant to support the introduction of a special category for assets backing insurance liabilities because this could impede comparability with other sectors.

We would support the designation of treasury shares as financial assets in limited circumstances (i.e. when held in investment-linked funds that exist solely to pay or fund those liabilities that are directly affected by the fair value of the assets held in such funds). Such a designation should be limited to treasury shares that are traded in an active market.

Finally, we would recommend that the IASB allow the transitional use of the fair value option for investment accounting because the shadow accounting available under IFRS 4 would eventually be eliminated under the new accounting regime and classification of investments as available-for-sale could no longer be a logical choice for insurers.

Next steps

The IASB is reviewing the responses to its discussion paper and is due to publish a revised 'exposure draft' for final consultations in 2009. The FASB is due to announce its decision on whether to enter into a joint project with the IASB in the third quarter of 2008. PricewaterhouseCoopers will continue to contribute to the project including the analysis of the key points through the publication of new analysis in our IFRS Briefing series.[7]

In addition, we are ready to help facilitate the Standard setters and insurance companies develop a targeted field testing programme.

'…we believe the Board should only include policyholder accounting within the current project to the extent that its inclusion does not delay the issuance of a standard for insurers…'

From PricewaterhouseCoopers' response to IASB discussion paper

7 All reports from the PwC IFRS Briefing series can be downloaded from the Market Reporting page at www.pwc.com/insurance.

04 Contacts and related publications

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- IFRS Insurance Alert, May 2007
- Get set for IFRS Insurance Phase II, August 2007
- European Insurance Digest – includes 'Measuring Up: Fair Value and IFRS for Insurers', September 2007
- Insurance reporting at the crossroads: What do the analysts think?, November 2007

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