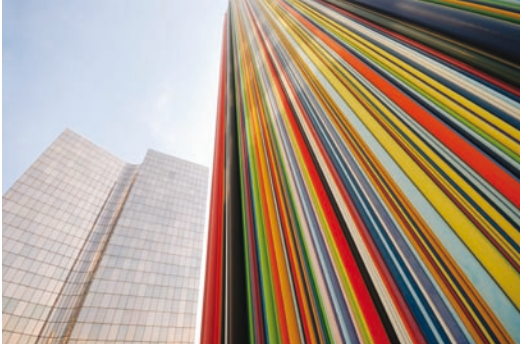


# Making sense of the numbers

Analysts' perspectives on current and future reporting in the insurance industry

November 2009





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‘The quality of reporting in the insurance industry certainly has an impact on valuations and also affects the amount of money going into the industry.’

*Analyst survey participant*

## Foreword

A financial reporting framework that enables the investment community to make informed judgements is critical to insurers’ ability to attract capital and ensure their share prices reflect the true level of value being created within their businesses. However, our 2007 survey of insurance analysts revealed strong dissatisfaction with the adequacy (level of quality, clarity and granularity) of financial reporting within the insurance industry.<sup>1</sup> In turn, some of the proposals for change being discussed at the time were seen by many analysts as creating what one described as ‘a bigger, blacker box’.

With the financial crisis having intensified the competition for capital and heightened the critical glare of market scrutiny, we felt that it would be useful to find out whether investment professionals believe that the ‘adequacy gap’ between their expectations and current practice has widened or narrowed since 2007. As the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) reach a decisive stage in their planned overhaul of insurance contract reporting, we also felt that this would be an opportune moment to ask analysts how the eventual framework could best meet their needs.

Several important messages came through loud and clear from the more than 40 interviews we carried out as part of this survey. Many of the participants believe that a lack of transparency is increasingly leading to the under-valuation of a number of the world’s leading insurance companies. To overcome these deficiencies, they would like the IASB and FASB to come up with a new and improved reporting framework as quickly as possible, encouraging the

standard setters to put pragmatism before theoretical precision. The desire for a swift solution was especially strong among life insurance analysts using IFRS.

Perhaps more of a surprise to us was the degree to which a consensus is emerging among the analysts interviewed on the fundamentals that they believe should form the bedrock of the new reporting framework. This consensus is rooted in a desire for reporting to reflect the economic reality of an insurer’s business model. Moreover, it has been interesting to note the areas where the analysts’ view of reporting coincides with – and differs from – that of the IASB and FASB.

We recognise the scale of the challenge facing the standard setters as they try to find a single solution that meets the needs of disparate stakeholder groups in different territories. The feedback from analysts is, however, clear. The current situation is harming the industry and so the Boards’ efforts must come to a conclusion, and quickly. It is inevitable that some analysts – and, indeed, insurers – will be disappointed by the Boards’ proposals. It is therefore essential that all sides engage in the debate and play an active part in achieving a workable compromise.

We would like to thank all the investment professionals who kindly gave their valuable time and insights to this survey. We hope that the findings will provide a useful contribution to the continuing debate over the future of reporting in the insurance industry.

**Ian Dilks**  
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Global Insurance Leader

<sup>1</sup> ‘Insurance reporting at the crossroads: What do analysts think?’, published by PricewaterhouseCoopers in November 2007.

# ‘It’s very difficult to gain a clear economic view of where profitability comes from.’

*Analyst survey participant*

## Executive summary

Interviews with more than 40 investment professionals revealed widespread dissatisfaction with the current state of financial reporting. Many participants, especially life insurance analysts using IFRS, would like the IASB to move to a revised reporting framework as quickly as possible. While recognising the difficulties of developing solutions for such a diverse and complex industry, many would encourage standard setters to put pragmatism before theoretical precision.

### Key findings on the current state of insurance reporting

IFRS and US GAAP financial statements (‘GAAP reporting’):

- Overall, the gap between participants’ expectations and current practice was still considerable in our current survey.
- Cash flow data was perceived as potentially more useful than in 2007 – a reflection of the current market environment.

Supplementary non-GAAP reporting:

- Potentially highly useful, but currently largely inadequate.
- While many held Market Consistent Embedded Value (MCEV<sup>®</sup>) to be theoretically more appealing than its predecessors, there was frustration with its implementation.

### Key findings on the future direction of the accounting for insurance contracts

As the IASB and FASB reach a decisive stage in their planned overhaul of insurance contract reporting, the survey findings offer the standard setters some clear messages:

- Reporting should reflect the fundamental economic realities and underlying business model of insurance companies.
- Underpinning these responses was strong support for the concept of ‘matching’ (e.g. matching the recognition of acquisition costs and profit).
- Most participants felt that insurance is distinctive enough to deserve its own reporting model.
- Very few respondents would wish to see profit from an insurance contract recognised at its inception.
- Most participants would like to see an explicit risk margin, primarily because ‘more information is better than less’. However, very few have experience of how the concept might work in practice.

### Key findings on the future direction of the measurement and classification of financial instruments

Most participants would support the continued use of multiple valuation bases.

The quality of the associated disclosures of both cost and fair values was critical to many participants, as this would enable them to make their own adjustments.

### Timing of implementation

Most participants favoured adopting the fundamental changes being proposed on financial instruments and insurance liabilities at the same time to avoid accounting mismatches.

## ‘There’s huge room for improvement in reporting in the industry.’

*Analyst survey participant*

# ‘What we want is an IFRS presentation that explains the proper drivers of the business.’

Analyst survey participant

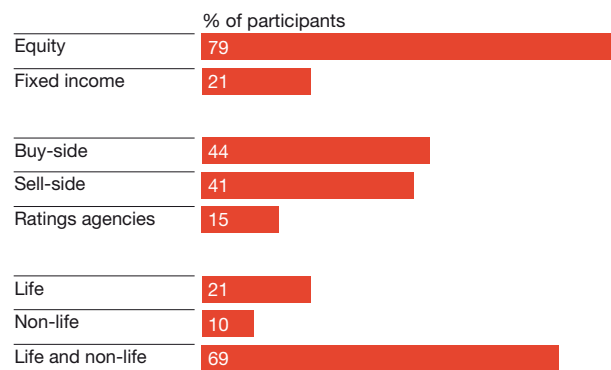
## About this survey

In the autumn of 2009, PricewaterhouseCoopers<sup>2</sup> conducted in-depth interviews with more than 40 insurance analysts from the US, Europe, Asia and Australia to gain their perspectives on the current state and future direction of financial reporting. The survey follows on from a similar study carried out in 2007.<sup>3</sup>

The survey respondents were chosen to provide coverage across all the major financial centres and include a broad mix of life/non-life, buy-side/sell-side and equity/fixed income analysts. The interviews were conducted face-to-face, allowing interviewers to explore the rationale for any given reply.

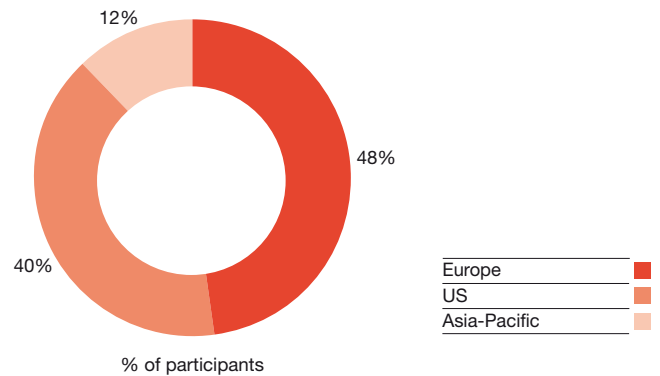
In this report, we have noted areas where there was significant variance between the findings for particular types of analysts – generally life or non-life. We have also noted distinctions between the perceptions of US analysts and those in the rest of the world.

Figure 1: Breakdown of survey participants



Source: PricewaterhouseCoopers

Figure 2: Geographical split of survey participants



Source: PricewaterhouseCoopers

<sup>2</sup> PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Ltd, each of which is a separate and independent legal entity.

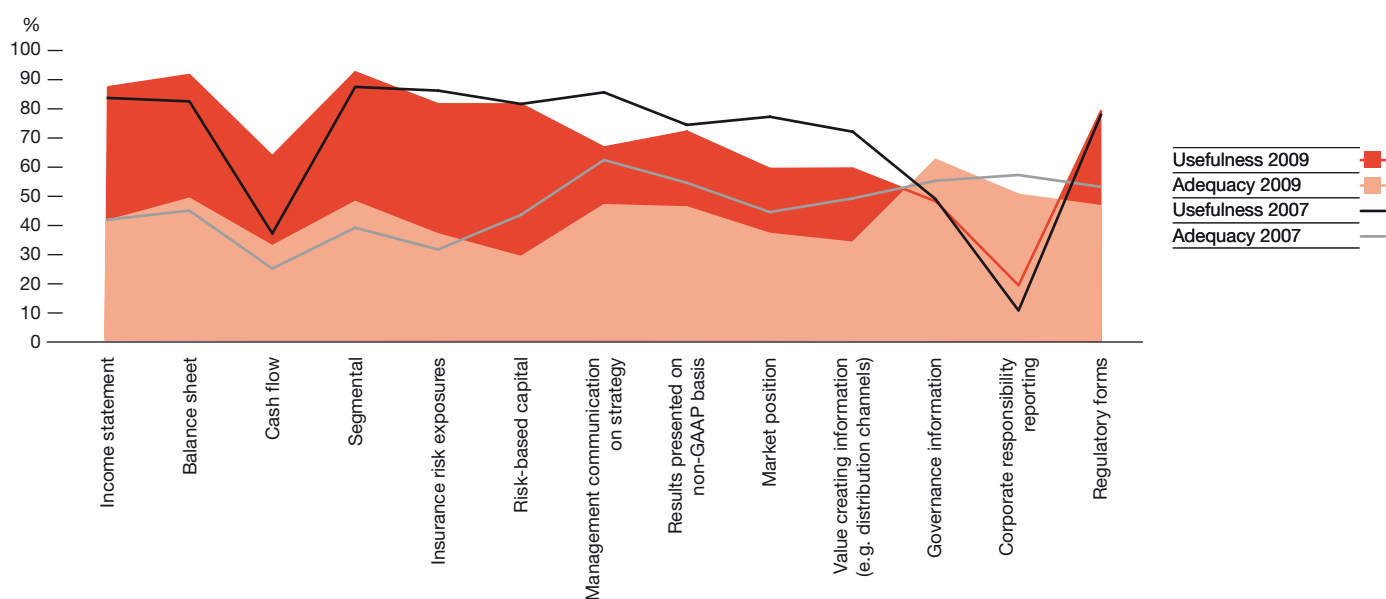
<sup>3</sup> ‘Insurance reporting at the crossroads: What do analysts think?’, published by PricewaterhouseCoopers in November 2007.

# 'The income statement does not reflect the reality of the business.'

Analyst survey participant

## Adequacy of current insurance reporting

Figure 3: How potentially useful are the following elements of financial and non-financial information? Are they adequate for your needs?



Source: PricewaterhouseCoopers

### Dissatisfaction with reported information remains

Our 2007 survey identified a substantial gap between analysts' perceptions of the usefulness and adequacy of insurers' primary financial disclosure (balance sheet, income statement, cash flow and segmental information). While most participants cited examples of a few companies that had 'gone the extra mile' with their corporate reporting, overall the gap between practice and expectations was as wide in our latest study. One participant described the income statement as a 'complete disaster', while segmental reporting was regarded by many respondents as insufficiently detailed for their analysis.

The only area where the perceived potential usefulness had significantly increased since 2007 is the cash flow statement, reflecting the importance of cash in the current

economic environment. However, dissatisfaction with this statement was high – one participant describing it as 'pretty much gobbledegook'. As the focus shifted towards cash, interest in non-financial information such as strategy and market position had marginally declined.

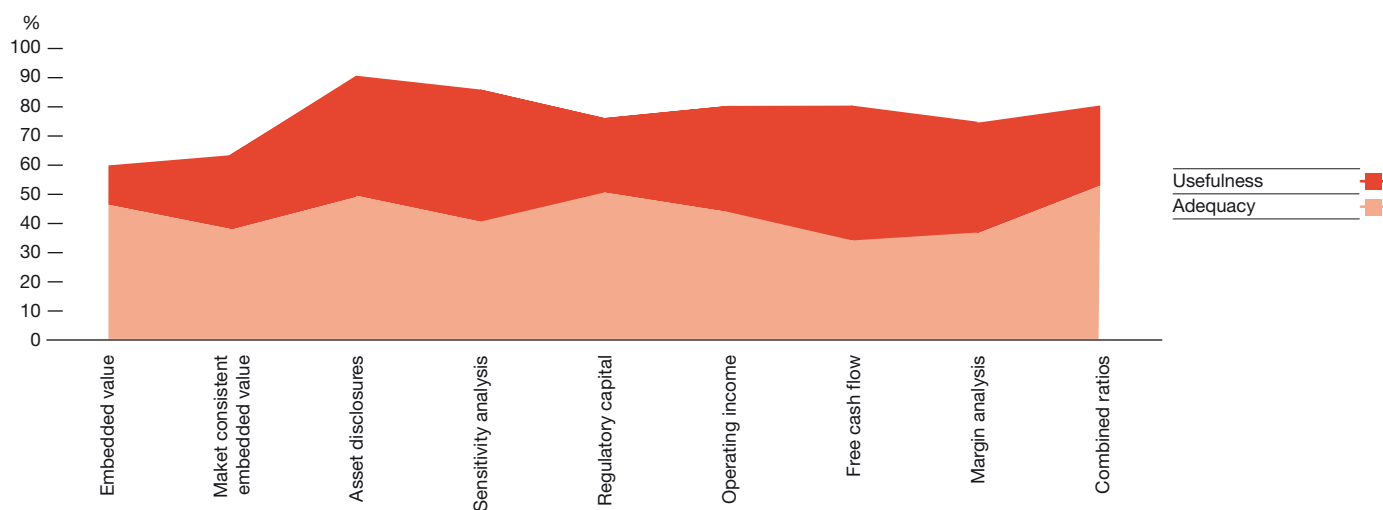
'The proof of the pudding is in the eating – we disregard the cash flow statement.'

Analyst survey participant

**‘I find that non-GAAP information provides the only reasonable basis to judge management.’**

*Analyst survey participant*

Figure 4: How potentially useful are the following elements of financial and non-financial information? Are they adequate for your needs?



Source: PricewaterhouseCoopers

### Non-GAAP information falls short of expectations

Overall, participants in the survey rated non-GAAP disclosures as extremely useful. Many commented that management had improved their asset disclosures over the past year. However, despite the insurance industry’s increased focus on non-GAAP reporting since our last survey in 2007, disclosure in many areas still fell some way short of expectations. For example, many participants felt that sensitivity analyses should be based on more realistic assumptions, recognising the interdependence of certain scenarios. They also felt that operating profit is inconsistently defined and would like more information on the inputs supporting the calculation of combined ratios.

Embedded value (EV) and Market Consistent Embedded Value (MCEV©) generated an interesting debate among the European life analysts we interviewed. While many held

MCEV to be theoretically more appealing than its predecessors, certain concerns were raised about its implementation. A number of participants complained that current practice lacks sufficient transparency and fails to reflect the economic reality of some products. ‘MCEV is fairly useless as it is inconsistently applied,’ said a participant.

**‘Non-GAAP numbers always seem to get better over time. It’s a little suspicious.’**

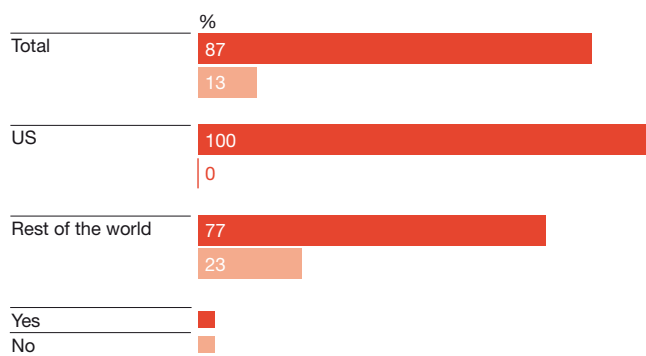
*Analyst survey participant*

# ‘Insurance has its own characteristics. That’s why we have specialists to analyse it.’

Analyst survey participant

## Future direction of financial reporting for insurance contracts

Figure 5: Does insurance require its own accounting model?

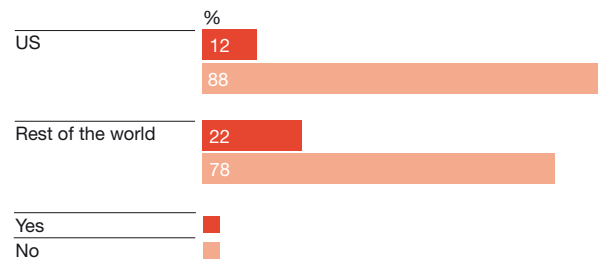


Source: PricewaterhouseCoopers

### Distinct accounting model

Nearly 90% of participants felt that insurance should have its own accounting model (this view was unanimous in the US). Of those supporting a distinct model, 56% would favour a separate approach for life and non-life business. Nearly 70% would like aspects of a particular contract that have different risk and earnings profiles, such as savings and investment management services, to be accounted for separately (unbundled). ‘It would be useful to distinguish between risk and investment business...It’s currently difficult to see exactly where the profits come from,’ said a participant.

Figure 6: Should an insurance company recognise a profit on day one?



Source: PricewaterhouseCoopers

### Day one profit

More than three-quarters of participants were opposed to recording a profit at the inception of the contract. Support for the concept of a day one gain was marginally stronger in parts of the world that are more familiar with embedded value. ‘To the extent that they’re writing profitable contracts, I’d like to see it,’ said a participant.

‘I don’t think that there should be a day one profit. Management expectations do not add up to value.’

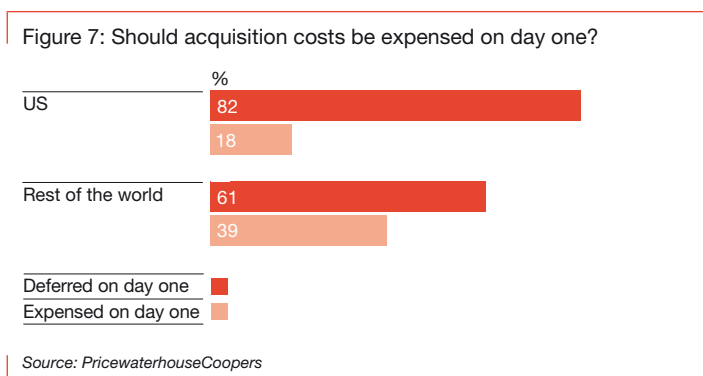
Analyst survey participant

‘I come from the old school. You earn it before you recognise it.’

Analyst survey participant

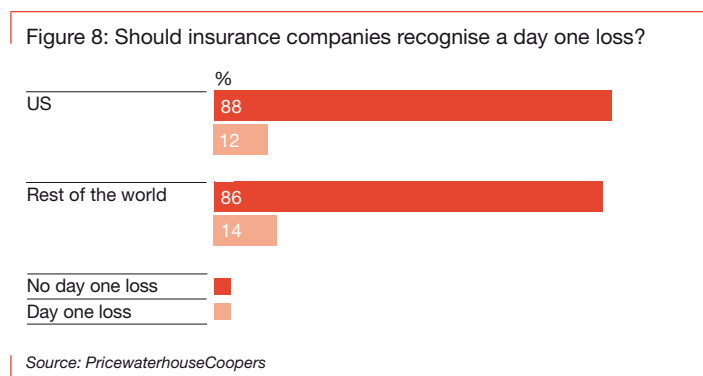
‘I think there should be some deferral of acquisition costs because you’re buying a stream of premiums rather than tossing money out of the door.’

Analyst survey participant



### Acquisition costs

Most participants felt that acquisition costs should be deferred. ‘Your day one acquisition costs do not represent the economics on day one,’ said a participant. However, many would like more control and consistency in how costs are deferred. ‘Deferred acquisition costs are too variable and too open to manipulation at present,’ said a participant.



### No day one loss on profitable contracts

Participants who favoured recording acquisition costs as an expense at the inception of the contract were then asked if revenue should be recognised to offset the resulting loss. When the results of these questions are combined, it is clear that, as long as the contract is expected to be profitable, few would favour the recognition of a day one loss.

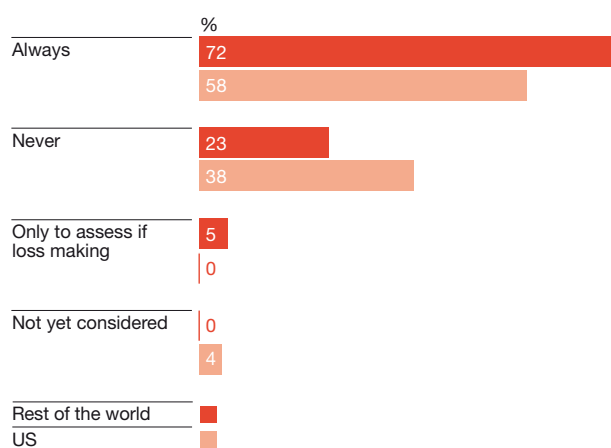
‘While I don’t care if you expense up front or not, I don’t think there should be a day one loss unless there is some indication that you are using the product as a loss leader.’

Analyst survey participant

‘While there should be a risk margin, what really matters is the disclosure around that risk margin.’

Analyst survey participant

Figure 9: Should an insurance contract liability include an explicit risk margin?



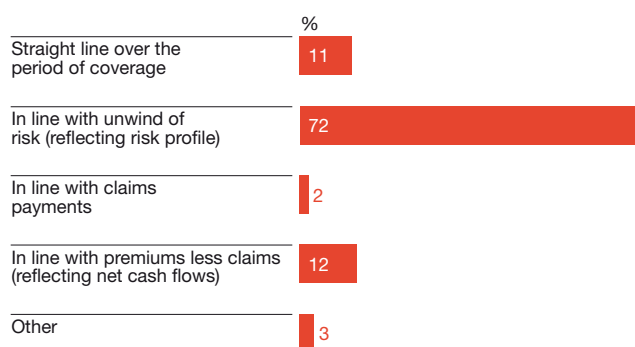
Source: PricewaterhouseCoopers

### Risk margin

A majority of participants would like insurers to report a risk margin, with some arguing that it might provide greater insight into the information that they believe some companies use when pricing their products. However, as insurers do not typically report risk margins at present, few participants had first-hand knowledge of how such margins would work. ‘This doesn’t mean anything to me,’ said a participant.

Those against the inclusion of a risk margin felt that it would be too subjective. ‘You’ll get a snowball of assumptions,’ said a participant. Another participant said that this was a further sign that insurance contract accounting ‘is becoming too complicated’.

Figure 10: How should profit be recognised over the life of the contract?



Source: PricewaterhouseCoopers

### Profit recognition over the life of the contract

Most participants would like to see profits realised over the lifetime of the contract in line with the unwinding of the associated risks. ‘Recognising profit in line with the unwinding of risk gives me a better indication of how management judges the contract’s current profitability,’ said a participant.

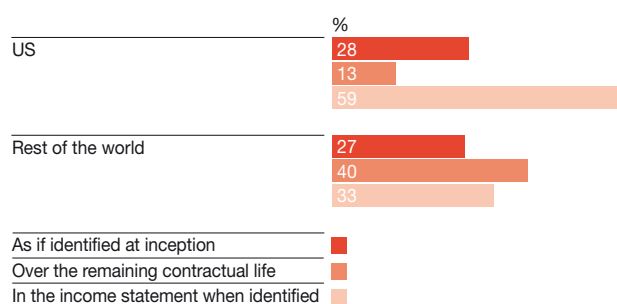
‘More information is better than less, I guess.’

Analyst survey participant

‘I find it difficult to put economic assumptions through the P&L on a reporting period basis. You’re just going to end up with wacky P&L numbers.’

Analyst survey participant

Figure 11: How should changes in economic and non-economic assumptions be accounted for?



Source: PricewaterhouseCoopers

### Changes in assumptions

There was a clear geographical split to this question. Around 60% of US participants wanted changes in assumptions to be immediately recognised in the income statement, typically arguing that they would like the impact of management adjustments to be as visible as possible. ‘If management has got it wrong, you want to know they’ve got it wrong,’ said a US participant. In contrast, there was no strong consensus in the responses from their counterparts in other parts of the world.

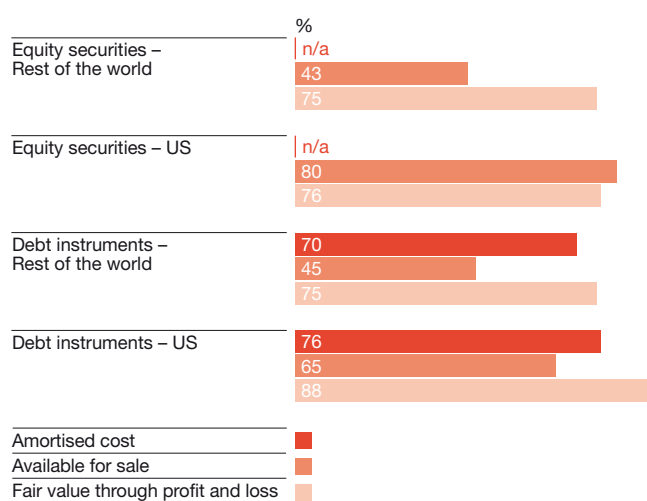
Only around 15% of total survey participants felt that companies should treat changes in economic assumptions (e.g. interest rates) and non-economic assumptions (e.g. mortality) in different ways.

‘You need the book value and the market value of all the instruments they have. As long as I have all of this, I can judge whether the unrealised gain or loss is real or not.’

Analyst survey participant

## Future direction of the measurement and classification of financial instruments

Figure 12: Which of the following classifications should be permitted under the IASB’s and FASB’s reforms for financial instruments?



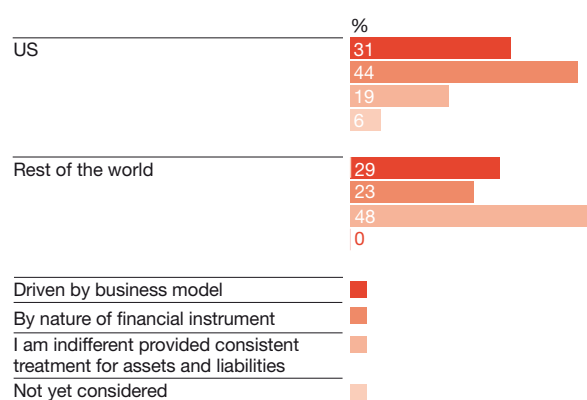
Source: PricewaterhouseCoopers

### Financial instrument classification

Most respondents support the continued use of amortised cost and fair value through profit and loss (FVTPL) for debt instruments. However, there was less of a consensus on the continued use of the available for sale (AFS) designation, with US participants more likely to be in favour than their counterparts in the rest of the world.

While marking-to-market might increase earnings volatility, some felt this was preferable to a potentially less transparent approach. ‘Volatility is OK because we can analyse it. To artificially suppress it is something we are less comfortable with,’ said a participant. Many participants would like both a cost and a fair value basis of measurement to be clearly disclosed in either the primary statements or the notes.

Figure 13: What should be the primary driver for the classification of financial instruments?



Source: PricewaterhouseCoopers

### Driver for classification

There were mixed views on what should drive the classification of financial instruments. Nearly half of US participants favoured an approach based on the nature of the financial instrument. In contrast, their counterparts in other parts of the world were more likely to express indifference, provided that assets and liabilities are treated consistently.

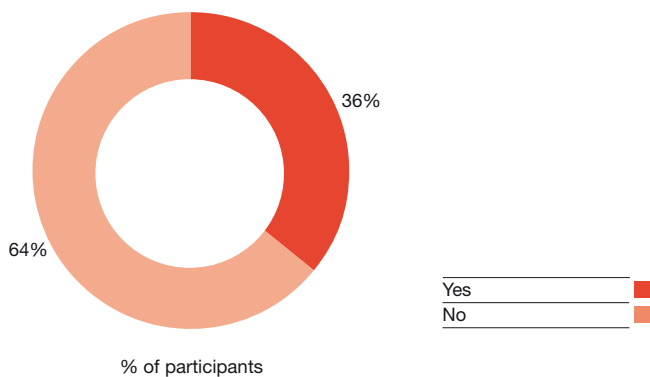
‘I believe in classification by the nature of the instrument because a company can hide behind a business model.’

Analyst survey participant

‘If they want to cause even more confusion than they have done already, they should adopt everything willy-nilly.’

Analyst survey participant

Figure 14: Should insurers adopt the new financial instruments standard before they apply the new insurance contracts standard?



Source: PricewaterhouseCoopers

### Timing of implementation

Most participants favoured adopting the proposed changes to financial instrument and insurance contract accounting at the same time. ‘I would hope that it is done as a package rather than piecemeal,’ said a participant. Those who preferred the earlier adoption of the new financial instruments standard believed this would preserve comparability with other financial sectors.

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