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THE DECISION-USEFULNESS OF INSURANCE ACCOUNTING INFORMATION

by

YOLINDI DE WET

LIMITED SCOPE DISSERTATION

submitted in the partial fulfilment of the requirements for the degree

MAGISTER COMMERCII

in

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at the

UNIVERSITY OF JOHANNESBURG

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ABSTRACT

The International Accounting Standards Board is presently working on Phase II of the Insurance Contract project. The objective of this project is to compile a standard, based on principles, which will address accounting for various insurance contracts issued by companies and improve financial reporting comparability between companies.

This research study critically evaluates whether decision-useful information will be provided by South Africa’s large, listed long-term insurers through the use of the IASB’s building block approach proposed in Phase II, the Exposure Draft on Insurance Contracts issued in 2013. A questionnaire developed for this study was used in a comparative analysis of current financial reporting and proposed financial reporting by long-term insurers.

The findings of this research study indicate that IFRS 4 Phase II will result in the provision of decision-useful insurance accounting information. A long-term insurer’s financial reporting will be more consistent and comparable, which is aligned with the basic requirements of financial reporting. IFRS 4 Phase II will enhance comparability between various long-term insurers in South Africa. These findings support the conclusion that a move to IFRS 4 Phase II for long-term insurer financial reporting in South Africa will be beneficial to users of financial statements in making economic decisions.

KEY WORDS

Building block approach

Disclosure

Exposure Draft Insurance Contracts

Financial reporting

GAAP

IFRS 4 Insurance contracts

Long-term insurance
DECLARATION

I hereby declare that:

- This is my own unaided work and that each significant contribution to, and quotation in, this dissertation from the work of other people has been cited and referenced.

- Neither the substance nor any part of the dissertation has been submitted in the past, is being or is to be submitted for a degree at this University or any other university.

Yolindi de Wet

October 2015
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1. INTRODUCTION, RESEARCH METHODOLOGY AND RESEARCH OUTLINE

1.1 Background

The International Accounting Standards Board (hereafter IASB) is presently working on Phase II of the Insurance Contract project. The objectives of this project are twofold. Firstly, the IASB is endeavouring to compile a standard, based on principles, which will address the accounting, and particularly the recognition and measurement, for various insurance contracts issued by companies. Secondly, the IASB is seeking to improve financial reporting comparability between companies (IASB, 2013b).

In 2004, the IASB completed Phase I by issuing the International Financial Reporting Standard (hereafter IFRS) 4 Insurance Contracts (hereafter IFRS 4). In IFRS 4, the IASB clarified the type of contracts that are to be considered as insurance contracts by including a definition of an insurance contract in the standard. The IASB’s objectives for Phase I were:

(a) to make limited improvements to accounting practices for insurance contracts, without requiring major changes that may need to be reversed in Phase II.
(b) to require disclosure that (i) identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and (ii) helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts. (IASB, 2004:IFRS 4 para BC5)

Phase I was considered an interim solution whilst the IASB worked on completing Phase II subsequent to the wide adoption of IFRS in 2005 (IASB, 2013b). For ease of transition from Phase I to Phase II and to avoid a repeat of significant system changes, the IASB allowed companies to continue to apply their existing accounting practices (IASB, 2004:IFRS 4 para BC78). Over many years, companies have developed and applied their own accounting practices for insurance contracts which have, however, caused difficulties in comparing financial information between different companies (IASB, 2013b). The IASB’s view is confirmed in an article in Accountancy SA (French & Greyling, 2007:24) where it stated that:

The IASB's search for consistent financial reporting is challenged by the unique features of insurance contracts compared with other contracts. The IASB has stated that it would ideally like to eliminate all differences between the accounting principles applied in IFRS 4 and other standards. The drive for consistency and comparability may impact other projects such as revenue recognition, performance reporting, liability-equity classification, financial instruments and fair value measurement.
The importance of the IASB completing Phase II of the project stems from the fact that users cannot obtain a meaningful understanding of the accounting of insurance contracts based on information presented in the financial statements. This is due to the high level of diversity experienced in the industry globally (IASB, 2013b). Information is thus potentially not considered decision-useful for today’s users (IASB, 2013b).

To achieve the objectives set for Phase II, the IASB has proposed the use of a building block approach for the recognition and measurement of insurance contracts in the Exposure Draft (hereafter ED) Insurance Contracts, issued in July 2010 (IASB, 2010b). The argument for applying the IASB’s building block approach is supported by the amount of research performed by the IASB in establishing its approach. The processes followed by the IASB include:

- establishing the Insurance Working Group to analyse accounting issues relating to insurance contracts;
- conducting field tests in 2009 and 2010 to assess whether the proposals under Phase II of the project can be applied rigorously and consistently in practice and to provide an understanding of how the proposed approach will change current practice; and
- facilitating round-table discussions with the purpose of listening to the views of, and obtaining information from, interested parties about the requirements proposed in the July 2010 ED (IASB, 2013b).

1.2 Research problem

The Insurance Contract project was launched in 1997 when the International Accounting Steering Committee (hereafter IASC) established an Insurance Steering Committee. An issues paper on insurance was drafted in 1999 which led to the development of the Draft Statement of Principles (hereafter DSOP) in 2001. The project also received a new owner in 2001 when the IASB replaced the IASC (Verma, 2009:66).

At this point, the project was divided into two phases. IFRS 4 Phase I, which provides some guidance on insurance contracts (mainly disclosure), was completed in 2004 to allow for the first-time adoption of IFRS in 2005 whilst the IASB continued to work on the measurement principles in IFRS 4 Phase II.

In 2007, the IASB published a Discussion Paper (hereafter DP), Preliminary views on Insurance Contracts (Verma, 2009:66). The DP proposed a fair value-based insurance accounting standard which effectively means that a company issuing insurance contracts would need to account for both the assets and liabilities at fair value (IASB, 2007a). From the comment letters received by the IASB on the DP, the question arose as to how an insurance contract liability should be measured at fair
value as insurance contracts rarely trade and are usually settled by insurers (IASB, 2008). The DP failed to clearly define the meaning of applying fair value accounting to insurance contracts. The IASB redeliberated and proposed a single measurement model with a fulfilment objective, rather than fair value, for all insurance contracts in the ED published in 2010. The objective of the fulfilment model is explained below:

The exposure draft proposes a single measurement model for all insurance contracts that portrays a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate as it fulfils its rights and obligations under the contract. This measure is referred to in the proposals as the “present value of the fulfilment cash flows”. (PwC, 2010:4)

The measurement model is applied through the use of a building block approach, as illustrated in Figure 1 below. The four building blocks together represent the insurance contract liability.

![Figure 1: The IASB’s building block approach, as outlined in the 2010 ED](source: IASB, 2010c)

In South Africa, long-term insurers apply the Actuarial Society of South Africa’s Standards of Actuarial Practice (hereafter SAP) 104 when accounting for insurance contracts (ASSA, 2012a). In terms of IFRS 4, insurers are allowed to continue to apply their existing accounting policies. This exemption will fall away once Phase II becomes effective.
As part of the IASB’s invitation for respondents to comment on the ED, questions were included in the introduction section of the ED. The IASB asked seven questions relating to the measurement model. Question 1 is of particular relevance to this research study:

Question 1 – Relevant information for users

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer’s financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why? (IASB, 2010b: para IN14)

In response to the IASB questions, a joint comment letter was prepared by the Life Assurance Committee (hereafter LAC) of the Actuarial Society of South Africa (hereafter ASSA) and the Long-term Insurance Project Group of the South African Institute of Chartered Accountants (hereafter SAICA) (LAC & SAICA, 2010). According to these two professional bodies, in order to assess whether information provided is relevant and useful, it will be measured by the users of the information. In other words, will stakeholders of insurance companies use the financial statements as their first source of reference for purposes of analysis and performance measurement if it is prepared on the basis proposed in the ED? It is their opinion that the ED will not provide more relevant and useful information due to the following key reasons:

- the treatment of the residual margin where profits are deferred on insurance contracts but losses are recognised on day one. This also contrasts with the treatment of the residual margin for reinsurance contracts where profits are recognised on day one but losses are deferred;
- the exclusion of overhead expenses and other non-incremental acquisition costs from the cash flow forecasts, but their inclusion in the product pricing;
- the application of a different valuation basis for insurance contracts pre- and post-transition date. The difference is not considered to be a short-duration difference but rather a long-duration difference, as in-force insurance contracts in certain cases cover periods of 20 to 30 years; and
- different measurement basis for certain investment contracts with discretionary participation features as it will be excluded from IFRS 4 and included in IAS 39 Financial Instruments: Recognition and Measurement (hereafter IAS 39) / IFRS 9 Financial Instruments (hereafter IFRS 9). Discretionary participation features arise where the policyholder has a contractual right to receive additional benefits in excess of guaranteed benefits from the issuer. These contracts were previously included as part of IFRS 4 as IAS 39 and IAS 32 Financial Instruments: Presentation (hereafter IAS 32) do not specifically include accounting treatment for the discretionary component included in these types of contracts. (LAC & SAICA, 2010)
The ED was subject to a comment period which ended on 30 November 2010. The IASB redeliberated the ED proposals from 2011 to 2013 based on the comments received and outreach projects undertaken. The IASB published a second ED in June 2013 which is currently in the process of redeliberation (IASB, 2013b).

Given the IASB’s objectives for Phase II, the question arises whether the IASB’s building block approach will provide decision-useful information to users through improved presentation and disclosure and more specifically, whether there will be a base for users to understand insurance reporting and improve the comparability of reporting between different long-term insurers in South Africa. The issue is therefore whether or not the IASB’s building block approach will address the deficiencies, identified as inconsistent application methods, in the current recognition and measurement and enhance the decision-useful information in South African long-term insurance reporting. The deficiencies are explored further in Chapter 3.

1.3 Research objectives

The objective of this research is to critically evaluate whether decision-useful information will be provided through the use of the IASB’s building block approach by:

- reviewing the current recognition and measurement model, as described in SAP 104, followed by South African long-term insurers;
- identifying lack of guidance in the current recognition and measurement model by performing a content analysis of South Africa’s large, long-term insurers by examining accounting policies and the presentation of insurance contracts in financial statements;
- reviewing the new recognition and measurement model in terms of the IASB’s building block approach; and
- assessing whether the new recognition and measurement proposal will enhance the decision-usefulness of insurance accounting by comparing the building block approach to SAP 104 and IFRS 4.

The research objectives are illustrated in Figure 2 below.
1.4 Research methodology

A blended framework consisting of interpretative and critical research is best suited to this research study. Such a framework allows the researcher to obtain insights into the current accounting policies applied by South Africa’s long-term insurers. Saunders et al (2012:137) describe the interpretative research framework as one obtaining meaningful insights into a complex field of interest. A critical assessment is then performed in order to determine whether an improvement of reporting in insurers’ financial statements occurs under Phase II. Henning et al (2004:22-23) and Roslender (2006:250) summarise the critical research framework as follows: “[c]ritical research questions the appropriateness of current theory, with the objective of changing the existing social structure”.

A combination of these frameworks is appropriate as the research study focuses on understanding the current and future insurance accounting followed and to be followed from the perspectives of South African long-term insurance companies and the IASB respectively, in order to assess whether the provision of decision-useful information improves. The interpretative research framework is applicable to the first section of the research study where an in-depth understanding of the current recognition and measurement model is obtained. The critical research framework is applicable to the section where the new recognition and measurement model, as included in IFRS 4 Phase II, is reviewed in detail. The conclusion to the research study presents views based on the above analyses.

Based on the interpretative and critical research framework, an inductive research approach is applied to better understand the nature of the research problem. The nature of the research design is
exploratory and is supported by a research methodological paradigm in which a mono-method, focused on qualitative data analysis, is preferred (Denzin & Lincoln, 2005:6).

1.5 Research approach

The research approach is a multiple critical and content analysis study of the recognition and measurement of insurance contracts. It consists of three units of analysis, these being SAP 104, accounting policies and presentation included in financial statements of South African long-term insurance companies and Phase II (ED issued June 2013 and includes redeliberations up to August 2015). These units of analysis are individually researched and compared to reach a conclusion on decision-useful information. A cross-sectional time horizon is applicable to the research study as a ‘snapshot’ of the current insurance accounting is taken and compared to the IASB’s new recognition and measurement model for insurance contracts (Saunders et al, 2012:190). As the IASB’s proposals are still in exposure draft format, they could possibly change when issued as the final standard.

The research study consists of three units of analysis. Each unit is addressed in its own chapter, which consists of a brief introduction describing:

- the purpose of the analysis;
- how the purpose of the analysis fulfils the ultimate objective of the research study;
- why the analysis is performed;
- the methods used to perform the analysis; and
- the structure of the chapter.

The research targets South Africa’s large, listed long-term insurance companies which include Clientèle Limited, Discovery Holdings Limited, Liberty Holdings Limited, MMI Holdings Limited, Old Mutual plc and Sanlam Limited. These companies represent 55% of the market share based on net premiums and 68% of total assets and total liabilities as stated in the Financial Services Board’s 16th annual report of the registrar on the results of the long-term insurance industry for the period ending 2013 (FSB, 2014).

When considering the validity of data in a research study, Mouton (2002:144) states that “the key validity criterion for data collection is reliability”. The first element to be examined as part of the research study is SAP 104. SAP 104 is considered to be a reliable source, being a specific practice area standard applicable to long-term insurance in South Africa, which was issued by ASSA (ASSA, 2013). ASSA governs the actuarial profession in South Africa (ASSA, 2013). One of ASSA’s
committees is the LAC which is primarily responsible for supporting the actuarial profession in the long-term insurance industry (ASSA, 2013). The LAC works with SAICA's Long-term Insurance Project Group to ensure the insurance industry remains up to date with the developments in Phase II, as indicated above in the comment letter written jointly by SAICA and ASSA.

To analyse the respective accounting policies and presentation applied by South Africa’s long-term insurers included in the population of the research study, information was obtained from each company’s annual financial statements. The annual financial statements are considered a reliable source as they are subject to a review by each company’s audit committee, consisting of independent, non-executive directors and an annual, independent audit as per section 94(2), 94(4), 94(7) and 30 of the Companies Act (2008) respectively. Section 29(1) (a) of the Companies Act (2008) requires companies to prepare financial statements in terms of IFRS. Section 8.62 of the Johannesburg Stock Exchange Limited (hereafter JSE) Listings Requirements requires that listed companies’ annual financial statements be prepared in accordance with IFRS and undergo an audit in terms of International Standards of Auditing (JSE, 2010).

Phase II is considered to be a reliable source of data for inclusion in the research study as it is formulated by the IASB. The IASB is an independent standard-setting body that is recognised internationally (IASB, 2013a). It is also subject to a governance and accountability framework set in place by the IFRS Foundation (IASB, 2013a). When setting standards such as the proposed revised IFRS 4, all IASB meetings are held in public and are webcast. Summaries of the IASB meetings and supporting IASB staff papers are publicly available (IASB, 2013a). To ensure the quality of the research study, only publicly available information was used in the accumulation of data for analyses. The data was sourced from the primary source of issuance, i.e. the IASB, and where applicable, supported by respected secondary sources. The results of the research study fairly and accurately represent the data analysed.

1.6 Limitations of the study

The research study is limited to South Africa’s large, listed long-term insurance companies. This study is based on IFRS 4 Phase II which is currently an ED and not an approved standard. The research study considered information included in the ED issued July 2010 as well as the re-exposed ED issued in June 2013. Redeliberations on the re-exposed ED were also considered up until August 2015. Detailed limitations on IFRS 4 Phase II have been included in Chapter 4.
1.7 Outline of chapters

This limited scope dissertation is divided into the following chapters:

Chapter 1: Introduction, research methodology and research outline

The background to the research study is discussed and the research problem and objectives of the research study are defined. An explanation of the research design and methodology used in the research study is provided. The research methods, including data collection and analysis, are also discussed.

Chapter 2: Critical review of SAP 104 – Calculation of the value of liabilities

A critical review analysis is performed of the current recognition and measurement model, as described in SAP 104, which is applied to insurance contracts of South African long-term insurers.

Chapter 3: Analysis of accounting policies, presentation and disclosure applied by South African long-term insurers

The application of the requirements of SAP 104 and IFRS 4 is considered through a content analysis of South Africa’s large, listed long-term insurers’ accounting policies and an examination of the way in which insurance contracts are presented and disclosed in the financial statements. The analysis highlights problem areas and areas of divergence in the current recognition and measurement model.

Chapter 4: Critical review of the building block approach

A critical review analysis is performed of the new recognition and measurement model in terms of the IASB’s building block approach.

Chapter 5: Conclusions and recommendations

The chapter includes a critical assessment of the IASB’s new recognition and measurement proposal and a comparison with the current recognition and measurement model in order to determine whether decision-usefulness of insurance accounting improves in relation to the above. Conclusions are drawn from the literature reviewed in Chapters 2 to 4. Recommendations for possible areas of further research are also proposed.
2. CRITICAL REVIEW OF SAP 104 – CALCULATION OF THE VALUE OF LIABILITIES

In this chapter, a critical review analysis is performed of the current recognition and measurement model, as described in SAP 104, which is applied to insurance contracts by South African long-term insurers.

2.1 Research approach and method

The purpose of this analysis is to obtain an understanding of the requirements contained in SAP 104 in order to determine how long-term insurers account for their policyholder liabilities on the statement of financial position (this is further explored in Chapter 3 through a content analysis study). This chapter forms the foundation for comparing the accounting treatment followed at present with the accounting treatment proposed in the 2013 ED, including any re-deliberations (refer to Chapter 5 for a comparison of results). This is done in pursuit of the overall objective of assessing whether decision-useful information is provided to users of the financial statements. This analysis concentrates on identifying areas where there is a lack of guidance in the requirements that could potentially lead to a reduction in the provision of decision-useful information.

A critical review analysis is generally defined as a summarisation and evaluation of a specific text which could either be a book, journal or other medium (Skene, n.d.). UNSW Australia (2014) explains a critical review analysis as a requirement to “[q]uestion the information and opinions in a text and present evaluation or judgement of the text”.

A critical review analysis is not merely a high level summary of a text; it requires a researcher to have a thorough understanding of the topic in order to provide a fair and reasonable evaluation of the text (UNSW Australia, 2014). This is performed in conjunction with reading and evaluating other texts which help in proving the researcher’s conclusion (Merkezi, n.d.).

This chapter firstly provides an overview of the background and history of SAP 104, after which the critical review analysis of SAP 104 is discussed. The requirements contained in IFRS 4 are also examined in order to evaluate the impact and limitations of IFRS 4 on SAP 104. The review assists in understanding the current guidance provided to South African long-term insurers in terms of financial reporting and identifies the long-term, insurance-specific concepts and terminology. The findings of this critical review analysis informed the development of the questionnaire which is used in Chapter 3.
2.2 History of SAP 104

IFRS 4 requires entities that issue insurance contracts to apply their territory’s local GAAP, i.e. existing accounting policies in South Africa, when measuring insurance contracts (IASB, 2004: IFRS 4 para BC78). In South Africa it is compulsory for statutory actuaries to apply SAP 104 when performing valuations of long-term insurance companies’ insurance contract liabilities (ASSA, 2012a:1). This valuation is referred to as the Financial Soundness Valuation (hereafter FSV) method (ASSA, 2012a:5). The FSV method is detailed in section 3 of SAP 104. It is utilised by long-term insurers to measure the policyholder liabilities for IFRS reporting, in line with the Long-Term Insurance Act of 1998 (1998) (Van den Berg, 2014). The FSV method in SAP 104 is also subject to specific requirements included in IFRS 4 (IASB, 2004: IFRS 4 para BC78). The requirements of SAP 104 and IFRS 4 specific to the valuation of policyholder liabilities are discussed later in this chapter. SAP 104 also includes requirements for performing valuations for statutory reporting as well as tax liability calculations, none of which, however, is considered within the scope of this dissertation.

The first approved version of SAP 104 was published in August 1986 and applied by long-term insurers as local GAAP in South Africa (Van den Berg, 2014). However, only when the sixth version of SAP 104 was published and effective for the period starting 1 January 2005, did IFRS 4 become effective for policyholder liability valuations performed for financial years starting on or after 1 January 2005 (IASB, 2004: IFRS 4 para 41). The effective date of IFRS 4 is in line with the adoption date of IFRS in South Africa (United Nations, 2009:119). South African long-term insurers did not experience significant change in reporting as they continued to apply their existing accounting policies, i.e. SAP 104.

2.3 Critical review of SAP 104 requirements

SAP 104 describes the FSV method for valuing insurance contract liabilities as including the actual premiums in terms of an insurance contract and the future expected experience in respect of interest rates, expenses, mortality, morbidity and other relevant considerations (ASSA, 2012a:5). This represents an actuary’s best-estimate assumption of the liability attached to the insurance contract. The FSV method then incorporates prudence in valuing the policyholder liability by including compulsory and discretionary margins on top of the best-estimate assumption. SAP 104 has included this requirement to ensure that profits that arise from insurance contracts are not recognised prematurely but rather cautiously over the term of the insurance contract so as to avoid the
recognition of losses in future periods (ASSA, 2012a:7). Figure 3 below illustrates each component in more detail.

![Diagram of insurance contract liability valued based on the FSV method.]

**Figure 3: A long-term insurer’s liability**

*Source: ASSA, 2012a*

### 2.3.1 Best-estimate assumptions

The best-estimate liability represents the present value of future cash in and outflows relating to an insurance contract. Expected cash flows are determined on actual information available today and assumptions are set based on past experience and future expectations. Information available today to the long-term insurer would be captured in the insurance contract, i.e. premium receivable, insured amount and duration of contract. Examples of assumptions to be included are admin and claims handling expenses expected on the contract, expense inflation, expected lapse and surrender of the contract and mortality and morbidity expectations. These assumptions are not necessarily set on a contract basis, but are applied to groupings of contracts that are deemed similar in nature, i.e. product type (ASSA, 2012a:5).

In determining the cash flows, little guidance is provided on these principles, either in SAP 104 or in IFRS 4. In allocating expenses to the best-estimate liability, it is not clear what type of expenses should be allocated. Without the appropriate guidance, long-term insurers could allocate only direct
expenses or all expenses. Von Wielligh and Van den Berg (2005:75) performed a comparative study of financial reporting by South African long-term insurers and noted that long-term insurers set assumptions based on their past experience, including changes where future expected trends are different from past experience.

Once the cash flows have been determined, they are discounted using a discount rate representative of market yields that are similar to the term, nature and duration of the insurance contract (ASSA, 2012a:5). A long-term insurer could use a yield derived from assets, however, the impact on insurance contract liabilities of discounting with these type of yield curves should be considered. For example, if a yield curve selected by one long-term insurer is based on its investment in riskier assets, i.e. higher yield curve, and used to discount similar insurance contract liabilities, this long-term insurer will report a lower insurance contract liability than the other long-term insurers (Source: Own analysis).

### 2.3.2 Compulsory and discretionary margins

SAP 104 provides the following table prescribing the compulsory margins that have to be added to the best-estimate liability.

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortality</td>
<td>7.5% (increase for assurance. Decrease for annuities)</td>
</tr>
<tr>
<td>Morbidity</td>
<td>10%</td>
</tr>
<tr>
<td>Medical</td>
<td>15%</td>
</tr>
<tr>
<td>Lapse</td>
<td>25% (e.g. if the best estimate is 10%, the margin is 2.5%)</td>
</tr>
<tr>
<td>Termination for disability income benefits in payment</td>
<td>10%</td>
</tr>
<tr>
<td>Surrenders</td>
<td>10% (increase or decrease, depending on which alternative increases liabilities)</td>
</tr>
</tbody>
</table>
Expenses | 10%
---|---
Expense inflation | 10% (of estimated escalation rate)

Charge against investment return | 25 basis points in the management fee or an equivalent asset-based or investment performance-based margin

*Source: ASSA, 2012a*

Prudence is included in the best-estimate liability by adding compulsory margins. By adding the compulsory margins on top of the best-estimate liability, a long-term insurer builds in protection against the effects of the actual outcome differing from the expected outcome, i.e. scenarios in which a life assured accidentally dies one day after entering into a life policy vs. an expectation that the life assured dies due to old age (ASSA, 2012a:6).

The statutory actuary needs to determine whether discretionary margins should be added to the best-estimate liability, including the compulsory margins. SAP 104 contains no guidance on the level of discretion which should be included and simply states that “[w]hen the compulsory margins are insufficient in a particular case for prudent reserving; or the discretionary margins should be used in order to defer the release of profits consistent with policy design or company practice” (ASSA, 2012a:7).

Although SAP 104 allows for prudence to be included in the insurance contract liability, it provides no guidance on what level of prudence should be included (Von Wielligh, 2004:209). This could lead to significant diversity in practice. Compulsory and discretionary margins also simultaneously ensure that profits are not recognised before they are earned. However, it is questioned whether margins added to the best-estimate liability could be a mechanism for long-term insurance companies to smooth profit recognition depending on their accounting policy on how margins are released to profit or loss. Alternatively, long-term insurance companies could change the level of discretion and add less discretionary margins to their best-estimate liability in order to recognise profits earlier (Von Wielligh & Van den Berg, 2005:75).

**2.4 Review of IFRS 4 requirements specific to the valuation of policyholder liabilities and the impact on SAP 104 valuations**
As stated above, the FSV method prescribed in SAP 104 is the practice recognised in South Africa for valuing long-term liabilities. IFRS 4 requires the application of local GAAP for measuring long-term insurance liabilities. However the IASB has included specific requirements that should be considered when performing these valuations (IASB, 2004:IFRS 4 para BC77). One of the inclusions in IFRS 4 provides an exemption to paragraphs 10 to 12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (hereafter IAS 8). Paragraphs 10 to 12 of IAS 8 specify a hierarchy which should be applied in order to develop an accounting policy to which an IFRS does not apply (IASB, 2003). This exemption was included in IFRS 4 as it was expected that Phase II of IFRS 4 would be developed and become effective by 1 January 2007 (IASB, 2004:IFRS 4 para BC84). This exemption has led to diversity in the measurement of long-term insurance liabilities globally and, more importantly, between long-term insurance companies in the same country (Kruger, 2010). IFRS 4 requires that when there is a change in accounting policy either by an entity that already applies IFRS or by a first-time adopter of IFRS, the change in accounting policy should provide more relevant and no less reliable information. IFRS 4 paragraph 22 states that:

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8. (IASB, 2004:IFRS 4 para 22)

IFRS 4 provides specific guidance on the following items in the event of a change in accounting policy:

- an insurer is permitted but not required to change accounting policies to measure designated insurance liabilities to reflect current market interest rates;
- an insurer may continue to measure:
  - liabilities on an undiscounted basis;
  - the contractual right to investment management fees at an amount higher than fair value; and
  - liabilities using non-uniform accounting policies for subsidiaries, however these accounting policies may not be introduced;
- additional prudence shall not be added to the measurement of insurance liabilities if the measurement already includes sufficient prudence;
- future investment margins need not be eliminated from the accounting policies related to insurance contracts but accounting policies which reflect those margins may not be introduced; and
- shadow accounting, which eliminates mismatches in profit or loss due to different treatment of asset and liability remeasurements, may be used but is applicable to insurance contracts
where the measurement is dependent on the underlying assets and therefore not considered as part of the scope of this dissertation.

(IASB, 2004:IFRS 4 para 23).

When a long-term insurer reports its financial information, IFRS 4 does not contain specific presentation requirements. It is expected that long-term insurers refer to the illustrative financial statements, as provided in IAS 1 Presentation of Financial Statements (IASB, 2007b). However, it is questioned how long-term insurers present insurance-specific line items in their financial statements and whether this leads to further lack of comparability and complexity among long-term insurers (Von Wielligh & Van den Berg, 2005:72).

IFRS 4 currently provides broad disclosure requirements which include:

- disclosure of accounting policies describing the accounting treatment applied to insurance contracts;
- disclosure of all amounts recognised in terms of an insurance contract, i.e. assets, liabilities, income and expenses;
- quantitative and qualitative disclosure of assumptions used in the measurement of an insurance contract asset and / or liability;
- disclosure of the impact of changes to assumptions used in the measurement of an insurance contract asset and / or liability;
- disclosure of a reconciliation of the movement in the insurance contract asset and / or liability;
- disclosure of insurance contract risks including:
  - what the insurance contract risks are;
  - why and how insurance contract risks are managed;
  - quantitative and qualitative disclosure of the sensitivity of those risks on profit or loss and equity;
  - concentration risk attached to insurance contracts;
  - comparison of actual claims to estimated claims; and
- disclosure of credit, liquidity and market risk relevant to an insurance contract.

(IASB, 2004:IFRS 4 para 36 to 39A).

These disclosure requirements are supplemented with implementation guidance provided in IFRS 4. The implementation guidance discusses potential methods to meet the disclosure requirements in IFRS 4 paras 36 and 38 (IASB, 2004:IFRS 4 para IG11). It could be argued that the current
Disclosure requirements are broad and vague and therefore allow for discretionary disclosure to be provided by long-term insurers which is not comparable (Von Wielligh & Van den Berg, 2005:72).

2.5 Major observations and criticisms identified from the review

The major observations and criticisms from this review have been summarised below:

- the recognition and measurement criteria of insurance contracts described in SAP 104 are broad and could deviate from long-term insurer to long-term insurer depending on the existing accounting policies applied by the long-term insurer;
- the measurement principles included in SAP 104 are vague as to which cash flows should be included in the best-estimate liability, e.g. should only direct cash flows relating to the insurance contract be included or should indirect cash flows be included as well;
- SAP 104 defines the compulsory margins clearly by including a table with specific % margins to be added; thus no material difference is expected among long-term insurers;
- the discretionary margins directly impact on profit recognition and are based on the long-term insurer’s discretion. This could lead to various profit recognition profiles that are not comparable and significant disclosure is expected to explain this to the user of the financial statements;
- differing approaches of presentation of insurance-specific line items are expected among long-term insurers due to insufficient guidance; and
- broad and vague disclosure requirements could lead to different types of disclosure being provided as well as some long-term insurers providing either more or less disclosure, based on their discretion in meeting the requirements of IFRS 4.

A questionnaire has been formulated based on the critical review analysis performed of SAP 104 and IFRS 4 above. The questionnaire contains questions targeting the long-term insurers’ accounting policies, presentation and disclosure of their insurance business. The aim of the questions is to determine whether the information provided by long-term insurers is sufficient to explain how the policyholder liability and related insurance line items have been measured and if that explanation is sufficient for a user to understand the long-term insurer’s business and if results are comparable among long-term insurers. The questionnaire is included in Appendix A of this dissertation. The results of the questionnaire are analysed in Chapter 3.
3. ANALYSIS OF ACCOUNTING POLICIES, PRESENTATION AND DISCLOSURE APPLIED BY SOUTH AFRICAN LONG-TERM INSURERS

In this chapter the application of the requirements of SAP 104 and IFRS 4 is considered through a content analysis of South Africa’s large, listed long-term insurers’ accounting policies and how the insurance contracts are presented and disclosed in the financial statements. The analysis further highlights problem areas as well as areas of divergence in the current recognition and measurement model.

In order to understand the presentation and disclosure of long-term insurers, one first needs to understand how a long-term insurance company operates and generates profit. An insurance company provides protection to its client (hereafter referred to as policyholder) against a loss caused by an uncertain future event by indemnifying the policyholder in exchange for a premium (Asensio, 2011). Examples of long-term insurance include, but are not limited to, death, disability and dread disease. As an insurance company grows in terms of policyholders, it is able to pool its insurance risks. Pooling insurance risks is a risk management strategy which insurance companies utilise to spread their risks across a homogenous group of policyholders. For example, an insurance company provides insurance for death to policyholders who pay a premium for this cover. Where policyholders enter into insurance contracts with an insurance company to cover similar risks, homogenous groups are formed. Within a homogenous group where death is covered and a policyholder dies accidentally, the insurance company is able to pay the claim to the beneficiaries of the policyholder from the cash flow received and managed from the portfolio (American Academy of Actuaries, 2009:1). A long-term insurer generates profits principally from the premiums it receives from policyholders after deducting claims and other expenses as well as investment return from investing premiums received (Sha, 2007). This is the business model used by insurance companies. It is therefore expected that the financial reporting would be consistent for similar policies offered to the market.

3.1 Assessment of decision-usefulness

The Conceptual Framework for Financial Reporting (hereafter Conceptual Framework) defines the objective of financial statements as:

Provid[ing] financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and
In order for information to be decision-useful it needs to be relevant and presented faithfully. Additional characteristics include information that is comparable, verifiable, timely and understandable (IASB, 2010a:Conceptual Framework para QC4). The research study identifies deficiencies in reporting that decrease consistency and comparability of information that reduces understandability for users. Without these characteristics it is questioned whether the information currently reported is relevant and faithfully presented.

Marszalek (2014) performed a study that investigated the key principles and likely impacts of IFRS 4 Phase II applicable to the South African long-term insurance industry. The investigation was focused on the proposed IFRS 4 Phase II measurement approach to profit reporting and was contrasted with the current FSV method. In the study, Marszalek (2014:34) identified the following users in addition to the primary users identified above:

- Insurance supervisors or regulators;
- Tax authorities;
- Company management;
- Employees;
- Distributors and sales channel operators;
- Clients and potential clients (policyholders);
- Reinsurers;
- Potential acquirers;
- General public; and
- Media.

The Conceptual Framework identifies user needs for information to help them assess the prospects for future net cash inflows to an entity as decision-useful (IASB, 2010a:Conceptual Framework para QC3). This raises the question of whether the information currently presented and disclosed by long-term insurers in South Africa provides users with an understanding of expected future net cash inflows or not.

3.2 Research approach and method

The presentation and disclosure practices of the long-term insurance companies were empirically tested through content analysis of their annual financial statements. The most recently available
annual financial statements of long-term insurance companies for the period from April 2015 to June 2015 were analysed. The presentation and disclosure practices for the listed companies included in the JSE’s life insurance sector were examined.

3.2.1 Population

The study focused on the presentation and disclosure of large, JSE listed long-term insurance companies in South Africa. This population is deemed appropriate due to limitations on availability of annual financial statements of non-listed long-term insurers. An assessment of the population was performed in order to illustrate the size of each listed long-term insurer to the total market share of long-term insurers in South Africa. This assessment is based on the individual market shares per life licence, as reported in the Financial Services Board’s sixteenth annual report of the registrar on the results of the long-term insurance industry for the period ending 2013 (FSB, 2014:38-39). The assessment is detailed below.

Table 2: Long-term insurance market share

<table>
<thead>
<tr>
<th>Long-term insurance company</th>
<th>Total net premiums</th>
<th>Total assets</th>
<th>Total liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clientèle Limited (hereafter Clientèle)</td>
<td>0.29%</td>
<td>0.12%</td>
<td>0.11%</td>
</tr>
<tr>
<td>Discovery Holdings Limited (hereafter Discovery)</td>
<td>2.87%</td>
<td>1.59%</td>
<td>1.17%</td>
</tr>
<tr>
<td>Liberty Holdings Limited (hereafter Liberty)</td>
<td>11.09%</td>
<td>12.98%</td>
<td>12.94%</td>
</tr>
<tr>
<td>MMI Holdings Limited (hereafter MMI)</td>
<td>14.37%</td>
<td>13.56%</td>
<td>14.56%</td>
</tr>
<tr>
<td>Old Mutual Plc (hereafter Old Mutual)</td>
<td>16.26%</td>
<td>23.54%</td>
<td>23.91%</td>
</tr>
<tr>
<td>Sanlam Limited (hereafter Sanlam)</td>
<td>10.34%</td>
<td>16.43%</td>
<td>15.34%</td>
</tr>
<tr>
<td><strong>Total market share</strong>*</td>
<td><strong>55.22%</strong></td>
<td><strong>68.22%</strong></td>
<td><strong>68.03%</strong></td>
</tr>
</tbody>
</table>

* Market shares have been derived from the main life licence for each insurer included above.

The population used in this research study also represents the most significant part of the total market value of long-term insurance companies in South Africa.
3.2.2 Content analysis of annual financial statements

Krippendorff (2013) described the analysis of content as a research technique where information is reduced into smaller, related content categories based on rules of coding. This research technique has further been supported by Beattie et al. (2004), Berelson (1952), Stemler (2001) and Weber (1990).

For the purpose of coding the presentation and disclosure practices, the following content analysis guidelines were used.

<table>
<thead>
<tr>
<th>Guideline</th>
<th>Yes</th>
<th>No</th>
<th>Not Applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the required information is fully disclosed and appropriately described, the item is marked as Yes in the questionnaire.</td>
<td>If there is no disclosure of all the required information, the item is marked as No in the questionnaire.</td>
<td>An item is marked Not Applicable if it is not relevant or appropriate. If an item is marked as No it will not be considered further as part of the population in sub questions and marked as Not Applicable.</td>
<td></td>
</tr>
</tbody>
</table>

3.2.3 Research control

The research consisted of analysing the annual financial statements of large, JSE listed long-term insurance companies. Financial statements of six South African long-term insurers listed on the JSE were reviewed against the questions set out in the questionnaire in order to assess their usefulness in decision-making by users of the financial statements.

The annual reports of South Africa’s largest listed long-term insurers, based on the JSE long-term insurance sector, were used in the content analysis. These reports were the following:

- Clientèle Limited Annual Report 2014;
- Discovery Holdings Limited Annual Report 2014;
- Liberty Holdings Limited Annual Report 2014;
The analysis was performed using a questionnaire against which presentation and disclosure were measured. This questionnaire was developed from the observations and criticisms identified in the critical review analysis in Chapter 2. The questionnaire was tested for completeness through discussions with suitably qualified and experienced members of the accounting community. The results were tabled in Sections 3.3 to 3.8 below. In the interests of accuracy and reasonableness, the results were independently adjudicated.

3.3 Classification

The IASB included a definition of an insurance contract in IFRS 4 Phase I. This definition assists preparers in the identification of insurance contracts issued for IFRS purpose and inclusion in the scope of IFRS 4.

Table 3: Classification

<table>
<thead>
<tr>
<th>Classification</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Has an insurance contract been defined?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>2 If yes, is the provided definition in line with IFRS 4?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Own analysis

This definition has been applied consistently across all long-term insurers in the population. As part of the accounting policies disclosed by each long-term insurer, it is clear that long-term insurers have appropriately identified insurance contracts issued from other contracts issued, specifically investment contracts, which are accounted for in terms of IAS 39 Financial Instruments: Recognition and Measurement.

3.4 Accounting policies – Recognition
It is considered whether long-term insurers have included accounting policies that describe the recognition principles applied to insurance contracts issued. As each long-term insurer applies local GAAP principles, the accounting policies are key to users in determining how insurance contracts have been recognised.

**Table 4: Recognition**

<table>
<thead>
<tr>
<th>Recognition</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Recognition of an insurance contract:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Are premiums recognised when due?</td>
<td>5</td>
<td>83%</td>
<td>1</td>
<td>17%</td>
<td>0</td>
</tr>
<tr>
<td>b. Does the long-term insurer differentiate between components of premium?</td>
<td>2</td>
<td>33%</td>
<td>4</td>
<td>67%</td>
<td>0</td>
</tr>
<tr>
<td>c. Does the long-term insurer recognise premium in line with IAS 18 Revenue?</td>
<td>1</td>
<td>17%</td>
<td>5</td>
<td>83%</td>
<td>0</td>
</tr>
<tr>
<td>d. Are claims recognised as incurred?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>e. Has the long-term insurer explained when the insurance contract liabilities are recognised?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>f. Has the long-term insurer explained when the changes in the insurance contract liabilities are transferred to profit or loss?</td>
<td>3</td>
<td>50%</td>
<td>3</td>
<td>50%</td>
<td>0</td>
</tr>
</tbody>
</table>

**Source: Own analysis**

The majority of the companies in the population recognised premiums only once the premium was due. One long-term insurer, however, recognised premiums as they were earned by the long-term insurer, with the unearned portion included in the insurance contract liability. Recognising premiums only when they are due is a measure that presents information about a long-term insurer's right to unconditional payment (IASB, 2013c:ED Insurance Contracts para BC106(d)). This is inconsistent with revenue recognition principles included in IAS 18 Revenue (hereafter IAS 18) and its successor, IFRS 15 Revenue from Contracts with Customers (hereafter IFRS 15) where the objective is to recognise revenue as goods or services which are transferred (IASB, 2014:IFRS 15 para 2).
Insurance contracts could be either paid up-front, monthly or annually. Long-term insurers recognise the upfront, monthly or annual premium when due for payment based on the financial statements inspected. Therefore, the premium recognised as revenue for contracts that are priced economically the same, could vary significantly. The inconsistency arises because long-term insurers are currently recognising premiums before they have transferred a service e.g. providing insurance coverage to the policyholder. The accounting treatment applied by long-term insurers is akin to cash flow accounting rather than accrual accounting.

Based on these findings, the long-term insurer’s premium recognition policy to recognise premiums once earned is inconsistent with other long-term insurers, making comparability problematic. Comparability is also impaired between the long-term insurance industry and other industries that apply IAS 18. This would affect the usefulness of the information, given that comparability is regarded as an enhancing, qualitative characteristic of financial reporting (IASB, 2010a:Conceptual Framework para QC4). This view has been confirmed by an IASB board member, Steve Cooper, in an article on investor perspectives published in February 2015 (Cooper, 2015). Only two out of the six long-term insurers provided additional details on the amounts that make up the premium due in the notes of the financial statements.

Accounting policies for the recognition of claims and insurance contract liabilities were disclosed consistently among the six long-term insurers in the population. However, only 50% of the population (three of the six long-term insurers) included an accounting policy for changes in the insurance contract liability.

### 3.5 Accounting policies – Measurement

This section of the questionnaire addresses accounting policies relating to the measurement of insurance contracts issued by long-term insurance companies.

**Table 5: Local GAAP principles**

<table>
<thead>
<tr>
<th>Measurement – Local GAAP principles</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 Has the objective of the methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models and the source of</td>
<td>2</td>
<td>33%</td>
<td>4</td>
<td>67%</td>
<td>0</td>
</tr>
</tbody>
</table>
information used in the models been disclosed?

Source: Own analysis

Only two long-term insurers endeavoured to appropriately explain the objective of the methods used to adjust insurance liabilities for risk and uncertainty, the nature of those models and the source of information used in the models by including detailed disclosure on SAP 104. The remaining long-term insurers simply stated that measurement was performed based on the FSV method contained in SAP 104 and provided no further detail. Without the appropriate, descriptive accounting policy in place, a non-insurance specialist may struggle to understand what measurement basis has been used for the insurance contract liability.

From the results, it can be seen that the long-term insurers in the population use various accounting policies. Von Wielligh (n.d.) noted that the use of different accounting policies by long-term insurers weakens the understandability of the financial statements to users. In the research performed by Von Wielligh (n.d.) and Von Wielligh and Van den Berg (2005:68), it was reported that the comparability, relevance and ultimately, the understandability of long-term insurers’ financial statements is potentially influenced negatively as a result of the absence of authoritative guidelines on financial reporting by issuers of insurance contracts.

**Table 6: Contract-specific measurement**

<table>
<thead>
<tr>
<th>Measurement – Contract-specific</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Is a description of different types of long-term insurance policies provided?</td>
<td>5</td>
<td>83%</td>
<td>1</td>
<td>17%</td>
<td>0</td>
</tr>
</tbody>
</table>

a. If the long-term insurer has different policies, are the accounting policies clear on individual measurement? (i.e. group life policies are measured retrospectively [with reference to the premium charged which is akin to a deferred revenue liability] whilst other life policies are measured prospectively [prospective valuation of future...
cash flows and margins] in terms of SAP 104).

<table>
<thead>
<tr>
<th></th>
<th>Measurement of the insurance contract:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Has a description been provided of the measurement of premiums?</td>
</tr>
<tr>
<td>b.</td>
<td>Has a description been provided of the measurement and nature of claims?</td>
</tr>
<tr>
<td>c.</td>
<td>Has the long-term insurer explained if, how and when a liability adequacy test will be performed, including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in the test?</td>
</tr>
<tr>
<td>d.</td>
<td>Has the long-term insurer disclosed whether insurance liabilities are discounted and, if they are discounted, explained the methodology used?</td>
</tr>
<tr>
<td>e.</td>
<td>In determining the best-estimate liability, has the long-term insurer stated whether the calculation is based on the mean, median or mode value of data?</td>
</tr>
<tr>
<td>f.</td>
<td>Has the contract boundary for policies been defined? (i.e. a description of the duration of cash flows which are included in the valuation).</td>
</tr>
</tbody>
</table>

*Source: Own analysis*
The long-term insurers in the population clearly disclosed their measurement policies on premiums, claims and liability adequacy.

All long-term insurers included in the population discounted their insurance contract liability; however, different yield curves were used by long-term insurers, with limited disclosure indicating the impact on the insurance contract liability. This leads to the question of whether an appropriate yield curve is used to reflect the time value of money specific to the insurance contract liability. Examples of yield curves currently used by long-term insurers include risk-free, adjusted risk-free and asset-based yield curves. Higher yield curves lead to the recognition of lower insurance contract liabilities whilst lower yield curves result in the recognition of higher liabilities. If long-term insurers use different yield curves for similar insurance contracts along with the provision of minimal disclosure, comparability will be negatively impacted.

No information was provided by long-term insurers on determining the best-estimate liability in terms of their own data analysis and industry data. The understanding of data collection and analysis inform a user’s decision-making in events where there are uncertainties. It is not clear from the financial statements whether the long-term insurer utilised the mean, median or mode value for data analysis. The ‘mean’ point of data refers to the average value and is determined by the summation of all the values in the data set which are then divided by the number of values one has summed. The ‘median’ identifies the middle value by separating the data set in a higher and lower half. The ‘mode’ refers to the value in the data set that has the highest frequency of occurring (Michigan State University, 2008).

As illustrated by the definitions above, utilising different values in data by long-term insurers for the same type of insurance contract provides different best-estimate liabilities, thus causing a lack of comparability of financial information, especially where limited or no disclosure is provided.

It is further noted that no information was provided on the duration of cash flows included in the best-estimate liability. The absence of this information is to the detriment of users as they are unable to obtain an understanding of how the insurance contract’s best-estimate liability was calculated.

**Table 7: Acquisition cost**

<table>
<thead>
<tr>
<th>Measurement – Acquisition cost</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 Has a policy been included on the treatment of acquisition costs?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
</tbody>
</table>
a. Are acquisition costs expensed on day 1?  6  100%  0  0%  0

b. Are acquisition costs implicitly deferred as part of the insurance contract liability?  6  100%  0  0%  0

c. Has the long-term insurer included only costs that are linked directly to the insurance contract as acquisition costs?  2  33%  4  67%  0

Source: Own analysis

Acquisition costs are incurred by long-term insurers when issuing new insurance contracts. Examples of these costs include underwriting costs, commission, medical inspection costs and initiation costs. Insurance contracts are priced in such a way as to recover acquisition costs incurred. From the financial statements reviewed, all six long-term insurers expense acquisition costs through the statement of financial performance, creating a loss in profit or loss at initial recognition.

When measuring the insurance contract at inception, a long-term insurer would only include the future cash flows expected, thus acquisition costs already expensed would not be included in the measurement of the insurance contract liability. The measurement would therefore show a higher expected profit on the insurance contract. At this point, long-term insurers would add the margins to the measurement that would defer the recognition of expected profit. The level of discretionary margin added would be impacted by the long-term insurer’s profit recognition policy. Various scenarios exist, for example:

- zeroising negative liabilities causing accounting losses (as acquisition costs were expensed) to be shown in profit or loss at inception;
- recognising profits to the extent of acquisition costs expensed in order to achieve a net nil position in profit or loss; or
- no / limited zeroisation of negative liabilities and recognition of profits at inception.

(Source: Own analysis)

The last two scenarios create an implicit asset as it is not shown as a separate line item on the statement of financial position but rather as an offset against the insurance contract liabilities. These accounting policies of long-term insurers (except for one long-term insurer) do not clearly explain this accounting treatment and therefore users are unable to assess whether this approach is appropriate.

When examining the financial statements, consideration was given as to whether long-term insurers were consistent in classifying different types of costs as acquisition costs. It was noted that some
long-term insurers only included direct acquisition costs that could be linked to an insurance contract while others included both direct and indirect acquisition costs. It therefore remains unclear exactly what was deemed to be acquisition costs. Comparability was once again affected by the inconsistent accounting treatment of acquisition costs and profit recognition through discretionary margins as long-term insurers included different types of acquisition costs in the implicit deferred acquisition cost asset created. Some long-term insurers only included costs that directly related to the insurance contract whilst others included both direct and indirect costs.

Table 8: Compulsory and discretionary margins

<table>
<thead>
<tr>
<th>Measurement – Compulsory and discretionary margins</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>8 Is an explanation provided for compulsory and discretionary margins? (i.e. an explanation of the difference between the margins and how they impact the insurance contract liabilities).</td>
<td>4</td>
<td>67%</td>
<td>2</td>
<td>37%</td>
<td>0</td>
</tr>
<tr>
<td>9 Is an explanation provided to detail what compulsory margins are set at?</td>
<td>2</td>
<td>33%</td>
<td>4</td>
<td>67%</td>
<td>0</td>
</tr>
<tr>
<td>10 Discretionary margins:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Is an explanation provided to detail what discretionary margins are set at?</td>
<td>3</td>
<td>50%</td>
<td>3</td>
<td>50%</td>
<td>0</td>
</tr>
<tr>
<td>b. If yes, is this in line with market expectations?</td>
<td>0</td>
<td>0%</td>
<td>3</td>
<td>100%</td>
<td>3</td>
</tr>
<tr>
<td>c. Has the objective of the discretionary margin been explained?</td>
<td>2</td>
<td>67%</td>
<td>1</td>
<td>33%</td>
<td>3</td>
</tr>
<tr>
<td>d. Is the profit recognition profile for the discretionary margin described?</td>
<td>1</td>
<td>33%</td>
<td>2</td>
<td>67%</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Own analysis
Compulsory and discretionary margins are added to the best-estimate liability to form the insurance contract liability, as illustrated in Figure 3 above. Four long-term insurers included in their accounting policies that compulsory and discretionary margins were added to the insurance contract liability and stated the objective of these margins as adding prudence to reserving and deferring profit recognition to the point that economic benefits flow to the long-term insurer. Compulsory margins were consistently prescribed and added to the best-estimate liability by the long-term insurers. Discretionary margins, however, are not prescribed and are at the discretion of the long-term insurers. Discretionary margins are not based on market expectations, i.e. observable information in the market, but rather on the long-term insurer's experience of the past and expectations of the future that relate directly to its business as well as a long-term insurer's risk appetite. Based on this, one would expect differences between the discretionary margins recognised by long-term insurers and the provision of significant disclosure to help users understand the discretionary margin recognised by the long-term insurers.

The majority of long-term insurers in the population did not provide an accounting policy describing how profit deferred in the discretionary margin was subsequently released to the statement of profit or loss and other comprehensive income. The absence of such a policy weakens the user's understanding of the long-term insurer's profit recognition profile and does little to assist users in determining the value of the company (IASB, 2010a:Conceptual Framework para A22).

**Table 9: Embedded options and guarantees and discretionary participation feature policies**

<table>
<thead>
<tr>
<th>Measurement – Embedded options and guarantees and discretionary participation feature policies</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>For embedded options and guarantees:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Is there a description of the measurement of insurance liabilities reflecting the intrinsic value and time value of these items?</td>
<td>4</td>
<td>67%</td>
<td>2</td>
<td>33%</td>
<td>0</td>
</tr>
<tr>
<td>b. Is there a description of their measurement being consistent with observed current market prices?</td>
<td>5</td>
<td>83%</td>
<td>1</td>
<td>17%</td>
<td>0</td>
</tr>
</tbody>
</table>
For discretionary participation features, is there a clear statement of how the long-term insurer classifies that feature as a liability or as a component of equity?

Source: Own analysis

Insurance contracts issued by long-term insurers could contain embedded options and guarantees. For these type of contracts, IFRS 4 does not require the embedded options and guarantees to be separated from the host insurance contract if it meets the definition of an insurance contract. If a contract does not meet this definition, it should be measured in accordance with IAS 39, i.e. fair value (IASB, 2004:IFRS 4 para 7). Long-term insurers do not separate embedded derivatives. Four of the six long-term insurers had accounting policies addressing the accounting treatment of embedded derivatives whilst two long-term insurers only stated compliance with Advisory Practice Note (hereafter APN) 110. APN 110 prescribes that embedded derivatives that are separated from the host contract should be measured at fair value (ASSA, 2012b:1). Without an indication of the policy of the accounting treatment, users of the financial statements could potentially struggle to interpret the results.

Contracts with discretionary participation features (hereafter DPF contracts) are defined as follows:

A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;
(b) whose amount or timing is contractually at the discretion of the issuer; and
(c) that are contractually based on:
   i. the performance of a specified pool of contracts or a specified type of contract;
   ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
   iii. the profit or loss of the company, fund or other entity that issues the contract.
   (IASB, 2004:IFRS 4 Appendix A)

The analysis has shown that long-term insurers fail to adequately describe the accounting treatment of DPF contracts in their accounting policies. However, from inspection of the statement of financial position, it is clear that all long-term insurers classify DPF contracts as a liability. Long-term insurers that issue contracts with DPFs should consider indicating their policy of classifying these contractual features as liability or equity. The IASB has indicated that there is a need to review the liability equity classification in its entirety instead of addressing this in individual standards (IASB, 2015a).
3.6 Presentation on the statement of financial position

Table 10: Statement of financial position

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have the following line items been presented:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Insurance contract liability for long-term insurance policies?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>b. Insurance contract asset for long-term insurance policies?</td>
<td>1</td>
<td>17%</td>
<td>5</td>
<td>83%</td>
<td>0</td>
</tr>
<tr>
<td>c. Investment contracts with a discretionary participation feature?</td>
<td>2</td>
<td>40%</td>
<td>3</td>
<td>60%</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Own analysis

The statements of financial position analysed for the six long-term insurers were consistent with respect to insurance contracts except for the presentation of an insurance contract asset in one long-term insurer’s statement of financial position. The insurance contract asset arises from policyholder liabilities that are negative in aggregate. This could be caused by either significant upfront acquisition costs or recognising profit at initial recognition of the insurance contract from valuing future premium income not offset by the discretionary margin (Source: Own analysis).

Where investment contracts with DPF were not presented separately, three long-term insurers included this as part of other policy liabilities and disclosed it as part of a note.
3.7 Presentation on the statement of profit or loss

Table 11: Statement of profit or loss

<table>
<thead>
<tr>
<th>Statement of profit or loss</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>14 Have the following line items been presented:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Premiums / revenue?</td>
<td>5</td>
<td>83%</td>
<td>1</td>
<td>17%</td>
<td>0</td>
</tr>
<tr>
<td>b. Claims / benefits?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>c. Changes in the insurance liabilities?</td>
<td>4</td>
<td>67%</td>
<td>2</td>
<td>33%</td>
<td>0</td>
</tr>
<tr>
<td>d. Acquisition costs attributable to insurance contracts?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Own analysis

Slight variations in the presentation of the statement of profit or loss were noted, as seen above from the analysis performed. Where items have not been presented separately, it can easily be traced to the notes of the financial statements. As this information is disclosed in the notes to the financial statements, comparability is achieved.

3.8 Disclosure in the notes of the financial statements

Table 12: Insurance contract liability reconciliation

<table>
<thead>
<tr>
<th>Notes – Insurance contract liability reconciliation</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 Has a reconciliation for the insurance contract liability been provided detailing the movement from opening to closing balance?</td>
<td>6</td>
<td>100%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
</tr>
</tbody>
</table>
a. Has the carrying amount at the beginning and end of the period been included?  | 6  | 100%  | 0  | 0%  | 0

b. Have additional insurance liabilities arising during the period been included?  | 5  | 83%  | 1  | 17% | 0

c. Does the reconciliation include cash paid?  | 2  | 33%  | 4  | 67% | 0

d. Have income and expense included in profit or loss been included?  | 0  | 0%  | 6  | 100% | 0

e. Have liabilities acquired from, or transferred to, other insurers been included?  | 4  | 80%  | 1  | 20% | 1

f. Have net exchange differences arising from the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity, been included?  | 5  | 100%  | 0  | 0% | 1

g. Is the user of the financials provided with detail of what the insurance contract liability closing balance consists of? (i.e. best-estimate amount, compulsory margin added and discretionary margin added).  | 2  | 33%  | 4  | 67% | 0

Source: Own analysis

IFRS 4 paragraph 37(e) requires an issuer of an insurance contract to identify and describe amounts arising from insurance contracts (IASB, 2004). By providing a reconciliation of the change in the insurance contract liability, a long-term insurer provides disclosure that assists users in understanding the financial reporting on insurance contracts. All long-term insurers provided a reconciliation from the opening to closing insurance contract liability, however, the reconciliations disclosed were not consistent from one long-term insurer to the next, making it difficult to compare reconciliations.
IFRS 4 provides guidance on what line items to include in the reconciliation (IASB, 2004: IFRS 4 para IG37). Although the long-term insurers reported these lines in their reconciliations, it could not easily be reconciled to the statement of financial performance or the cash flow statement. Some long-term insurers did not include all the suggested line items in their reconciliation, for example, cash paid. However, the reconciliation still reconciled, implying that the line items not disclosed separately were included in other line items. This resulted in a lack of comparability between long-term insurers’ reconciliations.

Only two long-term insurers provided disclosure on the composition of the insurance contract liability. A user can therefore not typically assess the level of margins applied to the best-estimate liability and is unable to compare the respective risk appetite of each long-term insurer. IFRS 4 does not explicitly require a long-term insurer to disclose the composition of the insurance contract liability, but such disclosure would assist in providing a better understanding of the liability reported by the long-term insurer.

**Table 13: Assumptions used in measurement**

<table>
<thead>
<tr>
<th>Notes – Assumptions used in measurement</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>The long-term insurer must include a description of the process used to determine assumptions. Sections a - g below include a list of possible significant disclosure.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Has the objective of the assumptions been disclosed? For example, the long-term insurer may disclose whether the assumptions are intended to be neutral estimates of the most likely or best-estimates or to provide a given level of assurance or sufficiency. If they are intended to provide a quantitative or qualitative level of assurance, the long-term insurer may disclose that level.</td>
<td>0</td>
<td>0%</td>
<td>6</td>
<td>100%</td>
<td>0</td>
</tr>
</tbody>
</table>
b. Has the source of data used as inputs for the assumptions that have the greatest effect been disclosed? For example, the long-term insurer may disclose whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, the long-term insurer may disclose the criteria used to determine when the studies are updated and the date of the latest update.

c. Has the extent to which the assumptions are consistent with observable market prices or other published information been disclosed?

d. Is there a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions? If a relationship would normally be expected between experience and future results, the long-term insurer may explain the reasons for using assumptions that differ from past experience and indicate the extent of the difference.

e. Has a description of how the long-term insurer developed assumptions about future trends been disclosed?

f. Has an explanation of how the long-term insurer identifies correlations between different assumptions been disclosed?

g. Has the nature and extent of uncertainties affecting specific assumptions been
disclosed?

Source: Own analysis

Question 17a was addressed above as part of the section on accounting policies (Question 6e) where no policy was provided by the long-term insurers. It was further noted that no disclosure relating to the objectives of assumptions was supplied as part of the notes to the financial statements.

The disclosure provided on the source of data, past experience and other conditions applicable to the long-term insurers was sufficient where the long-term insurers needed to consider internal information. However, long-term insurers were unsuccessful in disclosing information to users on the extent to which internal information was consistent with market information. This was due to limited qualitative and quantitative information supplied. This weakens decision-useful information as users are unable to determine why a long-term insurer adjusted its insurance contract liability by ‘X’ relating to a mortality risk if the market considers the assumption change to be ‘Y’.

Only two long-term insurers provided disclosure on the correlations identified within various assumptions set. Long-term insurers have a wealth of data relating to the various risks they insure. Long-term insurers could provide useful information to users on how they leverage the risks insured and the subsequent impact on the measurement of insurance contract liabilities.

Although long-term insurers provided sensitivity analyses (refer below) on assumptions used in setting insurance contract liability, no qualitative disclosure was provided on the uncertainties that impact assumptions used. Therefore, a user is unable to gain an understanding of the assumptions used in determining the insurance contract liability.

Table 14: Profit recognition

<table>
<thead>
<tr>
<th>Notes – Profit recognition</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 Has the long-term insurer explained how margins have been released to profit? (quantitative disclosure).</td>
<td>0</td>
<td>0%</td>
<td>6</td>
<td>100%</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Own analysis

None of the long-term insurers in the population disclosed the profit recognition profile for the period reported. The absence of this disclosure affects a user’s ability to understand how profit arose; for
example, did a long-term insurer earn profits from new insurance policies sold or by releasing discretionary margins that provided a smoothing effect to year-on-year profits?

**Table 15: Risk disclosure**

<table>
<thead>
<tr>
<th>Notes – Risk disclosure</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>19 Has the long-term insurer provided sensitivity analyses showing the impact on the company if they have used reasonable alternative assumptions?</td>
<td>5</td>
<td>83%</td>
<td>1</td>
<td>17%</td>
<td>0</td>
</tr>
<tr>
<td>20 Has the concentration risk of the insurer's long-term insurance products been provided?</td>
<td>4</td>
<td>67%</td>
<td>2</td>
<td>33%</td>
<td>0</td>
</tr>
</tbody>
</table>

*Source: Own analysis*

Long-term insurers provided detailed disclosure on the risks related to insurance policies and on the sensitivity of assumptions used in determining the insurance-related amounts recognised in the financial statements. The majority of long-term insurers also provided disclosure on how undue concentrations of insurance risks were managed.

Based on the results of Questions 17 and 19, it was noted that long-term insurers’ disclosure does not clearly explain the link between assumptions applied, sensitivity analyses performed and key risks.

**Table 16: Experience variances**

<table>
<thead>
<tr>
<th>Notes – Experience variances</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
<th>N/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 Has the long-term insurer included qualitative disclosure on experience variances for the period reported?</td>
<td>2</td>
<td>33%</td>
<td>4</td>
<td>67%</td>
<td>0</td>
</tr>
<tr>
<td>22 Has the long-term insurer included quantitative disclosure on experience variances for the period reported?</td>
<td>3</td>
<td>50%</td>
<td>3</td>
<td>50%</td>
<td>0</td>
</tr>
</tbody>
</table>

*Source: Own analysis*
Only 33% (two of the six long-term insurers) compliance has been noted for the qualitative disclosure and 50% (three of the six long-term insurers) for quantitative disclosure surrounding experience variances. It is expected that these variances were sourced by the long-term insurer’s actuarial team. The necessary disclosure was not included in the financial statements possibly due to lack of this information from the general ledger and poor understanding of the reporting requirements (IFRS) by the actuarial team which calculates the experience variances.

3.9 Summary of key deficiencies in providing useful information

This section summarises the key deficiencies identified in the analysis above. The following deficiencies have been noted after applying the questionnaire against the insurance information of the long-term insurers inspected:

- **Deficiency 1** – Long-term insurers recognise premiums as they are due, i.e. cash flow accounting, instead of when the long-term insurer has earned it.
- **Deficiency 2** – Long-term insurers apply existing accounting policies, i.e. SAP 104, when measuring insurance contract liabilities but do not provide clear accounting policies describing in detail how the principles are applied.
- **Deficiency 3** – Long-term insurers do not provide information on data inputs used in measuring the insurance contract liabilities.
- **Deficiency 4** – Long-term insurers do not provide information on the duration of cash flows included in determining the insurance contract liabilities.
- **Deficiency 5** – Long-term insurers are not consistent in their treatment of acquisition costs and day one profit recognition.
- **Deficiency 6** – Long-term insurers do not indicate accounting policies describing how profits are released from the discretionary margin to profit or loss nor disclosure reflecting the current reported year’s profit released.
- **Deficiency 7** – Long-term insurers do not separately present the insurance contract asset and insurance contract liability on the statement of financial position.
- **Deficiency 8** – Long-term insurers do not reconcile the insurance contract liabilities on a comparable basis. The reconciliations provided are too aggregated to provide useful information and are not easily reconciled to the statement of financial performance.
- **Deficiency 9** – Long-term insurers do not provide sufficient disclosure on the assumptions used in determining the insurance contract liabilities.

The results gathered in this chapter are critical in understanding the shortcomings in the current reporting model of long-term insurers. In the next chapter, the new proposed standard of the IASB is considered and a content analysis is conducted on the measurement principles, including principles
relating to presentation and disclosure. Chapter 5 assesses whether or not the deficiencies listed above are addressed through the principles contained in the ED on insurance contracts.
4. CRITICAL REVIEW OF THE BUILDING BLOCK APPROACH

In this chapter, a critical review analysis is performed on the new recognition and measurement model in terms of the IASB’s building block approach described in the ED Insurance Contracts, issued in July 2010 (IASB, 2010b), and the revised ED, issued in June 2013 (IASB, 2013c). The IASB has also held meetings after issuing the revised ED to redeliberate the principles contained in the ED. Where applicable, the deliberations are included in the analysis below. A study performed by Horton and Macve (1996:16) illustrated the difference between accounting for long-term insurance contracts and other industries as the long duration in time from receiving premiums to paying a claim. They concluded that a user of the financial statements would require specific guidance to determine the capital required and profitability of an insurance company.

The IASB embarked on a project to deliver a standard that provides a consistent accounting treatment for insurance contracts issued. The current standard, IFRS 4, is considered an interim one and does not adequately address certain weakness in reporting financial information on insurance contracts issued. These weaknesses include:

- not providing useful information to users of financial statements due to a lack of transparency in reporting the result of insurance contracts in financial statements;
- not providing relevant information on the measurement of insurance contracts issued; and
- providing information that is not comparable among entities which issue insurance contracts and other industries.
  (IASB, 2013c:ED Insurance Contracts para BC5)

A study performed by Klumpes et al (2009:197) on diversity in accounting for insurance noted the need for a single, consistent standard by the IASB. With IFRS 4 Phase II, the IASB has endeavoured to address these weaknesses by developing a single, consistent measurement model that can be applied to all types of insurance contracts along with detailed presentation and disclosure requirements. Bloomer (2004:56) conducted an impact analysis of insurance accounting on business reality and financial stability where he indicated that a new accounting standard would propose significant changes to current reporting practices. These changes could hold major consequences for a long-term insurer’s financial reporting practices (Bloomer, 2004:59).

This research study is focused on pure risk insurance contracts. This chapter therefore does not consider the following sections of the ED:

- scope of the ED;
• the premium allocation approach which is the simplified approach to measuring certain short-duration insurance contracts;
• contracts with participating features;
• portfolio transfers and business combinations; and
• transition requirements.

4.1 Research approach and method

The purpose of this critical review analysis is to obtain an understanding of the requirements contained in the ED in order to determine how long-term insurers will account for their insurance contract liabilities on the statement of financial position. A critical review analysis is an evaluation and summarisation of a specific text (Skene, n.d.) that enables the researcher to provide a fair and reasonable evaluation of the text (UNSW Australia, 2014).

The analysis assists the reader in understanding how the ED will propose a single, consistent recognition and measurement accounting treatment for insurance contracts issued, which is a significant stepping stone from IFRS 4 that currently allows a long-term insurer to apply existing accounting policies in terms of measurement. This is done in pursuit of the overall objective of assessing whether decision-useful information is provided to users of the financial statements.

The research approach and method applied in this chapter is consistent with the research approach and method applied in Chapter 2.

4.2 Definition of an insurance contract

Classification and the resulting accounting treatment to be applied is dependent on the definition included in a standard. The ED defines an insurance contract as follows:

A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (IASB, 2013c: ED Insurance Contracts Appendix A)

The definition in the ED is the same as the definition included in IFRS 4 (IASB, 2004: IFRS 4 Appendix A). Thus, it is considered reasonable to expect that there would not be significant differences in classification.
4.3 Recognition, derecognition and modification of an insurance contract

Insurance contracts issued will be recognised, at the earliest:

- from the start of the coverage period;
- when the policyholder is due to pay his first payment; and
- if the insurance contract forms part of a portfolio of onerous contracts.
  (IASB, 2013c:ED Insurance Contracts para 12)

Before the occurrence of the above events, the contract is executory and will not be recognised.

As part of recognition, entities that issue insurance contracts will have to consider whether a portfolio of contracts is onerous or not. For a portfolio of contracts that is onerous, the aggregate fulfilment cash flows are greater than zero. The excess over zero is expensed to profit or loss immediately (IASB, 2013c:ED Insurance Contracts para 15). Fulfilment cash flows are described in Section 4 of this chapter. Insurance contract modifications could either result in derecognition of the original contract and recognition of a new contract or accounting for the contract modification separately as a new contract (IASB, 2013c:ED Insurance Contracts para 49). An insurance contract is derecognised when the contract obligation is extinguished. The ED provides examples of extinguishment as a discharge, cancellation or expiration of the contract obligation (IASB, 2013c:ED Insurance Contracts para 50).

4.4 Measurement of an insurance contract

A fulfilment model will be used to measure insurance contracts issued (PwC, 2014:3). The fulfilment model will provide a current assessment of the amount, timing and uncertainty of future cash flows (Chung-Fern Wu & Hsu, 2011). This model is different to a fair value model, as originally proposed in the 2007 DP. A fair value model proposes the use of a current exit value which would be derived from determining the amount that would have to be paid in order to transfer an insurance contract to a third party (IASB, 2011: IFRS 13 para 9). Insurance contracts are rarely transferred but are rather fulfilled by the entity by paying a claim or benefit to the policyholder (IASB, 2013c:ED Insurance Contracts para BCA119). Deloitte (2013) describe the model as a “transparent approach that uses current measures and accounts for profit as insurers fulfil their obligations towards their policyholders”.

An insurance contract liability will initially be measured as the sum of the fulfilment cash flows and the contractual service margin, if applicable (IASB, 2013c:ED Insurance Contracts para 18).
Figure 4: Components to be measured of an insurance contract

Source: Own analysis

The fulfilment cash flows consist of future cash flows, discounting and a risk adjustment. Figure 5 below illustrates this.

Figure 5: Fulfilment cash flows to be measured comprise three building blocks

Source: IASB, 2015b

4.4.1 Future cash flows

Future cash flows to be included in the fulfilment model should be in direct relation to an insurance contract and represent the probability-weighted average of possible cash flows (IASB, 2013c:ED Insurance Contracts para BCA32). These cash flows include premiums, claims and benefits paid, acquisition costs, claims handling costs and other costs that the insurer can charge the policyholder in terms of the insurance contract (IASB, 2013c:ED Insurance Contracts para B66). Cash flows
should be unbiased, explicit, current estimates that do not contradict available market information. (IASB, 2013c: ED Insurance Contracts para BCA25)

When determining which cash flows to include, the contract boundary should be considered. The ED defines the contract boundary as follows:

Cash flows are within the boundary of an insurance contract when the entity can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage or other services. (IASB, 2013c: ED Insurance Contracts para 23)

Entities will no longer be bound to an insurance contract if they are able to evaluate and reprice an insurance contract that reflects the risks of the policyholder or can evaluate and reprice the risk related to a portfolio of insurance contracts and the risks included do not relate to future periods (IASB, 2013c: ED Insurance Contracts para 23). The contract boundary assists an entity in distinguishing existing insurance contracts from future insurance contracts. Only cash flows relating to existing insurance contracts should be included as fulfilment cash flows. (IASB, 2013c: ED Insurance Contracts para 16)

Acquisition costs that are directly attributable in a portfolio of insurance contracts must be included as part of the fulfilment cash flows (IASB, 2013c: ED Insurance Contracts Appendix B para B66(c)). A portfolio of insurance contracts consists of contracts that “provide coverage for similar risks and are managed together as a single pool”. (IASB, 2015c: 42)

Acquisition costs to be included as part of the fulfilment cash flows would consist of selling, underwriting and the initiation of insurance contracts that are incurred on a portfolio level for both successful and unsuccessful acquisitions of new or renewed insurance contracts (IASB, 2013c: ED Insurance Contracts Appendix A). Thus, no separate asset would be recognised relating to acquisition costs. The insurance contract liability will only represent fulfilment cash flows which incorporate expected acquisition costs and the contractual service margin (IASB, 2013c: ED Insurance Contracts para BCA50).

4.4.2 Discounting

Once the cash flows have been identified, insurers would need to consider time value of money. Time value of money explains that the same amount of money today is worth less in the future. The ED proposes that future cash flows relating to the insurance contract should be adjusted for the time value of money. In order to achieve this, a discount rate, represented by a yield curve, that incorporates the characteristics of the insurance contract’s cash flows should be used (IASB, 2013c: ED Insurance Contracts para 25).
The IASB produced a principles-based ED and therefore did not propose a specific yield curve, although it did include guidance on the specific principles to use when selecting a yield curve in the Application Guidance (Appendix B) of the ED. This process, however, remains complex due to the long duration of discounting applied to long-term insurance contracts.

Two approaches have been proposed, namely the top-down and bottom-up approaches (IASB, 2013c:ED Insurance Contracts para B70). The top-down approach selects a yield curve of an actual or replicating portfolio of assets reflecting current market information. Yield curves relating to assets include a market risk premium based on credit risk and liquidity risk. The yield curve in a top-down approach should be adjusted to:

- exclude factors not relevant to the insurance contract;
- adjust for timing differences between the asset portfolio and the insurance contract; and
- not include the entity’s own risk of non-performance (IASB, 2013c:ED Insurance Contracts para B70 (a)).

It is appropriate to exclude own credit risk from the yield curve as the ED proposes the use of a fulfilment model (IASB, 2013c:ED Insurance Contracts para BCA80). In a fulfilment model, there is the expectation that the entity will not default on payment. If an allocation was allowed for own credit, it would lead to the measurement of a reduced liability which would not represent the entity’s true liability.

The bottom-up approach proposes the use of a risk-free yield curve, usually derived from liquid instruments adjusted with the liquidity characteristics that are reflective of those in the insurance contract as an insurance contract is an illiquid instrument.

Faithful representation is achieved by requiring an entity to present the impact of time value of money to its insurance contracts (IASB, 2013c:ED Insurance Contracts para BCA65). The comparability of information presented by entities that issue insurance contracts is, however, questioned as various yield curves could be selected (IASB, 2013c:ED Insurance Contracts para BCA83). The ED has incorporated specific disclosure requirements around the yield curves used, as discussed in Section 6 below. Yield curves also apply to the contractual service margin when accreting interest, as detailed below.

### 4.4.3 Risk adjustment

Once the expected present value of cash flows is determined, a risk adjustment will be added. The risk adjustment is described as follows:
The risk adjustment measures the compensation that the entity would require to make the entity indifferent between:

(a) fulfilling an insurance contract liability that has a range of possible outcomes; and
(b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contract.

(IASTB, 2013c:ED Insurance Contracts para B76)

The goal of the risk adjustment is to measure the remaining uncertainty in an insurance contract that has not already been captured in the expected present value of cash flows (IASB, 2013c:ED Insurance Contracts para BCA89). This means that the best-estimate would already include market observable inputs, however, the adjustment would focus on inputs that are not necessarily market-observable such as mortality and morbidity inputs. The risk adjustment is determined from the view of the entity and not a market participant as this reflects the entity’s appetite for risk (PwC, 2012:2). This will enable a user to understand the risk appetite of various insurers (IASB, 2013c:ED Insurance Contracts para BCA100).

No specific techniques in calculating the risk adjustment have been proposed in the ED, which is consistent with a principle-based standard (IASB, 2013c:ED Insurance Contracts para BCA98). This could, however, negatively impact the comparability characteristic of financial statements (Source:Own analysis). The ED has incorporated specific disclosure requirements around the confidence level, as discussed in Section 6 below, which will aid in achieving comparability. The risk adjustment is subsequently released to profit or loss as the entity is released from risk and will provide a profit recognition profile that details the profit or loss generated by the entity for bearing the risk attached to the insurance contract. Changes in the estimates that relate to coverage or services to be provided in the future should be adjusted against the contractual service margin to the extent that it does not become negative (IASB, 2015c:15).

When considering the fulfillment cash flows and the measurement model proposed for insurance contracts, it is noted that this approach is similar to the accounting treatment applied to provisions in terms of IAS 37 Provisions, Contingent Liabilities and Contingent Assets (hereafter IAS 37). IAS 37 requires that an expected present value of the best-estimate of a provision be recognised after adjusting it for risk and uncertainty (IASB, 1998: IAS 37 para 37, 43 and 45). IAS 37 does not, however, provide for the accounting treatment of profit recognition in a contract and thus cannot be seen as a standard that caters for insurance contracts. The ED has a specific building block in its measurement model that applies to profit recognition.

4.4.4 Contractual service margin

The contractual service margin is the last building block in determining insurance contract liability and represents the profits not yet earned by the entity that issued the insurance contract (PwC, 2014: 5).
The profit is earned and recognised in profit or loss as the entity provides the policyholder with coverage and other services over the period of the contract. The deferral of profit recognition in the contractual service margin is consistent with IFRS 15 as it has not yet been earned by the entity that issued the insurance contract as neither coverage nor other services have been provided to the policyholder. The contractual service margin is calculated by calibrating the measurement of the insurance contract to the transaction price (Van den Berg, 2015). Any day one losses arising from issuing insurance contracts should immediately be recognised in profit or loss (IASB, 2013c:ED Insurance Contracts para BCA105).

Interest is accreted on the contractual service margin using the yield curve, as initially identified at contract inception (PwC, 2014:5). As the contractual service margin is released to profit or loss, the effect of accreting interest ensures that the amount of revenue recognised in the later years of the insurance contract reflect the time value of money. This is different to the other building blocks of the insurance contract liability where current yield curves are applied at each reporting date (IASB, 2013c:ED Insurance Contracts para BCA71).

The contractual service margin is subsequently ‘unlocked’ to reflect changes in cash flows relating to future coverage. Favourable changes are added to the contractual service margin while unfavourable changes are deducted from the contractual service margin. The contractual service margin may not be negative, thus any unfavourable changes to cash flows relating to future coverage that cannot be absorbed by the contractual service margin should be recognised directly in profit or loss. Any changes to the insurance contract liability relating to current and previous estimates not relating to future coverage should be recognised in profit or loss (IASB, 2013c:ED Insurance Contracts para 60).

4.5 Presentation of an insurance contract

The statement of financial position presents separately the carrying amount of insurance contracts that are in an asset position and a liability position (IASB, 2013c:ED Insurance Contracts para 54).

The statement of financial performance presents revenue and expenses relating to insurance contracts issued. Revenue includes the release of the risk adjustment and contractual service margin (PwC, 2014:6) which depicts the revenue earned from bearing risk and providing coverage and other services (IASB, 2013c:ED Insurance Contracts para 60). Insurance contract revenue is made up of the following items:
• current estimates of the expected claims and expenses relating to the current period of
  coverage provided (excluding amounts recognised in profit or loss immediately);
• change in the risk adjustment;
• portion of the contractual service margin recognised in profit or loss in the period; and
• the portion of the premium allocated that relates to recouping directly attributable acquisition
costs.

(PwC, 2013:18)

Expenses presented relate to incurred claims and other insurance contract expenses, as detailed in
paragraph 60 of the ED (IASB, 2013c). The ED provides a list of items to be recognised in profit or
loss which relate to this research study:

• initial losses and subsequent changes in terms of onerous contracts;
• changes in the risk adjustment relating to current and past estimates;
• release of the contractual service margin for coverage provided and services rendered to
  policyholders;
• changes in the risk adjustment and contractual service margin for future cash flows where the
  contractual service margin has been depleted;
• experience adjustments, i.e. the difference between estimated and actual cash flows;
• where profit or loss is presented using initial yield curves, interest expense will be presented
  and the difference between initial and current yield curves will be presented in other
  comprehensive income; and
• where profit or loss is presented using current yield curves, gains or losses relating to
  changes in the yield curve are applied.

(IASB, 2013c:ED Insurance Contracts para 60)

Paragraph 60 of the ED also refers to the following items to be reported in profit or loss although this
does not apply to the type of insurance contracts considered in this research study:

• changes in the credit risk of a reinsurer who has issued a reinsurance contract to the entity;
  and
• changes in the yield curves relating to participating contracts.

(IASB, 2013c:ED Insurance Contracts para 60)

Both revenue and expenses presented exclude non-distinct investment components (IASB,
2013c:ED Insurance Contracts para 10(b) and EY, 2013:13). Non-distinct investment components
refer to deposit amounts that an entity would pay a policyholder regardless of whether the insured
event occurs or not. Non-distinct investment components included in an insurance contract are
measured in terms of the ED but deposit accounting is applied as it does not represent insurance contract revenue. Deposit accounting implies that these non-distinct investment components are recognised directly on the statement of financial position and not via profit or loss. Amounts received in terms of non-distinct investment components are not received as compensation for providing coverage and other services to the policyholder and therefore are not recognised as revenue in profit or loss (PwC, 2013:18).

An accounting policy choice is provided to present the effect of changes in yield curves in either profit or loss or other comprehensive income (IASB, 2015c:29). Where an entity chooses to present the effect of changes in yield curves in other comprehensive income, profit or loss will reflect the interest expense by using the yield curve as determined at inception of the insurance contract. However, if an entity decides to present changes in yield curves in profit or loss, current yield curves will be used to calculate the change from one reporting period to the next. The amount recognised in other comprehensive income will represent the difference between the carrying amount of the insurance contract liability discounted using the contract inception rate and the carrying amount of the insurance contract liability using the current yield curves as at the reporting date (IASB, 2015c:29). At derecognition of an insurance contract, an entity will recycle any amount in other comprehensive income to profit or loss (IASB, 2013c:ED Insurance Contracts para 65).

Figure 6 below depicts the impact on the financial statements.
4.6 Disclosure of an insurance contract

The ED predominantly focuses on the measurement of an insurance contract but also includes more detailed disclosure requirements that will assist users in understanding the methods and processes an entity applied in presenting its results. The disclosure requirements included in the ED emphasise three main areas:

- the disclosures on insurance contract-related amounts recognised in the financial statements;
- judgements applied in measuring insurance contracts; and
- the risks attached to insurance contracts.

(IASB, 2013c:ED Insurance Contracts para 69)

The disclosure requirements proposed in the ED are not dissimilar to IFRS 4.

4.6.1 Disclosures required to explain amounts recognised

Reconciliations for insurance contracts, separately reconciling the liabilities for remaining coverage, the onerous contracts liabilities and the liabilities for incurred claims.

Reconciliation of opening to closing balances of the expected future cash flows, the risk adjustment and the contractual service margin for insurance contracts.

Reconciliation from premiums received to revenue recognised.

Cash outflows, acquisition costs, change in risk adjustment and contractual service margin recognised in the period in determining the insurance contract revenue.

For contracts initially measured in the period, the expected future cash flows, risk adjustment and contractual service margin.

Illustration of the relationship between the interest on insurance liabilities and the investment return on related assets held.

Figure 6: Presentation of movements to profit or loss
Source: IASB, 2015b

Figure 7: Disclosure on the amounts recognised
Source: PwC, 2013:36
The ED requires the disclosure of two types of reconciliations for the insurance contract liability and a third reconciliation for insurance contract revenue. The reconciliation reconciling the liabilities for remaining coverage, the onerous contracts liabilities and the liabilities for incurred claims provide information on the measurement of the insurance contract liability (IASB, 2013c:ED Insurance Contracts para BCA228(a)(i)). Secondly, a reconciliation of opening to closing balances of the expected future cash flows, the risk adjustment and the contractual service margin for insurance contracts provide information on the source that determine profit (IASB, 2013c:ED Insurance Contracts para BC82). These reconciliations are performed separately for the insurance contract liability and insurance contract asset. The IASB believe that these reconciliations will provide users with information on the components of the insurance contract liability and enable them to see how the contractual service margin has been impacted during a period by changes processed to estimates (IASB, 2013c:ED Insurance Contracts para BCA84(a)). These reconciliations will provide useful information to users to assist them in understanding the measurement and presentation of an insurance contract (IASB, 2013c:ED Insurance Contracts para BC85).

Disclosure has been included to assist users in understanding the insurance contract revenue recognised in profit or loss. Providing disclosure on new insurance contracts issued during the period will provide users with information on whether the insurance business is expanding or diminishing which will enable them to draw conclusions about the future of the business (IASB, 2013c:ED Insurance Contracts para BC86). The IASB has also included disclosure requirements around measures not presented on in profit or loss, for example insurance premiums written during the period, which refers to the total premiums included in the insurance contract boundary. This disclosure enhances comparability from the current period to previous periods and provides useful information on the volume of insurance business being written (IASB, 2013c:ED Insurance Contracts para BC88). The disclosure on measures not presented will have to be reconciled to insurance contract revenue, strengthening users’ understanding of the business.

4.6.2 Disclosure required to explain significant judgements and changes in those judgements
Entities use methods and inputs in determining insurance contract liability that are generally not observable in the market but rather specific-based on their business, i.e. historical trends. The IASB has included disclosure requirements to ensure that transparency is achieved by requiring entities to disclose the methods and inputs used (IASB, 2013c:ED Insurance Contracts para BCA228 (e)). The risk adjustment represents the entity’s expectation on the amount of compensation required for the uncertainty accepted in the insurance contract and it would be fair to expect the risk adjustment to be different from one entity to the next due to different risk appetites (IASB, 2013c:ED Insurance Contracts para BCA100). To enhance comparability between entities, the IASB requires disclosure of the confidence level obtained by including the risk adjustment in the measurement (IASB, 2013c:ED Insurance Contracts para BCA228 (f)). A confidence level represents a range of probable values that describes the uncertainty surrounding an estimate and illustrates to the user the entity’s confidence in the probability of a value falling in a specific range (Easton & McColl, 1997).

Yield curves utilised in the measurement of insurance contract liabilities will also differ among entities depending on the approach applied in determining the discount rate. Entities would need to disclose the methods and inputs used in determining the yield curve as well as the range of yield curves considered in the measurement process (IASB, 2013c:ED Insurance Contracts para BCA83). Disclosure of the yield curve would enable users to understand whether yield curves are different amongst entities as well as the extent to which they are different.

IFRS 4 currently contains requirements to disclose information that will enable users to evaluate the nature and extent of risks attached to insurance contracts. When the IASB issued IFRS 7 Financial
Instruments: Disclosures (hereafter IFRS 7), disclosure requirements between IFRS 4 and IFRS 7 which overlapped were moved to IFRS 7 (Pienaar, 2007). In setting the disclosure requirements in the ED, the IASB looked to the current requirements in IFRS 4 and IFRS 7 as a base (IASB, 2013c:ED Insurance Contracts para BCA228).

4.6.3 Disclosure of the nature and extent of risks attached to insurance contracts
The figure above summarises the main disclosure requirements relating to the nature and extent of risks arising from insurance contracts. The disclosure requirements listed above have been included in the ED and will aid users in understanding the risks attached to insurance policies (IASB, 2013c:ED Insurance Contracts para BCA227).

4.7 Determining decision-usefulness of information supplied under the proposals of the ED

The critical review analysis has highlighted the single, consistent measurement approach that applies to insurance contracts issued. All entities that report under IFRS will have to apply these proposals once the ED is issued as a standard and becomes effective. The measurement approach proposed will improve consistency in reporting by entities that issue insurance contracts as well as enabling users to make meaningful comparisons. The IASB has included detailed disclosure requirements to
ensure comparability is not undermined where certain elements of the measurement approach allow for possible diversity, for example, the yield curve and risk adjustment. The disclosure requirements further assist users in understanding the results reported by providing the necessary explanations of amounts reported, risks related to insurance contracts and judgements taken by the entity.

Chapter 5 provides a detailed comparison based on the critical review analysis of the ED and the results of the questionnaire in Chapter 3. The comparison assists in determining whether the proposals contained in the ED resolve the deficiencies identified in Chapter 3.
5. CONCLUSIONS AND RECOMMENDATIONS

In this chapter, the main findings from the literature review and empirical studies are summarised. A detailed comparison has been performed of the IASB’s new recognition and measurement proposal and the current recognition and measurement model to determine whether decision-usefulness of insurance accounting will improve relative to the above. The key deficiencies noted in Chapter 3 have been evaluated against the changes proposed in the ED to determine whether information reported under the ED will be decision-useful.

Table 17: Summary of key deficiencies in providing useful information

<table>
<thead>
<tr>
<th>Summary of key deficiencies in providing useful information</th>
<th>Addressed by</th>
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<tbody>
<tr>
<td></td>
<td>IFRS 4 Phase II</td>
</tr>
<tr>
<td>Deficiency 1 – Long-term insurers recognise premiums as they are due, i.e. cash flow accounting, instead of when the long-term insurer has earned it.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 2 – Long-term insurers apply existing accounting policies, i.e. SAP 104, when measuring insurance contract liabilities but do not provide clear accounting policies describing in detail how the principles are applied.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 3 – Long-term insurers do not provide information on data inputs used in measuring the insurance contract liabilities.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 4 – Long-term insurers do not provide information on the duration of cash flows included in determining the insurance contract liabilities.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 5 – Long-term insurers are not consistent in their treatment of acquisition costs and day one profit recognition.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 6 – Long-term insurers do not indicate accounting policies describing how profits are released from the discretionary margin to profit or loss nor disclosure reflecting the current reported year’s profit released.</td>
<td>Yes</td>
</tr>
<tr>
<td>Deficiency 7 – Long-term insurers do not separately present the insurance contract asset and insurance contract liability on the statement of financial position.</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Deficiency 8 – Long-term insurers do not reconcile the insurance contract liabilities on a comparable basis. The reconciliations provided are too aggregated to provide useful information and are not easily reconciled to the statement of financial performance.

Deficiency 9 – Long-term insurers do not provide sufficient disclosure on the assumptions used in determining the insurance contract liabilities.

Source: Own analysis

Recommendations are also provided that should contribute to the existing knowledge of the preparers and users of long-term insurance companies’ financial statements. Areas for future research are also outlined.

5.1 Deficiency 1 – Long-term insurers recognise premiums as they are due, i.e. cash flow accounting, instead of when the long-term insurer has earned it

Most long-term insurers have adopted recognising revenue on a premium’s due approach, as noted in Chapter 3’s content analysis. This has compromised comparability between the long-term insurance industry and other industries recognising revenue based on IAS 18 and in future, IFRS 15. In order to increase comparability, the IASB included principles on revenue recognition in the ED that are more consistent with IFRS 15 and present an amount based on what the long-term insurer has earned for providing a service to the policyholder and taking on the risk related to the insurance contract (IASB, 2013c:ED Insurance Contracts para BC92). Decision-usefulness is also achieved as the revenue recognition principles in the ED are closely aligned to IFRS 15, thus assisting non-specialist users in understanding the financial reporting of a long-term insurer (IASB, 2013c:ED Insurance Contracts para BC106). Users will nonetheless require education on how insurance revenue is calculated. The IASB has also included requirements to disclosing two types of reconciliations, a component and profitability reconciliation (IASB, 2013c:ED Insurance Contracts para BC80 and BC82). This disclosure will enhance comparability from the current period to previous periods and provide useful information on insurance contract revenue (IASB, 2013c:ED Insurance Contracts para BC85).
5.2 Deficiency 2 – Long-term insurers apply existing accounting policies, i.e. SAP 104, when measuring insurance contract liabilities but do not provide clear accounting policies describing in detail how the principles are applied

As noted in the content analysis, all long-term insurers apply SAP 104 in measuring their insurance contract liabilities, however, from the information disclosed in the financial statements, it is not clear how those principles, in particular discretionary margins, are applied within each long-term insurer’s business. The ED proposes the use of a single, consistent measurement model that will have to be applied by issuers of insurance contracts. The ED is a principle-based, proposed standard which means that long-term insurers will still have varying approaches on the level of risk adjustment and yield curves used, however, the ED requires specific disclosure to explain the long-term insurer’s approach to measurement. This will improve overall understandability of financial information as well as comparability between various long-term insurers (IASB, 2013c:ED Insurance Contracts para EA11).

5.3 Deficiency 3 – Long-term insurers do not provide information on data inputs used in measuring the insurance contract liabilities

Currently, long-term insurers do not disclose information about the data used in determining the insurance contract liability, thus reducing the decision-usefulness of information. Secondly, comparability is also impaired as long-term insurers use different sets of data to determine the insurance contract liability, i.e. mean, median or mode. The ED establishes the mean as the appropriate data input to use when measuring the insurance contract liability. This requirement will increase comparability and consistent reporting by long-term insurers (IASB, 2013c:ED Insurance Contracts para EA12 and 13).

5.4 Deficiency 4 – Long-term insurers do not provide information on the duration of cash flows included in determining the insurance contract liabilities

Based on the current reporting of financial information, it is unclear as to the extent of future cash flows included in the measurement of insurance contract liabilities. The ED contains principles that detail the boundary of a contract and which cash flows form part of that boundary and therefore should be included in the measurement. These principles provide for more consistent financial reporting (IASB, 2013c:ED Insurance Contracts para EA13).
5.5 Deficiency 5 – Long-term insurers are not consistent in the treatment of acquisition costs and day one profit recognition

IFRS 4 currently contains no guidance regarding which costs are considered to be acquisition costs. This has led to long-term insurers including various types of costs as acquisition costs that has made comparison difficult. Comparability will be enhanced as the ED requires the inclusion of directly attributable costs that are incurred on a portfolio level for both successful and unsuccessful acquisitions of new or renewed insurance contracts as a contractual cash flow in the measurement of the insurance contract liability (IASB, 2013c: ED Insurance Contracts para BCA53 and BCA 54). This principle will aid in presenting comparable information irrespective of the long-term insurer following a direct or broker-based business model. Acquisition costs are expensed as incurred and this principle is carried forward in the ED. Currently, the impact of acquisition costs expensed can be offset through the inclusion of margins to the best-estimate liability which will provide a profitable transfer of insurance liability in profit or loss. The transparency provided by disclosure requirements in the ED will assist users in understanding which margins have been applied to the insurance contract liability and also illustrate the movement in margins to profit or loss.

5.6 Deficiency 6 – Long-term insurers do not provide an accounting policy describing how profits are released from the discretionary margin to profit or loss nor disclosure reflecting the current reported year’s profit released

Cooper (2015) stated that long-term insurers provide little or no information regarding the policy on profit recognition and disclosure to this effect in their financial statements. This was confirmed in the findings of Chapter 3. This directly impacts a user’s ability to obtain an understanding of the long-term insurer’s profitability and prevents any sort of comparison to other long-term insurers. The ED’s measurement model includes two building blocks, the risk adjustment and the contractual service margin. The risk adjustment is released to profit or loss as the long-term insurer is released from the risk attaching to the insurance contract (IASB, 2013c: ED Insurance Contracts para EA9). The contractual service margin is released to profit or loss in a systematic manner that reflects the transfer of services that are provided in terms of the contract (IASB, 2013c: ED Insurance Contracts para 32). The contractual service margin for insurance contracts considered as part of this dissertation (i.e. insurance contracts with no participation features) will be released to profit or loss on a straight line basis (IASB, 2015c:16).

The introduction of the risk adjustment and contractual service margin will lead to more consistent recognition and measurement of an insurance contract and the resulting profit from the contract as
long-term insurers reporting in terms of IFRS will have to apply these measurement principles. Changes in future cash flow assumptions will be unlocked through the contractual service margin and released to profit or loss on a straight line basis. Thus, the profit reported can no longer be manipulated through the use of margins. Users will therefore be able to compare profitability amongst long-term insurers as well as other industries, thus enabling them to make economic decisions based on useful information. The disclosure requirements will provide further information on profitability with the inclusion of the requirement to disclose information on new insurance contracts entered for the period, i.e. cash flows, risk adjustment and contractual service margin. This will assist users in determining how profitable the new business is that the long-term insurer has underwritten in a period (IASB, 2013c:ED Insurance Contracts para BC86).

5.7 Deficiency 7 – Long-term insurers do not present separately the insurance contract asset and insurance contract liability on the statement of financial position

The majority of long-term insurers currently present a net insurance contract liability on the statement of financial position. The ED proposes the presentation of an insurance contract asset and liability as two separate line items on the statement of financial position (IASB, 2013c:ED Insurance Contracts para 54) based on a portfolio level. The insurance contract asset and liability will individually represent a combination of cash inflows and outflows relating to the insurance contract. This is aligned once again to IFRS 15 where a contract represents rights and obligations to a customer that together form a single contract (IASB, 2013c:ED Insurance Contracts para BC224). The proposal will increase decision-usefulness and increase comparability between various industries. The portfolio level as defined in the ED is expected to be on a more granular level than current portfolios identified by long-term insurers. A granular portfolio will provide more useful information for users to make economic decisions.

5.8 Deficiency 8 – Long-term insurers do not reconcile the insurance contract liabilities on a comparable basis. The reconciliations provided are too aggregated to provide useful information and are not easily reconciled to the statement of financial performance

The content analysis performed in Chapter 3 highlighted inconsistent reconciliations being disclosed by long-term insurers as some insurers provided profit or loss reconciliations whilst other disclosed a reconciliation of the components of the insurance contract liability, akin to the building block approach proposed in the ED. This leads to a decrease in comparability amongst long-term insurers. The ED explicitly requires the disclosure of both these types of reconciliations relating to the insurance
contract asset and liability respectively. Paragraph 78 of the ED (IASB, 2013c) details the line items to be included in the reconciliations. This will improve comparability amongst long-term insurers considerably as long-term insurers that report under IFRS will have to include these reconciliations. The IASB noted that the disclosure of these reconciliations will provide useful insight as it will indicate the sources of profits from insurance contracts issued (IASB, 2013c:ED Insurance Contracts para BC83) as well as the movements in the contractual service margin due to unlocking it for changes relating to future estimates of cash flows (IASB, 2013c:ED Insurance Contracts para BC84 (a)).

The addition of further disclosure requirements in the ED, as noted in Chapter 4, will assist with increased comparability and decision-usefulness due to different judgements exercised by long-term insurers.

5.9 Deficiency 9 – Long-term insurers do not provide sufficient disclosure on the assumptions used in determining the insurance contract liabilities

The disclosure of assumptions used in determining the insurance contract liability is included in the IFRS 4 currently and has been retained in the ED. In Chapter 3 it was noted that long-term insurers provide no clear or concise disclosure on the assumptions applied. This could potentially lead to users of the financial statements misunderstanding the initial assumptions and subsequent changes to assumptions applied in measuring insurance contract liability. The ED requires disclosure of the changes in cash flows taken to the contractual service margin, reconciliations of the insurance contract asset / liability and judgements applied, in particular, disclosure of the confidence level and yield curve ranges. These disclosures will improve comparability as users will be able to assess a long-term insurer’s risk appetite and compare it to other long-term insurers along with the appropriateness of the yield curve utilised in the measurement of the insurance contract (IASB, 2013c:ED Insurance Contracts para EA14 and 15).

5.10 Conclusion

It has been determined that users of financial statements require useful information that enables them to draw comparisons between different entities and make economic decisions. Chapter 2 provided a critical review analysis of the current recognition and measurement model, as described in SAP 104 and IFRS 4. The review identified the major observations and criticisms of SAP 104 and IFRS 4. The observations and criticisms were used to develop a questionnaire for the content analysis in Chapter 3. The content analysis focused on the presentation and disclosure in the
financial statements of South African large listed long-term insurance companies. The content analysis highlighted nine key deficiencies in the different accounting practices of the long-term insurers in the population. It was concluded that the current financial reporting of South Africa's large listed long-term insurers was not comparable and therefore reduced the decision-usefulness of information reported.

The IASB’s ED on insurance contracts was examined by way of a critical review analysis which was used in conjunction with the findings of Chapter 3 to perform a comparison. The comparison set out to determine whether the proposals contained in the ED would address deficiencies in the current reporting and provide comparable information for users to consider when making economic decisions.

The research study in its totality found that the ED is a much-needed stepping stone in providing decision-useful information that is comparable amongst South African long-term insurers as well as other industries. The ED predominantly provides a comprehensive measurement model for companies that issue insurance contracts. This model will provide for more comparable, consistent and transparent measurement of insurance contracts issued. It remains, however, a complex model and would require education for both preparers and users. The presentation and disclosure principles included in the ED will help explain this model to users of the financial statements. This will assist users in making better economic decisions due to the provision of decision-useful information. It is believed that the ED, once issued and effective as a standard, will make a valuable contribution to improving the current presentation and disclosure practices of long-term insurers.

The research performed is considered to be of value to:

- preparers of the financial statements of long-term insurers, illustrating to them the current reporting differences in long-term insurance as well as highlighting the proposals of the ED;
- analysts, in helping them to understand the complexities of financial reporting by the large listed South African long-term insurers and providing detail on the future of insurance reporting; and
- academics performing research on long-term insurance.

5.11 Further research opportunities related to long-term insurance accounting

Topics for further research on long-term insurance accounting include:

- comparability of South African long-term insurers internationally;
• measurement, presentation and disclosure relating to participating insurance contracts;
• practical application of the ED once it is an issued and effective standard; and
• operational implications of applying these principles to a long-term insurer’s business.
Reference list


PricewaterhouseCoopers (PwC). (2012). SAM Focus - The International Accounting Standards Board (IASB) is planning to publish a second exposure draft setting out its final proposals for IFRS 4 Phase II in the first half of 2013. Issued November 2012.


**Annual reports**

Clientèle (Clientèle Limited Annual Report, June 2014).

Discovery (Discovery Holdings Limited Annual Report, June 2014).


MMI (MMI Holdings Limited Annual Report, June 2014).

Old Mutual (Old Mutual plc Annual Report, December 2014).

Sanlam (Sanlam Limited Annual Report, December 2014).
Appendix A – Questionnaire created for the content analysis in Chapter 3

Classification

1. Has an insurance contract been defined?
2. If yes, is the provided definition in line with IFRS 4?

Recognition

3. Recognition of an insurance contract:
   a. Are premiums recognised when due?
   b. Does the long-term insurer differentiate between components of premium?
   c. Does the long-term insurer recognise premium in line with IAS 18 Revenue?
   d. Are claims recognised as incurred?
   e. Has the long-term insurer explained when the insurance contract liabilities are recognised?
   f. Has the long-term insurer explained when the changes in the insurance contract liabilities are transferred to profit or loss?

Measurement – Local GAAP principles

4. Has the objective of the methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models, and the source of information used in the models been disclosed?

Measurement – Contract-specific

5. Is a description of different types of long-term insurance policies provided?
   a. If the long-term insurer has different policies, are the accounting policies clear on individual measurement? (i.e. group life policies are measured retrospectively [with reference to the premium charged which is akin to a deferred revenue liability] whilst other life policies are measured prospectively [prospective valuation of future cash flows and margins] in terms of SAP 104).

6. Measurement of the insurance contract:
   a. Has a description been provided on the measurement of premiums?
   b. Has a description been provided on the measurement and nature of claims?
   c. Has the long-term insurer explained if, how and when a liability adequacy test will be performed, including a description of the cash flows included in the test, whether and
how the cash flows are discounted and the treatment of embedded options and guarantees in the test?

d. Has the long-term insurer disclosed whether insurance liabilities are discounted and, if they are discounted, explained the methodology used? (i.e. is an asset-based or risk-free yield curve used as a discount rate).

e. In determining the best-estimate liability, has the long-term insurer stated whether the calculation is based on the mean, median or mode value of data?

f. Has the contract boundary for policies been defined? (i.e. a description of the duration of cash flows which are included in the valuation).

Measurement – Acquisition cost

7. Has a policy been included on the treatment of acquisition costs?
   a. Are acquisition costs expensed on day one?
   b. Are acquisition costs implicitly deferred as part of the insurance contract liability?
   c. Has the long-term insurer included only costs that are linked directly to the insurance contract as acquisition costs?

Measurement – Compulsory and discretionary margins

8. Is an explanation provided for compulsory and discretionary margins? (i.e. an explanation of the difference between the margins and how they impact the insurance contract liabilities).

9. Is an explanation provided to detail what compulsory margins are set at?

10. Disclosure margins:
   a. Is an explanation provided to detail what discretionary margins are set at?
   b. If yes, is this in line with market expectations?
   c. Has the objective of the discretionary margin been explained?
   d. Is the profit recognition profile for the discretionary margin described?

Measurement – Embedded options and guarantees and discretionary participation feature policies

11. For embedded options and guarantees:
   a. Is there a description of the measurement of insurance liabilities reflecting the intrinsic value and time value of these items?
   b. Is there a description of whether their measurement is consistent with observed current market prices?

12. For discretionary participation features, is there a clear statement of the long-term insurer classifying that feature as a liability or a component of equity?
Statement of financial position

13. Have the following line items been presented:
   a. Insurance contract liability for long-term insurance policies?
   b. Insurance contract asset for long-term insurance policies?
   c. Investment contracts with a discretionary participation feature?

Statement of profit or loss and other comprehensive income

14. Have the following line items been presented:
   a. Premiums / revenue?
   b. Claims / benefits?
   c. Changes in the insurance liabilities?
   d. Acquisition costs attributable to insurance contracts?

Notes - Insurance contract liability reconciliation

15. Has a reconciliation for the insurance contract liability been provided detailing the movement from opening to closing balance?
   a. Has the carrying amount at the beginning and end of the period been included?
   b. Have additional insurance liabilities arising during the period been included?
   c. Does the reconciliation include cash paid?
   d. Have income and expense included in profit or loss been included?
   e. Have liabilities acquired from, or transferred to, other insurers been included?
   f. Have net exchange differences arising on the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity, been included?

16. Is the user of the financials provided with detail of what the insurance contract liability closing balance consists of? (i.e. best-estimate amount, compulsory margin added and discretionary margin added)

Notes – Assumptions used in measurement

17. The long-term insurer must include a description of the process used to determine assumptions. Sections a - g below include a list of possible significant disclosure:
   a. Has the objective of the assumptions been disclosed? For example, an insurer might disclose whether the assumptions are intended to be neutral estimates of the most likely or best-estimates or provide a given level of assurance or level of sufficiency. If
they are intended to provide a quantitative or qualitative level of assurance, the long-term insurer may disclose that level.

b. Has the source of data used as inputs for the assumptions that have the greatest effect been disclosed? For example, the long-term insurer may disclose whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, the long-term insurer may disclose the criteria used to determine when the studies are updated and the date of the latest update.

c. Has the extent to which the assumptions are consistent with observable market prices or other published information been disclosed?

d. Has a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions been disclosed? If a relationship would normally be expected between experience and future results, the long-term insurer may explain the reasons for using assumptions that differ from past experience and indicate the extent of the difference.

e. Has a description of how the long-term insurer developed assumptions about future trends been disclosed?

f. Has an explanation of how the long-term insurer identifies correlations between different assumptions been disclosed?

g. Has the nature and extent of uncertainties affecting specific assumptions been disclosed?

Notes – Profit recognition

18. Has the long-term insurer explained how margins have been released to profit? (quantitative disclosure).

Notes – Risk disclosure

19. Has the long-term insurer provided sensitivity analyses showing the impact on the company if they have used reasonable alternative assumptions?

20. Has the concentration risk of the insurer’s long-term insurance products been provided?

Notes – Experience adjustments

21. Has the long-term insurer included qualitative disclosure on experience variances for the period reported?

22. Has the long-term insurer included quantitative disclosure on experience variances for the period reported?