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Henry is Mostly Right about IFRS for Insurance

By Jim Milholland

Henry Siegel makes a number of good points in his article *10 Things I Think About the New Insurance Contracts IFRS* in the December, 2016 issue of *The Financial Reporter*. I agree with most of what he says and I appreciate his efforts to help actuaries not get lost as they address the new standard.

On one point I disagree with Siegel. That is the first part of his point #6, which says.

> "The new definition of revenue will prove to be of little value, but a pain to calculate. Use of a gains-by-source approach for analysis will make the exact revenue number irrelevant except for short-duration contracts. It might be a better indicator of a company's size, I suppose, but it isn't useful for things like loss ratios or expected profits."

The new definition of revenue has value. The value comes from understanding how an insurer makes a profit. Keep in mind that the statement of profit and loss will show underwriting profit separately from financial profit. The underwriting profit is the amount that insurance revenue exceeds insurance benefits and expense and the financial profit is the amount that the investment income exceeds the interest credited to the liability. The presentation allows users of the financial statement to see how much the revenue exceeds expenses, the same as for any company. Insurers try to make money by having a margin (or margin*s*, if one wants to distinguish risk margin from contractual service margin) above the amount that they expect to need to cover benefits and expenses. The presentation proposed in the new standard makes clear if the revenue does in fact cover benefits and expenses and leave a margin for profit.

Gains by source short-cuts the presentation. Summarized margins lack the quantitative information found in the financial statements of all other businesses. An expanded analysis of margins is just a different presentation of the information the standard requires, so why not present it in an intuitive way.

Revenue is not a pain to calculate. Keep in mind that all the information comes from information required in the disclosures, namely the reconciliation of the beginning and ending liabilities. The disclosure requirements have been part of the anticipated standard for a long time, and, to my memory, no one has objected to them. Siegel likes them! (See his point #4.) No one has said that they are not appropriate or not practicable. It's no great difficulty to take what will be existing information and to make the entries to show revenue, benefits, and expenses in the way that the new standard requires. Moreover, the presentation will be very useful for loss ratios. For the first time ever, the ratio of benefits and expenses to revenue will be meaningful.

Siegel does not say what he would prefer for revenue recognition. Perhaps there should be no revenue, only a margin analysis. As already said, this approach leaves out a lot of useful quantitative information.

Many people involved in the discussion about the presentation of profit and loss would prefer premiums as revenue. In fact, the FASB has recommitted itself to premiums as revenue, except for universal-life type contracts. The problem with premiums as revenue is that the collection of premiums bears no necessary relationship to the service provided. What's worse, recognizing premiums as revenue permits companies to record as revenue amounts that contribute to deposit features and to recognize an expense for money that is returned to policyholders. Taking money for deposits is not revenue and returning money is not an expense for other deposit-taking institutions, and they should not be for insurers either.

When premiums are revenue, generally there is an expense for the change in reserve. This creates a conundrum. If there is an expense when the insurer provides for future benefits, what is the treatment of benefits when they are incurred? Traditionally benefits are an expense when incurred and the change in reserve contains an offsetting amount, a release of liability, for the expected benefits. The benefits are in effect expensed twice, the first time when the provision is made, and the second when the benefit is incurred. To stay in balance the company makes the offsetting adjustment. Although common, this treatment is irrational, especially so if, as is usual, the offsetting amount is not explicit.

One alternative is to have only an expense when claims are provided for. When claims are incurred, they would not affect profit and loss. The change in reserve would be limited to the increase in the reserve. While more correct than expensing claims twice, there is little rationale for having an expense for benefits except when they are incurred.

The new accounting will be more informative (Siegel's point #1) and analysts and others will benefit from the presentation (so I disagree as well with Siegel's point #2). Actuaries will not find revenue recognition to be a pain, but will find that it helps to explain the results, a task that often falls to them. ■

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