

Critical Study of the IASB Insurance Accounting Project

Keisuke Hane

ABSTRACT

Under the International Accounting Standards Board (IASB) insurance accounting project, discussion has proceeded along the two axes of (a) consistency with the IASB's Conceptual Framework (that is, departure from the traditional matching concept) and (b) adoption of fair value measurement. In addition, the IASB appears to be attempting to solve insurance accounting problems by matching assets and liabilities while turning its back on the revenue-expense matching concept. By taking an overview of the evolution of the IASB insurance contract project, this paper has looked into (i) what the IASB aims to achieve in this project and (ii) where the fundamental problem lies as to the situation where the project is still ongoing after more than 15 long years of deliberations. Also, revenues and expenses as derived from the matching of assets and liabilities, or income as the difference between the two, are totally different in character from revenues and expenses as arising from the traditional matching concept, and this inevitably transforms the role that net income information has long played. The reality is that repeated attempts to reject the traditional matching concept have not, or at least not completely, succeeded.

[190 words]

Keywords: insurance contracts; deferral and matching view; asset and liability measurement view; fair value; entity-specific value; net income

Acknowledgements

The author would like to thank Eiko Tsujiyama and Yuri Biondi for their valuable comments and suggestions. Any remaining errors are the responsibility of the author.

I. Introduction

The current International Financial Reporting Standard (IFRS) 4 “Insurance Contracts” (IASB 2004) is tentative standard that only contain limited provisions for accounting treatment for insurance contracts. The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have set up an “insurance contracts” project as one of their joint convergence projects whereby deliberations are continuing to formulate permanent standard that comprehensively cover accounting treatment for insurance contracts to replace IFRS 4. Launching an insurance (contracts) accounting project in 1997 under its predecessor, the International Accounting Standards Committee (IASC), the IASB has, to date, released a number of deliverables only to receive critical comments and be forced to make changes to its proposals each time. In 2010, the IASB at long last released the Exposure Draft (ED), but is still in a situation where a lot of comments raise issues with its proposals despite receiving overall approval. The ED failed to bring about standardization, and, as of 2013, deliberations are still continuing to release a re-exposure draft. As can be seen from the above, more than 15 years have passed since the initial launch of the project, and nobody knows when the final standardization of insurance contract accounting standards might occur.

Of the two accounting views, the asset and liability approach (or the asset and liability view) and the revenue and expense approach (or the revenue and expense view), the IASB favors the asset and liability approach, and has been going about standard setting on that basis. The insurance contract project is no exception. The asset and liability approach is an accounting view which considers earnings as “a measure of increase in net resources of a business enterprise during a period” (FASB 1976, par. 34),

while the revenue and expense approach is an accounting view which considers earnings as “a measure of the effectiveness of an enterprise in using its inputs to obtain and sell output at a profit” (*Ibid.*, par. 38). Under the asset and liability approach, earnings or net income is derived from the change in clearly defined assets and liabilities, whereas, under the revenue and expense approach, net income arises from a periodic matching of revenues and expenses.

In particular, under the current insurance accounting practices and insurance accounting standards in Japan and the United States, procedures that are close to the revenue and expense approach have been adopted, so that, if a shift to accounting standards based on the asset and liability approach as proposed by the IASB occurs, major changes may be forced upon current accounting practices. The history of the IASB’s insurance contract project has also been a history of rejecting the traditional matching concept and pursuing fair value measurement. The IASB is attempting to eliminate accounting problems in insurance contracts by rejecting the traditional form of matching and instead matching assets and liabilities.

To accurately determine the merit or lack thereof of the IASB’s proposals, which are bound to be standardized someday, it is necessary to understand what the IASB aims to achieve through insurance contract accounting standards and where the fundamental problem lies as to the situation where the IASB’s insurance contract project is still ongoing after more than 15 long years of deliberations. After all, standards cannot be converted to practices without first being accurately assessed. Otherwise, any conversion attempt is likely to end in failure. By taking an overview of the evolution of the IASB insurance contract project, this paper aims to fathom the IASB’s “way of thinking”, which appears to be fundamentally unchanged over the years despite being

forced to make numerous changes to its proposals.

This paper is structured as follows: Section 2 takes a brief look at the evolution of the IASC/IASB insurance contract project, centering on proposals relating to measurement attributes for insurance liabilities. Sections 2 also describe the present situation where the IASB is unable to totally deny the traditional matching concept in its proposals despite its clear intention to do so given its history of rejecting the traditional matching concept or pursuing fair value accounting throughout the course of the evolution of the insurance contract project. Section 3 is a little different in that it investigates potential problems that can ensue if the accounting model being pursued by the IASB (non-traditional matching model = asset and liability matching model/fair value model) is adopted exactly as intended by them. Section 4 provides a summary and future outlook.

2. Evolution of Insurance Contract Project

The history of the IASB formulation work for insurance contract accounting standards dates back to September 1996, when the IASC added “insurance” to its international accounting standards (IAS) formulation project. In April of the following year, an insurance project was launched, with the Steering Committee on Insurance established under the IASC. Notable publications from the IASB include the Issues Paper, Draft Statement of Principles, IFRS 4, Discussion Paper, and Exposure Draft. In the following subsections, the paper takes a brief look at the evolution of the IASB insurance contract project by focusing on these publications. Table 1 summarizes the IASB insurance contract project evolution.

Table 1 Long-term trends in the IASB statements on measurement of insurance liabilities

	Measurement attribute (model)	Cash flows			Margin		Other issues	
		Market assumptions (Discounting rate)	Non-market assumptions	Deferral of acquisition costs	Risk margin	Other margin	Reflecting credit risk	Alternative measurement attribute (model)
IP (1999)	<ul style="list-style-type: none"> Current value model Fair value (if IAS39 was replaced by full fair value accounting) 	Consistent with current market data	Consistent with market assumptions	No	Consistent with current market data	N/A	N/A	Unearned premium approach (rejected)
DSOP (2001)	<ul style="list-style-type: none"> Entity-specific value Fair value (if IAS39 was replaced by full fair value accounting) 	Consistent with current market data	Consistent with market assumptions	No	Consistent with current market data	N/A	Yes (for fair value)	Cost accumulation basis (rejected)
DP (2007)	Current exit value	Consistent with current market data	Consistent with market assumptions	No	Consistent with current market data	Service margin	Yes	<ul style="list-style-type: none"> Current entry value Unearned premium approach Embedded value (All of them rejected)
ED (2010)	Present value of fulfillment cash flows	Consistent with current market data	Not required to search for market inputs	Yes (only incremental acquisition costs)	Reflecting entity specific view	Residual margin (deferral of Day 1 gains)	No	Premium allocation model (for short-duration contracts)
TD (2013)	Present value of fulfillment cash flows	Consistent with current market data	Not required to search for market inputs	Yes (only direct acquisition costs)	Reflecting entity specific view	Residual margin	No	<ul style="list-style-type: none"> Premium allocation model Discounting not required when the effect of discounting would be immaterial.

2.1 Issues Paper (IASC 1999)

In December 1999, the Steering Committee released the Issues Paper (IASC 1999, hereinafter “IP”) as a foothold for the development of IAS for insurance. The IP sorted through/analyzes various issues relating to insurance accounting in preparation for standard formulation, and also showed the Steering Committee’s tentative views on those issues. Starting with the objectives of the formulation of IAS for insurance, the IP covered wide range topics, including issues relating to the recognition and measurement of insurance contracts, individual issues relating to life insurance, general insurance, participating (with-profits) insurance and reinsurance, and matters to be considered when applying fair value measurement to insurance contracts.

(1) Objectives of formulation of IAS for insurance

The IP explained a need for an IAS on Insurance Accounting because: (a) the insurance industry is an important, and increasingly international, industry; (b) there is currently great diversity in accounting practices for insurers; and (c) current IAS do not address specific insurance issues (para. 2). The IP also insisted the IASC project on insurance accounting necessarily emphasizes general purpose financial statements and the IASC’s Framework for the Preparation and Presentation of Financial Statements (IASC 1989, hereinafter “the IASC’s Framework”).

(2) Insurance contracts and financial instruments

The Steering Committee pointed out “most insurance contracts are financial instruments”, because they create contractual rights or obligations that will result in the flow of cash or other financial instruments (*Ibid.*, para. 13). At the time of the release of

the IP, the Joint Working Group (JWG) was engaged in discussion on full fair value accounting for financial instruments with a view to replacing IAS39 “Financial Instruments: Recognition and Measurement”, which adopted a mixed attribute model. The Steering Committee pointed out a need for consistency in accounting treatment for insurance contracts and financial instruments because of the similarity in characteristics between the two (*Ibid.*, para. 109). The Steering Committee also pointed out that, under the insurance project, the JWG discussion on full fair value measurement would be monitored and that, if IAS39 was replaced by full fair value accounting prior to the conclusion of the insurance project, full fair value accounting would have to be applied to assets and liabilities arising from insurance contracts (*Ibid.*, paras. 108 and 164). However, it also mentioned the possible desirability of choosing multiple measurement attributes in the absence of changes to IAS39 (*Ibid.*, para. 164).

(3) Deferral and matching view and asset and liability measurement view

The IP identified and comparatively analyzed two approaches to the recognition and measurement of insurance contracts. One of these approaches is called the “deferral and matching view”, which is consistent with the revenue and expense approach mentioned above. The other is called the “asset and liability measurement view”, which is consistent with the asset and liability approach.

In the case of adopting the deferral and matching view, the objective of insurance accounting is to establish correspondence between claim payments (which are generally unknown and difficult to estimate) and premium revenues (which can be relatively easily measured) (IP, para. 154). The asset and liability measurement view, on the other hand, requires the kind of accounting treatment that is consistent with the definition of

assets and liabilities under the IASC’s Framework (*Ibid.*, para. 157).¹ Under the IASC’s Framework (and therefore the asset and liability measurement view), assets and liabilities are defined first, and then income is defined from changes in assets and liabilities. In concrete terms, the deferral and matching view and the asset and liability measurement view differ in accounting treatment as shown in Table 2.

Table 2 Accounting treatments in case of adopting deferral and matching view or asset and liability measurement view

Topic	Deferral and Matching	Asset and Liability Measurement
1. Accounting treatments for acquisition costs	These costs should be deferred and amortized in order to match those costs with related premium revenue over the term of the contract.	These costs do not meet the Framework’s definition of an asset and should not be reported as such.
2. Accounting treatments for unearned premiums	Premiums should be deferred and recognized as revenue over the term of the contract.	Unearned premium liabilities cannot be included as liabilities if deemed not reflective of the value of the remaining risk exposure of a contract.
3. Selecting measurement assumptions	The insurer should look to long-term trends rather than reflecting current information.	The insurer should look to current information.
4. Propriety of reckoning catastrophe and equalization reserves	These reserves are appropriate when necessary to report a pattern of sustainable income and to properly portray portfolio diversification over time.	These reserves do not meet the Framework’s definition of liabilities and should not be reported as such.
5. Fair value	Changes in the fair value of an insurer’s assets and liabilities are not relevant until liquidation.	Claim liabilities should be reported at their present value.

Source: IP (tabulation by author)

Under the deferral and matching view, acquisition costs, which refer to “direct or indirect expenses paid to sell, underwrite and initiate a new insurance contract”, are

sometimes deferred and included as assets rather than processed immediately as expenses by treating them as items that should be matched with premium revenues to be earned after the start of the insurance contract. On the other hand, under the asset and liability measurement view, these costs do not satisfy the definition of an asset once incurred, acquisition costs cannot be used to produce goods and services, exchanged for other assets, used to settle liabilities, or distributed to owners (*Ibid.*, para. 325-328).

Unearned premiums, which are the amount of premium deferred and treated as a liability, are validated based on deferral and matching view. For insurers, the receipt of premiums usually occurs before the payment of any claim, but, in some cases, a deferral procedure is used whereby premiums are not recognized as revenues upon receipt, with revenue recognition delayed until the occurrence of claim payments to match revenues and expenses. On the other hand, under the asset and liability measurement view, unearned premium liabilities cannot be included as liabilities if deemed not reflective of the value of the remaining risk exposure of a contract.

Under the asset and liability measurement view, it is preferred to apply present value measurement to insurance liabilities, but opinion is divided over whether to apply it to general insurance contracts, which usually have short contract periods (*Ibid.*, paras. 358-368). In addition to the practical difficulty associated with the application of discounting calculations to short-term contracts, opponents of application point out “[i]f claim liabilities are recorded using present value, the balance will increase with the passage of time until the claims are paid (...) As a result, the enterprise recognises a cost (accrual of interest) after all of the related premium revenue has been recognised” and criticize it from the viewpoint of “proper matching of revenues and expenses” (*Ibid.*, para. 361). Proponents, on the other hand, argue that, because of “[t]he insurer invests

premiums received and earns interest on those investments until amounts are needed to pay claims. By using present value to measure claim liabilities, the entity matches increases in the claim liability with the interest revenue earned on those investments”, proper matching of revenues and expenses can only be achieved under a present value framework (*Ibid.*, para. 364). In the end, the Steering Committee, after carefully considering the two views, recommended an extension of the use of present value measurement to insurance liabilities under general insurance contracts on the grounds that measuring insurance liabilities at present value is applying “information that is relevant and decision-useful” as emphasized by the IASC’s Framework (*Ibid.*, para. 368).

As can be seen from the above, under the deferral and matching view, assets and liabilities contain items that are deferred until the matching of revenues and expenses in line with the accounting objective of calculating sustained income, while, under the asset and liability measurement view, deferred items that do not indicate a future economic benefit (or an outflow thereof) are not recognized on the grounds that they do not satisfy the definition of assets and liabilities. The Steering Committee, despite recognizing that the deferral and matching view has been adopted under the accounting practices of many countries, prefers the asset and liability measurement view in line with the objective of developing an accounting model consistent with the IASC’s Framework (*Ibid.*, para. 162). The IP discussed matters to be considered when measuring assets and liabilities held by insurers under the asset and liability measurement view, and those matters were basically passed on to the IASB to have a great significance in the insurance contract project later on. Table 3 summarizes matters to be considered when measuring insurance liabilities (assumptions and conventions to be used) as

contained in the IP. Subsequently, of the proposals listed in Table 3, (i) Use of explicit assumptions, (ii) Use of current information and (iii) Inclusion of all future events were passed on to the IASB's publications.

Table 3 Assumptions and conventions to be used in measurement

Measurement Issues	Alternatives
(i) Approach to assumptions	<input checked="" type="checkbox"/> Explicit approach
	<input checked="" type="checkbox"/> Implicit approach
(ii) Basis for assumptions	<input checked="" type="checkbox"/> Current information
	<input checked="" type="checkbox"/> Long-term trends
(iii) Future events included in estimates	<input checked="" type="checkbox"/> All future events that would affect the amount and timing of cash flows
	<input checked="" type="checkbox"/> Only some future events
	<input checked="" type="checkbox"/> No future events
(iv) Assumption about the amount and timing of cash flows	<input checked="" type="checkbox"/> Market's expectations
	<input checked="" type="checkbox"/> Insurer's expectations

Source: Table 3 of IP (with modifications and additions by author)

Nevertheless, the Steering Committee had expressed that adopting the asset and liability measurement view does not automatically lead to the selection of fair value as the measurement attribute for assets and liabilities generated from insurance contracts (insurance assets and insurance liabilities) (*Ibid.*, para. 164). However, as described in (4) below, the IP revealed great interest in the applicability of fair value measurement to insurance liabilities.

(4) Problems with fair value measurement

The IP, which shows the Steering Committee's tentative views, did not conclude to apply fair value as the only measurement attribute for insurance liabilities. Rather, it treated it as one of the candidates. Nevertheless, the fact that one whole chapter (paras.

517-652) was dedicated to the use of fair value as the measurement attribute for insurance liabilities and related problems indicates a great interest in fair value. In the chapter on fair value, it was again pointed out that an insurance contract is identified as a form of financial instruments (*Ibid.*, para. 537), and this reminds us of the fact that the IASC had proposed fair value measurement for most financial instruments under its financial instruments project.

The IP pointed out various problems likely to arise from the application of fair value measurement, starting with “volatilities in income and equity”. Opponents of application point out these volatilities will lead to reported net profit or loss and equity that are more volatile and less predictable and manageable, and current fluctuations of financial markets are not representative of that fundamental characteristic of the insurance industry (*Ibid.*, para. 339). On the other hand, Proponents see these volatilities as an economic reality.

From a reading of the IP, the Steering Committee appeared to recommend the use of an identical measurement attribute for assets and liabilities.² Although the Steering Committee recognized other problems, such as Day 1 gains as arising from the application of fair value measurement and fair value estimation methods for insurance liabilities, which have very little marketability, it characterized them as matters for future investigation, thus stopping only at inviting comments.

As can be seen from the above, it is clear that the IP aims for fair value measurement despite stating that it has not drawn a final conclusion on measurement attributes for insurance liabilities and taken a sit-back-and-watch stance on the future progress of the financial instruments project.

2.2 Draft Statement of Principles (IASB 2001)

Coinciding with the restructuring of the IASC as the IASB, the IASC's insurance project was taken over by the IASB along with the intention to adopt the asset and liability measurement view, leading to the release of the Draft Statement of Principles (IASB 2001, hereinafter "DSOP") in November 2001. The 14 chapter-long DSOP was published on the IASB website, updated as needed from 2001 to 2002, but updating was suspended (effectively discontinued) in May 2002 upon the spinning off of the insurance contract project, and this remains the case today. The DSOP examined the comments submitted on the IP, and proposed a more active approach towards the measurement of insurance liabilities. Meanwhile, the "insurance contracts = financial instruments" relationship as shown in the IP was passed on to the DSOP.

The IP took a sit-back-and-watch stance on the future progress of the financial instruments project, and did not actively propose measurement attributes for insurance liabilities. Since it continued to be unclear at the time of the release of the DSOP whether IAS39 would be replaced with full fair value accounting, the DSOP proposed different measurement attributes depending on whether IAS39 would remain valid standards. Thus, the DSOP proposed (a) while IAS 39 is still in place, insurance liabilities and insurance assets should be measured at entity-specific value,³ or (b) if a successor standard to IAS 39 introduces fair value measurement for the substantial majority of financial assets and liabilities, IASB should consider introducing fair value measurement⁴ for all insurance liabilities and insurance assets (paras. 3.3 and 3.4).⁵

The DSOP decided that focusing on settlement in accordance with the contractual terms is more relevant than the focus of fair value on a hypothetical transaction with a third party, because (a) most insurance liabilities are settled by payments to

policyholders rather than by an exchange transaction with another party, (b) insurers have better information than other market participants about the characteristics of the insurer's assets and liabilities, and (c) there is no active and observable market for insurance liabilities (para. 3.22 and 3.24). Still more important, the DSOP rejects measurement objectives that focus on cost accumulation (para. 3.27).

2.3 IFRS 4 (IASB 2004)

In May 2002, the IASB decided to proceed with the insurance contract project by splitting it into phase I for the formulation of tentative standards and phase II for the formulation of permanent standards on the grounds that it would be impossible to formulate permanent standards for insurance contracts by 2005, the year of the introduction of IAS in Europe. In March 2004, the IASB released IFRS 4, a deliverable of phase I. IFRS 4 only represents tentative standards, valid until the completion of permanent standards under phase II, and basically tolerates current accounting practices (i.e. those based on the deferral and matching view) so as to avoid imposing major changes on insurers when the provisions of IFRS 4 are overturned upon the release of permanent standards. Still, one can identify provisions that hint at the direction of phase II with regard to the measurement of insurance liabilities.

For example, IFRS 4 prohibits the recognition of catastrophe reserves and equalization reserves, which can only be included under the deferral and matching view (para. 14[a]). Most notably, in cases where insurance liabilities are measured after being discounted to present value under the current practice, IFRS 4 prohibits a switch to measurement without discounting to present value (para. 25[a]),⁶ despite stating it “*permitted, but not required*, to change its accounting policies so that it remeasures

designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss” (para. 24, emphasis by the author).

2. 4 Discussion Paper (IASB 2007)

As examined in the previous section, the DSOP preferred entity-specific value as the measurement attribute for insurance liabilities, but the tentative agreement of January 2003 back flipped and proposed the use of fair value. The reason for this move is believed to be a close similarity in amount between entity-specific value under the DSOP and estimated fair value as determined using the measurement guidance tentatively adopted by the IASB under phase II of its business combinations project (IFRS 4, para. BC7). Subsequently, the applicability of fair value measurement to insurance liabilities gradually became the main issue under the insurance contract project, phase II.

(1) Current exit value as measurement attribute for insurance liabilities

In May 2007, the IASB released Discussion Paper “Preliminary Views on Insurance Contracts” (IASB 2007, hereinafter the “DP”) as a deliverable of phase II discussion. The DP is understood to have proposed fair value accounting for insurance contracts. The DP proposed “current exit value” as the measurement attribute for insurance liabilities, with insurance liabilities to be re-measured in each period using this measurement attribute.

Current exit value defines as “the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity” (DP, para. 93). The revenue recognition of contracts depended on

changes in current exit value, and any change in amount was to be included in net income. From today's viewpoint, the definition of current exit value itself is understood to be on par with the definition of fair value under the current edition of IFRS13 "Fair Value Measurement" (IASB 2011a).⁷ However, since the current exit value of insurance liabilities is usually unobservable, it is proposed to be estimated using a market-compatible method on the basis of three building blocks (components) comprising (i) an estimate of the future cash flows, (ii) the effect of time value of money (discount rate) and (iii) the margin, with entity-specific estimation not tolerated. Among these building blocks, take up the discussion of the risk margin.

As insurers face uncertainty (risk) over the amount and timing of cash flows generated from insurance contracts, there is a need to have this risk reflected in the measurement of insurance liabilities. The DP described that input which reflects the extent of uncertainty as a risk margin. The DP discussed the two alternative purposes of a risk margin; "shock absorber view" and "compensation view". The first view regards risk margins as a "shock absorber" that something included in the liability to avoiding recognizing an expense in the future if payments to policyholders exceed the amount previously recognized as a liability (DP, para. 73). On the other hand, the second view regards risk margins as an explicit and unbiased measurement of the compensation that entities demand for bearing risk (*Ibid.*, para. 73).

There is some difference in indications of the risk margin at the end of the period between "shock absorber view" and "compensation view". In shock absorber view, the risk margin at the end of the period indicates decreases in the amount of risk (i.e. release from risk), on the other hand, in compensation view, in addition to that indicates the amount of risk remaining at the end of the period (*Ibid.*, para. 73). The DP stated "the

remaining risk margin reported under the shock absorber view can be described only as the result of a computation”, so that the IASB regards the compensation view approach as preferable because it is consistent with the asset and liability measurement view.

(2) Exclusion of alternative measurement attributes

In addition to proposing current exit value (fair value) as the measurement attribute for insurance liabilities, the DP looked into other potentially alternative measurement attributes. One of the alternative measurement attribute is “current entry value”. Current entry value can be defined as “the amount that the insurer would charge a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract” (*Ibid.*, para. 97). The DP rejected current entry value because “it is not generally available later in the contract because an insurer would not typically sell new contracts with the same remaining exposure” (*Ibid.*, para. 97[a]).

The DP also discussed an unearned premium approach because some insurer uses this approach for short-duration non-life insurance pre-claims liabilities. In the end, the DP stated that “current exit value is the most relevant and reliable measurement attribute for all insurance contracts” (para. 112).

(3) Comments on DP

Although a lot of comments submitted for the DP agreed that the proposed three building-blocks approach would provide a useful framework for the measurement of insurance liabilities, there was no support for the use of current exit value as the measurement attribute (IASB 2008, para. 5 and 11). The main criticisms raised against current exit value are summed up as (a) preference of market-compatible cash flows

over entity-specific cash flows,⁸ (b) reflection of credit risk in measurement,⁹ (c) a fundamental error of setting current exit value, i.e. transfer value, for insurance liabilities because they are usually impossible to transfer to others (*Ibid.*, para. 11).¹⁰ If credit risk (possibility of an insurer being unable to meet their obligations as required) is incorporated into the measurement of liabilities, liabilities decrease due to a rise in credit risk (reduction in creditworthiness) and increase due to a fall in credit risk (improvement in creditworthiness). The discussion on credit risk was a contributing factor to the IASB's failure to introduce fair value measurement in insurance contract accounting. In the face of those comments, the IASB was forced to make changes to its pro-fair value measurement basic policy.

2.5 Exposure Draft (IASB 2010a)

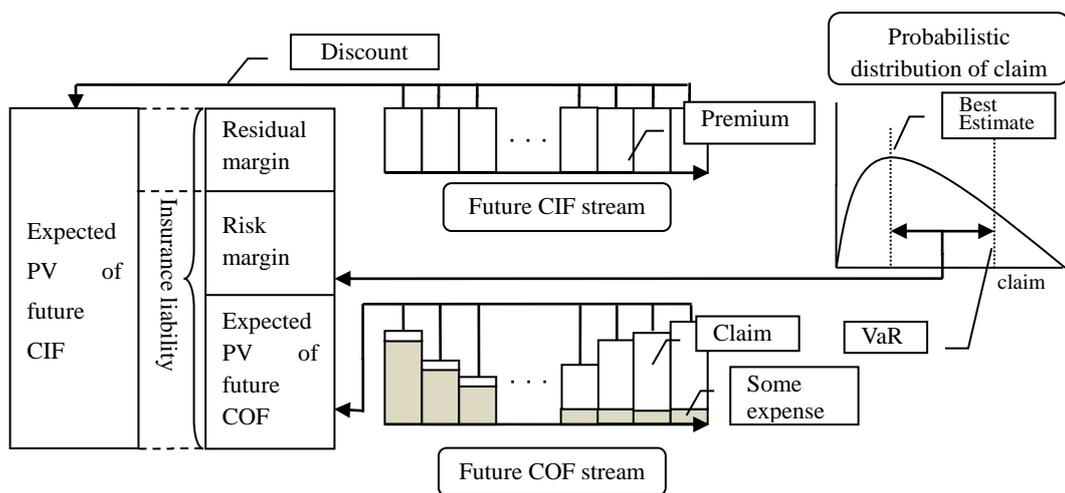
(1) Present value of fulfillment cash flows model

Taking into consideration the criticisms thrown at the DP, the IASB released the Exposure Draft "Insurance Contracts" (IASB 2010a, hereinafter the "ED") in August 2010. The ED proposed a measurement model called the "present value of fulfillment cash flows". The ED defined the present value of fulfillment cash flows as the sum of (i) explicit, unbiased, probabilistically weighted expected value of future cash outflows generated as insurers fulfill insurance contracts minus future cash inflows, (ii) discount rate and (iii) risk adjustment (margin relating thereto), with the total amount of insurance liabilities at the time of initial recognition derived from this by further adding (iv) residual margin.

Figure 1 shows the relationship between building blocks as described in (i) to (iv) above. First, future cash inflows streams (mainly premiums) and future cash outflows

streams are estimated taking into consideration the probability of occurrence in the envisaged scenarios of existing contracts, and then each set of streams is discounted to present value. Future cash outflows streams include claims and incremental acquisition costs and other expenses. Incremental acquisition costs are “the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs”. The IASB (IASC) had been proposed that insurer should recognize all acquisition costs as an expense when incurred. However, the ED proposed that the contract cash flows should include only incremental acquisition costs because those cost is clearly identified as relating to the contact. Thus, no expense or income should be recognized when acquisition costs are incurred. Instead, those costs would be recognized as part of the insurance liability.

Figure 1 Insurance liabilities measurement model



Source: Hane (2012)

The risk adjustment shall be “the maximum amount the insurer would rationally pay

to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected” (ED, para. 35). And the ED allows using only the following techniques for estimating risk adjustments: (a) confidence level (Value at Risk: VaR), (b) conditional tail expectation, and (c) cost of capital. In the case of the VaR techniques, for example, a certain level (confidence level) that exceeds the expected value (best estimate) according to the probability distribution of actual claim payments made over a set period is measured as risk adjustment. If the present value of future cash inflows exceeds the sum of the present value of future cash outflows and risk adjustment, profit at inception (Day 1 gains) is recognized. In this regard, this amount is recognized as a residual margin to avoid recognizing these profits without fulfilling contracts. The residual margin is a margin to report the profitability of a contract over its coverage periods. The residual margin at the time of initial measurement is released (amortized) over the period of insurance coverage in a systematic way based on the passage of time, or on the basis of the expected timing of incurred claims and benefits (*Ibid.*, para. 50). The ED introduced the residual margin so as to avoid Day 1 gains in response to the criticism that a gain would occur at the start of a contract under the present value (current value) model despite contracts not having been fulfilled. For this reason, the residual margin is understood as deferred Day 1 gains. The DP stated prohibiting the recognition of profits at inception would lead to the inclusion in liabilities of “deferred profits” that do not represent obligations (para. 82). Thus, the recognition of a residual margin is a prohibited strategy in asset and liability measurement view.

The ED proposed the re-measurement of all building blocks, except the residual margin, in each period, with the changes in their values all included in net income. The ED also proposed a presentation model called “summarized margin presentation”,

which would indicate changes in the measured values of building blocks (particularly the margin), as a presentation model for the comprehensive income statement (Table 4). Based on this model, the sum of the change in risk adjustment and the released portion of the residual margin are first included as the “underwriting margin”. Next, the amount arrived at by adding/subtracting the change in experience adjustment in cash flows (difference between the previous cash flows estimate and the amount actually paid or received) and estimates of future cash flows and the discount rate to/from the underwriting margin is included as the “underwriting result”. Finally, net income is obtained by adding/subtracting interests and investment revenues from insurance liabilities to the underwriting result. As can be seen above, under the summarized margin presentation method, premium revenues and claim payments (presented in many current accounting models) are not presented in the comprehensive income statement itself.

Table 4 Comprehensive income statement based on summarized margin presentation

	20XX
Risk adjustment	XXX
Residual margin	XXX
Underwriting margin	XXX
Experience adjustments	XXX
Changes in estimates	XXX
Underwriting result	XXX
Investment income	XXX
Interest on insurance liability	XXX
Net interest and investment	XXX
Profit or loss	XXX

The ED allows alternative measurement model ‘premium allocation approach’ for some short-duration contracts. For this approach, an insurer should measure its

pre-claims obligation at initial recognition as (a) the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any; less (b) the incremental acquisition costs (*Ibid.*, para. 57), and subsequently, the insurer should reduce the measurement of the pre-claims obligation over the coverage period in a systematic way (*Ibid.*, para. 58).

(2) Comments on ED

Although a lot of comments supported the measurement model based on building-block approach as proposed by the ED, concerns were expressed by many financial statement users that the model would lead to increased volatilities due to its extreme reliance on estimates in the inclusion of changes in all building blocks, except the residual margin, in net income (IASB 2011b, 5). Also, despite the volatilities resulting from the proposed model certain to affect income and equity, almost all insurers commented that such volatilities did not faithfully represent insurer performance (*Ibid.*, 7). Furthermore, many accounting standard setters, for example Accounting Standards Board of Japan (ASBJ) and German Accounting Standards Board (GASB) criticized the fact that a model that immediately recognized changes in estimates under net income would increase short-term volatilities in income and thereby impair the usefulness of net income as a performance indicator for the insurance industry (e.g. ASBJ 2010, 1; GASB 2010, 6).

Although the summarized margin presentation method won the acknowledgment of a certain level of usefulness, a lot of comments, including those from most financial statement users, criticized its exclusion of information on premiums, claims, etc., which was, under traditional presentation models, included in the comprehensive income

statement itself (IASB 2011b, 18).¹¹ In addition, most standard setters were very skeptical about the usefulness of the summarized margin presentation method¹². In response to those comments, the IASB has tentatively agreed to include premium revenues and claim payments in the re-exposure draft due in 2013.

(3) Subsequent discussion

In the face of those comments mentioned above, the IASB was again forced to make changes to its proposal. In the following, we will overview the IASB's Tentative Decision (TD) as the latest tentative agreement in this post-ED stage. There is a minor change with respect to acquisition costs and risk adjustment. The IASB tentatively decides that insurer should include in fulfillment cash flows all the direct costs that the insurer necessarily incurs in acquiring the contracts in the portfolio, and exclude indirect costs such as software dedicated to contract acquisition (IASB 2013, 28). In the TD, the objective of the risk adjustment should be to reflect "the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract" (IASB 2013, 31), because some commentators on the ED have questioned whether "risk adjustments are more consistent with an exit value notion than with a fulfilment notion" (IASB 2011b, 13).¹³

There is a big change from the ED for treatment of residual margin and discount rate. On the TD, there is a major departure from the ED such that any changes in insurance liabilities due to the updating of the discount rate are to be indicated under other comprehensive income (OCI). This is attributed to the fact that a lot of comments submitted for the ED pointed out that changes in the market interest rate and market variables should be separated from the performance indicator (net income) of insurance

and underwriting services as insurers' main business activities. The TD also proposes not requiring discounting when it has no insignificant effect (IASB 2013, 29).

In response to criticisms against the ED's proposal not to subject the residual margin, among all components of insurance liabilities, to re-measurement, investigations are under way on the re-measurement of the residual margin.¹⁴ Against this background, the TD proposes: "the residual margin should be adjusted only for changes in estimates of future cash flows" (IASB 2012a, para. 6). For this reason, the residual margin can change upward or downward in sync with changes in the estimate of future cash flows. After adjustment, the residual margin is systematically amortized over the period of insurance coverage as is the case with the ED. Behind the proposal as to the re-measurement of the residual margin was the reflection of the characterization of the residual margin as "the unearned profit in the contract" (*Ibid.*, para. 13). Namely, this represents a view that the residual margin is the difference between the present value of premiums and the present value of fulfilled cash outflows so that, if there is any change in the estimate of future cash flows, the profitability of the contract (unrealized profits from the contract) changes.

2.6 Midway recap

The this section mainly traced the evolution of the proposal content on measurement attributes for insurance liabilities under the IASB insurance contract project. Table 5 summarizes the characteristic proposals in IASB statements on measurement of insurance liabilities.

At the inception of the insurance contract project, the foremost issue in the consciousness of the IASC with regard to the standardization of insurance contract

accounting was a lack of consistency between the deferral and matching view, employed under the current accounting practice, and the IASC's Framework. Under the deferral and matching view, income and expenditure excluded from period matching involving current net income calculation based on the revenue-expense matching concept are subjected to deferred processing as items earmarked for matching in the next or any subsequent period. The IP rejects the deferral and matching view (or the traditional matching concept) on the grounds that such deferred items include those that do not satisfy the definition of assets and liabilities under the IASC's Framework. Also, while the IASC proposed the adoption of the "present value (current value) model" through the adoption of the asset and liability measurement view, it is clearly aiming for fair value measurement as can be seen from its requirement for "market-compatible measurement" for each component. Subsequently, fair value-oriented discussion took place through the adoption of the asset and liability measurement view based on the IASC's Framework under the insurance contract project.

Subsequently, the DSOP proposed entity-specific value as the measurement attribute for insurance liabilities in line with fair value, but the DP, which proposed current exit value as the measurement attribute, prohibited having entity-specific cash flows reflected in measurement, thus settling on fair value measurement based on the estimation of all components from the viewpoint of market participants. However, regardless of which measurement attribute is adopted, an active market rarely exists for insurance liabilities, making their values generally unobservable, and this makes it necessary to estimate them using a suitable measurement model. IASB proposes to estimate insurance liabilities by splitting them into multiple components (mainly the cash flows, discount rate and margin). Through various publications up to the DP, all

accounting treatment practices inconsistent with the definition of assets and liabilities under the IASC’s Framework (e.g. the unearned premiums approach and the shock absorber view relating to the risk margin) were excluded by faithfully adopting the asset and liability measurement view, while market-consistent measurement methods were required.

Table 5 Characteristic proposals in the IASB statements on measurement of insurance liabilities

	Consistent application of Asset and Liability Measurement	Consistent application of Deferral and Matching
IP (1999)	<input checked="" type="checkbox"/> The application of present value measurement for insurance liabilities	<input checked="" type="checkbox"/> The acceptance of unearned premium approach <input checked="" type="checkbox"/> Capitalization of acquisition costs
DSOP (2001)	<input checked="" type="checkbox"/> The application of fair value or entity-specific measurement for insurance liabilities	<input checked="" type="checkbox"/> The acceptance of alternatives to entity-specific value and fair value (a cost accumulation basis)
IFRS4 (2004)	<input checked="" type="checkbox"/> The acceptance of present value measurement for insurance liabilities <input checked="" type="checkbox"/> Prohibition of catastrophe and equalization reserves	<input checked="" type="checkbox"/> The acceptance of continuing application of unearned premium approach <input checked="" type="checkbox"/> The acceptance of capitalization of acquisition costs
DP (2007)	<input checked="" type="checkbox"/> The application of current exit value measurement for insurance liabilities <input checked="" type="checkbox"/> Recording of Day 1 gains	<input checked="" type="checkbox"/> The acceptance of unearned premium approach <input checked="" type="checkbox"/> Risk margin as a “shock absorber”
ED (2010)	<input checked="" type="checkbox"/> Re-measurement of insurance liabilities by entity-specific value	<input checked="" type="checkbox"/> Deferral of Day 1 gains as a residual margin <input checked="" type="checkbox"/> Deferral of incremental acquisition costs as present value of fulfilment cash flows

However, questions were raised about the DP over (i) application of current exit value (fair value) to insurance liabilities, for which transfer to third parties is not usually considered, under the pretense of the transferability of such liabilities and (ii) imperative of having the effect of credit risk reflected in insurance liabilities as a result of the application of fair value measurement. In response to this, the ED proposed a

measurement model based on the “fulfillment” of insurance liabilities and more consistent with the insurance business model, and permitted having entity-specific estimates reflected in the cash flows and risk margin.

Given the certain level of acceptance enjoyed by the measurement model proposed by the ED, it is safe to say that the discussion over measurement attributes for insurance liabilities under the IASB has been settled through adoption of entity-specific value. For this reason, the IASB’s initial goal to “apply fair value measurement to insurance liabilities” under the assumption “insurance contracts = financial instruments” is considered to have ended in failure. This is considered to show that there was a problem right with the IASB’s goal setting, whereby the fair value model, a measurement (revenue recognition) model unamenable to the insurance service industry, was embraced as ideal. The other goal to “reject the traditional matching concept and formulate accounting standards consistent with the definition of assets and liabilities under the IASC’s Framework” is also collapsing through the introduction of the residual margin, which can be considered as deferred profits from contracts. Although the TD proposes the re-measurement of the residual margin, the revenue recognition method essentially remains unchanged in that the re-measured margin is to be systematically amortized period after period in each using a set method.

In the meantime, the handling of the volatilities in net income and equity brought about by the application of a current value model is identified as one of the problems the IASB still faces even after the resolution of the measurement attribute problem. Since the ED proposed that the effect of all changes relating to insurance liabilities be recognized through net income, short-term volatilities would occur to net income due to such changes, particularly those relating to the market interest rate, and this invited

criticism for obscuring the intrinsic performance of the insurance and underwriting industry. Against this background, the IASB repropoed, as remedies for the volatilities brought about by changes to estimates, (a) absorption of the volatility attributed to the change in the estimate of cash flows in the residual margin and (b) accounting for the volatility attributed to the change in the discount rate through the recognition of the resulting change in amount as OCI. Although these proposals would lead to a reduction in the volatilities attributed to changes in future estimates relating to the measurement of insurance liabilities, the causes of volatilities likely to be suffered by insurers are not limited to those attributed to the measurement of insurance liabilities. Namely, there is a need to address the volatility brought about by the relationship between insurance liabilities and assets that back them up. The IASB's proposal on this point will be investigated in the next section.

3. Significance of Matching Assets and Liabilities

Briefly looking back at the discussion presented up to the previous section, it is clear that the IP favored fair value, despite stating that the adoption of the asset and liability measurement view did not automatically mean the selection of fair value as the measurement attribute for insurance liabilities. The ED proposed an entity-specific value model called the "present value of fulfillment cash flows", which received many favorable comments, and it is planned to steer the discussion toward the adoption of this model in a future re-exposure draft. With the discussion on measurement attributes for insurance liabilities more or less settled, the IASB's plan to use fair value as the sole measurement attribute for insurance liabilities as proposed under the DP hit the wall. It appears that, with the ED, the IASB has shifted its policy direction from "*use of fair*

value as the sole measurement attribute” to “use of entity-specific value as *the sole measurement attribute*”.

Here, prior to examining the significance of the IASB insurance contract project, the author would like to investigate the following question: What is the IASB trying to achieve by proposing fair value or entity-specific value as the sole measurement attribute for insurance liabilities? In addition, the IASB appears to be attempting to solve insurance accounting problems by matching assets and liabilities while turning its back on the revenue-expense matching concept. The most notable example is the incorporation of requirements for “reporting economic mismatches” and “eliminating accounting mismatches” in the “ideal measurement model for insurance contracts” proposed by the IASB. In this section, a brief investigation is provided focusing on those requirements.

3. 1 Ideal measurement model for insurance contracts

IASB states that (a) providing of transparent reporting of changes in insurance liabilities, (b) providing of complete information on changes in estimates, and (c) requiring consistent measurement of assets and liabilities can be achieved by applying the current measurement model to insurance liabilities (IASB 2013, para. 20). However, it is unavoidable that some kinds of volatilities are generated through the application of such a model. For example, in the case of a change in the market interest rate having different magnitudes of effect on assets and liabilities, volatilities can arise in both income and equity. The IASB lists two concepts of matching as remedies for such volatilities.

IASB proposes that an ideal measurement model would report all economic

mismatches and would not create any accounting mismatches (DP, para.179; ED, para.BC173). IASB explains that an “economic mismatch” arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions (ED, para.BC172 [a]). On the other hand, an “accounting mismatch” arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because different measurement attributes are applied (ED, para.BC172 [b]). It appears that the reason why focus is placed on “changes in the economic situation” alongside economic mismatches and accounting mismatches is that the practice of asset and liability management (ALM) in the insurance industry is kept in mind.

“Reporting economic mismatches” request to report true economic situation for insurance contracts about cash flow mismatch, and value mismatch. In order to fulfill the “reporting economic mismatches”, adopting a historical cost (or the amount of historical receivable) for the measurement attribute of insurance liabilities and the assets backing the liabilities would not be justified. Because historical cost is the past tense measurement attribute, it reflects the economic conditions at the time of purchase or acceptance of assets and liabilities; therefore it does not reflect the changes in current economic conditions of the assets and liabilities. To reflect the changes in current economic conditions of the assets and liabilities and to report on economic mismatches timely basis, one would select current tense measurement attribute (for example, fair value), and re-measure each period (Akiba 2011). While it is unavoidable to generate volatilities (in income or equity) by subjecting assets and liabilities to present value measurement to achieve “reporting economic mismatches”, the IASB has expressed

some kind of “belief” that such volatilities “faithfully represents the underlying economics” (IASB 2013, para. 21[a]).¹⁵

Although “reporting economic mismatches” is a proposal specific to insurance contract accounting, “eliminating accounting mismatches” can be seen in other IFRS. For example, in IFRS 9 “Financial Instruments” (IASB 2010b), “eliminating accounting mismatches” describes measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases (para.4.5). Looking at the difference between the description of the accounting mismatch ED and IFRS9, IFRS9 refers to mismatch at the time of recognition of gains and losses to net income (that is, selection of OCI) in addition to the mismatch between the measurement attribute. Emphasis only mismatches of measurement attribute may lead to emphasis of the balance sheet (stock) information. Thus, this can be derived different accounting treatment from the hedge accounting, that matching the balance sheet components as a mean to match the income statement components.

Regarding the relationship between economic mismatches and accounting mismatches, the requirement for “reporting economic mismatches” has a strong impact on the requirement for “eliminating accounting mismatches”. As mentioned before, because “reporting economic mismatches” requests to re-measuring of assets and liabilities held by insurance companies at economic value, selecting means to eliminate an accounting mismatch will be limited to measurement attribute that can measure the economic value of assets and liabilities at the time.¹⁶ Only to eliminate an accounting mismatch, there will be no problem to select amortized cost each asset and liability.¹⁷

Some of the comments submitted for the ED point out that the insurance business

model relies on ALM and that failure to reflect such practice causes volatilities to insurers (IASB 2011c, 2-3). Also, according to International Association of Insurance Supervisors (IAIS), ALM is regarded as focusing on the matching of assets and liabilities (asset and liability matching), which is aimed mainly at minimizing market interest rate risk from life insurers' perspective (IAIS 2006, para. 7). If the impact of the economic situation is similar on assets and liabilities (in other words, if assets and liabilities are matched on the basis of ALM), volatilities due to interest rate risk, etc. are mitigated as an upward change in one of the assets and liabilities pair is canceled out by a downward change in the other.

As can be seen from the above, “eliminating accounting mismatches” is understood to be applied when measuring assets and liabilities at present value to smooth the volatilities in income or equity generated by changes in assets and liabilities as a secondary procedure to “reporting economic mismatches”.

3.2 Significance of matching assets and liabilities

Here, the consequences of matching assets and liabilities for the objectives of “reporting economic mismatches” and “eliminating accounting mismatches” will be examined.

(1) Active promotion of full fair value accounting

“Reporting economic mismatches” requires the timely recognition of changes in insurance liabilities and their backup assets that occur as a result of changes in the economic situation. For example, in cases where assets and liabilities have different levels of sensitivity towards interest rate changes, mismatches occur in the stock if

present value is recalculated on the basis of this interest rate and in the flow if the received or paid interest changes. “Eliminating accounting mismatches” is understood as requiring the adoption of a measurement method consistent across assets and liabilities to reduce any inadvertent volatilities in the stock and flow that may arise as part of the effort to achieve the “reporting economic mismatches” goal. In concrete terms, it aims to smooth the equity (stock) and net income (flow) by subjecting both assets and liabilities to economic value measurement and thus cancel out the changes in one with the changes in the other. The main objectives of matching assets and liabilities can be summarized as (i) ensuring the accurate reporting of the economic state and (ii) reducing volatilities. Here, the fact that the matching of assets and liabilities is intended to smoothing equity as well is believed to constitute a departure from the traditional matching concept, which is aimed at smoothing period-by-period net income.

Though the ED does not, as a stated objective, require any change to accounting treatment for assets held by insurers (para. BC176), it essentially restricts or limits asset-side accounting treatment by requiring “reporting economic mismatches” and “eliminating accounting mismatches” as shown above. Given that insurance liabilities are said to account for 80 to 90% of all liabilities held by insurers (Ueno 2009, 173-174), the application of fair value measurement (or entity-specific value measurement) to insurance liabilities may lead to requiring the application of fair value measurement to assets that back up insurance liabilities as an extrapolation of the concept, and this would essentially impose full fair value measurement on insurers.¹⁸

The IASB also appears to attach more importance to “reporting economic mismatches” than “eliminating accounting mismatches” (IASB 2011d). The IASB seems to emphasize the provision of “faithful representations” of economic events

surrounding insurance contracts in its assertion of the justifiability of “reporting economic mismatches”, but this stance is fundamentally problematic because of its major premise that information on “changes in insurance liabilities and backup assets” that faithfully reports on the economic state itself is “relevant”.

It is true that, while a lot of comments on the ED agreed that the discounting of insurance liabilities to present value on the basis of the current interest rate leads to the supply of relevant information on an insurer’s financial state, concerns were also expressed that the reporting of economic mismatches in any circumstances does not necessarily provide useful information in terms of the objectives of financial reporting from the standpoint of attaching importance to net income as an indicator of the long-term performance of entities. As discussed above, it is pointed out that changes in the market interest rate and other market variables are a consequence of short-term market volatilities, which should be separated from the long-term performance of insurers (IASB 2011c, 8). In addition, it is noteworthy that a lot of comments attach more importance to the smoothing of income than the smoothing of equity (IASB 2012b, para. 25[c]). This also suggests that, of the two objective of matching assets and liabilities, “eliminating accounting mismatches” is the one that deserves more emphasis from the viewpoint of smoothing volatile net income.

(2) Significance of matching revenues and expenses arising from changes in assets and liabilities

As discussed above, discussions in the IP and elsewhere point out, as a theoretical basis of promoting the present value of measurement of assets and liabilities, that the application of present value measurement does not necessarily mean ignoring the

matching of revenues and expenses. Namely, discounting to present value matches revenues and expenses as represented in a common unit of measurement (i.e. present value at the same point in time) (DSOP, para. 3.48).

Let us now review why the traditional matching concept matches revenues and expenses. As pointed out in Paton and Littleton (1940, 7), which describes the traditional matching concept in a systematic manner, “the principal concern of accounting is the periodic matching of costs and revenues as a test reading by which to gauge the effect of the efforts expended”. Paton and Littleton (1940)’s concrete matching process begins with the adoption of the concept of “realization” when recognizing revenues as a fruition. Paton and Littleton (1940, 49) describes “[r]evenue is realized, according to the dominant view, when it is evidenced by cash receipts or receivables, or other new liquid assets. Implicit here are two tests: (1) conversion through legal sale or similar process; (2) validation through the acquisition of liquid assets”.

And, Paton and Littleton (1940, 69) points out “accounting for costs involves three stages: (1) ascertaining and recording costs as incurred, appropriately classified; (2) tracing and reclassifying costs in terms of operating activity; (3) assigning costs to revenue”. Paton and Littleton (1940, 15 and 70) also points out that “[i]deally, all costs incurred should be viewed as ultimately clinging to definite items of goods sold or service rendered”, and “the cost of any factor utilized in operating activity is chargeable to revenue only as the resulting product is recognized as having produced revenue”. Namely, expired costs (expenses) are allocated in a manner to match them with ‘realized’ revenues.

As can be seen from this, the traditional matching concept as exemplified by Paton

and Littleton (1940) is generally understood as something that clarifies the net income of an entity as its pure fruit of business by matching its expenses and revenues as a way of linking the entity's business efforts and their fruit, and, in this sense, "[a]ppropriate reporting of costs and revenues in such a way as to disclose most vividly the relationships between efforts and accomplishments" (AAA 1965, 368). Moreover, reallocating cash flows through "proper matching to avoid distorting periodic net income" (Storey and Storey 1998, 51) makes it possible to expect income to have significance as a long-term performance indicator. Namely, the traditional matching concept attaches positive significance as "net fruit of business activities" to income by identifying/linking revenues and expenses in terms of a causal relationship between "efforts" and "fruit" in business activities.

Moreover, revenues and expenses, as matched under the traditional matching concept, are definite amounts that are already realized (or incurred). As a result, net income, as a quantity obtained by matching the two quantities, assumes a definite character. As examined through the discussion on unearned premiums and acquisition costs, if either of revenue and its matching expense is unrealized (yet to be incurred), the other item is deferred until realization (incurring) occurs or a causal relationship between the two is established.

With a method that matches revenues and expenses as a secondary process to the matching of assets and liabilities under the framework of present value measurement, the meaning of net income as derived from such matching changes. Of the various variation factors of present value, a change in the estimate of future cash flows is the prime example. While the estimation of future cash flows is performed by taking into consideration all kinds of information, both within and outside the entity, it only

represents an expectation, so that there is a fair possibility of a revision being forced upon it in the next or any subsequent period. Under asset and liability matching, only “expected” income can be calculated from the matching of “expected” revenues and “expected” expenses. Moreover, no causal relationship exists between those revenues and expenses, with only an indirect correlation involving the effect of changes in the interest rate as an intermediate link likely to be observed (even if AML is assumed). It is not clear whether one can attach positive significance as a long-term performance indicator of “net fruit of business activities” to such income.

4. Conclusion

By taking an overview of the evolution of the IASB insurance contract project, this paper has looked into (a) what the IASB aims to achieve in this project and (b) where the fundamental problem lies as to the situation where the project is still ongoing after more than 15 long years of deliberations. Section 2 looked at the IASB’s fundamental way of thinking with regard to insurance contract accounting by reviewing the change over time of the IASB (IASC)’s proposals relating to measurement attributes for insurance liabilities. It showed that, while the IASC’s goal in IAS for insurance contracts was to abolish the accounting model based on the traditional matching concept involving revenues and expenses and formulate standards that would be consistent with the definition of assets and liabilities under the IASC’s Framework, it had favored fair value measurement right from the outset. Under the insurance contract project, discussion has proceeded along the two axes of (i) Consistency with the IASC’s Framework (departure from the traditional matching concept) and (ii) Adoption of fair value measurement. However, (ii) has gone aground as the “pure” fair value model for

insurance liabilities proposed by the DP was rejected amid bewilderment at the nonsensical application of fair value measurement to insurance liabilities, for which market settlement between third parties is not usually assumed. Subsequently, the ED attempted to promote (i) with the intention of making entity-specific value the sole measurement attribute for insurance liabilities, but it too seems to have collapsed as a result of the introduction of the residual margin. On this point, the ED may be interpreted as a hybrid model between the asset and liability measurement view and the deferral and matching view. The reality is that repeated attempts to reject the traditional matching concept have not, or at least not completely, succeeded. Meanwhile, the tentative agreement has proposed re-measuring the residual margin, but this is synonymous with the proposal of the re-measurement of deferred profits. This after all makes no difference with regard to the fact that the revenue recognition of the residual margin has not been able to totally free itself from the traditional revenue recognition process based on “realization/matching”.

Section 3 investigated the attempt by the IASB, which has given up on the introduction of fair value measurement in insurance contract accounting, to use entity-specific value as the sole measurement attribute and match assets and liabilities (in a departure from revenue-expense matching concept), as well as its consequences. It was shown that the use of entity-specific value as the measurement attribute for insurance liabilities under the slogans of “reporting economic mismatches” and “eliminating accounting mismatches” could lead to the promotion of full fair value accounting, also applicable to assets that back up insurance liabilities. In fact, the Exposure Draft “Classification and Measurement: Limited Amendments to IFRS 9” released in November 2012 introduced additional fair value categories through OCI for

some financial instruments, with consideration for the relationship with the insurance ED given as a background reason for it (IASB 2012c, para. IN1[b]). This move may be seen as a first step towards setting accounting standards that are more on the assets side than insurance contract accounting.

Also, revenues and expenses as derived from the matching of assets and liabilities, or income as the difference between the two, are totally different in character from revenues and expenses as arising from the traditional matching concept, and this inevitably transforms the role that income information has long played. As long as the IASB takes the stance that equity (value) is more important than income, the “transformation” of the character of income may be a trivial problem. However, it is a fact that many commentators on the ED opposed summarized margin presentation, which did not present premium revenues and claim payments and attached greater importance to income smoothing than equity smoothing, in other words, income information than equity value information.¹⁹ Does this not show that many financial statement users recognize the fact that, as pointed out by Tsujiyama (2003, 73), net assets on a market price (fair value) basis does not show shareholder value itself and that net income information is essential for the estimation of equity value? As mentioned above, the ED drew opposition by proposing summarized margin presentation, which did not present either premium revenues or claim payments, both shown under the traditional performance reporting model. The same can be said of the proposal to include in net income evaluation difference attributed to changes in the market interest rate, which has nothing to do with the results of main operations whatsoever. This also shows that the kind of income information required by investors is not mere market-price changes or income attributed to changes in future estimates.

What is really important is the kind of information that helps us have a firm grip on the results of main operations.

Note

¹ An asset is “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”, and a liability is “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits” (IASB’s Framework, para. 49).

² The Steering Committee tentatively decided “(a) if the other enterprises use fair value for financial instruments, insurers should not be excluded; (b) if all other financial assets and financial liabilities of an insurer are at fair value, insurance contracts should be at fair value; (c) movements in the fair values of an insurer’s financial assets and liabilities should be reported in a consistent manner; and (d) accounting for insurance contracts at fair value should be covered in the insurance standard, not in the financial instruments standard” (IP, para. 540).

³ Entity-specific value represents the value of an asset or liability to the enterprise that holds it, and may reflect factors that are not available (or not relevant) to other market participants (DSOP, para. 3.3).

⁴ Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction (DSOP, para. 3.4).

⁵ The differences between entity-specific value and fair value arise when “the insurer may have superior management or other skills that enable it to maximise cash inflows from an asset or minimise the cash outflows from a liability” (DSOP, para. 3.20).

⁶ IFRS 4 permits an insurer may continue using accounting policies that measuring insurance liabilities on an undiscounted basis (para. IN5)

⁷ IFRS13 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” (para. 9).

⁸ Many respondents objected to using estimates of the expenses that market participants would incur, rather than entity-specific expenses (IASB 2008, para. 7 [d]).

⁹ For example, Towers Perrin (2007) states if insurance liabilities decline with changing insurer’s credit characteristics, users may find it harder to assess the insurer’s solvency. Fairfax (2007) states if income is recognized when the credit characteristics of liabilities change, that amount will ultimately be reversed as an expense in later periods. CIGNA Corporation (2007) notes an insurer cannot typically realize gains caused by declining their credit characteristics while it is a going concern.

¹⁰ For example, ASBJ (2007, 4-5) noted that “given that there is no active market for insurance liabilities, we believe that it is necessary to further consider whether the recognition of profit or loss (day1 profits and profits on re-measurement) arising from the measurement based on the inputs that are not available in the market would actually provide users with relevant information, even though such model would be meaningful to some extent in measuring insurance liabilities on the balance sheet”.

¹¹ Although Standard & Poor’s (2010, 10) supports summarized margin presentation approach, also “believes the traditional income statement, specifically information related to premium, provides context for our analysis regarding the volume of new business in a given period”.

¹² China Accounting Standards Committee (CASC) and GASB note that the summarized margin presentation results in quite a specific presentation model that is not used for other industries (CASC 2010; GASB 2010).

¹³ ASBJ (2010, 5) notes “[t]he phrase ‘the maximum amount the insurer would rationally pay’ implies settling an obligation by payment to the third party and therefore it does not appropriately describe the measurement of an insurance liability that should be based on the assumption that an insurer fulfills its own obligation”.

¹⁴ The main objections locking in the margin at inception are: (a) introducing an inconsistency between measurement of the insurance contract on day one and the subsequent measurement, (b) leading to a situation in which an insurer recognizes losses in a period, even though there are gains allocated from the release of the margin in the current and future periods, and (c) introducing an ability to influence profit for the period by manipulating assumption changes and also allows some degree of subjectivity (IASB 2011e, para. 22)

¹⁵ As everyone knows, the IASB's Framework amended in 2010 (IASB 2010c) states "[t]o be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent" (para. QC12).

¹⁶ Given the current treatments, measurement attribute for both assets and liabilities that can be adopted is fair value or value in use. However, there may be a mismatch between the fair value hierarchy of assets and liabilities, or the economic calibration within the ED measurement of insurance liabilities (Foroughi *et al.*, 2013; Ogawa 2009).

¹⁷ FASB (2010) proposes that amortized cost option for financial instruments as a way to eliminating accounting mismatches.

¹⁸ According to annual statistics compiled by the Life Insurance Association of Japan, the combined balance sheet totals of 43 life insurers in FY 2011 came down to 326.9 trillion yen of assets, 315.4 trillion yen of liabilities (including 300 trillion yen of insurance liabilities) and 11.5 trillion yen of net assets. Namely, insurance liabilities account for as high as 95% of total liabilities. Even compared to total assets, insurance liabilities exceed 90%. According to the AXA group's annual reporting in 2012, insurance liabilities (including liabilities arising from investment contracts) made up 80% of total assets.

¹⁹ Notable publications from the IASB state that an insurer estimates future payments for claims under existing contracts on the basis of not only current information but also information about claims already reported by policyholders (DSOP, para. 4.18; DP, para. E15; ED, para. B53). The proposed summarized margin presentation is inconsistent with the IASB's own indication.

References

- AAA. (1965) The matching concept (1964 Concepts and Standards Research Study Committee), *The Accounting Review*, 40 (2), pp. 368-372.
- Akiba, K. (2011) IFRS and matching: Is there no need of matching concept? *Weekly Report on Financial Accounting*, 3039, pp. 44-47 (in Japanese).
- ASBJ. (2007) *Comments on Discussion Paper 'Preliminary Views on Insurance Contracts'*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Discussion-Paper-and-Comment-Letters/Comment-Letters/Documents/ASBJCommentsonInsuranceContracts.pdf> (accessed 31 Dec 2012).
- ASBJ. (2010) *Comment on the Exposure Draft Insurance Contracts*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-draft-2010/Comment-letters/Documents/ASBJCommentsonEDInsuranceContracts.pdf> (accessed 31 Dec 2012).
- CASC. (2010) *Re: Exposure Draft on Insurance Contracts*. Available at: [41](http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-</p></div><div data-bbox=)

- draft-2010/Comment-letters/Documents/ChineseMoFCommentstoInsuranceContractsED.pdf (accessed 31 Dec 2012).
- CIGNA Corporation. (2007) *Response to Discussion Paper-Preliminary Views on Insurance Contracts*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Discussion-Paper-and-Comment-Letters/Comment-Letters/Documents/CL18.pdf> (accessed 31 Dec 2012).
- Fairfax. (2007) *Subject: Invitation to Comments-Preliminary Views on Insurance Contracts*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Discussion-Paper-and-Comment-Letters/Comment-Letters/Documents/FairfaxResponsetoIASB-PreliminaryViewsonInsuranceContracts.pdf> (accessed 31 Dec 2012).
- FASB. (1976) *An Analysis of Issues Related to Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*, Discussion Memorandum (Stamford, CT: FASB).
- FASB. (2010) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, Exposure Draft (Norwalk, CT: FASB).
- Foroughi, K., Barnard, C. R., Bennett, R.W., Clay, D. K, Conway., E. L., Corfield, S. R., Coughlan, A. J., Harrison, J. S., Hibbett, G. J., Kendix, I. V., LanariBoisclair, M., O'Brien, C. D., and Straker, J. S. K. (2013) Insurance accounting: a new era? *British Actuarial Journal*, First View Article (February 2013), pp. 1-54.
- GASB. (2010) *Comment letter on Exposure Draft ED/2010/8 Insurance Contracts*. Available at: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-draft-2010/Comment-letters/Documents/101203_CL_GASB_ED_Insurance.pdf (accessed 31 Dec 2012).
- Hane, K. 2012. A significance of economic mismatches for insurance contracts accounting, *Graduate School of Commerce Waseda University*, 75, pp. 201-225 (in Japanese).
- IASB. (2001) *Insurance*, Draft Statement of Principles (London, U.K.: IASCF).
- IASB. (2004) *Insurance Contracts*, IFRS 4, (London, U.K.: IASCF).
- IASB. (2007) *Preliminary Views on Insurance Contracts*, Discussion Paper (London, U.K.: IASCF).
- IASB. (2008) *Overview of comments*, IASB Agenda Paper 2A, (London, U.K.: IASCF).

- IASB. (2010a) *Insurance Contracts*, Exposure Draft (London, U.K.: IFRS Foundation).
- IASB. (2010b) *Financial Instruments*, IFRS 9 (London, U.K.: IFRS Foundation).
- IASB. (2010c) *The Conceptual Framework for Financial Reporting 2010* (London, U.K.: IFRS Foundation).
- IASB. (2011a). *Fair Value Measurement*, IFRS 13 (London, U.K.: IFRS Foundation).
- IASB. (2011b) *Summary of comment letters on the IASB ED Insurance Contracts*, IASB Agenda Paper 3E (January 2011) (London, U.K.: IFRS Foundation).
- IASB. (2011c) *Accounting mismatch and volatility overview (for information)*, IASB Agenda Paper 3 (16 May 2011) (London, U.K.: IFRS Foundation).
- IASB. (2011d) *Reducing accounting mismatches in profit or loss through presentation*, IASB Agenda Paper 6B (12 May 2011) (London, U.K.: IFRS Foundation).
- IASB. (2011e) *Whether to unlock the residual margin*, IASB Agenda Paper 3B (June 2011) (London, U.K.: IFRS Foundation).
- IASB. (2012a) *Unlocking the residual margin*, IASB Agenda Paper 2A (December 2012) (London, U.K.: IFRS Foundation).
- IASB. (2012b) *The use of other comprehensive income (OCI) for presenting the effect on the insurance contract liability arising from changes in specified assumptions*, IASB Agenda Paper 2I (May 2012) (London, U.K.: IFRS Foundation).
- IASB. (2012c) *Classification and Measurement: Limited Amendments to IFRS 9*, Exposure Draft (London, U.K.: IFRS Foundation).
- IASB. (2013) *Cover note: Background information and progress report (January 2013)*, IASB Agenda Paper 2 (London, U.K.: IFRS Foundation).
- IASC. (1989) *Framework for the Preparation and Presentation of Financial Statements* (London, U.K.: IASCF).
- IASC. (1999) *Insurance*, Issues Paper (London, U.K.: IASCF).
- IAIS. (2006) *Standard on Asset-Liability Management* (Basel, Switzerland: IAIS).
- Ogawa, J. (2009) Issues of fair value disclosure in insurance sector, *Japan Institute of Life Insurance Journal*, 168, pp. 63-87 (in Japanese).
- Paton, W.A., and Littleton, A.C. (1940) *An Introduction to Corporate Accounting Standards*, American Accounting Association Monograph No. 3 (Urbana, IL: AAA).
- Standard & Poor's. (2010) *Re: IASB Exposure Draft: Insurance Contracts and FASB Discussion Paper: Preliminary Views on Insurance Contracts*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-draft-2010/Comment-letters/Documents/CL240StandardPoors.pdf> (accessed 31

- Dec 2012).
- Storey, R.K., and Storey, S. (1998) *The Framework of Financial Accounting Concepts and Standards*, Special Report (Norwalk, CT: FASB).
- Towers Perrin. (2007) *Response to Discussion Paper-Preliminary Views on Insurance Contracts*. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-draft-2010/Comment-letters/Documents/CL240StandardPoors.pdf> (accessed 31 Dec 2012).
- Tsujiyama, E. (2003) The international movement on performance reporting and the challenges of accounting research, *Accounting (Kaikai)*, 163(2), pp. 63-80 (in Japanese).
- Ueno, T. (2009) Economic consequences of accounting standards of insurance contracts, *Journal of Insurance Science*, 604, pp. 165-184 (in Japanese).