



Institute of Actuaries of Australia

# Managing an Australian Life Insurer/Wealth Manager in an IFRS World

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## **Abstract**

The introduction of Margin on Services reporting in Australia led to significant changes in the information available to management in order to manage their business.

What may be the changes that the IFRS environment brings?

Questions to be considered include:

1. Will KPIs need to change?
2. Impact on strategy?
3. What will be the impact of potential volatility?
4. What does this mean for other shareholder/analyst measures currently reported?

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# 1. Introduction

Life insurance and wealth management entities in Australia have undergone a reporting revolution since the mid 90s. In particular, the introduction of Margin on Services (“MoS”) reporting was a major change for all life insurers as was the introduction of holding subsidiaries at appraisal value on balance sheet for a number of entities.

At the same time we have seen significant industry consolidation, resulting in wider use of various measures of performance of financial services businesses as part of larger conglomerates.

This consolidation as well as the various demutualisation’s of the 1990s has exposed reporting for these entities to a wider audience, whether the management and shareholders of large financial conglomerates as well as the sharemarket analysts tracking these stocks. Analysts have been focussed on both the reported profit results on the MoS basis as well as more traditional measures such as embedded and appraisal values, still published by many companies as part of their investor information packs each half year.

Increasingly businesses have been focussing on a broader array of services in the wealth management industry, with focus on distribution, funds management, life insurance and asset management. There has been, to some extent, alignment of reporting across these entities, with increased use, for example, of appraisal value techniques for funds management and distribution businesses. However profit reporting has remained different for example between investment products sold through a life insurance entity and that sold through a funds management entity.

With the adoption of International Financial Reporting Standards (IFRS) in Australia, management of Australian wealth management businesses face yet another significant change in financial reporting requirements. The requirements will now apply uniformly by contract type rather than by entity. Regulators will reconsider what their requirements are and analysts will be faced with a new array of data on which to base their views of the stocks they follow.

In this paper, we consider the potential strategic impacts of the introduction of the IFRS based reporting requirements for Australian wealth managers and what the implications of the changes may be for a number of key stakeholders.

## 1.1. *Acknowledgments*

This paper is the result of research and information collated by various people beyond the authors as well as comments from other colleagues. To all, we thank you for your efforts and contribution. Specifically, we thank – Jennifer Lang and Wayne Kenafacke for their review and Joyce Au-Yeung for her assistance in the development of models.

We note that any opinions or points of view put forward in this paper are ours, and do not necessarily reflect those of our employer.

## 2. Current Environment

In recent times, Australian reporting for wealth management entities has been largely based on the MoS financial reporting requirements for life insurers as covered by Actuarial Standard 1.03 (“AS1.03”) and the relevant accounting standard AASB 1038 Life Insurance Contracts (“AASB1038”), together with use of Embedded and Appraisal Value measures.

MoS profit reporting, which was introduced during the mid-90s, was the first adoption of a realistic profit reporting basis for life insurers in Australia.

At the time of introduction, the change in reporting basis was anticipated to lead to many changes for life company management – both due to comparisons of company profitability by external observers but also from the internal stakeholders, shareholders, policyholders, Boards and management focussing on published profit in the same year.

Edwards and Swinhoe (1996) noted that while the expectation was that “published profit will become the key indicator of a company’s success, both internally and externally”, the “internal use of published profits is both good and bad”. It is good due to there being alignment between the internal and external focus on profitability. The reasons given in support of MoS as a management tool apart from it being the primary external measure, in summary, included features such as:

- largely objective reporting basis
- easily understood and realistic measure of profit
- comparability between companies

Criticisms included the following:

- no information provided regarding the cost of capital
- no linkage to shareholder distributable profits
- no indication of value added by new business
- incorrect signals on experience variance, particularly lapses and disability incidence
- no information about the actuary’s changed view of the future

Nearly ten years later we face similar issues again and need to reconsider the appropriate management reporting under a new profit reporting basis. Will the IFRS results provide management and other stakeholders with useful information about business performance? Similarly, have the criticisms above been addressed or added to?

Further, companies are facing a broad and potentially growing range of reporting requirements, with the potential for regulatory reporting to diverge significantly from accounting requirements. The Australian Prudential Regulation Authority (“APRA”) together with the Life Insurance Actuarial Standards Board (“LIASB”) is responsible for setting these requirements.

It is worth highlighting the fact that IFRS does not change any contract features, nor does it change the cashflows from those contracts. IFRS is simply a reporting standard which changes the timing of how profits emerge from a contract. But over the full term of the contract, the total profits reported under any two accounting systems is the same.

### **3. Overview of Main Features of IFRS**

The following describes the main changes affecting life insurers in Australia from IFRS. There are numerous papers describing the changes that IFRS has brought for life insurers. The intention of this paper is not to discuss these changes in detail, but we give a high-level overview to set the scene for the remainder of the paper.

#### **3.1. Revision to AASB 1038**

The Australian Accounting Standards Board (AASB) has issued a revised version of the accounting standard for life insurance contracts, *AASB 1038 Life Insurance Contracts*. The revised AASB 1038 has been updated for IFRS changes. At the same time, the AASB has made further changes for insurance contracts, largely in relation to discount rates. These changes are described in more detail in the subsections below.

AASB 1038 also refers to other accounting standards, most notably *AASB 139 Financial Instruments* and *AASB 118 Revenue*.

#### **3.2. Contract classification**

##### **3.2.1. Insurance contracts**

AASB 1038 provides a definition for an insurance contract, and we give a concise version of this definition below:

An “*insurance contract*” is one which contains a “*significant insurance risk*”.

In addition, AASB 1038 gives a definition for a life insurance contract. Again, we provide a cut-down version of this definition:

A “*life insurance contract*” is either:

- an insurance contract
- or an investment contract with a discretionary participating feature

If a contract meets the definition of a life insurance contract, it must be accounted for under AASB 1038. Examples of such contracts are:

- Risk products:
  - Individual term
  - Income Protection
  - Group risk
- Lifetime annuities
- Participating contracts:
  - Long Term Risk

- Investment Account

### **3.2.2. Financial Instruments (Investment contracts)**

A contract that does not meet the definition of a life insurance contract is defined as a “Financial Instrument” (or Investment contract). Financial Instruments are accounted for under AASB 139 and AASB 118. Examples of such contracts are:

- Unit Linked
- Fixed term annuities
- Other fixed term contracts

### **3.2.3. Unbundling**

Some contracts contain both an insurance component and a deposit component. For IFRS purposes, a company must separate these components for the reporting of premiums and claims. The insurer can also choose to “unbundle” when determining policy liabilities. If unbundling is done then:

- The life insurance component is treated as insurance
- The deposit component is treated as:
  - i. Insurance, if it includes a discretionary participating feature
  - ii. Investment, otherwise

If the deposit component cannot be measured separately, the insurer need not unbundle the deposit component and the entire contract will be treated as insurance.

### **3.2.4. Embedded Derivatives**

These must be separated from the host contract and be fair-valued. Examples of embedded derivatives are:

- Investment guarantees under unit-linked
- Guarantees associated with participating contracts

Embedded derivatives include those embedded within insurance contracts unless the embedded derivative itself meets the definition of an insurance contract.

### **3.2.5. “Multifund” contracts**

Multifund contract is a term used to describe contracts that can switch between Unit Linked and Investment Account at the discretion of the policyholder. There remains debate as to the appropriate classification of these contracts and whether they should be treated as investment

contracts with allowance for the cost of the option to switch, or insurance contracts reflecting the potential to become an insurance contract.

### **3.3. Valuing Life Insurance Contracts under AASB 1038**

#### **3.3.1. MoS Methodology**

For insurance contracts under IFRS, the valuation of policy liabilities uses the same approach as current MoS, namely a “BEL plus PVFM” approach<sup>1</sup>. With the exception of discount rates, all assumptions are best estimate assumptions under IFRS.

#### **3.3.2. Discount Rates**

The AASB has changed the approach to discount rates for insurance contracts. This change is not officially an IFRS change, but the AASB has taken the opportunity to revise AASB 1038 so as to have consistent approaches for insurance and investment contracts.

Under the old AASB 1038, discount rates were based on best estimate earnings rates. Under the revised AASB 1038, discount rates are determined as follows:

- If policy benefits are not contractually linked to the performance of the underlying assets then policy liabilities should be discounted using risk-free rates, based on current observable, objective rates relating to the nature, structure and term of the cashflows. In other words, a yield curve based on risk-free rates must be used where policy liabilities are not dependent on asset performance.
- If policy benefits are contractually linked to the performance of the underlying assets then discount rates are based on expected returns on underlying assets. This is essentially the same as the old AGAAP.

There has been much debate over what risk-free rates should be used, but we do not intend discussing further in this paper.

Under the old AGAAP a change in discount rate was caused by one of three causes:

- i. a movement in investment markets
- ii. a change in asset allocation
- iii. a change in discount rate methodology.

The first of these caused a shift in policy liability, but ii. and iii. involved a shift between BEL and PVFM, resulting in an unchanged policy liability. The change in discount rates brought about by the revised AASB 1038 has caused some discussion on what is the correct treatment for the change: should there be a shift between BEL and PVFM, or should the revised policy liability be what would have been the liability if IFRS had been in force since policy outset? We do not intend discussing which approach is correct, but we do revisit this issue later in the paper due to its potential impact on reported results at the point of adoption of IFRS.

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<sup>1</sup> Policy liabilities under MoS consist of two components: the best estimate liability (BEL) component and the present value of future margins (PVFM) component, valued using best estimate assumptions.

There has also been discussion about the correct discount rate approach for participating contracts. Participating contracts consist of two components: the guaranteed part and the discretionary part. Some argue that the guaranteed component should be valued using a risk-free rate and the discretionary component should be valued using a best estimate rate. Again, we do not intend discussing further in this paper.

### **3.3.3. Liability Adequacy Test**

A company must recognise any deficiency in policy liabilities. In other words, the policy liability must not be less than present value of future outgo less present value of future income on best estimate assumptions. This should not be a problem for AGAAP, as the revised definition of the BEL component of policy liabilities should generally exceed the minimum liability. However, where participating contracts are discounted at a best estimate earnings rate (instead of a combination of risk free and best estimate) then a liability adequacy test should be performed.

## **3.4. Valuing Financial Instruments under AASB 139**

### **3.4.1. Base Policy Liability**

Under AASB 139, the base policy liability should be fair value<sup>2</sup>. For unit-linked contracts, this will usually be account balance. For fixed term contracts, policy liability will be the present value of future outgo less present value of future income on best estimate assumptions, discounted at risk-free rates.

### **3.4.2. Surrender Value Floor**

The fair value of a contract cannot be less than the surrender value. This test should be applied to fair value portion of the contract only (i.e. the test excludes DAC portion).

### **3.4.3. Management Services Component**

For contracts valued under AASB 139, there may be a management services component, e.g. providing investment management services for unit-linked contracts. This component is accounted for under AASB 118.

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<sup>2</sup> Under AASB 1038, 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.

Under AASB 118, a company can set up an explicit asset for deferred acquisition costs (DAC) in the balance sheet. This differs from old AGAAP where DAC is implicit in policy liabilities. The DAC asset spreads high initial expenses over a policy's lifetime, resulting in a smoother emergence of profit. There has been little guidance on what expenses are deferrable, but generally only incremental acquisition costs will be deferrable (ie no overheads). Also, there has been little guidance on how to amortise the DAC asset, although it should be amortised over the period for which margins are received. In addition, the DAC must be recoverable from future revenue.

Similarly, a company may also set up a liability for deferred entry fees under AASB 118. Under current AGAAP, entry fees are not deferred but recognised up-front. The idea behind the deferred entry fees is to spread high initial revenue over a policy's lifetime, resulting in a smoother emergence of profit. The deferred fees should be amortised over the period for which the service is provided and the approach should be consistent with that for DAC. There has been much debate over what should and shouldn't be deferred, eg

- Should entry fees be offset against acquisition costs (or vice versa) before being deferred?
- What service is provided at outset?

We do not intend discussing the issues with deferred fees further in this paper.

### **3.5. Valuation of Assets**

There are potential options available to companies in relation to the valuation of assets that can affect the reported results. For example, assets in excess of those required for insurance liabilities ie shareholder assets are able to be valued either at fair value or other valuation approaches. Particular requirements exist for the treatment of owner occupied property.

### **3.6. Other Features of IFRS**

#### **3.6.1. AASB 138**

Under AASB 138, the Excess of Market Value over Net Assets (EMVONA) should be written off - no internally generated goodwill is to be recognised. In addition, acquired goodwill is subject to an annual impairment test.

#### **3.6.2. AASB 112**

Under AASB 112, tax liabilities must not be discounted. This change raises various issues relating to tax, but we do not intend to discuss here.

### **3.7. Phase II Changes**

IFRS is being implemented in two phases. What is described above are the Phase I changes, which come into force for reporting periods on or after 1 January 2005, Phase II changes are expected to follow some time after 2007, and will include further changes for insurance contracts.

It is currently unknown what the ultimate position will be for insurance contracts yet to be covered by the IFRS requirements, other than the changes to AASB 1038 for insurance contracts.

### **3.8. Regulatory Reporting requirements**

There also remain uncertainties associated with the associated regulatory reporting changes that may be implemented by the regulator, APRA, and the Life Insurance Actuarial Standards Board. They are currently considering what the changes to prudential requirements may be to incorporate allowance for the introduction of IFRS, taking account of the different requirements of prudential reporting and financial accounting.

## **4. Effect of IFRS on Products**

As described earlier, the aim of this paper is to investigate what management need to do differently, if anything, as a result of the introduction of IFRS. Before we can do this, we first need to know the effect that IFRS has on the reporting of a life company.

The approach we have taken for this paper is to consider a typical life company which sells a selection of the main products available in the Australian life market. To assist with the investigation, we have used a simple model office with outputs on both a MoS and an IFRS basis. We consider 4 products for this purpose, namely term assurance, fixed term annuity, lifetime annuity and single premium unit linked. These products were chosen for a number of reasons including being representative of products affected by the Phase 1 changes as well as being significant in relation to the portfolios and performance of many wealth managers in Australia. For simplicity, income protection business has been excluded from our simple model. Similarly we have excluded participating contracts as these are largely unchanged by IFRS.

The base assumptions behind the model office are given in Appendix A.

In this section, we have prepared some illustrative financial results for the above mentioned products to assist in demonstrating the potential impact of the changes, both for a contract from inception as well as at the date of change to the new reporting requirements. We also consider the overall effect for a typical Australian company using representative proportions of the sample products.

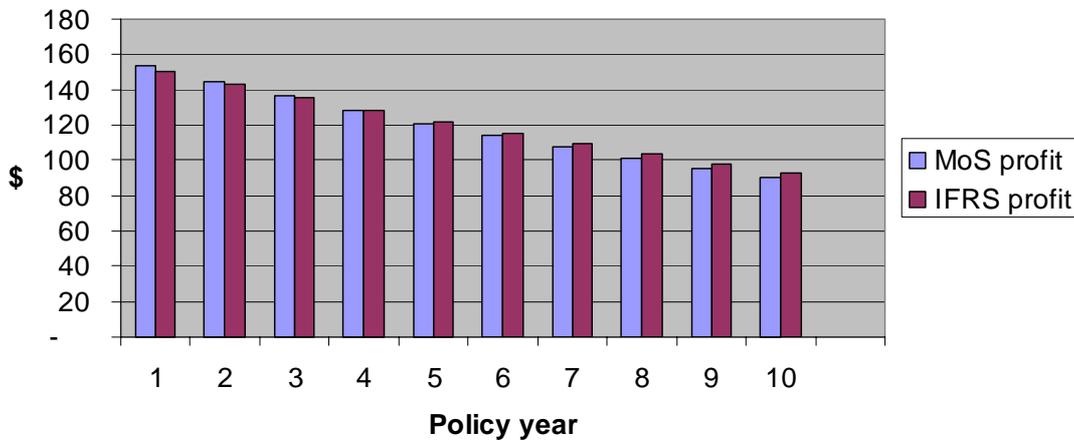
For each product we have considered the results under two reporting bases: the existing MoS requirements and the new IFRS or revised AASB1038 requirements. We consider in a later section the interaction between these results and the results under an appraisal value approach to reporting.

In the following section, we discuss how these changes impact management actions.

### **4.1. Term Assurance**

Under IFRS, this product continues to be accounted for under AASB 1038, although with a revised approach to discount rates. Graph 1 shows the different emergence of profit under MoS and IFRS for term assurance from policy inception.

**Graph 1: Emergence of Profit - MoS vs IFRS  
Term Assurance**



Graph 1 is based on a product that has positive profit margins, as will be the case for most life companies in Australia. It is also based on the assumption that the discount rate has reduced when moving from a best estimate earnings assumption to a risk-free rate. This may not always be the case, for example if the assets backing the product are invested in cash. We assume actual experience follows best estimate assumptions.

Graph 1 shows little difference moving from MoS to IFRS. We note that IFRS profits are slightly lower than MoS profits in earlier reporting periods, but higher in later periods. The small change observed is caused by the following effects:

- The “BEL” component under IFRS is higher (that is less negative) than under MoS as a result of the lower discount rate. (Note we use the term BEL loosely as under IFRS the discount rate is no longer best estimate.)
- This leads to lower profit margins at outset under IFRS, and therefore lower profit margins released in each period.
- Experience investment profits are negative under IFRS (assuming the return exceeds the risk-free rate), as the policy liability is negative. There are higher investment losses in earlier years when the policy liability is larger, resulting in IFRS profits being lower than MoS in earlier years.

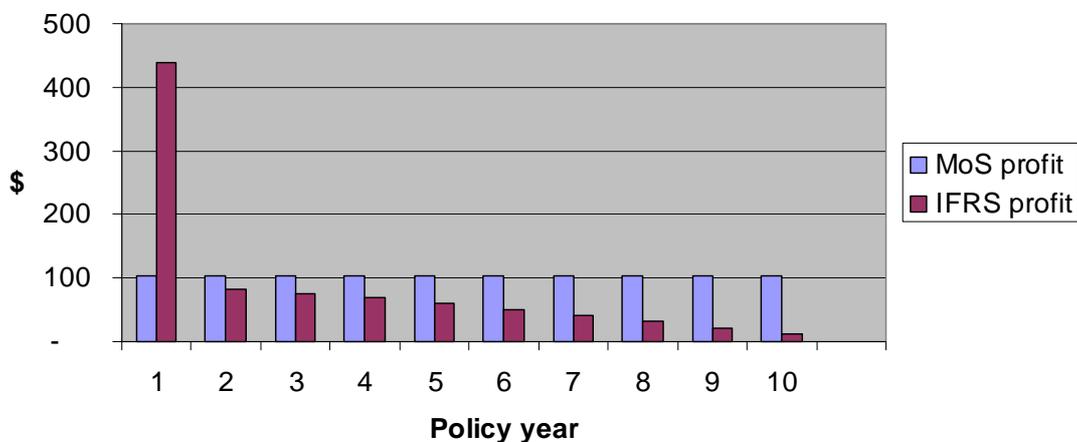
As mentioned, Graph 1 shows the effect on a term assurance from policy inception, considering a policy part-way through its term, as will be the case when companies switch from MoS to IFRS, gives a similar picture, i.e. not much change in profit emergence.

## 4.2. Fixed Term Annuity

Under IFRS, this product is now accounted for under AASB139. The policy liability is the value of future benefits and expenses discounted on a risk-free rate. Under MoS, the policy liability consisted of a BEL and PVFM component – the latter component disappears under IFRS.

Graph 2 shows how profit emerges on both a MoS and IFRS reporting basis from policy inception.

**Graph 2: Emergence of Profit - MoS vs IFRS  
Fixed Term Annuity**



Again, we have assumed that there are positive profit margins on a MoS basis, and that the discount rate has reduced from MoS to IFRS.

Graph 2 shows a “spike” in IFRS profit in year 1 compared to MoS. This is due to the fact that MoS spreads the profit over the term of the contract via the use of the profit margin mechanism. As IFRS policy liabilities do not have a PVFM component, much of the profit is recognised at outset. All experience is assumed to follow best estimate assumptions in this example. Therefore, subsequent years’ profits under IFRS are experience investment profits, as investment returns exceed risk-free rates.

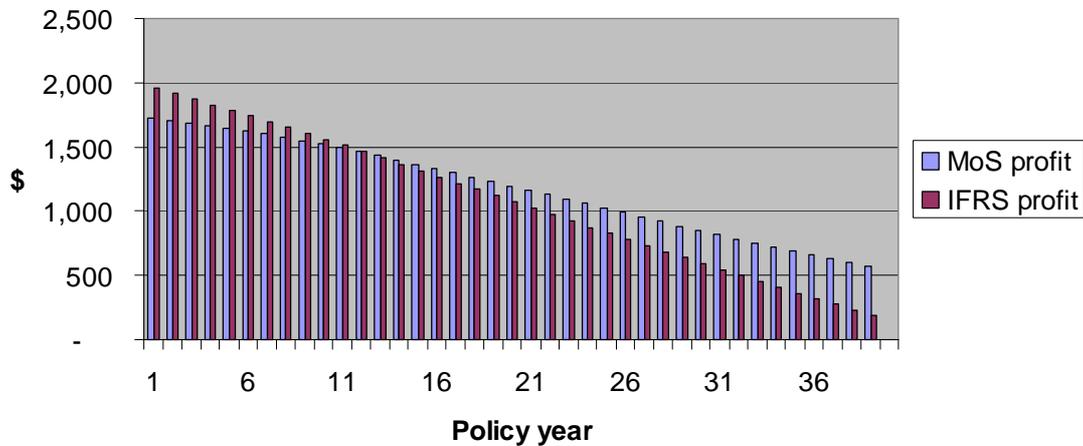
If we consider what happens when we move to IFRS part-way through the policy term, we get a similar picture to Graph 2, except that the spike occurs in the year after moving to IFRS, due to the PVFM component being released.

## 4.3. Lifetime Annuity

Lifetime annuities are treated as for term assurances under IFRS: still accounted for under AASB1038, but using a risk-free discount rate.

If we consider a policy from inception which has positive profit margins (on both a MoS and an IFRS basis), we get an emergence of profit as shown by Graph 3.

**Graph 3: Emergence of Profit - MoS vs IFRS  
Lifetime Annuity**



We can see that in earlier years IFRS profits are higher than MoS profits, but lower in later years. This can be explained by the following effects:

- The BEL component is higher for IFRS due to the lower discount rate.
- The PVFM component is therefore lower under IFRS.
- Profit margins released in each year are therefore lower under IFRS.
- Experience investment profits emerge under IFRS, as investment returns are higher than the risk-free rate. Under MoS, credit is taken for investment profits in advance as the BEL is calculated using a best estimate discount rate. When the policy liability is higher in earlier years, the experience profit under IFRS is high, leading to profit being higher under IFRS than MoS. But in later years, the policy liability is lower and so investment profits are small.

The impact of IFRS on lifetime annuities is potentially significant for Australian companies because many companies' annuities portfolios are in, or close to, a capitalised loss position.

For this reason, it is important to consider the effect of moving to IFRS part-way through the policy term. Below, we describe below various scenarios that might reflect the position of a company's annuity portfolio when moving from MoS to IFRS.

Moving from MoS to IFRS can be done in one of two ways:

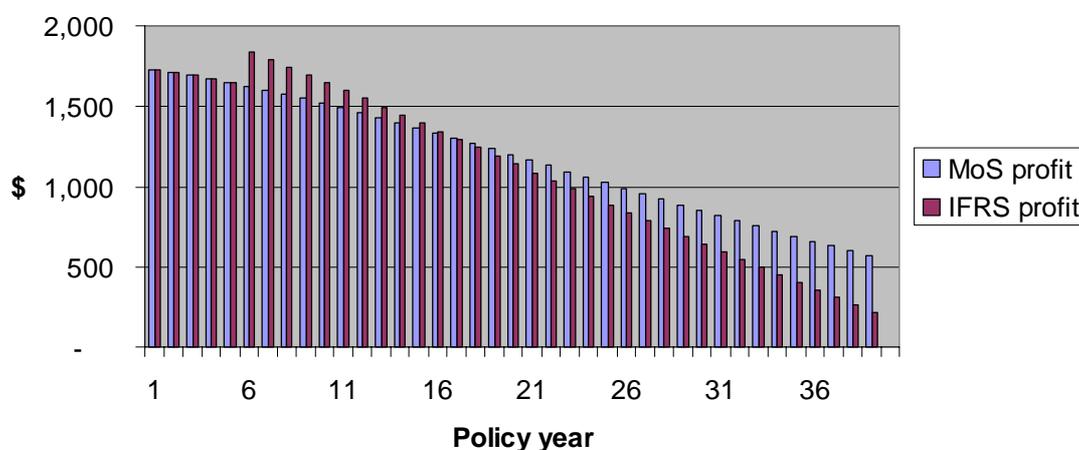
- (i) The change in discount rate can lead to a shift between BEL and PVFM (when there are positive profit margins), with no change in policy liability, or
- (ii) Profit margins can be recalculated at policy outset on an IFRS basis, leading to a change in policy liability.

Currently there is a debate over which approach is most appropriate, but our intention is not to discuss details here. We do, however, provide a comparison of approaches (i) and (ii) in the scenarios below.

### 4.3.1. Scenario 1

Firstly, we consider the case where there are positive profit margins on both a MoS and an IFRS basis. In addition, we use approach (i) above when changing discount rates, ie the change in discount rate causes a shift between BEL and PVFM, with no change in policy liability. The effect is shown in Graph 4.

**Graph 4: Emergence of Profit - MoS vs IFRS  
Lifetime Annuity**



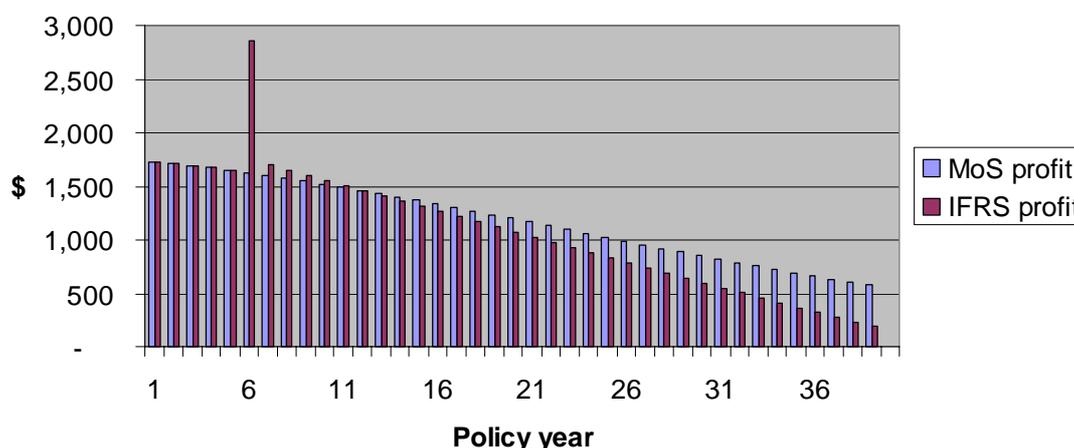
As we do not change to IFRS until after year 5, the graph shows IFRS and MoS profits to be the same for years 1 through 5. After year 6, IFRS profits are higher than MoS initially, but in later years MoS profits are higher. This pattern is caused by the same effects as described above, namely:

- The BEL component increases on moving to IFRS in year 6 due to the lower discount rate.
- This causes a corresponding reduction in PVFM component under IFRS (as we are using approach (i) above).
- Profit margins released are therefore lower under IFRS.
- Experience investment profits emerge under IFRS, as investment returns are higher than the risk-free rate. Under MoS, credit is taken for investment profits in advance as the BEL is calculated using a best estimate discount rate. When the policy liability is higher in earlier years, the experience profit under IFRS is high, leading to profit being higher under IFRS than MoS. But in later years, the policy liability is lower and so investment profits are small.

### 4.3.2. Scenario 2

The next scenario we consider is as above, but the IFRS policy liabilities are based on profit margins being recalculated at outset (ie approach (ii) from above). Graph 5 shows the effect.

**Graph 5: Emergence of Profit - MoS vs IFRS  
Lifetime Annuity**



As can be seen by comparing Graphs 4 and 5, whether we choose approach (i) or (ii) makes a significant difference for this product in our example. When we recalculate profit margins from outset for IFRS (ie approach (ii)), there is a spike in year 6 profits. This is caused by the following:

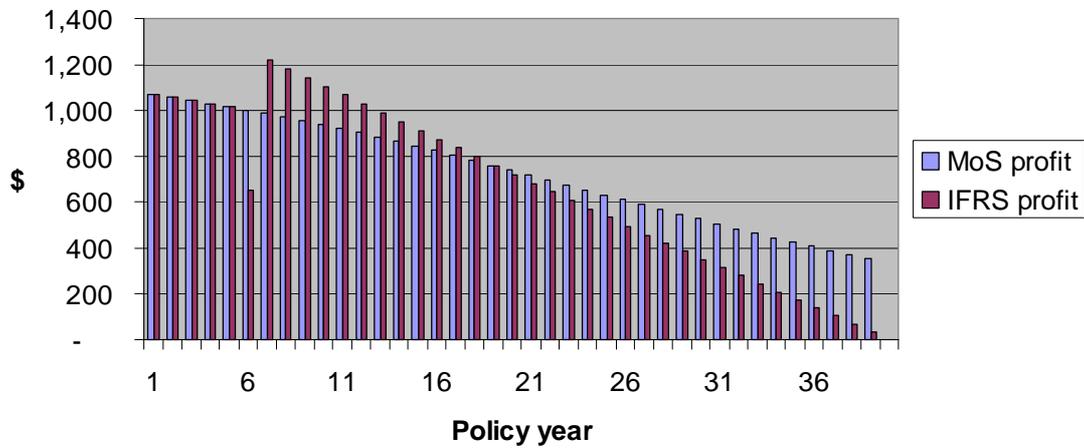
- Recalculating PVFM at outset for IFRS involves recalculating the BEL at outset. Using a lower discount rate, the BEL is higher at outset (ie less negative). This leads to lower profit margins under IFRS. The excess profit margins under MoS are released on moving to IFRS in year 6.
- At the end of year 6, the BEL is higher under IFRS than under MoS.
- At the end of year 6, the PVFM is lower under IFRS.
- Moving from MoS to IFRS, the reduction in PVFM has a greater effect on profits than the increase in BEL, resulting in the spike we see in Graph 4 in year 6.

Post year 6, the effect is similar to the previous scenario: investment experience profits cause slightly higher profits under IFRS in the early years after moving to IFRS. Thereafter, IFRS profits are lower than they would be under MoS.

### 4.3.3. Scenario 3

Our next scenario looks at what happens when the product has positive profit margins under MoS (albeit lower than in the above scenarios), but moving to IFRS causes it to move into capitalised losses. Graph 6 shows this scenario.

**Graph 6: Emergence of Profit - MoS vs IFRS  
Lifetime Annuity**



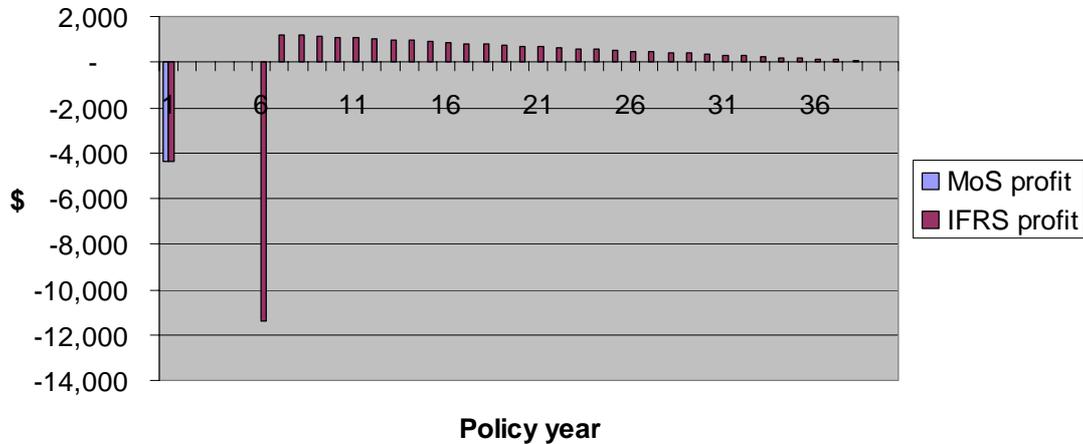
The shape of graph 6 can be explained by the following effects:

- Policy liabilities increase under IFRS, causing a relatively smaller profit in the year we move to IFRS.
- There are no profit margins released after the move to IFRS (as we are now in a capitalised loss position), unlike MoS profits where the profit margins are positive.
- Subsequent years' have a similar pattern to the previous scenario: investment experience profits cause slightly higher profits under IFRS in the early years after moving to IFRS. Thereafter, IFRS profits are lower than they would be under MoS.

#### 4.3.4. Scenario 4

The final scenario we consider for this product is the one where the product is already in a capitalised loss position on a MoS basis. Under our assumption that the discount rate is lower under IFRS, the product is pushed further into capitalised losses. Graph 7 shows the effect.

**Graph 7: Emergence of Profit - MoS vs IFRS  
Lifetime Annuity**



Graph 7 can be explained as follows:

- In year 1, the future losses are recognised at outset (ie they are capitalised).
- In years 2 through 5 we are reporting on a Mos basis. There are zero profits reported, as there are no profit margins and experience is assumed to follow best estimate, hence no experience profits.
- In year 6, when we move to IFRS, there is an increase in policy liability caused by the reduction in discount rate. This causes a loss in year 6.
- In subsequent years, there continue to be zero profits on a Mos basis. On an IFRS basis, we observe some experience investment profit, as investment returns exceed risk-free rates.

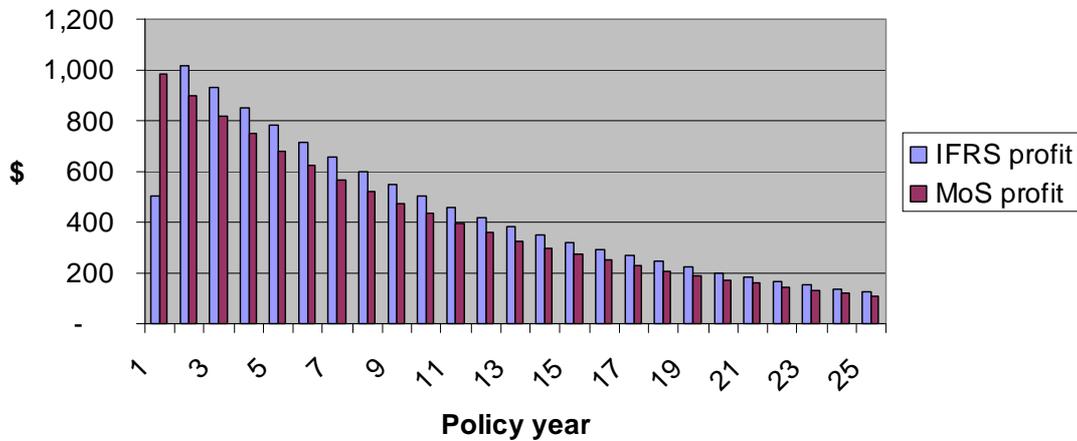
The above scenarios suggest a wide range of outcomes for lifetime annuities, with some of those outcomes having a significant effect on reported profits. We discuss the implications of this further in the next section.

#### **4.4. Single Premium Unit Linked**

Under IFRS unit-linked will be valued using account balance with a DAC asset and a corresponding liability for deferred entry fees.

We have considered the different profit emergence (from policy outset) under MoS and IFRS, and this shown in Graph 8.

**Graph 8: Emergence of Profit - MoS vs IFRS  
Single Premium Unit Linked**



Because the costs that can be deferred under IFRS are less than those implicitly deferred under MoS, some initial costs must be recognised up-front under IFRS. Therefore, relatively smaller profit is made under IFRS in year 1. As the total profits emerging over the whole term must be the same, subsequent years' profits are higher under IFRS.

If we consider what happens when we switch from MoS to IFRS part-way through the policy term, we get a similar picture: a relatively smaller profit is made on IFRS in the period after adopting IFRS, with subsequent years' profits being higher under IFRS.

#### 4.5. Typical Australian Life Company

As described earlier, we have taken the above products and used them in a simple model office to assess how IFRS profit emergence compares with that on a MoS basis for a typical Australian life company.

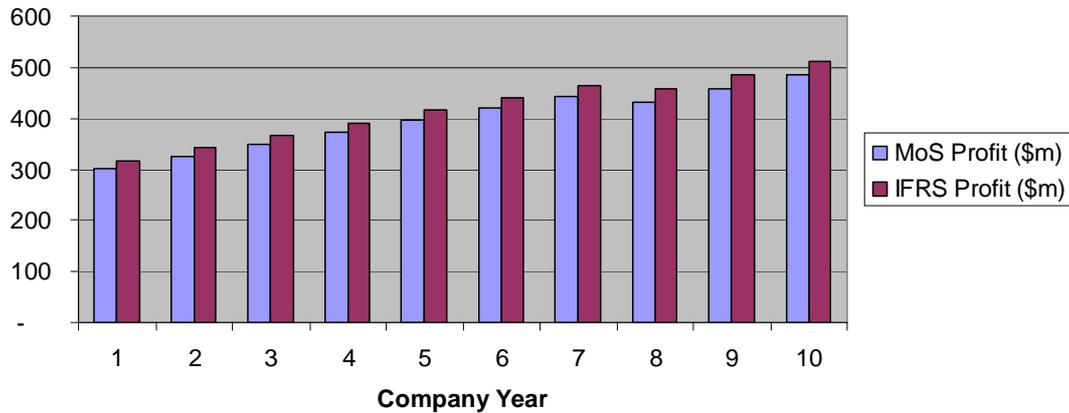
The assumptions behind the model office are given in Appendix A.

Some assumptions worth highlighting are as follows:

- All products are assumed to have positive profit margins on a MoS and, where applicable, an IFRS basis. As we have seen above, if profit margins are not positive, there can be significant differences in profit emergence.
- For products where the discount rate has changed under the revised AASB 1038, we use approach (ii) described earlier to move to IFRS ie we recalculate profit margins at policy outset on an IFRS basis.

Graph 9 shows the different profit emergence under IFRS and MoS in the sample case:

**Graph 9: MoS Profit vs IFRS Profit  
Company Results**



As would be expected for a sample company with a large block of existing business, the impact of lower new business profits has a relatively small impact on the overall company position.

#### **4.6. Summary**

In summary therefore, some overall points to draw from the analysis regarding changes to reported profits:

- Lower profits at point of sale due to less DAC on investment business
- Increase in BEL on transition (where positive) due to lower discount rates
- Decrease in profit margins on transition following higher BEL, causes lower profits in the long-term
- However, in the short-term this is offset by increased investment “experience profits” because investment returns will be expected to exceed the discount rate.
- For some products, such as immediate annuities, which are currently unprofitable or marginally profitable under a MoS basis for new business, the IFRS reporting basis will likely lead to lower profits or increased losses being reported in most cases. Similarly in force products in this category currently in capitalised losses will experience in transition further capitalised losses.

## 5. Use by Management: Management Reporting

### 5.1. Short term

At the point of adoption of the new requirements there will be some initial changes to reported results. Typically these shouldn't change an entity's view on the appropriate decisions to be taken as it affects only the pattern of emergence of profit or the associated tax position and neither cash flows nor underlying profits nor the policyholder's experience.

However, depending on the business environment and relative magnitude of the impact on reported results, the changes may have some immediate impact on decisions taken in the following areas:

- Immediate annuities – immediate annuities will in many circumstances be unprofitable at inception on an IFRS basis and may lead to immediate changes in the level of focus on these products.
- Investment contracts with significant deferred fees – entities that have significant fees that need to be deferred under IFRS may have to re-assess their balance sheets. This could cause a decrease in the net assets and may require additional capital raising to ensure positive accounting net assets exist, even though there may have been little or no change in solvency or capital adequacy requirements.

Whilst these effects are short-term, possible management reaction may take some time to implement:

- Changes in business mix targeted – a move away from products that under this basis contribute either large initial losses or volatility in profits may arise.
- Changes to asset mix backing products to more closely align the actual asset mix with the risk free rate underpinning the liability calculation, to reduce the volatility of experience profits. Two sources of volatility are worth mentioning specifically here:
  - i. For products now valued using a risk-free discount rate, there is a reporting mismatch, resulting in more volatile investment profits.
  - ii. In the case where a company currently invests the assets backing non-participating business in cash, policy liabilities are calculated on a risk-free discount rate, and so investment losses are expected to arise. However, no reserves are set up for these expected losses, causing a strange profit emergence to occur. Companies may wish to change their investment strategy to avoid such a situation occurring.
- Changes to product pricing/structure to better align with IFRS reporting, such as changes to the fee structure to limit issues of deferred fees outlined above.

A further implication in the short term will be the multiple reporting requirements faced by Australian life insurers. With APRA yet to indicate what its revisions to prudential

requirements will be as a result of the IFRS changes, reporting on both the new and old bases may be required.

## **5.2. Long term**

In the longer term, IFRS aims to achieve some substantial benefits particularly for external stakeholders, who will benefit from:

- Increased disclosure
- Greater comparability between entities distributing similar products through a different corporate structure
- Greater comparability between entities in different countries who report under different accounting systems

Issues particular to external stakeholders are considered in Section 6.

For the company adopting IFRS, key concerns in relation to the reporting basis may include:

- Volatility of results – any mismatching of assets and liabilities will emerge in reported profits on a regular basis. Three sources of volatility are described below:
  - i. The reporting mismatch as described in section 5.1 above.
  - ii. The investment losses that can arise if invested in cash as described in section 5.1 above.
  - iii. The removal of the profit margin component for Phase 1 products will lead to higher volatility in results, as this component of policy liabilities acted as a buffer to changes in views of future experience.
- Extent to which reporting basis reflects economic reality or extent of divergence between the two and the need to explain the differences between results to illustrate that the net financial outcome for certain activities is anticipated to be positive even if the IFRS position appears to be negative in the short term. In particular, under IFRS, some business may appear loss-making, although an appraisal value approach may show in fact that the business is adding value to the company.

Specific impacts in the longer term will potentially include:

- Business mix – focus on business which appears more attractive on an IFRS basis. This may lead to, for example, less desire to be selling long term annuities which will appear relatively unattractive.
- Investment mix – there is an incentive for companies to move toward a more closely matched position in order to minimise volatility of reported results due to the emergence of investment profits and losses from unmatched positions.

### **5.3. Management Reporting & Incentives**

Management reporting requirements under any reporting basis require careful consideration. Useful criteria for management reporting include:

- Appropriate messages for management decisions can be readily ascertained from reporting
- Reporting limited to key requirements rather than being voluminous
- Measures incorporated readily understood
- Consistency of measures over time given no change in business approach or environment ie that given the same circumstances the reported management information provides same indicators

The introduction of IFRS will require reconsideration of the elements of management reporting and incentives, particularly where these have been built up historically from the elements of the accounting profit calculations.

With differences between MoS and IFRS, these items may not longer be providing the appropriate indicators or may need to be augmented by other measures which provide additional insights into the long term outcomes of decisions.

Returning to the issues and benefits of MoS identified by Edwards and Swinhoe, and considering the IFRS reporting requirements in the same light, some issues remain and some have been dealt with through the changes in the requirements, in particular increased disclosure. Considering each of the positives identified previously and whether these continue to apply:

- largely objective reporting basis – the change in requirements does not impact on the view that the reporting basis was largely objective
- easily understood and realistic measure of profit – there is an argument that the new requirements are less readily understood and not necessarily leading to intuitively obvious decisions
- comparability between companies – comparability between companies may well be increased through the adoption of the new standards, with significant focus on industry discussion and evolution of discussion notes on topics of potential variance of practice

In addition to the above, IFRS also allows greater comparability across countries, at least for investment contracts where reporting standards in different countries are now more aligned.

Criticisms included the following:

- no information provided regarding the cost of capital – this remains an issue with the IFRS reporting requirements
- no linkage to shareholder distributable profits – this remains an issue with the IFRS reporting requirements

- no indication of value added by new business – this remains an issue with the IFRS reporting requirements
- incorrect signals on experience variance, particularly lapses and disability incidence – largely will not have been impacted by changes to date for contracts classified as Insurance, but for Phase 1 contracts the removal of the profit margin component will lead to higher volatility in results, as is described in the following example:
  - A changed view of future discontinuance experience for contracts being reported under AASB139 would be soaked up by a change in profit margins under MoS. Under IFRS this volatility will more immediately and directly impact the current year's profit reporting, with the capitalised effect of changes in assumptions immediately impacting the Best Estimate Liability where relevant.
- no information about the actuary's changed view of the future – increased disclosure regarding assumptions and their impact should lead to greater insights into changes in the actuary's views on the future

In particular, where IFRS will introduce more volatility to results, companies will need to consider whether this volatility should be smoothed out in tracking and assessing performance internally and decision making. Further there are questions raised about whether one period profit figures will necessarily provide the correct long term messages, particularly for certain products that may report negative profits at inception under the new requirements, but generate shareholder value on a longer term basis.

Further, education will be required to ensure that users of management reporting information understand the differences between what certain indicators meant in the prior reporting basis to what they might mean in the new reporting environment.

## **6. Use by External Stakeholders**

For external stakeholders, the introduction of IFRS reporting will introduce a new set of information being released for the first time.

### **6.1. Increased Disclosure**

Extensive disclosure requirements will mean that there could be, depending on the interpretation of the requirements adopted by Australian entities, disclosure of items such as:

- More detailed disclosure regarding assumptions and the impact of various changes in assumption
- Increased disclosure of reinsurance impacts
- Increased disclosure of items related to insurance risk, in particular the disclosure of the sensitivity of profit and loss and equity results to changes in assumptions that have a material impact on them, such as mortality and morbidity

### **6.2. Reporting to Market of EV/AV**

A key question will be to what extent entities choose to continue to report appraisal value to the market, particularly for those entities that previously were reporting at net market value under AASB 1038 and therefore had to disclose these valuations for accounting purposes.

Given the limitations of IFRS results for assessing the economic position of the entity on a long term basis, it appears that the embedded value and appraisal value results will continue to serve a useful purpose in assisting external stakeholders in understanding the position of a company.

Further this information will be invaluable in management reporting in providing additional information, including particularly a view on value added by new business activities.

## 7. References

Edwards and Swinhoe (1996), Managing Profits in a MoS Environment

Accounting Standards:

- AASB 1038 Life Insurance Contracts
- AASB 139 Financial Instruments: Recognition and Measurement
- AASB 118 Revenue
- AASB 112 Income Taxes
- AASB 138 Intangible Assets

## Appendix A: Model Office Assumptions

### Economic

Equity returns	10%
Discount rate (risk-free)	5%
Inflation	3%

	Base Assumptions			
	Unit- Linked Sing Prem	Fixed annuity	Life annuity	Term
<b>Asset mix</b>				
Equity	80%	20%	20%	50%
Risk free	20%	80%	80%	50%
<i>Expected returns</i>	9.0%	6.0%	6.0%	7.5%
<b>Expenses</b>				
Acquisition expenses (per policy)	400	750	750	400
Maintenance expenses (per policy)	100	150	150	50
Commission (% premium)	4%	not used	not used	not used
<b>Premiums</b>				
Regular or single prem?	Single	Single	Single	Reg
Average Premium (annual or single)	80,000	10,000	150,000	1,000
<b>Benefits</b>				
Average Annual Payment	n/a	1,000	10,500	n/a
Average Sum Assured	n/a	n/a	n/a	100,000
<b>Charges</b>				
Initial fee (% premium)	3%	n/a	n/a	n/a
Annual mgt Chg (% acct balance)	1.5%	n/a	n/a	n/a
<b>Term</b>				
Policy term (years)	25	10	40	10
<b>Decrements</b>				
Base Mortality Rate	-	-	0.0090	0.0080
Annual mortality increments	-	-	0.10%	0.20%
Lapse Rate	15%	0%	0%	5%
<b>Product mix - In-force portfolio</b>				
FUM unit-linked products (\$m)	25,000	n/a	n/a	n/a
In-force premium (\$m)	n/a	500	1,000	360
Average age of portfolio (years)	5	3	10	3
<b>Product mix - New Business</b>				
Premium Income/Inflows (\$m)	2,400	50	300	80
New Business Inflation factor	3%	3%	3%	3%

### Other Assumptions

Policies are sold at start of financial yr  
 Maintenance expenses occur mid-yr  
 Benefit payments occur end yr  
 Lapses, deaths and maturities occur end yr - deaths, then lapses, then maturity payments  
 Model ignores tax  
 For unit-linked, annual charges are deducted at the end of the year, before withdrawals.