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Insurance rules will create accounting mismatches, FRC warns

by Richard Crump 13 Sep 2013

INSURANCE COMPANIES' financial statements could become less understandable and more complex as a result of proposed changes to the way insurance contracts are accounted for under IFRS, according to the UK reporting watchdog.

In a letter sent to global accounting standard setter the IASB, the FRC warned that measuring and presenting insurance liabilities in other comprehensive income (OCI) will "create extensive accounting mismatches and likely lead to asset liability mismatch being hardcoded into accounting for insurance contracts".

Such a mismatch will, the FRC claims, incentivise insurers to hold assets that can be held fair value through OCI - such as corporate debt - rather than those compulsorily required to be fair value though the P&L - such as equities.

"This will result in increased complexity in the financial statements rendering them less understandable for users," Roger Marshall, chair of the FRC's accounting council, said in response to the latest set of standards.

According to Marshall, the IASB should consider making the requirements for classification and measurement of insurance contracts consistent with those for financial assets.

"This would entail requiring insurance liabilities to be classified as FV-PL with an option to recognise and present them in OCI based on business model and nature of the liability," Marshall said.

The IASB refined its rules on insurance contracts - essentially the first comprehensive set of international standards governing insurance contracts accounting - in June following a public consultation on plans first published in 2010.

Although the FRC said the latest exposure draft has gone a long way in addressing concerns about flaws in the original model, certain aspects still need further work, such as a mirroring approach for measurement of assets and liabilities where the contract specifies a link to returns on those underlying items.

"Problems are likely to arise from the mandatory requirements: for there to be a contractually specified link between the assets and payments to policyholders; for a decomposition and separate measurement of cash flows between those that vary with the underlying assets and those that do not; and likely arbitrary presentation of those "decomposed" cash flows in the statement of financial position and the returns on them in the income statement," Marshall said.

The FRC is also unclear as to the rationale behind the draft requirement to accrete interest on the contractual service margin at locked-in rates.

"There is little merit in accreting interest on the contractual service margin at a locked-in rate when all other elements of the cash flows from the insurance liabilities will be discounted using current rate," Marshall said.