What's the Business Model for a Life Insurer's Equity Investment?

Ind AS 109: Financial Instruments bears the question of the link between a life insurer's business model and thereupon the accounting of equity investment. The authors attempt to deduce the link.

Over the next few months, Indian insurers will implement for financial reporting the IFRS-adapted Ind AS accounting standards. The activity would continue over a few reporting quarters. Significant to the implementation, particularly with Indian life insurers, are two accounting standards: a) Ind AS 104: Insurance Contracts, and b) Ind AS 109: Financial Instruments. The accounting treatment of a life insurer's equity investments under Ind AS 109: Financial Instruments is the subject matter of this discussion.

Accounting options for equities

Accounting for equity investment – recognising income and carrying assets – is done on a fair value basis under the existing IRDA financial accounting standards. Ind AS 109 continues the practice, however elicits greater discussion on classification of the marked-to-market gains and losses to either the Profit and Loss Account (P&L) or Other Comprehensive Income (OCI). While reporting periodically, Ind AS 109 frequents the question, "How is the asset, and in this case equity investment, held within the entity's business model?"

Business Model

As ordinarily understood, the business model does not allude to the life insurance business' product strategy or distribution philosophy. Rather, business model dwells on the organisation of groups of financial assets. Application guidance B 4.1.2 instructs that business models are determined at a level that reflects how groups of financial assets are arranged together to achieve a particular business objective. Basis of conclusion BC 4.1 (C) states that a business model encompasses the way the entity arranges its financial assets to determine its measurement attribute, to provide relevant and useful information to users for their assessment of the amounts, timing and uncertainty of entity's future cash flows.

Fair Value Accounting

If an asset is carried at fair value, Ind AS 109 provides the choice of recognising the gains/ losses between two reporting periods either under the OCI or P&L. The default treatment directs the gains/ losses to OCI, however to achieve the matching of revenues with costs, the gains/ losses should be recognised in the P&L (clause 4.1.5).

In some lines, the equity investment could have a direct corresponding change on policyholders' liabilities (e.g. unit reserves backed by equity assets). Here, if the change in liabilities is routed through the Revenue Account, the fair value change should also be recognised in the Revenue Account.

However, a contract sold by a life insurer could be classified as an investment contract if it fails the 'significant insurance risk' test under Ind AS 104: Insurance Contracts. In such case the change in liabilities would mirror the change in assets i.e., only a Balance Sheet movement without passing through the Revenue Account. The equity assets backing investment contracts of life insurers would meet the matching convention (clause 4.1.5) by directly reflecting themselves on the liabilities and without the need to pass the P&L.

Figure 1 records our views on plausible equity accounting treatment. Specific situations may warrant a treatment distinct from that tabulated.

Re-classification between OCI and P&L

Ind AS 109 permits re-classification in the case of equity investment if the life insurer changes the business model (clause 4.4.1 read with 5.6.1), however previously recognised gains and losses cannot be re-stated from OCI to P&L or vice versa.

On the other hand, a life insurer can also irrevocably elect (clause 5.7.5) to present all subsequent changes in the carrying value of equity investment in OCI. Two aspects need emphasis: one,

Figure 1: *Equity Accounting Treatment and Rationale*

Business segment	Objective of holding equity assets	Likely treatment	Ind AS 109 paragraph reference	Rationale
Unit Linked (UL) Fund, Insurance Business	Fair Value of equity assets translate to unit reserves (UL liability)	Fair Value, P&L	Para 4.1.5 (Minimise Accounting mismatch)	As the fair value change in liability is classified under P&L, the corresponding change in UL assets should also be classified under P&L.
Unit Linked (UL) Fund, Investment Business	Fair Value of equity assets translate to unit reserves (UL liability)	Fair Value, Balance Sheet asset-side	Para 4.1.5 (Minimise Accounting mismatch)	As the fair value change in liability reflects only in the Balance Sheet, the corresponding change in UL assets should also be classified in the Balance Sheet.
Non-participating, Traditional Fund	To match expenses	Fair Value, OCI	Para 4.1.4 (Irrevocable decision to classify equity through OCI)	Equity would be classified through OCI since although it could violate the accounting mismatch. The need to minimize volatility would mean that equity fair value change would be routed through OCI.
Participating Fund	To match expenses and discretionary benefits	Fair Value, OCI	Para 4.1.4	Change in the financial liability unlikely to be mirrored by a change in assets, e.g., bonus smoothing. Fund for future appropriations (FFA) may not fully lift the liability. Case for classifying equity assets backing reserves in OCI since although it could violate the accounting mismatch, the desire to minimize volatility would mean that equity fair value change would be routed through OCI.
Shareholders' Fund	No specific liability to match	Fair Value, OCI	Para 4.1.4 read with Para 4.1.5	Equity investment is usually held to assume risks for the long-term.

dividend would be recorded in P&L (clause 5.7.1A read with 5.7.6); and two, profit or loss on sale shall not be recorded in P&L i.e., recycling that is ordinarily allowed for bond investment will not apply for equity investment [clause 5.7.1(b)]. This treatment may need further debate whilst drawing up the taxable profits as ordinarily profit or loss on sale of equity investment will not be shown in P&L.

Conclusion

In summary, a considered evaluation is warranted in the accounting of equity investments of a life insurance business. There are long-term implications on recognition of profits or losses of equity investment in P&L, the resulting tax effect, and the adherence with the principle of matching equity asset movement with liabilities. Life insurers should hold this adage close to heart, *"With regard to accounting policy, we overestimate what new implementation can do in the short-run and underestimate what it can do in the long-run."* ■

About the author

Mr. Mayur Ankolekar

mayur.ankolekar@ankolekar.in

fellow of the Institute of Actuaries of India

Ankolekar & Co., Actuaries and Consultants.

About the author

Mr. Nandan Nadkarni

nandan.nadkarni@ankolekar.in

student member of the Institute of Actuaries of India

Ankolekar & Co., Actuaries and Consultants.