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Evolution of Financial Reporting of Life Insurers: The Predominance of Unregulated Embedded Value Disclosure - A Review

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Abstract This article was reviewed with the aim of examining the concept of EV, the implications of voluntary disclosure and the adoption of the concept in financial reporting of life insurance companies. It is also aimed to evaluate the effects of this concept on capital market perception of such firms and hence the market value of their securities. The metrics of valuation applying this concept were also considered with the aim to confirm the applicability for all similar cases. To achieve this, the objectives of the authors were highlighted and the theoretical bases adopted examined. The methodology adopted was reviewed to assess suitability and likely effectiveness for the subject under review. Findings of the authors were evaluated in terms of how well they resolved the identified problems and stated objectives. This review adopted a descriptive cum narrative approach. The conclusions of the reviewed were assessed in terms of universal application by accounting standard setting bodies.

Keywords Financial Reporting, Embedded Value, Disclosure, Accounting Standards Setting Bodies

1. Introduction

The paper titled, Evolution of Financial Reporting of Life Insurers: The Predominance of Unregulated Embedded Value Disclosure written by Rudolph A Jacob, Samir El-Gazzar and Scott McGregor in *Journal of Financial Regulation and Compliance* (JFRC), 25(1) published in 2017 was reviewed.

1.1. The Objectives of the Paper

The objectives of the paper were to examine the capital market effects and predominance of unregulated Embedded Value (EV) financial reporting in the life insurance industry in foreign domestic markets, and US markets for foreign firms that cross-list in the United States of America (USA).

1.2. The Scope of the Paper

The paper meant to address the needs of financial reporting regulators, financial analysts, firm compensation committees, managers and academics. The work reviewed the evolving issues surrounding reporting and disclosures in the life insurance sector as practiced internationally in the context of Solvency II and IFRSs. The work is situated in the USA, hence the emphasis on the US markets.

1.3. Methodology of the Paper

The study analyzed and evaluated recent empirical archival data to determine the incremental and relative value relevance of unregulated valuation metric that is disclosed by life insurers. The paper analyzed the association of traditional accounting measures and EV with stock prices in non-US stock markets: Sample of 53 companies and 329 observations for a period of 2000 to 2008. It also appraised incremental market reaction to EV announcements relative to the non-announcement period.

Finally, the paper examined the association of traditional accounting measures and EV with stock prices, non-US market: Sample of 10 companies and 76 observations for the period 2000-2010.

1.4. Theoretical and Conceptual Bases Adopted in the Paper

The paper drew much of its theoretical and conceptual backgrounds from the works of International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB) and CFO Forum. The inadequacy of traditional accounting measures to capture the economics of the industry was noted by the CFO Forum and it was observed that by supplementing their financial statements

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with unregulated embedded values 100 life insurance companies were able to better capture a firm's performance. This has provoked discussions which began in the United Kingdom and spread to most of Europe, Canada, Australia, Japan, China, South Africa and lately the USA.

In reviewing the usefulness of EV metrics for investors, the authors examined the works of early researchers on the subject. It was noted that early studies of the relevance of EV to stock prices were limited in scope (Horton, 2007; Wu and Hsu, 2011; Prefontane, et al. 2009, 2011; Almezweq and Liu, 2012, 2013; Gerstner, et al., 2015; Serafeim, 2011; Zimmerman, et al., 2015; El Gazzar, et al,. 2013). However, the scope broadened as researches advanced.

1.5. Findings of the Authors of Reviewed Paper

The authors noted that EV disclosure had significant information implications for the stock market: first, it possesses information content and secondly, it minimizes information asymmetry in the market. It was further discovered that EV disclosure influences stock valuation in more significant way than traditional GAAP measures through information content it provides (El Gazzar, et al., 2013). If EV were to be made mandatory in the USA it is capable of enhancing investors assessment and pricing. This seem to place a demand on accounting standards setting bodies for insurance to recognize EV as complement to basic financial data reflecting the economics of life insurers operations (El Gazzar, et al., 2013).

By regressing the changes in stock prices per share against the changes in EV per share as well as earnings per share and book value per share of 53 international life insurance companies publishing EV information for an eight year period (giving 329 firm year observation), the authors found that EV had the greatest explanatory value of the factors, R2. They also found that the market reaction to EV triggers market price revaluation and volume changes for the first time and for ongoing processes. Thus, the authors revealed the potential benefits to the company of adopting EV by reducing the asymmetry of information so measured.

To assess the incremental value relevance of EV, the authors regressed changes in stock prices per share against the changes in EV per share as well as earnings per share and book value per share in order to determine the association between EV and stock prices. The findings show that EV had the greatest explanatory value of the factors, R^2.

2. The Review

2.1. Objectives of This Review

This article written by Jacobs, *et al*. is reviewed with the aim of examining the concept of EV, the implications of voluntary disclosure and the adoption of the concept in financial reporting of life insurance companies. It is also aimed to evaluate the effects of this concept on capital market perception of such firms and hence the market value of their securities. The metrics of valuation applying this concept was also considered with the aim to confirm the applicability for all similar cases.

2.2. Methodology for the Review

This review adopted a descriptive research approach, wherein the objectives of the study are resolved through review of work done by the authors of reviewed article.

2.3. Findings of the Review

EV reporting is gaining acceptance as a result of standardization. Conceptually, EV is seen as comprising of present values of future cash flows of shareholders from existing business- which is referred to as in-force- and required capital after deducting the cost of holding the capital. As distinct from traditional measures EV was initially termed "achieved profits" basis of accounting was first disclosed in 1980.

The implications of voluntary disclosure of EV is one of anticipatory convergence of values across the globe. As observed by the authors of the article, "development of the EV was driven …by concern within the international life insurance industry that there is a mismatch of accounting results with economic performance because of delayed recognition of revenues and expenses and the mismatch of the valuation bases for assets (fair values) and liabilities (estimated future benefits)." A widely held opinion among practitioners is that EV provides a better basis for valuing life insurers than the traditional measures.

Going by the data available from analyses carried out by the authors, EV has significant positive value on the company, its shares, assets, liabilities and revenue/expenses (El Gazzar, et al., 2013). Furthermore, the adoption of EV as complementary disclosure will facilitate standardization and thus enhance investors' valuation of the companies' shares. This implies that both investors and companies would benefit from the enhanced information availability and the reduction of information asymmetry.

An interesting discovery about EV was brought to light by comparing EV to US GAAP and IFRS with allusions to the emphasis of market-consistent embedded value (MCEV) and Solvency II. It was noted that both US GAAP and IFRS differ from EV in measuring changes in accounting earnings in that while GAAP and IFRS defer most of the impact of economic changes and by so doing smoothen the impact of such changes on earnings, EV includes future earnings and the concomitant effect on shareholder value. Another remarkable difference between EV and IFRS equity is that EV considers the value of in-force business and expected renewals and its net asset excludes intangibles like goodwill whereas under IFRS, net asset values include intangible assets and excludes expected renewals. IFRS 4 Phase II, MCEV, Solvency II are in agreement in so many ways. They all require "best estimate approach to value liabilities, use market consistent discount rates and use similar concepts to adjust for uncertainty in cash flows". The only grounds for dissonance among these sources of metrics is in the use of "contract service margin to spread profits over the life of the contract" by IFRS, while EV and Solvency II recognized them immediately.

3. Conclusions

It was concluded that although EV provides a better basis for valuing life insurers than the traditional measures, its adoption calls for reconciliation of metrics used under traditional approaches to the EV. EV adoption affects perception of investors and enhances the value of the business. In view of its conflict with GAAP and IFRS, it was concluded that standardization of EV is inevitable considering the specialized nature of life insurance business.

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