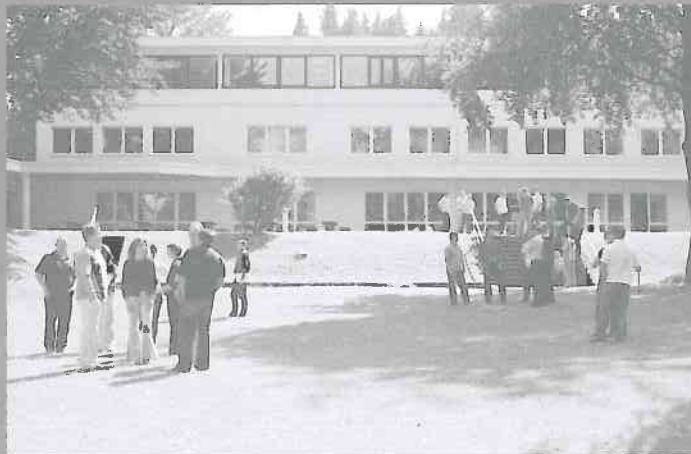


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**Accounting of Insurance Contracts  
According to IASB Exposure Draft IFRS 4**

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# Accounting of Insurance Contracts According to IASB Exposure Draft IFRS 4

Tristan Nguyen and Philipp Molinari

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## **Abstract**

*The International Accounting Standards Board (IASB, former IASC) has been working on a new international standard for insurance contracts based on fair value for about ten years now. However, details on how to measure such a value in practice were unclear for long time. Therefore the IASB decided to split the project into two phases: IFRS 4 as interim standard in phase I allowed insurers to mainly keep their former accounting models. Phase II was initiated by the publication of a Discussion Paper in May 2007. The Discussion Paper “Insurance Contracts” proposed accounting of insurance liabilities based on a so called “Current Exit Value”. Facing severe criticism from both science and industry mainly concerning the reliability of such a hypothetical value, the IASB decided to go for a completely different direction and abandoned the view of a hypothetical transfer of the insurance portfolio. The measurement model that the IASB proposed within its Exposure Draft “Insurance Contracts” published in July 2010 aims at incorporating the insurer’s own view in determining the value of insurance liabilities.*

*The building blocks for the valuation of insurance liabilities remain an explicit, unbiased and probability-weighted estimate of the future cash flows, a discount rate that adjusts those cash flows for the time value of money and an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows. However, as the IASB does no longer pursue the Current Exit Value, there are significant changes to the determination of these building blocks. In this chapter we analyze to which extents the accounting model for insurance liabilities in the exposure draft is qualified to generate useful information to users of financial statements. Furthermore, we give recommendations about which fields need further adjustments in order to comply with decision usefulness as the overriding principle.*

## 1 Introduction

The International Accounting Standards Board (IASB, former IASC) is currently developing an international accounting standard for insurance liabilities. The work on this project was started more than ten years ago and a first milestone was reached in 2004 by publishing IFRS 4 as an interim standard for insurance contracts. The final standard will be the result of the so called phase II of the project “Insurance Contracts” and shall remove the current IFRS 4. Phase II started with the publication of a Discussion Paper in May 2007 and described a valuation of insurance contracts with a so called Current Exit Value. After facing severe criticism from science and also from practice – particularly regarding the reliability of such a hypothetical value – the IASB radically turned away from this approach and dismisses the perspective of a hypothetical buyer of the contracts to be valued. The Exposure Draft “Insurance Contracts” published in July 2010 favours an accounting model that allows the use of the reporting company’s own expectations when estimating the value of the cash flows resulting from the respective contracts. An overview of the measurement approaches discussed in the past is given in *Table 1*.

Hence, the accounting model described within the Discussion Paper was to be adjusted in many details even if the general approach remains the same: The value of insurance liabilities will be estimated based on the same three building blocks already known from the Discussion Paper. However, the changes that had to be made will have significant impacts, both on the process how to calculate the value of the liability and also on the results. Such changes concern for example the calculation (resp. the calibration) of the risk margin, profits at inception or the consideration of the credit characteristics of insurance liabilities.

To critically analyze the rules presented in the Exposure Draft „Insurance Contracts“ and to discuss recommendations for and against other possible approaches, an examination of the proposed alternatives to the criterion of *decision usefulness* as well as its sub-criteria *relevance* and *reliability* is essential. These criteria are deducted from the ultimate objective of the IASB for developing new accounting standards: Providing information that is useful to the economic decisions taken by users of financial statements. Such decisions are mainly related to investments and disinvestments and to the assessment of the management of the reporting company.<sup>1</sup>

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<sup>1</sup> See IASB Framework.12-14.

	Issues Paper 1999	DSOP 2001	IFRS 4 (BC 6-9) 2004	CFO-Forum Elaborated Principles 2006	Discussion Paper 2007	Exposure Draft ED/2010/8
<i>Measurement</i>	Fair Value (Exit Value)	Fair Value (Entry Value) or preference: in the absence of market-based information Entity Specific Value	Fair Value (Entry Value) or: in the absence of market based information Entity Specific Value	Best estimate based on management's expectations, taking into account the uncertainty of future cash flows	Fair Value (Current Exit Value)	Fair Value based on fulfillment cash flows
<i>Revenue recognition</i>	Report full profit at inception of the contract	Depending on management expectations → usually no profit at inception of the contract	No profit at inception of the contract	No profit at inception of the contract	Recognition of profit in the income statement possible at inception of treaty	No profit at inception of the contract
<i>Risk adjustment</i>	Only non-diversifiable risks	Both diversifiable risks and non-diversifiable risks	Fair Value not less than the amount, the company would ask from the insured to sign an appropriate contract	In consistency with the risk management of the company	Neutral estimate of a margin that the market participant would ask for bearing the risk	Maximum amount the insurer would pay in order to be released from the risk of contributing actually higher than the estimated loss payments
<i>Credit characteristics</i>	Taken into consideration	No consideration in case of Entity Specific Value Consideration in case of Fair Value questionable due to practical problems	Taken into consideration	Not taken into consideration	Disclosure of the solvency influence at inception as well as in the subsequent measurement (impact expected to be weak)	Not taken into account

**Table 1: Measurement approaches for phase II of the project „Insurance Contracts“**

## **2 Purpose of the IASB Exposure Drafts „Insurance Contracts“**

The scope of the final IFRS for insurance contracts will be limited to insurance contracts (including reinsurance contracts), that the company issues and reinsurance contracts that it takes. Thus, accounting of a direct insurance asset is explicitly not in the scope of a final standard. Furthermore, the accounting treatment of financial instruments with discretionary participation features is still supposed to be regulated by a final standard for insurance contracts.<sup>2</sup> Basically this corresponds to the scope of IFRS 4 that is currently applied to the accounting of

<sup>2</sup> See ED/2010/8.1.

insurance contracts<sup>3</sup> and the IASB continues to prefer a product-related and not an institutional-related approach. Thus an insurer has to account all assets and liabilities that do not meet the definition of an insurance contract or a product with discretionary participation feature according to the other relevant IAS/IASB.<sup>4</sup>

However, the exceptions from the application of IFRS 4 that are currently listed in IFRS 4.4(a)-(f) have been modified. In particular, the option for financial guarantees (such as credit default swaps), which the issuer has previously asserted to regard as insurance contracts<sup>5</sup> and to account according to IAS 39, IAS 32 and IFRS 7 or IFRS 4, was cancelled. Such contracts are supposed to be mandatorily treated as insurance contracts in the future.<sup>6</sup> This rearrangement applies not only to credit insurance contracts, but also to financial guarantees issued by banks.

The definition of an insurance contract has also been adopted from IFRS 4 and remains unchanged. The existence of an insurance contract is still defined through the following three points:

- The policyholder receives compensation from the insurer if a specified uncertain future adversely affects the policyholder.
- An insurance risk will be transferred from the insured to the insurer.
- The transferred insurance risk is significant.

On the other hand, the definition of discretionary participation features is more restricted in the exposure draft than in IFRS 4: Investment contracts are only regarded as having a discretionary participation feature, if there are also existing corresponding insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.<sup>7</sup> Financial instruments with profit participation that do not fulfil these conditions are accounted according to the appropriate standards valid for financial instruments. The IASB differs consciously from the accounting practice according to US GAAP as investment contracts with discretionary participation features have to be accounted in the same way like financial instruments. A separate handling of these insurance contracts that are similar to financial in-

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<sup>3</sup> See IFRS 4.2.

<sup>4</sup> See ED/2010/8.3.

<sup>5</sup> See IFRS 4.4(d).

<sup>6</sup> See ED/2010/8.BC193-BC195.

<sup>7</sup> See ED/2010/8.Appendix A.

struments in many aspects would be complex, inconsistent and not comprehensible for the users of financial statements.<sup>8</sup>

Furthermore, the process of unbundling deposit components, embedded derivatives and service components is modified. If such a component is not closely related to the underlying insurance contract, it has to be unbundled and accounted according to the relevant IFRS/IAS. All options currently existing in IFRS 4 which allow renouncing unbundling under certain circumstances will not be available in future.<sup>9</sup> The current exposure draft does not specify any features which distinguish components that are closely related to an insurance contract from those that are not. The only indication to solve this issue is made by referencing to the criteria named within the application guidance of IAS 39 for embedded derivatives.

As shown above, the scope of the exposure draft goes beyond pure insurance contracts like it does IFRS 4. However, this chapter will focus on the valuation model for insurance contracts. The specific rules for reinsurance contracts, financial instruments with discretionary participation features, insurance contracts acquired in a portfolio transfer and unbundling will not be further analyzed and assessed.

### **3 Methods for accounting and valuation**

There is no liquid market for portfolios of insurance contracts which would allow to observe fair prices and to derive values for the portfolios that are to be measured. Therefore a fair value for insurance liabilities has to be determined synthetically. The proposal from the IASB for this matter is to value the liabilities based on *fulfillment cash flows*<sup>10</sup> adjusted for the time value of money<sup>11</sup> and for the risk that the actual claim payments are higher than their expected value. Initially, an insurer shall measure the insurance contract at the risk adjusted expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract. If this amount is negative a residual margin that eliminates any gain at inception has to be added. In this case the value of the liability at inception will be zero.<sup>12</sup> If the amount is positive the insurance company will have to recognize this amount immediately as a loss.<sup>13</sup>

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<sup>8</sup> See ED/2010/8.BC198-199.

<sup>9</sup> See ED/2010/8.8-12.

<sup>10</sup> See ED/2010/8.BC 49.

<sup>11</sup> The discounting is necessary to account for the time value of the cash flows.

<sup>12</sup> See ED/2010/8.17-22.

<sup>13</sup> See ED/2010/8.18.



### 3.1 Estimation of expected cash flows

The Exposure Draft specifies that the cash flows resulting from an insurance contract have to be determined by estimations. For these estimations the following shall hold:<sup>14</sup>

- the estimations are explicit (i.e. separate from estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows),
- reflect the perspective of the entity but, for market variables, be consistent with observable market prices,
- the estimations incorporate – in an unbiased way – all available information about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfills the insurance contract,
- the estimations are current (i.e. the estimates shall reflect all available information at the measurement date) and
- the estimations include only cash flows from existing contracts.

The IASB does not give any instructions with regard to the methods that can be used for estimations, but only depicts the approach of estimating an expected value in a conceptual way. Furthermore, the IASB allows for models of different degrees of detail taking into consideration the specific availability of data and the cost-benefit ratio.<sup>15</sup> The unspecific wording of the IASB when describing this part of the measurement approach for insurance contracts makes it possible to apply various models of different quality which might lead to considerable differences in the quality of the financial information. Furthermore, a lack of comparability of financial statements between different insurance companies is likely to arise.

In order to keep the estimations up to date the used variables have to be checked regularly for accuracy at the reporting date. In case of changes of particular parameters these differences will have to be justified. This is especially the case for parameters where the usage of a certain range of values is justifiable. If the actual conditions have not changed at the end of the reporting period, it is not possible to change the parameter from one end to the other end of the range.<sup>16</sup> Such a rule enhances the reliability of financial statements as it considerably decreases possibilities for earnings management.

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<sup>14</sup> See ED/2010/8.23.

<sup>15</sup> See ED/2010/8.B38-B39.

<sup>16</sup> See ED/2010/8.B54.

In order to clarify which cash flows have to be considered when estimating the fair value the IASB follows an approach similar to the concept of “guaranteed insurability” known from the Discussion Paper.<sup>17</sup> According to this concept only cash flows which the policyholder may legally claim from the insurer or which are within the boundary of the contract shall be taken into account for calculating the insurance liabilities. The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which an insurer either:

- is no longer required to provide coverage, or
- has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (i.e. no discernible effect on the economics of the contract).<sup>18</sup>

All cash flows allocable to an insurance contract according to this definition that are depending on the *behavior of the policyholder* are weighted with the respective realistically estimated probability for the particular behavior. It does not play any role if this behaviour is of advantage or disadvantage for the insurance company,<sup>19</sup> but there will be an adjustment for the risk that the actual behaviour differs from the expected behavior of the policyholder.<sup>20</sup> This rule is intended to allow for the modeling of surrender or conversion options. The particular design of such an option should not influence the accounting of these contracts. E. g. a contract with a lifelong contract period and an option for both parties to cancel the contract at the end of each year must be accounted in the same way as a contract with a coverage period of one year.<sup>21</sup>

Thus, in contrast to the Discussion Paper the IASB has abandoned the assumption that all policyholders choose the option which is of disadvantage for the insurance company. This leads to a more realistic depiction of the economic reality, but nevertheless does not take into account a complete picture of the value of the customer relationship, because the rule is limited to facts which belong to the contract according to the above described boundaries of the contract. Insurance companies which offer casualty coverage for a period of one year for in-

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<sup>17</sup> See DP. 150-160 and ED/2010/BC60.

<sup>18</sup> See ED/2010/8.26-27.

<sup>19</sup> In contrast, the Discussion Paper assumed that options in the contract would be exercised to the disadvantage of the insurance company by all policyholders. See DP.122 and ED/2010/8.BC60-BC63.

<sup>20</sup> See ED/2010/8.28.

<sup>21</sup> See DP.152.

stance, also benefit from an existing customer relationship.<sup>22</sup> This fact would not be taken into account according to the current model described by the exposure draft. Finally, this fact in combination with the recognition of acquisition costs as an expense when incurred could lead to the disclosure of a loss at initial recognition of a contract even if this particular contract is profitable from an overall perspective.<sup>23</sup> Besides incorrect information for stakeholders, this causes also misleading incentives for the management of an insurance company.<sup>24</sup> Furthermore, recognizing only a part of customer relationships related to insurance contracts would also lead to an inconsistency within the IFRS as according to IAS 38.63 an internally generated intangible asset must in general not be recognized.

### **3.2 Discounting for the recognition of time value of money**

In order to reflect the time value of money, cash flows have to be discounted by using a market consistent interest rate of financial instruments that have cash flows that equal those of the insurance contracts in terms of timing, currency and liquidity. In this process all factors which are not relevant for the insurance contract (e. g. risks that are included in the market price of the respective financial instrument) have to be excluded.<sup>25</sup> In case the cash flows resulting from the insurance contract depend on the performance of a particular asset, the interest rate used for discounting has to be adjusted accordingly.<sup>26</sup> Besides, also an adjustment for consideration of inflation of cash flows which are based on nominal values is necessary.<sup>27</sup>

Whereas adjustments for inflation and differing risk profiles still seem to be possible without any difficulties, the adjustment of the discount rate for the usual lack of liquidity<sup>28</sup> given in the context of insurance contracts will be much more complicated as it is difficult to determine a reliable price for the fact that a financial instrument is traded on an almost illiquid market. An insurance company could take advantage of this fact and apply an adjustment for liquidity that steers the annual profit in a direction favourable for the management of the reporting entity or the company itself. The IASB is aware of these problems and is still investigating possible solutions. However, also the final standard will not contain any kind of “instruction” describing in detail how the discount rate has to be determined.<sup>29</sup>

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<sup>22</sup> See *Molinari, Nguyen* (2009), p. 302.

<sup>23</sup> See *European Insurance CFO Forum, CEA* (2007).

<sup>24</sup> See *Molinari, Nguyen* (2009), p. 303.

<sup>25</sup> See ED/2010/8.30.

<sup>26</sup> See ED/2010/8.31-32.

<sup>27</sup> See ED/2010/8.33.

<sup>28</sup> See ED/2010/8.34.

<sup>29</sup> See ED/2010/8.BC100-BC104.

### 3.3 Risk adjustment for the uncertainty related to the estimated cash flows

A further part of the accounting model proposed by the IASB is the risk adjustment in order to reflect the price for bearing the risk related to the fulfillment of the insurance contracts. The amount shall be equivalent to the amount that an insurer would pay in order to be relieved of the risk that the ultimate fulfillment cash flows exceed the expected value of these cash flows.<sup>30</sup> That means that all risks which are not directly connected to the insurance service (e. g. investment risks, operational risks) must not be part of this risk adjustment.<sup>31</sup> In contrast to the Discussion Paper from 2007 the IASB has now abandoned the idea of solely use of market prices for determining the risk margin.<sup>32</sup> On the one hand, insurers will be enabled to use risk adjustments derived from their internal models also for accounting purposes. On the other hand, lack of market consistency will lead to entity specific adjustments for risks which will reduce the reliability of information given through the financial statements. Therefore the board has decided that changes in the risk adjustment from one period to another can only be made if evidence indicates that previous estimates are no longer valid.<sup>33</sup> However, the reporting entity and its management can significantly influence the amount of the risk margin specified at inception.

Furthermore, the IASB described the purpose of the risk adjustment in detail, specifies the attributes of the risk adjustment and limits the methods to determine the risk adjustment to confidence level, conditional tail expectation and cost of capital techniques.<sup>34</sup> However, the Exposure Draft does not give any statement neither on the parameters nor on details of the design of the models (e. g. confidence level, weighted average cost of capital etc.) although a small change of these parameters might have a significant effect on the risk margin and therefore on the annual results.<sup>35</sup> In our opinion this open setting regarding the methods for determining the risk margin (only the names and a very superficial overview of the methods are given) leads to a poor limitation of the possibilities for earning management.

Another part of the insurance liabilities is a residual margin which equals the difference of the time and risk adjusted expected cash-inflows and cash-outflows.<sup>36</sup> This topic is closely related to recognition of gains at inception of the contract which was discussed controversially in the past. One possibility would be to allow for an initial profit, another would be to distribute the

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<sup>30</sup> See ED/2010/8.35.

<sup>31</sup> See ED/2010/8.69.

<sup>32</sup> See Insurance DP.75-76.

<sup>33</sup> See ED/2010/8.48. and *Ellenbürger, Kölschbach* (2010), p. 1304.

<sup>34</sup> See ED/2010/8.B68-B90.

<sup>35</sup> See e. g. *Ernst & Young* (2007).

<sup>36</sup> See ED/2010/8.17(b).

profit of a particular insurance contract across the whole contract period.<sup>37</sup> Whilst the IASB has preferred the former approach in the Discussion Paper, the exposure draft stipulates a residual margin which in case that the cash-outflows do not exceed the cash-inflows (i. e. the contract is profitable at the time of the conclusion of the contract) prevents any profit at the initial recognition.<sup>38</sup> This residual margin is then released either on the basis of the passage of time or on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.<sup>39</sup>

Table 2 and Table 3 shall provide an illustration of the approach described by the exposure draft showing the respective positions of the balance sheet and the income statement under the following assumptions:<sup>40</sup>

*Insurance company A signs a professional indemnity insurance contract (duration 3 years) at the end of accounting year 0. The premium is 240 monetary units. Insurance company B sells the same product, however to a lower premium of 210 monetary units. Both companies expect claim payments of 60 monetary units per contract year. Following the methods for the calculation of the risk margin given in the relevant accounting standard both companies calculate a risk adjustment of 30 monetary units. The uncertainty on the amount of cash-outflows related to the contract declines proportional to the amount of the expected cash-outflows.<sup>41</sup>*

<b>Date 31.12.</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>
Expected claims payment	180	120	60	0
+ Risk margin	30	20	10	0
+ Residual margin	30	20	10	0
<b>= Provision</b>	<b>240</b>	<b>160</b>	<b>80</b>	<b>0</b>
- Changes in provision (=expense)	240	-80	-80	-80
+ Expense for claims payment	0	60	60	60
+ Premium	240	0	0	0
<b>= Profit</b>	<b>0</b>	<b>20</b>	<b>20</b>	<b>20</b>

*Table 2: Accounting at company A*

<sup>37</sup> See Insurance DP.78-80.

<sup>38</sup> If the contract is not profitable at initial recognition the difference between the present value of the risk adjusted cash out-flows and the premium has to be disclosed as a loss in the income statement at initial recognition.

<sup>39</sup> See ED/2010/8.50.

<sup>40</sup> See *Molinari, Nguyen* (2009), pp. 296-299.

<sup>41</sup> In order to simplify the effects of discounting are neglected in this example.

<b>Date 31.12.</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>
Expected claims payment	180	120	60	0
+ Risk margin	30	20	10	0
+ Residual margin	0	0	0	0
<b>= Provision</b>	<b>210</b>	<b>140</b>	<b>70</b>	<b>0</b>
- Changes in provision (=expense)	210	-70	-70	-70
+ Expense for claims payment	0	60	60	60
+ Premium	210	0	0	0
<b>= Profit</b>	<b>0</b>	<b>10</b>	<b>10</b>	<b>10</b>

*Table 3: Accounting at company B*

Each company shows a different amount of the insurance liability at any point in time during the contract period, though they represent the same facts. Users of financial statements would expect higher future cash-outflows for company A than for company B. However, the reason for the higher amount of provisions at company A is simply the higher premium company A is able to impose on the market. Furthermore, the above example shows us that the profit per period varies depending on the premium earned. In the past it was argued that this is reasonable for the accounting of insurance contracts as the service “providing insurance coverage” usually is delivered over a longer period of time. Therefore also the profit resulting from the delivery of this service should be distributed across this period.<sup>42</sup> We agree that this approach leads to relevant information which enables the users of financial statements to assess the earning power of a company.<sup>43</sup>

However, we doubt that the whole profit that arises from the business described above is leading back to the service “providing insurance coverage”. It is the risk margin which (per definition) reflects the price that the insurance company would pay to be disburdened from the service of “taking over the risk”. Reducing the risk margin over the contract duration the insurance company automatically spreads the profit for this service of this contract across the contract period. The example shows that this part of the profit is independent from the premium provided that the estimation does not change. In contrast, the residual margin and their liquidation across time are not directly connected to the insuring service provided by the company.

<sup>42</sup> See e.g. *Duverne, Le Douit* (2007), p. 47.

<sup>43</sup> See e. g. *Molinari, Nguyen* (2009), pp. 291-292.

Even the IASB does not assume the residual margin to be a profit margin for the service “insuring”, but a compound item for the following factors:<sup>44</sup>

- Compensation for originating contracts and assembling them into the portfolio.
- Compensation for additional services that are not unbundled (and that therefore are not treated as arising from a separate service contract which would be accounted according to the standards on revenue recognition).
- Compensation for the development of products.
- Additional gains that arise from market power and discounts that the insurer grants in order to assure market power.
- The risk that the insurer might not be able to fulfill its obligations.

It seems that the residual margin partly serves as a substitute for a service margin that should consider expected profits arising from services connected to the insurance contracts (the application of such a service margin was proposed by the IASB in its Discussion Paper). For the first two items mentioned above the distribution of a profit over the contract period is comprehensible, but certainly that does not seem reasonable for gains basing e. g. on the successful development of a product.

Similarly, the recognition of profits arising from market power of the insurance company through a residual margin is to be assessed critically. The market power usually is a result of past expenditures and investments (e. g. advertisement or merger costs). Therefore, profits resulting from such activities should be recognized when they are realized which is in this case the point in time when a corresponding contract is concluded. The fact that a corresponding gain is realized with the conclusion of a contract is unquestionable as it is clear that the insurer provides evidence that it is able to impose the recognized premium on the market by issuing that specific contract. If the respective profits have to be distributed over the contract period this could in the worst case lead to a stop of promotional activities if the management is interested in a short-term maximization of the annual result.

The literature criticizes the fact that the liquidation of the residual margin on the basis of timing (resp. risk) in combination with recognizing changes in the carrying amount of the liability directly in the income statement leads to an increased subjectivity of the annual result as the residual margin is not used as a “buffer” absorbing such changes in value of the liability.

[<sup>45</sup>] We cannot follow this criticism for two reasons:

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<sup>44</sup> See ED/2010/8.BC125.

<sup>45</sup> See *Ellenbürger, Kölschbach* (2010), p. 1232.

1. Changes of parameters are subject to strict prerequisites.
2. The respective profit or loss has to be shown separately in the income statement and should therefore be transparent for the users of financial statements.

### 3.4 Acquisition Costs

The accounting of acquisition costs is closely related to the recognition of the earnings. According to the exposure draft, acquisition costs are handled differently depending on their origin: All acquisition costs that are not incremental<sup>46</sup> are directly recognised as an expense when incurred whereas the incremental part of acquisition costs is included in the present value of the fulfilment cash flows and reduces the amount of the residual margin.<sup>47</sup> These costs drop out of the measurement of the insurance liability as soon as they are incurred (which usually will be shortly before or after the conclusion of the respective contract) and are then recognised as an expense in the profit and loss statement. Hence the recognition of the incremental acquisition costs is outweighed by a reduction of the insurance liability by the same amount and has no influence on the income statement.

This differential approach for incremental and non-incremental acquisition costs is crucial for a faithful presentation of the underlying business transaction. Assume this differentiation between the two types of acquisition costs is not applied and the entire amount of the costs of initiating the contract is recognised as an expense when incurred.

- On the one hand, such an approach would lead to a completely distorted picture of the economic reality as contracts that are profitable would produce a loss in the moment of their first recognition in a company's statement of accounts. Even following the approach proposed by the IASB, the conclusion of a contract might produce a loss in the moment of its first-time recognition, if the company has had a lot of expenses that are not considered as incremental acquisition costs. This could for example be in the case a company has spent a large amount of money for a marketing campaign that allows the company to sell a big number of high-priced contracts. As the residual margin avoids any gain at inception, those costs could not be recovered, thus the company would report a loss in the period of inception for maybe highly profitable contracts.

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<sup>46</sup> The IASB defines acquisition costs as „direct and indirect costs of selling, underwriting and initiating an insurance contract.” Incremental acquisitions costs are “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.” See ED/2010/8.Appendix A.

<sup>47</sup> See ED/2010/8.39 and ED/2010/8.B35.



- On the other hand this accounting model can also produce undesirable incentives to the management of the reporting insurer: If the management's goal for the short term is to maximize the company's net earnings, it might not focus on the conclusion of new contracts even if they are profitable in the long run. This phenomenon can be summarized as having a negative influence on the stewardship function of the accounting rules described.

Furthermore, the described approach impairs the reliability characteristics of the accounting information: The differentiation between incremental and non-incremental acquisition costs is not unambiguous because the proposed definition of the term "incremental acquisition costs" is neither very precisely nor is it very detailed. Without further specification the current definition of the term allows for accounting a wide range of costs either in the one category or the other as the allocation to one of these categories is strongly dependent on the assumed time horizon. If one assumes a very long time horizon, each contract can be seen as producing a small part of all overhead costs that would not have been incurred if that specific contract had not been issued.

### **3.5 Level of aggregation**

The definition of the unit of account has no impact on the present value of the cash flows, but it substantially influences the amount of the risk adjustment. Diversification effects within a portfolio reduce the risk of the cash flows exceeding their expected value through random fluctuations. Such effects in general are the more intense the greater the considered portfolio is. Therefore, they have to be included when calculating the value of the liability.<sup>48</sup>

For the final accounting standards "Insurance Contracts", the IASB proposes the calculation of the risk margin based on a portfolio level.<sup>49</sup> A portfolio of insurance contracts is defined as a group of contracts "that are subject to similar risks and managed together as a single pool."<sup>50</sup> This means that all risk reducing effects arising from diversification between contracts of the portfolio that the valuated contract is part of are to be considered when calculating the margin for this specific contract. All other effects that result from diversification effects between risks that are managed in different portfolios do not influence the amount of the risk margin.

The definition of the portfolios relevant for calculating the risk margin will bring in an entity specific component into the measurement of the whole contract. Obviously, the size of the

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<sup>48</sup> See Farny (2006), p. 86-87.

<sup>49</sup> See ED/2010/8.36.

<sup>50</sup> ED/2010/8.Appendix A.

portfolio relevant for measuring the risk margin is strongly related to the specific criteria of an insurer to put together its contracts to a portfolio for managing risks. Furthermore, the terms used within the definition of an insurance contract portfolio allow for a wide range of interpretations. For example, it is not clear what risks are considered to be “similar”. The term similar could be referring to the probability distribution of the expected losses, but it could also refer to the origin of the underlying risk.<sup>51</sup>

Beside, the exposure draft offers the possibility to use replicating portfolio techniques instead of estimating the cash flows of the contract and adjusting them for the time value of money and the underlying risks separately. If such a replicating asset exists, the insurer can simply include the observable market price of this asset in the measurement of the whole contract.<sup>52</sup> However, this leads to another problem related to the level of aggregation: The observable market price of such a replicating asset or portfolio of assets does not necessarily reflect the above described unit of measurement which is to be applied when measuring insurance liabilities.<sup>53</sup>

Another aspect of the aggregation level which should be examined when analyzing the decision usefulness of the resulting accounting data is the effect that it has on the relevance of the financial information. Applying the approach proposed by the IASB implies that an insurer has to measure the risk margin for insurance contracts on a portfolio level independent of its size. Hence, a large insurance company will have to apply the same diversification effects in its measurement as a small insurer, even if the large company benefits much more from diversification effects arising from different portfolios. The user of the financial statement is not able to consider that fact when focusing on the balance sheet which would show an insurance liability of the same amount for both, the smaller and the larger company. Consequently it is crucial to inform the user of financial statements about further risk mitigating arising from diversification effects between different portfolios of insurance contracts within the notes.<sup>54</sup>

### **3.6 Pre-claims liability for short-duration contracts**

Unlike in the Discussion Paper “Insurance Contracts”, the IASB proposes a different measurement approach for short-duration contracts. The “*pre-claims liability*”<sup>55</sup> for insurance con-

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<sup>51</sup> For information on portfolio building from a risk theoretical point of view see *Albrecht* (1982), pp. 501-538.

<sup>52</sup> See ED/2010/8.B45-47.

<sup>53</sup> See *Ellenbürger, Kölschbach* (2010), p. 1231.

<sup>54</sup> This was also requested during the review phase of the discussion paper. E.g. see *Fitch Ratings* (2007).

<sup>55</sup> The pre-claims liability is defined as „An insurer’s stand-ready obligation to pay valid claims for future insured events arising under existing contracts (i. e. the obligation relating to the unexpired portion of risk coverage). See ED/2010/8.Appendix A.

tracts with coverage of approximately one year or less that do not contain embedded options or other derivatives that significantly affect the variability of cash flows, is measured by allocating premiums over the coverage period. Therefore the insurer has to calculate the so called pre-claims obligation which is the premium, if any, received at initial recognition plus the expected present value of future premiums, if any, that are within the boundary of the existing contract less the incremental acquisition costs. If the contract is not onerous, the pre-claims liability is the pre-claims obligation less the expected present value of all future premiums.<sup>56</sup>

A contract is onerous, if at initial recognition or subsequently, the present value of the fulfillment cash flows relating to future insured claims that are within the boundary of an existing contracts exceeds the carrying amount of the pre-claims obligation. In this case, the insurer shall recognize an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims liability and the present value of the fulfillment cash flows. This liability-adequacy-test is to be carried out on a portfolio basis, covering insurance contracts with similar date of inception.<sup>57</sup> The exposure draft does not contain any information about the frequency of the liability-adequacy-test. Thus, it is not clear if it is only applied when an insurance contract is recognized for the first time, on a regular basis or if it should be done when there occur certain triggering events. However, once a contract is onerous, the additional liability has to be adjusted at the end of each reporting period.

The incremental acquisition costs are deferred and presented as a deduction from the part of the premium allocated to the remaining coverage period as described above. Those deferred incremental acquisition costs would be recognized as an expense over time in a pattern that is consistent with the pattern in which the premium is recognized as revenue to maintain consistency with the measurement for insurance contracts generally.<sup>58</sup>

The goal of this separate measurement approach for short-duration contracts is to simplify accounting of certain insurance contracts in order to comply with the cost-benefit principle.<sup>59</sup> However, this approach requires an insurer to implement a dedicated process to determine if contracts are onerous (which requires the same information that would be needed to apply the general accounting model for insurance contracts according to the exposure draft) and also to apply a liability-adequacy-test as described above. Furthermore, we have to consider that this modified approach in general can not be applied for all insurance contracts of an insurer.

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<sup>56</sup> See ED/2010/8.54-59.

<sup>57</sup> See ED/2010/8.60.

<sup>58</sup> See ED/2010/8.BC148 (d).

<sup>59</sup> See IASB Framework.44 and ED/2010/8.BC146.

Therefore an insurer would have to implement two different accounting models, a fact, that definitely relativizes the cost savings through the simplified approach.

#### **4 Balance sheet, income statement and disclosures**

The Exposure Draft “Insurance Contracts“ demands the disclosure of substantial additional information to help users of financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts. Such additional information can for instance be found in the income statement: one requirement is to show the profits and losses which results out of changes of the risk margin, the residual margin, the estimation of the cash flows, the discount rate and losses at initial recognition of contracts separately.<sup>60</sup> Besides, also quantitative and qualitative details about the aggregated portfolio have to be given (e. g. about the nature and extend of risks arising from insurance contracts). The level of aggregation of that information has to be chosen in a way that leads to a maximum of decision usefulness for the users of financial statements.<sup>61</sup> Furthermore, a detailed reconciliation from the opening to the closing balance consisting of:

- the carrying amounts at the beginning and end of the period,
- the number of new contracts recognized during the period, the cash inflows and cash outflows,
- amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations and
- the net exchange differences arising on the translation of foreign currency amounts into the presentation currency,

is required for insurance assets and liabilities separately and also for the risk and residual margin.<sup>62</sup>

Besides, the steps of the calculation of insurance liabilities are to be described in detail. The methods and the input parameters used for calculating the risk margin, the discount rate, the estimation of policyholder dividends and other parts that have the most material effect on the recognized amounts arising from insurance contracts have to be disclosed. The effects arising from changes in the input parameters have to be shown separately for each parameter, if this

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<sup>60</sup> See ED/2010/8.72.

<sup>61</sup> See ED/2010/8.79-84.

<sup>62</sup> See ED/2010/8.86-89.

has a major impact on the financial statements. Furthermore, the IASB proposes to show a measurement uncertainty analysis of the inputs that have a material effect on the measurement.<sup>63</sup> The Exposure Draft also imposes substantial disclosures on the risk management of the insurance company. Not only nature and origin of the underwriting risk, but also information on other risks (e. g. credit risks, liquidity risks and market risks) have to be disclosed.<sup>64</sup> The insurance company will also have to comment on the management of certain risks (goals, directives and processes) and how changes in particular parameters affect the result (sensitivity analysis).<sup>65</sup>

The purpose of the substantial disclosures on underwriting and other risks should be that users of the financial statements obtain a transparent view of how the insurance company sees future developments. The disclosures shall enable the users to better estimate the uncertain future cash flows.<sup>66</sup> Probably, the IASB also wants to enhance the reliability of financial statements by requiring the insurer to give additional information as *transparency and reliability of financial information correlate positively*. Empirical studies have shown that accounting options and leeways when estimating input parameters for fair values do not necessarily lead to unreliable financial information. Transparency of *the possibilities for earnings management* (and earnings management will be possible in the case of insurance contracts as seen above) can lead to transparency of the whole financial statements which makes the information reliable again.<sup>67</sup> However, we criticize the fact that the IASB is intentionally very unclear regarding the extent and the quality of the additional information.<sup>68</sup>

## 5 Comparison: Discussion Paper vs. Exposure Draft

In the following section we would like to outline the most important changes in the Exposure Draft in comparison to the Discussion Paper besides the pre-claims liability for short-duration contracts discussed in section 3.6.

### 5.1 Service Margin

One of the most disputed parts of the model presented in the Discussion Paper “Insurance Contracts” is the service margin. Purpose of the service margin is the recognition of the com-

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<sup>63</sup> See ED/2010/8.90.

<sup>64</sup> An overview of the risks which an insurance company typically faces can be found e. g. in *Bittermann/Lutz* (2003), p. 391.

<sup>65</sup> See ED/2010/8.91-97.

<sup>66</sup> See ED/2010/8.BC242.

<sup>67</sup> See *Coenenberg, Schmidt, Werhand* (1983), p. 321 and the following pages.

<sup>68</sup> See also ED/2010/8.BC242.

compensation that a third party would require for providing management services that are linked to the insurance contract.<sup>69</sup> The service margin is calculated based on market participants' expectations with respect to the profit for providing similar services. If an insurance company calculates its premiums by using a service margin which deviates from the market values, an initial profit or loss would arise, assumed that no further margin (such as the residual margin) is considered:<sup>70</sup>

- A calculation based on a lower value than observable on the market results in an initial loss.
- In contrast, a calculation based on a higher value than observable on the market leads to an initial profit.

Hence, in theory the service margin leads to the recognition of a "usual profit" amounting to a market-conform compensation for services connected to the insurance contract during the contract period. Any profits or losses that lead back to a premium calculation which deviates from market values are recognized at inception of the contract instead. Hereby, the users of financial statements would be informed if the contracts that have been concluded in the reporting period are more or less profitable than the market average. Thus, the approach of including a service margin into the measurement of insurance liabilities can be supported from a *relevance* point of view.

However, critics fear that the practical implementation will be difficult due to the lack of market data. Usually, no active market exists for providing services that have to be considered in the margin and even if supplier for such services do exist, it would be impossible to separate the observable prices into the compensation for management services and for further issues (e. g. for operational risk and overhead expenses).<sup>71</sup> This is certainly one reason why the IASB has chosen the residual margin approach in the Exposure Draft, which takes over the functionality of the service margin at least partially. Nevertheless, we would like to emphasize that the residual margin implies a service margin amounting to the difference between the premium and the present value of the risk adjusted claims payments plus variable acquisition costs. In cases in which the residual margin amounts to zero at initial recognition, the insurance liability does not contain any amount for the expected profits of additional services. Therefore, we think that in such cases the liabilities on the balance sheet might be too low.

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<sup>69</sup> Administrative services could e. g. be the management of an investment fund. See Insurance DP.87.

<sup>70</sup> The accounting model described in the discussion paper did not intent to calibrate the insurance liability to the premium by recognizing any kind of residual or composite margin.

<sup>71</sup> See *Engeländer, Kölschbach*, (2007), p. 396.

## 5.2 Recognition of the own financial strength

The accounting approach described by the Discussion Paper “Insurance Contracts” includes also the credit characteristics of insurance liabilities within their measurement, i. e. when estimating the cash flows the insurer has to account for the probability that it falls into bankruptcy and can not pay its obligations.<sup>72</sup> However, the IASB abandoned this idea and does not intend to include the responsibility to consider the credit characteristics of insurance liabilities in a final accounting standard for insurance contracts. Considering the comments to the Discussion Paper both from scientists and users, a majority of the IASB stakeholders certainly appreciates that fact.

Nevertheless, we would like to have a look at the effect of including credit characteristics in to fair value measurement as it was the case for the Current Exit Value model.<sup>73</sup> The basic impact of recognizing the own probability of default when estimating future cash flows is a reduction in the amount of the underlying liability. Accordingly, a deterioration of the final strength of the company leads to a respective profit in the income statement.

First, it is obvious that this approach causes misleading information for the users of financial statements. Secondly, the recognition of the financial strength of an insurer is intensively disputed also from a conceptual perspective.<sup>74</sup> Furthermore, the recognition of the financial strength of an insurer would also lead to wrong incentives for the management of the insurance company if the management is interested in a high short-run annual result: as described above the deterioration of the financial strength of the own company would lead to a profit in the income statement, so the management could be interested in deteriorating or at least not improving the company’s financial strength.

## 6 Conclusion

With the Exposure Draft the IASB substantially modified the valuation approach for insurance liabilities compared to May 2007 when issuing the Discussion Paper. It is noticeable that

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<sup>72</sup> See ED/2010/8.BC50.

<sup>73</sup> See DP.232 (a).

<sup>74</sup> Heckman (2004) argues that a reduction of the measurement of liabilities due to a reduction in own credit rating is related to the right of the investors not to make any additional payments in case of bankruptcy (insolvency option). The value of this right would increase if the credit rating deteriorates and thus causes a reduction of the value of the liability. However, this right is seen as belonging to the investor and therefore should not be recognized in the company’s balance sheet by reducing the corresponding liability. Furthermore, the concept of a current exit value would require to include the financial strength of the fictitious buyer of the insurance contract, but certainly not the own. On the other hand Rockel (2004) advances the view that the value of the so called „insolvency option“ should not be recognized in the balance sheet, because also other factors relating to the credit risk are not included in the measurement of the liability (e.g. so called financial distress costs). A synthetic value would never aim at including each impact observable in the real world.

the IASB was strictly orientated towards market prices in the Discussion Paper and now has abandoned that guiding principle completely. Finally, this was also due to the fact that in the eyes of a great majority of the respondents to the Discussion Paper a synthetic construction of market prices would not be realizable. Furthermore, the IASB was influenced by the dramatic impacts of the recent financial crisis that became visible during the elaboration phase of the exposure draft: The crisis clearly showed that a price which can be directly observed on a market or which is indirectly derived from market observations can be as inaccurate as the whole market is over -or underrated. The question now is to which extend the changed model proposed by the exposure draft can enhance the decision usefulness for the users of financial statements. We think that especially the risk margin which is based on internal assumptions in combination with the residual margin give a distorted picture of economic reality. Giving a more detailed description and strict requirements would have enhanced the reliability of information from financial statements without decreasing the relevance of the information from the financial statement in such a dramatic manner.

It will be very interesting to see how the results of the second round of a field test conducted by the IASB will influence the accounting model defined through the final standard. However, the IASB clearly stated that this will not be issued before second quarter of 2011, considering the delays experienced within this project up to now, it will certainly become even late 2011 or 2012. Furthermore, also other factors are to be considered for the project "Insurance Contracts". For instance, the FASB deviates from the IASB in two essential points: In contrast to the exposure draft the FASB Discussion Paper excludes contracts with discretionary participation features from the scope of a standard for insurance contracts. In addition, the model does not contain a separate risk margin, but calibrates the insurance liability directly to the premium by using a composite margin.

Both the IASB model and the FASB model deviate from the rules according to Solvency II which require an adjustment of the insurance liabilities by an explicitly calculated risk margin. <sup>[75]</sup> In general, the concept of measuring insurance liabilities according to Solvency II is more related to a current exit value than to a fulfillment value. Therefore the exposure draft should be reviewed with respect to a consistent approach for accounting and solvency purposes. Taking into account that Solvency II and IFRS 4 projects will be required to run in parallel additionally to the implementation of the already partly issued IFRS 9 "Financial Instru-

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<sup>75</sup> See directive 2009/138/EG of the European Parliament and of the Council on 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II) (recast), articles 76-77.



ments”, two different models for solvency and accounting purposes will lead to a lack of qualified resources. A close cooperation between the related projects for changing the relevant organizations and systems with regard to Solvency II and IFRS seems to be indispensable already today as both models will require similar valuation techniques, similar data as well as similar quantitative and qualitative disclosures.

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