



**Strathmore**  
UNIVERSITY

**AN ANALYSIS ON THE ADOPTION OF IFRS 17 AND THE TRANSPARENCY OF  
FINANCIAL REPORTING IN INSURANCE COMPANIES IN KENYA.**

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**Abstract.**

This study was carried out to analyse the effect that the adoption of IFRS 17 by insurance companies in Kenya would have on financial reporting transparency. Insurers across the world and various scholars had raised concerns on the limitations of the current standard being used (IFRS 4) in insurance accounting. The data used in the analysis was obtained from the financial statements of 18 insurance companies in Kenya from 2010 to 2019. The dependent variable in the analysis was a transparency measure represented by  $R^2$  obtained from a regression involving earnings from the current and previous years. The independent variables were the Contractual Service Margin (CSM), Profit before tax (PBT) and the disclosure intensity measure. The Ordinary Least Squares (OLS) estimator was used in the analysis. Results from the analysis showed that CSM unlocked at varying rates and the disclosure intensity measure under IFRS 17 were statistically significant. All variables had positive coefficients apart from the disclosure intensity under IFRS 4. The conclusion therefore was, the adoption of IFRS 17 would enhance financial reporting transparency if, CSM was unlocked using varying interest rates, the building block approach was applied and if the disclosure requirements provided by IFRS 17 were followed.

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## **Definition of terminology**

**IASB:** International Accounting Standards Board. An independent, private-sector body that develops and approves International Financial Reporting Standards (IASB)

**IRA:** Insurance Regulatory Authority. A statutory government agency established to regulate, supervise and develop the insurance industry in Kenya.

**IFRS:** International Financial Reporting Standards. A set of common rules that are in place to ensure that financial statements are consistent, transparent, and comparable around the world (Scott, 2020)

**BBA:** Building Block Approach. The standard model of measuring the value of insurance contracts as per IFRS 17 (Elske, 2017)

**CSM:** Contractual Service Margin. This is the unearned profit the entity will recognise as it provides services in the future (Domingues, 2019)

**GAAP:** Generally Accepted Accounting Principles. A common set of accounting principles, standards, and procedures that facilitates analysis by investors and creditors. (Tuliva, 2020)

**Fair value:** The amount for which an asset could be exchanged or a liability settled between knowledgeable parties in an arm's length transaction (Dickinson, 2004)

**Financial reporting transparency:** The extent to which financial reports reveal an entity's underlying economics in a way that is readily understandable by those using the financial reports. (Schipper & Barth, 2008)

**Ordinary Least Squares (OLS) estimator:** A type of method used to estimate unknown parameters in a linear regression model.

**Variance Inflation Factor (VIF):** A measure of the amount of collinearity in regression variables

## **1. INTRODUCTION**

### **1.1 Background Information**

Financial reporting is the process of communicating information about a company's financial position, performance, and changes in the financial position to the management of the company and the relevant stakeholders such as investors and government (Grimsley, 2012). Financial reports provide information that is useful in making economic decisions. Smith (1971) states that communication occurs in financial reporting only if the meanings intended by the information source are assigned to the financial statement messages by the destination. Therefore, it is important for the users of the financial information to get the meaning that was intended by the party that prepared the financial information.

Greuning and Terblanche (2011) state that up until the mid-1990s, there was no single International Financial Reporting Standard (IFRS) that dealt with the accounting treatment of insurance contracts. Insurance accounting was based on IAS 32 (Financial instruments: Presentation) and IAS 39 (Financial instruments: Recognition and Measurement). Meyer (2005) states that while financial assets were accounted for in accordance to IAS 39, there was no IFRS for actuarial reserves (Insurance liabilities). This meant that Generally Accepted Accounting Principles (GAAP) were used to fill in where the IFRSs were missing. This situation led the International Accounting Standards Board (IASB) to start a project called "Insurance contracts". Dickinson (2003) states that the overall goal of this project was to move to fair value accounting.

The project was divided into phase I and phase II. Hennie and Simonet (2011) argue that the split of the project is because it was clear to the IASB when they embarked on this project, that all the aspects relating to insurance accounting could not be improved within a short period of time. IFRS 4 is the first phase of the project and was implemented in 2004. It requires disclosure of information about the timing, amount and uncertainty of cashflows reported in the financial statements. With IFRS 4, insurance companies evaluate, at the end of each financial reporting period, whether their liabilities are adequate. The IASB provides that this evaluation should be done using current estimates of future cashflows. If the assessment shows that the carrying

amount of the liabilities is inadequate, the deficiency is recognized as a loss. This adequacy test is a way of ensuring the goal of fair value accounting is met (Wu & Hsu, 2011)

Bloomer (2005) argues that with IFRS 4, there exists a mismatch between assets and liabilities. This is due to the differences in the valuation principles used in assets and liabilities. While the assets are valued at fair value, liabilities are valued at historical cost since obtaining fair values for liabilities is difficult due to lack of a liquid market. This creates a mismatch hence fair value accounting is not achieved. Rogers and Rubin (2006) observe that reliable market-based price information from which to measure fair value is not always available.

Scott (2007) observes that insurance accounting standards in various countries are developed on varying bases depending on the jurisdiction. This is possible because IFRS 4 allows companies to continue with some of their accounting practices. For example, Tripe and Stugnell (2013) note that in South Africa, financial reporting in the insurance industry is currently done using the Financial Soundness Valuation (FSV) method. This method requires a portion of profit to be deferred and the remaining portion to be recognized at the inception of the insurance contract yet IFRS 4 prohibits the recognition of profits at inception. Tissoudal (2016) observes that the financial reporting standards for insurance companies in Morocco are not clear. South Africa and Morocco are among the countries with large insurance industries (as per 2018) compared to other African countries therefore they can serve as an example of how insurance accounting practices vary by jurisdiction hindering transparency in the insurance industry as a whole.

In Kenya, the task of valuing insurance liabilities is vested on the insurer's board and senior management of the insurance company. Makove (2013) notes that this practice is as per the guidelines provided by the Insurance Regulatory Authority (IRA). In addition, the guidelines allow the insurer to value insurance liabilities in a way that is not in accordance with the provided principles. This is on condition that the reason for not following the guideline and the alternative valuation method is disclosed in the notes to the financial statements. This practice makes financial reporting in the insurance industry inconsistent and it also hinders transparency. Muraya and Njeru (2017) make a similar statement, they note that a large number of market participants in the insurance industry find it hard to understand and evaluate the language of insurance business and the financial statements are complicated making it difficult to assess the financial position of the insurer.

Due to limitations discussed above, IFRS 4 can be seen as a stepping stone that provides limited improvements to insurance accounting. Hence, the second phase of the project is necessary to achieve the goal of fair value accounting. This second phase is what is referred to as IFRS 17. The IASB states that IFRS 17 will ensure that insurance companies will provide relevant information that faithfully represents their financial position. Molinari and Nguyen (2012) note that this intended goal of IFRS 17 will be achieved by the introduction of an accounting model that enables the insurance company to estimate the value of its future cashflows based on their expectations. Engeländer and Kölschbach, (2006) state that the introduction of the building block approach (BBA) which is the valuation model that all insurers will be expected to use, will ensure that assets and liabilities are valued consistently at their fair values.

Cheng (2018), observes that IFRS 17 will improve transparency by providing information about the drivers of performance and source of earnings. Profits will be recognized as insurance services are being provided and disclosures about judgments made and changes in assumptions will also be provided. In addition, current estimates and up-to-date information about cash flows arising from insurance contracts will be used. Felix (2017) illustrates this point by stating that, with IFRS 17, the cashflows that are expected to arise will not only reflect the company's expectations when it entered into the insurance contract but will keep on being updated to reflect any changes in expectations.

## **1.2 Problem Statement**

Mignolet, in 2017 carried out a study in Belgium on the expected impact of IFRS 17 on the transparency of financial statements of insurance companies. The study involved interviewing professionals from four insurance companies. The findings of this study were, some of the professionals were of the opinion that the new standard will improve transparency, some were indifferent and others thought it will not improve transparency. Another study was done in Malta by Agius in 2019 on understanding the implementation process in preparation for IFRS 17. Seven interviews with audit firms who are licensed to provide services to insurance companies were conducted and a discussion with a CFO of a general insurance company. The conclusion made was, the implementation of IFRS 17 is necessary to improve comparability in the insurance industry.

Bas and Yanik, in 2017 also carried out a study on the evaluation of IFRS 17 in Turkey. Professionals from six insurance companies were interviewed. The findings of the study

conclude that IFRS 17 will be beneficial for both investors and the insurance companies by requiring recognition of all insurance contracts consistently and this will solve the comparison problems created by the IFRS 4. A factor that cuts across these studies is the research method used; they all involved interviewing relevant professionals. However, these studies take a general perspective of the standard. Their aim is to evaluate the general effect of adopting IFRS 17, therefore, general changes to the standard were studied. This can be attributed to the fact that there is a need to educate insurance companies on the dynamics of IFRS 17 since it is a relatively new standard. Jimmy and Widing (2017) make a similar observation; they state that since the standard is new in the industry, the emphasis is on educating the relevant industry players.

In Kenya, a study was done by Kabiru and Mwangangi in 2012 on financial reporting and disclosure by insurance companies. The study involved identifying the gaps in financial reporting against best practice. This was done by reviewing relevant literature and documentation such as financial statements of insurance companies. The conclusion was, there exist gaps in reporting and disclosure of information by insurers. They further observe that there is a general dissatisfaction with insurance companies' current primary financial disclosure statements and the form of financial reporting in terms of usefulness and adequacy. The conclusions of this study show that financial reporting transparency is lacking in the Kenyan insurance company. Njiruh (2011) states that the future of financial reporting of insurance companies needs to reflect the key economic realities of the day and underpin the underlying business model of insurance companies.

Based on the Kenyan case study, there is a need to improve insurance financial reporting transparency. Lucrezia (2019) states that IFRS 17 has introduced changes with regards to the valuation model, the contractual service margin (CSM) and the presentation of items in the income statement, with the intention of enhancing transparency. However, will these changes enhance transparency in financial reporting in the Kenyan insurance industry? It follows that this study will be useful in analysing whether the problem of lack of transparency will be solved by implementing IFRS 17. It will involve comparing the current financial statements as per IFRS 4 to the requirements of IFRS 17 as opposed to carrying out interviews.

### **1.3 Objectives of the study**

1. To analyse the effect of the building block approach (BBA) on financial reporting transparency.
2. To analyse whether the contractual service margin (CSM) will enhance transparency of profitability.
3. To analyse whether the new concept of recognizing revenues and expenses in the income statement provided by IFRS 17 will enhance transparency.

### **1.4 Research Questions**

1. What effect does the building block approach (BBA) have on financial reporting transparency?
2. Does the contractual service margin (CSM) enhance transparency of profitability?
3. Does the new concept of recognizing revenues and expenses in the income statement provided by IFRS 17 enhance transparency?

### **1.5 Importance of the Study**

This study seeks to add to the existing pool of studies done on the implementation of IFRS 17. AIB Capital (2019) states that insurance companies are expected to educate the users of their financial statements on the implications of IFRS 17, since majority of them are not conversant with the new standard. The users that need to be educated are mostly investors and the regulator. For the investors, understanding of the financial statements is important as the economic decisions they make are based on them. For the regulators, a good understanding of the financial statements will make supervision easier.

#### **1.5.1 Insurance Companies**

Mwarania (2018) notes that insurance companies in Kenya face the challenge of understanding the operational impact of the standard on data, systems and processes and therefore it is necessary to understand the likely impact as early as practicable. This research will be important in helping insurance companies understand what the new standard requires of them, especially in terms of transparency. The insurance companies will know the type of data and information systems needed for them to provide information that will reveal a true and fair value of its financial position as per the requirements of IFRS 17.

### **1.5.2 Investors**

Kabureck (2018) argues that the changes brought by the adoption of IFRS 17 will make it easier for non-specialist investors to understand insurers' income statement. This is so because insurance companies will recognise revenue as the insurance coverage is delivered and will also provide information about the different components of profit (IFRS, 2017). The investors will therefore get more transparent information about the profitability of the company since the insurance revenue will only reflect insurance services offered by the insurance company.

### **1.5.3 Insurance Regulators**

IFRS 17 will lead to a consistent accounting framework for insurance companies (Palmborg & Lindskog, 2017). This will make it easier for the Insurance Regulatory Authority (IRA) to assess the compliance of insurance to the financial reporting guidelines. With the current accounting practices, insurers apply a wide range of accounting practices (IASB, 2016) and this makes it challenging to discover non-compliance since the assumptions and estimates made are based on the company's judgement which is subjective.

### **1.6 Scope of the study.**

This study focuses on the insurance industry of Kenya. As such, it will analyse financial reporting in insurance companies in Kenya. The analysis will cover time period from 2010 to 2019. This time period is relevant because the insurance companies apply IFRS 4 in their financial reporting and also because most insurance companies make their financial statements available to the public. The analysis will be done by comparing the current financial reporting practices to the provisions of the new standard.

## **2. LITERATURE REVIEW**

### **2.1 Introduction.**

IFRS 17 establishes the principles for recognition, measurement, presentation, and disclosure for insurance accounting. The standard provides a comprehensive model for insurance financial reporting while taking into account all relevant accounting aspects (Ernst & Young, 2017). George and Mironela (2009) observe that at a general level, transparency is achieved by full disclosure of information and providing a fair representation of such information. The study in this section will therefore expound on how IFRS 17 will achieve transparency by ensuring fair representation of information and the requirement on disclosure of information, as per the explanation given in the previous sentence.

The main source of the information discussed in this section will be the publications from the IASB. This is because the development of IFRS 17 is a task that has been done by the IASB. The study will look into the discussion paper, exposure drafts and any amendments to the standard. Other than the Board's publications, this section will also take into account the perspectives of different scholars and professionals with an interest in IFRS 17. As mentioned in previous sections, the focus will be on the building block approach, the contractual service margin and presentation of items in the income statement.

### **2.2 Theoretical Literature**

#### **Building Block Approach**

Darrel (2017) notes that the board's preliminary view was that the insurer should measure all its insurance liabilities using three building blocks. This method of valuation is known as the building block approach. This model calculates the present value of future net cashflows taking into account the risks that the entity expects to incur. Tan (2010) states that the variables used for the valuation should be consistent with the observable market price. This ensures that the valuation produces up to date results. The latest exposure draft published by IASB in June 2019, does not contain any amendment to this valuation method. This means that there is no objection to this valuation method from the interested parties, hence, it will be implemented when the final standard is published.

The first building block contains all the cashflows the insurance company expects, that is, both inflows and outflows. IFRS (2017) explains that these cashflows should be within the boundary

of the insurance contract. This means that the cashflows to be included are only those which either party have a contractual obligation to pay. For example, for an insurance contract that will be reviewable at some point, the boundary is that point at which there is the possibility of the contract ending. Any cashflows beyond that point should not be considered even though the insurer expects the contract to be renewed. Laffler (2018) gives examples of the cash flows to be considered as, premiums, claims, claims expenses and acquisition or maintenance expenses that can be attributed directly to the insurance contract and are part of providing the insurance service.

The IASB provides that these estimates of the future cashflows should take into account the probability-weighted mean of all possible outcomes, should be explicit and should reflect the assumptions made at the measurement date. Nicholl (2018) argues that this requirement means that the future cashflows should be estimated using best estimate assumptions of the company's future experience. This will ensure that the information used is not outdated and it reflects the true and fair financial position, hence enhancing transparency. The estimates will be based on relevant market and non-market variables. For instance, an insurance company can use historical data to estimate claims or use inflation forecasts to estimate the cost of benefits (Lucrezia, 2019). The aim here is to choose variables which will reflect the perspective of the entity, in this way financial reporting transparency will be enhanced.

The estimated future cashflows will then be discounted to reflect the time value of money. This is where the second building block comes to play. It contains the discount rate that will reflect not only the time value of money but also the financial risks related to the cashflows. McKenzie & McWilliam (2017) argue that the general principle is; the chosen rate should be consistent with the characteristics of the future liability cash flows. Therefore, the rate should be consistent with observable current market prices and should exclude the effect of factors that do not affect the future cash flows of the insurance contracts (Burton, 2017). These requirements have been put in place to ensure that discounting is based on relevant and current information.

The third building block involves risk adjustment for non-financial risk. Non-financial risks bring about uncertainty about the timing and amount of cashflows. Typical non-financial risks an insurer is prone to face include mortality risk and withdrawal risk. These risks need to be reflected in the discounted estimates of the future cashflows, therefore, the risk adjustment can be understood as the price assigned by the insurer for bearing the non-financial risks associated

with the portfolio of insurance contracts (Iturria, 2019). The risk adjustment will give the users of the financial statements the insurer's perception of the effects of the uncertainty about timing and amount of cashflows arising from the contract. This information will enhance their decision making as they will be more informed on the financial position of the company with regards to non-financial risk (Mignolet, 2017). The three building blocks are collectively called the fulfilment cash flows.

### **The Contractual Service Margin (CSM)**

The CSM is the final element of the building block approach. It represents the unearned profit the entity will recognise as it provides services in the future. Domingues (2019) argues that the idea is to release profits steadily as services are being provided as opposed to recognizing a big profit at the inception of the contract. This practice will enhance the smoothness of profits and act as a buffer for changing assumptions (Ford, 2018). It follows therefore that the CSM is only created in cases where the estimated future cashflows project a profit on the day of inception. So as to enhance transparency in profitability, there will be two elements, CSM at initial recognition and CSM at subsequent recognition.

#### **CSM at initial recognition**

CSM is calculated initially as the difference between the present value of the cash inflows and the present value of cash outflows and the risk adjustment. Where the present value of the cash inflows is greater than the present value of cash outflows and the risk adjustment, the result will be the profit the insurer expects to make (CSM). This is the amount that will be released and recognized in the income statement as the insurance services are being delivered. Herbert (2018) states that the reason why day one gains are not recognized is because the entity has not yet satisfied any of its performance obligations. Therefore, recognizing all profits at inception, as is currently the practice, gives a distorted view of the company's profitability.

In cases where the present value of cash outflows and the risk adjustment is greater than the present value of the cash inflows, the company expects to incur a loss. The contract is said to be onerous in this case. IFRS (2017) provides that such losses should be recognized immediately in the income statement. This practice is consistent with accounting principles that require recognition of losses up front. CSM is set to be equal to zero thereafter. Sammy (2018) argues that CSM cannot be a negative value as this would mean that the company is recognizing a loss and spreading it over time which is not a prudent measure. Generally, there

is an asymmetric treatment of profit and losses, where profits are smoothed out over the lifetime of the insurance contracts, losses are recognized immediately (Murphy, 2017)

### **Subsequent recognition of CSM**

The fulfilment cash flows will be updated in each reporting period so as to reflect current underlying assumptions. Lindholm (2017) notes that any changes to the fulfilment cashflows will reflect on the carrying amount of CSM. Consequently, CSM will be evaluated after each reporting period. Changes in fulfilment cash flows that relate to future services will be added to CSM if favourable and deducted from the remaining CSM if unfavourable. If as a result of the unfavourable changes CSM becomes zero, any further changes will be recognised in profit or loss. This process of subsequently adjusting CSM is referred to as unlocking of the CSM (Marszalek, 2017)

Mathias (2020) states that the Board provides that the accretion of interest on the CSM should be based on a locked-in rate. This means that the rates that were used at inception should still be applied. This presents an inconsistency as the fulfilment cashflows are measured on the current basis. It can be argued that since CSM is not unlocked for changes in discount rates, it is sensible to use locked-in rates, (Actuarial Society of South Africa, 2018). However, should locked-in rates still be used despite the fact that they reflect the financial position as at the inception of the contract as opposed to the current financial position? This research will consequently seek to determine whether the use of locked-in rates to unlock CSM enhances financial reporting transparency.

### **Separation of components to be included in P&L and OCI**

Wong (2017) argues that IFRS 17 will be based on the concept of releasing margins. This is opposed to the current way of recognizing impacts on assets and liabilities when they occur. An example that illustrates this point is the CSM which has been discussed in the previous section. In particular, the IASB requires insurance companies to split the amounts recognized in the income statement into, an insurance service result and insurance result. Tristan (2012) argues that this distinction is meant to clearly differentiate the sources of income, that is, whether it is as a result of services arising from the insurance contract or from the investments that the insurance company has undertaken. This enhances the quality of information hence the users of the financial statement will make better economic decisions.

IFRS (2017) provides that the insurance service result comprises of revenue and expenses arising from the insurance contracts issued. Insurance revenue entails the consideration that an entity expects to be entitled to in exchange for the services it has provided in line with the contract. Insurance expense, on the other hand, entails incurred claims and any other amounts incurred in providing insurance service. Whittington (2017) states that profits included are those arising from the release of margins held against insurance risk, such as the release of the CSM and the risk adjustment. The insurance service result will be recognized in the profit or loss statement of the entity.

Insurance finance result comprises of the profit or loss arising from the net effect of financial assumptions made about the entity's assets and liabilities. An example is investment return on the assets and insurance finance expense on the liabilities. Lothar (2018) additionally, states that the change in the carrying amount of the insurance contract resulting from changes in the time value of money and changes in financial risk. The IASB provides that an entity can choose whether to recognize the whole amount insurance finance result in the statement of profit or loss or a portion of it in other comprehensive income. The disaggregation of the total amount is done to eliminate any accounting mismatches. Mignolet (2017) argues that this will have the effect of smoothing volatility of the market interest rate impacting the entity's profit or loss. The question that this study will seek to answer is; Is there an appropriate basis on which the insurance company should choose to allocate proportions between the statement of profit or loss and other comprehensive income so as to enhance transparency?

### **2.3 Empirical Literature**

IFRS 17 is a relatively new standard and seeing that the implementation date provided by the IASB has been set for 2023, most insurance companies have not yet implemented it. This explains why most of the empirical studies are qualitative in nature mostly involving interviews with professionals in the insurance industry in an attempt to obtain their opinions on the perceived effect of the standard. It follows therefore that this section will look at different interviews that were carried out by various researchers on the effects of the implementation of IFRS 17.

#### **Transparency levels with the application of the Building Block Approach**

In an attempt to include the relevant industry players in the process of developing the standard, the IASB carried out fieldworks. The main objective of these fieldworks was to evaluate if IFRS 17 is applicable under the normal conditions and to identify any challenges that may be

faced in the implementation process. The fieldworks that were undertaken between 2010 and 2012 involved 194 different companies that are affected by the standard. Most of the respondents supported the core measurement approach (BBA), at a general level. However, there were differing opinions on the discount rates that will actually give a true representation of the company's economic reality. Some argued that locked-in rates should be used and they should not be further updated. Others argued that the discount rates should be updated to reflect the characteristics of the contract and that the basis of these rates should be chosen by the respective company.

### **Transparency in profitability**

Deloitte carried out a study in 2018 whose aim was to obtain insurers' perspective on IFRS 17 and how they are preparing for its implementation. The study involved 340 insurers across the globe. In relation to the new concept of CSM, most insurers agreed that this concept of releasing profits as they are earned will result in financial statements that reflect the performance of business results better. Consequently, they expect that the profits in the first year after the application of IFRS 17 will be lower than or the same as before. The findings also reveal that most insurers still need further guidance on how to recognize this unearned profit or loss subsequently. There were conflicting views on the accretion of interest on the CSM.

### **Income statement transparency**

Eleonora and Nadya carried out a study in Russia in 2017 seeking to determine whether insurance companies are ready for the implementation of the new standard. It involved carrying out interviews in 10 insurance companies. One of the questions of interest was that of the split recognition between the income statement and other comprehensive income. Most respondents agreed that this concept is likely to reflect the company's core business and this will enhance the quality of information provided to the users of the financial statements. However, it still remains unclear to some of the respondents how this new concept will actually work. They foresee difficulties arising from the fact that some companies have a strong tradition of using the profit or loss account to account for changes in the time value of money.

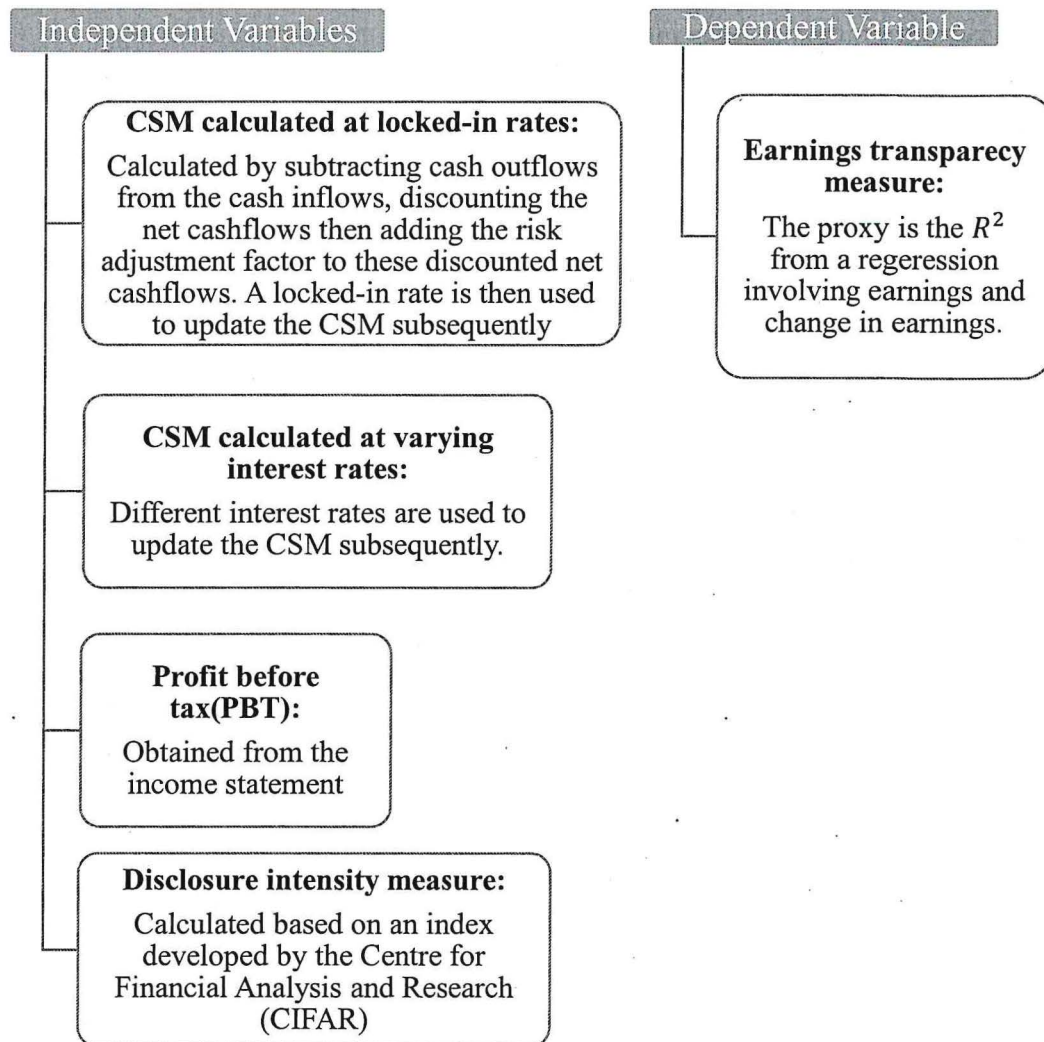
## **2.4 Conceptual Framework**

From the above discussions the key elements that will be used in this study to measure transparency will be, the measurement model, the contractual service margin and the presentation of items in P&L and OCI. The independent variables that will be used as

approximate measures of the key elements are: CSM calculated at a locked-in interest rate, CSM measured at varying interest rates, profit before tax and the disclosure intensity measure. CSM is used as a variable because it is a direct and measurable result of the BBA measurement model. Profit before tax is included since it is a measure of profitability under IFRS 4 and can therefore be compared to CSM. The disclosure intensity is a measure that is used to determine the level of disclosure in the income statement.

The dependent variable will be a measure of transparency. The measure that will be used is the earnings transparency measure developed by Landsman. et al (2014). This transparency measure is used because the independent variables are related to the earnings of the company. Below is a diagram representing the variables and a brief description of how they are calculated. A detailed explanation of the calculation procedure will be given in the methodology section.

**Figure 1: Representation of the conceptual framework**



### **3. METHODOLOGY**

#### **3.1 Research Design**

This study was carried out to determine whether financial reporting transparency in the Kenyan insurance company would be enhanced as a result of implementing IFRS 17. This was done by establishing whether there was a causal-effect relationship between the independent and dependent variables that were used in the study. As such, the study was therefore classified as an experimental research. Since the study involved objective measurements and statistical analysis of the data collected using computational techniques it was classified as a quantitative study.

#### **3.2 Population and Sampling**

The population was based on the insurance companies that were in existence as of 2010. This year was chosen because it was the start of the period of this study. The convenience sampling method was used to obtain a sample from the population. This method was chosen because the availability of the required data was not systematic and the decision to make the financial statements public rests entirely on the insurance companies, especially those not listed on the Nairobi securities exchange. This meant that the sample could only include data that was accessible to the public. As of 2010, there were 45 insurance companies in Kenya.

There were 6 acquisitions in the industry. The acquired companies were, CFC insurance, Gateway insurance, Mercantile insurance, Real insurance, Shield Assurance and First Assurance. There were 2 mergers in the industry, the first was between Insurance Company of East Africa (ICEA) and Lion of Kenya Insurance company and the second was between UAP and Old Mutual. 3 insurance companies were liquidated. These were, Blue Shield insurance, Concord insurance and the Kenya National Assurance Limited (KNAC). During the 2010 to 2019 period there were some insurance companies that were incorporated. These were, Xplico, Takaful, Pioneer, Metropolitan Cannon and Mua Insurance companies. All these mentioned companies were excluded from the sample because it was not possible to obtain financial statements for the whole study period of 2010 to 2019.

Out of the original 45 companies, the above exclusions left 32 insurance companies available for the study. 18 companies out of the 32 companies had their financial statements available

to the public. Therefore, the sample contained financial statements of 18 insurance companies from the year 2010 to 2019.

### 3.3 Data Collection

Secondary data was used in the analysis. Data from financial statements of 18 insurance companies in Kenya was used. The financial statements were obtained from the respective companies' websites. The data that was obtained from these statements was; the premiums received, claims expenses and other expenses related to the provision of insurance services. These amounts were used to calculate the fulfilment cashflows as per the BBA approach. Disclosures to the financial statement, specifically in relation to the income statement and the accounting policy used were also obtained from the financial statements. These disclosures were used to come up with the disclosure intensity measure. Information on earnings, obtained from the financial statements was used to determine the measure for earnings transparency.

In order to discount the net cashflows obtained as a result of subtracting expenses from premiums, data on discount rates was needed. Inflation rates and the discount rates provided in the Actuarial tables were used as proxies to the discounting rate. These rates were applied to the net cashflows to determine their present values. Inflation rates data was obtained from the Central Bank of Kenya. The Kenya Mortality tables, obtained from the Insurance Regulatory Authority website, was used to obtain data on mortality rates that was used as the proxy for the risk adjustment factor. This risk adjustment was added to the fulfilment cashflows to obtain the CSM. Profit before tax (obtained from the financial statements) was used as the approximate equivalent of CSM in the previous IFRS 4. Therefore, it was used as a tool of comparison in our analysis.

### 3.4 Data Analysis

#### 3.4.1 Earnings transparency measure calculation

The proxy for earnings transparency measure, denoted by *Transp*, is the  $R^2$  obtained from the regression below:

$$PBT_{i,t} = \gamma_0 + \gamma_1 E_{i,t} + \gamma_2 \Delta E_{i,t} + \varepsilon_{i,t}$$

Where:

$PBT_{i,t}$ : The profit before tax of company  $i$  at time  $t$

$E_{i,t}$ : The earnings of company  $i$  at time  $t$ .

$\Delta E_{i,t}$ : The change in earnings from year  $t-1$  to  $t$  for company  $i$ .

$\varepsilon_{i,t}$ : Error term

$\gamma_j$ : The unknown parameters.

### 3.4.2 Disclosure Intensity measure calculation

The disclosure intensity measure was calculated based on an index developed by the Centre for Financial Analysis and Research (CIFAR) and the disclosure requirements of IFRS 17. The disclosure measure was evaluated by examining a list of 30 items disclosed by a sample of large companies with regards to the accounting policy used and the income statement. If the information on an item was available in the financial statements under study, one point was awarded. The results were then converted into a percentage and translated into scores from 1 to 10 with a higher score indicating greater disclosure.

### 3.4.2 Model Specification and Variable Description

The model used was a standard linear panel data model. This was because the analysis was carried out using cross-sectional data over a period of time. The model is given by:

$$Transp_{it} = \beta_0 + \beta_1 PBT_{it} + \beta_2 CSML_{it} + \beta_3 CSMU_{it} + \beta_4 DisclA_{it} + \beta_5 DisclB_{it} + \varepsilon_{it}$$

Where:

$Transp_{it}$ : The transparency measure for company  $i$  at time  $t$

$PBT_{it}$ : Profit before tax for company  $i$  at time  $t$ .

$CSML_{it}$ : CSM unlocked using locked-in rates for company  $i$  at time  $t$ .

$CSMU_{it}$ : CSM unlocked using varying discount rates for company  $i$  at time  $t$ .

$DisclA_{it}$ : Disclosure intensity under IFRS 17 for company  $i$  at time  $t$ .

$DisclB_{it}$ : Disclosure intensity under IFRS 4 for company  $i$  at time  $t$ .

$\varepsilon_{it}$ : The error term for company  $i$  at time  $t$ .

$\beta_j$ : The unknown parameters that will be estimated.

### 3.4.2 Estimation Procedure

The financial statements for some of the companies for the year 2019 were not yet made public. This problem needed to be dealt with first so as to make the analysis thorough. Linear interpolation was the method that was used to deal with the missing data points, due to its simplicity. A multiple regression of the panel data was then run. The OLS estimator was used to estimate the variable coefficients. Diagnostic tests on multicollinearity, heteroskedasticity and normality were then carried out. These tests were performed to determine whether the OLS estimator produced efficient estimates.

Multicollinearity exists where the independent variables are highly correlated. Severe multicollinearity makes the estimates of the coefficients very sensitive to small changes in the model making it difficult to interpret them. To check for this, the value inflation factor obtained from running a simple regression was used. Heteroskedasticity exists where the variance of the error term is not constant. The presence of heteroskedasticity makes the Ordinary Least Squares (OLS) estimator insufficient. The test that was carried out to check for heteroskedasticity was the Breusch-pagan test. A histogram of residuals was used to check for normality.

#### 4. FINDINGS.

##### 4.1 Introduction.

To comprehend the data set more, a descriptive analysis was first carried out then the OLS estimator was used to determine whether the adoption of IFRS 17 will have an impact on the level of financial reporting transparency in insurance companies in Kenya.

##### 4.2 Descriptive statistics.

**Table 1: Descriptive statistics**

Variable	Mean	Std dev	Min	Max	Kurtosis	Skewness
Transp	0.69	0.18	0.37	1.00	1.08	0.00
PBT	78,968,729	253,774,102	-3,365,500	1,239,405,530	1.80	0.53
CSML	237,133,100	1,004,003,115	0	7,475,126,123	2.42	1.25
CSMU	228,784,560	967,136,314	0	7,475,126,123	3.04	2.28
DisclA	7.38	0.96	5.67	9.00	0.66	-0.10
DisclB	5.54	1.01	3.67	7.00	1.14	-0.22

There was a total of 180 observations, that is, 18 insurance companies across 10 years. From the table, the average Transp was 0.69. Transp is the  $R^2$  obtained from the regression that was used to come up with the transparency measure. This showed that the model used was a good fit of the observed data. The minimum value for CSM under both standards was 0, this was consistent with the requirement of the standard to recognize a zero amount whenever the company incurred a loss.

The disclosure intensity measures were negatively skewed while the other variables were positively skewed. A kurtosis of greater than 3 implies non-normality of the data. In this case, CSMU had a kurtosis that was slightly more than three which indicates that the data was not normal. This should not have any impact on the main regression since the model requires normality of the residuals and not necessarily the variables used in the regression.

##### 4.3 Findings.

The results from the regression are given in the table 2 below.

**Table 2: Regression results**

<b>Variable</b>	<b>Coefficients</b>	<b>Standard Error</b>	<b>t Stat</b>	<b>P-value</b>
PBT	2.89145	0.65990	0.07682	0.93886
CSML	0.43980	0.35433	1.55820	0.12100
CSMU	5.02349	0.36933	-1.58030	0.01585
DiscIA	1.20018	0.06512	-1.12095	0.04385
DiscIB	-3.38933	0.06096	0.99588	0.32069

#### **4.3.1 The effect of the building block approach (BBA) on financial reporting transparency.**

The first objective of this study was to analyse the effect of BBA on financial reporting transparency. As mentioned in the conceptual framework, our measure of the effectiveness of BBA was the CSM. The results of the analysis showed that CSM unlocked at varying interest rates was statistically significant at a 95% confidence interval level. It had a positive coefficient which implied a positive relationship with financial reporting transparency. CSM unlocked using locked in rates was statistically insignificant but the value of its coefficient signified a positive relationship with financial reporting transparency.

#### **4.3.2 The enhancement of transparency of profitability.**

The second objective was to analyse whether CSM will enhance transparency of profitability. As mentioned in previous sections, profitability was measured using CSM under IFRS 17 and for this analysis, PBT was the measure of profitability under IFRS 4. The coefficients on these two variables were used to achieve the second objective. PBT was statistically insignificant but had a positive coefficient, which indicated a relationship between it and transparency. CSM also had a positive coefficient, which indicated a positive relationship with transparency.

#### **4.3.2 Recognition of revenues and expenses.**

The last objective was to analyse whether the new concept of recognizing revenues and expenses in the income statement provided by IFRS 17 will enhance transparency. To achieve this objective, the disclosure intensity measure was used. How the company recognized its revenues and expenses was reflected by its disclosure intensity score. This analysis found that

the disclosure intensity measure under IFRS 17 was significant at a 95% confidence interval level. It also had a positive relationship with transparency. The disclosure intensity measure under IFRS 4 was however statistically insignificant but its coefficient showed a negative relationship with transparency. Therefore, there is a relationship between the criteria used to recognize revenues and expenses and financial reporting transparency.

#### 4.4 Diagnostic tests.

##### **Multicollinearity.**

The variance inflation factor(VIF) was used to test for multicollinearity. As a general rule, a VIF factor that is greater than 10 shows high multicollinearity. The null hypothesis was; no multicollinearity existed while the alternative was; multicollinearity existed. This assumption was critical for the OLS estimator to be efficient. The VIF of the independent variables were all less than 10, hence the null hypothesis was accepted.

**Table 3: VIF factors**

<b>Variable</b>	<b>VIF</b>
PBT	1.56
CSML	3.42
CSMU	1.81
DiscIA	1.05
DiscIB	2.15

##### **Homoskedasticity.**

For the OLS estimator to be efficient, the assumption of homoskedasticity needed to hold. This meant that the variance of the error terms had to be constant. The Breusch Pagan test was used to test for homoskedasticity. The null hypothesis was; the error term was homoskedastic while the alternative hypothesis was; the error term was heteroskedastic. The p-value of the f statistic was greater than 0.1, therefore the null hypothesis was accepted.

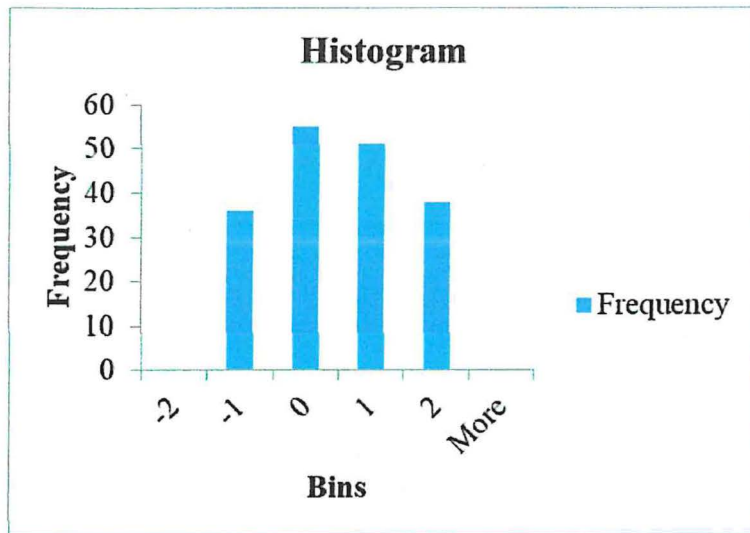
**Table 4: Breusch Pagan test**

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>p-value</i>
Regression	5	0.00582	0.00116	1.2703678	0.278825674
Residual	174	0.15931	0.00092		
Total	179	0.16512			

## Normality

The residuals had to have a normal distribution for the OLS estimator to be efficient. Therefore, the null hypothesis was; the residuals had a normal distribution and the alternative hypothesis was; the residuals had a non-normal distribution. To test for normality, a histogram of the residuals was plotted. In our case, the histogram indicated a normal distribution hence the null was accepted.

**Table 5: Normality test**



The results of the diagnostic tests showed that the OLS estimator was an efficient estimator.

## **5. DISCUSSIONS AND CONCLUSIONS.**

### **5.1 Introduction and overview.**

In this section, the results presented in the previous chapter are interpreted, linking them to the objectives of the study and conclusions are made. The objectives of this study were, to analyse whether: the contractual service margin (CSM) will enhance transparency of profitability, the new concept of recognizing revenues and expenses in the income statement provided by IFRS 17 will enhance transparency and to analyse the effect of the building block approach (BBA) on financial reporting transparency. To realize this objectives, the OLS estimator was used.

### **5.2 Discussions.**

#### **5.2.1 The building block approach (BBA).**

CSM had a positive relationship with financial reporting transparency. This meant that the application of the BBA, whose direct result is the CSM, increased financial reporting transparency as shown by the positive coefficients. This result was consistent with literature that supported the application of the BBA model so as to enhance transparency (Burton, 2017). This enhancement can be attributed to the fact that the building block approach only considered cash flows that could be attributed directly to the insurance contract and are part of providing the insurance service.

#### **5.2.2 The contractual service margin (CSM)**

Both profit before tax (PBT) and CSM had a positive relationship with financial reporting transparency. However, the coefficient on CSM unlocked at varying interest rates was the highest, followed by that of PBT, then the one on CSM unlocked at locked-in rates. This implied that financial statements were more transparent when CSM was subsequently unlocked at varying interest rates. Moreover, the financial statements were more transparent when PBT was used as a measure of profitability than when CSM unlocked using locked in rates was used as a measure of profitability. Since the coefficient on the latter was higher than that of the former.

Studies that state locked-in rates should be used to update the CSM consequently, were negated by the results of this study (Actuarial Society of South Africa, 2018). This can be explained by the fact that locked in rates do not provide an updated view of the current economic situation. Based on the results, an insurer is better off using PBT as a measure of profitability than using CSM unlocked using locked-in rates if the goal is to be transparent. However, CSM unlocked

using varying interest rates enhanced financial reporting transparency to a higher level. This is because the rates took into account current economic conditions.

### **5.2.3 Income statement transparency.**

The disclosure intensity measure under IFRS 17 increased financial transparency, shown by the positive coefficient. This supported a study that showed the application of the disclosure requirements by IFRS 17 enhanced financial reporting transparency (Tristan, 2017). On the other hand, the disclosure intensity measure under IFRS 4 had a negative coefficient. This meant that it decreased financial reporting transparency. This result did not support the objective that was designed by the board when coming up with those disclosure requirements but it supported studies that stated the disclosure practices under IFRS 4 were limited (IFRS, 2017).

### **5.3 Conclusions.**

Based on the results of this study, the adoption of IFRS 17 will have an effect on the transparency of financial reporting in insurance companies in Kenya, either positive or negative. The use of the building block approach to recognize cashflows, the use of CSM unlocked using varying interest rates and the application of the disclosure requirements of IFRS 17, will all serve to increase transparency of financial reporting. On the other hand, the use of CSM subsequently unlocked using locked-in rates and the use of the current disclosure practices will decrease the levels of transparency in financial reporting.

### **5.4 Areas of further research**

Insurance companies invest a substantial amount of their income in financial instruments. This therefore implies that they are greatly affected by the standard guiding the accounting treatment of financial instruments. With the amendments that have been made to IFRS 9-Financial instruments, it would be interesting to carry out a research on how these two new standards (IFRS 17 and IFRS 9) will interplay to enhance financial reporting transparency.

### **5.4 Limitations to the study.**

This study was carried out with the assumption that all insurance companies in Kenya will comply with the requirements of IFRS 17 when the mandated time for them to adopt the standard comes. The problem with this assumption is that different insurers might understand (and hence apply) the standard in different ways, given its technicality and complexity. It is

therefore recommended that the study should be carried out again once the standard is adopted and the results compared.

## APPENDIX.

### The disclosure index.

1	Accounting policies for insurance contracts and related assets, liabilities, income, and expense.
2	The recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts.
3	Information about the assumptions that have the greatest effect on the measurement of assets, liabilities, income, and expense.
4	The effect of changes in assumptions.
5	Reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs.
6	Risk management objectives and policies.
7	Terms and conditions of insurance contracts that have a material effect on the amount, timing, and uncertainty of the insurer's future cash flows.
8	Sensitivity to insurance risk.
9	Concentrations of insurance risk.
10	Actual claims compared with previous estimates.
11	Information about credit risk, liquidity risk and market risk.
12	Information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.
13	The amounts recognised in its financial statements that arise from insurance contracts.
14	The significant judgements, and changes in those judgements, made when applying IFRS 17.
15	The nature and extent of the risks that arise from insurance contracts.
16	Statement of Comprehensive Income disclosures.
17	The reconciliation of contract revenue.
18	The disaggregation of information for insurance contracts issued and reinsurance contracts.
19	The carrying amounts of financial assets measured at fair value through profit or loss.
20	Operating income.
21	Income tax expense.
22	Minority interest.
23	Net income reported.
24	Details of long-term investments.
25	Accounting for goodwill.
26	Deferred taxes.
27	Research and development costs.
28	Foreign exchange gains/losses.
29	Foreign currency translation method.
30	Acquisition method.

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