The risk of true and fair view concept achievement by insurance companies in their financial statements.
Case of Poland.

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by

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Abstract

Insurers, as one of the key sector in every economy, need to be perceived as entities presenting in their financial statements, true picture of their financial situation. The problem with truth, however, is still a subject of many discussions within the literature and on the sector authorities level. The aims of that paper is to present how additional disclosures required by stakeholder (through so called market discipline) and new regulatory framework (as international financial reporting standards) may close information gap between insurers' investors and management. Additional disclosures in our opinion should also lead to enlarging the scope of truth within financial statements of insurance companies.

Key Words: insurer's financial statement, disclosures of insurer

Introduction:

Different groups of stakeholders, including analysts, owners, sector regulators and standard setters depend on information included in financial statements. Though there is quality and quantity of information that really matters while undertaking business decisions. However, disclosure of information concerning risk exposure is one of such omission the may strongly affect financial standing of reporting company in the eyes of financial statements' recipients (Jorgensen and Mano, 1985; Arenberg 1970). Furthermore, there is widely agreed assumption that enlarging the scope of disclosures, especially those, which are included in year-end financial statements, enables investors closing the information asymmetry gap and agency costs related to agency theory (Huang and Zhang, 2012; Black 2001; Bushman and Smith, 2001). Under classical approach to agency theory the separation of corporate managers from outside investors involves an inherent conflict. Therefore there is a need for designing and implementing effective corporate control mechanisms by which managers would be disciplined to act in the investors' interest. These mechanism include both internal mechanisms, such as managerial incentive plans, director monitoring, and the internal labour market, and external mechanisms, such as outside shareholder or debtholder monitoring, the market for corporate control, competition in the product market, the external managerial labour market, and securities laws that protect outside investors against expropriation by corporate insiders (Bushman and Smith, 2001).

Financial reporting, apart from measurement of effects of business operations, which ought to be quantifying in monetary measure, depends in many cases on decisions of the preparer of the financial statements. It can be argued that this human aspect, which relates to intentions and behaviour of people responsible for financial statement preparation, need to be evaluated depending on measurement adequate to social science (including sociology). It largely agreed that truth in accounting might be achieved as a consequence of implementing true and fair view concept. True and fair view concept was presented as an overriding accounting assumption and in accounting means fundamental truths (Byrne, 1937) or general law and rules adopted as a guide to action (May, 1937). Financial statements should disclose all those necessary things to make them not misleading (Sprouse and Moonitz, 1962). Otherwise they give completely wrong impression about entity's financial standing. That simple tenet is obvious but (unfortunately) often forgotten by financial statements' preparers.

Truth in accounting is perceived to be on of the three main underlying principles in accounting. The other two underlying principles are justice and fairness. In an accounting sense truth means that financial accounts must not comprise any kind of distortion. This is because the vital function of accounting in general and reporting in particular, is to provide reliable information about economic resources and obligations of a business enterprise in order to evaluate its strengths and weaknesses, show its financing and investment, evaluate its ability to meets its commitments and show its resources base for growth.

Essential cognitive studies pertain truth in financial reporting. Piechocka-Kałużna (Piechocka-Kałużna, 2014) proposed applying grounded theory (within the meaning of Charmaz, Glaser and Strauss) for that purpose (Charmaz, 2006; Charmaz, 2009; Glaser, 1978; Glaser, 2002; Glasser and Strauss, 1967). The results of application of the mentioned method were to obtain the so-called middle-range theory, in the form of theoretical concept.

First of all it should be emphasized that one of the side effects, regardless of the theoretical concept mentioned above, was the emergence of different patterns of causes problems with truth in financial reporting. These were 'censoring', 'omitting' and 'silencing' information in financial statements.

Secondly, diagnosed causes, according to the method of grounded theory, were grouped in the form of so-called initial codes. Under grounded theory methodology 'code' means effect of coding process – categorising segments of data with a short name that simultaneously summarised and accounts for each piece of gathered data (Charmaz, 2006; Böhm, 2004; Holton, 2007). As a result 'censoring', 'omitting' and 'silencing' information became codes. First of these codes, 'censoring', is mainly referring to cease publishing in Monitor Polski B (Polish registry court periodical magazine) additional notes, which are very important parts of year-end financial statements. Second code, 'omitting' is linking to not providing (which in fact is illegal) financial statements to the court registry. In addition, such actions had not been punished or penalties were completely insignificant and practically had not served disciplining role. Third code, 'silencing', can be applied to using imprecise words during description of entity's accounting policy. 'Silencing', regardless of whether they were intentional or not, may lead to the wide spectrum of alternatives in recognition, measuring or presentation certain issues in financial statements.

Finally, these codes turned in focused code, which was considered as an urgent problem to solve within financial reporting. That problem interferes with the truth in financial reporting in Poland and has been tentatively defined as 'less than an true'.

The existence of such easy to eliminate code as 'censoring' inspired authors to carry out further studies on diagnosis of progress in the removal truth problems related to financial statements. Generally, one may notices that over the years, the increase in the scope of the requirements related to financial reporting is accompanied by enlargement of the scope of the recipients of these financial statements. In the case of insurance companies (especially those, which are not publicly listed) the range of recipients of their financial statements is practically limited to such professionals as investors, rating agencies, sector regulators or sometimes to policyholders. Notwithstanding, their analyses are mostly concentrated on statutory reporting presenting ability to pay compensation or on solvency of the insurers (Frasca and Tucker, 2005). Activity of insurance companies, including adopted accounting rules, is the subject of control exercised by regulators (Balotta, Esposito and Haberman, 2006). There are also three areas that regulatory bodies need to cope:

- comprehensive financial reporting framework for the appropriate assessment of the specific risks that insurance companies are running,
- the standardization of approaches between countries and industries, where sensible and
- an improved transparency and comparability of accounting information (Balotta, Esposito and Haberman, 2006).

The complexity of the financial results of insurance companies lead to anomalies that increased the difficulty of analysing such companies and particularly of comparing companies (Clark P. K. and others, 2003). Due to the fact that the operations of insurance companies are becoming more and more complicated, and furthermore insurers' stakeholders are increasingly aware of the complexity of the activities of insurance companies, insurance companies are required to publish additional disclosures. These disclosures might be helpful in assessing the insurance business (in general) and associated risks. Increasing the scope of disclosures may lead to presentation of insurers' financial condition in appropriate way however, there are still problems with which one can still encounter. These are the issue of the quality of additional disclosures and data comparability between different entities from the sector.

The next section of this paper contains literature review and develops the hypothesis. Sections three and four discuss the method and results, respectively. The final section summarizes the work, discusses the implications, and suggests directions for future research.

Literature review and hypothesis development

True and fair view concept and its linkage with truth is a subject of discussions. As it is emphasized financial statements are closely linked to decision making process since according to accounting theory accounting itself is usually defined as the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information (Hendriksen and Breda, 1992). The benefits of the financial report presenting true situation of an entity is indisputable since disclosures included in such a report reduce both (1) information gap between investors (principal according to agency theory) and management (agent) and additionally (2) market-level uncertainty about current business ventures a financial statement's preparer. Of course one ought to remember that accounting presents an incomplete picture of value-relevant events by incorporating information about the results of current and past decisions. But on the other hand, the eagerness with which market participants await earnings releases to see if and how they comport with market expectations of future profitability cannot be ignored (Arya, Mittendorf and Ramanan, 2017).

Academic researches suggest that disclosures enable investors to make reasonable decisions (Black 2001). Some authors argue that greater transparency allows investors to better estimate different factors affecting their decisions and consequently lowers the cost of capital (e.g. Barry and Brown, 1985). While, in theory, increased disclosure should reduce agency costs, the efficacy of corporate disclosure activity in constraining self-interested managers from misusing resources remains an empirical question (Huang and Zhang, 2012).

Historically insurance financial reporting has been driven by mostly by insurers' interpretation and practice than by accounting principles. It was International Accounting Standards Board that made first step towards establishing insurers' dedicated principle in purpose to unify sector specific issues and enforcing fair value accounting to insurers' assets and liabilities. Fair values according to international rules means 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (IFRS 13). Implementation of standard dedicated to insurance sector, which is IFRS 4 *Insurance contract*, required enlarged scope of disclosures of accounting information with initially limited changes to accounting methodology.

The first phase of common worldwide-recognized insurance standard has affected insurance companies by enhancing disclosure requirements for financial reporting purposes. The second phase that has an important effect on recognition, measurement, presentation and disclosure of insurance contracts, has been issued on May 2017 and is effective from 1 January 2021 (IFRS 17). According to this new standard affecting insurance sector an entity shall disclose qualitative and quantitative information about:

- the amounts recognised in its financial statements that arise from insurance contracts,
- the significant judgements, and changes in those judgements, made when applying IFRS 17, and
- the nature and extent of the risks that arise from insurance contracts.

Though insurers are demanded to disclose the key assumptions used in valuing policyholder liabilities because making assumptions increase a degree of subjectivity. High quality disclosure of assumptions helps decision makers to understand the impact of illiquidity or market changes on the amounts reported. As a result, implementation of new comparable financial statements in the insurance industry would make markets more efficient by letting investors compare companies. However that will be true only if the standard is applied in a consistent manner.

The usual problem about disclosures, which are required by IFRS, but also due to some local GAAPs, associates to their accessibility. It is not the case when one wants to find some disclosures about publicly traded insurer that ought to to meet information criteria appropriate to public companies. But how about over-the-counter insurers? Since they operate outside the public market, they should just reach obligations appropriate proper to 'usual' entities. These conditions force every business entity to prepare, audit, approve and submit to court registry whole year-end financial statements. But according to some local regulations (e.g. Polish ones) it is not necessary to publish the whole financial statement (which means with additional notes and disclosures) in an opened issue.

We have noticed a gap between increasing demand for disclosure (demand represented by different kind of stakeholders) and actual endeavour of insurance companies. The purpose of this research is investigation the presence of problems with truth in financial statements of insurance companies in Poland, on the market that is said to be an example of emerging market. The reasoning described above led us to our hypothesis:

H1: Developing legal requirements related to disclosures in year-end financial statement of insurance companies lead to less problems with truth in financial reporting (especially it allows to avoid problems with 'censoring' information).

Data, methodology

Insurance companies as well as banks, due to their status and required public creditability, should avoid problems related to truth in their financial statements. Especially problems related to lack of transparency or avoiding publishing of year-end financial statements. Censoring, omitting and silencing information must not relate to insurers' reporting. That is the purpose why our research covers all population of insurance companies (life and non-life), which have their headquarters in Poland.

There are 27 companies offering life insurance (including 25 joint-stock companies and 2 mutual insurance societies), 34 offering non-life insurance (including 25 joint-stock companies and 9 mutual insurance societies) and 1 reinsurer in Poland. Research relates to public but also to non-public entities and was conducted in 2017 basing on publishing transparency of financial statements for the years 2013 to 2016. The range of our research is a natural choice because of earlier studies on truth in financial reporting conducted by Piechocka-Kałużna (Piechocka-Kałużna, 2014) that covered the period 2011-2012.

Our research was based on the results of Piechocka-Kałużna (Piechocka-Kałużna, 2014) conducted using grounded theory methodology. First, we made an analysis of the manner and extent of publication of insurers' financial statements. Then we interviewed a sample of representatives responsible for drawing up and publishing (releasing) financial statements of insurers. Subsequently we prepared an analysis of the development of the legal requirements (framework), which could impact on the evolution of the code 'censoring' in the case of insurance companies. According to analysed financial statements we applied comparative method basing on chronological order. Finally we concluded forming requests addressed to accounting standards setters and insurers' financial statements preparers.

Preliminary results

At the beginning of our study, it turned out that the existence of harmful code 'censoring' not only has not been eliminated, but also has gained momentum. It is strongly undesirable that unlisted insurers financial statements' stakeholders have no access to whole set of financial statements. The set that contains:

- a balance sheet (or statement of financial position if prepared under IFRS),
- a profit and loss account (or statement of profit or loss and other comprehensive income if prepared under IFRS),
- a statement of changes in equity,
- a statement of cash flows, and
- notes, comprising a summary of significant accounting policies and other explanatory notes.

It occurred that only one insurer published on its Internet site the whole set of financial statement. To be honest this insurer was the only one that is publicly listed. Therefore this particular insurer has an obligation to release financial statements as periodical reports. The rest of insurers, whether offering life non-life insurances, were very restrained in presenting their financial data. There was only one (!) of 61 private insurers that gave access to its financial statement (including additional disclosures). The rest either concentrated on balance sheet and profit and loss account or totally ignored stakeholders' demand for financial statement and published only random data, which were treated as a marketing tool rather than objective financial performance presentation.

Criticism of respondents of the research conducted in 2011-2012 was the "censoring" involving, among other things, that the most comprehensive source where financial statements are published, which is in Poland Monitor Polski B (Polished register court periodical magazine), did not publish the most interesting parts of the financial statements – additional notes. Monitor Polski B contained only balance sheet and profit and loss account. Despite the criticism of such approach, there has not been increasing range of transparency achieving by publishing full financial statements (including additional notes mentioned above). Moreover in Monitor Polski B was liquidated, taking away access to the essential parts of the financial statements: balance sheet and profit and loss account.

Such a step was in the completely opposite direction than recommended by Piechocka-Kałużna (Piechocka-Kałużna, 2014). People who care about truth in financial reporting should be considered detrimental to the transparency of financial reporting insurers. Furthermore research found out that the fact that insurers are institutions of public trust does not affect in any way the degree of transparency in the publication of their financial statements. This transparency depends only on the legal form of the insurer.

It should be emphasized the publicly listed entities are required to publish their financial statements on their websites. But regarding insurance companies, which are also as much important as public companies, such obligation does not exist. Moreover liquidation of Monitor Polski B took stakeholders the source of financial statements giving anything in return. As a result of insurers' websites analysis we came to the conclusion that insurance companies are not interested in non-compulsory publishing of financial statements. Thus, in the case of some insurers, the only possibility to reach their financial statements is a personal visit to the registry and direct inspection of the financial statements! These barriers to access to financial statements in general were also described in Polish literature (Piechocka-Kałużna, 2014). We would also like to fill the gap in research related to these obstacles, which relate to insurance sector.

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