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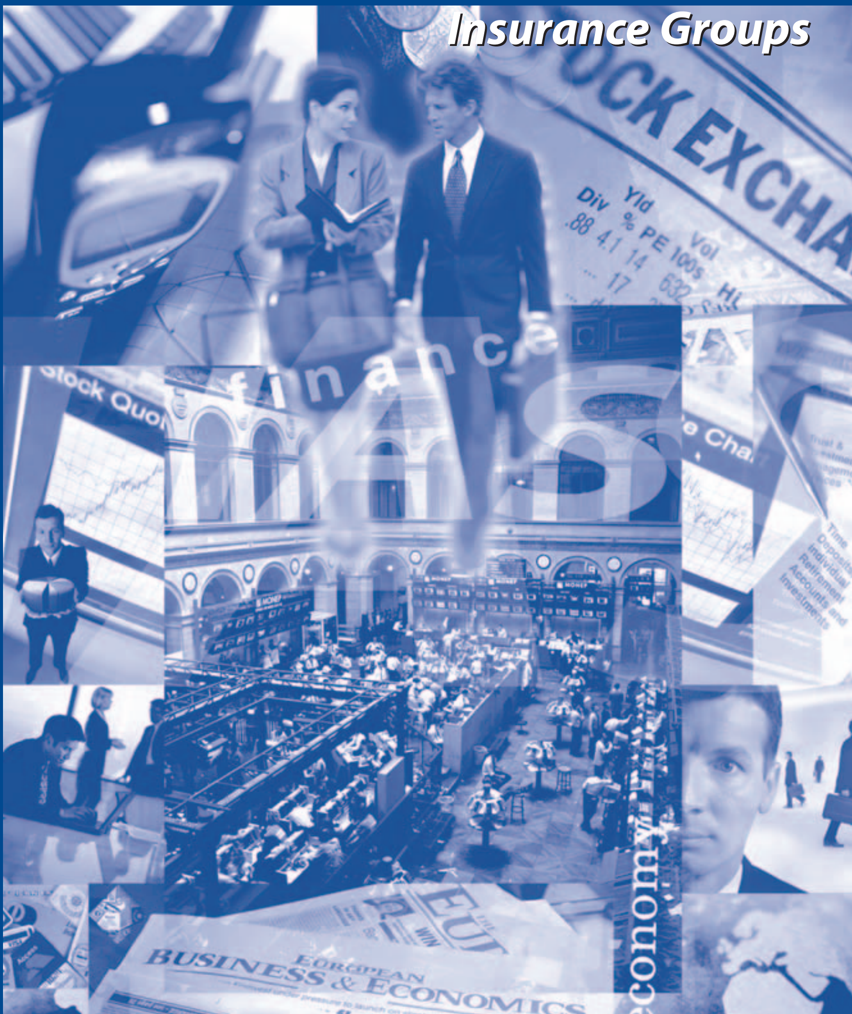
General Overview on Performance Reporting Issues by Insurance Groups



The purpose of the following publication is to provide an overview, as at the end of September 2001, of the current international discussions focused on performance reporting by insurance groups, in the context of the Standard on insurance contracts, being prepared by the International Accounting Standards Board (IASB).
The IASB, taking over the legacy of the former IASC Board, has on its agenda some priority projects that may change significantly financial reporting by the insurance industry. This publication, primarily prepared for distribution to participants at the Forum on the Insurance Industry and IAS, to be held in Paris on 9 and 10 October 2001, attempts to outline, in a simple way, the key issues in the presentation of performance reporting by insurance groups that are under discussion internationally.

HISTORY OF THE INSURANCE DSOP

The former IASC Board started a project on Insurance Accounting in 1997. An Insurance Steering Committee was set up, and in December 1999 they published an Issues Paper on Insurance. The IASC received 138 comment letters in response to this Issues Paper worldwide. The Steering Committee met in September 2000 and November 2000 to review the comment letters and to develop a report to the former IASC Board in the form of a first draft of a Draft Statement of Principles (DSOP).
In April 2001, a new International Accounting Standards Board was appointed (IASB), to replace the former IASC Board. The new Board decided to allow the Insurance Steering Committee to complete its work on the Insurance DSOP.
In June 2001, the Insurance Steering Committee met in Paris and discussed the last draft of the DSOP, which they aim to finalise by October 2001 as a report to the IASB. At the September 2001 IASB meeting, the IASB agreed to the Steering Committee's proposal to carry out field visits with insurance companies, to discuss practical issues on the basis of the current proposals in the DSOP but did not otherwise discuss the June 2001 draft DSOP.

HISTORY OF THE PERFORMANCE REPORTING DSOP

The former IASC Board established in 1999 a Steering Committee to examine the issues related to the display and presentation in the financial statements of all recognised changes in assets and liabilities arising from transactions or other events, except those related to transactions with owners as owners, sometimes called comprehensive income.
The purpose of the project is to consider items that are presently reported in the income statement, cash flow statement and statement of changes in equity. Issues addressed in this project include distinguishing revenue and expense from other sources of

comprehensive income and expense, reporting of holding gains and losses, and distinguishing operating and nonoperating items.

In May 2001, the Performance Reporting Steering Committee prepared a first draft of a Draft Statement of Principles (DSOP) on Performance Reporting for the new IASB. In July 2001, the IASB decided to add this project on Performance Reporting to its initial agenda. The IASB plans to conduct this project in partnership with the UK Accounting Standards Board, which has had an active project on this topic since 2000.

PLEASE NOTE

The June 2001 draft Insurance DSOP and May 2001 draft Performance Reporting DSOP were not prepared by the IASB. In addition, the IASB has not yet discussed any of the proposals in the draft DSOP.

The June 2001 draft Insurance DSOP and the May 2001 draft Performance Reporting DSOP are not public documents and have not been officially published by the Steering Committees. However they are widely discussed within the insurance industry as working papers.

For the purposes of the Forum on the Insurance Industry and IAS, to be held on 9 and 10 October 2001 in Paris, the Chairman of the IASB and the Chairman of the Insurance Steering Committee have permitted that we quote sections of the June 2001 draft Insurance DSOP and the May 2001 draft Performance Reporting DSOP in order to facilitate discussion.

Neither the IASB, nor the Steering Committees' on Insurance and Reporting Performance are responsible for this publication. This publication has not been reviewed or approved by the IASB or the Steering Committees' on Insurance and Performance Reporting.

Introduction

This publication gives first a general background to performance reporting, followed by some key definitions under discussion. It then places performance reporting in the context of an insurance company and discusses the various implications the current proposals may have on the presentation of the financial statements of an insurer. This publication does not provide answers. We just hope that it will help you follow and contribute to the very important debate on how insurance groups should present performance reporting.

General Environment for Performance Reporting

The objective of financial statements, as set out in the IASC's Framework for the Preparation and Presentation of Financial Statements ("the Framework"), is to provide information about the financial position, performance, and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

What is financial performance?

The Framework states that information about the financial performance of an enterprise is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about financial performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources. Information about variability of financial performance is important in this respect.

The Framework also states that "performance" is an element of the financial statements, noting that profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The Framework identifies income and expenses as the elements directly related to the measurement of profit. The definition of income encompasses both revenue and gains, while that of expenses encompasses both losses as well as those expenses that arise in the course of ordinary activities of the enterprise.

Should the income statement reflect all aspects of performance reporting?

Up to now, IAS allow certain aspects of performance reporting to be reported **outside** the "traditional" income statement, sometimes directly in equity through a separate statement of changes in equity and sometimes through disclosures in the notes.

In the same way, IAS 39, Financial Instruments: Recognition and Measurement, proposes an option to report changes in fair values of available-for-sale financial assets and certain hedging activities, either in net profit or loss or in equity. IAS 40, Investment Property, permits enterprises when valuing investment property to choose either the fair value model or cost model. Therefore, the impact of similar transactions conducted by two companies can be accounted for and reported in different ways.

The former IASC Board believed that the lack of consistency in how fair value changes are reported in the financial statements prepared using IASC Standards **undermines comparability** between enterprises and is potentially confusing for users. Therefore, they established a Steering Committee to examine the subject of performance reporting and to make recommendations on how these Standards should be changed. The new Board, the IASB, has decided to continue the project, although at the time this publication was written, it had not yet stated its views.

The draft of the DSOP on Performance Reporting represents a further development in the debate about where to report fair value changes and whether it would be preferable to have a single or combined financial performance statement. In the May 2001 draft DSOP, the Performance Reporting Steering Committee proposed that all items of income and expense should be reported in a single statement.

In this draft, the Performance Reporting Steering Committee also proposed the following definitions:

- "***Financial performance*** is the change in the net assets of the enterprise as measured by recognised income and expense".
- "***Income*** is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from or distributions to equity participants".
- "***Expense*** is a decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to contributions from or distributions to equity participants".
- "***Investing income and expenses*** are increases or decreases in assets that result in a change in net assets other than an increase or decrease in assets held for sale or consumption in the normal course of the enterprise's operating cycle".

- "***Financing income and expenses*** are increases or decreases in financial liabilities and liabilities carried at present value that result in a change in net assets other than an increase or decrease in liabilities for income taxes and discontinuing operations".

- "***An equity instrument*** is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities". Equity instruments do not embody an obligation on the part of the issuing enterprise. Common examples of contracts that do not embody an obligation include common or preferred shares that are not mandatory redeemable.

- "***Owners*** are holders of equity instruments issued by the enterprise".

- "***Treasury activities*** are increases or decreases in financial assets and financial liabilities and liabilities carried at present value that result in a change in net assets, other than an increase or decrease in liabilities for income taxes and discontinuing operations".

Some of above proposed definitions are different from the definitions in the current IAS. The IASB plans to focus on the Performance Reporting project at its next meeting in October 2001.

In this context, what would the financial reporting of an insurance company look like if the June 2001 draft Insurance DSOP is adopted ? [(1)]

Would general principles on financial reporting apply to insurance contracts?

The June 2001 draft Insurance DSOP proposes that:

"An insurer should present a balance sheet, income statement and cash flow statement in accordance with the general principles and requirements that apply to all other enterprises. Illustrative formats for Insurance companies should be provided as an appendix to the Standard."

It is acknowledged that the presentation of revenues and expenses arising from insurance contracts may not be similar to those arising in other commercial activities. However, the Performance Reporting Steering Committee believes that the general principles for reporting financial position, performance and cash flows in IAS 1, Presentation of Financial Statements, and IAS 7, Cash Flow Statements, are sufficiently flexible that they can be applied equally to insurance contracts.

Therefore, the June 2001 draft Insurance DSOP considers combining accounting and presenting information on general and life insurance in a single balance sheet, a single income statement and a single cash flow statement. Further separate analysis on general and life insurance would be provided as segment information in the notes to the financial statements, as required by IAS 14, Segment Reporting. As a consequence, the detailed analysis of revenue accounts of an insurer would not need to be given on the face of the income statement but adequate segment analysis would be disclosed in the notes of the financial statements.

[(1)] In June 2001, the Insurance Steering Committee prepared a draft DSOP for the IASB's discussion. It proposes to carry insurance contracts at either fair value or entity-specific value. All changes in insurance liabilities will be recognised in the income statement. The IASB has not yet discussed the Insurance Steering Committee's proposals. For further discussion on the issues surrounding insurance contracts, refer to the publication "Future International Accounting Standard on Insurance Contracts".

Should the income statement of an insurer include changes in the present value (Fair Value or Entity-Specific-Value) of insurance assets and liabilities?

The June 2001 draft Insurance DSOP proposes that:

"All changes in present value of insurance liabilities and insurance assets to be included in the income statement for the period in which they arise."

This issue of whether all changes in the present value of insurance assets and liabilities should be included in the income statement is one of the main issues that is currently being debated around the world.

Arguments against this proposal are the following:

- Immediate recognition can cause volatile fluctuations in liability and expense and implies a degree of accuracy that can rarely apply in practice. This volatility may not be a faithful representation of changes in the obligation but may simply reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measures.

- Some believe it is inappropriate to recognise a gain on an insurance contract before the coverage period has expired (for instance, on a product liability or catastrophe policy).

- Current market interest rates are irrelevant if an enterprise does not intend to (or cannot) dispose of an asset or liability.

- The effects of experience adjustments and changes in assumptions, including also changes in estimates, release of risk on insurance liabilities, changes to adjustment for risk and uncertainty, unwinding of the discount changes in discount rate, and changes in credit standing, if included should be recognised not in the income statement but in a second performance statement or directly in equity.

Arguments in favour of this proposal are the following:

- Deferred recognition attempts to avoid volatility. However, a financial measure should be volatile if it purports to represent faithfully transactions and other events that are themselves volatile.

- It generates income and expense items that are not arbitrary and that have information content.

- This approach is straightforward, easy to understand and does not require enterprises to keep the complex records that might be needed to support possibly arbitrary allocations to determine whether items are recognised in the income statement or in equity.

How might the Income Statement of an insurer be presented?

Under the June 2001 draft Insurance DSOP, it is proposed that the income statement would include the line items detailed below:

- ***Underwriting - new business:*** it would include the expected present value of all future pre-tax cash flows arising from the closed book of insurance contracts at inception of a contract, including a provision of risk and uncertainty.

  It could be split via the following line items:

  - premium income;

  - claims expense;

  - provisions for risk and uncertainty; and

  - acquisition costs and other operating costs.

- ***Underwriting - changes to estimates for previous years' business:*** it would include experience adjustments and changes in assumptions related to estimates of previous years' business underwritten. It would also include the effects of experience adjustments (differences between actual events and previous assumptions about those events), such as:

  - changes in estimates and assumptions;

  - release of risk on insurance liabilities; and

  - changes to adjustment for risk and uncertainty.

- ***Financing:***

  - increase in insurance liabilities and insurance assets because of the passage of time (an effect similar to interest, sometimes called "unwinding of discount")[(2)];

  - effects of changes in discount rate; and

  - effects of changes in own credit standing, if included.

[(2)] The term "unwinding of the discount" is sometimes used to describe that part of the change in present value that arises solely because of the passage of time. The Insurance Steering Committee believes that the unwinding of the discount should always be presented as finance income or expense because in particular, economically, this component of the change in present value is similar to interest. It is driven by the balance of the asset or liability and the discount rate.

What might be included in the notes to the financial statements of an insurer?

Under the June 2001 draft Insurance DSOP, it is proposed that:

- An insurer would disclose premium income and claims expense on an accrual basis in the notes to the financial statements.

- Policyholder assets and liabilities and related income, expense and cash flows would be disclosed separately in the notes to the financial statements; separate presentation on the face of the income statement, balance sheet and cash flow statement would be permitted but not required. Separate disclosure may also be needed for cash flows between policyholders' funds and shareholders' funds.

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