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Future International Accounting Standard on Insurance Contracts

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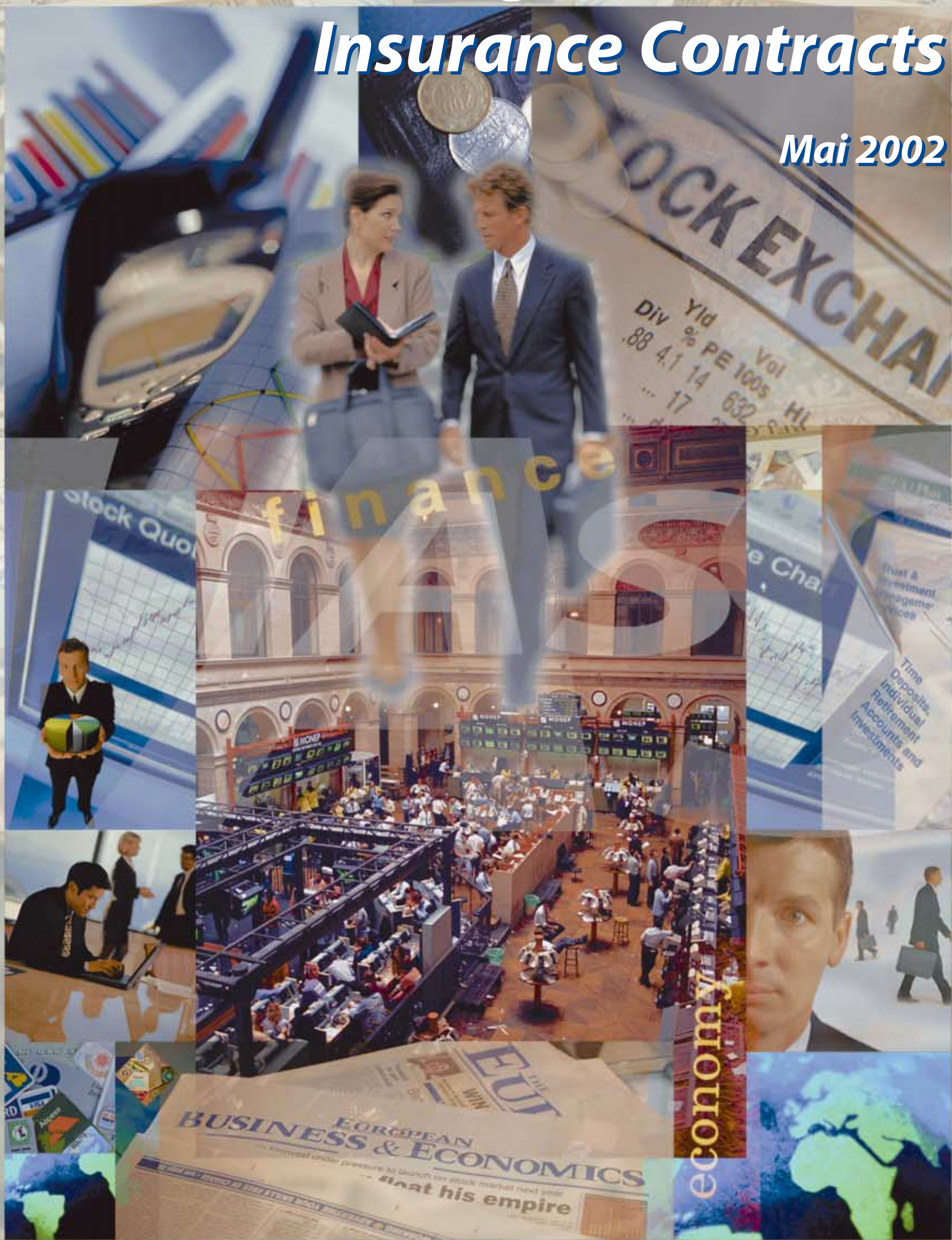

The purpose of the following publication is to provide an overview, as at the end of May 2002, of the current international discussions surrounding financial reporting by insurance groups, particularly on the accounting for insurance contracts.

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, initially prepared for distribution to participants at the Forum on the Insurance Industry and IAS, which was held in Paris on 9 and 10 October 2001, attempts to outline, in a simple way, the key changes in financial reporting by insurance groups that are under discussion internationally.

This publication was initially based on the June 2001 draft DSOP but this version has been updated for changes made to the June 2001 draft DSOP. It includes all amendments found on the IASB website and all amendments included in the published DSOP chapters as at the end of May 2002. The latest additions to the IASB website were in January 31, 2002.

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 expected last draft of the DSOP, which they aimed 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. The IASB began to discuss the draft DSOP at its November 2001 meeting. The IASB has continued its deliberations at subsequent meetings and has made tentative conclusions on some of the proposals made.

PLEASE NOTE

The current draft insurance DSOP was not prepared by the IASB. In addition, the IASB has only discussed some of the proposals in the draft DSOP.

The current draft Insurance DSOP has not been officially published by the Insurance Steering Committee. However it is widely discussed within the insurance industry as a working paper and most chapters can be accessed on the IASB website.

For the purposes of the Forum on the Insurance Industry and IAS, which was held on 9 and 10 October 2001 in Paris, the Chairman of the IASB and the Chairman of the Insurance Steering Committee permitted that we quote sections of the June 2001 draft Insurance DSOP in this publication in order to facilitate discussion.

This publication was initially based on the June 2001 draft DSOP but this version has been updated for changes made to the June 2001 draft DSOP. It includes all amendments currently found on the IASB website and all amendments included in the published DSOP chapters. The latest additions to the IASB website were in January 31, 2002.

Neither the IASB nor the Insurance Steering Committee is responsible for this publication. This publication has not been reviewed or approved by the IASB or the Insurance Steering Committee.

Key Issues: Summary

In accordance with the IASC framework, the future standard on insurance is prescribing the accounting and disclosure in general financial statements by insurers and policyholders for all insurance contracts, regardless of the industry of the enterprise concerned.

The assets and liabilities of an insurance company not directly linked to insurance contracts should be evaluated and accounted for in accordance with other relevant standards (e.g., IAS 39, Financial Instrument: Recognition and Measurement, for financial assets and liabilities, IAS 40, Investment Property, for investment property). As a consequence, a significant part of the assets could be measured at fair value.

As it is sometimes difficult to distinguish an insurance contract from other financial instruments, it is important to define what is an insurance contract and to highlight the principal elements of differentiation. An insurance contract would be defined as "a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable)". The new definition includes the notion of "uncertain future event". That is, it is uncertain at the inception of a contract whether:

- a future event specified in the contract will occur;
- when the specified future event will occur; or
- how much the insurer will need to pay if the specified future event occurs.

This definition should result in the classification of, and accounting for, some insurance products as financial instruments (especially a great majority of saving-oriented products).

As there should be a single definition of an insurance contract, there should be a single recognition and measurement approach for all forms of insurance contracts, and as a consequence for the insurance assets and liabilities, regardless of the type of risk underwritten (i.e., life insurance or non-life insurance). That approach would be an "Asset and Liability" measurement approach rather than the traditional "Deferral and Matching" measurement approach. The "Deferral and Matching" approach is the most common approach applied today, under which revenues and expenses are deferred and matched accordingly.

Within this context and following the Joint Working Group[1] (JWG) proposals, insurance assets and liabilities should be measured on a prospective basis, reflecting the present value of all future cash flows arising from the closed book of insurance contracts in existence at reporting date. Two methods of prospective measurement could be considered:

- fair-value, and
- entity-specific value.

The first method, fair value, is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. This corresponds to an exchange value.

The second method, entity-specific value, represents the value of an asset or a liability to the enterprise that holds it, and may reflect factors that are not available (or not relevant) to other market participants. This corresponds to a "value in use".

(1) The international Joint Working Group of Standard Setters (JWG) was established by the former IASC Board and other national accounting standard-setters to develop an integrated and harmonised standard on financial instruments. It published a Draft Standard and Basis for Conclusion on Financial Instruments and Similar Items in December 2000. Under the proposed Standard, all financial assets and liabilities would be carried at fair value with changes in fair values recognised in net profit or loss.

The proposal in the DSOP is that if IAS 39, Financial Instruments: Recognition and Measurement, is still in place, insurance assets and insurance liabilities should be measured at entity-specific value. If a successor standard to IAS 39 introduces fair value measurement for the substantial majority of financial assets and liabilities, IASB should consider introducing fair value measurement for all insurance assets and insurance liabilities.

The measurement approach should reflect risk and uncertainty either in the discount rate or in the amount of cash flows. The current draft DSOP[2] is currently leaning towards a "stochastic method" to estimating future cash flows. The stochastic approach captures the full range of possible outcomes and the shape of their probability distribution, in comparison with a "deterministic approach", which has no ready means of capturing correlation between cash flows and interest rates.

The draft DSOP expresses the view that the value of an insurance contract should be independent of the investing strategy of an enterprise. Consequently, the insurance liabilities should not be affected by the type, or by the yield, of the financial assets held by an enterprise. Within this context, insurance liabilities should be linked to risk-free rates and not to the yield of the financial assets. A different approach should nevertheless be used for some specific insurance contracts such as unit-linked and participating contracts.

The future Standard would introduce some major changes in the current measurement and financial reporting for insurance contracts: variations in the present value would be reflected in the income statement, present value of some part of the future margins would be recognised in the income statement at inception (the amount taken will depend on certain variables), some technical reserves that would not meet the definition of a liability would not be recognised (such as unearned premiums or equalisation reserves).

Nevertheless, no final decisions have yet been made. The IASB began discussing the draft DSOP at its November 2001 Board meeting. The IASB has continued its deliberations at subsequent meetings and has made tentative conclusions on some proposals made. Before resolving the key issues raised by the draft DSOP, the Board will probably attempt to define clearly what the overall objectives of financial reporting should be.

(2) 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 new IASB in the form of a first draft of the DSOP.

Key Questions

This document tries to raise issues surrounding some of the key questions and will attempt to explore potential ramifications of each area, without giving any opinion.

The main issues that the draft DSOP tries to address include the following:

- Should an accounting standard for insurance apply to insurance companies or to insurance contracts only?
- What are the defining characteristics of an insurance contract? What is the difference between an insurance contract and a financial instrument? What is insurance risk?
- Should contracts that bundle together an insurance and financial element be separated?
- What philosophical approach should drive accounting recognition: "Deferral and Matching" or "Asset and Liability"?
- Under what conditions should an enterprise recognise an asset or liability related to an insurance contract? Should implied renewal options be recognised in the valuation of insurance contracts?
- What method should be used to value insurance assets and insurance liabilities?
- In the "Asset and Liability" approach, should discounting rates used to evaluate the present value of contracts be linked to the related investment portfolio or not?
- Should the measurement of insurance liabilities reflect risk and uncertainty? If so, how should risk and uncertainty be incorporated into the measurement process?
- On what should companies base the assumptions used to determine Entity-Specific Value or Fair Value?
- Should the discount rate be linked to the enterprise's own credit standing?
- In the case of the "Asset and Liability" approach, what would be the components of the income statement?

The above questions are addressed on the subsequent pages, with the key points highlighted in a box at the end of the relevant section. The text shown in bold and Italics on the subsequent pages are direct extracts from the last version of the draft DSOP found on the IASB website as at the end of May 2002

Should an accounting standard for insurance apply to insurance companies or to insurance contracts only?

"The IAS on insurance contracts will prescribe the accounting and disclosure in general purpose financial statements by insurers and policyholders for all insurance contracts."

- The specific Standard for insurance would be restricted to prescribe accounting for insurance contracts only, and would not apply to other aspects of insurance companies' operations. Accounting for insurance contracts should be consistent among issuers (including insurers and reinsurers) and policyholders.

- All other items found in the financial statements would be dealt with by other Standards, such as IAS 39 for financial instruments and IAS 40 for investment properties.

  - IAS 39 applies to financial instruments. Under the current version of this Standard, financial assets are classified into 4 areas: loans and receivables originated by the enterprise, available-for-sale, trading, and held-to-maturity. Given the definition of held-to-maturity financial assets, there is a high probability that this category has limited use for insurance companies in practice. Also, loans and receivables originated by insurance enterprises usually do not represent a significant portion of their financial assets. Therefore, most financial assets (i.e., trading and available-for-sale) will be carried at fair value, with movements in fair value going through either the income statement or equity, depending on the classification and/or the decision of management. Financial liabilities (other than those held-for-trading) are accounted for at amortised cost. The IASB is in the process of considering amendments to IAS 32 and IAS 39 in light of issues raised by audit firms, national standard-setters, regulators and others. An exposure draft is expected during quarter 2, 2002. Proposed amendments would give enterprises the possibility to classify any financial asset or financial liability in the trading category, so that the enterprise could value all financial instruments at fair value, with movements in fair value going through the profit and loss statement.

  - IAS 40 applies to investment property. Initial measurement should be at cost, however it permits enterprises to choose either a fair value model or a cost model for subsequent measurement. With a fair value model, investment property is measured at fair value, and changes in fair value should be recognised in the income statement. With a cost model, investment property should be measured at depreciated cost less any accumulated impairment losses. Fair value of the investment property is still required to be disclosed.

- The Standard for insurance would apply to insurance contracts only, and will not address all other aspects of an insurance company.
- If the DSOP is adopted as currently drafted, an important part of assets found in an insurer's balance sheet would be reported at fair value.

What are the defining characteristics of an insurance contract? What is the difference between an insurance contract and a financial instrument? What is insurance risk?

"An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable)."

- Under this definition, many contracts currently sold by insurance enterprises and accounted for as insurance contracts could fail to meet the proposed new definition of an insurance contract. For example, a contract that exposes the issuer to financial risk without insurance risk would not be accounted for as an insurance contract. This could mean that a significant portion of existing European products might have to be accounted for as financial instruments in accordance with IAS 39. Most investment-oriented products would no longer be accounted for as insurance. This would mean that premium received will be a financial liability rather than recognised as revenue by the issuer and premium paid will be a financial asset (deposit) of the owner.

- The definition is similar in substance to the US GAAP definition. Nevertheless, investment contracts in the US are accounted for under FAS 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses From the Sale of Investments, and have specific accounting guidelines.

- Implementation issue: Is this distinction between Insurance Contracts and Financial Instruments operational?

- A contract that expose the issuer to financial risk without insurance risk would not be accounted for as an insurance contract, rather is would be accounted for as a financial instrument under IAS 39.

- Under the current version of IAS 39, financial liabilities (other than those held-for-trading) are accounted for at amortised cost. The amortisation amount (determined using the effective interest rate method) is reflected as an adjustment to interest expense in the net profit or loss for the period.

- Nevertheless, the proposed amendment to IAS 39 is to allow the use of fair value for any financial instrument. It means that insurers will have a choice at this stage in measuring insurance contracts, which fall into the category of a financial instrument between amortised cost or fair value. This is of course subject to the final decision of the IASB.

"A contract creates sufficient insurance risk to qualify as an insurance contract if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether there is a reasonable possibility of such significant change, it is necessary to consider both the probability of the event and the magnitude of its effect."

This is consistent with the IASC Framework in that economic substance over legal form should be considered.

- The US GAAP guidelines relating to reinsurance risk transfer propose quantitative guidelines when determining what is a "material" change. This is not the case in the current draft DSOP as no quantitative guidelines are proposed.

- Implementation issue: Would a block of life policies meet this definition, as the present value of aggregate future benefit payments may not be subject to significant variability? The DSOP proposes that the test for insurance risk be performed on a contract-by-contract basis, rather than by book of insurance contracts.

Should contracts that bundle together an insurance and financial element be separated?

"An insurer or policyholder should not account separately for the components of an insurance contract that bundles together:

a) An insurance element and a non-derivative investment element; or

b) An embedded derivative and a host insurance contract."

- This is consistent with IAS 39 and the JWG proposals. According to IAS 39, where the host contract is measured at fair value, the derivative does not need to be separated. As the current draft DSOP is suggesting either fair value or entity-specific value, it is roughly consistent with IAS 39.

- Nevertheless, it could imply that the total carrying amount would be equal to entity-specific value, which implies that the derivative is valued at entity-specific value too.

- Furthermore, for contracts which under the current draft DSOP are not classified as insurance contracts, but as financial instruments, if the enterprise chooses to value them at amortised cost, then they would need to separate the embedded derivative.

What philosophical approach should drive accounting recognition: "Deferral and Matching" or "Asset and Liability"?

"There should be a single recognition and measurement approach for all forms of insurance contracts; regardless of the type of risk underwritten."

- **A. Deferral and Matching Approach**

Most insurance accounting models used in practice today follow this approach. That is, they recognise revenue and expenses from insurance contracts over time as services are provided. Premiums are deferred and recognised as revenue over the term of the contract. Acquisition costs are often deferred and amortised over the term of the contract.

The approach is consistent with models used in other industries where revenues, expenses and profits are recognised as earned or incurred. Also, insurance contracts provide continuing services throughout the contract and settlement period.

- **B. Asset and Liability Approach**

The asset and liability approach is consistent with the IASC framework, which establishes criteria for evaluating whether an item should be recognised as an asset or liability. An asset is defined as "a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise". A liability is defined as "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits". Based upon these definitions, some believe the deferral and matching approach violates these basic principles and results in deferred costs which do not meet the definition of an asset and deferred revenues or gains which do not meet the definition of a liability. Strict application would preclude the deferral of premiums and acquisition costs, or the establishment of equalisation or catastrophe reserves.

- The current draft DSOP proposes an asset and liability approach.
- This approach would create major changes in financial reporting for all insurers in the world, which currently apply some variation of the deferral and matching approach.
- Significant issues arise as to the contents and format of the statement of financial performance and ensuring that the information is relevant to the users of financial statements.
- Under this approach, a main component of the income statement for insurers would be the change in financial assets and financial liabilities.

Under what conditions should an enterprise recognise an asset or liability related to an insurance contract? Should implied renewal options be recognised in the valuation of insurance contracts?

"Insurance assets and insurance liabilities are assets and liabilities arising under an insurance contract. An insurer or policyholder should recognise an insurance asset/liability when, and only when, it has contractual rights/obligations that result in an asset/liability."

- This definition would be consistent with the IASC framework.
- It also would imply that future profits could be recognised in the income statement and as an asset at the beginning of the contract, consistent with the definition (i.e., when the company has the right to "future economic benefits").

"Cash flows arising from the contractual rights and obligations associated with the closed book of insurance contracts should include cash flows from future renewals to the extent, and only to the extents, that their inclusion would increase the measurement of the insurer's liability; or policyholders hold uncancellable renewal options that are potentially valuable to them."

"A renewal option is potentially valuable if, and only if, there is a reasonable possibility that it will significantly constrain the insurer's ability to reprice the contract at rates that would apply for new policyholders who have similar characteristics to the holder of the option."

- This principle defines what is called a "closed book" as opposed to "open book" approach. The closed approach excludes expected renewals, except for contracts meeting the specified criteria. The open approach includes all potential renewals. Many insurance contracts are one-year contracts but are in substance similar to multi-year contracts. With this definition, cash flows from many automatic renewal contracts will be excluded from the "closed book".
- Implementation issue: It is clear that certain renewal options will have to be taken into consideration in the valuation of insurance liabilities. This will require insurers to project the cash flows from such renewals. The inclusion of such option cash flow renewals could increase or decrease the carrying amount of the liability. This is in contrast to traditional written options, which generally can only be liabilities.

What method should be used to value insurance assets and insurance liabilities?

- The IASB will be working on a specific project to resolve issues related to selection of the appropriate measurement of items recognised in the financial statements. Similar to the JWG paper, it could be difficult to conclude on whether the fair value valuation model is appropriate until the Accounting Measurement and Performance Reporting projects are better understood and finalised by the IASB.
- Nevertheless, the current draft DSOP proposes the following definitions for the measurement of insurance assets and insurance liabilities.

"The starting point for measuring insurance assets and insurance liabilities should be the expected present value of all future pre-income tax cash flows arising from the contractual rights and contractual obligations associated with the closed book of insurance contracts."

- Expected value should be the probability weighted average of all cash flows at a given date, without adjustment for risk and uncertainty. It is the present value of expected cash flows determined for different scenarios. It includes probability of lapses and surrenders, as appropriate.
- Until now, insurance liabilities were evaluated with a "deterministic" approach. Usually enterprises discounted a single best estimate of the most likely cash flows using a single discount rate intended to reflect the risks specific to the asset or liability.
- The proposed approach in the current draft DSOP is a "stochastic" approach. This allows the valuation process to separately address the uncertainty around the amount and timing of cash flows and the term structure of interest rates. It is supposed to capture the full range of possible outcomes and the shape of their probability distribution.
- The discounting method would be extended to non life insurance business. This is consistent with the proposal that there be only one methodology for all insurance contracts, as detailed at the beginning of this document.

- Regarding life insurance, this approach could result in the recognition of an asset or in the measurement of a liability at less than the amount of the customer's deposit. This can be contrary to US GAAP and to most current local practices, as there would be no minimal liability.
- It would also likely result in the recognition of a portion of the present value of expected future margins in the income statement at the inception of the contract. This could place significant emphasis on the production of profitable new business, as part of the net profit or loss arising on initial recognition of an insurance contract would not be deferred.
- There would be a significant discrepancy between contracts classified as financial liabilities, if the enterprise chooses to value them at amortised cost, and contracts classified as insurance liabilities (prospective approach valued at either fair value or entity-specific value).
- The expected present value approach is a much more sophisticated approach than that previously used in accounting models.
- Implementation issue: It may be a challenge for some insurance companies to implement such methodology within the required time frame.

Assumptions used to determine the expected present value of future cash flows as defined by the entity-specific approach.

"While IAS 39, Financial Instruments: Recognition and Measurement, is still in place, insurance liabilities and insurance assets should be measured at entity-specific value. Entity-specific value represents the value of an asset or liability to the enterprise that holds it, and may reflect factors that are not available (or not relevant) to other market participants. In particular, the entity-specific value of an insurance liability is the present value of the costs that the enterprise will incur in settling the liability with policyholders or other beneficiaries in accordance with its contractual terms over the life of the liability.

If a successor standard to IAS 39 introduces fair value measurement for the substantial majority of financial assets and liabilities, IASB should consider introducing fair value measurement for all insurance liabilities and insurance assets. Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. In particular, the fair value of a liability is the amount that the enterprise should have to pay a third party at the balance sheet date to take over the liability."

IAS currently does not use the term entity-specific value. In developing a definition of entity-specific value, the Insurance Steering Committee referred to two precedents. The current draft DSOP adopted the definition proposed by the former IASC Present Value Steering Committee. This Steering Committee defined entity-specific value as "the value of an asset or liability to the enterprise that holds it". This is a generalisation of the notion of value in use, defined in IAS 36, Impairment of Assets, as "the present value of estimated future cash flows from the continuing use of an asset and from its disposal at the end of its useful life". The Steering Committee also defined entity-specific value of a liability as "the present value of the costs that the enterprise will incur in settling the liability in an orderly fashion over the life of the liability". This definition builds on a statement in the IASC Framework that the present value of liabilities is "the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business."

- IAS define fair value as "the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction". The fair value of a liability is its fair value in exchange, i.e. the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability.

- Entity-specific value allows the use of an enterprise's own costs, assumptions and experience. Fair value by comparison, requires that an enterprise use assumptions and expectations inferred from market data. Even if the insurer and the market have the same level of knowledge about the asset or liability, the entity-specific value of an asset or liability may differ from its fair value if:

  - The insurer has superior management skills that enable it to maximise cash inflows from an asset or minimise cash outflows from a liability

  - They form different estimates about the timing or amount of future cashflows

  - They have different liquidity needs or have different views about the relevance of their own credit standing.

This essentially means that for entity-specific value, an insurer will use their own assumptions as opposed to market assumptions, and they will use their own expense levels as opposed to market expected expense levels (for instance, based on industry averages). The fair value concept revolves around the principle of a "transaction", whereas the entity-specific value concept is based on the principle of "normal course of business".

- Usually given arguments for entity-specific value are:

  - Most insurance liabilities are settled by payments to policyholders, rather than by an exchange transaction with a third party;

  - Management has better information than other market participants about their company's future cash flows;

  - Most insurance liabilities are not traded; hence their fair value will not be observable in the market.

- Usually given arguments for fair value are:

  - Market prices are more informative and neutral predictors of future cashflows;

  - Entity-specific value is not determinable on a reliable basis, except by reference to market data;

  - Fair value should be independent of the entity performing the measurement, which improves comparability;

  - Future IAS (if based on the JWG draft) could require full fair value accounting for financial instruments;

  - Fair value of insurance liabilities may not generally be observable directly in the market, but their fair value can be estimated using reliable models, which can use observable market data.

What does it mean for the income statement?

The profit or loss will vary based on whether the insurance liability is evaluated under fair value or entity-specific value:

- In entity-specific value, the profit or loss for the year will reflect management's estimate of future cash flows, based on their unique circumstances.
- Fair value would be based on industry averages or market estimates of future cash flows.
- The main point is that while results will reflect the impact of management's decisions, results will also be impacted significantly by differences between the actual experience of the company and the market's expectations.
- This will include differences between the assumptions used in the valuation models (e.g., interest rates) and the actual variables.

In the "Asset and Liability" approach, should discounting rates used to evaluate the present value of contracts be linked to the related investment portfolio or not?

"The entity-specific value or fair value of insurance liabilities should not be affected by the type of assets held or by the return on those assets (unless the amount paid to policyholders is directly influenced by the return on specified assets, as with certain performance-linked contracts)."

- With fair value or entity-specific value, the discount rate used will be an adjusted "risk free rate" rather than the investment return expected over the life of the policy. The conclusion is based on the belief that the measurement of liabilities should be independent of an enterprise's investment strategy, except for participating, unit-linked and variable contracts.

- Note that the valuation of insurance contracts will include adjustments for risk and uncertainty. This may be incorporated into the valuation process by adjusting the interest rate or the cash flows, but not both.

- It is consistent with the concept of entity-specific value, where the measurement of the liability would be dependent on the enterprise's cost structure. However, should valuations consider the operating or administrative processes but not the investment strategy of the enterprise?

What is the impact on the income statement?

- For assets invested in interest bearing instruments whose cash flows exactly match the cash flows of the insurance portfolio, the impact of any movement in the market rates could be zero. An exception might of course arise from differences in credit quality. Nevertheless, it is usually hard to achieve a matched cash flow; therefore the profit or loss of the insurer will also be impacted by any mismatch in duration.

- Some portion of the present value of the investment margin may be taken at inception.

- The income statement will be impacted by any mismatch in duration between interest-bearing investments and the related liabilities.

- For certain participating, unit-linked, and variable contracts, the current draft DSOP indicates that the related investments will be taken into consideration when determining the contract liability. The current draft DSOP does not currently provide much detail, however, exactly how this is to be implemented. However the IASB is currently discussing this point, as it remains a major point for most insurers.

Should the measurement of insurance liabilities reflect risk and uncertainty? If so, how should risk and uncertainty be incorporated into the measurement process?

"The entity-specific value and fair value of insurance assets and insurance liabilities should always reflect risk and uncertainty."

"Adjustments for risk and uncertainty should be reflected preferably in the cash flows, or alternatively in the discount rate(s), without any double counting."

"Estimates of both entity-specific value and fair value should reflect the market's risk preferences, inferred, as far as possible, from observable market data. Inferences about the market's risk preferences should be determined using a consistent methodology over time. Changes in the inferred level of risk preferences should be made only in response to observable market data."

- Insurance assets and liabilities would always reflect risk and uncertainty. The question is how: through discount rates or cash flows? It should also reflect market's preferences, except that these might be difficult to assess. Also, would the provision for risk and uncertainty be presented as a distinct line item in the balance sheet, with the corresponding change displayed separately on the face on the income statement?

- Implementation issue: Again, the issue of risk and uncertainty raises the concern regarding implementation and comparability between insurance companies.

- How will risk and uncertainty be evaluated?
- Will there be guidance so that risk and uncertainty will be comparable between insurance companies?
- Shouldn't a simpler approach be used for high cost/low frequency risk?

On what should companies base the assumptions used to determine Entity-Specific Value or Fair Value?

"Assumptions (Entity-Specific Value)

Entity-specific value should be based on reasonable, supportable, explicit (where each assumption is meaningful in its own right) assumptions that reflect:

- **All future events;**
- **Inflation;**
- **All entity-specific future cash flows;**
- **And are consistent with:**
  - **- Most recent financial budgets/forecasts**
  - **- Current market conditions**
  - **- Current market experience and trends.**

Assumptions (Fair Value)

If fair value is not observable directly in the market, estimates should be based on reasonable, supportable and explicit assumptions that reflect:

- **All future events;**
- **Inflation;**
- **Cash flows that would arise for other market participants;**
- **And are consistent with:**
  - **- Current market prices and data."**

● The required use of explicit assumptions is new to accounting guidance. Very often, actuaries use implicit assumptions, which express assumptions in term of relationships between variables such as inflation, rates of salary increase, etc. Assumptions should consider all available evidence, including pricing assumptions, experience studies, market conditions (including competitor crediting rates and pricing of similar products).

● The use of "future events" is also explicitly listed in the definition above. Some IAS standards exclude the effect of some future events: IAS 12, Income Taxes, and IAS 19, Employee Benefits. The position of the current draft DSOP is that those future events affect the measurement of insurance asset or liability. Another party would consider the possibility of those future events in determining an acceptable price.

The difference between assumptions used for "entity-specific value" and "fair value" seems consistent with the definitions for those terms, which were addressed above.

● Implementation issue: The source of assumptions could be an important issue for people who will have to assess the reasonableness of assumptions. In order to be useful for users of financial reports, wouldn't assumptions need to be clearly disclosed and understandable? Another related issue is whether the assumptions will be auditable, and what impact this might have on the audit report wording.

Should the discount rate be linked to the enterprise's own credit standing?

"The entity-specific value of an insurance liability should not reflect the insurer's own credit standing. Conceptually fair value should reflect the insurer's own credit standing, but this would have practical implications that need further investigation."

This concept was dealt with in the JWG draft Standard on Financial Instruments, published in December 2000. This comprehensive project could consider moving towards a fair value model for measurement of virtually all financial instruments. [3]

- An "enterprise's own credit standing" relates to the credit-worthiness of the enterprise and its ability to meet debts as and when they fall due. It will impact the level of liability an insurance company can write, and solvency requirements.
- The issue of accounting for an enterprise's own credit standing is not unique to insurance companies. As the JWG proposals would apply to financial assets and liabilities for insurers, there is a need to make clear if it agrees or not with the principle proposed in JWG.
- A fundamental issue is raised, which is still unresolved, of whether the fair value of a liability must equal the fair value of the asset. A decision will be made in the future as to whether this is the case under the IASB Accounting Measurement project.
- Should a liability be evaluated taking into account the enterprise's own credit standing and going concern issues? It could result in two enterprises having an identical liability, but valuing it at different amounts (with the less credit-worth company having a lower liability) or for an enterprise to recognise a gain in response to a credit rating downgrade.
- Nevertheless, it seems that the current draft DSOP has concerns about the practical implications of this approach.

(3) The development of a comprehensive project on financial instruments, to follow up on the work of the JWG, does not form part of the current IASB's initial agenda. However, the IASB will monitor the efforts of liaison standard setters that may be working on this project. Therefore, it is unlikely that the IASB will issue a revised Standard on financial instruments in the near future, based on the JWG proposals.

In the case of the "Asset and Liability" approach, what would be the components of the income statement?

Each year, the income statement could contain the following items:

- For the year then ended, the impact of the difference between the actual investment return and the risk-free discount rate from prior year.
- For the year then ended, the impact of the change in the risk free rates year to year.
- Modifications of assumptions, if any, that affect the expected amount or timing of future cash flows.
- Present value of part of expected profit or loss of new business for the year (the level of profit or loss will be linked to the level of risk and uncertainty).
- The impact of differences between market expectations and actual results.
- The variation on the appreciation/depreciation of risk and uncertainty each year would impact the income statement directly.
- In order to be understandable and useful for the users, financial statements would need to be very detailed. Hence the format of the income statement and related disclosure is a significant unresolved issue. The current draft DSOP to date has a strong balance sheet focus, with less consideration having been given to the income statement presentation.

For further discussion on the issues surrounding the presentation of the income statement by insurance groups, refer to the publication "General Overview of Performance Reporting Issues of Insurance Groups" which outlines recent international discussions on performance reporting, particularly in relation to insurance groups.

Notes

Notes

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