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Mr. Peter Clark
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CL 94

EXPOSURE DRAFT ED 5 INSURANCE CONTRACTS

Dear Mr. Clark

We welcome very much the opportunity to comment on the above-mentioned draft.

As industrial businesses our member companies are unlikely to be much affected by the resulting IFRS. Neither would we claim to have any deep expertise or practical experience in the area of insurance accounting which would enable us to make a worthwhile contribution to the technical discussion on ED5. We therefore confine our comments to a few specific areas which are, or could be, relevant for industrial companies. Nevertheless, we appreciate that there are many difficult technical problems to solve, even in the "stop-gap" Phase I. This seems to be the case especially in the area of mismatch of asset and liability measurement bases, for instance. We would therefore encourage the Board to work actively and pragmatically with our fellow preparers in the insurance industry to find appropriate solutions for Phase I: for the stop-gap in particular, practicality should be allowed to take precedence over conceptual purity where the two conflict.

ED5 does not mention the question of consolidation. We believe that this is a gap which could prove problematical for industrial companies which have captive insurance subsidiaries and ask you to devote some attention to it. As we see it:

- Inter-company insurance contracts and their financial effects should be eliminated in line with IAS 27. The provision retained by the insuring company to cover the liabilities involved, usually supported by an actuarial assessment, is retained in the consolidated financial statements. The eliminated insurance contracts fall outside the scope of the proposed IFRS.

- Also, in cases where one subsidiary acts as an (internal) insurance company for another and passes on some or all of the risks to a third party through a reinsurance contract, the elimination of the inter-company insurance contracts converts the contract with the third party into an insurance (rather than reinsurance) contract from a consolidated economic viewpoint. Considering it as such would also take it outside the scope of the proposed IFRS and thus avoid non-insurer preparers having to comply with burdensome disclosure requirements which actually target a different industry.

- There may, however, be situations where an operating subsidiary holds an insurance policy written by a third-party insurer which then passes back the risk to the captive insurance subsidiary, in whole or in part, by way of a reinsurance contract. This may be done where the group wishes to self-insure and where local insurance regulations etc. necessitate such a back-to-back procedure. In this case we assume that the normal netting constraints in IAS 1 apply, so that ED 5 would apply to the group by virtue of the reinsurance contract.

We support the principle that you have adopted in this and other standards that scoping should be based on type of transaction, not on type of industry. However, this does mean that, where a relatively small amount of a given transaction-type occurs in a group or the group enters into such arrangements as described under the last bullet point above, that group has potentially to fulfil many cumbersome, costly requirements (especially, but not only, in disclosures) which are actually primarily directed towards a particular “industry”. For example, an industrial group’s captive insurance subsidiary might undertake a minor amount of third-party insurance business, as a small side-line to bring in some extra contribution, and thus put the group in the position of having to set up more complex systems to account for and collect data and to make disproportionate disclosures (e.g. in line with paragraphs 26-30 in ED5). In IAS this problem was overcome by the opening materiality clause in a standard, but in ED5 as in the IASB’s other proposals to date this clause has been dropped, without any practical, pragmatic substitute. We strongly request the IASB to take up the question of describing sensible materiality considerations – for this and for other proposals – as a matter of urgency. Also, further consideration needs to be given to the fair presentation of the back-to-back procedure in terms of economic substance as opposed to legal form.

Another gap in ED5 is any consideration of income statement effects. We understand the IASB’s approach of “look after the balance sheet and the income statement will follow automatically”. However, for preparers and for the majority of grass-roots users, it is the income statement which is the key presentation, directed at showing the real, underlying results of the business both as an indication of what has happened and as a starting-point for forecasting what will happen. For these purposes the balance sheet is generally of secondary importance. We hope that Phase II of the insurance project will consider carefully how the real, underlying results of insurance business should be presented.

Procedurally, we have doubts about legitimacy of the Board’s approach on measurement. We believe that, at least until the issue of fair value measurement has been subject to due process, the IASB’s proposals can only legitimately be made with more widely accepted, traditional assumptions at least as alternatives. Implicitly ED5 assumes that Phase II will take a fair-value approach and asks for endorsement of the disclosure of fair values from 2006 onwards without proposing how this disclosure is to be arrived out – in an area where market values are practically non-existent. We strongly believe that such a disclosure should not be mandatory. The missing proposals on calculation could not in any case simply be accepted without being subject to due process.

We thank you in advance for your attention to these comments.

Yours sincerely

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