

Chapter 3

Measurement: Overall Issues

- 3.1 Principles 2.2 determines when insurance liabilities and insurance assets should be recognised. Principles 3.1-6.2 discuss how recognised insurance liabilities and insurance assets should be measured.
- 3.2 The discussion in principles 3.1-3.4 relates primarily to measurement by the insurer. Principles 8.2-3 discuss measurement by policyholders for a reinsurance contract. Principle 9.1 addresses measurement by a policyholder for a direct insurance contract.

Measurement Objective

Principle 3.1

- 3.3 *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.*
- 3.4 *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 would have to pay a third party at the balance sheet date to take over the liability.*
- 3.5 The following discussion deals with several aspects of principle 3.1:
- (a) implications of the Framework (paragraphs 3.6–7);
 - (b) possible future developments in accounting for financial instruments (3.8-10);
 - (c) entity-specific value and fair value (paragraphs 3.11–25);
 - (d) possible (but rejected) alternatives to entity-specific value and fair value – a cost accumulation basis and embedded value (paragraphs 3.26–33);
 - (e) the contrast between prospective approaches and retrospective approaches (paragraphs 3.34-39);

- (f) the contrast between entry value and exit value (paragraphs 3.40-46); and
- (f) present value (paragraphs 3.47-50).

The Framework

3.6 The Framework highlights various factors that the Steering Committee considered in determining a measurement objective for insurance liabilities and insurance assets. The objective of financial statements 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. The Framework identifies four qualitative characteristics that make the information provided in financial statements useful to users. In summary, the information should be:

- (a) readily understandable by users;
- (b) relevant to the decision-making needs of users. Information is relevant to their decision-making needs when it helps them to evaluate past, present or future events or confirm, or correct, their past evaluations. For example, information about the current financial position and past performance and cash flows has value to users when they evaluate the ability of an enterprise to generate cash and cash equivalents;
- (c) reliable, in other words:
 - (i) represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent;
 - (ii) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;
 - (iii) be neutral, that is, free from bias;
 - (iv) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and
 - (v) be complete within the bounds of materiality and cost; and
- (d) comparable with information provided by the enterprise itself in its financial statements through time and with information provided in the financial statements of different enterprises.

3.7 The Framework notes the need for a balancing, or trade-off, between these four qualitative characteristics. It also recognises that the provision of relevant and reliable information may be constrained by the need for timely reporting and for a balance between the benefits of the information and the cost of providing it.

Accounting for Financial Instruments

- 3.8 At the end of 2000, an international Joint Working Group of Standard Setters (JWG) produced a Draft Standard and Basis for Conclusions on Financial Instruments and Similar Items (the “JWG Draft”). The JWG Draft proposes, among other things, that
- (a) all financial instruments (except certain private equity instruments and certain financial instruments excluded from the scope of the document) should be measured at fair value; and
 - (b) changes in those fair values should be recognised immediately in the income statement.
- 3.9 In developing the Issues Paper, the Steering Committee adopted a working hypothesis that the work of the JWG would lead, before the end of the insurance project, to a new International Accounting Standard requiring full fair value accounting for substantially all financial assets and financial liabilities, other than insurance contracts. While not all members of the Steering Committee prefer this approach to financial instruments, this appeared the most productive way to tackle work on insurance contracts, given the uncertainty about the ultimate conclusion on financial instruments.
- 3.10 The JWG Draft has proved controversial. Accordingly, the Steering Committee addressed the possibility that IAS 39, Financial Instruments: Recognition and Measurement, may still be in place when IASB finalises a standard on insurance contracts. The proposals in this DSOP consider both this possibility and the possibility that a successor standard to IAS 39 may be broadly consistent with the JWG Draft.

Entity-Specific Value and Fair Value

- 3.11 The Issues Paper put forward two prospective asset and liability measurement models. One is a fair value model. Unlike the Issues Paper, this DSOP identifies a measurement objective for the other model: entity-specific-value.
- 3.12 Paragraphs 3.13-14 discuss the meaning of entity-specific value and paragraphs 3.15-19 discuss the meaning of fair value. Paragraphs 3.20-25 summarise the differences between entity-specific value and fair value and examine the arguments for and against each of these as a possible measurement objective. Paragraphs 3.26-33 discuss two alternative measurement objectives that this DSOP rejects: a cost accumulation basis and embedded value.

Entity-Specific Value

- 3.13 International Accounting Standards do not use the term entity-specific value. In developing a definition of entity-specific value, the Steering Committee referred to two precedents.

- (a) IASC’s Present Value Steering Committee has defined:

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- (i) 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”; and
 - (ii) the entity-specific value of a liability more specifically 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 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”.¹
- (b) In paragraph 86 of its February 2000 Exposure Draft, Accounting for Obligations Associated with the Retirement of Long-Lived Assets, the US Financial Accounting Standards Board (FASB) described entity-specific value as “the amount at which other independent parties that share the same information and the ability to generate or propensity to incur the entity’s estimated cash flows would agree to a transaction”.²

3.14 Some consider the description in that FASB Exposure Draft more appropriate because it emphasises the notion of a market price for a set of entity-specific cash flows. However, this DSOP adopts the definition proposed by the Present Value Steering Committee, because it emphasises the fact that the enterprise expects to hold the asset or liability; in relation to an insurance liability, this definition places emphasis on the insurer’s intention to discharge the liability by paying policyholder claims in accordance with the contract rather than by transferring the liability to another party. Nevertheless, with one exception, the practical results of applying the proposals in this DSOP will often be very close to the results of applying the FASB’s description. The exception relates to the effect of the insurer’s own credit standing. Under the FASB description, this is included in entity-specific value. However, it is excluded from entity-specific value in this DSOP (see principle 4.8).

Fair Value

3.15 International Accounting Standards 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”.

¹ Framework, paragraph 100(d)

² The FASB rejected entity-specific measurement, both in this exposure draft, and in the resulting standard, SFAS 143, Accounting for Asset Retirement Obligations. Paragraph B37 of SFAS 143 refers to “entity-specific measurement that would attempt to measure a liability in the context of a particular entity. An entity-specific measurement is different from a fair value measurement because it substitutes the entity’s assumptions for those that marketplace participants would make. Therefore, the assumptions used in an entity-specific measurement of a liability would reflect the entity’s expected settlement of the liability and the role of the entity’s proprietary skills in that settlement.”

- 3.16 Although there are some conceptual and practical issues involved in determining the fair value of an asset, it is reasonably clear what this definition means for an asset. It is less clear what the fair value of a liability is. There are three possibilities:
- (a) fair value as an asset (the amount at which others are willing to hold the liability as an asset);
 - (b) fair value in settlement with the creditor (the amount that the enterprise would have to pay to the creditor to extinguish the liability); and
 - (c) fair value in exchange (the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability).
- 3.17 Some argue that the definition of fair value refers to a single amount – the price of a transaction. On this basis, they believe that the fair value of a liability from the perspective of the debtor is the same as its fair value (as an asset) from the perspective of the creditor. In other words, they believe that the fair value of a liability is the same as its fair value as an asset (the amount at which others are willing to hold the liability as an asset).
- 3.18 Some argue that the fair value of an insurance liability is its fair value in settlement with the policyholder (the amount that the enterprise would have to pay to the policyholder to extinguish the liability). They argue that:
- (a) because many insurance liabilities are not, and perhaps cannot be, traded, it is more meaningful to refer to a hypothetical transaction with an actual counterparty – the policyholder – than to a hypothetical transaction with another party; and
 - (b) IAS 37, Provisions, Contingent Liabilities and Contingent Assets, states that a provision is measured by reference to “the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time”.³ This appears to permit reference to either fair value in settlement or fair value in exchange.
- 3.19 This DSOP takes the view that the fair value of a liability is its fair value in exchange (the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability). The definition of fair value in International Accounting Standards implies a transaction with a party other than the policyholder because:
- (a) if the insurance contract permits the insurer or policyholder to terminate its obligations under the contract for an agreed surrender value, any such termination reflects a price agreed at the time of entering into the contract, not a current transaction price;⁴

³ IAS 37, paragraph 37.

⁴ See paragraph 90(a) of the JWG Draft.

- (b) if the insurance contract does not permit the insurer or policyholder to terminate its obligations under the contract, any settlement will require negotiation with the other party to the contract. An insurer or policyholder is unlikely to be a willing party, because it would commence such negotiations only for compelling reasons that would weaken its bargaining position;⁵
- (c) the definition of fair value refers to a hypothetical transaction in which the debtor transfers its liability to another party, not one in which the creditor transfers its asset to another party; and
- (d) premature settlement with the policyholder contradicts the economic rationale for insurance, which is based on the insurer's ability to pool and diversify risks.

Differences between Entity-specific Value and Fair Value

3.20 Table 2.1 summarises the differences between entity-specific value and fair value. Depending on the approach taken to certain issues, the entity-specific value of an asset or liability may differ from its fair value for one or more of the following reasons:

- (a) the insurer may have superior management or other skills that enable it to maximise cash inflows from an asset or minimise the cash outflows from a liability.⁶ Alternatively, the insurer may have unusually high concerns about its reputation (for example, to protect the value of a brand) and this may lead it to accept a higher level of cash outflows than a more aggressive insurer might tolerate;⁷
- (b) the insurer and the market may both have the same ability to generate cash inflows or propensity to generate cash outflows, but still form different estimates about those cash flows (for example, if they have the same information, but draw different conclusions);⁸
- (c) the insurer and the market may have different views about the amount of risk associated with the cash flows;⁹

⁵ See paragraph 90(b) of the JWG Draft.

⁶ In principle 3.2, this DSOP concludes that the type of assets actually held or the return on those assets should not affect the entity-specific value or fair value of insurance liabilities. It follows that superior asset management skills do not affect the entity-specific value or fair value of an insurance liability (except for any indirect effect through influence on lapse and renewal rates).

⁷ Principles 4.4 and 4.5 discuss the approach where the insurer is able to generate entity-specific cash flows that would not arise for other market participants.

⁸ Principle 4.4 and 4.5 discuss the approach where the insurer does not make the same estimates of cash flows as other market participants.

⁹ Principle 4.1 requires an insurer to determine entity-specific value or fair value based on the expected present value of future cash flows. Expected present value incorporates estimates of the uncertainty associated with future cash flows, as well as their amount and timing. It follows that entity-specific value reflects the insurer's own view of the amount of risk while fair value reflects an estimate of the market's view of the amount of risk.

- (d) the insurer and the market may have the same views about the amount of risk associated with cash flows, but may price that risk differently because they have different risk preferences. For example, the insurer may be more or less risk-averse than other market participants in general. Similarly, the insurer may not have the same time preferences as other market participants, which would lead to different views of the time value of money;¹⁰
- (e) the insurer and the market may have different views about the relevance or impact of the insurer's own credit standing in measuring insurance liabilities;¹¹ and
- (f) the insurer and other market participants may have different liquidity needs – for example, an insurer with liabilities for which payment cannot be required for several years may have lower liquidity needs than other market participants.¹²

3.21 As the definition of fair value refers to knowledgeable parties, the insurer and the market may be assumed to have identical knowledge about the characteristics of the liability for the purpose of determining fair value. For example, if an insurer has very lax underwriting criteria, the portfolio of insurance contracts is likely to be substandard and the fair value of the portfolio should reflect this. It follows that both entity-specific value and fair value reflect the actual knowledge of the insurer.

3.22 Those who support entity-specific value as a measurement objective argue that:

- (a) most insurance liabilities are settled by payments to (or on behalf of) policyholders rather than by an exchange transaction with another party. For that reason, financial statement users are likely to be more interested in management's expectations than in assumed, and largely unobservable, market expectations relating to a hypothetical exchange transaction that may be very unlikely to occur;
- (b) in practice, management has better information than other market participants about the characteristics of the insurer's assets and liabilities. Financial reporting based on this superior information will be more relevant than financial reporting based on fair value, which reflects information available (or assumed to be available) to other market participants;
- (c) because most insurance liabilities are not traded, and are perhaps not tradeable, their fair value will not generally be observable directly in the market. It follows that their fair value will need to be estimated using models. As market expectations are usually not directly observable, the inputs to these models will normally need to reflect the insurer's own expectations, which defeats the purpose of a fair value objective; and

¹⁰ Principles 5.3 and 6.1 discuss the approach where the insurer does not have the same risk or time preferences as other market participants.

¹¹ Principle 4.8 discusses own credit standing.

¹² Principle 5.8 discusses whether illiquidity should affect the measurement of insurance liabilities.

- (d) some performance-linked contracts give the insurer considerable discretion over the amount and timing of bonuses. Assumptions about the future exercise of that discretion are inevitably entity-specific.

3.23 Those who support fair value as a measurement objective believe that it provides the most relevant and, particularly if directly observable, reliable information for users. They believe that:

- (a) the consensus estimates embodied in market prices are more informative and neutral predictors of future cash flows than subjective estimates by any one market participant;
- (b) entity-specific value is not determinable on a reliable basis, except by reference to market data. However, the use of market data would negate the arguments given for using entity-specific value instead of fair value;
- (c) fair value is, within the limits of estimation, independent of the entity performing the measurement. As a result, fair value provides a neutral basis for comparing one entity with another;
- (d) if a future International Financial Reporting Standard based on the JWG Draft requires full fair value accounting for the substantial majority of (non-insurance) financial assets and financial liabilities, IASB should also require full fair value accounting for insurance assets and insurance liabilities;
- (e) although the fair value of most insurance liabilities will not generally be observable directly in the market, their fair value can be estimated using models that are sufficiently reliable for financial reporting purposes. As far as possible, these models will use observable market data. This DSOP includes principles for determining the nature of those models and the required inputs; and
- (f) in principle, option-pricing models should be able to estimate the fair value of the option-like features that give the insurer considerable discretion over the amount and timing of performance-linked bonuses.

3.24 In the Steering Committee's view:

- (a) 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 refers to settlement with policyholders or other beneficiaries in an orderly fashion over the life of the liability. In the context of the variety of measurement objectives used in IAS 39, the Steering Committee believes that this focus on settlement in accordance with the contractual terms is more relevant than the focus of fair value on a hypothetical transaction with a third party; and

- (b) if substantially all of an insurer's financial assets are measured consistently on one basis, that basis should also be adopted for its insurance liabilities. Accordingly, if IASB 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.

3.25 Except where otherwise stated, measurement principles in this DSOP apply to both entity-specific value and fair value.

Cost Accumulation Basis

- 3.26 Some propose another prospective basis, sometimes described as cost-accumulation or cost-accrual. Such measurements attempt to capture the costs (usually incremental costs) that an entity expects that it will incur in acquiring an asset or satisfying a liability over its expected term. Those measurements exclude certain other assumptions that would be included in an estimate of fair value. For example, an entity that is accruing the costs of settling a liability might exclude the overhead, profit margin and risk premium (the price for bearing uncertainty) that third parties would incorporate in the price they would charge to assume the liability.
- 3.27 This DSOP rejects measurement objectives that focus on cost accumulation. The Steering Committee believes that these attempt to identify one form of entity-specific value, but do not provide a well-defined measurement objective in their own right. Principles 4.4, 4.5 and 5.1 discuss whether entity-specific value and fair value include overhead, profit margin and risk premium.

Embedded Value

- 3.28 Some insurers, notably many UK life insurers, report information about the embedded value of their insurance contracts. They measure insurance liabilities on a basis required by legislation or supervisory requirements. They then recognise¹³ or disclose an asset representing the present value of amounts that will be released for other uses as experience unfolds and policyholder liabilities are paid. The computations usually reflect the fact that capital must often be tied up to meet regulatory requirements. The discount rate is usually a rate commensurate with a risky asset, the insurer's risk adjusted discount rate or the investor's target rate of return. Embedded value does not include the potential value of future policies to be sold.
- 3.29 Unlike entity-specific value or fair value as they are described in this DSOP, embedded value includes the present value of estimated future cash flows from investments representing the insurance liability. As a result, embedded value generally:
- (a) in effect, attributes an amount other than fair value to investments currently held, by discounting the cash flows from those investments at a rate other than the estimated return on those assets. The resulting present value is one

¹³ UK Banking groups with life insurance subsidiaries generally recognise embedded values. Listed UK life insurers generally disclose embedded value but, for legal reasons, do not recognise it as an asset.

element of embedded value. That embedded value is generally reported as an asset in addition to the carrying amount (often fair value) of the investments;

- (b) in relation to investments to be acquired out of future premiums arising from the closed book of insurance contracts, effectively attributes an amount that differs from the current market price that the insurer will have to pay when it acquires them; and
- (c) attempts to reflect the economic cost of capital locked in by capital requirements. Some believe that this is one way of determining margins for risk and uncertainty (see paragraph 5.19).

3.30 Some argue that embedded value methods are appropriate, on the grounds that:

- (a) in countries where embedded value information is widely available, users of financial statements generally state that they find it useful as an indicator of economic value created;
- (b) although transfers of books of insurance liabilities are rare, they tend to occur together with a transfer of assets. Anecdotal evidence suggests that negotiated prices tend to reflect expectations about investment returns and the impact of capital requirements, on a basis similar to that assumed by embedded value methods; and
- (c) there is now substantial experience of using embedded value methods in the UK and growing experience in their use elsewhere. It would be preferable to base measurement requirements on this tested methodology, rather than on entity-specific value or fair value which have never been implemented in practice.

3.31 For reasons discussed in principle 4.3 (in relation to future investment returns and capital requirements), this DSOP does not permit embedded value methods, either as a means of measuring insurance liabilities or as means of reporting a separate asset to compensate for an unrealistically high measurement of the insurance liability.

3.32 Recent actuarial literature divides methods of measuring insurance liabilities into two categories. Direct methods measure the liability by discounting future cash flows arising from a book of insurance contracts. Indirect methods measure the liability by discounting all cash flows arising from both the book of insurance contracts and the assets supporting the book, to arrive at a net measurement for the contracts and supporting assets. The measurement of the assets is then deducted to arrive at a measurement of the book of contracts. Embedded value methods are one form of indirect method.

- 3.33 If the same assumptions are made in both methods, it is possible to show that direct and indirect methods can produce the same results.¹⁴ However, this DSOP takes the view that direct methods are more transparent and, hence, preferable.

Prospective Basis

- 3.34 There are two broad approaches to measuring insurance liabilities and insurance assets:
- (a) **retrospective approaches:** these approaches focus on an accumulation of past transactions between policyholders and insurers; and
 - (b) **prospective approaches:** these approaches focus on the future cash inflows and outflows from the closed book of insurance contracts.
- 3.35 Under a retrospective approach:
- (a) for a typical general insurance contract, an insurer recognises a liability for unearned premiums on the date when coverage begins under the insurance contract. Over the life of the contract, the unearned premium liability is reduced as premium revenue is recognised. In some cases, the liability for unearned premiums is less than the estimated present value of future claim payments under existing insurance contracts. In such cases, a general insurer generally recognises an additional provision for premium deficiency, after first writing down any deferred acquisition costs;
 - (b) for a traditional life insurance contract, the insurer measures the insurance liability initially on the basis of the premium received, and defers acquisition costs, either as if they were an asset or as a reduction in the liability. The expected profit margins on the contract impact the measurement gradually over the life of the contract, on various bases depending on the accounting standards followed and the nature of the product;
 - (c) for the life insurance contracts discussed in paragraph 4.29 that use a policyholder account, the measurement of insurance liabilities is generally based on the balance in the policyholder account. Similarly, for insurance contracts with an explicit surrender value, measurement may be based on that surrender value; and
 - (d) the initial recognition of an insurance contract does not generally give rise to the immediate recognition of income and expense.
- 3.36 Under a prospective approach:
- (a) an insurer measures an insurance liability at an amount representing the estimated present value of all future net cash outflows arising from the

¹⁴ Luke N. Girard, Market Value of Insurance Liabilities: Reconciling the Actuarial Appraisal and Option Pricing Methods, North American Actuarial Journal, Volume 4, Number 1

contract.¹⁵ This amount, described in the Issues Paper as a provision for unexpired risk, may be more or less than the premium already paid by the policyholder. If it is less (more) than the premium, the insurer will report a net profit (loss) on initial recognition; and

- (b) the provision for unexpired risk decreases as claims are paid and as the insurer is released from risk.¹⁶ It changes because of changes in assumptions. Because the provision is determined on a discounted basis, the provision increases as interest is added to the balance and changes when the discount rate changes.

3.37 Supporters of retrospective approaches argue that they are:

- (a) less subjective, more reliable and less complex, than prospective methods, because they rely more on objectively observable prices of recorded transactions and less on estimates of future cash flows. A wide range of reasonably supportable assumptions could be made in implementing prospective methods and often no point within such a range is demonstrably superior to the others. As a result, prospective measurements will be inherently unreliable and subject to manipulation. Furthermore, small changes in assumptions may lead to a large change in reported profit under prospective methods. It may not be easy for an auditor to confirm whether these changes result from genuine changes in estimates rather than from a desire to influence the level of reported profit;
- (b) more consistent than prospective approaches with the approach to revenue recognition in IAS 11, Construction Contracts, and IAS 18, Revenue.¹⁷ IAS 18 indicates that revenue associated with a transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date. For example, if the sale price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed; and
- (c) consistent with the amortised cost basis used to measure most financial liabilities under IAS 39.

3.38 Both entity-specific value and fair value are the result of prospective approaches. This DSOP is based on the view that:

¹⁵ If the present value is negative, the result is an insurance asset.

¹⁶ Under current accounting requirements in some countries, the net profit arising under a profitable contract is recognised over the premium-paying period. Under this DSOP, that net profit will be recognised over the period when the insurer is at risk. For many insurance contracts, that period extends beyond the premium-paying period.

¹⁷ Prospective approaches are, arguably, more compatible with IAS 11 and IAS 18 if they are based on entry prices rather than on exit prices. See paragraphs 3.40-46 for further discussion.

- (a) a prospective approach is more consistent with the Framework's emphasis on giving information that helps users to evaluate the ability of an enterprise to generate cash and cash equivalents;
- (b) clear reporting of changes in assumptions (see principle 13.5) should overcome any concerns that insurers may manipulate assumptions persistently; and
- (c) a prospective approach leads to more informative performance reporting, as changes in circumstances and conditions are reported more quickly. Although IAS 18 does not allow recognition of a gain on inception of a service contract, this should not prevent standard setters from improving accounting for insurance contracts. If standard setters do not provide such improvements, the markets will encourage insurers to develop parallel reporting systems, as UK insurers have using embedded value. Such parallel systems undermine market confidence in the relevance of the "official" financial statements.

3.39 To assess concerns expressed by commentators on the Issues Paper about the reliability of prospective measurements and to identify related practical issues, the Steering Committee proposes that IASB should conduct field visits in 2001 and a field test in 2002.

Entry Value and Exit Value

3.40 To apply a prospective model (based on either entity-specific value or fair value), it is necessary to specify whether the future cash flows are to be measured on the basis of their (current) entry value or (current) exit value. Current entry value is the amount of the premium (perhaps net of acquisition costs) that the insurer would charge in current market conditions if it were to issue new contracts that created the same remaining contractual rights and obligations. Those who favour entry values:

- (a) question the relevance of exit values if the enterprise does not, in fact, intend to settle the insurance obligation in a current transaction;
- (b) argue that entry values are more consistent with the revenue recognition principles in IAS 18, Revenue, and IAS 11, Construction Contracts. Although profit margins may be intended partly to provide a risk premium and the cost of capital, profit margins are sometimes also compensation for supplying goods or performing services, particularly in inefficient markets, such as some (perhaps, most) insurance markets. Under IAS 18 and IAS 11, those profit margins are attributed to the periods when the goods are supplied or the services are provided;
- (c) consider that entry values have a considerable practical advantage over exit values. Insurers and actuaries have experience in determining the amount of premium charged for particular risks. Premiums can be observed in the marketplace. Entry-value proponents contend that exit values are not determinable reliably; and

- (d) suggest that, in an arm's-length transaction, the amount of premium may be taken as an approximation of the value of the risk assumed, absent evidence to the contrary.
- 3.41 For the following reasons, principle 3.1 proposes that fair values of insurance liabilities should be based on (current) exit values, that is, the amount that the insurer would pay another insurer in exchange for transferring all of the obligations associated with the insurance liability to that other insurer:
- (a) the use of exit values is consistent with the definition of fair value in current IASB standards as “the amount for which an asset could be exchanged, or a liability settled”. Similarly, IAS 37 refers to exit value, “the best estimate of the expenditure required to settle the present obligation at the balance sheet date” and the JWG’s guidance on fair value refers to “an estimate of the price an enterprise would have received if it had sold an asset or paid if it had been relieved of a liability on the measurement date in an arm’s-length exchange motivated by normal business considerations”.¹⁸
 - (b) although paragraph 3.40(c) cites practical advantages of entry values, these are limited because the insurer typically determines the premium at the inception of policies only. Determining the entry value of existing contracts at subsequent dates may be as difficult as determining the exit value;
 - (c) in some countries, premium tariffs are heavily regulated and so entry values do not necessarily reflect normal interactions in a free market;
 - (d) profit margin is, in an efficient market, simply another way of describing the required risk premium and the return required to cover the cost of capital;
 - (e) if the entry-price basis is used, an insurer that prices its products conservatively will report larger liabilities than an insurer that prices its products more aggressively. This will lead to lack of comparability; and
 - (f) use of exit values portrays the economic value that an insurer adds by issuing an insurance contract in a retail market and that the insurer can, conceptually at least, realise in a wholesale market.
- 3.42 For entity-specific value, most of the arguments in the preceding paragraph are still valid, even though the notion of an exit value may be less relevant if sale or settlement is not imminent. In particular, entity-specific value should capture the economic value arising from differences between the retail market and the wholesale market (paragraph 3.41(f)). Therefore, this DSOP proposes that entity-specific value should also be consistent with the way that the market would price the estimated entity-specific cash flows that will arise as the insurer settles the liability with policyholders or other beneficiaries in an orderly fashion over the life of the liability.

¹⁸ JWG Draft, paragraph 28.

- 3.43 One consequence of the exit value basis is that an insurer will report a net profit or loss on initial recognition of an insurance liability if the measurement of that insurance liability differs from the initial premium paid by the policyholder, less acquisition costs. The Steering Committee acknowledges that some have reservations about the recognition of a net profit at inception of an insurance contract – partly because many insurance contracts, particularly long-duration contracts, contain a significant administrative and service component. However, the Steering Committee believes that this is a logical result of adopting the more informative reporting offered by a prospective exit value model.
- 3.44 As a practical matter, a significant net profit or loss on initial recognition of an insurance contract may suggest that the insurer has used flawed assumptions or failed to consider properly the amount of risk premium that another insurer might demand in determining the price of settling the liabilities in question. If first estimates suggest that there may be a significant net profit or loss on initial recognition, it will be particularly important to double check all assumptions to avoid errors or omissions. However, an insurer operating in a niche market or with special distribution channels may sometimes be able to realise a significant net profit on initial recognition. Similarly, there may be cases when an insurer decides to write unprofitable insurance contracts in order to gain or protect market share.
- 3.45 Principle 5.7 addresses exceptional cases when an insurer is unable to estimate reliably the market value margin at initial recognition of an insurance liability or insurance asset.
- 3.46 Principle 4.2 on renewals discusses, among other things, whether entity-specific value should be combined with a requirement that insurance liabilities should be measured at no less than a minimum amount, which is the result of applying a retrospective approach. This requirement is sometimes described as a “deposit floor”.

Present Value

- 3.47 In current practice, most life insurance measurements use present value (discounting), either directly or indirectly, and it is generally accepted that this is appropriate. Most measurements of general insurance obligations do not use present value. Those who oppose discounting for some insurance contracts, particularly some general insurance contracts, argue that:
- (a) the predominant base for today’s accounting is historical cost. Historical cost accounting is not concerned with measuring the economic value of assets and liabilities. Therefore, the time value of money should not be considered in measuring assets and liabilities;
 - (b) discounting will increase the volatility of the amounts reported in the balance sheet and income statement if the discount rate is a current market rate. This will make it more difficult for users to understand an insurer’s performance;
 - (c) discounting of general insurance liabilities accelerates recognition of future investment income and is imprudent, especially given the inherent subjectivity

involved in estimating the amount and timing of future cash flows. Discounting also fails to match the cost of claims with related premium revenue. If insurance liabilities are discounted, the balance will increase with the passage of time until the claims are paid. As a result, the insurer will recognise a cost (accrual of interest) after all of the related premium revenue has been recognised;

- (d) some general insurance liabilities generate cash flows that vary with price changes. In current practice, they are sometimes “implicitly” discounted by being measured at undiscounted amounts that ignore future inflation. Particularly for short-tail general insurance, this may give a reasonable approximation with less cost and complexity than explicit discounting; and
- (e) the amount and timing of cash flows cannot often be estimated in practice in a reliable and reasonably objective way at a reasonable cost. Consequently, discounting does not generate a reliable result and may diminish comparability between the financial statements of different enterprises. It also places an undue burden on preparers.

3.48 Both entity-specific value and fair value are forms of present value. For the following reasons, this DSOP is based on the view that a present value is more appropriate than an undiscounted measurement:

- (a) by reflecting the time value of money and uncertainty, discounting measures future cash flows at different amounts if they are economically different and at the same amount if they are economically the same. The resulting measurement is more relevant than undiscounted measurement to users of financial statements. This is true even if financial statements are prepared on a historical cost basis;
- (b) discounting is consistent with rational pricing decisions, which typically reflect the time value of money and the risk inherent in the contract. Therefore, any volatility resulting from discounting is likely to be a faithful representation of an insurer’s activity. Similarly, discounting eliminates the incentive for transactions (for example, some financial reinsurance transactions) that lack economic substance and are designed to capture the economic realities excluded from undiscounted measurements;
- (c) discounting matches revenue and expenses because it expresses them in terms of a common measuring unit – present value at a given time - rather than comparing revenue expressed in terms of present value at one time with expenses expressed in terms of present value at another time. The insurer invests premiums received and earns interest on those investments until amounts are needed to pay claims. By discounting insurance liabilities, the insurer matches the accretion of discount on an insurance liability with interest revenue earned on the investments;

- (d) implicit discounting makes the unrealistic assumption that two different variables (inflation and time value) will more or less offset each other in every case;
 - (e) International Accounting Standards already require discounting for some items, such as long-term provisions, employee benefit obligations and finance leases. There is no obvious conceptual basis for exempting insurance assets and insurance liabilities from similar measurement;
 - (f) discount rates, the amount and timing of future cash flows and the impact of risk and uncertainty can generally be estimated in practice in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Present value techniques can be applied in a way that will lead to answers within a reasonably narrow range and their greater use will result in more relevant information for users. Indeed, many enterprises already have experience of present value techniques, both to support investment decisions and to measure items for which International Accounting Standards already require discounting; and
 - (g) although discounting may cause some increase in both subjectivity and cost, the increase in relevance outweighs these concerns. Indeed in some cases, measurements that use present value techniques may be more reliable, and less likely to vary from one insurer to the next, than undiscounted measurements. The present value discount tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.
- 3.49 Some believe that discounting should be prohibited, or at least not required, for insurance liabilities and insurance assets that will lead to cash flows no later than one year after the balance sheet date. They argue that:
- (a) the effect of discounting is not likely to be material in these cases; and
 - (b) a one-year cut-off is practical and cost-effective, as it does not require preparers to estimate the effect of discounting before deciding whether discounting is needed.
- 3.50 Discounting could sometimes have a material effect, even for items that will lead to cash flows within one year. Therefore, this DSOP proposes that discounting should always be required, except when the effect of discounting would not be material.

Interaction with Measurement of an Insurer's Non-insurance Financial Assets

Principle 3.2

3.51 *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, as discussed in chapter 7).*

- 3.52 Some argue that the measurement of liabilities should represent the current amount of assets that, if invested today, will provide future cash flows that match the cash outflows for a particular liability, rather than settlement of the liability in a current market transaction. One way to achieve this is by discounting the liabilities at a discount rate that reflects the rate of investment return that the enterprise expects to obtain over the life of the liabilities. They suggest that such measurements appropriately reflect the implications of particular investment strategies that may, for example, affect the level of required regulatory capital, or affect the risk of default by the insurer.
- 3.53 Those who oppose the use of asset-based discount rates argue that the value of an enterprise's liabilities has little to do with its investment decisions. They offer the example of two insurers that offer identical policies paying the same fixed interest rate. Insurer A chooses to invest in high-risk bonds with a yield of 9 percent (after expected defaults), while insurer B invests in high-grade bonds with a yield of 7 percent (after expected defaults). Using asset-based discount rates, insurer A will report a smaller liability, even though the expected cash flows from their liabilities are the same. Apart from differences in credit standing (discussed in principle 4.8) a policyholder would be indifferent between policies from insurer A and insurer B. Also, another insurer would demand the same price to assume either liability.
- 3.54 Some believe that the characteristics of assets held by an insurer are not relevant in determining the fair value of its liabilities, but may be relevant in determining their entity-specific value.
- 3.55 Current IASC Standards are based on the view that the characteristics of liabilities should not affect the measurement of assets and the characteristics of assets should not affect the measurement of liabilities. For example:
- (a) the discount rate used to determine an asset's value in use under IAS 36, Impairment of Assets, reflects the risks specific to the asset. The discount rate does not reflect the enterprise's capital structure, its incremental borrowing rate or the way it financed the asset; and
 - (b) under IAS 19, Employee Benefits, the discount rate used to measure obligations under a defined benefit plan does not reflect the assets actually held by the plan.
- 3.56 This DSOP reflects the view that:
- (a) any interaction between assets and liabilities is best communicated by:
 - (i) using the same measurement basis for both assets and liabilities. If substantially all of an insurer's financial assets are measured consistently on one basis, that basis should also be adopted for its insurance liabilities; and

- (ii) disclosing asset-liability management policies and the degree of mismatch risk (see principle 14.XXX for these disclosures). The presence (or absence) of asset-liability mismatch risk should not affect the entity-specific value or fair value of assets and liabilities;¹⁹ and
 - (b) the entity-specific value and fair value of insurance liabilities are independent of the carrying amount of the insurer's assets (subject, possibly, to the insurer's own credit standing), unless the amount paid to policyholders is directly influenced by the return on specified assets, as with certain participating or unit-linked insurance contracts.
- 3.57 Some argue that a model that consistently uses cost-based accounting for substantially all of an insurer's financial assets might require "cost"-based accounting for insurance liabilities, based on for example, the original premium received (after deducting acquisition costs), combined with (a) a planned release of margins over the period of insurance cover or over the period of risk and (b) a loss recognition test requiring the insurer to recognise an additional provision if it becomes apparent that the deferred premium is insufficient in the light of estimated costs of insured events. This DSOP is based on the view that such a model is unlikely to emerge, given existing International Accounting Standards (notably IAS 39) and the JWG Draft.
- 3.58 If assets are measured on a mixture of different bases, mismatches may arise. At this stage of the project, it is not efficient to consider whether possible solutions should be found for such mismatches, as it is impossible today to predict the nature of the mismatches, if any, that may be in existence when the insurance standard is finalised.
- 3.59 The Steering Committee considered the possibility that mismatches could arise from the interaction of entity-specific value for insurance liabilities with the use of IAS 39 for an insurer's financial assets. Under IAS 39:
- (a) the following are measured at fair value: derivative financial assets and derivative financial liabilities, financial assets and financial liabilities held for trading purposes and available for sale financial instruments;
 - (b) the following are measured at the lower of (i) recoverable amount and (ii) either amortised cost (if they have a fixed maturity) or cost (if they do not have a fixed maturity): loans and other receivables originated by the enterprise and not held for trading; held-to-maturity investments; any financial asset for which there is no price quotation in an active market and whose fair value cannot be reliably measured; and all financial liabilities (other than derivatives and those held for trading purposes); and
 - (c) changes in carrying amount are recognised in the income statement immediately, except that an entity may elect to recognise changes in the fair value of available for sale financial assets directly in equity.

¹⁹ Mismatch may affect the amount of capital that an insurer should hold. It is beyond the scope of an accounting standard to set capital requirements.

3.60 The main causes of possible mismatches would be:

- (a) an election to recognise changes in the fair value of financial assets directly in equity while changes in the entity-specific value of insurance liabilities are recognised in the income statement. An insurer could avoid this by electing to recognise changes in the fair value of financial assets in the income statement;
- (b) use of the amortised cost basis for hold-to-maturity investments, combined with entity-specific value for insurance liabilities. In practice, an insurer will not classify any financial asset as a held-to maturity investment if it does not declare that it has the positive intent and ability to hold that asset until maturity;
- (c) use of the amortised cost basis for originated loans and receivables, combined with entity-specific value for insurance liabilities. Principle 4.1 proposes, among other things, that policy loans should be treated as a prepayment of the policy benefits, rather than as a separate financial asset. Therefore, no mismatch would arise for policy loans. However, there may be a mismatch to the extent that the insurer holds other originated loans and receivables not held for trading; and
- (d) use of fair value for financial assets held for trading (including derivatives) and available-for-sale financial assets, combined with entity-specific value for insurance liabilities. In practice, the fair value of most such financial assets is likely to be the same as their entity-specific value.

3.61 As noted in the previous paragraph, a insurer need not face significant mismatches if it exercises the options in IAS 39 in particular ways. If an insurer exercises some of these options in other ways, more significant mismatches are possible. This DSOP does not take a position on whether insurers should exercise these options in a way that minimises these mismatches. Also, this DSOP does not attempt to deal with these mismatches. The Steering Committee urges the Board to consider them in its project on performance reporting.

3.62 Principle 5.3 on risk preferences discusses, among other things, whether the concept of a replicating portfolio has a place in measuring insurance liabilities.

Neutrality

Principle 3.3

3.63 *Overstatement of insurance liabilities in general purpose financial statements should not be used to impose implicit solvency or capital adequacy requirements.*

3.64 Some argue that insurers should exercise greater prudence than other enterprises, because of the need to protect policyholders and because uncertainty is the essence of insurance – the insurer takes on risks from policyholders. The Framework describes prudence as the inclusion of a degree of caution in the exercise of the judgements

needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

- 3.65 However, others note the Framework's statement that the exercise of prudence does not allow the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral, that is, free from bias. The Framework explains the information contained in financial statements must be neutral if it is to be reliable and hence useful to users.
- 3.66 One aim of accounting standards is to ensure that enterprises report the amount of assets, liabilities and equity they actually have, not the amount of assets and equity that they need to hold in order to cope with shocks. Accordingly, this DSOP is based on the view that the best way to serve the interests of policyholders is by requiring an insurer to:
- (a) report neutral information in its general purpose financial statements about its assets, liabilities and equity, as this gives policyholders (and other users, such as insurance supervisors) the best insight into the insurer's financial position;
 - (b) disclose the nature and extent of uncertainties; and
 - (c) satisfy solvency and capital adequacy tests that specify how much equity an insurer should have, so that there will be reasonable assurance that the insurer holds sufficient assets to meet all claims, even if there are unexpected adverse developments. It is not the responsibility of IASB to develop solvency and capital adequacy tests, as these are matters for insurance supervisors. However, general purpose financial statements may provide some of the information that insurance supervisors could find helpful as inputs for such tests.

Annual Basis of Accounting

Principle 3.4

3.67 *Deferred and fund methods of accounting should not be used.*

- 3.68 Deferred and fund methods recognise premium revenue and claims expense at a predetermined time (for example, three years) after the end of the underwriting year, or as soon as premiums, claims, and expenses can be reliably measured. Until that time, premiums received (less claims and expenses paid) are reported in the balance sheet as a fund. If the fund is deficient, the loss is recognised immediately. This DSOP is based on the view that deferred and fund methods are now unnecessary, given modern advances in communications. Principle 5.7 discusses the cases – which the Steering Committee expects to be exceptional – when an insurer cannot make a reliable estimate of the entity-specific value or fair value of a book of insurance contracts.

Introduction to the Discussion of Measurement in the Rest of this DSOP

3.69 The rest of this DSOP discuss measurement under the following headings:

- (a) estimating future cash flows (chapter 4);
- (b) risk and uncertainty (chapter 5);
- (c) discount rate (chapter 6);
- (d) performance-linked contracts (chapter 7);
- (e) reinsurance (chapter 8); and
- (f) measurement of direct insurance contracts by policyholders (chapter 8).

3.70 Except where otherwise indicated explicitly, the discussion covers both entity-specific value and fair value.

3.71 For convenience, the rest of this DSOP often refers to insurance liabilities. Except where an explicit statement is made to the contrary these references apply equally to insurance assets.

3.72 This DSOP discusses measurement in a certain amount of detail. In some cases, estimates, averages and computational shortcuts may provide a reliable approximation of the proposed measurements.