

Recognition and Measurement – Overall Objectives

116. Basic Issues 4-11 address a number of recognition and measurement issues. Basic Issue 4 addresses the overall objective of accounting for insurance contracts. Basic Issue 5 asks whether the measurement of an insurer's assets should affect the measurement of its liabilities. Basic Issues 6-10 explore various specific recognition and measurement implications of adopting a traditional approach to measuring insurance liabilities: Basic Issue 6 addresses general recognition and measurement issues common to several types of insurance contract and Basic Issues 7 to 10 deal with specific applications (general insurance, life insurance, participating contracts, reinsurance). Basic Issue 11 explores recognition and measurement implications of adopting a fair value approach to measuring insurance liabilities.
117. The Steering Committee recognises that the measurement of insurance liabilities poses difficult practical issues. To avoid excessive detail, this Issues Paper discusses measurement issues in fairly general terms. The Steering Committee will develop more specific guidance on measurement issues at a later stage in the project.

Basic Issue 4 What should be the Overall Objectives of a Recognition and Measurement System for Insurance Contracts?

118. Basic Issue 4:
- (a) summarises IASC's Framework for the Preparation and Presentation of Financial Statements;
 - (b) discusses the needs of users of financial statements;
 - (c) considers the role of special purpose reports prepared for insurance supervisors; and
 - (d) reviews various possible objectives of accounting for insurance contracts.

The Framework

119. The Board of IASC uses IASC's Framework for the Preparation and Presentation of Financial Statements (the "Framework") to assist it in:
- (a) the development of International Accounting Standards and in its review of existing International Accounting Standards; and
 - (b) promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards.
120. The Framework states that 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 users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers (for example, the policyholders of an insurer), governments and their agencies (for example, supervisors and regulators) and the public.

121. The Framework is concerned with general purpose financial statements. Such financial statements are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of the Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.
122. The Framework's two underlying assumptions are that financial statements are prepared on:
 - (a) the accrual basis of accounting, which means that the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are reported in the financial statements of the periods to which they relate; and
 - (b) the basis that an enterprise is a going concern and will continue in operation for the foreseeable future and has neither the intention nor the need to liquidate or curtail materially the scale of its operations. Although the Framework does not state this explicitly, the purpose of the going concern assumption is to indicate that financial statements are not normally to be prepared on a break-up basis.
123. 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 their decision-making needs;
 - (c) reliable; 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.
124. The Framework argues that information is relevant to the decision-making needs of users 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.

125. To be reliable, information must:

- (a) represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent;
- (b) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;
- (c) be neutral, that is, free from bias;
- (d) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and
- (e) be complete within the bounds of materiality and cost.

126. The Framework notes the need for a balancing, or trade-off, between the 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.

Definition and Recognition of Assets and Liabilities

127. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The Framework identifies five elements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets, liabilities or equity. The elements directly related to the measurement of performance in the income statement are income and expenses.

128. The Framework defines equity as the residual interest in the assets of an enterprise after deducting all its liabilities. It also defines income and expenses in terms of changes in assets and liabilities. Therefore, in terms of balance sheet recognition, this paper concentrates on assessing whether insurance contracts give rise to assets or liabilities. Paragraph 49 of the Framework establishes the following definitions:

- (a) an asset is a “resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise”; and
- (b) a liability is 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”.

129. The Framework's recognition criteria are set out in Paragraph 83: an item that meets the definition of an asset or liability should be recognised (that is, included in the balance sheet) if:
- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
 - (b) the item has a cost or value that can be measured with reliability.
130. Paragraph 82 of the Framework observes that the failure to recognise an item that meets the definition of an element and satisfies the recognition criteria is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

Sub-issue 4A Should the Project Focus on General Purpose Financial Statements?

131. The objectives of accounting for insurance contracts are the same as the objectives of accounting for any other commercial transaction or of financial reporting generally. Paragraph 12 of the Framework makes the statement quite simply:

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.

132. The Framework describes several categories of potential financial statement users, including three - investors, customer-lenders, and government agencies - who are of particular interest in this project.
133. **Investors.** Most insurers are organised as either stock or mutual companies. Mutual insurance companies are owned by their policyholders and do not have investors in the usual sense. Some insurers are state-owned.⁶
134. **Customers-Lenders.** The customers of an insurance enterprise (its policyholders) are also its principal creditors. The typical buyer of an individual life or general insurance contract probably pays little attention to an insurer's financial statements, although the buyer may consider the reports of rating agencies that examine those statements. In some countries, such as the United Kingdom, insurance contracts are sold through independent advisers who are required to give customers "best advice": to do this, they generally consider several factors, including the financial strength of the insurer. Large corporate and government purchasers of insurance frequently evaluate the financial soundness of competing insurers in making their purchase decisions.
135. **Government agencies.** In most jurisdictions, government agencies (insurance supervisors) regulate and monitor the solvency, pricing, and business conduct of insurance enterprises in order to safeguard the interests of policyholders. Because of the specific characteristics of insurance business (in particular, the need to protect

⁶ In its Guideline 1, the Public Sector Committee of IFAC (the International Federation of Accountants) recommends that government-owned business enterprises follow IASC standards.

policyholders), financial reports based on prescribed regulatory accounting and measurement rules are usually part of the regulatory scheme.

136. These three user groups may sometimes have different views on the objectives of accounting for insurance. Regulatory accounting rules often incorporate a measure of prudence in measuring liabilities and assets, as many consider this to be consistent with the governmental mandate to oversee the financial soundness of insurance enterprises and so protect consumers. In contrast, investors are concerned with assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Customers tend to stand between the two other groups. Like supervisors, they are especially interested in the insurer's ability to pay claims. However, most corporate purchasers of insurance are accustomed to using financial information produced by other commercial enterprises. They may be ill equipped to evaluate the differences between the information produced under regulatory accounting rules and the information produced under the principles followed by commercial enterprises in other sectors.
137. In general, all potential users of an insurer's financial statements (investors, policyholders and government agencies) are interested in the insurer's financial soundness. However, some maintain that the different interests of supervisors and investors are incompatible. There are various approaches to this question:
- (a) in some countries, insurers prepare two sets of financial information - one for submission to supervisors and one for general purpose financial reporting;
 - (b) in some countries, some insurers provide supplemental information designed to overcome perceived shortcomings in regulatory rules as a basis for general purpose financial reporting;
 - (c) a few countries have developed a single set of accounting principles designed to provide information acceptable for both regulatory and general purpose reporting. In some jurisdictions, supervisors now believe that it is unnecessary to incorporate conservatism in liability measurement if there is close monitoring of solvency and of capital adequacy on a risk-adjusted basis. (Clearly, liability measurement is intertwined with solvency and risk-based capital requirements – such requirements are not likely to meet their objectives if they are based on conservatism that is not present); and
 - (d) in most other jurisdictions, regulatory accounting rules govern financial reporting by insurers.

Reporting to Supervisors

138. Financial information plays a vital role in monitoring by insurance supervisors, as it is an essential part of the information that supervisors use to assess whether insurers:
- (a) are solvent – in other words have sufficient assets to settle their liabilities; and

- (b) have adequate capital to meet regulatory capital requirements that are designed to ensure that insurers remain solvent if there are unexpected adverse developments.
139. Insurance supervisors generally focus on minimising the risk of an insurer's insolvency and on maintaining public confidence in the ability of insurers to meet their liabilities under insurance contracts. For reasons of prudence, they often require insurers to exclude certain assets from solvency and capital adequacy computations. Also, the computations sometimes include conservative values for assets and liabilities. It is sometimes argued that this conservative focus is also necessary to ensure that the information reported is reliable and objectively verifiable.
140. Insurance is a regulated activity in most jurisdictions. For this reason, the computations required by insurance supervisors have influenced general purpose financial statements prepared by insurers in some countries. The Steering Committee considered whether this is appropriate in the light of the Framework. In particular, the Steering Committee considered the role of prudence in this process.
141. The Framework acknowledges that preparers of financial statements have to contend with uncertainties. This is particularly true for insurers because uncertainty is the essence of insurance – the insurer takes on risks from policyholders. The Framework explains that uncertainties are recognised by disclosing their nature and extent and exercising prudence in the preparation of the financial statements. Prudence is 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.
142. However, the Framework argues that the exercise of prudence does not allow, for example, 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 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. The Framework states that financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
143. Some argue that understatement of assets or income, or overstatement of liabilities or expenses, is necessary to protect policyholders. However, such practices do not make it easier for insurers to pay claims (except perhaps indirectly if this affects the level of dividend payments to stockholders). Therefore, others argue that the best way to serve the interests of policyholders is by requiring insurers to:
- (a) report information in their general purpose financial statements that is neutral as this gives policyholders (and other users) the best insight into an insurer's financial position, financial performance and cash flows; and
 - (b) satisfy solvency and capital adequacy tests that aim to give reasonable assurance that insurers hold sufficient assets to meet all claims as they fall due.

Tentative Steering Committee View

144. *In the Steering Committee's view, the interests of different user groups overlap. All share an interest in relevant and reliable information about the insurance enterprise, its assets and liabilities, its financial performance, and its ability to meet obligations. The IASC project on insurance accounting necessarily emphasises general purpose financial statements and the IASC's Framework of financial reporting concepts.*
145. *Although the project will focus on general purpose financial statements, the outcome of the project may have implications for insurance supervisors. In some countries, national requirements for general purpose financial reporting may change in response to an International Accounting Standard on Insurance. Such changes could have a direct effect on those insurance supervisors who rely mainly on general purpose financial statements to assess capital adequacy and solvency. In other countries, insurance supervisors receive separate special purpose reports prepared on a different basis and may be affected less directly. Nevertheless, insurance supervisors are increasingly looking to develop a common international approach to issues such as solvency and capital adequacy - and may wish to look to an International Accounting Standard to define the data used in such requirements - although supervisors will, of course, still have responsibility for setting the requirements.*
146. *The Steering Committee hopes that insurance supervisors will find that they can build on general-purpose financial statements in performing their statutory function. Insurance supervisors have several tools that they can use to monitor solvency, including capital adequacy testing, risk-based capital requirements and restrictions on investment policies. In the Steering Committee's view, those devices allow insurance supervisors to maintain appropriate control within their jurisdictions, while allowing the development of general purpose financial reporting that is useful to a broad range of financial statement users.*
147. *In the Steering Committee's view, overstatement of insurance liabilities in general purpose financial statements should not be used to impose implicit solvency or capital adequacy requirements.*

Sub-issue 4B Should IASC use the IASC Framework as a Basis for Developing an International Accounting Standard on Insurance?

148. A number of features distinguish insurance from some other industries:
- (a) policyholders may suffer a significant loss if their insurer is unable to pay valid claims. Thus policyholders, who are often unsophisticated in financial matters, have a great interest in the insurer's solvency;
 - (b) largely in response to (a), insurance is a heavily regulated industry;
 - (c) in many other industries, the costs of a product or service are known before the associated revenue. However, in insurance, the revenue (premiums) is

generally known (and received) in advance and the costs (claims) are not known until later;

- (d) long-tail general insurance contracts and many life insurance contracts expose insurers to risks that will not be fully resolved for many years. In other industries, such long-term exposures are much less frequent; and
 - (e) there is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts, which may make it difficult to measure such liabilities and assets.
149. Some believe that these differences between insurance and other industries are so significant and pervasive that IASC's Framework is not an appropriate basis for a Standard on Insurance. In particular, they believe that the Framework's focus on items that meet its definition of assets and liabilities is misplaced in the context of insurance. They believe that the specific features of insurance listed in paragraph 148 justify a deferral and matching approach.
150. Others acknowledge the special features of insurance as set out in paragraph 148, but believe that these special features do not invalidate the Framework. In particular:
- (a) the focus of the Framework is on reporting financial information that best meets the common needs of a wide range of users;
 - (b) the Framework identifies five (and only five) elements of financial statements (assets, liabilities, equity, income and expense). Those elements are just as applicable to insurance as they are to other industries. Also, there is no compelling reason to identify any further elements specific to insurance. For example, users of an insurer's financial statements can assess its solvency more easily if the only assets and liabilities included in its balance sheet meet rigorous definitions and recognition criteria, such as those set out in the Framework;
 - (c) it is certainly more difficult to measure long-term non-traded liabilities than assets that are traded routinely in active and liquid markets. This difficulty calls for close attention to measurement concepts and techniques. However, it does not require or justify a different approach to defining the elements of financial statements and to setting recognition criteria; and
 - (d) the Framework underlies other standards issued by IASC. If a Standard on insurance is also based on the Framework, it will be easier to avoid sharp discontinuities between accounting for insurance contracts and accounting for contracts that marginally fail to qualify for insurance accounting.

Tentative Steering Committee View

151. *The Steering Committee intends to use the IASC Framework as the basis for developing an International Accounting Standard on Insurance, for the reasons set out in paragraph 150.*

Sub-issue 4C What should be the Overall Objectives of Recognition and Measurement in Accounting for Insurance Contracts?

152. Accountants and financial statement users often develop their views on specific accounting questions from a view of the overall recognition and measurement model. The paragraphs that follow contrast two approaches to analysing recognition and measurement issues. The contrast is somewhat artificial and existing accounting models incorporate elements of each. An individual might describe himself or herself as generally favouring one model, but might adopt elements of another when examining particular issues. However, disagreements about a particular recognition or measurement issue often arise from more fundamental disagreements about the overall model.
153. *In commenting on specific issues in this paper, readers can assist the Steering Committee by describing both their general objectives and the rationale for their positions on individual issues.*

Deferral and Matching

154. Under a deferral and matching view, the objective of accounting for insurance contracts is to associate costs, which are generally unknown and hard to estimate, with revenues, which are more readily measurable. Those who favour this approach consider it consistent with the diversification of risks that is inherent in an insurance activity. The profit from insurance, in this view, should emerge in a stable pattern that reflects that diversification.
155. When viewed from a deferral and matching perspective, premium revenue and claim payments are two separate, albeit related, phenomena. Accounting should associate claim costs, which are paid over the contract term and beyond, with premium collection, which usually happens at the beginning of the contract term, and to report the activity over the contract term.
156. An individual who takes a deferral-and-matching view usually emphasises the appropriate measurement of income. Those who take this perspective often characterise insurance as a multi-year undertaking and speak of the need for a pattern of sustainable income, as opposed to annual income that varies unpredictably from year to year. For example, the following assertions (which are examined in greater detail elsewhere in this document) might be characterised as a consistent application of a deferral-and-matching model:
- (a) acquisition costs should be deferred and amortised in order to match those costs with related premium revenue over the term of the contract;
 - (b) premiums should be deferred and recognised as revenue over the term of the contract;
 - (c) in selecting measurement assumptions, the insurer should look to long-term trends rather than reflecting short-term variations;

- (d) catastrophe and equalisation reserves are appropriate when necessary to report a pattern of sustainable income and to properly portray portfolio diversification over time;
- (e) changes in the fair value of an insurer's assets and liabilities are not relevant unless and until the insurer must liquidate assets to satisfy liabilities; and
- (f) an insurer's liabilities should be measured in a manner that captures the relationships between those liabilities and the assets that fund them.

Asset and Liability Measurement

157. Others favour a model that emphasises measurement of the insurer's liability to policyholders, an approach that they consider more consistent with the Framework's definition of assets and liabilities. Under the Framework, the definitions of assets and liabilities stand alone, and the income and expenses are defined in terms of changes in assets and liabilities. While not denying the central role of diversification, an insurance contract is similar to other financial instruments and the profit from insurance should result from changes in measurement of assets and liabilities.
158. Those who favour a liability measurement approach maintain that income or loss should be recognised as uncertainties are resolved and the insurer is *released from risk* under the insurance policies.
159. An individual who takes an asset-and-liability-measurement view usually emphasises the appropriate measurement of amounts in the balance sheet. Those who take this perspective often characterise income as a residual that results from changes in an insurer's assets and liabilities. For example, the following assertions (which are examined in greater detail elsewhere in this document) might be characterised as a consistent application of an asset-and-liability-measurement model:
 - (a) acquisition costs do not meet the Framework's definition of an asset and should not be reported as such (However, some may take the view that insurance contracts create intangible assets for the insurer and that the acquisition costs are an appropriate measure of that asset);
 - (b) the liability often described as unearned premium revenue should reflect the value of the insurer's remaining exposure to risks under the contract;
 - (c) claim liabilities should be reported at their present value;
 - (d) in selecting measurement assumptions, the insurer should look to current information;
 - (e) catastrophe and equalisation reserves do not meet the Framework's definition of liabilities and should not be reported as such. However, it may be appropriate to report those amounts as designations of equity; and

- (f) an insurer's liabilities should be measured based on the cash flows and risks inherent in those liabilities, rather than on the cash flows and risks inherent in the insurer's asset portfolio.
160. Some who take an asset-and-liability-measurement view believe that fair value is the most relevant measurement attribute for an insurer's assets and liabilities. Other supporters of an asset-and-liability-measurement view might select a different measurement attribute.
161. Table 2 compares the deferral-and-matching view and the asset-and-liability-measurement view.

Table 2 – Overview of Different Approaches

This table gives an overview of four approaches to accounting for insurance contracts.

- (a) Deferral and matching – This is the most common form of approach found today. There are a number of different ways of implementing such an approach. The Steering Committee has tentatively rejected deferral and matching approaches.
- (b) Asset and liability measurement – This column of the table illustrates a range of possibilities, depending on the measurement objective specified. Possible measurement objectives range from cost-based measures to fair value. The Steering Committee has tentatively decided to adopt an asset and liability measurement approach.
- (b) (i) Steering Committee proposals (non-fair value) – This column shows the Steering Committee’s tentative proposals under an asset and liability measurement approach, if fair value is not adopted as the measurement objective.
- (b) (ii) Fair value – This column shows the Steering Committee’s tentative proposals under an asset and liability measurement approach, if fair value is adopted as the measurement objective.

Topic (Basic Issue or Sub-issue in parentheses)	(a) Deferral and matching	(b) Asset and liability measurement	(b) Asset and liability – tentative Steering Committee proposals	
			(i) (non-fair value)	(ii) (fair value)
Objective (4)	Defer income and expense so that they can be matched with each other	Measure assets and liabilities that arise from insurance contracts	Measure assets and liabilities that arise from insurance contracts	Measure assets and liabilities that arise from insurance contracts
Does measurement of assets affect measurement of insurance liabilities? (5)				
• General insurance	No	No	No	No
• Life – unit-linked and similar	Yes	Yes	Yes	Yes
• Life - other	In practice, often yes (see discussion of discount rate)	Possibly (for example, in embedded value approach)	No	No (but see 11G below on treatment of future investment margins)

Topic (Basic Issue or Sub-issue in parentheses)	(a) Deferral and matching	(b) Asset and liability measurement	(b) Asset and liability – tentative Steering Committee proposals	
			(i) (non-fair value)	(ii) (fair value)
Assumptions (6B-E)	Various. May be: <ul style="list-style-type: none"> locked-in at inception locked-in at inception, but subject to loss recognition test current best estimate long-term trend mandated by supervisor some combination of the above 	Various. May be: <ul style="list-style-type: none"> locked-in at inception locked-in at inception, but subject to loss recognition test current best estimate long-term trend mandated by supervisor some combination of the above 	Current best estimate of all future events that will affect amount and timing of cash flows (including legislation and lapse)	Current best estimate of all future events that will affect amount and timing of cash flows (including legislation and lapse)
Risk reflected in measurement of general and life insurance liabilities? (6F)	Usually May exceed market value margin (note 1)	Possibly	Yes – market value margin	Yes - market value margin
Measurement reflects insurer's own credit standing:				
• At inception of contract?	Yes (may be implicit in transaction price)	Yes (may be implicit in transaction price)	Yes (may be implicit in transaction price)	Yes (may be implicit in transaction price)
• Subsequent changes? (11I)	No	Possibly	To be decided	To be decided (may be implicit in definition of fair value)
Changes in carrying amount of insurance liabilities (6G)	Generally recognised immediately in the income statement	Generally recognised immediately in the income statement (note 2)	Recognised immediately in the income statement (assuming same basis for financial instruments)	Recognised immediately in the income statement (assuming same basis for financial instruments)

Note 1 **Market value margin** = risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties.

Topic (Basic Issue or Sub-issue in parentheses)	(a) Deferral and matching	(b) Asset and liability measurement	(b) Asset and liability – tentative Steering Committee proposals	
			(i) (non-fair value)	(ii) (fair value)

Note 2 Some might argue that some components of changes in carrying amount should be recognised in equity or in a second performance statement, not in the income statement.

General insurance liability includes:				
• claims payable, including IBNR? (7B)	Yes	Yes	Yes	Yes
• expected claim handling costs? (7B)	Yes	Yes	Yes	Yes
• deferral of unearned premium for unexpired part of contract period? (7C)	Yes (amount deferred may exceed present value of claims)	No (but see unexpired risk)	No (but see unexpired risk)	No (but see unexpired risk)
• provision for unexpired risk? (7C)	Yes (if unearned premium is not enough to cover claims during unexpired part of contract period)	Yes (present value of expected claims for unexpired part of contract period)	Yes (present value of expected claims for unexpired part of contract period)	Yes (present value of expected claims for unexpired part of contract period)
• catastrophe and equalisation reserves? (7H)	Possibly	No (majority view)	No (majority view)	No
Acquisition costs (7D)	Generally deferred, subject to loss recognition test	Not deferred (but some view acquisition costs as the cost of an intangible asset that should be recognised at cost)	Not deferred	Not deferred
Discounting used:				
• general insurance? (7I)	Usually not in current practice	Probably	Yes	Yes
• life insurance? (8A)	Yes	Yes	Yes	Yes

Topic (Basic Issue or Sub-issue in parentheses)	(a) Deferral and matching	(b) Asset and liability measurement	(b) Asset and liability – tentative Steering Committee proposals	
			(i) (non-fair value)	(ii) (fair value)
Discount rate (7J / 11G)	Often based on expected long-term earnings on actual or notional investments backing the liability	Various possibilities. Rate based on actual investments is not acceptable if liabilities and assets are measured independently	Risk-free, adjusted for any risk not reflected in cash flows	Risk-free, adjusted for any risk not reflected in cash flows. (but see 11G below on treatment of future investment margins)
Income from long-term contract (7C / 8A / 11F)	Emerges based on predetermined attribution pattern.	Some income or loss emerges at the point of sale. Rest emerges as the insurer is released from risk and as actual experience differs from expected experience.	Some income or loss emerges at the point of sale. Rest emerges as the insurer is released from risk and as actual experience differs from expected experience.	Some income or loss emerges at the point of sale. Rest emerges as the insurer is released from risk and as actual experience differs from expected experience.
Include cash flows from future renewals: (8B)				
• if current contract commits insurer to pricing (typical life insurance contract)?	Possibly	Yes	Yes	Yes
• if the insurer retains full pricing discretion (typical general insurance contract)?	No	No	No	No
Basis for measuring liability for a life insurance contract that has an explicit or implicit account balance (8D)	Practice varies. Liability may or may not be less than the account balance.	Different approaches are possible. Liability is based on future cash flows and may or may not be less than the account balance.	Liability is based on future cash flows, but cannot be less than the account balance.	Liability is always based on future cash flows and may be less than the account balance.

Topic (Basic Issue or Sub-issue in parentheses)	(a) Deferral and matching	(b) Asset and liability measurement	(b) Asset and liability – tentative Steering Committee proposals	
			(i) (non-fair value)	(ii) (fair value)
Future investment margins affect measurement of insurance liabilities? (5 / 11G)				
• General insurance	No (except where loss recognition is reduced by future investment returns)	No	No	To be decided
• Life	In practice, often yes (see discussion of discount rate).	Possibly (for example, in embedded value approach)	No	To be decided
Premium revenue (19)	Recognised as earned – unearned premium is deferred.	Recognised when due, whether or not earned. Recognise a separate expense for lapse during the current premium period.	Recognised when due, whether or not earned. Recognise a separate expense for lapse during the current premium period.	Recognised when due, whether or not earned. (note 3) Recognise a separate expense for lapse during the current premium period.
Claims expense (19)	Estimate recognised as insured events occur. Additional amounts recognised when there is a premium deficiency.	Estimate recognised when premium is received. Changes in estimate recognised when they occur.	Estimate recognised when premium is received. Changes in estimate recognised when they occur.	Estimate recognised when premium is received. Changes in estimate recognised when they occur.

Note 3 In a fair value model, some may favour reporting just a net change in fair value, without separate reporting of premium and claim information.

Tentative Steering Committee View

162. *The Steering Committee believes that the deferral and matching view is not consistent with IASC's Framework, as the Framework does not permit the recognition of items in the balance sheet that do not meet the Framework's definition of assets and liabilities. The Steering Committee acknowledges that insurance has special features, but does not believe that these special features are sufficient to justify a departure from the Framework. Accordingly, the Steering Committee favours the asset-and-liability measurement view. By restricting the recognition of assets and liabilities to items that meet the definitions in the Framework, the Steering Committee considers that insurers will report financial information that better meets the needs of users. Also, the asset-and-liability view enhances the ability of users to make comparisons, as the asset and liability view forms the basis for other standards issued by IASC.*
163. *Although the Steering Committee does not favour the deferral and matching view, this view has formed the basis of accounting for insurance in many countries. Therefore, the Steering Committee has also examined certain accounting issues from a deferral and matching perspective, as a useful analytical double-check on the solutions that the asset-and-liability view offers.*
164. *Although the Steering Committee favours the asset-and-liability measurement view, this does not lead automatically to a preference for fair value as the measurement attribute for the assets and liabilities that arise under insurance contracts. The Steering Committee is working on the assumption that IAS 39 will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities (see discussion in Basic Issue 2). The Steering Committee believes that, if such a standard exists, assets and liabilities arising under insurance contracts should also be measured at fair value. However, if such a standard is not in place, it may be appropriate to select a different measurement attribute.*
165. *For this reason, Basic Issues 5 to 10 examine issues in the context of largely traditional approaches to measuring assets and liabilities. Basic Issue 11 extends that analysis to consider the further issues that arise when assets and liabilities connected with insurance activities are measured at fair value or at embedded value.*

Basic Issue 5 To what extent should the Measurement of an Insurer's Assets Affect the Measurement of its Liabilities?

Measurement Bases

166. Most accounting measurements can be described as representations of real-world characteristics of the asset or liability. The Framework describes four *measurement bases* or attributes currently employed in financial reporting - historical cost, current cost, realisable (settlement) value, and present value. Recent attention to accounting for financial instruments has added the concepts of market value and fair value. Other accounting pronouncements have added concepts that focus on the value of assets in the control of a particular entity. There is considerable overlap among these various measurement concepts, and a clear understanding of each will prove useful to the discussions that follow.
167. IAS 32, Financial Instruments: Disclosure and Presentation, defines **market value** as “the amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market.” IAS 32 defines **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.” When assets or liabilities trade in active markets, fair value and market value are the same amount.
168. Depending on the circumstances and implementation, all four of the measurement bases described in the Framework may represent the fair value of an asset or liability at a point in time. For example, the amount that an entity pays to acquire an asset (its cost) is usually indicative of the fair value of that asset on initial acquisition. Historical cost is typically not the same as fair value in periods following initial recognition. Current cost and realisable value may approximate fair value if based on a current transaction. Present value is often a useful tool for estimating fair value if assumptions about future cash flows and interest rates are those that market participants would use in estimating an asset's price.
169. From time to time, accounting pronouncements have referred to a notion of **current value**, although the term is not well defined. In some cases, the term is used to describe a current measurement that may or may not be consistent with fair value. In other cases, the term refers broadly to a measurement other than historical cost. In view of the ambiguity surrounding the idea of current value, this document does not use the term.
170. Some accounting standard setters, including the IASC, the United States Financial Accounting Standards Board, and the United Kingdom's Accounting Standards Board have explored the concept of **value in use** or **entity-specific measurement** of assets and liabilities. IAS 36, Impairment of Assets, defines **value in use** as “the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.” Paragraphs 26-56 of IAS 36 provide guidance on the estimated cash flows and interest rates used to compute value in use. IASC has recently started a project on discounting that will address some of these issues.

171. An asset or liability has an entity-specific measurement that differs from fair value if the entity has the ability to realise or pay cash flows that differ from those expected by market participants. For example, an entity may have particular skills, information, or use for an item that others do not share. Those factors may give an asset or liability greater value in the control of the entity than others could expect. It is also possible that the same factors render an asset less valuable to the entity, or render a liability more burdensome, than its fair value. If the entity cannot alter the amount or timing of cash flows, then fair value and an entity-specific measurement are the same. For example, the cash flows from a debt instrument issued by a national bank or sovereign entity are the same for any holder and, therefore, entity-specific measurement and fair value are the same.

Asset-Liability Measurement Interaction

172. One of the main tasks for the Steering Committee will be to determine a measurement basis for liabilities under insurance contracts. Arguably, this should be consistent with the measurement basis used for other assets and liabilities held by insurance enterprises, particularly the investments held by them.
173. The measurement of an insurer's assets in general-purpose financial statements varies considerably from one jurisdiction to another. Some jurisdictions have adopted fair value in the measurement of most of an insurer's debt and marketable equity securities. The measurement of the insurer's liabilities, in contrast, does not reflect fair value in most cases. Other jurisdictions use a variety of techniques that incorporate some information about current market conditions but do not measure assets and liabilities at fair value. For example, the carrying amount of assets might reflect historical cost with an adjustment for a portion of the change in fair value during the current period.
174. The IASC's Steering Committee on Financial Instruments issued a Discussion Paper in March 1997 that advocates the use of fair value in subsequent measurement of most financial assets and liabilities. The Insurance Steering Committee will work on the assumption that IASC will complete an integrated and comprehensive International Accounting Standard on financial instruments before the end of IASC's insurance project and that Standard will:
- (a) exclude liabilities and capitalised costs under insurance contracts from its scope; and
 - (b) require full fair value accounting for the substantial majority of financial assets and financial liabilities, including financial assets held by insurance enterprises as investments.
175. Increased attention to fair value in measuring financial assets has focused attention on the relationship between the measurement of assets and liabilities in an insurer's financial statements. Modern insurance enterprises strive to manage assets and liabilities in a co-ordinated strategy. An insurer that prices its contracts based on an eight percent return cannot long survive if its assets earn only six percent. However insurance, especially life insurance, is a long-term undertaking. Some question

whether current information, including realised gains and losses in the current period, properly represents that long-term activity.

Measure Assets and Liabilities Independently of One Another

176. Some argue that it is useful to apply a common measurement basis to assets and liabilities, but the measurement of liabilities should be independent of the measurement of assets. For example, if assets are measured based on fair value, those who favour this approach would likely argue that liabilities should also be measured at fair value. In their view, any interaction between assets and liabilities is best communicated by using the same measurement basis for both assets and liabilities and by disclosure about asset-liability management policies and about the degree of **mismatch risk** arising because assets and liabilities do not respond equally to economic events, such as changes in interest rates.
177. Those who favour use of a common measurement basis typically reject the deferral mechanisms described in the long-term view. They reason that such deferrals are accounting devices unrelated to any meaningful characteristic of an insurer's assets and liabilities. In their view, a deferred gain is not an asset or a liability, nor is it an attribute of other assets and liabilities, nor of owners' equity.

Use Information about Assets in the Measurement of Liabilities

178. Some maintain that the measurement of an insurer's liabilities should reflect the characteristics of the assets associated with those liabilities. For example, if assets are reported at fair value, then changes in the fair value of assets should be accompanied by proportionate changes in measurements of liabilities. In their view, the insurer's liabilities should reflect the entity's expectations about settlement and the assets it expects to use in satisfying its liabilities, rather than settlement in a current market transaction. They reason that financial statement users are more interested in how the entity plans to manage its assets and liabilities than in temporary changes in the market. Supporters of this view also argue that many market transfers of insurance liabilities involve the simultaneous transfer of a portfolio of liabilities together with the assets backing that portfolio.
179. Many who hold this view contend that measurement of an insurer's liabilities should be based on the insurer's estimate of future cash flows. Since the insurer will use its assets to settle the liabilities, supporters of this view argue that the measurement should incorporate the same assumptions about interest rates inherent in measurement of the assets. This reflects the investment decisions that the entity has made (or intends to make) to fund its obligations.

Tentative Steering Committee View

180. *In the Steering Committee's view:*

- (a) *the measurement basis adopted for an insurer's liabilities should be consistent with the measurement basis adopted for its assets; and*
- (b) *in general, the actual measurement of liabilities should not be affected by the type of assets or by the return on those assets (except where the amount of benefits paid to policyholders is directly influenced by the return on specified assets, as with certain participating contracts and unit-linked contracts). However, the Steering Committee is evenly divided on the effect of future investment margins in a fair value model (see Sub-issue 11G). Some members believe that the future investment margins should be considered in determining the fair value of insurance liabilities. Other members believe that they should not.*