

Fair Value Issues

Basic Issue 11 What Issues are Raised by the Use of Fair Value in the Measurement of Insurance Obligations?

517. Most of the discussion in Basic Issues 5 through 10 focused on the problems of insurance accounting in a traditional framework. While the discussion touched on fair value, most of the issues and alternatives were outlined in a “historical cost” or “transaction-based” system. In recent years, IASC and national accounting standard setters have struggled with the problems that arise from transaction-based accounting, on one hand, and rapid changes in financial markets, on the other. The problems encountered by standard setters, as well as financial statement preparers, users, and auditors, have led some to argue that financial reporting should move toward a fair value system, at least for financial assets and liabilities.
518. Basic Issue 11 deals with the following sub-issues that will arise if assets and liabilities arising under insurance contracts are measured at fair value:
- (a) are insurance contracts financial instruments (Sub-issue 11A);
 - (b) should insurance contracts be included in a fair value standard (Sub-issue 11B);
 - (c) what should be the general approach in applying fair value to insurance contracts (Sub-issue 11C);
 - (d) should the fair value of insurance contracts:
 - (i) include the fair value of intangibles and other items related to the insurance contract (Sub-issue 11D);
 - (ii) be based on individual contracts or books of similar contracts (Sub-issue 11E);
 - (iii) be estimated using entry or using exit values and should the application of fair value measurements result in a gain or loss on the sale of insurance contracts (Sub-issue 11F);
 - (iv) be estimated using rates of return on the insurer’s assets or using some other discount rate (Sub-issue 11G);
 - (v) include a provision for the risk inherent in the insurance contracts (Sub-issue 11H);
 - (vi) reflect the insurer’s credit standing (Sub-issue 11I);

- (e) does a fair value accounting system for insurance contracts include deferred acquisition costs (Sub-issue 11J);
 - (f) is the embedded-value method an appropriate approach to use in estimating and reporting the fair value of insurance assets and liabilities (Sub-issue 11K); and
 - (g) should decisions about the fair value of an insurer's financial assets and liabilities be extended to other assets and liabilities of an insurer (Sub-issue 11L)?
519. Determining the fair value of insurance liabilities on a reliable, objective and verifiable basis poses difficult conceptual and practical issues, because there is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts. To avoid excessive detail, this section discusses some of these issues in fairly general terms. If the project eventually leads to the conclusion that fair value measurement is appropriate, the Steering Committee recognises that it will need to develop more specific guidance on measurement issues.

Background

520. 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”.
521. In March 1997, the IASC Steering Committee on Financial Instruments issued a Discussion Paper, Accounting for Financial Assets and Financial Liabilities (the Discussion Paper). Paragraphs 4.1-4.6 of Chapter One begin to outline that Steering Committee's case for a broad-based change:

4. The Case for Change - the Inadequacies of Existing Accounting and Reporting Practices

- 4.1 It is important to understand what has caused the need for new accounting approaches for financial instruments. What precisely are the inadequacies of existing practices? An analysis of the underlying factors driving change not only helps to demonstrate what is wrong with current accounting, but also helps to lay the framework for developing the directions that more relevant accounting should take.

Financial Markets

- 4.2 At the roots of the need for change in accounting for financial instruments are fundamental changes in international financial markets. Global capital markets have experienced, and continue to experience, significant development, both in the variety and sophistication of financial instruments and in the extent of their use by all types of business enterprises. Improvements in information technology have been a leading factor in enabling cost effective use of innovative derivative products and combinations of financial instruments in

complex financial arrangements. These developments have enabled the unbundling, rebundling and transfer of financial risks (including interest rate risk, foreign currency risk, specific price risks, and credit risk). As an example, the financial risks and benefits in a portfolio of receivables may be effectively unbundled through a securitisation transaction that transfers the future cash flows to investors through a securitisation trust, while the transferor retains the servicing rights and, perhaps with other guarantors, the credit risk. Other parties may take on any interest rate or foreign currency risks that are contained in the receivables.

- 4.3 The successful management of financial risks in a global environment has become a highly dynamic activity, requiring careful and continuous monitoring. An enterprise can substantially change its financial risk profile virtually instantaneously, by entering into interest rate or foreign exchange swaps, or by acquiring options or forward contracts to hedge or take positions on future price movements.
- 4.4 Derivative financial instruments may be used to modify a particular financial risk, so as to reduce or even eliminate exposure to it. Alternatively, derivatives may be used as speculative tools to multiply the effects of changes in interest rates, foreign exchange rates, or security or commodity prices, thus multiplying the gains that will be achieved if prices move advantageously or, alternatively, multiplying the losses that will be incurred if they move adversely. The potential for large losses resulting from the use of derivatives has been well demonstrated by the highly publicised problems of some prominent public enterprises. These situations have heightened public concern about accounting and disclosure, as well as management controls.
- 4.5 Increasingly, business enterprises find that they must be competitive in international market-places, not only in their primary operating activities, but also in their capital financing and investing activities. Enterprises that sell their products abroad often have an exposure to foreign currency risk, and many companies have found it advantageous to raise capital outside their home countries, and perhaps to enter into swaps to manage interest rate exposures and foreign currency risks. In other words, international activities add a major element of financial and other business risks, in comparison with enterprises that operate solely in a local economy, isolated from international influences. However, in today's global environment few businesses of any size are not susceptible to the volatility of interest rates, foreign exchange rates, and commodity prices resulting from continually changing international economic conditions.
- 4.6 These developments in the financial market place are clear and well documented. They have been the subject of much attention in finance and economics literature, business publications, company boardrooms, and the media.

- 522. Paragraphs 4.12-4.18 outline that Steering Committee's view of the problems with current accounting conventions.

Problems with Current Accounting

- 4.12 Certain of the more major deficiencies of current accounting practices for financial instruments are summarised in the following paragraphs.
- 4.13 First, in current practice many derivative financial instruments are not recognised. This is the result of using historical cost accounting for derivatives that have no initial cost (for example, financial forward contracts, including interest rate swaps). Since their initial cost is nil, if no recognition is given to changes in their fair values, these derivatives are effectively invisible. Depending on underlying price movements, such derivatives can have substantial values and can represent significant risk positions that may transform an enterprise's financial risk profile. Their lack of recognition results in financial statements that are incomplete.
- 4.14 Second, enterprises increasingly recognise the need to actively manage financial risks to avoid being excessively exposed to loss as a result of sudden price changes (for example, in interest rates). The historical cost of financial assets and financial liabilities has little relevance to financial risk management decisions. A system of accounting that reports the historical costs of these assets and liabilities in published financial statements lacks relevance and information value for investors attempting to evaluate enterprise performance, liquidity, and financial risk exposures.
- 4.15 Third, as noted earlier, current practice in many countries uses some form of mixed measurement, under which some financial instruments are carried at historical cost and some on a fair value basis. This has caused a series of interrelated problems.
- (a) It has not been possible to define a sound principle for distinguishing those financial instruments that are appropriately carried on a cost basis and those that should be carried at fair value. E48 proposed differentiation based on management intent. Instruments to be held for the long term or to maturity would be measured at cost, those to be held for hedging purposes based on the hedged position, and other instruments at fair value. Many respondents to the exposure draft strongly criticised this reliance on management intent. There was particular concern that it would be inconsistently applied, difficult to audit and not operational, and that it would not have any sound economic basis. These criticisms have been borne out by the experiences of national standard setters that have attempted approaches along these lines. Alternative approaches for differentiation based on the type of instrument (e.g., derivatives versus non derivatives) or types of enterprise (e.g., distinguishing financial institutions from other enterprises) also seem to suffer from significant difficulties. (These alternatives are considered in Chapter 5.)

- (b) A mixed measurement system provides opportunities for abuses, such as selective recording of sales to manage reported income (sometimes referred to as 'cherry picking'). For the reasons stated above, it has proved to be very difficult to develop a mixed measurement system that is not susceptible to this problem.
- (c) A mixed measurement system inevitably leads to mismatches, for example, when an investment portfolio carried on a fair value basis is financed by debt carried on a cost basis, or when derivatives measured at fair value are used to hedge financial risk positions that are not recognised or are carried on a cost basis.

- 4.16 Mismatches resulting from mixed measurement and recognition practices have resulted in hedge accounting adjustments to try to match the timing of income recognition of gains and losses on instruments designated as hedges with offsetting losses and gains on the designated hedged positions. There are many problems with hedge accounting. These include a reliance on management designation so that identical situations may be treated differently depending on whether management decides to designate a qualifying situation as a hedge. To provide some discipline to the process, some qualifying conditions have been required by national accounting standard setters. However, it has proved to be impossible to define such conditions on a basis that does not leave considerable flexibility of interpretation, with the result that there have been inconsistencies in their application. Accounting guidance has had to be complex. In addition, hedge accounting results in the deferral of realised and unrealised losses and gains on the balance sheet that cannot be justified as assets or liabilities within the IASC Framework.
- 4.17 Hedge accounting proposals in E48 were severely criticised by many respondents for the above and other reasons. Recent efforts of several national accounting standard setters (notably the FASB in the US and the ASB in the UK) have focused on trying to reduce the need for hedge accounting adjustments by reducing the underlying measurement and recognition mismatches.
- 4.18 Concern about these accounting problems has grown in recent years as the use and complexity of derivatives and financial risk management and hedge accounting practices have increased. Securities regulators and others have urged the IASC and national accounting standard setters to resolve these problems, and develop a sound and viable accounting and disclosure system that will stand the test of time. There is considerable urgency in these demands. There has been a mounting frustration with the seeming inability of the accounting profession, and accounting standard setters, to come to grips with the issues.

523. Insurance enterprises represent a major part of world financial markets, both as buyers and sellers of financial products. Many insurers have experienced some of the problems described in the Discussion Paper, especially the problems that arise when financial assets are measured on one basis and insurance liabilities are measured on

another. Nor are insurers immune from the changes in capital markets described in the Discussion Paper. Today, many insurers purchase derivative financial instruments to address interest rate and currency risks. Some insurers have incorporated derivative-like features in otherwise traditional insurance contracts. Some commodity markets offer futures contracts indexed to insurance losses and products are being developed in the capital markets to provide services that were once offered only by reinsurance companies.

524. The Financial Instruments Steering Committee developed a number of proposals dealing with the recognition and measurement of financial instruments, hedge accounting, reporting income, and disclosure. Three of the proposals listed in the Discussion Paper are especially relevant to Basic Issue 11:

- (a) an enterprise should measure a financial instrument, on its initial recognition, at the fair value of the consideration given or received for it;
- (b) an enterprise should measure financial assets and financial liabilities at their fair value subsequent to initial recognition; and
- (c) all gains and losses arising from changes in the fair value of financial assets and financial liabilities should be recognised in a statement of profit and loss immediately when they arise.

525. In 1998, IASC approved IAS 39, Financial Instruments: Recognition and Measurement, which is intended to move existing practice in the direction of fair value accounting. However, in areas where support for the use of fair values is less widespread, IAS 39 continues existing accounting conventions, including some practices cited by the Discussion Paper as causing problems. In early 1998, IASC began working with national accounting standard setters in a Joint Working Group on Financial Instruments. That group is charged to:

develop an integrated and harmonised international accounting standard on financial instruments. That standard would build on the IASC Discussion Paper, existing and emerging national standards, and the best thinking and research on the subject worldwide.

526. It is inevitable that the work of the Insurance Steering Committee will touch on areas being considered by the Joint Working Group. The Joint Working Group is considering the question of fair value accounting for all financial instruments, and some of the issues under consideration, like the role of an enterprise's credit standing in the measurement of its liabilities, are of particular interest in applying fair value principles to insurance contracts. This Issues Paper is limited to questions that arise in the context of insurance contracts, but some duplication is unavoidable.

Sub-issue 11A Are Insurance Contracts Financial Instruments?

527. IAS 39 includes the following definitions of financial instrument, financial asset, and financial liability:

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.

A financial asset is any asset that is:

- (a) cash;**
- (b) a contractual right to receive cash or another financial asset from another enterprise;**
- (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or**
- (d) an equity instrument of another enterprise.**

A financial liability is any liability that is a contractual obligation:

- (a) to deliver cash or another financial asset to another enterprise; or**
- (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.**

528. In Basic Issue 1, the Steering Committee recommended the following definition of an insurance contract:

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

529. The Financial Instruments Steering Committee concluded that insurance contracts are financial instruments and described its conclusion in the following discussion:

6.23 These items include the obligation of an enterprise to provide benefits to its present and past employees, the obligations and reinsurance receivables of an insurance company arising under insurance contracts and the obligations of a pension plan to make future payments to members. An insurance contract is defined to be "a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death, (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption" (see IAS 32, paragraph 3).

- 6.24 Such items are financial instruments because they are contractual rights or obligations that will result in the flow of cash or other financial instruments. Nevertheless, IAS 32 excludes pension type obligations and obligations arising under insurance contracts from its scope, although it encourages enterprises that have obligations under insurance contracts "to consider the appropriateness" of applying its presentation and disclosure provisions to insurance contract obligations (paragraph 3). The similar Canadian Standard on the presentation and disclosure of financial instruments (*CICA Handbook*, Section 3860) does not provide this exemption, but does defer application of the Standard to life insurance enterprises to allow them time to develop bases for applying the requirements.
- 6.25 These items present unique estimation problems, and are exposed to mis-estimation risk (i.e. the risk that the amounts ultimately payable may be higher than expected). The problem has been that actuarial methodologies developed for making these estimates have not been consistent with accounting framework concepts and measurement principles. The insurance industry and the accounting and actuarial professions have not yet reached a common understanding about how to estimate the fair value of these obligations.
- 6.26 On the one hand the Steering Committee has concluded that the objective should be to recognise and measure all financial instruments in accordance with the principles proposed in this Discussion Paper, and that these principles are relevant to pension and insurance obligations, reinsurance receivables and similar items. On the other hand, it is beyond the scope of this Discussion Paper to address the issues involved in recognising and measuring these items. The Steering Committee thus accepts that additional study and consultation will be necessary to resolve the application issues associated with pension and insurance obligations, reinsurance receivables and similar items before the principles proposed in this Discussion Paper can be applied to these items.

530. Some disagree with the conclusions reached by the Financial Instruments Steering Committee. In their view, the risks inherent in an insurance contract are more similar to the risks found in long-term production or service contracts. Insurers usually receive premiums from the insured party in advance before providing risk coverage to the insured party and diversifying the risks. The service provided by the insurer does not occur at a single moment in time but occurs over the contract and settlement period. At the inception of an insurance contract, the insurer is at an early stage in the development of economic returns. The amount and timing of future cash flows under the contract is uncertain and the insurer is still exposed to the risk that future claims payments may be higher than expected.
531. Those who take this view maintain that an insurer provides a continuing service over the life of an insurance contracts, namely protection against specifically identified losses. In their view, this element of protection is not a necessary component of financial instruments (such as derivatives). For example, an enterprise can purchase an interest rate option or corn futures contract even though the enterprise has no exposure to changes in interest rates or the price of corn. Changes in rates or corn

prices will affect the value of the contract to any enterprise that holds it. In contrast, insurance contracts typically require an insurable interest and evidence of loss by a particular policyholder. A policyholder does not receive payment simply because a tornado moved through his or her neighbourhood. The tornado must damage the insured property.

532. Consistent with their view of the insurance contract as a service contract, rather than a financial instrument, they reason that the accounting for insurance contracts should be designed to recognise income as the service is provided, with accompanying adjustments to assets and liabilities. They consider such an approach more relevant to financial statement users than an approach that attempts to estimate the fair value of assets and liabilities.
533. Some who view the provision of insurance coverage as a service argue that this feature is particularly apparent when there is some legal or regulatory requirement to buy insurance (for example, in the case of compulsory motor insurance, employer's liability or professional indemnity).
534. Some also argue that an insurance contract may have financial attributes but that an insurer also provides significant non-financial services. For example, an insurer may provide loss mitigation consulting and assistance with settlement after an insured event occurs. An insurer typically incurs higher loss adjustment and administrative costs than are incurred in other financial instruments, such as derivatives. Finally, some observe that an insurer provides significant investment management service to policyholders. Those who take this view point out that many investment managers account for investment management as a service activity; they recognise investment management fees as they are earned, without treating the investment management contract as a financial instrument.
535. Others acknowledge that the risks in an insurance contract are different from the risks that are present in other financial instruments. However, they do not agree that this function alters the fundamentally financial nature of an insurance contract. In their view, an insurer who writes 1,000 windstorm contracts faces a different exposure than a trader who writes 1,000 European options on a stock-exchange index. However, the fundamental feature of both contracts is a payment by the writer if the contract matures in the money. The insurance contract comes into the money if a storm occurs, while the option comes into the money if the stock-exchange index reaches the specified level, but that difference should not cloud the underlying economic characteristic. Both convey a right to receive cash if a future event occurs and both expire on a specific date.
536. Some also observe that recent trends in financial innovation include insurance contracts. Modern contracts like **weather derivatives** and **catastrophe bonds** blur the line between the traditional insurance and financial instruments.

Tentative Steering Committee View

537. *In the Steering Committee's view, insurance contracts should be considered financial instruments. Insurance contracts may have non-financial attributes. However, any*

attempt to exclude them from consideration as financial instruments will lead to accounting differences between insurance contracts and other economically similar instruments. The Steering Committee acknowledges that viewing insurance contracts as financial instruments may lead to conclusions that differ from those that follow from a view of insurance contracts as service contracts.

Sub-issue 11B Should Insurance Contracts be Included in a Fair Value Standard?

Common Concerns About the Use of Fair Value and Insurance Activities

538. Many in the insurance industry have expressed concerns about extending fair value concepts to financial reporting of insurance activities. They ask whether concepts that may be appropriate for other financial institutions are equally useful in what they see as a fundamentally different setting. This section summarises many of the frequently-voiced concerns and responses from those who favour extending the use of fair value to insurance activities.

Volatility in Income and Equity

539. Some argue that introducing fair values, which are always current measurements of assets and liabilities, will lead to reported net profit or loss and equity that are more volatile and less predictable and manageable than the amounts produced by traditional accounting conventions. In their view, insurance is a long-term undertaking and the current fluctuations of financial markets are not representative of that fundamental characteristic of the industry. They maintain that financial statement users will find financial reporting more useful if it reflects long-term expectations rather than current information (refer to sub-issue 6C).
540. Those who favour use of fair-value measurements observe that financial statements prepared on that basis may be more volatile, but they see that volatility as an economic reality. From their perspective, financial statement users should be told what actually happened - rather than what management hopes will happen over the long-term.
541. Some also suggest that comprehensive use of fair value measurements, at least for financial instruments, will produce less volatility than piecemeal approaches. They point to the experience in the United States. FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires equity securities that have readily determinable fair values and most investments in debt to be carried at fair value. However, insurance liabilities continue to be measured using traditional approaches. As a result, changes in the fair value of assets affect equity while changes in the fair value of liabilities (that might offset changes in asset values) are not recognised. The FASB was aware of this problem. In paragraph 51 of Statement 115, it observed:

The Board believes it would be preferable to permit certain related liabilities to be reported at fair value especially if all investments in debt securities were required to be reported at fair value. However, the Board was unable to identify, and respondents

did not propose, any approach for valuing liabilities that the Board considered workable and not unacceptably complex or permissive.

542. Finally, some suggest that year-to-year volatility produced by a fair value approach is preferable to the large adjustments sometimes produced by long-term approaches. This group observes that a long-term approach requires the use of accounting conventions to defer realised and unrealised gains and losses. Those deferrals can accumulate until the amount is no longer sustainable, even over the long term. The large adjustments that then become necessary often come as a surprise to financial statement users.

Ability to Measure

543. Some observe that insurers rarely settle their obligations by transferring those obligations to third parties. Instead, the obligation is usually settled by the insurer's performance of its obligations to the policyholders. This leads some to question whether insurers can develop reasonable estimates of fair value, which is based on settlement of the obligation through transfer to a third party. They argue that the lack of established markets will force insurers to make very subjective judgements about how markets would behave, if those markets existed. They question whether the resulting measurements will be sufficiently reliable for inclusion in financial statements.
544. Others disagree, and observe that estimation is inherent in all measurements of insurance liabilities. In their view, the estimates required to develop fair value measurements may be different from those used in traditional measurements. However, there is no reason to suppose that the judgements required to estimate fair value are necessarily more subjective. They point out that insurers typically have access to significant market-based information, even though organised markets for settlements of insurance obligations may not exist. Reinsurance prices and the prices of other long-dated financial instruments, for example, can provide information for use in estimating the fair value of insurance obligations. Those who hold this view observe that valuation models have been developed for mortgage-backed securities and similar financial instruments that were once thought to be impossible to value. Finally, they observe that some countries have made significant progress in developing consensus about the approach to developing key assumptions.

Value in Use

545. Because insurance contracts are usually settled through performance, rather than transfer, some maintain that a measurement based on expected performance over the contract term is more relevant than fair value. They favour an entity-specific measurement or value in use that incorporates the insurer's expectations about future cash flows rather than the market's expectations. In their view, the insurer's internal expectations are more relevant than those of a market that may not, in fact, exist.
546. Others disagree. They observe that similar arguments could be made for many financial assets and liabilities. In their view, any argument for applying value in use concepts to financial instruments should be applied to all financial instruments, rather

than only to insurance contracts. They also contend that observed market prices, when available, are more relevant and useful than a company's internal estimates. They acknowledge that experience may prove that the company's estimates were correct and the market was wrong. However, they suggest that the results of that experience should be recognised when it happens rather than anticipated in an entity-specific measurement of the liability.

Solvency and Confidence

547. Some argue that introducing fair value measurements may cause the stockholders of insurance companies and insurance consumers to behave inappropriately. This group is concerned that insurance stockholders may conclude that asset gains (whether realised or unrealised) allow them to receive higher current dividends. Insurance consumers may conclude that asset losses indicate that they should terminate or not renew existing insurance contracts, thus creating a "run on the bank." Those who are concerned with solvency and confidence point to situations in which apparently weak companies were able to survive market reverses.
548. Those who favour use of fair-value measurements argue that financial reporting is one of many tools that managers, stockholders, and consumers use in decision making. Good managers know that investments must provide the cash flows necessary to meet policyholders' claims, and that changes in fair value may not alter the cash flows provided by a particular investment portfolio. However, this group also observes that the failure to use fair value measurements often masks financial difficulty from financial statement users.

Is Fair Value a Relevant Measurement Attribute for Insurance Activities?

549. Many industry commentators have remarked on the importance of a consistent measurement approach for an insurer's assets and liabilities. The Steering Committee agrees with that observation (refer to Basic Issue 5). However, some commentators question whether fair value provides the most relevant measurement for either assets or liabilities of an insurance enterprise. They argue that IASC should consider exemptions from fair value accounting. Such exemptions might apply to insurance enterprises, insurance liabilities and related assets or insurance liabilities.

Exempt Insurance Enterprises

550. The Steering Committee could recommend that all financial assets and liabilities of an insurance enterprise be excluded from any standard on financial instruments or requirement for fair value measurement. However, many modern insurers are large, diversified, enterprises that engage in financial and other activities other than insurance. Other insurers are subsidiaries of entities that would not be excluded from fair-value standards.
551. IASC has historically focused on developing similar accounting for similar transactions, assets, or liabilities. Insurers and non-insurers follow the same accounting principles for leases, income taxes, and employee benefits and a broad exemption from a standard on financial instruments would be difficult to justify.

Excluding all of an insurer's assets and liabilities from a financial instruments standard would inevitably create differences between the financial reporting for similar activities based on the type of enterprise. This is counter to the Framework's objective of comparable financial reporting. Indeed, the Steering Committee rejected this approach in its tentative views on Basic Issue 1.

552. Most importantly, a broad exemption for insurance enterprises would leave that group with all of the problems identified in the March 1997 Financial Instruments Discussion Paper and no ready source of solutions.

Exempt Insurance Liabilities and Related Assets

553. The Steering Committee could recommend that liabilities connected with insurance activities and related assets should be excluded from any requirement for fair value measurement. However, many insurers lack the information systems needed to associate particular assets and liabilities. By their nature, financial assets are fungible and any attempt to associate those assets with particular liabilities is likely to be subjective and potentially arbitrary.

Exempt Insurance Liabilities

554. The Steering Committee could recommend that liabilities connected with insurance activities be excluded from any requirement for fair value measurement, but that an insurer's financial assets should be reported at fair value. (This is the approach found in IAS 39.) However, many insurers and industry observers have complained that this approach creates a misleading presentation because the same economic factors may affect the values of both assets and liabilities.

Include Insurance Enterprises

555. Finally, the Steering Committee could recommend that insurance enterprises be included in the scope of any standard on financial instruments and that an insurer's financial assets and liabilities be measured at fair value. This recommendation would require additional recommendations to address the "unique attributes" of insurance activities mentioned by the Steering Committee on Financial Instruments.

Tentative Steering Committee View

556. *The Steering Committee holds the following views, all in the assumed context of a future International Accounting Standard that requires all financial instruments to be measured at fair value:*
- (a) *if the other enterprises use fair value for financial instruments, insurers should not be excluded;*
 - (b) *if all other financial assets and financial liabilities of an insurer are at fair value, insurance contracts should be at fair value;*
 - (c) *movements in the fair values of an insurer's financial assets and liabilities should be reported in a consistent manner. For example, if some movements*

in the fair value of assets are excluded from net profit or loss for the period and reported as a component of equity, accompanying movements in liabilities should be reported in the same fashion; and

- (d) *accounting for insurance contracts at fair value should be covered in the insurance standard, not in the financial instruments standard.*

557. *The Steering Committee assumes that, on the completion of this project, IASC will have adopted a comprehensive approach to reporting all financial instruments at fair value, with all movements in fair value reported in the income statement. The Steering Committee considers consistency between the treatment of assets and liabilities of an insurance enterprise a precondition for proper reporting. Therefore, the assets and liabilities arising out of insurance contracts should be measured at fair value, with all movements in fair value reported in the income statement.*
558. *The Steering Committee acknowledges that, at this time, it is often difficult to estimate the fair value of assets and liabilities created by insurance contracts on a reliable, objective, and verifiable basis. Therefore, the Steering Committee intends to develop further guidelines to address estimation. In the meantime, the Steering Committee would welcome any suggestions for those guidelines.*

Fair Value in an Insurance Accounting Context

559. As noted earlier, 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. The concept of fair value assumes a current transaction, rather than settlement at some future date. The process of estimating fair value is a search for the price at which that transaction would occur. IAS 39 provides the following guidance on applying fair value in measuring financial instruments:

Fair Value Measurement Considerations

95. The fair value of a financial instrument is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) if the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. Often, an enterprise will be able to make an estimate of the fair value of a financial instrument that is sufficiently reliable to use in financial statements. Occasionally, the variability in the range of reasonable fair value estimates is so great and the probabilities of the various outcomes are so difficult to assess that the usefulness of a single estimate of fair value is negated.
96. Situations in which fair value is reliably measurable include (a) a financial instrument for which there is a published price quotation in an active public securities market for that instrument, (b) a debt instrument that has been rated by an independent rating agency and whose cash flows can be reasonably estimated, and (c) a financial instrument for which there is an appropriate valuation model and for which the data inputs to that model can be measured reliably because the data come from active markets.

97. The fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Valuation techniques should incorporate the assumptions that market participants would use in their estimates of fair values, including assumptions about prepayment rates, rates of estimated credit losses, and interest or discount rates. Paragraph 167(a) requires disclosure of the methods and significant assumptions applied in estimating fair values.
98. Underlying the definition of fair value is a presumption that an enterprise is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an enterprise would receive or pay in a forced transaction, involuntary liquidation, or distress sale. However, an enterprise takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of a financial asset that an enterprise has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realised from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.
99. The existence of published price quotations in an active market is normally the best evidence of fair value. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the current fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an enterprise has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values.
100. If the market for a financial instrument is not an active market, published price quotations may have to be adjusted to arrive at a reliable measure of fair value. If there is infrequent activity in a market, the market is not well established (for example, some 'over the counter' markets) or small volumes are traded relative to the number of trading units of a financial instrument to be valued, quoted market prices may not be indicative of the fair value of the instrument. In some cases where the volume traded is relatively small, a price quotation for a larger block may be available from the market maker in that instrument. In other circumstances, as well as when a quoted market price is not available, estimation techniques may be used to determine fair value with sufficient reliability to satisfy the requirements of this Standard. Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. In applying discounted cash flow analysis, an enterprise uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining

term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made.

101. If a market price does not exist for a financial instrument in its entirety but markets exist for its component parts, fair value is constructed on the basis of the relevant market prices. If a market does not exist for a financial instrument but a market exists for a similar financial instrument, fair value is constructed on the basis of the market price of the similar financial instrument.
102. There are many situations other than those enumerated in paragraphs 95–101 in which the variability in the range of reasonable fair value estimates is likely not to be significant. It is normally possible to estimate the fair value of a financial asset that an enterprise has acquired from an outside party. An enterprise is unlikely to purchase a financial instrument for which it does not expect to be able to obtain a reliable measure of fair value after acquisition. The IASC Framework states: ‘In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.’
560. Many techniques exist for measuring insurance liabilities and are discussed in other sections of this paper. Some components of existing insurance accounting, like the use of present value or risk adjustment, would also be components of fair value. However, few of the accounting conventions in traditional insurance accounting attempt to identify the price of a current transaction and, thus, are not likely to provide estimates of fair value as defined in IASC literature. This section discusses several fair value issues that are especially relevant to measuring the fair value of insurance liabilities, but it is not an in-depth analysis. The Insurance Steering Committee expects to use the response to these issues as background for its consultations with the Joint Working Group and, if necessary, the development of additional guidance on the use of fair value in measuring insurers’ liabilities.
561. The Steering Committee is not aware of any jurisdiction that has adopted a comprehensive fair value model for insurance financial reporting. However, the general principles of fair value measurement are sufficiently well known to allow some general observations about the differences between a fair value approach and existing accounting conventions. At a minimum, it is possible to identify current practices that are inconsistent with a fair value measurement system.

Deferral and Matching Conventions are generally inconsistent with a fair value accounting model. Fair value necessarily uses an asset and liability approach. (See Basic Issue 19 for a discussion of how insurers should address changes in fair value when they report their financial performance)

Deferred Policy Acquisition Costs as they are currently recorded probably disappear in a fair value model. However, some maintain that the amount expended as acquisition costs represents the cost of an intangible asset that should be recognised in a fair value model. (refer to discussion beginning at paragraph 627.)

Unearned Premiums are no longer used as a device to amortise premium revenues over the policy period. Instead, the measurement focuses on the insurer's obligation for payment of claims that may arise during the unexpired premium period. (Refer to the discussion of unearned premiums in Sub-issue 7C.)

Separate measurement of a premium deficiency (refer to Sub-issue 6C) is unnecessary in a fair value model, because the other assets and liabilities are already measured at fair value. There is no need for a separate loss-recognition measurement.

Claim Liabilities remain a liability in a fair value model, but the use of present value techniques is especially important. Few would argue that an undiscounted measurement of this liability is consistent with its fair value, except by coincidence.

The Liability for Future Policyholder Benefits remains a liability in a fair value model, but the assumptions used in measuring that liability must be consistent with its fair value, as opposed to the deferral and matching assumptions used in many measurements of this liability. In particular, some suggest that the Steering Committee's tentative conclusions about discount rates (Sub-issue 7J) and a minimum value based on the policyholder-deposit method (sub-issue 8D) may not apply in estimates of fair value.

Sub-issue 11C What should be the General Approach in Applying Fair Value to Insurance Contracts?

562. In a deep, transparent, and active market the fair value of a financial asset or liability is easy to determine. However, those markets do not exist for most insurance liabilities and are not likely to develop in the near future. Without an active market, fair value must be estimated by other means. Moreover, insurers typically have access to significant market-based information, even though organised markets for settlements of insurance obligations may not exist. Reinsurance prices, prices of risk-securitisation transactions, and the prices of other long-dated financial instruments, for example, can provide information for use in estimating the fair value of insurance obligations. Members of the actuarial profession are actively investigating techniques for estimating fair value when observed prices are not available, including the use of option pricing and similar models provided by modern finance theory.
563. The guidance in IAS 39 cited earlier refers to the use of discounted cash flow analysis (present value of expected future cash flows) as a well-established technique for estimating fair value. However, the discussion in IAS 39 describes the technique in measuring assets rather than liabilities. Estimating the fair value of insurance assets and liabilities often requires special skills and knowledge not usually necessary when estimating the fair value of other, often simpler, financial instruments.
564. The measurements described in IAS 37, Provisions, Contingent Liabilities and Contingent Assets, are not explicitly described as fair values, however, the Steering Committee has found the principles established in IAS 37 useful in analysing many of the issues raised in this Issues Paper. In general, the measurement described in IAS 37 includes the following components:

- (a) expected cash flows, rather than a single most-likely estimate of cash flows;
- (b) expected cash flows include assumptions about “future events that may affect the amount required to settle an obligation and should be reflected in the amount of a provision”;
- (c) an adjustment to reflect for “the risks and uncertainties that inevitably surround many events and circumstances”; and
- (d) the use of present value in measuring the provision.

565. Paragraph 37 of IAS 37 describes the measurement of a provision as “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.” In a fair value context, assumptions about the expected cash flows, future events, risk provisions, and discount rate should be those that an independent marketplace participant would make in determining the amount that it would charge to assume an insurance liability.

Tentative Steering Committee View

566. *In the Steering Committee’s view, the measurement approach described in IAS 37 provides a general model for estimating the fair value of most insurance obligations. The approach employs elements similar to those found in established techniques already used by insurers and actuaries. While there may be inconsistencies between the guidance found in IAS 37 and IAS 39, the Steering Committee observes that IAS 37 was designed to deal with liabilities that have uncertain cash flows - a common characteristic of most insurance liabilities.*

567. *The Steering Committee also notes the similarity between this approach and the present value techniques described in the recent FASB proposed Statement of Financial Concepts, Using Cash Flow Information and Present Value in Accounting Measurements. The Steering Committee observes that an insurer’s internal estimates may sometimes provide the only available information about its liabilities, and notes the observation in paragraph 26 of the FASB’s proposed Concepts Statement:*

Adopting fair value as the objective of present value measurements does not preclude the use of information and assumptions based on an entity’s expectations. An entity that uses cash flows in accounting measurements often has little or no information about the assumptions that marketplace participants would use in assessing the fair value of an asset or liability. In those situations, the entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity’s own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

568. The remainder of this section addresses issues that arise in applying the IAS 37 measurement approach to estimate the fair value of insurance liabilities.

569. Illustrations A51-A64 in Appendix A in the accompanying booklet include examples of how the general approach described above is applied to measuring the liabilities created by a book of hypothetical non-participating insurance contracts. Illustrations A65-A69 extend the examples to participating insurance contracts.

Sub-issue 11D Should the Fair Value of an Insurance Contract Include the Fair Value of Intangibles and Other Items Related to the Insurance Contract?

570. In Basic Issue 8, the Steering Committee described the several assets and liabilities that arise from a non-participating life insurance contract:
- (a) a liability for payments that an insurer is required to make on termination of the contract by the policyholder;
 - (b) a liability for payments that the insurer is required to make as a consequence of insured events that have occurred;
 - (c) a liability for payments of claims that may occur during the period covered by the current premium; and
 - (d) a net contractual right or obligation to receive or pay cash as a result of existing insurance contracts.
571. Items (a)-(c) listed in the previous paragraph also arise from general insurance contracts. In Basic Issue 8, the Steering Committee observed that most general insurance contracts do not have terms that would create the asset or liability listed as (d) in the previous paragraph. However, if a general insurance contract has those terms (the contract guarantees the policyholder's right to renew the contract and restricts the insurer's ability to change the amount of renewal premiums), then item (d) could apply to general insurance.
572. Sometimes, the observed price at which a financial instrument is exchanged in the market includes factors other than those listed above. A buyer may adjust the price to include the value of extra-contractual elements, like cross-selling opportunities, expected renewal business, and the value of customer lists. While observers can see the price at which the transaction took place, the individual elements of that price may be difficult to identify separately.
573. Some suggest that the fair value of an insurance financial instrument should be the value at which it would exchange in a market transaction. They reason that if the instrument and related extra-contractual elements are exchanged together, the appropriate fair value is the price that would exist in the marketplace. In their view, this price is a more relevant depiction of fair value than some other measurement that excludes those elements. They also point to the difficulty in separating the components of an observed market price.

574. Others disagree. They argue that the fair value measurement of any asset or liability should not incorporate indirectly the values of assets or liabilities that do not meet the criteria for separate recognition in financial statements.
575. Those who hold this view acknowledge that observed prices may include adjustments for future renewal premiums and related claims. However, those amounts do not (in the case of most general insurance) satisfy the definition of assets and liabilities. Similarly, an observed price may include the value of intangible assets like customer relationships. Paragraph 51 and 52 of IAS 38, Intangible Assets, state:

- 51. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.**
52. This Standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Tentative Steering Committee View

576. *In the Steering Committee's view, the fair value of insurance assets and liabilities should represent the value of the financial assets or liabilities embodied in the insurance contract and should not include the value of intangible assets, renewal premiums, and related claims that would not otherwise meet the criteria for recognition in financial statements.*

Sub-issue 11E Should the Fair Value of Insurance Contracts be based on Individual Contracts or Books of Similar Contracts?

577. The definitions of financial instruments and fair value focus on the value of an individual instrument - an individual share of stock, a bond, futures contract, or option. Many of an insurer's liabilities are traditionally measured based on books of similar contracts. In sub-issue 6A, the Steering Committee concluded that this practice is consistent with the diversification of risk inherent in an insurance activity.
578. Some commentators observe that the unit of measurement is especially important in determining the amount of risk adjustment used in estimating fair value (refer to paragraphs 612 to 619). An individual policyholder is often highly loss averse and is therefore willing to pay a premium well in excess of the expected value of the loss. In contrast, an insurer is able to pool a large number of contracts, diversify the exposure to loss, and receive a price that compensates the insurer for the value of its ability to diversify.
579. Some observe that insurers often diversify exposure over several different types of insurance. They suggest that the unit of account should therefore include all contracts issued by the insurer or, perhaps, all general or all life insurance-type contracts. Others disagree. They argue that the unit of account, for purposes of estimating fair

value, should be the unit that would be reasonably expected to transact in the marketplace, other than in a business combination.

Tentative Steering Committee View

580. *In the Steering Committee's view, any application of fair value to insurance contracts should continue the existing focus on groups of insurance contracts that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions, rather than on individual insurance contracts (see Sub-issue 6A). Consistent with that view, insurance exposures that are not similar (for example, residential and marine exposures or professional liability and auto exposures) should not be combined.*

Sub-issue 11F Should the Fair Value of Insurance Contracts be Estimated using Entry or Exit Values and should the application of Fair Value Measurements result in a Gain or Loss on the Sale of Insurance Contracts?

581. While the price of a transaction is the essential quality of fair value, there are several different transactions that may be relevant to estimating the fair value of insurance liabilities. Those transactions fall into two broad categories:
- (a) the price of a transaction in which the insurer issues a new contract or the price at which it would issue an existing contract based on current market conditions (**entry values**); and
 - (b) the price that the insurer would pay to settle existing contracts in a current transaction (**exit values**).
582. The proceeds from a loan are a common example of an entry value. The loan proceeds represent the price (the fair value) that a lender paid to hold the borrower's promise of future cash flows. Similarly, some suggest that the initial premium received, perhaps net of acquisition costs, is the fair value on entry of the insurer's obligation at the inception of the contract. This approach might be extended to existing contracts by estimating the price that the insurer would charge for the unexpired portion of those contracts in a new transaction.
583. There are several possible exit values for insurance contracts, including:
- (a) the price for a transaction, initiated by the policyholder, in which the policyholder terminates the contract. Many life insurance policies include provisions that entitle the policyholder to terminate the policy and receive a specific amount;
 - (b) the price for a transaction, initiated by the insurer or the policyholder, in which an insurer would settle existing liabilities in a current exchange with policyholders. This transaction contemplates an exchange in which policyholders agree to surrender all rights under a contract in exchange for a

single current payment. In insurance, this transaction is often referred to as a **commutation**; and

- (c) the price for a transaction in which an insurer would settle existing liabilities in a current exchange with another insurer. This transaction involves an exchange in which the insurer pays another insurer to take on its liabilities and relieve the original insurer of all liability to policyholders. In some jurisdictions, this transaction (referred to as a **transfer, assumption or novation**) requires approval by policyholders.

584. In a deep, transparent, and active market entry and exit values typically converge to a fairly narrow range. However, those markets do not exist for most insurance liabilities and are not likely to develop in the near future. Without an active market, estimated entry and exit values may differ and, in some situations, use of an exit value may produce a material gain or loss on the initial recognition of insurance contracts. Some suggest that there is little justification for using one approach on initial recognition and another approach in subsequent measurements, especially when the subsequent measurement may occur one day after the measurement on initial recognition.

Views in Favour of Entry Values

585. Some maintain that fair values of insurance liabilities should be based on entry values, that is, the premiums (perhaps net of acquisition costs) that the insurer would charge if it were to issue new contracts that created the same liabilities and exposures. Those who favour entry values maintain that the initial measurement of a financial instrument is not an event that should give rise to recognition of gains and losses, and observe that using entry values would eliminate the possibility of gains on initial recognition. They question the relevance of exit values if the enterprise does not, in fact, intend to settle the insurance obligation in a current transaction and observe that entry values are often easier to determine. They also observe that IAS 39 requires the use of entry values in measurements on initial recognition. Paragraph 66 of IAS 39 reads:

When a financial asset or financial liability is recognised initially, an enterprise should measure it at its cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability) for it. Transaction costs are included in the initial measurement of all financial assets and liabilities.

586. Those who favour entry values also observe that entry values have a considerable practical advantage over exit values. Insurers and actuaries have significant experience in determining the amount of premium charged for particular risks. Premiums can be observed in the marketplace and a well-managed insurer maintains a continuous review of premium adequacy.

587. Entry-value proponents contend that exit values are hard to observe. For a transaction price to constitute a true exit value, they reason, the transaction would have to meet the restrictive conditions found in paragraph 57 of IAS 39, which reads:

An enterprise should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged, cancelled, or expires.

588. Reinsurance contracts are a possible source of information about exit values, but reinsurance contracts do not typically satisfy IAS 39's conditions. The primary insurer (the ceding company) is not legally released from primary responsibility for the liability. While some jurisdictions provide mechanisms for settlement transactions that would satisfy IAS 39's conditions, transactions are few. In some jurisdictions, requirements for policyholder approval effectively eliminate the possibility of a true settlement transaction.

Views in Favour of Exit Values

589. Others maintain that fair values of insurance liabilities should be based on exit values, that is, the amount that the insurer would pay another enterprise to assume all of the risks. In their view, the definition of fair value implies the use of an exit value. That definition uses exit value, "the amount for which an asset could be exchanged, or a liability settled," and makes no reference to entry values. Similarly, IAS 37 refers to exit value, "the best estimate of the expenditure required to settle the present obligation at the balance sheet date."
590. Those who favour exit values consider the practical advantages of entry values to be limited. They observe that the insurer typically determines the premium at the inception of policies only. Determining the entry value of existing contracts at interim periods may be as difficult as determining the exit value.

Gain or Loss on the Sale of Insurance Contracts

591. Measurement of insurance contracts at fair value could result in the recognition of a gain when an insurance contract is sold. Table 9 **Error! Reference source not found.** uses information from Appendix A in the accompanying booklet to show the amount of gain that an insurer might recognise on the sale of contracts.

	at 5 percent risk-free rate	at 7 percent asset-earning rate
Premium collected	1,000	1,000
Expected claim payments	<u>(1,150)</u>	
Present value	<u>(946)</u>	<u>(877)</u>
Gain on sale	<u>54</u>	<u>123</u>

Table 9 - Gain on Sale

592. Some contend that the results portrayed in Table 9 are a natural extension of fair-value measurement. In their view, the insurer received assets with a fair value of 1,000 and incurred liabilities with an estimated fair value of 946 (or 877). Events that occur during Year 2 may change the estimated fair value of the insurer's liability, and may even result in a loss arising from remeasuring the liability, but the financial consequences of those events should be recognised in Year 2.
593. Others disagree. In their view, the insurer has not earned the income from this contract until it provides the service (risk assumption) called for in the contract. They point out that the March 1997 Discussion Paper recommended initial measurement of financial instruments based on "the fair value of the consideration given or received for it." From their perspective, the insurer received 1,000 of compensation for this liability and should not report any gain on sale.
594. Those who take the view that insurance contracts are long-term service contracts also argue that it would be inconsistent with IAS 18, Revenue, to recognise a gain on the sale of an insurance contract. 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. IAS 18 states, for example, that if the sale price of 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. IAS 11, Construction Contracts, leads to similar results for construction contracts.
595. Others note that IAS 18 and 11 do not allow recognition of a gain on inception of a service contract, but argue that this should not prevent standard setters from looking for an improvement in accounting for insurance contracts consistent with accounting principles developed for financial instruments.
596. Some argue that, as a practical matter, a significant gain on the sale of insurance contracts may be indicative of flawed assumptions used in the estimation of fair value. In particular, a significant gain may suggest that the insurer has failed to properly consider the amount of risk premium that another insurer might demand in determining the price of settling the liabilities in question. However, there may be situations in which an insurer operating in a niche market or with special distribution channels may be able to realise significant gains on sale.

Tentative Steering Committee View

597. *The Steering Committee considers exit value to be consistent with the definition of fair value, with the provisions of IAS 37, and with previous conclusions in this paper. The Steering Committee acknowledges that exit values may give rise to gains and losses upon the sale of insurance contracts, and that some may be concerned with that result.*

Sub-issue 11G Should Fair Value of Insurance Contracts be Estimated using Rates of Return on the Insurer's Assets or using some other Discount Rate?

598. The interactions between assets and liabilities and the effect of those interactions on measurement were discussed in Basic Issue 5. Attempts to estimate fair value bring that conceptual discussion into sharper focus, especially in the relationship between anticipated investment returns and the discount rate used in measuring liabilities. The paragraphs that follow outline the conceptual arguments for and against incorporating anticipated asset returns in estimating the fair value of liabilities.

Arguments in Favour of Incorporating Asset Returns in the Measurement of Liabilities

599. Some suggest that the fair value of insurance liabilities is best determined by computing the present value of the expected net cash flows from and to policyholders. Many suggest that the appropriate rate of interest for this computation is the earnings rate that the insurer expects to realise from investing assets over the life of the book of policies. The idea of using the earnings rate to measure the present value of liabilities is well-established in actuarial literature and accounting standards in several jurisdictions. The idea has intuitive appeal, because it reflects the business practice of insurers and pricing of products.
600. Those who favour an asset-based discount rate argue that such a rate is consistent with the observed prices of settlement transactions (to the extent they exist) and the pricing of reinsurance transactions. They argue that insurers transfer both liabilities and supporting assets in a settlement transaction. In their view, the price accepted by an assuming insurer includes the assuming insurer's expectations about investment earnings during the term of the liabilities. If observed transaction prices include the value of future investment earnings, they reason, estimated fair values should also include that value.
601. Finally, some suggest that asset values may be relevant in measuring insurance liabilities, even though the assets owned by a particular insurer are not relevant. They observe, for example, that the value of a contract that promises to pay the same rate of interest as a particular stock index is (barring credit risk) closely linked to the value of that index. Similarly, if cash flows from an insurance contract are correlated with particular assets or the market in general, the return on those assets is relevant to the fair value of the insurance contract. However, such close relationships are rare, except in unit-linked, indexed, and similar insurance contracts.

Arguments Opposed to Incorporating Asset Returns in the Measurement of Liabilities

602. Others oppose the use of asset-based discount rates in the estimating the fair value of liabilities. In their view, the insurer's investment decisions have little to do with the value of its liabilities. They offer the example of two insurers that offer identical policies that pay a fixed interest rate. Insurer A chooses to invest in high-risk bonds with a yield of 15 percent, while Insurer B invests in high-grade bonds with a yield of 7 percent. Using asset-based discount rates, Insurer A will report a much smaller liability, even though the respective expected cash flows from their liabilities are the

same. Apart from differences in credit risk (discussed later in this section) a policyholder would be indifferent between policies from Insurer A or Insurer B. Another insurer would demand the same price to assume either liability.

603. Those who oppose the use of asset-based discount rates suggest that such measurements ignore the implications of particular investment strategies. For example:
- (a) an insurance regulator might respond to Insurer A's decision to invest in high-risk bonds by requiring Insurer A to hold more capital in support of its obligation. As a result, Insurer A may actually have to commit more assets to support its liability than Insurer B; and
 - (b) insurer A has increased the total risk to its shareholders, all other things being equal, and may have increased the chance that it may default on its obligation.
604. Those who oppose the use of asset-based discount rates observe that such rates are inconsistent with the body of modern asset-pricing theory. Modern pricing theory holds that the value of an asset (or by extension, a liability) is independent of the holder. Modern asset-pricing models like the Capital Asset Pricing Model or Black-Scholes Option Pricing Model use the risk-free rate of interest in the computation or adjust the rate for risks unique to the asset being measured. In this context, the returns on particular assets would be relevant to the measurement of an insurer's liability if the returns on the asset are highly correlated with the behaviour of the liability. Such a correlation is unlikely to exist in general insurance contracts and many life insurance contracts.
605. Finally, some observe that the composition of an insurer's assets is not unrelated to the fair value of its liabilities. An insurer with a portfolio of very risky assets probably presents a much greater default risk than an insurer with an equal fair value of very low-risk assets. An insurer with assets that are mismatched to its liabilities may find that it cannot pay market returns to policyholders and that the policyholders surrender their policies. However, those who oppose the use of asset-based discount rates argue that such factors should be reflected as explicit assumptions about credit risk or lapse rates rather than being subsumed in the discount rate.

Illustrations of Asset-Liability Interaction

606. The Steering Committee is aware of two approaches that incorporate the expected return on an insurer's assets in the measurement of its liabilities. The first, and most common, is to employ a discount rate based on that expected return. The second is through the use of the **embedded-value** method. An insurer using the embedded-value method records a liability based on the amount required by the insurance regulatory authority. The insurer then records an asset equal to the present value of amounts that will be released for other uses (**distributable amounts**) as experience unfolds and policyholder liabilities are paid. The embedded-value method and arguments for and against its use are discussed later in this chapter.

607. Appendix A in the accompanying booklet to this chapter includes several illustrations designed to show the computational techniques and financial statement interactions of different approaches to estimating fair value. Readers may find it helpful to refer to these illustrations as they work through the rest of this chapter. Table 10 compares the first four of those illustrations, illustrations A51-A54.

Methodology	Basic Models			
	<u>Regulatory Illustration A51</u>	<u>Direct Illustration A52</u>	<u>Direct Illustration A53</u>	<u>Embedded Value Illustration A54</u>
Measurement uses this rate	na	5% risk-free	7% asset-based	7% asset-based
Risk adjustment incorporated in	na	na	na	na
Unrealized loss in year 2	na	na	na	na
Year 2 activity				
Reported amount of liability	(1,150)	(1,043)	(1,004)	(1,150)
Embedded value asset	-	-	-	146
Net liability	<u>(1,150)</u>	<u>(1,043)</u>	<u>(1,004)</u>	<u>(1,004)</u>
Net income before adjustment	(81)	(31)	(15)	(15)
Unrealized loss on investments	-	-	-	-
Adjustment to net liability measurement	-	-	-	-
Net (income)/loss	<u>(81)</u>	<u>(31)</u>	<u>(15)</u>	<u>(15)</u>
Reported net (income)/loss				
Beginning of year 1	<u>150</u>	<u>(54)</u>	<u>(123)</u>	<u>(123)</u>
End of year 1	69	(88)	(143)	(143)
End of year 2	(81)	(31)	(15)	(15)
End of year 3	(81)	(29)	(11)	(11)
End of year 4	<u>(81)</u>	<u>(26)</u>	<u>(5)</u>	<u>(5)</u>
Total	<u>(174)</u>	<u>(174)</u>	<u>(174)</u>	<u>(174)</u>

Table 10 - Comparison of Measurement Approaches

608. Readers familiar with the embedded-value method will note that the method usually employs a discount rate higher than the expected earning rate on invested assets. This higher rate is intended to capture the risks involved in the insurance activity. The illustrations in Appendix A chapter introduce that adjustment in the discussion of risk. The initial illustrations summarised above focus only on the interaction between assets and liabilities.

609. Some who favour an estimate of fair value that incorporates the expected earning rate on assets contend that the approach is necessary to avoid what they consider a measurement mismatch. Table 11 shows the effect of an unrealised loss in year 2 under each of the four measurement approaches described in Appendix A. The underlying assumptions are described in detail in Appendix A. Those who favour an asset-based measurement approach point to the loss in year 2 of Illustration A52 as an example of what they consider a mismatch.

Methodology	Unrealized Loss in Year 2			
	Regulatory Illustration A56	Direct Illustration A57	Direct Illustration A58	Embedded Value Illustration A59
Measurement uses this rate	na	5% risk-free	7% asset-based	7% asset-based
Risk adjustment incorporated in	na	na	na	na
Unrealized loss in year 2	40	40	40	40
Year 2 activity				
Reported amount of liability	(1,150)	(1,043)	(968)	(1,150)
Embedded value asset	-	-	-	182
Net liability	<u>(1,150)</u>	<u>(1,043)</u>	<u>(968)</u>	<u>(968)</u>
Net income before adjustment	(81)	(31)	(15)	(15)
Unrealized loss on investments	-	40	40	40
Adjustment to net liability measurement	-	-	(36)	(36)
Net (income)/loss	<u>(81)</u>	<u>9</u>	<u>(11)</u>	<u>(11)</u>
Reported net (income)/loss				
Beginning of year 1	<u>150</u>	<u>(54)</u>	<u>(123)</u>	<u>(123)</u>
End of year 1	69	(88)	(143)	(143)
End of year 2	(81)	9	(11)	(11)
End of year 3	(85)	(52)	(17)	(17)
End of year 4	<u>(83)</u>	<u>(49)</u>	<u>(9)</u>	<u>(9)</u>
Total	<u>(180)</u>	<u>(180)</u>	<u>(180)</u>	<u>(180)</u>

Table 11 - Effect of an Unrealised Loss on Investments

Tentative Steering Committee View

610. *Pending further discussion, the Steering Committee is evenly divided on whether the fair value of an insurer's liabilities incorporates the expected return on the insurer's assets. In the view of some members of the Steering Committee, such a measurement is consistent with the manner in which an insurance enterprise is managed. They also consider such a measurement consistent with the observed price of settlement transactions, to the extent they exist, and reinsurance transactions.*
611. *In the view of other members of the Steering Committee, the fair value of liabilities should not be affected by the type of assets held by the insurer or the return on those assets. In their view, the Steering Committee reached the appropriate conclusion in Basic Issue 5, and they see no justification for not extending that view to estimates of fair value.*

Sub-issue 11H Should the Estimated Fair Value of Insurance Contracts include a Provision for the Risk Inherent in those Contracts?

612. A non-insurance enterprise usually knows the maximum amount of its financial liabilities. It is obliged to pay the amount of principal and interest, but no more. In contrast, an insurer is obliged to pay amounts that are uncertain in timing or amount. Traditional insurance pricing theory suggests that an insurer charges for assuming that risk. For example, the insurer in the preceding illustrations expects claims of 1,150 and charged a premium of 1,000. The difference between 1,000 and the present value

of expected claims represented the insurer's compensation for bearing the uncertainty that claims may exceed the expected amount. Sub-issue 6F discussed the impact of risk in a traditional measurement framework.

613. Based on this traditional view, some conclude that the fair value of insurance liabilities should include a risk premium (sometimes described as **market-value margin**) consistent with the amount demanded for bearing uncertainty. Stated differently, the fair value of insurance liabilities should be greater than the present value of the expected value of the claims or benefits. An assuming insurer would probably demand a premium for uncertainty as well, and the objective of reflecting insurance risk in the fair value measurements is to imitate, to the extent possible, the market's behaviour toward uncertain assets and liabilities. This should not be confused with excessive prudence or bias.
614. Others acknowledge that fair value may include a risk premium in principle, but maintain that the adjustment should not be included in estimates of fair value unless it can be measured with sufficient reliability. Also, they observe that modern finance theory holds that markets do not allow a risk premium for any risk that can be eliminated by diversification. In particular, the theory suggests that uncertainties that are particular to individual assets (referred to as **specific, idiosyncratic** or **diversifiable** risk) are eliminated in the marketplace by combination with other assets that have different risk profiles. Uncertainty that cannot be diversified (referred to as **systematic** or **undiversifiable** risk) is reflected in the tendency of returns on an asset to be correlated with the returns on the market as a whole. This suggests in turn that in a deep and efficient market, the amount attached to the risk premium would be expected to be small relative to expected cash flows, except to the extent of systematic risk. However, some note that deep and efficient secondary markets do not exist for most insurance liabilities, and question whether theories based on such markets are relevant.
615. Table 12 shows how an adjustment for risk and uncertainty might be incorporated into a fair value measurement. The hypothetical regulatory system assumed in these examples does not include an explicit adjustment for risk and is included for purposes of comparison.
616. In this case, the insurer determines that an adjustment of 50 (raising expected claim payments to 1,200) is consistent with the price that another insurer would charge to assume this claim liability and its accompanying uncertainty. For purposes of illustration, the adjustment for risk diminishes rateably with interest over the term of the illustration. In a fair-value system, both the claim liability and the risk adjustment would be remeasured at fair value each period to represent changes in the risk-free interest rate, the best estimate of claims, and risk of claims in excess of the insurer's expectation.

Methodology	Including Adjustment for Risk			
	Regulatory Illustration A50	Direct Illustration A61	Direct Illustration A62	Embedded Value Illustration A63
Measurement uses this rate	na	5% risk-free	7% asset-based	10% risk-adjusted
Risk adjustment incorporated in	na	estimated claims	estimated claims	interest rate
Unrealized loss in year 2	na	na	na	na
Year 2 activity				
Reported amount of liability	(1,150)	(1,064)	(1,024)	(1,150)
Embedded value asset	-	-	-	141
Net liability	<u>(1,150)</u>	<u>(1,064)</u>	<u>(1,024)</u>	<u>(1,009)</u>
Net income before adjustment	(81)	(31)	(15)	(15)
Unrealized loss on investments	-	-	-	-
Adjustment to net liability measurement	-	(10)	(9)	(6)
Net (income)/loss	<u>(81)</u>	<u>(41)</u>	<u>(24)</u>	<u>(21)</u>
Reported net (income)/loss				
Beginning of year 1	<u>150</u>	<u>(13)</u>	<u>(85)</u>	<u>(107)</u>
End of year 1	69	(57)	(114)	(132)
End of year 2	(81)	(41)	(24)	(21)
End of year 3	(81)	(39)	(21)	(14)
End of year 4	<u>(81)</u>	<u>(37)</u>	<u>(15)</u>	<u>(7)</u>
Total	<u>(174)</u>	<u>(174)</u>	<u>(174)</u>	<u>(174)</u>

Table 12 - Effect of a Risk Adjustment

617. While the notion of a risk element is easy to illustrate, its measurement may prove very difficult in practice. Some suggest that introducing risk adjustments to fair value measurement may lead insurers to see the element as an opportunity to manage the amount of reported net profit or loss, rather than to determine fair values. They argue against including a risk element, and their views are similar to those expressed in sub-issue 6F.
618. Some argue that there is also an interaction between the amount of a risk adjustment and the unit of measure, as discussed in Sub-issue 6F (paragraphs 235-237).

Tentative Steering Committee View

619. *Consistent with its view in Sub-issue 6F, the Steering Committee observes that the estimated fair value of an insurer's liability should include the premium that marketplace participants demand for bearing the uncertainty inherent in estimated future cash flows. The Steering Committee observes that this premium may be difficult to estimate, however, excluding the adjustment for risk may lead to measurements that make different liabilities, with different risk profiles, appear the same.*

Sub-issue 11I Should the Estimated Fair Value of Insurance Contracts reflect the Insurer's Credit Standing?

620. The fair value of most debts reflects the credit standing of the borrower. High quality corporate bonds trade at prices and yields that reflect the very small chance of default. Lower quality bonds pay a higher yield to compensate investors for the expectation that some bonds may default and the risk that defaults may be more than expected. Consumer credit is often granted at even higher rates, reflecting the greater expectation of default.
621. Some suggest that the fair value of insurance liabilities should similarly incorporate the insurer's credit standing. They observe that rating agencies in some countries evaluate an insurer's claim-paying capability in a manner similar to the evaluation of corporate debt securities. Large corporate buyers of insurance policies study those ratings and use them in their purchase decisions. Insurers that receive low ratings may find it difficult to sell new policies or may have to offer policies at lower premiums (or higher returns). Proponents of this approach also maintain that IASC's transaction-based definition of fair value necessarily reflects the insurer's credit standing, as this would be a factor in any real-world transaction.
622. Others maintain that an insurer's financial statements should not reflect changes in the insurer's credit standing since the inception of an insurance contract. In their view, the objective is to report the fair value of the obligation, not the price that others might demand to hold that obligation as an asset. In their view, an enterprise's credit standing is not relevant to the amount that it would pay to settle its obligation with a third party and, thus, should be excluded in estimating the fair value of insurance liabilities. They also observe that including the insurer's credit standing in the measurement of its liabilities may lessen the acceptability of the resulting financial statements to insurance regulators and some other financial statement users.
623. Those who favour excluding credit standing acknowledge that their view creates a discontinuity, in which the insurer and policyholder would report different fair values for the same policy. However, they maintain that excluding credit standing from the measurement of the liability produces information that is more relevant to users of financial statements.
624. Finally, some observe that the role of an insurer's credit standing in the fair value of its liabilities may be less significant than might be true in other industries. In many jurisdictions, insurers are subject to prudential regulation that limits the possibility of an insurer placing policyholders at risk from default. In many jurisdictions, insurance liabilities are covered by government sponsored guarantee funds. Finally, claims by policyholders often rank before other creditors in case of bankruptcy.
625. Accountants and financial statement users are not accustomed to financial statements that report liabilities at fair value. Some may find that either incorporating or excluding credit risk can produce reported results that seem counterintuitive. For example:

- (a) if liabilities are measured at fair value, and that computation **includes** credit standing, then an insurer with declining credit standing will report progressively smaller liabilities as its credit standing declines. Some believe that it may be difficult to evaluate an insurer's solvency and ability to pay claims as they fall due if a decline in credit standing leads to a decline in reported liabilities; and
- (b) if liabilities are measured at fair value, and that computation **excludes** credit standing, then an insurer may report a loss that results from the measurement. For example, a relatively weak insurer may issue contracts at rates that reflect its credit standing. If subsequent measurements of the insurance obligation exclude credit standing, the obligation will be reported at an amount higher than the amount for which it was issued. The move from initial premium (which included credit standing) to subsequent measurement (which does not) will result in a reported loss.

Tentative Steering Committee View

626. *Questions about the role of an enterprise's credit standing (and changes in credit standing) in measuring liabilities extend beyond the measurement of insurance liabilities. The Joint Working Group on financial instruments is also considering these issues. The Insurance Steering Committee expects to monitor that activity and to co-ordinate its deliberations with those of the Joint Working Group.*

Sub-issue 11J Does a Fair Value Accounting System for Insurance Contracts include Deferred Acquisition Costs?

- 627. Some suggest that fair value is essentially a prospective concept. They reason that the holder of an insurance contract or the insurer that might assume another's liabilities are interested in future payments under the contract. Amounts that the original insurer might have paid as sales commissions or other costs of acquiring the contracts are of no relevance to this prospective computation. Accordingly, they conclude that deferred acquisition costs should not be recognised as assets in a fair-value system.
- 628. Some also observe that measuring insurance liabilities at fair value may remove much of the perceived need to capitalise acquisition costs. If an insurer has priced the contracts properly, the premium should be adequate to recover initial costs and pay claims while leaving a profit for the insurer.
- 629. Others disagree, and their views are similar to those found in Sub-issue 7D. They argue that part of the rationale for capitalising acquisition costs rests on the proper measurement of net profit or loss. The conventions used to estimate fair value may still result in an insurer reporting a loss on the inception of an otherwise profitable contract. In that case, they maintain that it is still appropriate to capitalise acquisition costs as an asset. Some might also maintain that the acquisition costs are the costs of acquiring an asset (rights under the contract) and that asset should be recognised if it meets definition and recognition criteria laid down in the Framework and recognition of that asset does not depend on the measurement of other assets and liabilities.

630. In a fair value context, presumably the insurer's rights under the contract would be measured not at cost (i.e. deferred acquisition costs) but at fair value. If those rights are regarded as a separate asset rather than as one component of an overall insurance liability, embedded values might be regarded as one method of determining the fair value of that asset. Embedded values are discussed in greater detail later in this chapter.

Tentative Steering Committee View

631. *In the Steering Committee's view, the practice of reporting deferred acquisition costs as an asset, while consistent with some traditional accounting models, is not consistent with determining the fair value of the insurer's financial assets and liabilities. That determination is fundamentally a prospective computation unrelated to costs that the insurer may have incurred in selling insurance contracts. However, the Steering Committee observes that cash flow assumptions used in estimating fair value should reflect the fact that other marketplace participants may accept less to assume an insurer's obligations, because they would likely avoid the acquisition costs incurred by the insurer.*

Sub-issue 11K Is the Embedded-Value Method an Appropriate Approach to use in Estimating and Reporting the Fair Value of Insurance Assets and Liabilities?

632. This chapter has referred several times to the embedded-value method as an approach to estimating the fair value of insurance assets and liabilities. The embedded-value method reflects the view that insurance contracts have two elements. One element is the obligation to make future payments to policyholders and (in some cases) the right to future premiums. The other element is an asset, referred to as **embedded value**, representing the right to compensation for services provided under the contracts and earnings from investments.
633. Computations of embedded value usually measure the asset based on the present value of future amounts deemed to be released to shareholders. Those amounts represent the total amount of profits earned from the contracts, but the insurance regulatory framework usually controls (or at least influences) the periods in which those amounts are released to stockholders. The computations usually reflect the fact that a certain amount of capital must often be tied up to meet regulatory requirements. The discount rate used to compute present value is usually a rate commensurate with a risky asset, the insurer's risk adjusted discount rate or the investor's target rate of return. The potential value of future policies to be sold is not included in the calculation of embedded value. When embedded value is reported, the liability to policyholders is usually the amount determined under the regulatory framework in that jurisdiction.
634. Table 13 summarises the components of an embedded-value asset, taken from Illustration A63 in Appendix A.

	Beginning of Year 1	End of Year 1	End of Year 2	End of Year 3	End of Year 4
Excess of regulatory liability over present value of expected claims	204	157	107	55	-
Present value of future investment spreads	69	55	39	21	-
Risk adjustment	(16)	(11)	(5)	(2)	-
Embedded value asset	<u>257</u>	<u>201</u>	<u>141</u>	<u>74</u>	<u>-</u>

Table 13 - Components of an Embedded-value Asset

635. Those who support the recognition of embedded value as an asset argue that:
- (a) embedded value meets the definition of an asset. The insurer controls a resource – the right to receive future cash flows from policyholders as a result of a past event (the signing of the insurance contract). An insurer willingly pays for that asset when it acquires a book of policies from another insurer or acquires another insurer in a business combination;
 - (b) at least for a large population of contracts, it is probable (and perhaps even virtually certain) that the insurer will pay or receive future cash flows. Some draw a parallel with paragraph 24 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets. This states that “[w]here there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met)”;
 - (c) for a large population, the value of those future cash flows can be measured reliably on the basis of past experience of factors such as lapse rates; and
 - (d) embedded values convey useful information to users. They provide a better measure of the value of an insurer’s rights than the amount paid to acquire those rights – deferred acquisition costs. They are consistent with the performance measurements used by management of many life insurers. They are also increasingly being used as one factor in determining how much an acquirer is prepared to pay for an insurer in a business combination. They provide users with a complete picture of the insurance enterprise by reporting both the obligation required by regulators and the value of in-force contracts – two amounts which are offset in other computations of fair value.
636. The country with the greatest experience of embedded value is probably the UK. Banking groups in the UK include embedded value of life subsidiaries in their balance

sheets. Many listed UK life insurers disclose embedded values, although for legal reasons they provide this as supplementary information.

637. Users of financial statements have indicated that they find the embedded value information useful. They regard embedded value as a good indicator of economic value created and the direction that an insurance business is taking. For example, where the embedded value increases but the volume of business remains the same, it is an indication that the insurer has written relatively more profitable business in the most recent reporting period.
638. Those who oppose the recognition of embedded value as an asset put forward one or more of the following arguments:
- (a) embedded value does not meet the definition of an asset. The insurer does not control a resource because the policyholder is not usually obliged to pay future premiums;
 - (b) embedded value does not meet the definition of a financial instrument. It is not a contractual right to receive cash. As a result, it should not be recognised as a result of attempting to measure the fair value of a financial instrument;
 - (c) the insurer's rights under an insurance contract (especially the "right" to future investment earnings) are contingent assets. IAS 37 prohibits recognition of contingent assets;
 - (d) embedded values are simply a means of compensating for liability measurements prescribed by regulatory authorities that do not represent fair value. If the liabilities were measured at fair value, there would be no need to recognise embedded values; and
 - (e) although some users of financial statements find disclosures about embedded values useful, this information could be conveyed by note disclosure rather than by recognising embedded values in the balance sheet and changes in embedded value in the income statement.
639. If embedded value does meet the definition of an asset, some would regard it as a financial asset; others would regard it as an intangible asset. Although intangible assets arising from an insurer's contracts with policyholders are excluded from the scope of IAS 38, Intangible Assets, two aspects of IAS 38 set relevant precedents:
- (a) IAS 38 lays down additional recognition criteria for internally generated intangible assets beyond the recognition criteria for assets in general and intangible assets in particular. Among other things, it prohibits the recognition of internally generated intangible assets at an amount other than cost. If the cost cannot be determined reliably, an enterprise should not recognise the asset. This is likely to be the case for the rights underlying embedded value because the cost of generating those rights probably cannot be distinguished from the cost of enhancing or maintaining the enterprise's internally generated goodwill or of running day-to-day operations; and

- (b) IAS 38 prohibits the revaluation of intangible assets for which there is no active market. There is no active market, as that phrase is defined in IAS 38, for the contractual rights underlying embedded value.
640. Many financial activities generate intangible assets similar to embedded value. However, those internally-generated intangible assets are not recognised for accounting purposes. Opponents characterise embedded value as an element in the value of the enterprise as a whole rather than a fair value of the insurance contracts.
641. Critics of embedded value also argue that a large portion of the amount does not represent services provided under the policies. In many cases, the largest contributor to embedded value is the spread between earnings on invested assets and the interest credited to policyholders. They argue that many financial intermediaries rely on interest spreads for their profitability, but do not report the value of anticipated spreads as an asset. Instead, the interest differential emerges and is reported in net profit or loss as earned.
642. For example, banks and similar financial institutions usually have a core of deposits from customers that is stable, even though the customers have an option to close their accounts. These customers are a likely source of future net income for banks arising from the difference between the interest paid to customers by the bank and the interest earned on the deposits by the bank and also the difference between account fees charged to customers and the cost of providing account services. Some consider this core deposit base to be an intangible asset of a bank or similar financial institution. Some argue that the bank's future interest spread and potential future net income on fees is similar to the future profits embedded in a group of insurance contracts. The Joint Working Group on Financial Instruments is reviewing the treatment of core deposits.

Tentative Steering Committee View

643. *The Steering Committee considers that:*

- (a) *embedded values should not be recognised as assets in financial statements as a means of correcting for inappropriate measurement of insurance liabilities;*
- (b) *an insurer's rights under an insurance contract should be factored into the measurement of the insurer's net liability under the contract; and*
- (c) *depending on the measurement basis adopted for insurance liabilities, there may be a need for disclosure of additional information about embedded values.*

Sub-issue 11L Should Decisions about the Fair Value of an Insurer's Financial Assets and Liabilities be extended to other Assets and Liabilities of an Insurer?

644. For most insurers, the vast majority of their assets and liabilities comprise assets and liabilities under insurance contracts and other financial assets and other financial liabilities. If an insurer measures all of these assets and liabilities at fair value, some suggest that the insurer should also measure its other assets and liabilities at fair value. The most important category of other assets and liabilities held by some insurers is property, held either as an investment (investment property) or for use in the insurer's own operations (owner-occupied property).
645. In Exposure Draft E64, IASC proposes that all investment property should be measured at fair value, and that changes in fair value of investment property should be recognised in the income statement.
646. Accounting for owner-occupied property (and for plant and equipment) is covered in IAS 16, Property, Plant and Equipment. IAS 16 requires an enterprise to measure property, plant and equipment at either depreciated cost (benchmark treatment) or revalued amount less subsequent depreciation (allowed alternative treatment). IAS 38, Intangible Assets, contains similar requirements for intangible assets, although the conditions for using the allowed alternative treatment are more restrictive than in IAS 16. IAS 38 does not deal with intangible assets arising in an insurer from contracts with policyholders, but it does deal with other intangible assets of insurers.
647. If an enterprise adopts the allowed alternative treatment, IAS 16 requires that revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from fair value. However, the fair value model that will probably be proposed by the Joint Working Group (JWG) on Financial Instruments for financial assets and financial liabilities is different from the IAS 16 allowed alternative treatment. The JWG's proposal is likely to involve recognising increases and decreases in fair values as income and expenses in the periods in which they occur.
648. The allowed alternative treatment in IAS 16 involves recognising increases in fair values in a revaluation surplus that is part of equity. In addition, under IAS 16, decreases are recognised as a reduction in the revaluation surplus to the extent that there is a previously recognised surplus relating to the asset concerned, and otherwise as an expense. Depreciation (based on the revalued amount) is recognised as an expense in the income statement.
649. Consideration needs to be given to whether the owner-occupied property and plant and equipment of insurers should be measured on a basis that is consistent with their financial assets or on the basis in IAS 16.
650. The amount of property, plant and equipment, and intangible assets may not be material in relation to an insurer's total assets. Some view this as a reason for arguing that they should be treated in the same way as investments. Others view it as a reason for arguing that they should be treated in accordance with IAS 16, which is generally

the same way as entities in other industries treat property, plant and equipment and intangible assets.

651. Measuring both financial assets and property, plant and equipment at fair value would remove the problem of determining which measurement approach to use where items of property, plant and equipment could be both financial assets and items used in an insurer's day-to-day activities. Examples of such assets include an owner-occupied office building and a business that provides information processing services to the insurer that is also owned by the insurer as an investment. An alternative solution to the problem of dealing with property, plant and equipment with a dual purpose would be to deem all such assets to be investments or to deem all such assets to be operating assets for reporting purposes. Given the importance of the investing activity to insurers, if a deeming approach were to be adopted, it may be best to deem property, plant and equipment with a dual purpose to be investments.

Tentative Steering Committee View

652. *Although it is not part of the Steering Committee's mandate to review accounting for property, plant and equipment generally, the Steering Committee believes that IASC should review accounting by insurers for these assets.*