

Preface

This Issues Paper is the first stage in IASC's project on insurance accounting. The insurance industry is an important, and increasingly international, industry. There is currently great diversity in accounting practices for insurers. Also, insurance industry accounting practices in a number of countries differ significantly from accounting practices used by other enterprises in the same countries. These factors make it difficult for users to compare financial statements issued by insurers in different countries, or by insurers and other enterprises in the same country.

The aim of this Issues Paper is to identify the important issues in insurance accounting and to evaluate the merits of alternative approaches to those issues. To provide a focus for commentators, the Issues Paper sets out the tentative views that IASC's Insurance Steering Committee has developed at this early stage of the project. Readers should be aware that the expression of tentative Steering Committee views on the issues identified in the paper does not imply unanimous agreement amongst voting members of the Steering Committee. Where a significant minority have a contrary view on an issue, this has been identified in the Paper. Before proceeding to the next stage of the project, the Steering Committee will reconsider its tentative views carefully in the light of comment letters received and will assess whether those views are appropriate.

When it reassesses its tentative views, the Steering Committee will pay particular attention to the need for insurers to provide relevant and reliable information that users of their financial statements can use as a basis for economic decisions. The information disclosed by insurers should enable users to compare the financial position and financial performance of insurers in different countries; that information should also be comparable with information disclosed about similar transactions by enterprises that are not insurers.

In reassessing whether its tentative views achieve these objectives, the Steering Committee will make use of IASC's Framework for the Preparation and Presentation of Financial Statements. The Steering Committee will also pay close attention to the work of the international Joint Working Group on Financial Instruments, which is currently developing proposals for a comprehensive approach to accounting for financial instruments other than insurance contracts.

The Steering Committee recognises that accounting for insurance inevitably requires estimates of uncertain future events. Therefore, the measurement of insurance liabilities on a reliable, objective and verifiable basis poses difficult practical issues. These difficulties arise in any method of accounting for insurance. However, the Steering Committee acknowledges that they are particularly apparent in the context of fair-value measurement models and of other asset-and-liability measurement models, because there is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts. To avoid excessive detail, this Issues Paper discusses measurement issues in fairly general terms. The Steering Committee will develop more specific guidance on measurement issues at a later stage in the project.

After reviewing the public response to this Issues Paper, the Steering Committee will publish specific proposals for public comment in a Draft Statement of Principles (DSOP). The

Steering Committee will review the public response to the DSOP and then develop an Exposure Draft of a proposed International Accounting Standard. On approval by the IASC Board, the Exposure Draft will be issued for public comment. The Steering Committee will consider responses to the Exposure Draft and then prepare an International Accounting Standard for Board approval.

Although the project will focus on general purpose financial statements, the outcome of the project may have implications for insurance supervisors. Financial information is a vital part of the information that supervisors use to assess solvency and capital adequacy. The Steering Committee hopes to maintain a close dialogue with insurance supervisors and to avoid unnecessary differences in reporting rules.

I encourage everyone with an interest in financial reporting of insurance activities to comment on the Issues Paper.

Warren McGregor
Chairman, IASC Insurance Steering Committee

November 1999

Acknowledgement

The Steering Committee wishes to thank the following, who have generously contributed substantial amounts of their time and expertise to this Issues Paper: Angus Thomson, Hitesh Patel, Joachim Koelschbach, Hans Schoen, Michel Lamie and Karolien Miedema. Above all, the Steering Committee owes an immense debt to Wayne Upton for bringing this Issues Paper to life with his energy, enthusiasm and encyclopedic knowledge of insurance accounting.

Members of the Steering Committee

Voting Members:

Warren McGregor, Australia (Chair)
David Allvey, United Kingdom
Adrian Cowell, International Council of Investment Associations
Howard E. Dalton, United States
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Non-voting Observers:

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Ulf Linder, European Commission
Florence Lustman, International Association of Insurance Supervisors
W. Paul McCrossan, International Actuarial Association
Wayne S. Upton, US Financial Accounting Standards Board

Invitation to Comment

In 1997, the International Accounting Standards Committee set up a Steering Committee on Insurance. The Steering Committee has published this Issues Paper for comment by professional accountancy bodies, standard setting bodies, members of the IASC Consultative Group and other interested individuals and organisations.

The Steering Committee welcome comments on the basic issues and sub-issues set out in this paper, even if they deal only with a limited number of those issues.

Comments are particularly helpful if they:

- (a) indicate the specific basic issues and sub-issues to which they relate;
- (b) explain the issues clearly;
- (c) provide supporting reasoning; and
- (d) indicate which issues are interdependent.

The Steering Committee requests comments by **31 May 2000**. All replies will be put on public record unless confidentiality is requested by the commentator. Comments should preferably be sent by E-mail to: CommentLetters@iasc.org.uk. If commentators respond by fax or E-mail, it would be helpful if they could also send a hard copy of their response by post. Comments should be addressed to:

**The Secretary-General
International Accounting Standards Committee
166 Fleet Street, London EC4A 2DY
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The Next Steps in the Project

The Steering Committee will consider comments received on this Issues Paper and then prepare a Draft Statement of Principles. This will recommend solutions to the questions raised in this paper and explain the reasons for rejecting alternative solutions. The Steering Committee will publish the Draft Statement of Principles for public comment.

The Steering Committee will then develop a final Statement of Principles in the light of public response and submit it to the IASC Board for approval. The Steering Committee will then use the approved Statement of Principles to develop an Exposure Draft of a Proposed International Accounting Standard. On approval by the Board, the Exposure Draft will be issued for public comment. The Steering Committee will consider responses to the Exposure Draft and then prepare an International Accounting Standard for Board approval.

EXECUTIVE SUMMARY OF PROPOSALS

The Steering Committee emphasises that the views expressed in this paper are, inevitably, tentative at this early stage of the project. Before proceeding to the next stage of the project, the Steering Committee will review these tentative views carefully in the light of comment letters received and will assess whether those views are appropriate. The Steering Committee has not yet discussed its tentative views with the Board of IASC.

The Steering Committee's tentative views may be summarised briefly as follows:

- (a) the project should deal mainly with accounting for insurance contracts (or groups of contracts), rather than all aspects of accounting by insurance enterprises. In particular, the project should not deal with accounting for investments held by insurance enterprises;
- (b) an insurance contract should be defined as 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);
- (c) the objective should be to measure the assets and liabilities that arise from insurance contracts (an asset-and-liability measurement approach), rather than to defer income and expense so that they can be matched with each other (a deferral-and-matching approach). Table 2 (pages 47-51) summarises the two approaches;
- (d) insurance liabilities (both general insurance and life insurance) should be discounted;
- (e) the measurement of insurance liabilities should be based on current estimates of future cash flows from the current contract. Estimated future cash flows from renewals are:
 - (i) included if the current contract commits the insurer to pricing for those renewals; and
 - (ii) excluded if the insurer retains full discretion to change pricing;
- (f) in the view of a majority of the Steering Committee, catastrophe and equalisation reserves are not liabilities under IASC's Framework. There may be a need for specific disclosures about low-frequency, high-severity risks - perhaps by segregating a separate component of equity;
- (g) the measurement of insurance liabilities should reflect risk to the extent that risk would be reflected in the price of an arm's length transaction between knowledgeable, willing parties. It follows that the sale of a long-term insurance contract may lead in some cases to the immediate recognition of income. The Steering Committee recognises that some may have reservations about changing current practice in this way;

- (h) overstatement of insurance liabilities should not be used to impose implicit solvency or capital adequacy requirements;
- (i) acquisition costs should not be deferred as an asset;
- (j) all changes in the carrying amount of insurance liabilities should be recognised as they arise. In deciding what components of these changes should be presented or disclosed separately, the Steering Committee will monitor progress by the Joint Working Group on Financial Instruments;
- (k) the Steering Committee is working on the assumption that IAS 39, Financial Instruments: Recognition and Measurement, will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities. The Steering Committee believes that;
 - (i) if such a standard exists, portfolios of insurance contracts should also be measured at fair value. IASC defines fair value as “the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction”;
 - (ii) in a fair value accounting model, the liability under a life insurance contract that has an explicit or implicit account balance may be less than the account balance; and
 - (iii) 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 Issues Paper discusses measurement issues in fairly general terms. The Steering Committee will develop more specific guidance on measurement issues at a later stage in the project;
- (l) pending further discussion, the Steering Committee is evenly divided on the effect of future investment margins. Some members believe that future investment margins should be reflected in determining the fair value of insurance liabilities. Other members believe that they should not;
- (m) for participating and with-profits policies:
 - (i) where the insurer does not control allocation of the surplus, unallocated surplus should be classified as a liability; and
 - (ii) where the insurer controls allocation of the surplus, unallocated surplus should be classified as equity (except to the extent that the insurer has a legal or constructive obligation to allocate part of the surplus to policyholders).

Liability classification is the default, to be used unless there is clear evidence that the insurer controls allocation of the surplus;

- (n) for investment-linked insurance contracts, premiums received may need to be split into a risk component (revenue) and an investment component (deposit);
- (o) the accounting for reinsurance by a reinsurer should be the same as the accounting for direct insurance by a direct insurer;
- (p) amounts due from reinsurers should not be offset against related insurance liabilities; and
- (q) most of the disclosures required by IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 37, Provisions, Contingent Liabilities and Contingent Assets, are likely to be relevant for insurance contracts. Some of the disclosures required by IAS 39, Financial Instruments: Recognition and Measurement, may not be needed in a fair value context. Other items that may require disclosure are regulatory solvency margins, key performance indicators (such as sum insured in life, retention / lapse rates), information about risk adjustments and information about value-at-risk and sensitivity.

Appendix E lists all of the tentative views expressed by the Steering Committee in this document.

The following information will help readers to find their way around this Issues Paper:

- (a) pages vii to viii contain a summary table of contents; and
- (b) pages ix to xxi contain a detailed list of contents.

Please note that the appendices to this document are published as a separate document.

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