# Basic Issue 1

Should the Project Cover all Aspects of Accounting by Insurers (Insurance Enterprises) or should it Focus Mainly on Insurance Contracts of All Enterprises?

### Sub-issue 1A

Should the Project Cover all Aspects of Accounting by Insurers or should it Focus Mainly on Insurance Contracts of all Enterprises?

11. The Steering Committee recommends that the main focus of the project should be on insurance contracts of all enterprises. However, the project will also need to deal with some enterprise-wide issues, such as the following:

   (a) identifying the reporting entity; and

   (b) presentation requirements, including format of the financial statements.

(see IAA comments under paragraph 12)

12. Sub-issue 1A addresses a scope issue – should the project focus on particular types of enterprise (insurers) or on particular types of transaction (insurance contracts)? Sub-issue 6A addresses a separate recognition and measurement issue: should an enterprise account for groups (or “books”) of insurance contracts on a portfolio basis or should it account for individual insurance contracts? The Steering Committee’s scope decision to focus on insurance contracts is not intended to prejudge that recognition and measurement issue.

The IAA agrees with paragraph 11. However, this agreement does not imply that decisions with respect to the measurement of the value of liabilities can be considered in a vacuum. Other factors that need to be considered include:

- The treatment of assets must be considered in order to ensure appropriate and consistent accounting treatment of the obligations resulting from insurance contracts.

- A number of other aspects of the enterprise offering insurance contracts, including disclosure and presentation, are so closely related, that they need to be addressed within the scope of this project as well.

### Sub-issue 1B

How should Insurance Contracts be Defined?

16. The Steering Committee believes that the definition used in IAS 32 needs to be refined so that it focuses more specifically on the features of insurance contracts that cause accounting problems unique to insurance contracts.
The IAA agrees that such refinement is desirable, in order to distinguish between insurance contracts and other financial instruments. On a generic level, the definition encompasses insurance, but it fails to capture the significant characteristics of insurance that in the aggregate may help determine the most appropriate accounting treatment, particularly as they relate to guarantees of a long term nature included in many insurance contracts. Nevertheless, the IAA believes, and expects, that the differences in accounting treatment between those financial instruments that are substantively similar should not be material, whether they are categorized as insurance or not.

17. The Steering Committee believes that the feature that distinguishes insurance contracts from other financial instruments is the risk that the insurer will need to make payment (in cash or in kind) to another party if a specified uncertain future event occurs.

The IAA agrees with this conclusion. However, we would like to emphasize, as we have noted above, that there is a set of features of most insurance contracts that should be considered in the development of accounting standards. They include:

1. Transfer of risk (always present, by definition)
2. Pooling of risk
3. Guarantees of a long-term nature, including guaranteed insurability.
4. Bundle of real and financial options that can be complicated and difficult to separate
5. Restrictions on entry and re-entry
6. A continuous option to terminate by one or both parties
7. Policyholder expectations regarding insurer’s actions
8. Constraints on the insurer’s utilization of its options
9. Insurance contracts and insurance enterprises are highly regulated
10. Expected use of contract options are reflected in entry and exit prices
11. Exit value to contract-owners (as opposed to the exit value to the insurer) may not be related to economic value at time of exit
12. Relevant contingent events may occur that result in one or more benefit payments
13. Assets may accumulate because of differences in timing of revenues and benefit payments
14. Many contract-owners participate in the profits generated
15. Markets for insurance liabilities are usually incomplete, either relatively non-liquid or inactive.

Together, these form unique types of financial instruments. Note that not all insurance contracts contain each one of these features and that it would be rare for a specific insurance contract to contain all of them. Further details of these features and some of their possible accounting implications are
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described in an accompanying paper entitled “FEATURES OF INSURANCE CONTRACTS”.

18. The Steering Committee believes that a contract that transfers only *price risk* (i.e. a derivative) should not be included in the definition of an insurance contract and should fall within the scope of the financial instruments project. Therefore, the Steering Committee proposes that the definition of insurance contract should exclude contracts where the only uncertain future event that triggers payment is 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. This is consistent with IAS 39, Financial Instruments: Recognition and Measurement, which defines a derivative as “a financial instrument:

(a) whose value changes in response to the 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 (sometimes called the “underlying”);

(b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and

(c) that is settled at a future date.”

The IAA agrees that it is reasonable for accounting purposes that a contract that transfers only price risk (defined as a “derivative”) should not be included within the definition of an insurance contract for the purpose of this project, but rather should fall within the scope of applicable IASC financial instruments projects. Nevertheless, as mentioned earlier, the accounting treatment for both types of financial instruments should be similar. For example, certain derivatives often have certain characteristics similar to insurance contracts, which should result in similar accounting.

19. Under some insurance contracts, the insurer is required to make payments in kind rather than by transferring cash or other financial assets to the policyholder (or other beneficiary named in the contract). An example is where the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Such contracts may not meet the definition of financial instruments in International Accounting Standards. The Steering Committee acknowledges that payments in kind may make it more difficult to measure an insurer’s obligations under such contracts. However, the Steering Committee believes that there is no conceptual reason to treat such contracts differently from other insurance contracts that are financial instruments.

The IAA recommends that, for the purpose of developing accounting standards, the definition of insurance should include those contracts that
provide payments in kind. We believe this applies beyond insurance contracts to other financial instruments or near financial instruments such as oil futures. We believe that there is no financial difference between contracts that provide payment in kind and those that provide monetary payments. In each case, the measurement of the obligation involves estimation of both the timing and amount of what could be an equivalent financial amount.

The difference between insurance contracts that provide for cash transactions and insurance contracts that provide payments in kind is so minor compared with their other characteristics, that such contracts should be treated in a consistent manner, without regard to whether they meet a tight definition of financial instruments.

20. An important economic feature of insurance is that a population of policyholders are pooling their risks when they take out insurance. Some believe that the pooling of risks – either between different policyholders or over time - is a factor that may need to be considered in measuring insurance liabilities. However, the Steering Committee believes that this feature is not relevant in defining insurance contracts for financial reporting purposes.

The IAA agrees with the conclusion reached. Although the pooling of risks is fundamental to the successful management of insurance risks in a statistical sense (through the application of the law of large numbers), the existence of such a pool should be neither necessary nor sufficient for a contract to be treated as insurance for the purpose of measuring the liabilities of insurance contracts. For example, at a particular point in time an insurance enterprise may only insure a single property, yet the contract should still be characterized as insurance (of course, the existence of such a single insured object within an insurance enterprise would be quite unusual).

However, it should be noted that in order to provide insurance, almost all insurance enterprises utilize risk pools, since such pools are very important to the management of insurance risk. We also note that, due to the desire to develop or maintain a pool of risks with a set of desirable characteristics, certain restrictions to entry, re-entry or exit from the pool may be involved. Such restrictions will have an impact on expected experience and should be considered in the development of accounting standards for insurance.

21. In some countries, the legal definition of insurance requires that the policyholder (or the beneficiary under the contract) should have an insurable interest in the insured event. Such requirements are often created on public policy grounds to discourage behaviour such as insuring other people's lives and then causing their death or to discourage gambling. Insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities.
22. Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest. Accordingly, the Steering Committee believes that there is no need to refer to insurable interest in defining an insurance contract for financial reporting purposes.

The IAA agrees that there is no need to refer to insurable interest in defining an insurance contract for accounting purposes. Rather, the requirement for an insurable interest is a regulatory matter concerning the public interest. Although a specific payment may depend on the existence of insurable interest, we have not identified any reason that the accounting treatment for insurance should vary based on whether insurable interest exists.

23. Because it does not contain a notion of an insurable interest, the proposed definition of an insurance contract captures not only transactions that are traditionally viewed as insurance but also other transactions that are sometimes regarded as gambling. There are important social, moral, legal and regulatory differences between insurance and gambling. Nevertheless, issuers of insurance contracts and issuers of gambling contracts both accept an obligation to make payments of unknown timing or amount related to uncertain future events. Accordingly, the Steering Committee has so far identified no economic reason to exclude gambling transactions from the definition of insurance contract used for financial reporting purposes and from the scope of the project.

Although the IAA sees no reason to exclude gambling contracts from this project, our observations and opinions offered in response to this Issues Paper do not necessarily cover such contracts. In other words, we do not consider gambling to be insurance; however, we see no reason to account for them differently.

24. An insurer generally receives a payment (often known as a **premium**) as consideration for undertaking the obligations set out in the insurance contract. However, the receipt of a premium is not a feature that distinguishes an insurance contract from other types of contract. Accordingly, the Steering Committee believes that there is no need to refer to the premium in defining an insurance contract for financial reporting purposes.

The IAA agrees.

25. The Steering Committee proposes the following definition of an insurance contract, for use in all International Accounting Standards, and related guidance. The Steering Committee recognises that other definitions may sometimes be appropriate for other purposes. ...
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).

Suggested Guidance to Support the Definition

Uncertainty (or risk) is the essence of an insurance contract. Accordingly, it is uncertain at the inception of a contract:

(a) whether a future event specified in the contract will occur;
(b) when the specified future event will occur; or
(c) how much the insurer will need to pay if the specified future event occurs.

Some insurance contracts cover events that are discovered during the term of the contract, even if they occurred before the inception of the contract; these contracts do not cover events that are discovered after the end of the contract term, even if the events occurred during the contract term. Other insurance contracts cover events that occur during the term of the contract, even if those losses are discovered after the end of the contract term.

Insurance contracts may require payments to be made directly to the policyholder, to their dependants or to third parties. Insurance contracts may require payments to be made in cash or in kind.

It is convenient to describe the risk that is present in an insurance contract as insurance risk and the risk that is present in a derivative financial instrument as price risk. Insurance risk may be analysed into a number of different types of risk, including:

(a) occurrence risk (the possibility that the number of insured events will differ from those expected);
(b) severity risk (the possibility that the cost of events will differ from expected cost); and
(c) development risk (a residual category. It refers generally to changes in the amount of an insurer’s obligation after the end of a contract.
period. Such changes may result from the late identification of insured events that occurred during the contract period, the possibility that claims will settle more quickly or in amounts greater than expected, that courts may interpret the insurer’s liability differently than expected, and other factors that may change the insurer’s initial estimate of costs to settle incurred claims).

25.6 Insurance contracts often expose an insurer to further risks, in addition to insurance risk. For example, an insurer is often exposed to financial risk (the possible variation in amounts earned from investing premiums during the period from receipt to payment of claims. It includes the possibility of duration mismatch and liquidity risk). Similarly, many life insurance contracts guarantee a minimum rate of return to policyholders and such guarantees expose the insurer to financial risk. However, a contract that exposes the issuer to financial risk without insurance risk is not an insurance contract.

25.7 The amount to be paid under an insurance contract may be affected by changes in a price or a similar variable, such as an index. However, a contract does not meet the definition of an insurance contract if the only event that triggers payment is 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. Such a contract is a derivative financial instrument and falls within the scope of IAS 39, Financial Instruments Recognition and Measurement.

25.8 Some insurance contracts include an embedded derivative with economic characteristics and risks that are not closely related to the characteristics and risks of the insurance contract. An example is a guarantee of the returns on an investment (either an absolute return or by reference to an index or interest rates). IAS 39 requires that an enterprise should separate the embedded derivative from the “host” insurance contract and account for it at fair value as if it were a separate derivative, unless the enterprise measures the combined instrument at fair value and includes the changes in fair value in net profit or loss.\(^1\)

25.9 The following are examples of contracts that meet the definition of an insurance contract: …

…

25.11 Under some contracts, the amount payable is linked to a price index, but the uncertain event that triggers payment is not a change in a specified interest

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\(^1\) Sub-issue 1E addresses the question of separate accounting for embedded derivatives or other components of an insurance contract.
rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. Such contracts are insurance contracts. For example, an annuity linked to a cost-of-living index is an insurance contract. That is because payment is based not solely on changes in the index but is triggered by an uncertain event – the survival of the annuitant.

The IAA agrees that the definition of insurance contracts as stated in paragraphs 25.1 to 25.11 is reasonable for the purpose of this project. Any standard should strive to provide continuity between the accounting treatment of products as risk elements are added or removed. Further discussion of the features incorporated in most insurance contracts is included in an accompanying paper entitled “FEATURES OF INSURANCE CONTRACTS”.

Sub-issue 1C How much Uncertainty is Required for a Contract to Qualify as an Insurance Contract?

38. Contracts that do not create insurance risk are financial instruments, but not insurance contracts for financial reporting purposes. The Steering Committee intends to develop guidance to clarify that these products fall within the scope of the Financial Instruments project. This sub-issue will not be particularly significant if the recognition, measurement and disclosure requirements for insurance contracts are consistent with those for other financial instruments.

Most importantly, the IAA encourages all efforts to achieve consistent accounting treatment and demonstrated continuity for similar financial products and the avoidance of arbitrary breaks in treatment. We believe that, while difficult, continuity of measurement of liabilities is achievable, despite the historical differences in reporting of similar products, including those offered by financial institutions such as insurers and banks. This may involve change from approaches traditionally used for certain products. We encourage close co-operation between the efforts of this insurance project and those of the Joint Working Group and subsequent IASC financial instruments projects.

The IAA encourages the IASC to seek agreement that would achieve such consistency in accounting recognition and measurement principles among financial instruments and products offered by various types of financial institutions. If discontinuities in recognition result in the use of fair values for one financial services industry or for one product and the use of other than fair values for others, we would consider the result to be inappropriate. Any solution that does not provide a continuum of measurement of liabilities (and hence, a continuum of measurement of net income) has the potential to produce non-comparable and potentially misleading financial reporting and is, therefore, unacceptable.
39. The Steering Committee has not yet developed guidance on the amount of insurance risk that should be present for a contract to qualify as an insurance contract for financial reporting purposes. The Steering Committee welcomes comments on:

(a) whether detailed guidance is needed on the amount of insurance risk that should be present for a contract to qualify as an insurance contract;

(b) the amount of insurance risk that should be present for a contract to qualify as an insurance contract; and

(c) whether any contracts that do transfer insurance risk should be excluded from the definition of insurance contracts.

The IAA reiterates the need for demonstrated continuity to avoid manipulation of product design. Otherwise, product design might be artificially modified simply to obtain more “favorable” accounting treatment.

(a) The actuarial profession, through its standards of practice, can ensure continuity in measurement where there is continuity of recognition. However if, for example, accounting recognition leads toward historical cost treatment for one product and toward prospective treatment for another similar product, then serious problems are bound to result. The actuarial profession, through the IAA, stands ready to work with the IASC in developing examples for appropriate guidance.

(b) A material amount of risk being transferred should qualify the contract as an insurance contract for presentation purposes.

(c) If our suggestions in (a) and (b) above are implemented, then the point raised in (39c) above is not an issue.

40. The Steering Committee believes that insurance risk is present if either the amount or timing (or both) of the insurer’s payments vary directly with the amount or timing (or both) of losses incurred by the policyholder.

The IAA agrees.

41. The Steering Committee proposes that reinsurance contracts should be defined simply as insurance contracts between two insurers. To determine whether a contract transfers insurance risk, the same principles should be used for both a reinsurance contract and a (direct) insurance contract.

(see IAA comments under paragraph 42)
Some argue that the definition of a reinsurance contract should exclude contracts where the timing of payments by the reinsurer does not vary directly with the timing of losses incurred by the direct insurer. They believe that this restriction is necessary to avoid the abuse of reinsurance accounting where the direct insurance liability is measured on an undiscounted basis. However, as explained in sub-issue 7I, the Steering Committee proposes that all insurance liabilities should be discounted. Accordingly, there is no need to consider such a restriction.

The IAA agrees with the conclusions reached in paragraphs 41 and 42. We believe that a proper set of accounts must have continuity of measurement. If that criterion is achieved, the definitions applied become less important. Nevertheless, additional guidance may be needed (such as provided in the examples included in Volume II of the IASC Insurance Issues Paper) to ensure consistent interpretation of the resultant standards. In order to encourage reinsurance treaties to be based on economic considerations, rather than solely to provide justification for a given accounting treatment, the differences in accounting treatment between reinsurance as an insurance financial instrument and as a non-insurance financial instrument should be held to a minimum, if not eliminated. An example of this is a reinsurance contract which is a financing arrangement used principally to supplement or to enhance regulatory capital. We observe that the current driver of a number of reinsurance treaties is the fact that accounting regimes and regulatory regimes often do not reflect economic reality, a phenomenon the Issues Paper identifies in paragraph 42.

Sub-issue 1D  Should an Enterprise Assess whether a Contract Creates Insurance Risk Only at Inception of the Contract or Throughout the Life of the Contract?

For the reasons described in the previous paragraph, the Steering Committee believes that:

(a) a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire; and

(b) if a contract does not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if an uncertainty that was previously considered insignificant becomes significant.

The IAA agrees.
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47. Paragraph 27 describes an investment contract that does not create insurance risk at inception, but includes an option for the policyholder to buy an annuity at market rates that are current when the investor buys the annuity. Until the policyholder exercises the option, the contract is not an insurance contract for financial reporting purposes. If the policyholder decides to buy the annuity, the insurer will account for the annuity as an insurance contract from that date.

The IAA agrees with the conclusions reached in the example cited. Note that if the annuity had included a guaranteed re-entry that was not otherwise available or where a material degree of risk exists associated with a future annuity rate guarantee, our response would change.

The IAA encourages the IASC to treat such investment contracts (even if they do not incorporate a material degree of risk during their accumulation stage) on a continuum in a manner consistent with that for similar insurance contracts with a material degree of risk. In this way, major discontinuities in financial reporting arising from the exercise of the option will be avoided.

Sub-issue 1E Should an Enterprise Account Separately for the Components of Insurance Contracts that Bundle Together an Insurance Element and Other Elements, such as an Investment Element or an Embedded Derivative?

57. The Steering Committee believes that unbundling as described in paragraph 48(a) is conceptually preferable but that it relies on distinctions that may be difficult to make in practice. The Steering Committee proposes that contracts should be unbundled when the separate components are either:

(a) disclosed explicitly to the policyholder; or

(b) clearly identifiable from the terms of the contract.

(see IAA comments under paragraph 60)

58. The Steering Committee believes that a derivative embedded in a host insurance contract is clearly identifiable from the terms of the policy, and should be separated from the host insurance contract, where all of the following conditions are met:

(a) the embedded derivative does not create insurance risk;

(b) the embedded derivative has characteristics and risks that are not closely related to the characteristics and risks of the host insurance contract; and

(c) a stand-alone instrument with similar terms would meet the definition of a derivative.
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(see IAA comments under paragraph 60)

59. The Steering Committee would welcome comments on whether unbundling should be used for other contracts.

(see IAA comments under paragraph 60)

60. If all financial instruments, including insurance contracts, are measured at fair value, it may be less important to account separately for the components of insurance contracts that bundle together an insurance element and other elements. This is because there would be no scope for accounting arbitrage between contracts treated as insurance and contracts treated as other financial instruments. On the other hand, there may still be a need for some – for example, if all cash inflows for insurance contracts are treated as premium revenue and cash inflows for some other financial instruments are treated as deposits.

The IAA believes that unbundling insurance contracts, including the extraction of "embedded derivatives," is unnecessary, inappropriate, and can be misleading, for the following reasons.

1. Unbundling may separate contract elements with interdependent risks, leading to misstatement of liabilities.

Cash flows arising from insurance contracts as well as each of their components (including premiums, benefits, expenses, and associated investment income) are typically uncertain with respect to their timing and amounts. There may be a significant degree of uncertainty associated with each of the components and sources of risk that in the aggregate should be reflected in the value of the contracts’ liabilities in an appropriate way. Most insurance contracts cover more than one type of risk. In practice, careful design of insurance contracts may combine elements in order to offset a portion of the risks when looked at separately.

Examples of such contracts include:

- **Endowments.** In their classical form, a combination of a term insurance and a savings element providing the same benefit upon death during the policy period or upon survival to the end thereof.
- **Universal life insurance.** Where the death benefit is the greater of the contract value and a specified fixed amount, complicated by the option provided to the contract-owner of changing the amount and timing of premium payments.
- **Pension contracts.** A combination of deferred annuities and a widow’s pension.
These types of contracts share the inherent offsetting of one risk with another within one contract. The risk of dying during the contract term (partly) compensates for the risks of staying alive longer. Pricing of these types of contracts takes into account this offsetting of risks.

Unbundling could result in a valuation in which the sum of the expected values with their risk adjustments would be higher than would occur if the same contracts were not unbundled. That would result in higher liabilities than would be necessary given the contract contents (and hence might lead to an unwarranted loss at issue if the contract is unbundled). Note that these contracts typically cover the same life (person) and that, while coverage of the offsetting risks may also be available (and sold) separately, larger total premium rates are typically involved.

Conversely, the combination of correlated risks in the same contract can lead to understatement of liabilities if the elements are valued independently.

2. The criteria proposed for such unbundling are inappropriate and unworkable.

Accounting should be based on the financial terms of the contract, not simply on disclosures and illustrations to policyholders. To do otherwise not only would be conceptually unsound but, in the context of unbundling, could lead to inexplicable inconsistencies between insurers and even between similar contracts in the same insurer. There are a number of reasons for these inconsistencies, including differing pricing cross-subsidies among elements of different contracts. In addition, policyholder disclosures may not be fully documented or consistent with independently set explicit assumptions and would likely not be readily auditable.

Treatment that would vary if components were "clearly identifiable from the terms of the contract" would similarly be unworkable because similar coverages could utilize different contract language. The extreme difficulties currently being experienced in the adaptation of SFAS 133 for specific insurance products serves as an example of the complexities and problems involved.

3. When accounting is on a fair value basis, the need for unbundling is no longer present.

Much of the motivation to unbundle is driven by the mixed attribute aspects of existing accounting models. In particular, the purpose for extracting embedded derivatives is clearly to enable those elements of the contract to be accounted for on a fair value basis. If a single attribute
model is used, the need for such unbundling is reduced significantly, if not eliminated.

4. *Unbundling can lead to inappropriate accounting differences.*

Unbundling can lead to elements of an insurance contract falling outside the definition of insurance contracts and even outside the definition of financial instruments. Accordingly, it can lead to other than fair value accounting for such elements (if those elements would be otherwise accounted for on an inconsistent basis) or to different approaches to measuring fair value.

In addition, for a contract as complex as are many insurance contracts, unbundling may not lead to a unique set of component elements. The sequence under which elements are extracted can also lead to different results. Revenue can thus be allocated differently to the various elements, particularly if different bases are required (e.g., if both insurance and non-insurance elements are involved). There are numerous cross-subsidies in insurance contracts that can be apportioned in different ways. Accordingly, comparable contracts could have significantly different accounting recognition and measurement issues, with the potential for "accounting arbitrage" to arise.

In general, an "unbundling" approach or extraction of embedded derivatives would inevitably lead to inconsistencies in values among similar contracts and with the basic objectives of the accounting model.

5. *Unbundling may lead to misleading information.*

Often elements of an insurance contract are "disclosed" separately, but are really inseparable parts of a bundle, both from the perspective of the insurer and the policyholder. The insurer analyzes the contract’s profitability and designs the product based on the composite profitability and competitiveness of all elements on a combined basis. The insurance purchase is made based on a sales illustration, which demonstrates the combined effect of all elements on the value delivered to the customer. Specifics such as the projected and guaranteed mortality charges at, for example, age 61 are disclosed, but rarely play a role in the decision to buy. It is the whole bundle that is purchased and sold.

An example from the U.S. upscale universal life market illustrates this point. In the past, it was common for these products to provide a "power loan" feature, under which the policyholder could borrow all of the cash value of the contract. The policyholder would pay the insurer interest on this loan, and the insurer would credit the policyholder's account balance with 50 or 100 basis points more than it received from the policyholder!
This very common feature apparently did not cause concern about the profitability from the insurer's perspective. But as a separate item, outside of the bundle, it surely never would be offered.

This is an extreme example to illustrate the point. There have been other extremes in the market -- e.g., negative first year mortality charges combined with high early surrender charges – to achieve the desired combined result. Another example has been single premium life contracts with no explicit mortality charge; rather, these charges are included as a reduction in interest credited. But the point here – that the aggregate effect of all the elements is the only thing that matters – is almost always true in real markets, even where such extreme elements do not exist. If the separate parts are calculated on a sequential basis, the combined value may not be affected, but the values of the separate parts will depend on the order in which the separate parts are calculated.

The IAA believes that attempts to unbundle can lead to results which vary depending on the sequence in which the options are separated from the whole. Further, the inter-dependence of the risks insured under an investment-linked contract may lead to a significant misstatement of the liabilities if such risks are evaluated independently.

Regarding the last sentence of paragraph 60, consideration should be given to consistent treatment of premiums and deposits, in order for these two items to be combined where that is appropriate.

Sub-issue 1F Should Catastrophe Bonds be Treated as Insurance Contracts?

62. In substance, the holder of a catastrophe bond has issued an insurance contract that is embedded in a conventional bond. The premium for that contract is the additional interest that the bondholder will receive if the specified event does not occur. Consistent with the Steering Committee’s view on sub-issue 1E, both an issuer and a bondholder should account separately for (unbundle) the host bond and the embedded insurance contract:

(a) the host bond should be treated as an asset of the bondholder and a liability of the issuer; and

(b) the embedded insurance contract should be treated as an insurance contract issued by the bondholder (in substance, an insurer) to the issuer of the bond (in substance, a policyholder).

(see IAA comments under paragraph 63)

63. Separate accounting will be particularly important if there are any differences between the measurement bases for insurance contracts and financial
instruments. However, where a catastrophe bond is quoted in a deep and liquid market, the fair value of the bond will be readily obtainable and this may reduce the need for separate accounting for the components.

The IAA agrees that the inclusion of catastrophic risk, or any other insurance risk, in a debt instrument makes the resulting contract one of insurance and therefore subject to insurance accounting. For the reasons cited with respect to Sub-issue 1E, we recommend that such contracts not be unbundled into their insurance and investment elements. Paragraph 63 suggests that if a deep and liquid market for such instruments develops, it would reduce the need for separate accounting for the components. Significantly, it is the fact that such instruments are recorded at fair value that reduces the need for unbundling, not the presence of a liquid market. Additionally, a suggestion that accounting might differ depending on the liquidity of the market would be troubling.

Sub-issue 1G Should Financial Guarantees be Treated as Insurance Contracts or as (Other) Financial Instruments?

65. The Steering Committee has identified three types of financial guarantee:

(a) financial guarantees that require payments in response to changes 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. Such financial guarantees meet the definition of derivatives in IAS 39 and IAS 39 establishes accounting requirements for them. In the Steering Committee’s view, these financial guarantees should remain within the scope of the financial instruments project;

(b) financial guarantees that require payments to be made if the debtor fails to make payment when due. In the Steering Committee’s view, the credit risk resulting from these contracts is a form of insurance risk. Therefore, the Steering Committee believes that they should be covered by a standard on insurance rather than by IAS 37 (as at present) or a standard on financial instruments; and

(c) financial guarantees that require payments to be made (either to the debtor or to the creditor) if the debtor’s income is reduced by specified adverse events such as unemployment or illness, even if the debtor continues to pay off the loan when due. The Steering Committee believes that the insurance project should cover these contracts.

The IAA agrees.
Sub-issue 1H  Should Product Warranties be Included in the Scope of the Project?

68. The Steering Committee believes that the insurance standard should address product warranties issued by insurers on behalf of other parties (such as a retailer or manufacturer) because such product warranties are excluded from the scope of IAS 37 and IAS 39. However, the Steering Committee believes that the insurance standard should not address product warranties issued directly by a retailer or manufacturer, as these are already covered by IAS 37.

The IAA agrees that product warranty insurance should fall within the scope of this project.

In general, we believe that liability measures for insurance exposures should be the same as those for self-insurance exposures for the following reasons:

- From an economic standpoint, they constitute the same obligations. In particular, if judged on a fair value basis, the amount it would take to exchange the obligations would be identical.

- If accounting standards are different, the standards themselves, rather than the economics of the exposures, may drive the business decision as to whether to insure or not to insure product warranty obligations. The IAA believes that accounting standards themselves should not drive economic decision-making.

- In a fair value context, the exit price in either the insured or uninsured exposure would be similar.

Thus, if non-insured product warranties are not included in this project, an evaluation of standards for non-insured product warranties should immediately follow the finalization of standards for insurance contracts.

Sub-issue 1I Should the Project Deal with Accounting by Insured Enterprises?

72. The Steering Committee’s view is that accounting by insured enterprises for insurance contracts should not be excluded from the project at this stage. The Steering Committee will consider such an exclusion later in the project. The Steering Committee has not considered whether recognition and measurement requirements for insured enterprises should be the same as the recognition and measurement requirements for insurers.

At this stage, the IAA considers that accounting for insured enterprises should not be considered. Once the conclusions are reached for the insurer,
this issue should be revisited. We do not believe that recognition and measurement of an insured exposure need to be the same when reported as the insured’s asset as when reported as a liability of an insurer.

Sub-issue 1J  Should the Project Deal with Employee Benefit Plans?

75. The Steering Committee proposes to exclude employee benefits from the scope of the project, as IAS 19 and IAS 26 already deal with this issue.

The IAA agrees that employee benefit plans can be excluded from this project. However, upon conclusion of this project and the IASC project on discounting (present values), it would be appropriate to revisit IAS 19 promptly, particularly with respect to the discounting approach to be used.

Sub-issue 1K  Is the Distinction between General Insurance and Life Insurance Important? If So, How should the Distinction be made?

82. The Steering Committee intends to develop accounting models for general insurance and life insurance that are separate, but based on the same underlying principles.

(see IAA comments under paragraph 84)

83. The Steering Committee believes that the main economic feature that distinguishes most general insurance contracts from most life insurance contracts is the length of the contract. For most general insurance contracts, the contract is for a short term and the insurer is free to change premiums after the end of the period covered by the current premium, or even to decline to renew the contract. For many life insurance contracts, the contract is for a long term and the insurer has limited or no ability to reset premiums and is required to continue to provide cover if the policyholder continues to pay premiums. This requirement to continue providing cover is a source of additional liabilities (and, perhaps, assets) that do not arise in contracts that do not have this feature.

(see IAA comments under paragraph 84)

84. Accordingly, the Steering Committee proposes to make the distinction for financial reporting purposes as follows:

(a) insurance should be treated as general insurance for financial reporting purposes if the insurer is committed to a pricing structure for not more than twelve months; and
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(d) insurance should be treated as life insurance for financial reporting purposes if the insurer is committed to a pricing structure for more than twelve months.

The IAA does not believe that the type of insurance risk should affect the accounting treatment of insurance contracts. The distinction made in paragraph 84 between life insurance and general insurance does not provide a source of meaningful accounting guidance. This does not imply that measurement techniques, valuation models used and the relative importance of different elements of the liability of different types of insurance are the same, e.g., claim liabilities are more prominent in general insurance while non-level (e.g., varying by insureds' ages) expected claim incidence is more likely within life or health insurance. However, this difference implies only that the risk assessment is different, not that different accounting treatment should applied.

Pricing structures can vary considerably by contract and by country. The range of possible pricing structures can be illustrated by a review of the following list of types of insurance contracts:

1. One year term life insurance – sold to individuals or to groups
2. One year general insurance, often with the expectation of both the insured and the insurer that renewal will occur at the same or different premium rate
3. Multi-year general reinsurance
4. Multi-year package general insurance, with or without the right to cancel at any time or specific time, or with or without the right to change rates at monthly or annual intervals
5. Long-term homeowners with guaranteed premium with a savings fund offered either on a composite contract or as a policy and rider – Japan
6. Health insurance with no right to change rates, with the right to change rates, with the right to terminate a class of business, or with the right to terminate on an individual policy basis – U.S.
7. Interest sensitive life insurance with the right to change interest rates
8. Guaranteed renewable disability with a right to change rates at future contract anniversaries
9. Participating life insurance with the right to change dividends
10. Life insurance with guaranteed maximum premiums or maximum insurance charges with current premiums or charges less than this maximum
11. Warranty, mortgage guarantee, and financial guarantee insurance on a single or periodic payment basis for coverage for anywhere between one year and more than thirty years
12. Whole life insurance.
As can be seen, the duration of the contract does not necessarily vary in a manner consistent with the type of risk. Nevertheless, segment reporting incorporated in an insurer’s financial statement based on the types of risks covered (or other characteristic such as distribution system) may be appropriate. Rules of such segment reporting should be consistent with corresponding rules for a non-insurer.

A distinction between contracts for one year or less should be made only where it is appropriate; the IAA believes that even in the case of unexpired obligations, all insurance contracts should be treated in a consistent manner independent of the duration of contract.

Moreover, we question the advisability of distinguishing contracts based on a fixed duration; for example, if the twelve month distinction makes a difference in accounting treatment, it will be inevitable that contracts will be developed with a term of nine months or fifteen months to obtain a desired accounting result. An arbitrary fixed cut-off in the application of different accounting models is not warranted and will lead to non-comparable reported results.

In summary, although certain features of the many types of insurance contracts may not be relevant to all aspects of a single accounting treatment, the IAA believes that a single accounting approach is practical and appropriate for all types of insurance contracts. As the course of this project evolves, we will continue to seek reasons that one model will not work for all insurance; so far, we have not identified any.

Sub-issue 1L Are there any Specific Issues that are Unique to Health and Medical Insurance?

86. The Steering Committee has not identified any characteristics of health and medical insurance that are not already addressed elsewhere in this Issues Paper. The Steering Committee welcomes comments on any aspects of health and medical insurance that need to be considered separately.

The IAA is not aware of any characteristic of health and medical insurance that is not addressed elsewhere in this Issues Paper. As noted in our response to Sub-issue 1K, we do not believe that, for the purpose the development of accounting standards for the measurement of insurance liabilities, the types of risk covered need to be differentiated on the basis of the type of insurance risk involved.

However, a few observations regarding health insurance may be relevant:
• There is a need to address the several types of health insurance premium structures that are not generally found in other coverages (e.g., in the U.S., non-cancellable unless all similar contracts within a territory are
cancelled and capitation rating for Health Maintenance Organizations) and the contract features that are less common in other contracts (e.g., Japanese return of a specific percentage of premium if no claims have been submitted). Nevertheless, some other types of contracts also have such features. They should be addressed in a more general context.

- It is common in health insurance coverages for the benefits to be provided in kind.
- Continuity of accounting treatment for Administrative Services Only contracts, Minimum Premium Plans, and fully insured plans is needed.
- With respect to liabilities for outstanding health claims, consistency in the determination of the identification and recognition of when a claim occurs is desirable.
- For certain Health Maintenance Organizations, the principal asset consists of the health facilities through which health care benefits are provided. This situation may influence risk based capital requirements to a far greater extent than the value of an insurance liability.
- For some personal health insurance (PHI) contracts in various countries, including Germany, premiums are calculated for each insured on the basis of her/his risk characteristics according to the principle of "life-long" equivalence. This means that over the lifetime coverage period, the estimated premiums are expected to provide for the total of the benefits, including expenses. Premiums are calculated under actuarial principles using mortality tables and voluntary termination assumptions, as well as claims per capita and estimates of interest. The equivalence principle indicates the need for a benefit provision determined on the basis of the collective book of business and not individually as in life insurance. For such contracts, (1) the insurer must continue coverage as long as the policyholder continues to pay premiums, (2) the insurer generally is not completely free in adjusting premiums, in some jurisdictions even only according to specified rules set by law ("accommodation" clause) and (3) on surrender there are surrender penalties or no surrender values at all.

87. The Steering Committee believes that health and medical insurance will sometimes be best classified for accounting purposes as general insurance and sometimes as life insurance, depending on the specific characteristic of each contract.

The IAA does not agree with the formulation of this belief, because we believe that there should be a single accounting treatment for all insurance contracts.
Sub-issue 1M Should Different Accounting Requirements be Set for Different Types of Insurer or for Insurers with Different Legal Forms?

92. The Steering Committee sees no reason to set different accounting requirements for different types of insurer. As the project progresses, the Steering Committee will consider whether there is a need for additional requirements for certain types of insurer to supplement the requirements that it will develop for all enterprises that are parties to insurance contracts.

The IAA agrees that there is no reason to establish different accounting requirements for different types of insurer.

Sub-issue 1N Should Specific Guidance be Given on Self-insurance?

94. The Steering Committee believes that the example that was contained in E59 is consistent with the principles set out in IAS 37: where there is no obligation at the reporting date to another party, no liability should be recognised. The Steering Committee does not intend to develop guidance on self-insurance, other than perhaps a brief reference to explain how self-insurance differs from insurance.

The IAA believes that liability measurement for self-insurance exposures should be the same as that for other insurance exposures for the following reasons:

- From an economic standpoint, they constitute the same obligations. In particular, if judged on a fair value basis, the amount it would take to exchange the obligations would be identical.

- If accounting standards are different, the standards themselves, rather than the economics of the exposures, may drive the business decision as to whether to insure or to self-insure. The IAA believes that accounting standards themselves should not drive economic decision-making.

- In a fair value context, the exit price in either the insured or uninsured exposure would be similar.

The IAA believes that a re-evaluation of standards for self-insurance provisions should immediately follow the finalization of standards for insurance contracts to assure consistency of recognition and measurement of the liability for such exposures.
Basic Issue 2 Should the Project Deal with Financial Instruments (Other than Insurance Contracts) held by Insurers?

108. The Steering Committee believes that the project should deal with financial instruments that are insurance contracts, but not with other financial instruments. The Steering Committee will monitor progress by the Joint Working Group on financial instruments.

The IAA agrees that the scope of this project should be confined to insurance contracts, both those that are considered financial instruments and those that are not (e.g., insurance contract whose benefits are payable in kind), rather than other financial instruments held by insurers.

It should be noted that since the nature of insurance is to provide insurance benefits, the starting point for the determination of the appropriate accounting treatment for insurance contracts should be the contract and its resulting liabilities, and not the insurer’s assets. Conceptually the project should not only deal with the liabilities arising from insurance contracts, but also with their corresponding assets, primarily with other financial instruments that back up insurance contracts.

Moreover, it is important that the project strive for consistency of accounting treatment, both in recognition and in measurement, between insurance contracts and similar financial instruments, as well as similar obligations that may be judged not to be financial instruments. Significant differences in treatment among these may lead to accounting arbitrage, i.e., small differences in product design made only for the purpose of receiving more “favorable” accounting treatment.

In addition, if the determination of the application of such differences is based on judgement, this could lead to non-comparable reporting. Consequently, every effort should be made to achieve consistency with treatment of near-insurance products, such as annuities with no mortality risk, reinsurance with insufficient risk-transfer, and health or warranty insurance with payment in kind rather than payment in monetary settlements. Decisions should also be made in a manner consistent with those made by the current Joint Working Group project on financial instruments (and any subsequent IASC project on financial instruments).

109. In developing proposals for the treatment of insurance contracts, the Steering Committee will work for consistency with the treatment of assets held by insurers. For this purpose, the Steering Committee has assumed that IAS 39 will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities, including all non-insurance financial assets and non-insurance financial liabilities held by insurers.
The IAA strongly believes that the basis of accounting for insurance contract liabilities should be consistent with the basis of accounting for assets of insurers (which generally consist primarily of financial instruments). To do otherwise would result in inconsistent and potentially misleading financial results. If fair value accounting for the substantial majority (such as seventy percent) of non-insurance financial assets and non-insurance liabilities is not in place, we may not favor the use of a fair-value based measurement of insurance contract liabilities.

If a material portion of the assets supporting the insurance liabilities is recognized or measured by historical or retrospective methods of accounting, serious and material distortions can occur, with resultant misleading financial statements. An example of that concern is raised if an insurer holds a significant percentage of its assets in investment property. The choice of an historical cost basis for these assets can be incompatible with the application of fair values of insurance liabilities. If insurance liabilities are valued on the basis of fair values, the IASC might consider whether to restrict the use of historical costs to value investment property for such insurers.
Basic Issue 3  Should IASC Issue Provisional Guidance on Certain Aspects of Insurance Accounting or Disclosure?

115. For the reasons discussed in paragraph 113, the Steering Committee considers that it is not worthwhile trying to develop an interim standard on recognition and measurement of insurance contracts. When it reviews the comment letters on this Issues Paper, the Steering Committee will consider whether there is case for trying to develop a separate Standard on disclosure issues at an earlier date.

The IAA agrees with the Steering Committee that there is no reason to develop an interim standard on recognition and measurement of insurance contracts. A substantial amount of resources may be required to implement an interim standard in most countries. Then in one or two years, to require a different or expanded set of standards would be wasteful and an inefficient use of resources, without significant added value.

Nevertheless, it is important to recognize that sufficient time and trial is needed to ensure that companies are ready for the changes that are involved and that there are not unforeseen snags. Therefore, the IAA recommends that an appropriate run-in period be made available that may be a function of the make-up of the accounting standards, to ensure that the regime will work as intended. This period should be determined as the standards are being developed, reflecting the difficulties of implementation of the standards.
Basic Issue 4  What should be the Overall Objectives of a Recognition and Measurement System for Insurance Contracts?

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

144. In the Steering Committee’s view, the interests of different user groups overlap. All share an interest in relevant and reliable information about the insurance enterprise, its assets and liabilities, its financial performance, and its ability to meet obligations. The IASC project on insurance accounting necessarily emphasises general purpose financial statements and the IASC’s Framework of financial reporting concepts.

(see IAA comments under paragraph 147)

145. Although the project will focus on general purpose financial statements, the outcome of the project may have implications for insurance supervisors. In some countries, national requirements for general purpose financial reporting may change in response to an International Accounting Standard on Insurance. Such changes could have a direct effect on those insurance supervisors who rely mainly on general purpose financial statements to assess capital adequacy and solvency. In other countries, insurance supervisors receive separate special purpose reports prepared on a different basis and may be affected less directly. Nevertheless, insurance supervisors are increasingly looking to develop a common international approach to issues such as solvency and capital adequacy - and may wish to look to an International Accounting Standard to define the data used in such requirements - although supervisors will, of course, still have responsibility for setting the requirements.

(see IAA comments under paragraph 147)

146. The Steering Committee hopes that insurance supervisors will find that they can build on general-purpose financial statements in performing their statutory function. Insurance supervisors have several tools that they can use to monitor solvency, including capital adequacy testing, risk-based capital requirements and restrictions on investment policies. In the Steering Committee’s view, those devices allow insurance supervisors to maintain appropriate control within their jurisdictions, while allowing the development of general purpose financial reporting that is useful to a broad range of financial statement users.

(see IAA comments under paragraph 147)

147. In the Steering Committee’s view, overstatement of insurance liabilities in general purpose financial statements should not be used to impose implicit solvency or capital adequacy requirements.
The IAA agrees with the Steering Committee’s view that the interests of different user groups overlap. Nonetheless, these groups all share a need for understandable, relevant, reliable, and comparable information. In many jurisdictions, even today, these diverse interests are met by generating different versions of what really should be the same information. The result is that many members of the public are simply confused by the diverse information available and doubt the validity of any of the diverse versions. As a result of this concern, we support the Steering Committee’s goal of developing a single approach to general purpose financial statements applied in a uniform manner in all circumstances.

The IAA also agrees that “overstatement” of insurance liabilities in general purpose financial statements should not be used to impose implicit solvency or capital adequacy requirements. Consequently, we support an initiative to adopt these general purpose financial statements as the basis for regulatory oversight as well. However, while these general purpose statements should be designed to produce appropriate measures of income, expense, assets and liabilities, they cannot be construed to deal effectively, if at all, with solvency concerns and with measurement of capital adequacy. We believe that additional information is required to provide users of the statements with the information necessary to assess whether the enterprise is, in fact, a viable and attractive going concern.

The IAA does not believe that the need is filled by a separate statement that revalues liabilities using unrealistically conservative assumptions, for general purpose or for regulatory purposes. A former, highly respected, Superintendent of Insurance in Canada has asserted that one of the essential tools in regulation is to monitor earnings measured on a realistic basis. Too easily, poor earnings based on an overly conservative regulatory basis can be blamed on that conservatism itself, when fundamental problems would be revealed by a realistic measure of assets and liabilities.

The IAA encourages the IASC to continue to engage in active dialogue with corresponding insurance supervisors (the IAIS) to develop a mutually acceptable accounting paradigm. We are willing to provide assistance to such efforts.

At the same time, a fair value accounting environment where liabilities are established on the basis of expected value assumptions together with “market value margins” does not provide sufficient information to fully assess the solvency, adequacy of capital and financial condition of the insurer. All users, whether investors, customers or regulators, need such information. It is our view that such general purpose financial statements would be enhanced by the incorporation of disclosure regarding the company’s financial position with respect to an objective and rigorously developed risk-
based capital measurement system integrated with the general purpose accounts.

The IAA directs attention to our accompanying paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH” which discusses an approach for assessing capital requirements in a manner consistent with the application of the fair value of liabilities. In that approach, the liabilities are established on the basis of risk-adjusted cash flows, approximately reflecting the market’s perception of these risks. Subsequently, these cash flows are discounted using forward rates or the expected return of an asset portfolio whose expected cash flow characteristics closely mirror the liability cash flows that we have referred to as a “replicating portfolio.”

In summary, although the focus of this project should be on general purpose accounting, the IAA hopes that the basis of the results of this project can also be applied to enhance regulatory accounting. In turn, a more realistic assessment of the financial condition of insurers in conjunction with risk-based capital measurements will enhance information disclosed in general purpose financial statements.

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

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

The IAA agrees.

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

162. The Steering Committee believes that the deferral and matching view is not consistent with IASC’s Framework, as the Framework does not permit the recognition of items in the balance sheet that do not meet the Framework’s definition of assets and liabilities. The Steering Committee acknowledges that insurance has special features, but does not believe that these special features are sufficient to justify a departure from the Framework. Accordingly, the Steering Committee favours the asset-and-liability measurement view. By restricting the recognition of assets and liabilities to items that meet the definitions in the Framework, the Steering Committee considers that insurers will report financial information that better meets the needs of users. Also, the asset-and-liability view
enhances the ability of users to make comparisons, as the asset and liability view forms the basis for other standards issued by IASC.

The IAA agrees.

163. Although the Steering Committee does not favour the deferral and matching view, this view has formed the basis of accounting for insurance in many countries. Therefore, the Steering Committee has also examined certain accounting issues from a deferral and matching perspective, as a useful analytical double-check on the solutions that the asset-and-liability view offers.

(see IAA comments under paragraph 164)

164. Although the Steering Committee favours the asset-and-liability measurement view, this does not lead automatically to a preference for fair value as the measurement attribute for the assets and liabilities that arise under insurance contracts. The Steering Committee is working on the assumption that IAS 39 will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities (see discussion in Basic Issue 2). The Steering Committee believes that, if such a standard exists, assets and liabilities arising under insurance contracts should also be measured at fair value. However, if such a standard is not in place, it may be appropriate to select a different measurement attribute.

As stated elsewhere in these comments, the IAA agrees with the Steering Committee in its view that assets and liabilities should be measured using consistent measurement attributes. We encourage the Insurance Steering Committee to continue to follow developments of the work of the Joint Working Group and subsequent deliberations. Nevertheless, we note that many attributes are shared by all asset/liability measurement approaches, no matter how close to a pure fair value reporting system the result of these efforts may come. In any event, we favor the asset/liability measurement approach.

165. For this reason, Basic Issues 4 to 10 examine issues in the context of largely traditional approaches to measuring assets and liabilities. Basic Issue 11 extends that analysis to consider the further issues that arise when assets and liabilities connected with insurance activities are measured at fair value or at embedded value.
Basic Issue 5  To what extent should the Measurement of an Insurer’s Assets Affect the Measurement of its Liabilities?

180.  In the Steering Committee’s view:

(a)  the measurement basis adopted for an insurer’s liabilities should be consistent with the measurement basis adopted for its assets; and

The IAA agrees. It has been our long-standing position that insurance contract liabilities should be measured on a basis consistent with the corresponding assets. We continue to believe that this is a fundamental feature of any acceptable set of accounting standards for insurance liabilities. For example, if an insurer’s assets are valued on a fair value basis, its liabilities should also be measured on a fair value basis.

It is important to note that this issue should not automatically be assessed in terms of “whatever basis is chosen for assets should determine the basis of liability measurement”. Since the purpose of insurance is to provide benefits or reimbursement for losses, recognition and measurement issues should be addressed first considering the obligation with its associated liabilities, rather than the assets held in support thereof. Thus for insurance, a more appropriate perspective would be to require that assets be valued in a manner consistent with the basis selected to value the liabilities.

The IAA recognizes that all assets owned by an insurance enterprise may not be valued on a consistent basis, e.g., certain investment property may not be valued on a fair value basis for all insurers. However, for the purpose of most of our comments, we currently assume that by the time that an agreed upon set of standards for insurance liabilities are implemented, such assets will be valued on a fair value basis.

Note that the existence of a significant portion of an insurer’s assets on a basis inconsistent with that of its liabilities may result in potentially misleading results and trends. Thus, if insurance liabilities are valued on the basis of fair values, the IASC might consider whether to restrict the use of historical costs to value investment property for insurers with a significant portion of its assets so invested.

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

The IAA’s response to 180(b) is split in three parts: (1) reflection of actual assets in a fair value model, (2) reflection of actual assets in a non-fair value model, and (3) future investment margins.

**Reflection of actual assets in a fair value model**

The IAA considers it most appropriate if the fair value of insurance liabilities is measured on a basis not reflecting the actual assets or their expected return. We believe that measurement of liabilities of insurance contracts should reflect the return on an asset portfolio whose cash flows replicate the liability cash flows (matched asset portfolio or replicating portfolio; for further discussion see our separate paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”, with further details included in our paper entitled “VALUATION OF RISK ADJUSTED CASH FLOWS AND THE SETTING OF THE DISCOUNT RATE – THEORY AND PRACTICE”).

As stated in paragraph 180(b), there are certain types of contracts whose benefits are directly influenced by the return on specified assets. The measurement of the liability cash flows for these contracts needs to reflect any such relationship; in such cases, the liability cash flow measurement will reflect the applicable (replicating) asset portfolio consistent with the contract terms. These contracts can be categorized in the following manner, including the following types of contracts:

1. **Unit-linked contracts**, in which the liabilities are expressed in terms of specific assets, without asset performance guarantees.

2. **Index-linked contracts**, in which the liabilities are expressed in terms of an asset-related index.

3. **Contracts in which bonus / dividends / premium adjustments are explicitly a function of a set of segmented or designated assets and whose contract performance is determined through a pre-specified formula.**

4. **Contracts in which bonus / dividends / premium adjustments are derived based on a pre-determined Board policy, with specific credits / charges approved by the Board.**

5. **Participating / with profit contracts whose distribution is consistent with broad Board policy, reflecting judgmental adjustments reflecting**
company-wide or segment-wide experience (see our comments under Basic Issue 9).

The approach using a replicating portfolio also holds in such situations, since the replicating portfolio would then be similar to the actual asset portfolio.

The IAA notes that currently in some jurisdictions a provision for mismatch risk is included in the valuation of insurance liabilities. If actual assets were not reflected in the measurement of the liabilities, it would be inconsistent to recognize this mismatch risk in the measurement of the liabilities. In this case, it would be appropriate to evaluate two portions of these assets:

1. To the extent that the replicating portfolio matches the expected liability cash flows, it is necessary that, to the extent that the actual assets differ from the matched (replicating) asset portfolio, such an accounting regime should be supplemented by an appropriate risk-based capital system, developed in a manner consistent with the accounting regime used to measure the insurance liabilities. This risk-based capital system will not necessarily be the same as any such system currently in place, although some of the attributes may be shared, but whose liabilities considered would be based on the liabilities actually recorded.

2. To the extent the replicating portfolio does not fully match the cash flow characteristics of the liabilities (which may be small or non-existent, except in cases such as the case in which available assets are not available for significant durations in which liabilities are due), mismatch risk would be provided for in the liabilities.

The IAA’s accompanying paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH” also discusses the assessment of capital requirements in a manner consistent with the application of the fair value of liabilities.

The advantage of a fair value based system is that its implementation would minimize (compared to other systems) possible accounting arbitrage; nevertheless it is not the only acceptable accounting system.

Reflection of actual assets in a non-fair value model

The IAA considers it appropriate that in a non-fair value model, the value of the liabilities be measured reflecting the actual assets or their expected return. If for example, amortized costs are used to measure the value of fixed income securities, not to reflect the nature of those assets may generate a misleading value of the liabilities. We believe that in such a case, the relation between assets and liabilities given the methodology for valuing the
assets is such that not reflecting the actual assets or their return results in misestimating the value of the liabilities.

Future investment margins

In order to satisfy the objectives as set forth in the IASC Framework, the IAA believes that any accounting system should reflect a prospective measurement approach that reflects the expected cash flows from all future cash flows, together with an appropriate risk adjustment consistent with market realities. As noted in the views of the Steering Committee, there has been significant disagreement as to whether such an approach would reflect expected investment margins.

The IAA believes that they should be reflected, for a number of reasons, summarized as follows:

1. Any prospective approach should reflect all future expected cash flows, however generated.

2. For unit-linked (variable) contracts, asset management charges are made. These charges reflect explicit charges for the asset management function, similar to the implicit charge in non unit-linked products. A risk adjustment may still be appropriate in the case of fees expressed in terms of a percentage of the investment return, although most of the investment risk is typically passed to contract-owners.

3. Entry prices or values, although not the basis for fair values, reflect such margins. The market place clearly demonstrates this fact. In addition, and particularly relevant to a system based on exit prices or values, in any exchange the forgone margins would always be reflected in any purchase price. Willing purchasers of the business reflect such expected margins in any purchase price.

4. In practice, expected margins are sometimes expressed in terms that are not consistent with expected costs. For example, expected mortality margins may be expressed as a percentage of assets and visa versa. This illustrates that all future expected cash flows are significant and are sometimes difficult to separate. The important point is that all expected cash flows should be recognized, independent of their source and how they may be expressed.

5. The fact that insurers are not by contract given the right to earn such margins cannot be distinguished, from a financial perspective, from the fact that insurers are not by contract given the right to earn a mortality or morbidity margin. Both types of contract charges and credits should
be recognized in a consistent manner. All expected cash flows generated from an insurance contract should be consistently recognized.

In addition, the need to reflect such margins may be most obvious in the case of term insurance or provisions for outstanding claims in which no interest credits are provided. In these cases, not to reflect investment margins would result in values undiscounted with respect to interest, clearly not an acceptable practice.

In summary and especially applicable to many life insurance and annuity contracts, such expected margins are an integral part of the expected future performance of the contract, recognized by both exit and entry prices. To ignore such margins would appear to be inconsistent with the concept underlying fair values. For additional discussion, see the accompanying IAA paper entitled “FUTURE INVESTMENT MARGINS.”

If insurance liabilities are measured on the basis of fair values (Sub-issue 11G), the realities of the market should be reflected. In our experience, any exit value of insurance contracts would incorporate expected future investment margins, reflecting the expected value of current and future assets held associated with current obligations, including expected future investment margins to the extent indicated in the accompanying IAA paper just referred to.

This does not suggest that the entire expected margin should be reflected in the measurement of the value of liabilities, as uncertainty exists for non-unit-linked contracts as to whether the total expected margins will materialize. Thus, appropriate levels of market value margins or adjustments for risk and uncertainty should be included. In addition, appropriate level of expenses should also be recognized.

The IAA encourages the IASC to recognize and measure all expected sources of cash flow, including relevant margins, in the determination of the liabilities of both insurance and non-insurance financial instruments (e.g., annuities in which a non-material amount of risk is incorporated) in a consistent manner.
Basic Issue 6  What Assumptions and Conventions should be used in Measuring Insurance Liabilities?

Sub-issue 6A  Should the Unit of Account be Individual Contracts or Groups of Similar Contracts?

190. In the Steering Committee’s view, the established practice of accounting for groups of similar contracts is consistent with the diversification of risk inherent in an insurance activity. However, the Steering Committee observes that contracts that are not similar (for example, property damage and professional liability contracts) should not be combined into a single accounting unit. The Steering Committee believes that the unit of account should be a group of contracts that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions.

The IAA agrees that the basis for recognition and measurement of insurance liabilities should be groups of contracts and claims rather than the individual contract or claim. This group approach is particularly appropriate for insurance, as pooling is such an important concept underlying most insurance contracts. The resulting group unit of measurement permits the accounting principles applied in the recognition and measurement of insurance liabilities to be consistent with the nature of insurance, that is, to reflect the application of probabilities and, where appropriate, the law of large numbers.

The IAA notes that, although recognition should be made on the basis of groups of contracts, for computational purposes it is sometimes appropriate to calculate liabilities one contract at a time using pooling principles.

The size of the block should not have a significant effect on the measurement of an insurance liability, other than (1) in an historical cost / deferral and matching accounting environment or (2) when measuring the impact of transaction costs. In any event, it is not appropriate to reflect the greater likelihood of statistical fluctuation in a smaller block of business in the measurement of insurance liabilities. Rather, it is more appropriate to reflect applicable diversifiable risk through risk-based capital measures. Nevertheless, it would be appropriate to reflect the risk corresponding to the uncertainty associated with the estimation of the expected value of the future cash flows, which may be more affected by the characteristics of the group rather than its size.

The IAA disagrees with the classification used in paragraph 190 of a “group of contracts that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions”. In any prospectively based measurement approach, which we support, an appropriate basis is not necessarily the one that was originally used in
pricing. Rather, it should reflect the current assessment of the future cash flows associated with the current obligations. This assessment would typically be related to the risk characteristics of the insureds or outstanding claims (in the case of provisions for outstanding claims) and the nature of the obligations.

In a fair value based measurement system, the actual grouping methodology would not be significant, since in general the sum of the value of the groups’ liabilities is equal to the value of the groups’ liabilities in total. Additivity, a characteristic of fair values, represents a significant advantage of a fair valuation-based accounting system.

It is important to note that in the development of reliable estimates of expected future cash flows of items such as outstanding claims, the groupings used will depend on the specific situation and characteristics of the exposures and expected claims, not necessarily consistent with the groupings used for initial pricing purposes.

If an historical cost or deferral and matching basis is applied, the methodology used to categorize the groupings used may be important. In this case, in order to promote comparability, additional guidance may be needed. An example is FASB’s Statement No. 60, paragraph 32, in which the identification of the block of long-duration business is required for the testing of whether a deficiency (impairment) exists, e.g., combining certain property and liability insurance coverages or combining multiple years of issue.

191. The Steering Committee favours a closed book approach, as an open book approach would be inconsistent with the Framework. The closed book comprises existing contracts, including only those renewals where existing contracts commit the insurer to a specified pricing structure for the renewals. The closed book excludes both new contracts and other renewals of existing contracts.

(see IAA comments under paragraph 192)

192. The Steering Committee believes that future cash flows that may arise from possible renewals of an insurance contract do not arise directly from the contract. Under IAS 38, Intangible Assets, it is highly unlikely that they would be considered to give rise to a recognisable asset for the insurer that issues the contracts.

The IAA believes that the three elements mentioned in paragraphs 191 and 192 appropriately frame the issue of the determination of the proper period over which the liability of an insurance contract (this does not apply to the liability for insurance claims) should be recognized:
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1. The contractually defined coverage period for the current contract,

2. Subsequent contracts of essentially the same type that will replace the current contract, and

3. Subsequent sales of related or non-related products to the same contract-owner.

In addition, included as part of the bundle of options included in many insurance contracts during the current contract term are (1) a one-time or continuous series of options available to the contract-owner through non-continuance of paying premiums or other voluntary forms of termination, and (2) a one-time or continuous series of options available to the insurer to terminate the contract or continue it only on the basis of revised terms that could include different premiums, interest rates, charges or credits.

Thus, the concept of the closed book approach referred to in the Issues Paper does not adequately capture the range and complexity of the options included within many insurance contracts. Both actuaries and the market typically reflect the expected utilization of these options in the measurement of the liability for insurance obligations associated with currently inforce contracts. The Issues Paper does not adequately address the effects of the options to terminate the contract before the end of the contract period, while at the same time ignoring the anticipated option to continue the contract at essentially the same terms at the end of the current contract period that often have similar probabilities of continuance. It appears to assume the special case in which during their remaining contractually guaranteed period, termination can only be initiated by the contract-owner (and not the insurer) and where rules are specified under which future premiums will be deferred (and are silent as to other contract features).

It may be appropriate to recognize contract renewals if business practice is to do so and contract continuation can be estimated, because:

1. There is no substantive difference between contract termination during a contract period and its expiry. Similarly, there is no substantive difference between renewal of a contract and the utilization of the option to continue a contract during its period.

2. The market recognizes the value of expected renewals in an exchange between willing parties. The continuance in substantively the same form can easily be distinguished from add-on sales.

3. Imposition of a rule not to recognize contract renewals that has substantive differences in accounting treatment will result in changes in contract forms to take advantage of such differences.
4. In a regulated industry in which significant contract-owner expectations exist, probabilities of non-renewal resulting from actions by an insurer may not be materially different than those of termination resulting from the application of contract termination provision at a similar period measured from original contract issue.

5. Many insurance contracts are designed, sold, and managed taking into account the probabilities of renewal. Not to reflect such probabilities does not reflect market realities.

Refer to a more detailed discussion of this issue in the accompanying IAA paper entitled “INSURANCE CONTRACT RENEWALS”. The IAA is in favor of a closed-book approach, but with the closed book defined as including the effect of expected continuance of existing contracts, excluding the effect of contracts that are not a continuation of existing contracts.

Note that if the concept of the “same premium structure” is used in an accounting standard as indicated in paragraph 191, guidance as to what this means would prove beneficial in promoting consistency in application across companies.

193. If insurance contracts are acquired in a business combination, one question that arises is whether the future cash flows should be represented as a separate asset or included in goodwill. The Steering Committee has not discussed this question. A similar issue arises when an insurer acquires a block of insurance contracts in a separate acquisition (not a business combination). Basic Issue 15 deals with such acquisitions.

The IAA believes that a fresh-start approach should be followed in the case of insurance contracts (through a business combination or block transfer) which are acquired by purchase. It would be the exceptional case in which the expected financial effect of renewals of outstanding contracts (1) would not be reflected in the transaction price (entry value) and (2) would not be expected to be reflected in any subsequent transaction (exit price).

As a result, such cash flows should be recognized in the valuation of the liabilities whether or not fair value accounting is adopted. As explained above, any value associated with future sales resulting from existing or new distribution systems or the value associate with developed brands should be included in any goodwill.
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Sub-issue 6B  Should there be an Implicit or an Explicit Approach to Assumptions?

199.  The Steering Committee considers an explicit approach to be superior to an implicit approach. An explicit approach is consistent with recently-issued IASC standards on provisions (IAS 37) and pensions (IAS 19), provides greater transparency, and produces estimates that are more understandable. An explicit approach does not preclude, and in fact requires, consideration of interactions between different assumptions. An explicit approach does not preclude the use of stochastic modelling and similar techniques.

The IAA favors a valuation approach that utilizes assumptions that are explicitly determined, as long as they are material to the measurement of the liability. We expect that guidance supporting the application of the explicit approach and describing considerations that would be used to develop explicit assumptions would be addressed in actuarial standards developed for the purpose of applying an IAS covering accounting for insurance contracts. It may be inappropriate to incorporate details regarding such a requirement in an accounting standard.

The IAA endorses the use of stochastic modelling and similar techniques, not only to determine the effect of expected interactions among different assumptions, but also to estimate expected values and to incorporate market value margins, as described in the accompanying IAA paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH” and elsewhere in our comments.

At the same time, we recognize the practical problems associated with the universal application of these methods. As a result, at this time, we would not recommend a requirement to use such methods. We encourage the actuarial profession to continue to enhance available methods and techniques that can be used for these purposes.

It should be noted that in certain cases, if transaction prices are used as a basis for fair values, it might be difficult to determine the explicit underlying expected experience assumptions used. However, it is most appropriate if independently determined realistic assumptions should be used for each material assumption, whether available through observation of market transaction prices or not.

Sub-issue 6C  Should Assumptions Reflect Current Information at the Date of the Financial Statements or Long-term Expectations?

205.  The Steering Committee favours an approach to measurement that focuses on current information and assumptions. If deferral mechanisms like the corridor
approach in IAS 19, Employee Benefits, are considered appropriate, financial statements will be more understandable and transparent if any deferrals are computed and presented separately from underlying measurements.

The IAA considers it appropriate to reflect current expected values of future cash flows over the duration of the obligation. These expectations would normally be based on the most recently available documented information, to the extent relevant and credible, and the best judgement of an expert if sufficient relevant historical information is not available (for example, in the case of a start-up operation).

The IAA believes that any deferral of recognition of changes in experience assumptions, whether through a corridor or any other approach, would be inappropriate. Efforts to smooth earnings as a result of the use of average long-term historical experience would not be appropriate. Such approaches tend to hide the financial impact of underlying changes in experience, which in turn hinder transparency and reduce comparability of financial statements.

Sub-issue 6D Should Measurement Reflect the Market’s Expectations or the Insurer’s Expectations?

210. In the Steering Committee’s view, a measurement based on market expectations is appropriate under the asset-and-liability measurement view.

The IAA believes the description of the use of “market expectations” as expressed in paragraph 210 is incomplete and is subject to potential inconsistent reading. Thus, it needs to be clarified. Market expectations should not necessarily mean that expected average industry experience be applied (even if available, which would be rare). Characteristics of the inforce insurance (or claim) portfolio dictate that a significant portion of future experience will be entity-specific in nature. For instance, a significant portion of future experience will follow directly from the marketing, underwriting and the risk characteristics of the insureds in a given insurance pool.

The way this sub-issue is expressed seems to presume a fair value accounting regime. Whether it is or not, as mentioned in the prior paragraph, it is appropriate that expected fair value-in-use experience would be appropriate to be recognized, since this experience is likely to be most representative of current expected experience under the contracts. The market itself would likely recognize that fact. As mentioned, it should be emphasized that the value of a block of business in the market takes into account many company-specific aspects of the business.
Under a fair value regime, the IAA has considerable concern with the exclusive use of average industry experience in the determination of the measurement of assumptions, not only as a result of the practicality of determining what those market expectations of the “explicit assumptions” (as described in paragraph 193) are, but also how such a concept would be applied. It is usually quite difficult to assess what market expectations are with regards to insurance contract performance, even if the market was more active than it is. In fact, the assumptions used in the valuation of these liabilities should not use market averages except where no better information is available.

The market for used cars does not apply an overall average price regardless of whether a rusty Chevrolet or an immaculate Mercedes is involved. Similarly, average industry mortality rates should not be imposed, except where they are the most relevant and reliable information available. In such cases, for example, for expected future mortality or claim cost trends, company-based history may not be sufficient or appropriate. In such cases, it would be more appropriate to incorporate an expected industry or nationwide trend. In most such cases, market expectations and individual insurer expectations with respect to mortality trends would be identical. Please see the attached IAA paper entitled “MARKET EXPECTATIONS REGARDING EXPERIENCE ASSUMPTIONS” for further discussion of this sub-issue.

211. *The Steering Committee recognises that market expectations may not always be observable directly. In such cases, an insurer would need to make its own estimates – but the important point is that the estimates should be an attempt to consider the factors that are considered by the market, not factors that are specific to the insurer itself and that would not be considered by the market.*

The IAA believes that the factors that the market would consider and the factors (i.e., insurance exposures assumed, expected types of experience assumptions, and risk characteristics) that an insurer would consider will be identical. Of course, due to the imbalance of available information, the insurer would in most cases have significantly more easily available information of a detailed nature from which expected cash flows could be estimated than would “the market.” We have not identified any company-specific factors that would be inappropriate to be considered.

Sub-issue 6E Should Assumptions Reflect All Future Events that will affect the Amount and Timing of Cash Flows?

222. *The Steering Committee favours an all-future-events approach to measurement assumptions, to the extent practicable, consistent with the requirements of IAS 37. While estimates are often difficult and subjective, financial statement users are*
best served by liability measurements that reflect the entire estimated cost of claims rather than measurements that exclude some costs.

The IAA agrees that the entire estimated cost of claims/benefits and the value of corresponding options to continue access to such claims/benefits should be reflected. In particular, the expected financial effects of policyholder behavior as a result of the application of options included in the contract should be incorporated, including probabilities of policyholder lapsation.

A special case, noted in paragraphs 217 and 218 with respect to possible future legislation or tax change may be appropriate. The IAA does not believe that such changes in the future environment should be reflected, except to the extent that such changes are imminent. We recognize that this approach may seem to be inconsistent with market assessments, as markets surely reflect projected probabilities of future legislation or tax changes. It may be difficult, however, to explicitly assess the probability of such changes and in turn the financial effect of such changes.

Nevertheless, in certain countries, if a majority government is in place, it would be appropriate to reflect proposed changes in taxation if included in a tabled bill. In other countries, such introduction would not be tantamount to adoption. We recommend that such decisions be left to national accounting/actuarial organizations to determine appropriate practice in their countries, determined in part based on the national political process involved.

This brief discussion assumes that market values may anticipate the expected effect of probabilities of future changes in tax or other laws, although with a high degree of adjustment for risk and uncertainty. Appropriate incorporation of such expected changes in a prospective discounted cash flow model may be difficult in many circumstances. Further discussion is needed to determine how to reflect such changes in a fair value accounting environment. Disclosure may be called for.

In certain relatively rare situations additional supplementary information should be disclosed. For example, if no reliable estimate of a potentially material event is available as a result of an extremely high degree of uncertainty, (e.g., a single litigation case in which either no loss or one with a very large loss could result), disclosure would be appropriate.

The Steering Committee emphasises that the all-future-events approach does not justify premature accounting for events that, at the measurement date, are not reasonably foreseeable consequences of exposures under existing insurance contracts. For example, there may be a 20% probability at the balance sheet date that a major storm will strike during the remaining six months of an insurance contract. After the balance sheet date and before the financial statements are
authorized for issue, a storm may actually strike. The measurement of the liability under that contract should not reflect the storm that, with hindsight, is known to have occurred. Instead, the measurement will reflect the 20% probability that was apparent at the balance sheet date (with an appropriate adjustment for risk and uncertainty, as discussed below).

The IAA also believes it inappropriate to account for events on a premature basis, particularly with respect to unexpired obligations. Nevertheless, we believe that it is reasonable to use estimates made on an expected value basis reflecting current information, together with an appropriate adjustment for risk and uncertainty.

The IAA agrees with the conclusions reached in the 20% example given. Subsequent event rules applicable to the general accounting situation would be appropriate to apply to the recognition and measurement of insurance liabilities as well.

224. The treatment described in the preceding paragraph is consistent with IAS 10, Events After the Balance Sheet Date, which would treat the storm as a non-adjusting event after the balance sheet date. If a non-adjusting event after the balance sheet date is of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions, IAS 10 requires an enterprise to disclose the nature of the event and an estimate of its financial effect (or a statement that such an estimate cannot be made).

The IAA agrees.

Sub-Issue 6F Should the Measurement of Assets and Liabilities arising from Insurance Contracts Reflect Risk and Uncertainty?

243. In the Steering Committee’s view, the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm’s length transaction between knowledgeable, willing parties.

The IAA agrees that the measurement of insurance liabilities should reflect such risk, whether a fair value or a more traditional asset / liability approach is applied. One viable methodology that achieves this objective is presented in an accompanying IAA paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”.

244. The Steering Committee notes that determining the necessary adjustment for risk will inevitably be subjective. To improve comparability, the Steering Committee intends to develop guidance on this topic.
The IAA agrees that guidance should be available through actuarial standards and if felt necessary through accounting standards as well. The IAA intends to address this topic in conjunction with the implementation of an IAS on insurance contract liabilities. We are committed to develop such standards.

245. In the Steering Committee’s view, there will be a need for some disclosure about the extent of risk adjustments. One possibility might be to require disclosure (either in the notes or on the face of the balance sheet and income statement) of the difference between the actual (risk-adjusted) amounts recognised and the expected values of the related cash flows.

The IAA believes that increased transparency in the reporting of the financial results of insurance enterprises is needed. Disclosures relative to the degree of risk adjustment should be provided in a consistent manner for both assets and liabilities. Further research and discussion are needed before determining the most appropriate method of disclosing the degree of risk adjustment included in financial statements, both to promote a comparable level of such adjustment and to provide the users of such information valuable yet not misleading information. The form of disclosure may be dictated or influenced by the type of risk adjustment made in the agreed-upon standard.

The IAA believes that including such information on the face of the balance sheet and income statement might lead to confusion regarding what is the most appropriate measurement of financial values. Any disclosure should be accompanied by a description of the major assumptions applied in the determination of the actual adjustments for risk.

Additional disclosure is needed to trace the sources of gains and losses in order to increase the transparency of insurers’ financial statements, for example, through the use of embedded value methodologies. Further comments on this issue are included in Basic Issue 18.

246. In addressing risk adjustments for small portfolios, it is worth considering the needs of both investors and policyholders. In the Steering Committee’s view, the additional diversifiable risk inherent in a small portfolio is irrelevant for investors who are able to diversify their investments. Although many policyholders may be unable to diversify risks of this kind, the most transparent way to protect their interests is through appropriate solvency or risk-based capital requirements, rather than through adjustments to reported liabilities. Therefore, the risk adjustment for a small portfolio should be the same as for a large portfolio (except for any indirect effect arising where the small size of a portfolio makes statistical evidence less credible).
The IAA agrees that such small portfolio risks should not be incorporated in the measurement of insurance liabilities. These risks are more properly reflected in risk-based capital measures that relate to company-specific risks, as disclosed through supplementary information to the financial statements. We note that, if such risks are material to the insurer, the financial effects of risk management techniques used, such as through reinsurance or retrocession, would be reflected.

Sub-issue 6G When and How Should an Insurer Account for Changes in Assumptions about Future Cash Flows and Actual Experience that Differs from Assumptions

272. The Steering Committee favours a fresh-start approach to changes in accounting estimates and current recognition of the effect of differences between actual experience and earlier assumptions. In the Steering Committee’s view, a consistent approach to changes in estimates is preferable to a collection of rules that use different approaches for different types of changes. Sub-issue 19D discusses how an enterprise should present and disclose the effects of changes in estimates and differences between actual experience and earlier assumptions. The Steering Committee does not favour a corridor approach to recognising changes in estimate.

The IAA agrees. We believe that a fresh-start approach is appropriate, reflecting the results of regular reviews of the material assumptions used in the development of estimates of the value of insurance liabilities. Such an approach is consistent with a prospective valuation of current obligations, which we favor. Whether an accounting system is adopted applying fair values to insurance liabilities or not, it would be inappropriate and misleading to attempt to smooth earnings through the use of a corridor approach to recognize changes in estimates. Nonetheless, this does not imply that changes have to be made if the results are not material to the financial statements of the enterprise.
Introductory IAA Comments on Basic Issues 7 and 8

As discussed in the IAA’s response to Sub-issue 1K, we question the need for the distinction that has been made between general insurance and life insurance in Basic Issues 7 and 8. First, given the way “general insurance” is defined, the labels would be presented better as “short term insurance” and “long term insurance.”

More importantly, the IAA doubts that these two simple categories, however labeled, are adequate to describe the universe of insurance contracts. General (short-term) insurance contracts are defined as those where the insurer can cancel the contract or adjust the terms (e.g., premium) at the end of any contract period. However, the real world is not so simple. The insurer may have that right, but it may be subject to contractual or regulatory limitations – e.g., all similar contracts in a jurisdiction must be cancelled, rate changes are subject to regulatory review, or any cancellation or rating actions must be non-discriminatory. Even where there are no explicit written contractual or regulatory obligations, market practice may result in a constructive obligation to renew the policy, and in some cases, may place limits on premium rate changes.

Further, there are many classes of insurance that are clearly general (non-life) insurance under which the coverage and premium rate are guaranteed for many years. Some of these involve cash value benefits.

Life (long-term) insurance is defined as insurance where the insurer has little or no ability to adjust the premiums during the term of the contract. That would exclude many types of life insurance in the U.S. – including term insurance, universal life, variable life, and indeterminate premium whole life – where the guaranteed premium level or charges are at statutory reserve assumption levels. For all practical purposes, those guarantees are often not material. The insurer does retain the right to change the premium, but often subject to regulatory review. In addition, in some cases there exists an implicit or explicit assurance, as evidenced by policyholder expectations or by regulatory requirements, that such changes will be made only to reflect changes in the future expected experience.

Rather than try to divide insurance contracts into two distinct classes which do not really exist, the IAA suggests that it would be preferable to use a consistent approach for all insurance contacts. We note that most of the conclusions reached in Basic Issue 7 are carried over to Basic Issue 8 as well, and this is consistent with our view. We would recommend, further, that all insurance contracts be valued based on the expected future experience.
including adjustments for risks and uncertainties of the grouping of contracts. That would reflect some lapses at the next anniversary, but also consideration of periods beyond that. For some types of business, almost all contracts may be assumed to end at the next anniversary (e.g., broker–controlled property and casualty). But that should not be an automatic assumption.

Sub-issue 7A Should Alternatives to the Annual Basis of Accounting be Prohibited, Permitted or Required?

288. The Steering Committee does not consider either the open-year model or zero-balance model to be appropriate for most insurance activities. Financial statement users are better served by periodic reporting of revenue and expenses when the events occur that give rise to those items. However, occasions may arise in which estimates cannot be made with sufficient reliability and periodic reporting is not possible. In those situations, the Steering Committee favours the zero-balance model, which it considers consistent with IAS 18.

The IAA agrees with this position.

Sub-issue 7B Should an Insurer Recognise a Liability for Claims Payable?

296. In the Steering Committee’s view, an insurer should recognise claims payable as a liability. An insurer’s liability for claims payable includes claims that have been reported, claims incurred but not reported, and claim handling expenses. Those amounts meet the definition of a liability as outlined in IAS 37. The Steering Committee believes that the insurer has a present obligation to incur claim handling expenses relating to existing contracts because the insurer will be compelled to pay these expenses if the policyholder presents a valid claim. (And, if the insurer settles the liability by a transferring the liability to another party, the insurer will pay claim handling costs implicitly through the pricing of the transfer.) Claim handling expenses should be recognised based on the manner in which the insurer expects to settle the related claim liabilities.

The IAA agrees with this position. The liabilities should separately reflect (i) claims payable and (ii) claims handling expenses. Claim handling expense liabilities should reflect expenses paid to third parties for claim settlement related services and the company’s internal claim administration expenses.

Sub-issue 7C Should an Insurer Recognise a Liability for Unexpired Risk?

316. The Steering Committee considers an asset-and-liability-measurement approach more consistent than a deferral-and-matching approach with the IASC Framework and with recent International Accounting Standards, including the recently-issued IAS 37, Provisions, Contingent Liabilities and Contingent Assets. Therefore, an insurer should recognise a provision for unexpired risk, rather than
provisions for unearned premium and premium deficiency. The provision for unexpired risk reflects the amount of estimated future claim payments arising from future insured events that are covered by existing insurance contracts. The provision for unexpired risk will also include an estimate of refunds that the insurer will need to pay to policyholders who cancel existing contracts during the term of the contracts. Sub-issue 7I discusses whether that provision should be determined on a present value basis.

The IAA agrees with this view, in combination with the conclusion in Sub-issue 7D that there should be no Deferred Acquisition Cost asset.

In Sub-issue 8D, the Steering Committee recommends that a minimum value be placed on the liability, equal to the amount the policyholders could receive in cash by surrendering the policy. As noted there and in a separate paper on this issue entitled “MINIMUM LIABILITY FLOOR”, the IAA strongly opposes that view. Similarly, we also oppose such an approach if applied to short-term/general insurance contracts. Using the surrender value (pro-rata or short-rate premium refund) as the minimum for the liability, combined with eliminating Deferred Acquisition Cost assets, would be a step backwards, rather than an improvement in financial reporting.

317. In the Steering Committee’s view, there is no logical reason to prohibit the recognition of a gain when an insurance contract is sold. However, the Steering Committee recognises that some commentators may have reservations about this change from existing practice. The Steering Committee concluded tentatively in Sub-issue 6F that the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm’s length transaction between knowledgeable, willing parties. The implications of this decision are that:

(a) the initial measurement of the liability at inception may be less than the premium charged to the policyholder; and

(b) the required margin to reflect risk will be recognised as income as the insurer is released from risks assumed at inception.

Consistent with response on the desirability of applying the “deferral and matching” or “asset and liability” approaches, the IAA supports this view.

In our internal discussions of this issue, there was a minority view in favor of keeping the deferral and matching approach, held by some actuaries practising in this field. That did not so much represent an objection to the proposal in principle, but rather a feeling that the current deferral and matching approach is well understood and works well so, “Why fix it?”

It may be noted that the proposed approach is currently used in at least one jurisdiction and in others such estimates of the liability relating to unexpired
risks are already calculated using actuarial approaches, in testing for loss recognition and sometimes resulting in an additional provision for unexpired risks.

Sub-issue 7D Should Acquisition Costs be Deferred and Recognised as an Asset?

328. The Steering Committee concludes that acquisition costs should be recognised as an expense, on the basis that they do not meet the Framework’s definition of an asset. Also, the measurement of insurance liabilities already reflects the future cash flows to be generated by the insurance contract, so the recognition of an asset would lead to double counting.

The IAA agrees with this conclusion, given the previous conclusion to use a provision for unexpired risks rather than an unearned premium reserve. The combined effect of these two changes, along with the use of a margin to reflect risk in the calculation of unexpired risk provisions, may generate little change in the net bottom line result in practice.

However, as noted on our comments on Sub-issue 7C, paragraph 316, this entire change in approach would not work if the policy surrender value were also adopted as a minimum for the liability. To do that while eliminating the Deferred Acquisition Cost asset would not be supported.

Sub-issue 7E If Acquisition Costs are Deferred and Recognised as an Asset, How Should they be Measured?

334. Given the Steering Committee’s view that acquisition costs should be recognised as an expense, there is no need to specify how deferred acquisition costs should be measured.

The IAA agrees.

Sub-issue 7F How Should an Insurer Account for Recoveries Related to Claims?

337. The receipt of salvage property from the policyholder and the subrogation of a policyholder’s rights to the insurer occur at the same time as the settlement of the claim with the policyholder. Accordingly, the Steering Committee believes that an insurer should recognise its potential recoveries as a reduction in its net liability to the policyholder.

(see IAA comments under paragraph 340)
338. In the Steering Committee’s view this is not inconsistent with IAS 37 because IAS 37 contemplates cases where an enterprise pays the creditor and then obtains a recovery by selling an asset or by claiming reimbursement from another party. However, salvage and subrogation differ because the insurer pays the claim and, at the same time, receives salvage or subrogation rights from the policyholder (rather than from another party). In other words, the insurer’s obligation is to make a net settlement, comprising a cash payment less the fair value of the simultaneous receipt of salvage or subrogation rights. Market participants would take both the cash payment and the salvage or subrogation rights into account when they price the insurer’s (net) obligation.

(see IAA comments under paragraph 340)

339. In the Steering Committee’s view, an insurer should measure estimated recoveries in a manner consistent with underlying claim liabilities.

(see IAA comments under paragraph 340)

340. Once an insurer acquires salvage property or subrogation rights, the insurer has an asset to which the normal asset recognition and measurement criteria should be applied.

The IAA agrees with the views as given in paragraphs 337 to 339. They are consistent with current actuarial practice in many countries. As a result, there are well tested and accepted actuarial techniques to implement this proposal.

With respect to paragraph 340, the IAA notes that after a claim is filed, the claims handling process and the salvage and subrogation process move along on linked but separate courses. Reassessing the salvage or subrogation asset every time a claim payment is made may be very difficult. Hence, for presentation purposes, we believe that it may be appropriate for salvage and subrogation to be treated as an offset to the claim liabilities until physical possession of the asset has occurred.

Sub-issue 7G How Should an Insurer Account for Retrospectively-Rated Contracts?

347. The Steering Committee favours an asset-liability approach to accounting for retrospectively-rated contracts. The Steering Committee considers this view to be consistent with the terms of these contracts.

(see IAA comments under paragraph 349)
348. In some cases, such retrospective rating may eliminate insurance risk for the reinsurer or may create a non-insurance element that may need to be accounted for separately. Sub-issues IC and IE deal with such questions.

(see IAA comments under paragraph 349)

349. The Steering Committee notes that retrospectively-rated contracts present certain similarities to participating contracts, which are discussed in Basic Issue 9.

The IAA agrees with this position, and offers the following comments that may help clarify the approach.

First, this approach should not just cover payments due to the insured, but should also cover similar payments due to others where the amount of the payment is dependent on the loss experience under the contract. The provisions for such payments should be calculated in a manner that is consistent with the calculation of the provisions for losses and for unexpired risk.

Second, paragraph 342 discusses contracts where the renewal of the contract, or the premium at renewal, is affected by experience during the contract term. In some cases, that may be a form of retrospective premium adjustment. However, in many cases (e.g., prospective experience rating of commercial risks, accident surcharges for personal auto), the level of the premium at renewal really reflects a reconsideration of the future expected losses during the new coverage period, not a refund based on past earnings. A well-established element of actuarial pricing practice is to use past loss experience, sometimes at the level of an individual risk, to improve estimates of expected future loss experience. In those cases, a provision for retrospective premium adjustments should not be held except to the extent applicable for future renewal periods.

Finally, it has been noted that some retrospectively rated contracts present issues similar to participating contracts covered in Basic Issue 9. It should be added that there are some “participating” contracts where the policyholder dividend is, in substance, a retrospective premium adjustment, based largely or entirely on pricing agreements with the policyholder, rather than a participation in the insurer’s earnings determined as a discretionary distribution by the insurer. Those contracts should be accounted for using the approach described above.

Sub-issue 7H Should Provisions for Catastrophes or Equalisation be Required, Permitted or Prohibited

357. In the view of a majority of the Steering Committee, catastrophe and equalisation provisions do not meet the definition of a liability articulated in IAS 37 and the
Framework. However, a minority concludes that they do meet the definition. The Steering Committee would welcome comments on these issues, including whether catastrophe and/or equalisation provisions should be recognised as a liability and how best to convey information about low-frequency, high-severity risks and about random fluctuations of claims.

As the Issues Paper indicates, this has been a controversial issue within the IASC Insurance Steering Committee. It has been similarly controversial within the actuarial community, with some strongly in favor of such provisions, and others strongly opposed.

The difference between catastrophe provisions and equalization reserves has not always been clear. The distinction is that catastrophe provisions are amounts set up for particular lines of business or for specific types of events, while equalization reserves are usually associated with the whole company and are not restricted to specific events (as mentioned in paragraph 352 in the Issues paper). The IAA believes it is necessary to differentiate between the two types of provisions, since catastrophe provisions have the objective to match income and costs over time, rather than to smooth out the profit and loss account.

The IAA agrees with the IASC Insurance Steering Committee’s tentative view that equalization provisions for general purpose accounting purposes should not be recognized as a liability.

However, the issue of whether, in an IAS, an insurer should be required, permitted, or prohibited to recognize catastrophe provisions is in our opinion of a different nature and hence an important one in the context of the recognition and measurement of an insurer’s liabilities. The IAA has presented a balanced discussion of the issues, with particular emphasis on areas where actuarial science may offer some additional insight to the IASC Committee. That information is included in our separate paper entitled “COMMENTS ON CATASTROPHE PROVISIONS.”

Sub-issue 71 Should General Insurance Liabilities be Measured using Present Value (Discounting) Techniques?

368. The Steering Committee concludes that the use of present value in measuring general insurance claim liabilities is consistent with the Framework’s emphasis on information that is relevant and decision-useful. A claim payable within one month imposes a higher economic burden than a claim of similar amount that will be paid two years in the future. The use of present value allows financial statements to provide information that distinguishes those two claims from one another. The Steering Committee also observes that IAS 37 mandates the use of present value in measurement of similar liabilities (provisions). The Steering
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Committee finds no basis for exempting general insurance claim liabilities from similar measurement.

The IAA supports the use of present value techniques in measuring general insurance claim liabilities. Present values are an integral part of the actuarial approach to measurement. For example, the Canadian Institute of Actuaries has specifically and unanimously stated that the recognition of the time value of money is an integral part of accepted actuarial practice. We believe that discounting the liabilities arising from general insurance contracts would enhance the fair presentation of their financial statements.

The general practice of not discounting general insurance loss provisions has often been suggested to be an implicit compensation for inflationary pressures and other development risks of claims. Using a discounting approach would imply the inclusion of the expected value of all ultimate costs as the starting point for determining claim liabilities. This would include recognition of all future cost drivers, such as inflation and other expected adverse development of claims. It would also include all internal and external costs of settling claims (claim expenses). Estimated recoveries (reinsurance, salvage, and subrogation) should be recognized at the same time and on a consistent basis.

In setting general insurance claims provisions, all material (future) developments affecting the ultimate amount of these claims should be reflected explicitly in the calculations. Whether or not to disclose these material developments separately in the accounts is a question of giving more or less explicit insight to the readers of financial statements. When discounting and inflation are included in the amounts in the balance sheet, the IAA believes that an appropriate disclosure as to the main factors should be included.

Sub-issue 7J  If Present Value Techniques are Used, What Discount Rate is Appropriate

369. The Steering Committee concluded in sub-issue 6F that the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties. To the extent that estimated cash flows reflect this risk, the discount rate should be a risk-free rate. To the extent that estimated cash flows do not reflect this risk, the discount rate should be a risk-adjusted rate. In developing further guidance on this topic, the Steering Committee will monitor the present value projects of IASC and national standard setters.

The IAA agrees that insurance liabilities should be measured using present value (discounting) techniques (Sub-issue 7I) and that risk margins should be
incorporated in the projected insurance cash flows (Sub-issue 6F). Further
guidance on how to establish risk margins should be developed. Also, the
present value deliberations of the IASC and national standard setters may
provide insights here.

The IAA refers also to our papers “INSURANCE LIABILITIES -
VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW
OF A POSSIBLE APPROACH” and “VALUATION OF RISK ADJUSTED
CASH FLOWS AND THE SETTING OF DISCOUNT RATES – THEORY
AND PRACTICE,” which discuss state-of-the-art techniques used in
insurance and other financial services industries. A major point
demonstrated there is that the insurance industry and the actuarial
profession have a clear understanding of the theory and techniques for
discounting in the capital markets and in other financial services industries,
and is well prepared to adopt those theories and techniques to value
insurance liabilities in a consistent and comparable manner.
Basic Issue 8  What Assumptions and Conventions Should be Used in Accounting for Life Insurance Contracts

Introductory IAA Comments on Basic Issues 7 and 8

As discussed in our response to Sub-issue 1K, the IAA questions the distinction that has been made between general insurance and life insurance in Basic Issues 7 and 8. First, given the way “general insurance” is defined, the labels would be presented better as “short term insurance” and “long term insurance.”

More importantly, the IAA doubts that these two simple categories, however labeled, are adequate to describe the universe of insurance contracts. General (short-term) insurance contracts are defined as those where the insurer can cancel the contract or adjust the terms (e.g., premium) at the end of any contract period. However, the real world is not so simple. The insurer may have that right, but it may be subject to contractual or regulatory limitations – e.g., all similar contracts in a jurisdiction must be cancelled, rate changes are subject to regulatory review, or any cancellation or rating actions must be non-discriminatory. Even where there are no explicit written contractual or regulatory obligations, market practice may result in a constructive obligation to renew the policy, and in some cases, may place limits on premium rate changes.

Further, there are many classes of insurance that are clearly general (non-life) insurance under which the coverage and premium rate are guaranteed for many years. Some of these involve cash value benefits.

Life (long-term) insurance is defined as insurance where the insurer has little or no ability to adjust the premiums during the term of the contract. That would exclude many types of life insurance in the U.S. – including term insurance, universal life, variable life, and indeterminate premiums whole life – where the guaranteed premium level or charges are at statutory reserve assumption levels. Those guarantees are often for all practical purposes not material. The insurer does retain the right to change the premium, but often subject to regulatory review. In addition, there exists an implicit or explicit assurance as evidenced by policyholder expectations or by regulatory requirement that such changes will be made only to reflect changes in the future expected experience.

Rather than try to divide insurance contracts into two distinct classes which do not really exist, the IAA suggests that it would be preferable to use a consistent approach for all insurance contacts. We note that most of the conclusions reached in Basic Issue 7 are carried over to Basic Issue 8 as well, and this is consistent with our view. We would recommend, further, that all insurance contracts be valued based on the expected future experience.
including adjustments for risks and uncertainties of the grouping of contracts. That would reflect some lapses at the next anniversary, but also consideration of periods beyond that. For some types of business, almost all contracts may be assumed to end at the next anniversary (e.g., broker – controlled property and casualty). But that should not be an automatic assumption.

Sub-issue 8A Are the Conclusions Reached in Previous Issues Applicable to Life Insurance?

379. In the Steering Committee’s view, the conclusions presented in Table 7 should also apply to life insurance contracts.

With the exception of the necessity and value of unbundling an insurance contract, the IAA agrees with the Steering Committee’s views. Our views on the appropriateness of unbundling are discussed fully in our response to Sub-issue 1E.

Sub-issue 8B What Assets and Liabilities are Created by Life Insurance Contracts?

387. In the Steering Committee’s view, payments that an insurer is required to make on termination of the contract by the policyholder meet the definition of a liability.

(see IAA comments under paragraph 404)

389. In the Steering Committee’s view, payments (including related claim handling costs) that the insurer is required to make as a consequence of insured events that have occurred (policyholder deaths) clearly meet the definition of a liability, even though the claims may not have been reported to the insurer.

(see IAA comments under paragraph 404)

393. In the Steering Committee’s view, an insurer’s obligation for claims (including related claim handling costs) arising from insured events that may occur during the period covered by the current premium meets the definition of a liability and should be recognised as such.

(see IAA comments under paragraph 404)

398. In the Steering Committee’s view, the combination of future premiums, expenses, and claims beyond the current premium period from contracts like the term-life contract described in this section create assets or liabilities. Those assets or liabilities exist as a consequence of a past transaction (signing the contract) that imposes benefits or sacrifices on the insurer.
399. In the Steering Committee’s view, contracts that guarantee the policyholder’s right to renew the contract and that restrict the insurer’s ability to change the amount of renewal premiums create an asset or liability that would not exist in the absence of such guarantees or restrictions.

(see IAA comments under paragraph 404)

400. The Steering Committee observes that the contract provisions described in these paragraphs are more common in life insurance than general insurance contracts. As a result, the Steering Committee observes that most general insurance contracts do not give rise to assets and liabilities related to premiums and claims after the end of the current premium period. However, general insurance contracts in some jurisdictions include the features described in this Steering Committee view. The Steering Committee’s views are based on the nature of the contractual relationships, not the nature of the insured events. Accordingly, the Steering Committee would extend its conclusions to general insurance contracts with similar features. Indeed, under the definition proposed in Sub-issue 1K, such contracts would be classified as life insurance contracts for financial reporting purposes.

(see IAA comments under paragraph 404)

402. Consistent with its tentative view in Sub-issue 7D for general insurance, the Steering Committee concludes that acquisition costs for life insurance contracts should be recognised as an expense, on the basis that they do not meet the Framework’s definition of an asset. Also, the measurement of insurance liabilities already reflects the future cash flows to be generated by the insurance contract, so the recognition of an asset would lead to double counting.

(see IAA comments under paragraph 404)

403. In summary, the Steering Committee concludes that the following assets and liabilities are created by 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
(c) a net contractual right or obligation to receive or pay cash as a result of existing insurance contracts.

(see IAA comments under paragraph 404)

404. The terms of some life insurance contracts allow for a different decomposition of the life insurance contract. For example, some contracts such as universal life, variable, and indexed contracts allow separate identification of future charges against the contract for administration and mortality coverage, future interest credits, and future charges for early termination. The ability to separately identify contract components is a prerequisite for the policyholder-deposit accounting model discussed later in this section. However, many contracts (including the term-life contract described earlier) do not allow for this level of analysis. In addition, the individual elements listed above are included in the cash flows associated with the several assets and liabilities described in the preceding paragraph.

Subject to the discussion in the following paragraph, the IAA agrees with the Steering Committee’s views as to the assets and liabilities that are created by life insurance contracts.

In paragraph 387, the Steering Committee asserts that “payments that an insurer is required to make on termination of the contract by the policyholder meets the definition of a liability”. The IAA agrees with this statement where a termination had in fact occurred. However, if a termination has not yet occurred, we would consider it as only a contingency, along with other contingencies. We would, therefore, expand the conclusion of paragraph 393 to include the insurer’s obligations for payments on estimates of policy terminations expected to occur during the current premium period. Paragraph 403 would need to be changed in the same manner. In part, this refinement in expression is due to the fact that the unit of account are groups of similar contracts, rather than individual contracts. Of course, similar estimates to measure liability will be made for the entire coverage period for a life insurance contract.

Sub-issue 8C Should the Various Assets and Liabilities Created by a Life Insurance Contract be Combined into a Single Recognition and Measurement Scheme?

411. In the Steering Committee’s view, the insurer’s rights and obligations under the contract create a single net liability or asset. Therefore, the Steering Committee favours an approach to accounting for life insurance that combines the various assets and liabilities created by a book of contracts in a single recognition and measurement scheme. Similarly, the Steering Committee considers that the offsetting requirements in IAS 32 are not relevant.
412. The conclusion in the previous paragraph does not apply to those components of insurance contracts that are unbundled under the tentative Steering Committee view in Sub-issue 1E.

The IAA strongly supports the IASC’s view that an insurer’s rights and obligations under a contract create a single net liability or asset.

In our view, an insurer’s rights and obligations are inextricably linked and therefore must be viewed as a single net asset or liability. Further, the separate identification of different components of the liability under a contract (e.g. liability for payment on termination versus liability for payment of future claims) is likely to involve arbitrary delineations or categorisations, and is therefore likely to be of only limited value to users of financial statements.

The IAA does not favour the “selective view” whereby the approach to the separation of a contract into a number of asset and liability components is dependent on the characteristics of the contract. This approach would lead to inconsistencies within an insurer’s financial statements that would detract from the overall usefulness of these statements.

In Sub-issue 8C, there is reference to unbundling of insurance contracts and to a tentative Steering Committee view in Sub-issue 1E. The IAA does not agree that unbundling is appropriate or desirable. We also believe the criteria proposed for such unbundling are inappropriate and unworkable. When accounting is on a fair value basis, the need for unbundling is no longer present, unbundling can lead to inappropriate accounting differences, and unbundling may generate misleading information.

In general, an “unbundling” approach would inevitably lead to inconsistencies among similar contracts, among companies with similar contracts, and with the basic objectives of the accounting model. Our comments on this issue are more fully set out in our response to Sub-issue 1E.

The IAA also observes that the conclusion stated in Paragraph 411 is inconsistent with that stated in Paragraph 412 and the considerations supporting Paragraph 411 also suggest that the Steering Committee’s conclusions in Sub-issue 1-E are inappropriate.
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Sub-issue 8D  Should IASC Prescribe a Single Accounting Model for Life Insurance Activities?

425.  In the Steering Committee’s view, a prospective (policyholder-benefit) approach is consistent with its view of a life insurance contract as a single set of interrelated assets and liabilities. However, the amount recorded as a liability should not be less than the amount that would result from applying a retrospective (policyholder-deposit) approach. The Steering Committee expects that a prospective approach, applied without restriction based on the retrospective approach, would be more consistent with an estimate of fair value. (see IAA comments under paragraph 426)

426.  In reaching the view outlined above, Steering Committee members noted the following points that influenced their deliberations:

(a)  when considered in a traditional (rather than fair-value) context, accounting for life insurance has typically focused on the service provided by the insurer. Traditional policyholder-benefit approaches attempt to report earnings from the contract as the service is provided. In this regard, they are similar to accounting for other long-term contracts, as described in IAS 18, Revenue; and

(b)  the liability recognised in a policyholder-deposit model - the policyholder’s account balance - is a financial liability that is typically payable to policyholders on demand (although it may be subject to surrender charges or penalties). When considered in a traditional context, the balance of this financial liability represents a minimum measurement of the liability.

The IAA supports the Steering Committee’s view that a prospective (policyholder-benefit) valuation approach is consistent with the view of a life insurance contract as a single set of inter-related assets and liabilities.

However, the IAA strongly disagrees that the liability should have a minimum that would result from applying a retrospective (policyholder-deposit) approach. While the liability under the policyholder-deposit model is typically the amount payable to individual policyholders on demand, this amount is not equivalent to the fair value of the liability in the context of the valuation of a portfolio of policies. Because not all policies are expected to terminate immediately, the fair value liability in respect of a portfolio of policies is typically lower than the demand liability. Hence we cannot see the relevance of applying the policyholder-deposit liability as a minimum. These concerns are referenced in Paragraph 597 of Sub-issue 11F [note 597 of Appendix E, which is inconsistent with Paragraph 597 of Volume 1]. This
point is discussed fully in a separate paper entitled “MINIMUM LIABILITY FLOOR”.

The IAA also notes that the policyholder-benefits model, as described, is a generic prospective valuation method based on a discounted cash flow approach. While the policyholder-benefits model can be applied in a manner consistent with a deferral-and-matching view, it equally can be used for determining liabilities under the asset-and-liability view. In practice typically, models used for determining the fair values of insurance enterprises use the policyholder-benefits model.

Sub-issue 8E  Should IASC Specify a Single Attribution Approach for Life Insurance Contracts?

430.  In the Steering Committee’s view, the income attribution approach should be the result of the liability measurement. Accounting conventions that produce liability measurements as a by-product of a predetermined pattern of reported income are inconsistent with an asset-and-liability-measurement approach.

(see IAA comments under paragraph 432)

431.  The Steering Committee observes that if its view is applied, income emerges as a function of contract margins for those periods in which the liability to policyholders is computed using the policyholder-deposit measurement. Income emerges as a function of release from risk for those periods in which the liability to policyholders is computed using the policyholder-benefit measurement.²

(see IAA comments under paragraph 432)

432.  The Steering Committee observes that other approaches to measuring the insurer’s assets and liabilities give rise to other patterns of income attribution. Some of those patterns are illustrated in Appendix A. The Steering Committee invites comments from readers who consider one or more alternative approaches superior to the approach that flows from the Steering Committee’s tentative views.

The IAA supports the Steering Committee’s view that, under an asset-and-liability measurement approach, income attribution should be a by-product of the liability measurement. As the Steering Committee notes, income emerges as a function of release from risk under the policyholder-benefit method.

² If insurance liabilities are measured at fair value, income will emerge as a function of release from risk.
However, the pattern of income under the policyholder-deposit method is not simply a function of contract margins – without explicit deferral and amortization of acquisition costs, the policyholder-deposit model will report acquisition costs as a loss at inception of a contract. In turn, the contract margins available for recovery of acquisition costs will be reported as profits in subsequent periods.
Basic Issue 9 Are there any Specific Accounting Issues for Participating (With-Profits) Contracts?

Sub-issue 9A Should Unallocated Divisible Surplus be Recognised as a Liability or as Equity?

461. In the Steering Committee’s view:

(a) unallocated surplus should be classified as a liability, except to the extent that the insurer:

(i) has no legal or constructive obligation at the balance sheet date to allocate part of the surplus to current or future policyholders; or

(ii) has such a legal or constructive obligation, but cannot measure that obligation reliably; and

(b) the rest of the unallocated surplus should be classified as equity. Where there is any doubt as to whether, or what amount of, that equity will flow to the insurer’s owners, the insurer should disclose the fact that the owners have restricted access to that equity.

The fair value of the liability arising from a participating contract is the estimated present value of:

(i) future contractual payments under the contract and future bonuses to policyholders in whatever form, where policyholders have a right or reasonable expectation to participate in any declared surplus, less

(ii) the estimated present value of future premiums under the contract.

To the extent that unallocated divisible surplus represents merely a deferral of the distribution of surplus to the present generation of policyholders, it seems clear that a constructive obligation exists and, to the extent that such surplus is allocated to policyholders as opposed to shareholders, is a liability. Thus, the IAA agrees with 461(a).

In respect of 461(b), the IAA agrees that the rest of the unallocated surplus should be classified as equity. However, where any of the unallocated surplus has not been clearly attributed to shareholders, we believe further disclosure would be helpful. The IASC’s Framework for the Preparation and Presentation of Financial Statements comments in paragraph 65: “Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. . . . . . Such classifications can be relevant to the decision-making needs of the users of financial statements when they
indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity”.

Therefore, the IAA believes that equity may be classified into the following categories:

(a) Shareholders’ equity.
(b) Policyholders’ equity.
(c) Unattributed equity.

Policyholders’ equity represents the unallocated surplus attributed to policyholders, not forming part of policyholders’ liabilities. The unattributed equity category represents any unallocated surplus where there exists significant uncertainty relating to its attribution to either policyholders or shareholders; this category should not often be used. Shareholders equity would represent the balance.

In most circumstances the IAA expects that all equity would be classified as either shareholders’ or policyholders’ equity. For example, in the U.K. we observe that it has been normal practice in embedded value calculations to allocate surplus in the long-term fund between these two categories. Similar assumptions are made in connection with profit-sharing rules imposed at a company level in other countries.

462. Allocations made after the balance sheet date should influence the classification of unallocated divisible surplus only to the extent that they give evidence of whether a legal or constructive obligation existed at the balance sheet date. This is consistent with the Framework’s definition of a liability and with IAS 10, Events After the Balance Sheet Date.

The IAA agrees.

463. For the purpose of determining whether an insurer can measure an obligation reliably, the Steering Committee refers to the following guidance in paragraphs 25 and 26 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

25. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.
26. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 86).

The IAA agrees.

464. Under some participating contracts, policyholder benefits are linked to the historical cost of designated assets. To the extent that the designated assets are measured at fair value in the financial statements, the measurement of the related liabilities should reflect the fair value of the assets.

The IAA agrees.

Sub-issue 9B Does a Mutual Insurer have Equity?

467. The Steering Committee notes that the question of whether a mutual has equity is not unique to the insurance industry. In the Steering Committee’s view:

(a) a mutual insurer should classify unallocated surplus as a liability, except to the extent that the mutual insurer;

   (i) has no legal or constructive obligation at the balance sheet date to allocate part of the surplus to current or future policyholders; or

   (ii) has such a legal or constructive obligation, but cannot measure that obligation reliably; and

(b) a mutual insurer should classify the rest of the unallocated surplus as equity.

The IAA agrees with the Steering Committee’s view on this issue. However, we return to the suggestion we introduced in our comments to Sub-issue 9A, i.e., we define the rest of the unallocated surplus as “policyholders’ equity”. This assures consistency between proprietary and mutual insurers.

Sub-issue 9C Should Insurers Recognise Allocations to Participating Policyholders as an Expense or as an Appropriation of Equity?

472. The Steering Committee supports the view that allocations to participating policyholders are expenses, regardless of whether the allocations have been made to individual policyholders or to a class of policyholders and regardless of whether the insurer is mutual or stockholder-owned. This is on the basis that the allocations give rise to increases in liabilities and are therefore expenses.
Similarly, increases (decreases) in the liability portion of unallocated divisible surplus are an expense (income).

The IAA considers that the arguments in favor of recognizing allocations to participating policyholders as an expense rather than an appropriation of equity are reasonable. However, the nature of this expense is very different from normal expenses and therefore it should be separately identified to enable readers of the accounts to distinguish between actual expense movements and changing bonus allocations.

Sub-issue 9D Are any Specific Disclosures needed about Participating (With-Profits) Contracts?

473. The Steering Committee believes that there may be a need for disclosures about an insurer’s policy in making allocations for participating (with-profits) contracts and about the related assumptions that are reflected in the financial statements. The Steering Committee invites commentators to indicate any specific disclosures that may be needed for such contracts.

In the U.K., there has been growing pressure to extend the information available in relation to with-profits contracts. It is anticipated that this trend will continue. However, extreme care is necessary to ensure that disclosure of a bonus policy developed for a class of policyholders does not result in enhanced Policyholders’ Reasonable Expectations (PRE) at an individual level. Market practice may be different for other countries, where bonus policy is considered commercially sensitive. The approach to disclosure should, therefore, take account of market practice.

However, the IAA does not anticipate that this issue will be contentious, as the level of disclosure is likely to be limited to a statement that fair values have been determined in a way which is consistent with a company’s public and private practice on bonuses.

Another aspect of disclosure for with-profits policies is whether the whole policyholder liability should be treated as a homogeneous amount. This would result in with-profit and non-profit contracts written on the same underlying basis (after including provision for future bonus) appearing equivalent. In fact the with-profit premium rate would offer substantially lower guarantees, with the prospect of future bonus. However, the bonus would be alterable at the company’s discretion or in light of circumstances. It would be useful to allow users to know the degree to which a liability can be varied in the future, particularly in adverse circumstances. There is, in fact, a strong argument that this element is another form of equity within the company.
Sub-issue 9E Are there any other Specific Issues for Mutual Insurers?

474. The Steering Committee invites commentators to indicate whether there are any specific issues for mutual insurers that this Issues Paper does not address. The Steering Committee is not aware of any such issues.

The IAA has not identified any other specific issues for mutual insurers.
Basic Issue 10 Are there any Specific Accounting Issues for Reinsurance Contracts?

Sub-issue 10A Is the Distinction between Direct Insurance and Reinsurance Important Enough to Warrant Different Accounting Treatments?

483. The Steering Committee has not identified any reason to set different accounting requirements for reinsurers. Among other things, the Steering Committee believes that improvements in communications mean that the deferred annual method is no longer needed. The Steering Committee would welcome comments on any aspects of reinsurance that warrant separate consideration.

(see IAA comments under paragraph 877)

484. The principles discussed in the Steering Committee’s view on Sub-issue 6A may sometimes lead to a unit of account in reinsurance that differs from the unit of account in direct insurance.

The IAA agrees that it is not appropriate to set different accounting requirements for reinsurers. Those requirements should be consistent for all insurers, be they direct writers or reinsurers. We also agree that the unit of account for reinsurance may differ from the unit of account for direct insurance. Note that this may result in assets and liabilities for reinsurers that will not mirror the associated liabilities and assets for the reinsured company. Hence, there should be no requirement or expectation that there will be mirror accounting.

With respect to deferred annual accounting, the Steering Committee should be aware that it is common that the reinsurer receives only limited financial information for at least part of the underwriting year at the time financial statements are prepared. In such circumstances, the IAA recommends that accounting should be based on estimates or by deferring the accounting until full information for the relevant period is available. Deferred accounting would be appropriate in case there is no reasonable way to estimate applicable assets and liabilities. This condition will be more prevalent in excess of loss treaties. When deferred accounting is used, the period of deferral will generally be less than a full year.

Sub-issue 10B Should a Ceding Insurer Recognise Gains or Losses when it Enters into a Reinsurance Transaction

498. The Steering Committee prefers an asset and liability approach to this Sub-issue. Deferred gains of the kind discussed above do not meet the Framework’s definition of a liability. Therefore, such gains should be recognised immediately.
The IAA agrees.

Sub-issue 10C Should a Ceding Insurer Recognise Separate Assets and Liabilities from Reinsurance Arrangements, or should Amounts be Offset against Related Ceded Liabilities?

503. In view of the requirements of IAS 32 and IAS 37, the Steering Committee knows of no basis for offsetting amounts due from reinsurers against related insurance liabilities.

The IAA agrees that there is no basis for offsetting receivables and payables from reinsurance transactions against related insurance assets and liabilities. However, an argument to offset actuarial liabilities would be that without offsetting, the illusion would be created that a ceding company has too little equity for its liabilities when, in fact, it has partially taken care of the liability by reinsuring out. Additionally, the net liability will tend to be a more reliable estimate than the gross amounts, in that errors in the estimate of the gross liability tend to be offset by the estimate of the related reinsurance asset.

In case of offsetting, disclosure of gross positions in the footnotes should be required.

Whether or not the amounts are offset, if there is doubt as to the recoverability of the reinsurance or if the reinsurer’s credit standing is recognized in the amount, the reinsurance amounts may differ from the comparable related assets and liabilities. The net liability associated with the ceded reinsurance exposure to the direct writer would represent the credit risk associated with the assuming reinsurer. If the credit standing of both companies are considered and if the reinsurer is more highly rated than the reinsured company, the reinsurance amounts may exceed the related assets and liabilities.

Sub-issue 10D How Should a Ceding Insurer Report Revenue and Expenses from Reinsurance Arrangements?

508. To enhance the comparability of insurance financial statements, the Steering Committee recommends that activity with reinsurers be reported gross in the income statement, rather than offset against related accounts. However, the Steering Committee does not find a strong conceptual basis for favouring either a net presentation or a gross presentation on the face of the income statement. If a net presentation is permitted, the Steering Committee believes that the gross amounts should be disclosed in the notes to the financial statements.
The IAA has observed that economic activity and earnings potential correlate more strongly to net amounts. The income statement is a measure of the financial performance of the business the company has retained for itself, not what it wrote for both itself and others (reinsurers). The IAA agrees that this consideration may not be compelling.

Sub-issue 10E  When, if Ever, should a Reinsurance Arrangement be Treated as an Extinguishment of Liabilities?

512. The Steering Committee observes that this issue is under consideration by the Joint Working Group on financial instruments. The conclusion reached in that context will be very important in determining conditions (if any) under which reinsurance contracts can serve as a basis for derecognition either of an entire liability or of certain components of a liability. At this stage, the Steering Committee believes that derecognition is appropriate only when the obligation specified in the contract is discharged or cancelled, or expires. In other words, derecognition is appropriate only for a novation or for assumption reinsurance, but not for indemnity reinsurance.

The Steering Committee conclusion appears to the IAA to be the correct one.

Sub-issue 10F  Are there any Special Considerations in Measuring Assets and Liabilities under Reinsurance Contracts?

516. At this stage, the Steering Committee does not intend to give additional guidance on measurement of reinsurance assets and liabilities. In the Steering Committee’s view, all important aspects of the measurement of reinsurance assets and liabilities are covered by the discussion in other parts of this Issues Paper.

The IAA has no further considerations to recommend.
### Basic Issue 11
What Issues are Raised by the Use of Fair Value in the Measurement of Insurance Obligations?

#### Sub-issue 11A
Are Insurance Contracts Financial Instruments?

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.*

The IAA believes that insurance contracts should be treated as financial instruments. It is important that this should not lead to inconsistencies in the accounting of obligations that constitute essentially the same risks but differ only by the issuer of the liability. Having said that, we believe that it is important to consider the holistic nature of an insurance contract, which may include financial and real options and a service element, with strong correlation between the cash flows associated with these different elements. We hope that any accounting standard being developed for financial instruments will properly take this holistic nature into account.

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

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.

(see IAA comments under paragraph 557)

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.

The IAA considers the consistency between the bases underlying the reporting of liability values and asset values to be fundamental for meaningful financial reporting. If insurance liabilities are not reported on a fair value basis, the implication is that assets values should not be reported on a fair value basis (and vice versa). We note the pragmatic assumption that the market value of an asset is its fair value.

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.

The IAA recognizes the difficulties involved in calculating a fair value for insurance contracts. These difficulties are, however, similar to those encountered when determining the fair value of any asset or liability for which there is no active and transparent market, again assuming that the fair value of a listed asset is its listed market value.

There is a much wider issue in that there are direct and indirect calculation processes for determining policyholder liabilities. Both processes can lead to the same liabilities with properly chosen assumptions, provided they follow consistent principles of calculation (despite the somewhat misleading observations included in the Issues Paper; please refer to our comments in Sub-issue 11K for further discussion of this issue). The IAA would prefer that the IASC would state the general principles to be adhered to in the calculation of the liabilities arising from insurance contracts, rather than giving specific directions as to the precise structure of the calculation.
In practice, pragmatic decisions will be necessary for both direct and indirect methods to be applied. Differences could arise between the two methods just as differences could arise for different applications of a direct method. The IASC should consider providing a framework or set of principles for determining the fair value of liabilities which would leave open the opportunity for the liabilities to be calculated through direct or indirect methods.

A possible direct approach for calculating the fair value for insurance contracts using discounted cash flow models incorporating appropriate adjustments for uncertainty, is given in the IAA paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”.

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

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.

(see IAA comments under paragraph 567)

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:

Although the IAA generally agrees with the conclusions reached in paragraphs 566 and 567, several elaborations and clarifications are important to consider. Adopting fair value as the objective of present value measurements should not preclude the use of information and assumptions based on an insurer’s own situation and expectations. In fact, little or no information is normally available concerning the assumptions that marketplace participants would use in assessing the fair value of similar assets or liabilities. In many cases, such assumptions would be identical to
that made by the insurer. In addition, even were this information fully available, the reflection of such assessments may not be appropriate, due to lack of information specific to the insurer’s obligations or to their desired use. In developing cash flow estimates, the insurer must necessarily use specific and relevant information that is available without undue cost and effort.

In summary, the use of an insurer’s own assumptions about its expected future cash flows is compatible with an estimate of fair value, as long as there is no contrary information indicating that marketplace participants would apply their assumptions in a different manner. For a more complete discussion of this and related issues, refer to the IAA paper entitled “MARKET EXPECTATIONS REGARDING EXPERIENCE ASSUMPTIONS.”

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?

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.

Regarding contract renewals, the IAA observes that it may be appropriate to recognize contract renewals if business practice is to do so and contract continuation can be estimated, because:

1. There is no substantive difference between contract termination during a contract period and its expiry. Similarly, there is no substantive difference between renewal of a contract and the utilization of the option to continue a contract during its period.

2. The market recognizes the value of expected renewals in an exchange between willing parties. The continuance in substantively the same form can easily be distinguished from add-on sales.

3. Imposition of a rule not to recognize contract renewals that has substantive differences in accounting treatment will result in changes in contract forms to take advantage of such differences.

4. In a regulated industry in which significant contract-owner expectations exist, probabilities of non-renewal resulting from actions by an insurer may not be materially different than those of termination resulting from
the application of contract termination provision at a similar period measured from original contract issue.

5. Many insurance contracts are designed, sold, and managed taking into account the probabilities of renewal. Not to reflect such probabilities does not reflect market realities.

Please refer to our response to paragraph 192 and a more detailed discussion of this issue in the accompanying IAA paper entitled “INSURANCE CONTRACT RENEWALS”. The IAA is in favor of a closed-book approach, but with the closed book defined as including the effect of expected continuance of existing contracts, excluding the effect of contracts that are not a continuation of existing contracts (that represents intangible assets that would not be appropriate to recognize in the balance sheet).

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

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.*

The IAA considers that the determination of the fair value of insurance liabilities requires a company to consider blocks of similar policies which could be transferred to a third party under reasonable assumptions. The basis for recognition and measurement of insurance liabilities should be groups of similar policies since the pooling of similar risks is a significant feature of most insurance contracts (see IAA comments on Basic Issue 6 and the IAA paper on “FEATURES OF INSURANCE CONTRACTS”).

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?

596. *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. However, the Steering Committee does not consider it appropriate to use artificial, or overly*
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Conservative, assumptions intended to produce no gain on the sale of insurance contracts.

Note that both the above quoted paragraph 596 and paragraph 597 that follows correspond with the ones indicated in Appendix E of the IASC Insurance Issues Paper, rather than the corresponding paragraphs in Volume I (for our comments on both, see IAA comments under paragraph 597).

597. The Steering Committee observes 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.

The IAA notes that transactions which involve the sale of a portfolio of insurance contracts are relatively infrequent, as are the sale of a portfolio of listed investments. It is difficult to determine the difference between a realized gain (or loss) on the sale of the insurance contracts and a realized gain (or loss) on the sale of the listed investments.

The IAA considers the fair valuation of insurance liabilities to be consistent with an “exit value” methodology. The IAA agrees that artificial, overly conservative assumptions intended to produce no gain on the sale of insurance contracts (including the imposition of a zero, or withdrawal value, minimum for each contract) are inappropriate. The concept of gain or loss on the sale of a contract is meaningful in the context of an accounting system with a retrospective or historical view. However, we agree with the Steering Committee that a prospective approach to the valuation of insurance contract liabilities should be adopted.

Consequently, the IAA believes that gain (or loss) on sale is not a pertinent issue. Nevertheless, we would agree that if, on analysis, significant gains (or losses) are being posted on sale, it is possible that the insurer has under (over) estimated the proper risk adjustment to be made. Exceptions may arise in the case of niche markets or special distribution channels, where the insurer may be able to realize significant gains on sale, or (where it expects interest earnings in excess of that in the replicating portfolio). If significant gains are anticipated, specific consideration would need to be given to the sustainability of these gains, given that such a situation would be expected to attract competition.
The IAA also notes that the use of exit value may lead to negative liabilities. We feel this possibility is also appropriate. In many cases, the initial costs of sales and underwriting a portfolio of insurance contracts are paid at the time of sale and recovered through margins in future contractual premiums. The present value of these future premium margins is a valuable asset (or negative liability) that is part of the fair value of the insurance contract obligations. An example where negative liabilities often arise is term life insurance shortly after a policy is issued. In this case, the present value of future premiums is often greater than the present value of future benefits and related costs, because future premiums include a margin for recovery of previously incurred sales and underwriting costs (some of which relate to policies which were not sold). When the present value of future premiums is larger than the present value of future claims and related costs, the fair value of the liability is negative.

Further, the IAA refers to our response to Sub-issue 8D concerning issues relating to a minimum deposit floor. We strongly disagree that the liability should have a minimum that would result from applying a retrospective (policyholder-deposit) approach, as this amount is not equivalent to the fair value of the liability in the context of the valuation of a portfolio of policies. We refer to our response on Sub-issue 8D and the accompanying paper entitled “MINIMUM LIABILITY FLOOR”.

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?

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.**

(see IAA comments under paragraph 611)

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.**
The IAA considers it most appropriate that the fair value of insurance liabilities be measured independently of the actual assets or investment policy of the company. As stated in our response to paragraph 180, there are certain types of contracts whose benefits are directly influenced by the return on a specific set of assets. The measurement of the liability cash flows for these contracts needs to reflect any such relationship; in such cases, the liability cash flow measurement will reflect the applicable (replicating) asset portfolio consistent with the contract terms. Thus, the matched asset portfolio would consist of actual assets if, as an example, a unit-linked block of business was involved, or an index-determined asset portfolio if interest credits is a function of an index.

For instance, the direct calculation method of determining the valuation of the insurance liabilities – as described in the IAA paper “VALUATION OF RISK ADJUSTED CASH FLOWS AND THE SETTING OF DISCOUNT RATES – THEORY AND PRACTICE,” is based on the risk-adjusted cash flows discounted at the asset yield of the matched asset portfolio. The matched asset portfolio is the set of assets whose cash flows match the liability cash flows as closely as possible, given the available assets in the market. Indirect methods may similarly be based on cash flows of assets, which match the liability cash flows as closely as possible.

As a result, the IAA believes that the fair value of an insurer’s liabilities should recognize the expected return from a “replicating portfolio” (see our separate paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”). Note that in the case of contracts whose benefits are directly influenced by the return of actual assets, the replicating portfolio is similar to the actual portfolio.

In order to be consistent with fair valuation and the recognition of other sources of expected prospective margins, it would be appropriate to reflect expected investment margins resulting from the replicating portfolio of assets in the measurement of the liabilities. However, deviations from actual investment returns from the replicating portfolio would be recognized as a profit or loss as they are earned. Please also refer to our comments on Basic Issue 5 and the more detailed paper on “FUTURE INVESTMENT MARGINS”.

If actual assets are not reflected in the measurement of the liabilities (which is currently the case in a number of jurisdictions), neither should expected mismatch risk (except as the replicating portfolio results in mismatches). As a result, to the extent that actual assets differ from the matched (replicating) asset portfolio, such risk should be provided for through an appropriate risk-based capital system which reflects the risks associated with any mismatch.
between the cash flows of assets and liabilities. In this case, it would be
appropriate to evaluate two portions of these assets:

1. To the extent that the replicating portfolio matches the expected liability
cash flows, it is necessary that, to the extent that the actual assets differ
from the matched (replicating) asset portfolio, such an accounting regime
should be supplemented by an appropriate risk-based capital system,
developed in a manner consistent with the accounting regime used to
measure the insurance liabilities. This risk-based capital system will not
necessarily be the same as any such system currently in place, although
some of the attributes may be shared, but whose liabilities considered
would be based on the liabilities actually recorded.

2. To the extent the replicating portfolio does not fully match the cash flow
characteristics of the liabilities (which may be small or non-existent,
except in cases such as the case in which available assets are not available
for significant durations in which liabilities are due), mismatch risk
would be provided for in the liabilities.

The IAA’s accompanying paper entitled “INSURANCE LIABILITIES -
VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW
OF A POSSIBLE APPROACH” also discusses the assessment of capital
requirements in a manner consistent with the application of the fair value of
liabilities.

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

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.

The IAA considers the inclusion of a market premium for risk to be essential
in the fair valuation of insurance contracts. This premium is the price for
uncertainty in respect of the expected cash flows and is independent of the
company, but dependent on the characteristics of the in-force block of
business, including any constructive obligation made to the inforce
policyholders. Hence, the “risk premium” for a particular company will
reflect the market’s perception of risk associated with that company. As
such, the “risk premium” is derived from the market’s view of risk within
the company and the premium for that risk in a manner consistent with that
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charged by the market. The IAA believes this is best defined as a “market value margin” (see the IAA paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”).

The IAA acknowledges that significant work on quantification of such “risk premium” will be required for the various risks inherent in an insurance contract. The IAA intends to develop analyses of the market’s assessment of these risk premiums and from that to establish standards of practice to be applied when using discounted cash flow models incorporating appropriate adjustments for uncertainty.

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

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.

With respect to this issue, both practical problems associated with such a provision and conceptual arguments involved are important to consider. Although there are good arguments on both sides of this issue, on balance the IAA believes that it is not appropriate to reflect credit standing in insurance liabilities. The IAA recognizes that because it is desirable that similar financial instruments be treated in a consistent manner, this issue should be given careful consideration in conjunction with the discussion relating to recognition and measurement as they apply to other financial instruments as well.

A detailed discussion of the stronger arguments on both sides of this issue is included in our accompanying paper entitled “EFFECT OF INSURER’S CREDIT STANDING ON INSURANCE LIABILITY”.

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

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
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*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.*

The IAA considers that under fair value reporting for insurance contracts, there is no need nor basis for a deferred acquisition cost asset. Since fair value accounting is based on expected liability cash flows, the present value of future acquisition expense loads is already incorporated in the determination of the liability of an insurance contract.

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?

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.*

The IAA agrees with the Steering Committee’s conclusions as stated. These are basically that a reporting method which shows a deliberately very conservative value of policyholder liabilities offset by a new asset associated with the value of in force business is not consistent with normal fair value reporting. However, we do not agree with the observations made on the embedded value approach in paragraph A133 of the Appendix to the Issues Paper. In particular, the illustrations

(i) do not include an experience assumption for the default risk on the assumed investment;

(ii) make no allowance for the additional risk adjustment created by a lock-in of capital (which a regulator regards as risk related); and

(iii) cannot be used to draw a conclusion as to whether or not the risk discount rate implied in the simplified example is within the normal range of discount rates.
Although the IAA considers that a direct approach in the determination of the fair value of insurance contracts has conceptual appeal, we envisage (as discussed in our response to Sub-issue 11B) both direct and indirect (embedded value type) calculation processes being used to determine fair values of liabilities. If applied in a consistent manner and with similar assumptions, these processes should produce the same results. The calculations for the embedded values can, if necessary, be refined, for instance to accommodate the concept of a replicating portfolio.

The shareholders’ net assets reported in financial statements that reflect appropriately calculated fair values of liabilities, will therefore be consistent with the embedded value of the enterprise (subject possibly to adjustments to some asset values, where these have not been reported at fair value).

Where the shareholders’ net assets are not recognized or measured in a manner consistent with the embedded value of the enterprise’s net assets (e.g., if a pure fair value liability measurement basis is not adopted by the IASC, or if certain assets are not held at fair value), then embedded value should be disclosed in the notes to the accounts, together with a reconciliation or explanation of the differences between the embedded value and the shareholders’ net assets.

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?

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.

In reference to our response to paragraph 557, the IAA considers the consistency between the reporting of liability values and asset values to be fundamental to meaningful financial statements. As such, we agree that the IASC should review accounting by insurers for these assets. For example, the standard on Investment Properties currently gives two options for the value. If insurance liabilities are measured at fair value, the investment properties supporting the insurance liabilities should also be measured at fair value.
Basic Issue 12  Should an Insurer Discount Deferred Tax Liabilities and Deferred Tax Assets Relating to Insurance Contracts?

661.  The Steering Committee recommends that IASC should consider in the project on discounting whether to require or permit discounting of all deferred tax assets and liabilities.

1.  Background

Basic Issue 12 canvasses whether deferred tax assets and liabilities relating to insurance contracts should be determined on a present value basis.  IAS 12, Income Taxes, requires an enterprise to determine deferred tax assets and liabilities by comparing the carrying amount of the asset or liability with its tax base.  However, IAS 12 does not require or permit the explicit discounting of future tax benefits or expenses in the determination of a deferred tax asset or liability.

2.  Summary of IAA View on Issue

The label “deferred tax”, while appropriate in a deferral-and-matching framework, is not appropriate in an asset-and-liability framework.  Instead, assuming that an asset-and-liability structure is adopted, the IAA suggests that the label “future tax” be adopted.

Provided the other financial assets and liabilities of an insurer are measured on a present value basis (which would include a fair value basis), the IAA considers that future tax liabilities and assets relating to insurance contracts should also be determined on a discounted basis.  This should result in these assets and liabilities being measured consistently with the other financial assets and liabilities of an insurer.

The discount rate for this purpose should be determined in the same manner as for the measurement of the fair value of an insurance liability with similar characteristics, and should be an after-tax rate.

3.  Arguments in Favor of Discounting Future Tax Liabilities and Assets

- On the presumption that the financial assets and liabilities of an insurer will be accounted for at fair value, future tax liabilities and assets should be treated in a similar manner.  In the absence of an observable fair value measure, this would involve the use of a discounted cash flow valuation approach.
• In a fair value context, if discounting is ignored, the normal result is that future tax liabilities and future tax assets are overstated (although there are theoretical situations where the opposite effect might arise). This outcome is inconsistent with fair value measurement.

• While the accurate measurement of a future tax liability or asset using discounted cash flow techniques can be complex, the data required to support the measurement is generally available, where discounted cash flow techniques are being used to measure the fair value of an insurance liability. Hence it will generally be practical to determine the future tax liabilities and assets in this manner.

• Where the benefits under an insurance contract are dependent on the after-tax return on a portfolio of backing assets, inequities between generations of policyholders can arise if future tax liabilities and assets are measured on an undiscounted basis. In such circumstances, the measurement of the policy liability could also become inconsistent with the measurement of the net assets backing the liabilities.

4. Choice of Discount Rate

Considerations relating to the choice of discount rate are identical to those in connection with the determination of the fair value of an insurance liability with similar characteristics (see the accompanying paper entitled “INSURANCE LIABILITIES - VALUATION & CAPITAL REQUIREMENTS, GENERAL OVERVIEW OF A POSSIBLE APPROACH”). For the purposes of determining future tax provisions, an after-tax discount rate should be used.
Basic Issue 13  What is the Reporting Enterprise for an Insurer?

Sub-issue 13A  Does the Reporting Enterprise for an Insurer Include any Separate Statutory Funds?

672. The Steering Committee considers that the insurer, comprising both policyholder and stockholder interests, is a single reporting enterprise which should prepare a single set of financial statements. Restrictions imposed by insurance regulators on the use of policyholder assets are not sufficient to justify excluding the assets and liabilities of different classes of policyholders and any stockholders.

(see IAA comments under paragraph 673)

673. Although policyholder interests and stockholder interests comprise a single reporting enterprise, there may be a need for separate disclosures about policyholder interests. Sub-issue 18D addresses that question.

The IAA agrees. Such disclosures are appropriate. In addition, disclosures regarding the performance of and assumptions underlying the measurement of liabilities of major business categories should be reported separately in a manner consistent with segment reporting, e.g., life insurance and general insurance, separate account and general account business.

Sub-issue 13B  Should the Reporting Enterprise include Investments and Liabilities Relating to Investment-linked Contracts?

686. The Steering Committee considers that liabilities under investment-linked insurance contracts, and the related investments, should be recognised in the balance sheet as two single line items (asset and liability). The Steering Committee notes that there is a strong argument for treating investment-linked contracts sold by insurers (life insurers in particular) in the same way that managers treat the funds they manage on behalf of investors, namely by not recognising assets and liabilities in relation to investment-linked contracts. However, the Steering Committee considers that the single line items treatment for investment-linked insurance contracts best reflects the terms of the contracts between insurers and policyholders. Sub-issue 18D addresses the question of separate disclosures about these items.

The IAA agrees that assets and liabilities under investment-linked insurance contracts should be recognized. To do otherwise fails to recognise the substantial rights and benefits contained in such contracts that are not included in mutual funds and other funds under management. These rights and benefits typically include substantial death benefits, guarantees as to mortality and expense charges, rights to continue premium payments under conditions that may be favourable to the contract holder, and in some cases guarantees of investment performance, interest credits, or in some cases the
right to switch from investment-linked to a with-profits investment environment. Further, insurance contract holders have claims against all the assets of the insurer, and it is therefore misleading to treat the assets as simply managed funds.

687. Where an insurance contract includes an investment-linked component, the contract may need to be unbundled so that the investment-linked component is treated in the same way as an investment-linked contract (see Sub-issue 1E).

In general, the IAA disagrees with the need or the desirability to unbundle. The liability would need to recognise the linked assets, but it is neither necessary nor desirable to unbundle to accomplish this.

As stated in our response to Sub-issue 1E, the IAA believes that any attempt to unbundle may produce misleading information, including generating results which vary depending on the sequence in which the options are separated from the whole. Further, the inter-dependence of the risks insured under an investment-linked contract may lead to a significant misstatement of the liabilities if such risks are evaluated independently. See our response to Sub-issue 1E for additional discussion of this issue.

Sub-issue 13C How should a Parent Treat its Interest in an Insurer Subsidiary?

696. The Steering Committee considers that a parent of an insurer subsidiary should consolidate the whole insurer subsidiary comprising the stockholder and policyholder interests that it controls.

The IAA agrees.

Sub-issue 13D Should Horizontal Groups be Required to Present Consolidated Financial Statements Covering all Enterprises under Unified Management?

701. In the Steering Committee’s view, horizontal groups should prepare combined financial statements covering all the enterprises under unified management.

The IAA agrees. In fact, consolidation should be treated in a consistent manner independent of the type or form of the parent. Otherwise, the organizational structure of the conglomerate would be dictated by accounting rules, which we deem not to be appropriate.

702. The Steering Committee would welcome comments on any specific disclosures that may be needed to reflect the fact that the enterprises in a horizontal group may have different stakeholders.
The IAA believes that the combination of a horizontal group should be treated the same as other corporate groupings, with disclosure requirements being similar as well. The IAA has not identified any reason to treat this arrangement of companies any differently.
Basic Issue 14  How Should an Insurer Account for Subsidiaries, Associates and Interests in Joint Ventures?

Sub-issue 14A  Should an Insurer Account for the Excess of Fair Value over the Net Assets and Liabilities of its Subsidiaries?

716. The Steering Committee favours the following approach:

(a) to the extent that policyholder benefits are linked directly to the fair value of a subsidiary, the consolidated balance sheet should include the goodwill of that subsidiary at its fair value (in other words the fair value of the investment in the subsidiary less its net assets). This goodwill should be disclosed separately because other goodwill is not measured at fair value – other acquired goodwill is measured at amortised cost and other internally generated goodwill is not recognised at all; and

(b) in all other cases, the consolidated balance sheet should exclude the excess of fair value over the net assets (including unamortised purchased goodwill) less liabilities of subsidiaries, as this exclusion is consistent with accounting by other types of enterprises.

As stated elsewhere in our comments, the IAA believes that accounting for financial reporting purposes should be conducted in a consistent manner. Therefore, if other assets and liabilities are valued on the basis of fair values, any goodwill should also be valued on that same basis. We believe that the accounting treatment for a consolidated reporting entity incorporating subsidiaries should be determined in a manner consistent with having the business being written by a single company.

717. Based on the Steering Committee’s tentative view on issue 13A, that the insurer reporting enterprise comprises both policyholder and stockholder interests, no distinction should be made based on whether the subsidiary is held via policyholder funds or via a stockholder fund.

The IAA agrees.

Sub-issue 14B  How should an Insurer Account for Associates and Interests in Joint Ventures?

722. As for investments in subsidiaries, the Steering Committee favours the following approach for investments in associates:

(a) to the extent that policyholder benefits are linked directly to the fair value of an associate, the consolidated balance sheet should include that associate at its fair value; and
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(b) in all other cases, the consolidated balance sheet should exclude the excess of fair value over the net assets (including unamortised purchased goodwill) less liabilities of associates, as this exclusion is consistent with accounting by other types of enterprises.

The IAA agrees.
Basic Issue 15  How should the Transferee Account for the Transfer of a Block of Insurance Contracts?

736. The Steering Committee considers that the acquisition of a block of insurance contracts should be treated in the same manner as the acquisition of an insurance enterprise to avoid having similar transactions being treated differently.

The IAA agrees.
IAA COMMENTS ON
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Basic Issue 16 Should the Effects of Internal Transactions be Eliminated from Financial Statements

750. The Steering Committee considers that transactions between separate policyholder funds of an insurer should not be recognised in the financial statements as assets, liabilities, income or expenses. Income and expense from transactions between policyholder funds and stockholder funds should be eliminated. However, where such transactions affect the relative interests of policyholders and stockholders in the assets held in the respective funds, the effect of such transactions should not be eliminated in determining the balance sheet effect.

The IAA agrees.

751. The Steering Committee notes, however, that the effects of transactions between separately reported segments need to be preserved in segment disclosures. Appendix 2 to IAS 14, Segment Reporting, contains a specimen disclosure that illustrates the presentation of segment disclosures before eliminations, with a final column to show the effect of eliminations.

The IAA agrees.
IAA COMMENTS ON
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Basic Issue 17  Is More Guidance Needed to Supplement IAS 34 on the Treatment of Insurance Contracts in Interim Financial Reports?

757. The Steering Committee does not intend to develop guidance on the application of IAS 34 to insurance contracts. If commentators believe that such guidance would be helpful, the Steering Committee would appreciate comments on the form that such guidance should take.

The IAA agrees with the Steering Committee’s intentions.
Basic Issue 18  How Should Information About Insurance Contracts be Presented in the Financial Statements?


762. The Steering Committee believes that an International Accounting Standard on insurance may need to require the presentation of certain insurance specific items on the face of the balance sheet, income statement and cash flow statement, in addition to those required by IAS 1 and IAS 7. The Steering Committee also recommends that illustrative formats for the balance sheet, income statement, cash flow statement and note disclosures should be provided as an appendix to the Standard. Illustrations A77-A82 in the accompanying booklet are illustrative balance sheet, income statement and cash flow statement formats for insurers.

While ensuring that insurance company financial reporting should continue to be subject to the same general rules as apply to other companies, the IAA believes that a move toward standardization of presentation is desirable in the interest of ease of interpretation. However, conformity at this stage should be “recommended” (i.e., not compulsory) instead of “required”. After some experience has been gained, it might be appropriate to revisit this issue. The need for cash flow statements in the case of insurers may be questioned (see our response to Sub-issue 18C).

Sub-Issue 18B  Should an Insurer Make the Current/Non-current Distinction in its Balance Sheet?

767 In the Steering Committee’s view, it is not useful for an insurer’s balance sheet to present current assets and liabilities separately from non-current assets and liabilities.

The IAA agrees. We expect that balance sheet items will still be presented in homogeneous groups and sub-groups so that, for example, items like “Outstanding Investment Income” will be shown separately from Investments.

Sub-Issue 18C  Should IAS 7, Cash Flow Statements, be Amended for Insurers?

774. The Steering Committee recommends that all insurers should present a cash flow statement under IAS 7. An illustrative cash flow statement could be provided in the Standard in order to promote consistency. The Steering Committee has not
yet discussed whether investment income and cash flows from purchase and sale of investments should be included in operating cash flows.

775. The Steering Committee will consider whether there is a need for specific cash flow disclosures about insurance contracts. The Steering Committee notes that traditional income statement formats for insurers often include information about cash flows. If this information is no longer presented separately in the income statement, there may be a need for specific disclosures.

(see IAA comments under paragraph 776)

776. The Steering Committee invites respondents to indicate whether the presentation and disclosure requirements in IAS 7 need any amendment in order to provide informative information to users of financial statements.

The IAA has not been able to identify any need for specific cash flow disclosures pertaining to insurance contracts or the insurance business.

Operating cash flows of insurers usually are not very different from those that can be inferred from the income statement. While the IAA does not object to a continued requirement for cash flow disclosures, it does not seem that they provide significant added value to what is readily available from other elements of the financial statements.

Sub-Issue 18D Should Policyholder Interests be shown Separately from Stockholder Interests on the Face of the Balance Sheet, Income Statement and Cash Flow Statement?

783. The Steering Committee believes that policyholder assets and liabilities and related income, expense and cash flows should be disclosed separately in the notes to the financial statements where practicable (practicability may vary by jurisdiction); separate presentation on the face of the balance sheet, income statement and cash flow statement should be permitted but not required. Separate disclosure in the notes may be needed where there is uncertainty about how assets of specific funds will be allocated between policyholders and stockholders, as is the case with some assets of some UK insurers. Separate disclosure may also be needed of cash flows between policyholders’ funds and stockholders’ funds.

(see IAA comments under paragraph 784)

784. Where insurance enterprises hold assets on behalf of policyholders and the benefits payable to the policyholders are directly linked to those assets, the Steering Committee recommends that these assets and liabilities and related income, expense and cash flows should be presented separately on the face of the balance sheet, income statement and cash flow statement.
Based on experience in Canada and Australia, separate presentation of stockholders’ and policyholders’ information does not seem to provide significant added value. Neither does separate disclosure of cash flows between policyholders’ and stockholders’ funds.

The IAA has not identified a need for unit-linked business assets and liabilities to require separate presentation on the face of the balance sheet, or for the relative income and expense items to be separately included on the face of the income statement. The differences between unit-linked business and with-profit business in various market-related forms are not in our view so fundamental as to justify separate presentation. However, separate disclosure of liabilities, premiums and claims by broad business categories in notes to the financial statements would be justified, in which for example group and individual, non-profit and with-profit, and within with-profit, reversionary and other bonus systems’ business could be disclosed separately.
Basic Issue 19  How Should Income and Expense from Insurance Contracts be Presented?

Sub-Issue 19A How Should an Enterprise Present Income and Expense Arising from Insurance Contracts?

803. The Steering Committee plans to review the progress made by the Joint Working Group on Financial Instruments and by the G4+1 before developing specific proposals for presenting income and expense arising from insurance contracts. The IAA offers its assistance to the IASC in its development of a specific presentation proposal.

Sub-Issue 19B Should an Insurer Present Premium Revenue and Claims Expense on the Face of the Income Statement?

810. The Steering Committee believes that premiums and claims should be presented as a single item for premium revenue and a single item for claims expense, not as cash receipts and payments alongside movements on related asset and liabilities. The IAA agrees.

Sub-Issue 19C Should an Insurer Present Unwinding of the Discount as Operating Expense or as Finance Expense?

814. In the Steering Committee’s view, the “unwinding” of the discount should be classified in the same way as interest income and interest expense.

In a fair value environment, the unwinding of the discount is a component of the change in the fair value of the liabilities, which should be presented as the “Change in Actuarial Liability”. In fact, there is no unwinding per se, as all calculations are performed on a fresh start basis reflecting a prospective valuation. Appropriate analysis of the components of the liabilities is a disclosure issue (see our response to Sub-issue 20F). A similar effect can arise in respect of discounted future (deferred) tax liabilities, where any unwinding amount (if separately identified for reasons of materiality) would be applied to reduce interest income.

Sub-Issue 19D How Should an Insurer Present the Effect of Experience Adjustments and Changes in Assumptions?

818. At this stage, the Steering Committee has not formed a view on this issue. The Steering Committee will monitor progress by the Joint Working Group on...
Financial Instruments and in IASC’s projects on Agriculture and Investment Property.

The effect of changes in assumptions about future risk and expense experience (and taxation) should be analyzed and disclosed in Notes to the financial statements.

The IAA offers our assistance to the IASC in its development of an approach to presentation, including the two aspects mentioned in this sub-issue.

Sub-Issue 19E Should an Insurer Include All, Part or None of its Investment Return in Operating Activities?

826. The Steering Committee believes that the results of operating activities should include the total investment return (dividend and interest income, as well as gains and losses both realised and – to the extent recognised – unrealised) as it reflects the total performance of the management in managing the underwriting and investment activities of the enterprise.

(see IAA comments under paragraph 827)

827. The Joint Working Group on Financial Instruments will be considering various issues about the reporting of changes in the carrying amount of financial instruments. The Steering Committee will monitor the progress of that work.

The IAA agrees with the Steering Committee’s view. Specifically for policyholder funds, we have not identified a reason to distinguish between realized and unrealized gains and losses on investments, and similarly to distinguish between gains and losses on investments and other forms of investment return on policyholder funds. Hence for policyholder funds the aggregated investment return should be presented on the face of the income statement.

For stockholder funds, income streams of varying degrees of reliability or volatility should be separately identified. Disclosure of the total stockholder funds investment return into a “dividends, interest and rentals” component and a “change in value” component would be valuable information upon which to judge the future earnings potential of the insurer.

We look forward to responding in due course to the outcome of the work of the Joint Working Group on Financial Instruments. We offer our assistance to the IASC in its further efforts in this area.
IAA COMMENTS ON
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Sub-Issue 19F  Should Income and Expense be Presented in the Income Statement Separately for Life Insurance Contracts and for General Insurance Contracts?

831. The Steering Committee believes that the most appropriate presentation format for the income statement is a single statement combining general and life insurance with further analysis provided as segmental information in the notes to the financial statements. The Steering Committee recognises that this approach may require amendment to legislation in certain jurisdictions.

The IAA agrees.

Sub-Issue 19G  Should Taxes and Levies be Included in Premium Income?

835. The Steering Committee recommends that insurers follow IAS 18, Revenue, in determining which amounts are included in Premium income. The Steering Committee further recommends that insurers disclose which taxes and levies have been included or excluded from the amount presented as premium income.

The IAA agrees.
Basic Issue 20  What Disclosures Should be Required about Insurance Contracts?

Sub-Issue 20A  Should the Disclosures about Financial Instruments in IAS 32 and IAS 39 be Extended to Cover Insurance Contracts?

847. The Steering Committee believes that most of the disclosures required by IAS 32 are also likely to be relevant for insurance contracts. The Steering Committee intends to give some additional guidance to clarify how these requirements should be applied to insurance contracts in an informative and concise way. The Steering Committee notes that the Canadian Institute of Chartered Accounts (CICA) has issued guidance (Accounting Guideline AcG-4, Actuarial Liabilities of Life Insurance Enterprises) on how life insurers should make disclosures required by section 3860 of the CICA Handbook. Section 3860 and IAS 32 were developed together as part of a joint project and are virtually identical. Unlike IAS 32, section 3860 does not have a scope exclusion for insurance contracts.

(see IAA comments under paragraph 877)

848. Most of the disclosures required by IAS 39 arise from specific details of the recognition and measurement requirements of IAS 39. Similar requirements may or may not be needed for insurance contracts; this will depend on the recognition and measurement requirements adopted for insurance contracts.

In general, disclosure of risk management policies under IAS 32 is acceptable when applied to insurance contracts and should be covered by a valuation report of the Actuary, published as part of the financial statements of an insurer. Such a valuation report should state for each broad category of insurance contracts the valuation methodology adopted and the more important assumptions made, with particular emphasis on future investment earnings, expected experience relative to underwritten risks and future renewal expense under inforce contracts.

Information in paragraph 47(a) of IAS 32 should include a description of the insurer’s liability portfolio in broad terms and also in very summarized form (see paragraph 845). In most jurisdictions this detailed information is available to the public from annual returns to the regulatory authorities and need not be repeated in general purpose financial statements.

Credit risk (see paragraph 66 of IAS 32) presents no special issues for insurers, except in the case of reinsurance exposures. In such cases, whether or not the amounts are offset, if there is doubt as to the recoverability of the reinsurance or if the reinsurer’s credit standing is recognized in the amount, the reinsurance amounts may differ from the comparable related assets and liabilities. The net liability associated with the ceded reinsurance exposure to
the direct writer would represent the credit risk associated with the assuming reinsurer. If the credit standing of both companies are considered and if the reinsurer is more highly rated than the reinsured company, the reinsurance amounts may exceed the related assets and liabilities.

The detailed disclosures required by IAS 39 in respect of financial assets imply similar disclosures in respect to insurance contract liabilities. These would form part of the valuation report of the Actuary and would be prepared in terms of professional guidelines established for the purpose, and would consist of general statements of principles and practice unless specific reasons exist for more detailed disclosures in particular instances.

Sub-Issue 20B Should IASC extend IAS 37’s Disclosure Requirements about Provisions to Cover Insurance Contracts?

854. The Steering Committee believes that the disclosures in IAS 37 should be extended to cover insurance contracts. The Steering Committee intends to give further guidance on the application of these disclosures to insurance contracts, including illustrative examples.

(see IAA comments under paragraph 855)

855. The Steering Committee believes that disclosures about the extent of risk adjustments may be useful. One possibility might be to require disclosure of the difference between the actual (risk-adjusted) amounts recognised and the expected values of the related cash flows, and of the movements in that difference during the period. The Steering Committee plans to develop further thoughts in this area. Illustrations A77-A81 show ways of presenting disclosures about the effect of risk adjustments.

Since policyholder liabilities fall into the generic classification of provisions, IAS 37 seems an appropriate starting point to address disclosure issues. The IAA agrees that further extension of IAS 37 is needed. We are ready to provide assistance to the IASC to develop such extensions.

The IAA believes that increased transparency in the reporting of the financial results of insurance enterprises should be provided. As part of this enhanced transparency, disclosures relative to the extent of risk adjustment should be provided in a consistent manner for both assets and liabilities. Further research and discussion is needed before determining the most appropriate method of disclosing the degree of risk adjustment included in financial statements, both to promote a comparable level of such adjustment and to provide the users of such information with valuable yet not misleading
information. The form of disclosure may be dictated or influenced by the type of risk adjustment made in the agreed-upon standard.

The IAA believes that including such information on the face of the balance sheet and income statement might lead to confusion regarding what is the most appropriate measurement of financial values. Any disclosure should be accompanied by a description of the major assumptions applied in the determination of the adjustments for risk.

Additional disclosure is needed to trace the sources of gains and losses in order to increase the transparency of insurers’ financial statements, for example, through the use of embedded value methodologies.

Our responses provided to Basic Issue 9 under Sub-issues 9A, 9B, 9C and 9D deal with disclosures specific to Participating Contracts and are not repeated here.

Sub-Issue 20C Should an Insurer Disclose Details of Claims Development?

861. The Steering Committee believes that claims development disclosures would be useful for general insurance activities. The Steering Committee has not yet developed detailed proposals, as these are likely to depend on recognition and measurement requirements.

The IAA considers that summarized disclosures regarding claims development would be appropriate. We are prepared to work with the Steering Committee in developing a detailed proposal in this area.

Sub-Issue 20D Should Disclosures of Solvency be Made in the Financial Statements?

865. The Steering Committee recognises that, for a large group, disclosure of regulatory solvency margins may turn out to be either very voluminous, or aggregated at such a high level that it is not meaningful. In the Steering Committee’s view, an insurer should disclose how much of its equity is not available for distribution to stockholders, distinguishing amounts that are not distributable because of legal or other regulatory requirements from amounts that the insurer’s management considers are not distributable for commercial reasons. The Steering Committee believes that an insurer should also disclose information about restrictions on its assets. The Steering Committee would welcome views on the best way to provide solvency information for a group in a concise and meaningful way.

The IAA believes that it would be useful to disclose information concerning insurers’ financial solvency condition, including risk-based capital
requirements and the financial impact of regulatory restrictions in such areas as assets and on the distribution of equity.

The IAA looks forward to working with the Steering Committee and the International Association of Insurance Supervisors in developing a risk-based capital requirement structure to operate in harmony with a fair value-based accounting structure.

Sub-Issue 20E Does IAS 14 give Sufficient Guidance on Segment Reporting by Insurers?

875. The Steering Committee recommends that segmental analysis following IAS 14 should be provided by all insurance enterprises, and not merely by those that have issued publicly traded equity or debt securities.

(see IAA comments under paragraph 877)

876. The Steering Committee intends to develop guidance on the identification of reportable segments by class of business. The Steering Committee believes that, the organisational and management structure and internal financial reporting system of some insurers may not indicate the insurers’ predominant source of risks and returns for the purpose of their segment reporting.

(see IAA comments under paragraph 877)

877. The Steering Committee will consider whether there is a need for insurers to provide any additional segment disclosures beyond those required by IAS 14.

The IAA supports the Steering Committee view. We are prepared to work with the Steering Committee in developing appropriate guidance.

Sub-Issue 20F Should Disclosures be Required About Key Performance Indicators?

881. The Steering Committee believes that insurers should disclose key performance indicators, including the level of new business and the sum assured in life business. The Steering Committee welcomes comments on the sort of key performance indicators that would give users relevant and reliable information at a reasonable cost.

The IAA agrees that disclosure of the results of key performance indicators would provide meaningful supplementary information to the users of financial statements. A few examples follow.

- Analysis of the gains or losses for the period into their main constituent components provides key performance disclosure information.
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- Information relating to new business usually would be a very significant component and would focus on its contribution for the year to future shareholder profit. This would provide more valuable information than merely disclosing New Business sums assured.

- Gains or losses arising from contract terminations by lapse and surrender should also be disclosed, also showing the single and recurring premium income involved, as well as termination payments.

- An insurer's actual level of management expenses measured in relation to the expected level incorporated in the calculation of liabilities is a further important performance indicator.

- Investment performance in the management of assets is a further key performance indicator. It is important that measurements used for the purpose conform to standards so that they are comparable between companies.

882. The Steering Committee will investigate whether there is a need for specific disclosures about low-frequency, high-severity risks – perhaps by segregating a separate component of equity.

Specific disclosure regarding an insurer’s exposure to low-frequency, high-severity events, such as earthquake exposures, would also provide valuable information. One approach that should be considered in cases of low-frequency, high-severity events such as catastrophes, if not reflected in the value of the liabilities, would be to provide for such risks as a component of risk-based capital or a segmentation of equity. Also see the IAA paper entitled “COMMENTS ON CATASTROPHE PROVISIONS” for more information regarding certain aspects of disclosures.

We are prepared to work with the Steering Committee in developing disclosure guidance in this area.

Sub-Issue 20G Should Disclosures be Required About Sensitivity?

887. The Steering Committee believes that sensitivity disclosures, possibly including value at risk measures, would be useful to users of financial statements. The Steering Committee plans to develop further thoughts in these areas.

The IAA believes that appropriately developed sensitivity disclosures can provide useful supplementary information to users of financial statements. We are prepared to work with the Steering Committee in developing disclosure guidance in this area.
Examples can be gained from current practice, including the following. Embedded Value sensitivity to changes in the discount rate used is routinely disclosed in the U.K., Australia and South Africa, accompanied in some cases by similar disclosures for renewal expenses, withdrawals and expected risk experience. Mismatch risk sensitivity should be taken into account in capital adequacy requirement disclosures. See our comments under Sub-Issue 20D for further information.

Sub-Issue 20H Should Other Disclosures be Required about Insurance Contracts?

888. The Steering Committee invites commentators to indicate whether any other disclosures should be required about insurance contracts.

The IAA has no further comments at this stage of the project.

31 May 2000