



7.September.2004

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RE: Exposure Draft (ED or Proposal) on the Proposed Statement of Financial Accounting Standards, Fair Value Measurements

File Reference No. 1201-100

Dear Ms. Bielstein:

The Chief Financial Officers of eleven leading insurance companies including life insurers, property and casualty insurers, and reinsurers formed the Group of North American Insurance Enterprises (GNAIE) in 2003. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets. The goal of GNAIE is to influence international accounting standards to ensure that they result in high quality accounting standards for insurance companies and, to that end, to increase communication between insurers doing business in North America and the International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB). GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports

We recognize that the objective of the ED is to develop a standard that will establish a framework clarifying the measurement of assets and liabilities currently under fair value. We also acknowledge that the ED, if adopted, will not extend fair value reporting in financial statements beyond current requirements.

However, the Board has:

- Stated that it plans to use the fair value framework developed in this ED as a basis for addressing fair value measurement issues in other projects



- Recently added a project to its agenda to consider whether entities should be permitted a one-time election to report financial instruments and possibly certain nonfinancial instruments to be reported at fair value.

As such, we feel compelled to offer our views on the ED since there is a possibility that the guidance could be extended to insurance products in the future. We believe that the issuance of this standard will have detrimental effects should it be applied to the insurance industry, will result in financial statements misleading and confusing to readers, and sacrifice high quality accounting standards currently in place.

For the reasons outlined above and addressed in the attached Appendix A, we believe that the ED should be modified to specifically indicate that the fair value guidance is **not** relevant to insurance products and cannot be used to measure insurance liabilities if an enterprise were to elect a one-time fair value election. Our specific concerns addressed on the following pages are limited to highlighting the problems applying the ED guidance to insurance products. We also have attached the recent Geneva Papers special report entitled, "*The Search for an International Accounting Standard for Insurance*" that addresses factors that must be kept in mind in developing a accounting standard for insurers and the effects of fair value accounting.

As you move forward we hope that you will strongly consider our concerns and recommendations. If you have any questions please contact myself, Mike Castelli or Anthony Valoroso regarding the contents of this letter, we would be pleased to discuss our comments with the Board or the FASB staff at your convenience.

Very Truly Yours,

/s/ Howard I. Smith
Chair, Group of North American Insurance Enterprises
Vice Chairman, CFO and Chief Administrative Officer, American International Group, Inc.

APPENDIX A-GNAIE Comments on Issues Outlined in the ED

Issue 1 - Definition of Fair Value

We would all agree that the objective of financial reporting is to provide information that is useful and comprehensible to those who might use them to base present and future decisions. To that end, financial reporting should also provide information about the economic resources of an enterprise, the obligation or claims to those resources and the effects of events that might affect those resources and claims.

For many reasons, fair value in the context of insurance achieves none of those objectives. It should be noted that sales of insurance products are not usually the arms-length transactions of investors. The nature of insurance is that for public policy reasons, buyers must be exposed to loss due to covered events. This “insurable interest” means that customers will pay to transfer risks that cannot be priced according to the Capital Asset Pricing Model. Based on classic economic theory, this model guides market participants to price risks that are systematic and diversifiable. A model such as this is grossly inadequate as it relates to insurance given the non-diversifiable nature and lack of transferability of insurance products. Further, we believe that no amount of development will close this gap between securities markets and insurance markets. The arbitrage forces that create discipline in the bond market would create unacceptable incentives in the insurance market.

Correlation through market prices alone does not capture measurement of profit and loss and its associated risks. Only measuring profits and losses on a deferral and matching system can capture these items adequately. The actual result from applying fair value can only be described as “measurement noise” that masks the true operating performance of insurers. To illustrate this, for life companies, fair value may artificially generate accounting losses at the inception of some policies while generating gains later on, rather than reflecting the true measurement of the enterprise’s performance, that is a steady margin of earnings on the policies a life insurer has issued.

If fair value were to be applied to property and casualty companies, the concepts of an underwriting profit and the combined ratio would be eliminated, leaving only measures that intertwine underwriting and investment performance and thereby encourage the discredited concept of “cash flow underwriting.” More importantly, using fair value eschews the ready comparison of property and casualty reserve balances to subsequent payments on those reserves in order to ultimately determine reserve adequacy. Reserve adequacy is the single most important factor in evaluating a property and casualty insurer.

In general, if fair value were to be applied to insurance liabilities, we are concerned that the Board would not recognize the uniqueness of these obligations. For one, insurance liabilities are not as some would term “community obligations” or liabilities that are readily transferable. Rather, they are negotiated contracts between a buyer and seller that are for many reasons legal, regulatory or otherwise, non-transferable.

If the Board is to continue the pursuit of fair value, the ED's definition of fair value **must** be modified to include the notion of transferability. The lack of transferability as it relates to many insurance contracts in our view cannot be overcome by applying fair value in a hypothetical transaction or otherwise. The legal impediment of certain liabilities that prevents them from being transferred causes any attempt to fair value these liabilities to be grossly inaccurate. Accordingly, we strongly recommend that the definition of fair value be modified as follows: *Fair value is the objectively determinable price at which an asset or liability that is legally and readily transferable could be exchanged in a current transaction between knowledgeable, unrelated willing parties.* Effectively, this definition as modified would exempt those insurance liabilities that are not transferable, or require the approval of the insured and/or regulator from fair value measurements.

Issue 2 - Valuation Techniques

The use of fair value for insurance liabilities, while presumably is intended to improve transparency and comparability of financial results between insurers, will result in increased subjectivity and judgment by an uninformed financial statement user and without the benefit of reasonable comparison to other insurance companies. This is because in most cases insurance contracts are not legally traded and the information required to benchmark them against does not exist with objective evidence subsequent to the pricing of the underlying product.

Specifically, when discussing the question of how enterprises would estimate the market value of an uncertain liability, accounting standards setters have agreed that fair value estimates should incorporate explicit consideration of the time value of money using current market rates of interest and explicit consideration of a "market value margin" or "market risk margin" that reflects a market consideration for the uncertainty in the amount (or its timing) to be paid to resolve the liability. However, given that there are no trading markets for insurance liabilities or reliable benchmarks, there is no place to calibrate these estimates.

For property & casualty insurance contracts, while it is true that current statutory accounting standards have determined that some level of discounting is appropriate (e.g., for claims with fixed and determinable payout patterns), it is still less evident that readers of financial statements will be better served if the discount rate is a constantly varying market rate of interest. Such a market rate of discount will end up causing substantial period-to-period volatility of results while obfuscating the more significant impact of changes in the underlying estimates of the ultimate costs of claims. Understanding the adequacy of the booked claims liabilities using the concept of loss reserve development is critical to the evaluation of non-life insurance enterprises, and most of the proposed accounting models make these evaluations more complex and difficult for readers of financial statements to understand.

The Casualty Actuarial Society released in May 2004 a study showing the efforts of two respected groups of actuarial consultants to estimate the amount of discount and the amount of market value margin that would be required under a fair value standard. While there was some disagreement between the two groups on the amount of discount estimated, there was substantial disagreement on the amount of market value margin estimated by the two groups and thus substantial disagreement

on how the original nominal value reserves compared to the sum of the discounted reserves and the estimated market value margins. The two groups of actuaries could come closer together if the accounting standards setters could exactly prescribe one method and one set of assumptions, but these prescriptions would be arbitrary and would eliminate the underlying precept that fair value is inexorably linked to the market.

As stated, GNAIE strongly believes that any attempt at fair valuation of insurance liabilities, intended to improve transparency and comparability of financial results between insurers, instead results in a subjective valuation without any means to ensure verifiability. Transparency and comparability is in fact completely lost.

Issue 9 - Level 3 Estimates

As proposed by the ED, application of fair value will require adjusting the discount rate or cash flows to reflect an entity's credit standing. In theory, the entity's credit reflects the value that the liability would be traded at. However, in fact insurance liabilities are not generally traded, transferable or reflect an increase or decrease in the credit standing of an entity. In certain instances, little if any pricing is determined by an entity's credit standing. Liabilities should represent the future claims on an entity's resources and not the artificial determination based on credit standing that a party deems to be appropriate at a given time.

We disagree with the Board's conclusion that valuations will not result in undue cost and effort. In some cases, Level 3 estimates will require multiple valuations to arrive at a so- called hypothetical fair value. To develop a fair value model will require an enterprise to consider inputs that are not readily available for insurance liabilities, thereby permitting an enterprise to use significant entity inputs or an entity's own internal estimates and assumptions. These valuations to attain the ED's proposed objective cannot be achieved without undue cost and effort for an enterprise that has a countless number of insurance contracts.

Issue 11 - Fair Value Disclosures

Accurate and reliable financial statements are the central feature of financial reporting. As such, the application of fair value is better suited for disclosure purposes (preferably within Management's Discussion and Analysis (MD&A)) and should **not** take the place of basic financial statements. Fair value disclosure is preferable as it fulfills the need to communicate information to interested parties allowing those parties to base decisions on market value estimates if they choose, but in no respects should fair value be the principal means in communicating the accounting information to readers. Accordingly, we believe fair value is better suited as a disclosure item only. Further, inclusion in the MD&A is appropriate given the expected lack of verifiability of the fair value of liabilities as it relates to insurance obligations.

Issue 13 - Other Issues

Recently, the Board has begun to deliberate the measurement issues associated with liabilities in its “Revenue Recognition” project. We fail to understand why the Board would consider re-measuring a contract at fair value at its inception. The implication is that if an enterprise were permitted to re-measure at fair value its obligations, it would be permitted to recognize upfront future profits prematurely. This is what some might refer to as “market jumping” to determine a fair value to justify up front profit recognition. We are concerned and alarmed at the direction the Board is taking on this project. Surely, there should be a presumption that if a transaction between unrelated parties dealing at arms length is completed it intrinsically represents fair value by its own terms.

A framework that relies on anything other than market verifiable fair values, cannot provide sufficient standardization to allow readers of financial statements to make meaningful comparisons of key information such as earnings growth, balance sheet strength and liquidity. Comparability ensures level playing fields across markets in accessing capital and ensures that capital resources remain fairly priced. The ED’s application beyond the stated scope could create an un-level playing field if insurers were to change their reporting to include irrelevant measurement noise.



**The GENEVA PAPERS
on Risk and Insurance
ISSUES AND PRACTICE
Special Issue**

**The Search for an International
Accounting Standard for Insurance**

**Special Report to the Task Force on Accountancy
of the Geneva Association**

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for the Study of Insurance Economics
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The Geneva Association

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The Activities of the Geneva Association

The International Association for the Study of Insurance Economics, or by its short name “The Geneva Association”, is a unique world organisation comprised of a maximum of 80 chief executive officers from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). It is a non-profit organisation. Its main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. It tries to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, it develops and encourages various initiatives concerning the evolution - in economic and cultural terms - of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. It provides a framework for its members to exchange ideas and discuss key strategic research issues, especially at the General Assembly where once per year over 50 of the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry. It seeks to clarify the key role that insurance plays in the development of the modern economy.

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Geneva Association Task Force on Accountancy

Introduction by the Task Force Chairman

The International Association for the Study of Insurance Economics, or by its short name “The Geneva Association”, is a unique world organisation comprised of a maximum of 80 chief executive officers from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). It is a non-profit organisation. Its main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. It tries to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, it develops and encourages various initiatives concerning the evolution - in economic and cultural terms - of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. It provides a framework for its members to exchange ideas and discuss key strategic research issues, especially at the General Assembly where once per year the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry. It seeks to clarify the key role that insurance plays in the development of the modern economy.

Following its 29th General Assembly in Washington in June 2002, attended by over 60 of the CEOs of the most prominent insurance companies worldwide, it was decided to establish a special Task Force on Accountancy. This Task Force is chaired by Mr. Claude Bébéar (President of the Surveillance Board, AXA Group) and me. Its aim is to research the critical accounting issues facing the insurance industry and to help facilitate the dialogue with other concerned/interested parties. It is to this end that the Task Force has appointed a Rapporteur, in Professor Gerry Dickinson, who has drafted the first report on this issue supported by the Task Force Members (usually the CFOs or Chief Accounting Officers of our members’ companies), which you now see before you.

It is very important to note that this report is not a Geneva Association or insurance industry position paper. There are no Geneva Association position papers since this organisation is concerned with research only and abstains from any lobbying whatsoever. It is a research document that has been elaborated by the Geneva Association, namely Professor Gerry Dickinson, with the help of the Task Force. While the members and especially Board Members of the Geneva Association, support the general idea of advancing the discussions in this area, they do not necessarily agree on each and every single point of the report. They are free from taking any personal and/or company positions in the future. However, their dedicated support and

willingness to sponsor the analytical work underlines the seriousness and relevancy of the issue to them. They hope to open up the dialogue with other stakeholders and exert an influence on a global scale to move the discussions in the proper direction. This direction is not predetermined by this report, which is, however, we feel, an appropriate starting point for going forward.

Jan Holsboer

Co-Chairman of the Accountancy Task Force

Former President of the Geneva Association

Claude Bébéar

Co-Chairman of the Accountancy Task Force

President of the Surveillance Board, AXA Group

Geneva Association Task Force on Accountancy

Foreword

The Geneva Association Task Force on Accountancy was established following a decision taken by our members at our 29th General Assembly in Washington in June 2002. It is chaired by Mr. Claude Bébéar (President of the Surveillance Board, AXA Group) and Drs Jan Holsboer (Former President of The Geneva Association). With this decision our general task of researching macroeconomic issues that are of strategic importance to the insurance industry was extended in an area that the insurance industry until recently did not regard as so critical to its business as it does now. The conceived wisdom had been that accounting rules and regulations would largely follow business procedures and try to describe what a company was doing in a (almost) disinterested way. It was thought that the relationship between management and the firm, on the one side, and accounting, on the other, was akin to a landscape and its photographer. The photographer would take the picture but had in principle no influence or impact on the landscape itself. The current debate suggests otherwise.

One of the key concerns of many CEOs and CFOs we talked to in the past months and a subject of important discussions at the Accountancy Task Force was how far changes in accounting rules would have a non-neutral effect on business practices and strategic decisions. Would tested and tried approaches – and maybe even certain lines of business – have to be abandoned because some idiosyncrasy in the accounting rules would make them either uninteresting or even counterproductive for insurance companies? This concern is shared by economists who believe that efficiency in our economy is achieved through taking management decisions that are not (unduly) influenced by the observation framework that accounting systems set. As Professor Gerry Dickinson argues, the accounting standard should ideally reflect best practice. He writes that "Financial statements should be neutral and reflect the underlying business models that are used; compliance with an accounting standard should not influence commercial decisions." There is a certain logic also that the internal accounts used by companies to run their business should be broadly the same as published financial statements. To revert back to the allegory of the photographer above: As recent accounting scandals have highlighted, it is counterproductive if the model dresses up only and specifically for the occasion of the photo shoot. The picture taken by the photographer should depict reality not an artificial condition. The same applies to accountants portraying a company's situation. It will be a huge task to develop our current, not wholly satisfactory, accounting systems in the future without losing sight of this fundamental issue.

Another set of problems arises from the following. In principle, accounting standards are based on transactions and are not enterprise or sector specific. This ensures consistent measurement and comparability across industries. Professor Gerry Dickinson describes how there is a weakness in this approach when the economic substance of a set of transactions cannot be captured by a simple aggregation of individual transactions. The decision interdependency between assets and liabilities, which is causal in nature and which cannot be captured fully by measuring correlations through market prices plays a key role in insurance, but also in commercial banks. The logic of insurance solutions resides precisely in its economic function of risk aggregation and (re)distribution where the sum of the individual parts differs from the exposure of the resulting portfolio. The economic discipline has unfortunately not yet progressed far enough in this field to produce a coherent and comprehensive theory that would completely describe portfolio effects and associated risk structures and exposures. In this area, too, The Geneva Association would hope to stimulate further understanding through our activities that encourage the work done by economic researchers and experts in related fields like accounting. The current attempts by the IASB to design a better and more efficient framework for accounting in the future are therefore an important and encouraging initiative, which will benefit from an open dialogue that we intend to support.

The Geneva Association's "International Conference on Insurance Accountancy: A Dialogue on Issues, Challenges and Potential Solutions" which will take place on 3 March 2003 in London, at Chatham House, will be an important activity to promote the dialogue and understanding of this complex field. The conference will include as many stakeholders in the debate as possible but the number of participants will be kept to a manageable level so as to facilitate productive discussions. It will bring together the top management, CEOs, CFOs and Financial Directors, of insurance companies with the leaders of other organisations that have an interest in accounting issues relating to insurance. Please contact The Geneva Association for further information.

It is a key part of our mandate to conduct, promote and develop research into topics that are of strategic importance to insurance. We encourage initiatives concerning the evolution - in economic and cultural terms - of insurance, risk management and the notion of uncertainty in the modern economy. This is achieved through open dialogue and co-operation with any and all interested and affected parties. It is in this spirit that we wish to further the understanding of the complex accounting problems and have decided to publish this document.

Patrick M. Liedtke
Secretary General
The Geneva Association

THE SEARCH FOR AN INTERNATIONAL ACCOUNTING STANDARD FOR INSURANCE

Report to the Geneva Association Task Force on Accountancy

by Gerry Dickinson¹

ABSTRACT

The paper seeks to provide an understanding of the background to the search for an international standard for insurance contracts, which was initiated by the International Accounting Standards Committee (IASC) in 1997 and is still proceeding under its successor, the International Accounting Standard Board (IASB). To do this the paper traces the evolution of the fair value initiative of the IASC/IASB which at the outset was designed to be for all financial instruments, but over time has been amended as the standard setters realised that there would be major problems of implementation, after listening to the views of preparers, particularly the commercial banks, and users, including financial services regulators. The paper identifies the origins of the fair value framework as emanating from an earlier accounting framework based on current values that was intended to be applied generally to all enterprises. The current value initiative, although conceptually sound, has only been adopted in part, again because of problems of implementation. The theoretical underpinning of the current value and fair value accounting approaches are discussed. The paper attempts to show why any early resolution to the insurance contracts project has proved so difficult. This difficulty is evidenced by the fact that insurance contracts have been excluded from the scope of the accounting standard for financial instruments in the United States, FAS 133, as it was clearly recognized that there is no ready market to trade and hence determine fair values for insurance contracts. The paper concludes by addressing some general factors that must be kept in focus when developing an international accounting standard and some particular factors that should be considered if there is to be a workable and transparent system of financial reporting which captures the economic substance of the commercial operations of insurance companies. Part of the suggested solution is to integrate the insurance contract project more into the revised proposed standard for all financial instruments, IAS 39, and for the IASB to work more closely with insurance companies, especially with their in-house accountants and actuaries. This greater co-operation is now possible as the project moves into the field-testing stage.

¹ Professor, Sir John Cass Business School, City of London, and Honorary Vice Secretary General, The Geneva Association.

EXECUTIVE SUMMARY

The insurance industry is a major industry that not only plays a key role within the financial system but also has an important socio-economic function. In 2001, the global insurance industry had premium revenue of US\$ 2,408 billion, US\$ 1,439 billion from life insurance contracts and US\$ 969 billion from non-life insurance contracts (Sigma, Swiss Re, June, 2002). In addition, it is globally the largest of the institutional investors, with financial assets of about US\$ 12,500 billion in 2001. One of the key socio-economic roles of life insurers is to mobilize long term saving, especially for retirement provision, while non-life insurers and reinsurers are the main private sector providers of risk financing for natural catastrophes and man-made disasters. Hence sound international accounting standards should help, albeit indirectly, to underpin these financial and socio-economic roles.

i. Key conclusions

With the greater globalization of business and internationalization of capital markets, it is generally agreed that the search for international accounting standards is a most desirable objective for both preparers and users of financial statements. It is also broadly agreed that international accounting standards based on sound accounting principles are better than those based on detailed rules which can be too prescriptive. At the same time there are a number of factors that must be kept in mind in designing an international standard, some general in nature and some specific to insurance. These are discussed below.

Conclusion 1: Accounting standards and emerging economies

First, an international standard must be capable of being adopted not just by enterprises in developed economies but also over time by enterprises in emerging economies where local commercial and capital market conditions are still evolving. Standards should establish a framework to which emerging economies can gradually improve their financial statements. This suggests a more evolutionary approach than introducing a new unproven system.

Conclusion 2: Aggregation of individual transactions

Second, accounting standards are based on transactions and are not enterprise or sector specific. This ensures consistent measurement and comparability across industries. However, there is a weakness in this approach when the economic substance of a set of transactions cannot be captured by a simple aggregation of individual transactions. This is the case for the core transactions of insurance companies, and indeed commercial banks, where there is a decision interdependency between assets and liabilities, which is

causal in nature and which cannot be captured fully by measuring correlations through market prices. An accounting system based on fair values alone does not capture this economic substance, in particular the measurement of profit and its associated risks. Measuring profits on a deferral and matching system is better suited to capturing these interdependencies, even though there is a need to adapt and strengthen the deferral and matching methods currently in use. Economic substance should always take precedence over form. These issues will become more evident to the IASB as it undertakes more field tests on the feasibility of its proposals within insurance companies in different countries.

Conclusion 3: The comparability of information

Third, an accounting standard requires that financial statements provide sufficient standardisation across enterprises to allow existing and potential shareholders, creditors and other users to make meaningful comparisons of key information, such as the level and growth in profits (earnings), balance sheet strength and liquidity. This comparability of information is particularly important to ensure that there is a level-playing field in the access to external capital and from the wider macro-economic perspective that capital as a resource is fairly priced. If all accounting transactions in all industries were measured on a system based on fair values, then one would have a logically consistent framework which would provide this comparability, even though the framework is not as theoretically robust as was sometimes thought, because of the existence of bubbles from time to time in asset prices. Industrial or non-financial services enterprises are not required to value their fixed assets at current or fair values in their core accounts nor are they required to value their corporate borrowings, including their corporate debt that is actually traded, at fair values. The prevailing standards, which will continue for the foreseeable future, mean that industrial firms will operate within a mixed measurement system, based on modified cost values and on accrual and matching principles. Similarly, commercial banks will not be required to report under a fair value system for the foreseeable future and they will continue to measure their profit broadly on an accrual and matching system. It could create an unlevel playing field if insurance companies were required to radically change their reporting such that their financial statements entailed a good deal of measurement noise, some of it irrelevant noise, when their competitors for capital are not required to do so.

Conclusion 4: The demand for greater transparency

Fourth, in the post-Enron and World-Com environment there is a demand for greater transparency and more caution in respect of early income recognition. In recent years there has been more transparency in the financial statements of insurance companies, often through more disclosures in the notes to their accounts, viz. information on embedded values, fair values of

assets, risk measures, etc. Some life insurance companies have gone even further and have published detailed Supplementary Financial Statements to complement those in their main Report and Accounts, using a different valuation basis. These disclosures have been more than those required under either accounting standards or the listing requirements of stock exchanges. Even so there is scope for more insurance companies to follow the example being set by these progressive companies.

This trend towards greater transparency has arisen mainly in response to the growing demands of financial analysts and other users, but also because management have seen the commercial benefit of more disclosure of relevant information since it helps to strengthen the trust on which the insurance business is built. Moreover, as leading institutional investors, insurance companies are well aware of the need to provide relevant and timely information to the capital market.

Under fair value accounting measurement, there is the inherent potential for the capitalisation of future profits, especially on long term insurances. Even though any up-front profit recognition can technically be allowed through an appropriate unwinding of discount rates and risk margins, this is a somewhat artificial adjustment. Best practice actuarial valuation systems achieve more naturally an appropriate pattern of profit recognition over time.

Conclusion 5: Prudence in financial reporting

Fifth, there has always been some concern that insurance companies and commercial banks have a degree of prudence in their reporting policies, because of the underpinning role that they play within the financial system. Financial stability within the financial system as a whole depends on sound financial institutions. Having some degree of prudence does not have to be at the expense of transparency. Moreover, one conditioning factor that the IASB must keep in mind when deciding on their final standards is that one of the users of the new financial statements will be insurance and banking regulators and supervisors.

One particular accounting issue associated with prudential reporting is how to allow for inherent uncertainty in setting aside provisions for large scale potential losses in non-life insurance, especially non-life reinsurance. This is because the amounts set aside to cover future claims liabilities, even if based on realistic forecasts, are exposed to very large potential error due to the nature of catastrophic events or uncertainty in estimating the probabilities of rare events. The IASB has so far considered that catastrophe or equalization provisions should not be recognized, but some further attention should be devoted to this issue, including the possible earmarking of capital which could also be easily identified for selective tax treatment.

Conclusion 6: Reflecting best practice

Sixth, the accounting standard should ideally reflect best practice. It is generally agreed that the internal accounts used by companies to run their business should be broadly the same as published financial statements. Financial statements should be neutral and reflect the underlying business models that are used; compliance with an accounting standard should not influence commercial decisions. Measuring the fair values of insurance liabilities (i.e. a portfolio of insurance contracts) is not a practice carried out by any insurance company, hence the problem that the IASB is currently facing in trying to develop a method of measurement. Because of the increasing use by insurance companies of risk-based capital systems for financial planning and control purposes, more realistic and market-related valuation models are being used, including embedded value or achieved profit models. But these models are not fair value models. Even if a fair value framework could be developed, it is unlikely that even the most progressive insurance companies would switch from their existing internal accounting systems that they have developed for corporate planning and control purposes. The danger of a mismatch between internal accounting systems and external reporting systems is all too clear. This is that an external accounting standard might over time change internal accounting systems, with the result that the processes and products of insurance companies may be altered so that they are not fully congruent with an optimal competitive strategy.

Having an international accounting standard which is aligned with internal accounting systems is also beneficial to shareholders and other users of accounts; if financial statements reflect the underlying decision-making processes, they will be more reliable in monitoring financial performance over time and in assessing profit forecasts and other financial forecasts of management. Greater insights will be gained on this by the IASB as it progresses with its field tests within insurance companies, especially in discussions with in-house accountants and actuaries.

Conclusion 7: The mix of international accounting standards

Seventh, insurance companies will have to adhere in the future to a mix of international accounting standards, but those relating to the financial instruments are clearly the most important. It should be kept in mind that the conceptual framework that has been developed under the amended IAS 39 will be the defining framework when it emerges as an IFRS (International Financial Reporting Standard). The insurance contract project, when complete, will have to dovetail into this. The financial instruments project has evolved into a mixed measurement system and according to the IASB 'will be in place for a considerable time'. Hence even if fair value remains on the agenda of the IASB, it is now on the long-term agenda. The reaffirmation of the four main classification categories for financial assets in the amended

IAS 39 and the decision to allow enterprises to choose to use fair value for those categories of financial assets not defined as being held for trading shows that the IASB is willing to accept a more evolutionary approach. The IASB has clearly been listening to the external opinions of preparers, users, auditors and regulators.

Although not clearly articulated in the amended IAS 39, the inherent logic of these four classification categories is that they should apply not only to financial assets but also to financial liabilities. There is an example of this in the treatment of the corporate debt issued by an enterprise. This can be viewed as being consistently defined within this framework as an originated liability and is thus required to be measured at amortized value, unless the enterprise voluntarily designates the corporate debt as being held for trading or available-for-sale when it would be measured at fair value.

ii. The way forward

What is the way forward for the insurance contracts project? There is a case for arguing that insurance contracts are long-term service agreements (long-term contracts which entail the supply of services) and hence they should not to be considered as financial instruments. But the more pragmatic view, given the wider standards initiative, is to consider insurance contracts as complex financial instruments, including services and embedded options, but accepting that to calculate their fair values will prove very difficult and subjective. This is because they are non-traded instruments and because the information to benchmark them against traded markets is very limited. Moreover, even if the insurance contracts project could come out with a credible and objective method for measuring the fair value of insurance contracts as financial instruments, any compulsion to use these values would be inconsistent within the framework of the amended IAS 39. This is because insurance contracts are both originated and held-to-maturity liabilities.

Within a scenario that fair values for insurance contracts can be measured objectively and with a sufficient consensus, which is a low probability scenario, the amended IAS 39 framework would imply that insurance companies could voluntarily designate their insurance contracts as available-for-sale or held for trading and thus carry them at fair values, albeit with different treatment as far as profit measurement is concerned. Such a voluntary designation would allow some consistency in the treatment of assets and liabilities. Where investments are broadly duration matched against policyholders' liabilities to reduce interest rate risk, such as for annuity business, these liabilities (insurance contracts) could remain as originated liabilities, with the matching assets being measured at amortized values. Similarly, in other areas where the matching between assets and liabilities is less strong, and where the investments would probably be classified as

available-for-sale, the insurance liabilities could also be designated as available-for-sale. The use of the system of voluntary designation would allow insurance companies some flexibility in reporting. This flexibility in reporting would not undermine the ability of the main users of financial statements to make consistent comparisons between insurance companies, providing there is adequate disclosure of relevant information in the notes to the accounts or in supplementary financial statements.

In the light of the above discussion, the suggested way forward is to allow a limited number of valuation methods based on realistic, market-related assumptions that are currently in use and considered to be best practice in liability measurement. These might be viewed as being broadly equivalent to fair value. Some choice, even if limited, of valuation methods would be desirable, as this would be more in line with an accounting standard based on principles rather than on rules. Insurance companies could still be encouraged, or required, to include estimates of the fair values of their policyholders' liabilities (insurance contracts) and those of their financial assets in the notes to the accounts, where this is feasible.

In addition, there is a case to identify a set of principles, if not an alternative framework based on best practice, which would allow more standardization within financial statements in the methods of valuation used to calculate policyholders' liabilities in life insurance companies and those in non-life insurance companies. This should be determined on a portfolio basis and be capable of being used in an appropriate asset-liability framework, but it would need to be designed in a way that could be seen as 'broadly equivalent' to amortized values to be consistent with IAS 39 and its IFRS successor. In addition, there is also strong case for looking at best practice among deferral and matching systems for profit measurement. Profit and loss accounts (income statements) do not have to be measured on exactly the same basis as balance sheets and, more importantly, they provide different information to the users of financial statements; for example, shareholders and financial analysts are likely to focus more on income statements, with creditors and regulators focusing more on balance sheets. These investigations could be included within Phase 2 of the insurance contracts project, and could run along side further research work on fair values, since there would no doubt be useful insights to be gained from looking at both approaches together.

THE SEARCH FOR AN INTERNATIONAL ACCOUNTING STANDARD FOR INSURANCE

1. Introduction

The search by the International Accounting Standards Committee (IASC), and its successor the International Accounting Standards Board (IASB) set up in January 2001, for an international standard for insurance contracts has entailed much analysis and debate and so far there is still no clear consensus on the way forward.

Since 1997, the IASC/IASB has been actively developing a conceptual framework that has sought to measure all financial instruments at fair values, wherever feasible. Fair value is defined by the IASC/IASB as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable parties in an arm's length transaction; the benchmark for measuring fair value is market value, if the asset or liability has a secondary market, or an estimated market value if it does not have a secondary market. But during 2002 this fair value initiative has come under more opposition from a majority of national insurance regulators and supervisors and from most of the major international insurance and reinsurance companies. This opposition has arisen from a mixture of concerns: (i) the feasibility and appropriateness of applying fair value to insurance contracts (policyholder liabilities); (ii) the impact of a fair value system on the volatility of reported profits (net income); and (iii) a perception that more pressure is being placed on insurance companies to adopt a fair value measurement system than commercial banks, since commercial banks would be exempted from the requirement to apply fair values on their core financial assets and liabilities under the general financial instrument standard, IAS 39. In addition, insurance companies have also seen other concessions to a compulsion to apply fair value measurement in other standards, such as investment property (IAS 40) and agriculture (IAS 41).

- The unease of the insurance supervisors is evident in the letter from the International Association of Insurance Supervisors (IAIS) to the IASB on June 20, 2002. The IAIS, which is based in Basel, represents the insurance supervisors from 100 member countries, including all the OECD countries and many emerging countries.
- A stronger response has come from the insurance industry in a series of letters which were sent to the IASB during 2002. Concerns were expressed in letters on March 21, 2002, and June 11, 2002, from the American Council of Life Insurers, the German Insurance Association and the Life Insurance Association of Japan and in a letter of September 17, 2002, from the American Council of Life Insurers, the American Insurance Association, the German Insurance Association and the Life

Insurance Association of Japan. In addition, a letter was sent on September 18, 2002, from the chief financial officers in a group of leading European insurance companies and a further letter on October 11, 2002, from the chief financial officers from a group of twenty leading European, American and Japanese insurance companies.

The search for an accounting standard for insurance contracts is a priority project for the IASB, since its predecessor, the IASC, developed no standards for insurance contracts, having excluded insurance contracts from its general 'fair value' standard for financial instruments, IAS 39. This urgency has been prompted by the statutory requirement under the *Financial Services Action Plan* of the European Union, approved by the European Parliament in March 2002, that all EU listed companies must adopt the IASB standards for their consolidated financial statements from 2005 onwards. Member states of the EU may defer application until 2007 for companies listed both in the EU and elsewhere where they currently use US Generally Accepted Accounting Principles (US GAAP) or another approved national accounting system.

IASB has standards in place for other financial instruments, some of which are being amended under its Improvement Project. But this means that the IASB must provide some accounting guidance on insurance contracts, if not a full standard, with sufficient time to permit the affected insurance companies to adopt it by 2005. The IASB standard will certainly become European. Whether or not it is adopted for general international use depends on wider considerations, not least a greater convergence with US standards.

This paper seeks to position the search for a standard for insurance within a wider context. It also seeks to identify some of the conceptual and operational problems why it has proved difficult to develop a recognition and measurement standard for insurance contracts based on a fair value approach. While the IASB seeks to cover all insurance contracts, as defined by IASB, the focus of the paper is on insurance contracts underwritten by insurance companies. Finally, the paper discusses issues that still need to be addressed and advances some proposals that could be considered by the IASB in its search for a logically consistent and workable standard.

2. The search for an international accounting standard

National accounting standards in various countries have evolved in different ways, conditioned by national legislation, domestic stock market listing requirements and by the accounting profession itself. With the greater globalization of insurance operations, there is a need for more standardized reporting systems for the overseas networks of subsidiaries and branches of global insurers and to allow for an easier consolidation of group accounts. As

some of the larger international insurance groups have sought additional listings outside their domestic stock markets, this has also put pressure on having a more standardized accounting approach.

Within Europe, the *Financial Services Action Plan* has mandated common accounting standards for listed companies within the European Union, which will also be adopted by Switzerland and Norway. At the same time, the International Organization of Securities Commissions (IOSCO) has been co-operating with the IASB to establish minimum standards for reporting and disclosure requirements to ensure national stock markets operate to a high standard and to ensure sound international surveillance of securities transactions, with more multiple listings and the greater internationalization of investment holdings. This link with IOSCO, which includes the US Securities and Exchange Commission (SEC), gives a particular influence to IASB standards. This is because under an agreement in 1995, if the IASB can come out with a range of standards of acceptable quality, IOSCO will support companies to obtain or retain listings using these standards on stock exchanges worldwide, subject to the approval of each national exchange. Thus, the priority is both European and international.

It should be stressed that regulators within national securities markets, when not governed by regional requirements, such as the EU, have the ultimate authority to decide what accounting standards will be required within their capital markets. Hence IASB standards must be of acceptable quality to meet these requirements, if there is to be no separate reporting or statements of reconciliation between the IAS standard and the various national standards. IAS, now to be renamed International Financial Reporting Standards (IFRS) by the IASB, must also be consistent with national company and commercial laws regarding reporting and disclosure, but these may be more easily met than the demands of securities regulators. The SEC is perhaps the most demanding of these, because of a well-developed US GAAP and the size and international nature of US capital markets.

Further, and with the endorsement of the SEC, the US Financial Accounting Standards Board (FASB), signed a memorandum of understanding with the IASB in October 2002, to seek to reduce the existing differences between IFRS standards and US GAAP in order to accelerate progress towards the attainment of global accounting standards.

3. Earlier attempts to introduce current value and fair value accounting

From the 1960s onwards the theoretical developments in financial economics within business schools and economics departments, especially in the areas of capital budgeting, the measurement of the cost of capital, the valuation of the firm and the information efficiency of the stock markets, had a significant impact on traditional accounting concepts. The emphasis in the

accounting valuation of assets/liabilities moved more towards that employed in economics, where the value of an asset/liability is the present value of the expected future net cash inflows/outflows that are generated by the asset/liability discounted at a risk-adjusted rate of interest, reflecting the opportunity cost to the providers of capital.

The theory (hypothesis) of information efficient capital markets came initially out of the University of Chicago, but then gained widespread acceptance across academia and the business world. This provided a further underpinning of the current value approach. Within this theoretical framework, the best way of estimating the expected future income streams (cash flows) of an enterprise from the shareholder or capital provider perspective is within a well-traded capital market; the consensus of views from informed participants in a deep and liquid capital market would provide the best determination of intrinsic value at a point in time. And it implicitly takes into account the degree of risk aversion among investors within the capital market. Hence an enterprise could be considered from the shareholder perspective as a bundle of risky assets and liabilities, whose overall value could be determined by the summation of the individual values placed on them in a well-informed and deep capital market.

Another aspect of the theory of finance which supported the view that the enterprise could be viewed as a simple aggregation of separate assets and liabilities, including risky assets and liabilities, was the theory of capital structure developed by Modigliani and Miller in the mid-1960s. This theory posited that subject to a number of assumptions, investment decisions of the enterprise can be considered to be independent of how they are financed, debt (fixed or floating) or equity. In other words, the valuation of assets and liabilities of an enterprise can be considered to be independent of each other as far as the stock market is concerned. This meant that cross-balance sheet risks did not need to be considered, thus in effect ruling out the relevance of asset-liability management for any enterprise. Although this theory of capital structure can be challenged on the grounds of its restrictive assumptions, it removed a further obstacle facing current value accounting theory since it permitted the simple aggregation of risky assets and liabilities without the need to consider any potential cross-balance interdependencies arising from management decisions.

But there were other more practical factors that were beginning to change the thinking within accounting circles. With high inflation caused by the oil shocks in the mid-1970s and early 1980s, the reliability of accounting figures based on historical cost were being put under strain. High levels of inflation caused a major distortion in reported profits and there were aggregation problems with assets and liabilities generated over time. During this period, professors of accounting and many professional accountants sought to move accounting valuation systems away from historical cost accounting toward current value accounting.

In addition, with the growth of mergers and acquisitions there was a realization that balance sheets based on historical cost produced unrealistic valuations, which often resulted in restatements of balance sheets in order to obtain more realistic, market-related valuations in take-over or merger negotiations. A particular problem with balance sheets based on historical cost meant that goodwill tended to be higher than it should be; a revaluation of balance sheets to a current value basis meant that goodwill was reduced to more realistic and defensible levels.

It was this interplay of academic rethinking of accounting concepts and these practical problems which had the effect of pushing the accounting profession and national accounting standard setters, including the IASC, towards a system based more on current values, which was later renamed 'fair value', with some minor changes in its definition.

If a comprehensive system could be developed based on market-related valuations, it would be better than one based on historical cost that were, after all, market values at arbitrary dates in the past. When one follows the debates within national accounting standard setters, or those within IASC/IASB, it is clear that the aim has been over the last two decades to have a conceptual framework for accounting based on current or fair values for most transactions in all industries.

But the reality has been rather different. The problem of implementation has proved a greater stumbling block than expected. On the valuation of plant and equipment (fixed assets) the intention to estimate the current or fair value proved too subjective, difficult and costly to apply. This difficulty should not have been surprising, if a closer dialogue had taken place earlier with executives within the companies themselves. The practical difficulty was how to estimate the market-related value of an integrated production facility when: (a) there is no traded or secondary market for plant and equipment; and (b) even if a market value could be estimated, the value of these fixed assets as part of an integrated production facility would have a different *value-in-use* than if sold (realized) in a hypothetical secondary market.

Even though the pursuit of fair value continues, practice in many cases still remains wedded to the historical cost approach and to deferral and matching models. The 'Holy Grail' of fair value for fixed assets for industrial enterprises has not been fully achieved in practice, even though the intention is still there within the IASB and within a number of other national standard setters. For example, under IAS 16 industrial companies can still opt to use the fair value for plant and equipment rather than historical cost, if they wish.

There are other reasons why the historical value system has remained, even though companies are encouraged to revalue assets from time to time towards what might be considered fair value. Many companies have done this voluntarily for commercial reasons. Moreover, in a world with lower inflation rates, the biases inherent in historical cost accounting are less. Nevertheless,

the current prognosis is that the aim of having a comprehensive accounting system based on fair values is unrealistic and that the associated lack of consistency will mean that it is a mixed system, with different bases of measurement for different types of transactions. This patchwork nature results from pragmatic compromises, in part a consequence of having accounting systems which are based on transactions rather than on the enterprise as a whole, or which reflect the sectors in which enterprises operate.

A further influence that has encouraged the maintenance of a simpler accounting system has been the demands from financial analysts and stock markets for more frequent reporting. There is a trade-off between the supply of timely information and the detail and complexity of the financial information provided, especially if there is a trend towards quarterly reporting, as evidenced by the recent proposal from the European Commission. Moreover, even though companies may have to formally report on a quarterly basis, many publicly traded companies are often under pressure to provide financial information more frequently to financial analysts and other parties.

4. Evolution of accounting standards for financial instruments

It is also important to set the current accounting initiative for financial instruments in a broader context. The process began in the late 1980s and early 1990s because of the growing use of derivatives by industrial and financial services firms for hedging purposes, and indeed by investment banks that were directly engaged in creating and trading in derivatives. Financial derivatives transactions were not adequately covered by existing accounting standards; it was often not clear from published accounts whether industrial or financial services enterprises had engaged in hedging or trading activities with derivatives and the associated unrealized gains or losses were not adequately disclosed in the published accounts. This caused distortions or lack of adequate information in financial reporting.

The wish to address the inadequate accounting treatment for financial derivatives led to a widening of the scope of the investigation to include all financial instruments, not least because transactions in financial derivatives were often linked to transactions in financial instruments. This widening in scope meant that a much broader set of transactions was now brought into the analysis.

It was clear from the outset that a project on financial instruments must cover the transactions of the main two financial intermediaries: commercial banks and insurance companies. Thus its scope must embrace bank loans and deposits and insurance contracts. The fact that bank loans and deposits and insurance contracts can be long term in nature, entail a significant consumer servicing aspect, and are not traded in secondary markets

posed measurement problems not found in many financial derivative contracts. Nevertheless, it was considered by the IASC, and indeed other national accounting standard setters, such as FASB in the US and ASB in the UK, that financial assets and liabilities could be more easily measured on a fair value basis than plant and equipment for industrial firms.

In 1997, the IASC produced a Discussion Paper to develop a new standard for the recognition and measurement of financial instruments. It proposed that all financial instruments should be measured at fair value. It was clear from the invited comments to the Discussion Paper there would be opposition to the proposals and there would also be a number of technical problems in measuring fair values for some financial instruments, especially those not traded on financial markets.

Because of the wish to progress quickly with a standard on the recognition and measurement of financial instruments, the IASC decided to adopt a two-stage approach. The first was to develop a standard that entailed compromises from fair value but which could be amended later. The second was to set up a longer-term project in partnership with a group of national standard setters to investigate how fair value could be applied to all financial instruments. This was the Joint Working Group (JWG) which was set up in 1997 and consisted of the representatives of a fast track group, the G4+1 group, from Australia, Canada, New Zealand the United Kingdom and the United States, and national standard setters from France, Germany, Japan and the Nordic countries.

For both stages, it was considered that insurance contracts might pose more difficult measurement problems and so it was decided they should be separated from the financial instruments project and analyzed separately. But there was the intention of bringing them back later and integrating them into the wider financial instruments project. This meant that the main transactions of insurance companies would be split and their measurement analyzed separately: policyholder liabilities would be covered under the insurance contract project while the investments of insurance companies would be covered under the wider financial instruments project.

The Discussion Paper for stage 1 was presented for outside comments in 1997, but it was clear early on that the banks, especially the commercial banks, did not think that it was realistic or meaningful to measure loans and deposits at fair values. In particular, they considered it inappropriate to measure fixed rate loans at fair value in their balance sheets and to bring the changes in fair values during an accounting period directly into their profit and loss accounts (income statements). To do so would mean that interest rate changes from period to period would cause volatility in their shareholder equity (capital and reserves) and cause potential capital adequacy problems if interest rates rose sharply in the short term, when not supported by the commercial reality of the underlying loan contract and its associated financing. In addition, there would be inherent volatility in reported profits

(net income) not fully related to the economic substance of their commercial activities. There was also adverse reaction from bank regulators, not least the Basel Committee on Banking Supervision, with its strong political influence due to its reporting line to the finance ministers and the central bank governors of the countries of the Group of 7 (now Group of 10).

There was some adverse reaction from insurance companies, since it required them to impute fair values to loans and other non-traded investments, and by life insurance companies in particular since it required them to impute fair values to their portfolios of bonds held to immunize the long-term interest guarantees offered within their life insurance and annuity books of business. But the reaction from the insurance sector was less vocal than that from the banks, in part because they could not see the full picture yet, as insurance contracts were excluded from the scope of the Discussion Paper.

The Discussion Paper was modified through further compromises until it was approved by the IASC Board in December 1998 as **IAS 39, *Financial Instruments: Recognition and Measurement***. The main feature of IAS 39 for the valuation of financial assets is that some assets must be measured at fair value while others can be measured at other than fair value. Financial assets that are defined as ‘held for trading’ and financial assets defined as ‘available-for-sale’ must be at fair values. Those financial assets exempted from the requirement to be measured at fair value are:

- (a) loans and receivables that are created or originated by an enterprise and not held for trading (at amortized value, with adjustment for impairment (default));
- (b) investments with fixed maturities where the enterprise intends and is able to hold to maturity, mainly fixed rate securities and some redeemable preference shares (at amortized value, with adjustment for impairment (default));
- (c) financial assets defined as ‘available for sale’ whose fair value cannot be reliably measured, generally limited to some unquoted equity securities and forwards and options on unquoted equity investments (at cost-related basis, with adjustment for impairment (default)).

These exceptions were major compromises to the original fair value proposals, and have produced a mixed system of valuation. It is clear that the pressure from the banks and the bank regulators was a telling factor in this. These changes meant that commercial banks could now avoid the volatile effects from changing stock market, interest rates and other major external influences on their equity capital (capital and reserves) and on their reported profits (income).

Another decision by the IASC within IAS 39 was that long-term corporate debt and other fixed rate borrowings of any enterprise, whether an industrial concern or a financial services company, would not have to be

measured at fair value. This also reflects one of the inherent problems with the fair value approach. If fair values were to be used for corporate debt, it would be incompatible with plant and equipment when not measured at fair values, especially if the fixed rate borrowing has been used to finance the plant and equipment. This is a special case of the need for consistency between the measurement of assets and liabilities, a problem that has a much greater significance for insurance companies and banks.

Concurrently, the JWG of Standard Setters continued to pursue their task of seeking to extend fair value to all financial instruments until December 2000 when it produced *'Draft Standard and Basis for Conclusions – Accounting for Financial Instruments and Similar Items'* for public comment. There were a large number of responses, most of which were critical of many of the proposals. The commercial banks and the banking associations were particularly strong in their opposition, as they had been earlier. In the meantime, the IASB replaced the IASC in January 2001.

In May 2001, the IASB held its first meeting with its 'partner' national standard setters from Austria, Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. During the discussion of the Financial Instruments standard, it became clear that the IASB would not be able to review the comments letters and complete the work started by the Joint Working Group in time for the European Union companies to adopt it for implementation in 2005. Of special concern was the need to have systems changes in place by year-end 2003 so that companies could start preparing their comparable statements for previous years.

At that meeting, IASB decided to move the full fair value project to 'active research' status and focus its financial instruments efforts on improving the current standard by proposing minor changes to resolve some conflicts with the US standards, FAS 133 and FAS 115, and deal with some of the issues raised in practice. They also agreed to forward all the responses they received to the Canadian standard setters who agreed to review them and present their findings at a subsequent meeting. Clearly, the newly formed IASB did not place a high priority on pushing forward the JWG proposals on fair value since (a) it already had a standard, IAS 39, which was mostly agreed, and (b) there were many practical and political problems to solve which were unlikely to be resolved by the time of the expected EU 2005 deadline. The activities of the JWG, which was set up under the former IASC, were discontinued.

Paralleling the evolution of IAS 39 has been *IAS 32, Financial Instruments: Disclosure and Presentation*. The IASC Board approved IAS 32 in 1995, with updates in December 1998 and October 2000 to ensure consistency with IAS 39. It deals with general principles of disclosure and presentation and not with the detailed structure of financial statement and has been less contentious than IAS 39. Its scope covers insurance companies as well as banks and other financial institutions.

In June 2001, the newly formed IASB announced as part of its initial programme a project to amend IAS 39 and at the same time to revise IAS 32, where necessary, to remove duplications and inconsistencies with IAS 39. The Board invited the IAS 39 Implementation Guidance Committee to function as an Advisory Committee to the Board in identifying and reviewing issues that need to be addressed on the project to improve IAS 39 and IAS 32. The Basel Committee on Banking Supervision, IOSCO and European Commission have observer status on the Committee.

In June 2002, the Board published an *Exposure Draft of Proposed Amendments to IAS 32 and IAS 39*, and invitations for outside comments were closed in October 2002, with the intention of their implementation into the standards in 2003. These proposed amendments do not press the case for a greater use of fair value for the two standards. Moreover, they reinforce a distinction between classifying financial instruments *held for trading* which would be governed by the original fair value framework from those *not held for trading* which are not required to follow the framework. This flexibility reflects in part the unresolved measurement problems of fair value and in part a wish of the new Board to accommodate the strong external views expressed against (a) a comprehensive application of fair values to all financial instruments and (b) any associated requirement to record all changes in fair values into profit and loss accounts. The IASB stated in its June 2002 Exposure Draft that ‘With one exception (i.e. financial liabilities which are designed with the purpose of being repurchased in the near term), the greater use of fair values would be optional. It is not proposed to force entities to measure more financial instruments at fair values’ (IASB, June 2002, p. 281). It also stated that ‘The Board will continue its consideration of issues relating to the accounting of financial instruments. It expects, however, that the basic principles in the improved IAS 32 and IAS 39, once finalized, will be in place for a considerable time’ (IASB, June 2002, p. 266). These statements were presumably made to reassure preparers and users of accounts that once agreed there would be sufficient stability in the reporting standard for their own planning and decision-making purposes. However, it should be noted in the first part of the last statement that the Board still wishes to keep open the possibility for further change to these standards in the longer term.

The June 2002 Exposure Draft, however, has been reworded so that enterprises would now be able to adopt the full fair value framework, if they so choose, for the three main categories of financial assets that are not held for trading. The Exposure Draft introduces a new concept which is that financial assets can be designated as held for trading, even though there may not be the management intention or ability to trade them. Hence financial assets that are classified as originated, held-to-maturity or available-for-sale under IAS 39 and can be designated as held for trading, and if so, would have to be measured at fair value, with the resulting changes in fair value being directly recorded into the profit and loss account (income statement). Similarly,

financial assets that are classified as originated or held-to-maturity could be designated as available-for-sale and measured at fair value rather than amortized value, with the change in fair value being recorded directly in equity and not in the profit and loss account (income statement); only when an asset is sold (derecognised) would the realized gain or loss have to be recorded in the profit and loss account. The choice in the earlier version of IAS 39 which allowed enterprises to elect, for financial assets that were considered available-for-sale, to record changes in fair value to either equity or to the profit and loss account has now been removed, bringing it in line with US GAAP. To impose discipline on the classification system, any such designation of a financial asset to either the category of held for trading or available-for-sale must be made at the outset and cannot be changed until the asset is sold. Under IAS 39 and IAS 32, as they are proposed to be amended, there is now a clearer delineation of the categories of non-traded financial instruments and their associated accounting treatment. The standards are more logically consistent.

One important change which is not fully articulated in the Draft Exposure, but is implied indirectly from time to time is that these four classification categories of originated, held-to-maturity, available-for-sale and held for trading could apply not only to financial assets but also to financial liabilities. One reason for the lack of a detailed discussion might have been that there are ongoing projects on the measurement of fair values for insurance contracts and bank deposits. But the other major category of financial liability that is not a financial derivative is corporate debt issued by an enterprise; this has been implicitly classified as a financial instrument that is originated and is thus carried at amortized value. The logic of the system is that there should be consistency of treatment between financial assets and liabilities, both in terms of measurement and accounting presentation, in a mixed measurement model just as it would be a single measurement model based on fair value. It would also be asymmetrical and inconsistent in a mixed measurement model to require financial derivative assets and financial derivative liabilities to be treated the same way, while other financial assets and liabilities in other classification categories are not similarly treated. This point has implications for the measurement of insurance contracts when set within the financial instrument framework as a whole. This will be discussed in more detail at the end of the paper.

5. Seeking to develop a standard for insurance contracts

As there were no detailed international standards for the measurement of insurance contracts, or indeed national ones, except for FAS 60 and FAS 97 in the United States, which are limited in scope, the IASC decided that insurance contracts should be split off as a separate project from other

financial instruments. A special Steering Committee to investigate the particular issues associated with insurance was set up by the IASC for this purpose in 1997. This Committee embraced the definition, recognition and measurement of insurance contracts, and certain aspects of disclosure and presentation of insurance company accounts. It should be noted that the Insurance Steering Committee began to develop its ideas at the time that the then influential JWG was working on its investigation of how fair value might be applied to all financial instruments, excluding insurance contracts. Since it was reasonable to suppose at the time that fair value might eventually be applied to all other financial instruments, consistency would argue in favour of fair value for insurance contracts.

The Insurance Steering Committee produced an Issues Paper for public comment and debate in 1999. The Issues Paper came out in favour of fair values for insurance contracts within its own particular and limited asset-liability framework and underplayed the existing accrual system, based on deferral and matching principles. An analysis of the discussions and correspondence prior to the Issues Paper on Insurance suggests that some representations from the insurance industry or those close to the insurance industry, in particular consulting actuaries, gave a stronger signal of support to (or were less vocal in their opposition to) the concept of fair value than those in the banking industry. The fact that actuaries were used to valuations based on discounted cash flows may have contributed to the position.

It should also be noted that a significant input into the IASC insurance project has come from specialist working committees within FASB, as indeed had been the case for the broader financial instruments programme. There is a good case for arguing that FASB sought to push the fair value approach more forcefully within the context of IASC, since to seek similar changes to US GAAP would have been much more difficult, at least in the short term. Indeed a similar argument about the role of the FASB could be made in widening the scope of IAS 39 beyond financial derivatives. This is evidenced in the rationales and the similarity of approach in the treatment of financial derivatives between IAS 39 and FAS 133 and in the preference of FASB, stated in its Concept Paper No.7, to have a fair value system for all financial instruments.

The public responses to the Issues Paper were considerable; some were in favour with suggestions for change and some against. A general analysis of the responses suggests that accounting firms and consulting actuaries tended to be broadly in favour, while insurance companies, including their in-house accountants and actuaries, and insurance regulators tended to be against or have serious misgivings.

In November 2001, the most recent version of a *Draft Statement of Principles (DSOP) of Insurance Contracts* was submitted to the IASB by the Insurance Steering Committee as work-in-progress, incorporating some of the recommendations from the public responses to the earlier Issues Paper,

including revisions that were required because of IASB decisions with respect to the fair value of financial instruments. One of the major revisions required to the fair value approach was that at least in the short to medium term an entity-specific value (ESV) basis would be used rather than the purely market-determined basis of fair value. An ESV approach sensibly seeks to rely on an insurer's own capability in managing and valuing cash inflows and outflows rather than using an external and hypothetical benchmark of these management capabilities. It recognizes directly the value-added provided by the management of an insurance company. This ESV approach can be traced back to the *value-in-use* concept in the current value debate for fixed assets for industrial enterprises in the 1970s. The acceptance of an ESV approach also removed a most contentious issue that would have arisen from the use of a full fair value approach, since under a fair value approach the credit risk of the insurance company issuing the insurance contract would have to be factored into the measurement process, with any changes in the credit standing of the insurance company over time being recorded in the profit and loss account.

The draft DSOP has produced much debate and adverse reaction, especially from the insurance industry and insurance regulators, as noted earlier. Since the Insurance Steering Committee was a committee of the IASC it was disbanded when the new IASB was established. It should be noted that the draft DSOP was the product of the old IASC, even though it was published in November 2001, several months after the new IASB was set up. The IASB has since appointed an Insurance Advisory Committee, one of several technical committees, whose role is merely to advise the IASB and its staff and not to draft documents.

One particular challenge that had to be addressed by the IASC and IASB is the definition of insurance contracts so that they can be differentiated from other financial instruments. The Insurance Steering Committee of the IASC decided to define an insurance contract. Given the lack of uniformity in what national insurance laws specify that an insurance company can supply, this is a contentious issue. The definition of insurance contracts excludes some important insurance contracts, for example, credit insurance and employer's assets and liabilities under employee benefit plans, and some classes of life insurance contracts. These excluded contracts are classified into the general category of financial instruments within IAS 39. The definition of what constitutes an insurance contract has recently been challenged by the International Association of Insurance Supervisors (IAIS). More difficult problems arise with a number of life insurance contracts, which contain both insurance and investment risk. Because of these problems, there has been no clear guidance given so far on whether participating (with-profits) life insurance contracts, variable life contracts and even some linked-life contracts should be defined as being insurance contracts or whether they should be defined under IAS 39. The criteria that is being used by the IASB to decide if

a financial instrument is an insurance contract or not is whether it contains a 'significant' degree of insurance risk. This is clearly subjective, and stems from the earlier decision to separate out insurance contracts from other financial contracts. The best way forward is for the IASB to work more closely with the IAIS to decide what can be sensibly classified as an insurance contract.

It is not appropriate here to go into any detailed analysis of the technical arguments for and against an ESV or a fair value approach for insurance contracts. The general point is that insurance contracts do not have secondary markets and hence fair values have to be estimated using discounted cash flow techniques. Both ESV or pure fair value approaches require a measurement of the following: (a) estimates of cash flows on insurance contracts from a closed book of business up to the end of the accounting period; (b) a market-related discount rate to reflect the time value of money; and, (c) an adjustment for insurance and timing risk which also incorporates the risk preferences that exist within the capital market. In addition, there are some insurance contracts, especially in life insurance, that have embedded options that may have to be measured separately, thus falling within the scope of IAS 39.

The overriding point is that the assets and liabilities of an insurance company will be covered by different requirements in the foreseeable future. Insurance liabilities will be covered under the emerging insurance contracts project and insurance assets (investments) under IAS 39, with fixed assets and current assets and liabilities under other standards.

The Economics and Finance Committee of the CEA (Comité Européen des Assurances) and the Insurance Committee within the European Financial Reporting Group (EFRAG) have played a key role in keeping the European Commission informed of the unfeasibility of having in place a comprehensive international standard for insurance companies by 2005. This has had the effect of taking pressure off the IASB to rush through a set of new standards to meet the 2005 deadline.

In May 2002, the IASB decided to split the insurance contracts project into two phases, so that some parts of the insurance contract initiative could be put in place by 2005 without delaying the rest of the project.

- Under Phase 1 an Exposure Draft would be published in the first quarter of 2003 and an International Financial Reporting Standard (IFRS) in 2004. At its meeting on November 12, 2002, the Board outlined the issues that Phase 1 would cover, including a clear definition of insurance contracts, and ensuring that there is consistency with other related standards, including IAS 39 and IAS 32. There would also have to be consistency with standard covering service contracts, since insurance contracts are not pure financial instruments. More importantly, the Board stated that it would not be establishing any definitive new accounting

standards for insurance contracts under Phase 1. But it did state that it would indicate in the conclusions to Phase 1 the direction that the Board was leaning towards for Phase 2. These future indications from the IASB are to provide guidance to insurance companies to allow them to prepare for change.

- Under Phase 2 of the insurance contracts project there would be a comprehensive analysis covering all aspects of recognition and measurement, including disclosure and presentation. No firm timetable has been set for Phase 2.

It would appear that the IASB has been listening to the comments from the insurance industry and others on the conceptual and practical problems of implementing a fair value approach to insurance contracts, but one cannot assume that they have yet been fully convinced. The situation is that there is now more time to develop a more workable standard for insurance contracts and one which permits sufficient integration with the measurement of the investments held by insurance companies. There should also be some consistency in approach between standards for the transactions of insurance companies and commercial banks, which are the two main financial intermediaries within the financial system, and which have many operational and servicing roles in common. Moreover, with greater convergence within the financial sector, there are a growing number of financial services enterprises with both insurance and commercial banking activities, and some consistency in accounting treatment between the two would make the interpretation of their consolidated group accounts more understandable.

Banks have so far argued cogently, with support of the Basel Committee, that bank loans should be differentiated from *investments held for trading* under the current IAS 39 and they should be classified as *originated investments* and also *held-to-maturity* and this allows them to value these loans at amortized cost and not at fair values. There is an equally strong case for arguing that most insurance contracts should be viewed as financial instruments that are *originated* and *held to maturity*. What is still needed is to find an appropriate measurement system for insurance contracts that is analogous to the amortized value for loans. Accounting standards for the measurement of bank deposits have not yet been developed, but the banks have made it clear that applying a fair value methodology would not be appropriate.

It should be stated that neither the IASB, nor indeed the earlier IASC, have made the firm determination that fair value is the appropriate approach in all cases. In fact, the IASB has set up a research project chaired by the Canadian standard setter with the purpose of reviewing the various methodologies; this project is still in its early stages.

6. How feasible is it to have fair value for insurance contracts?

The central issue that needs to be addressed is: *Can a fair value approach be feasibly applied to insurance contracts?* The first point that needs to be noted is that accounting standards focus on transactions and are not enterprise or industry specific. This emphasis on transactions allows comparability across industries. There are inherent problems when working within a transaction-based framework, especially when one is dealing with transactions that embody risk. Conventional transactions within an accounting system, such as payments and receipts, are known with a high degree of certainty, and hence can be easily aggregated. But, there are clear problems of aggregation when transactions entail risk, since risks by nature are not additive; one must allow for the interrelationships and correlations between the risks. In other words, risk must be measured at the macro or portfolio level.

If there is a traded market for risk transactions, then this allows risks to be additive, since market values will provide implicit risk premia that also reflect the risk preferences of market participants, thus allowing aggregation. But the interdependence that can be captured in a traded market is only one dimension of risk interdependence. It does not reflect the interdependence that emanates from business decisions that deliberately connect these transactions as part of a wider management process. For example, a life insurance company issuing annuity contracts often seeks to reduce the interest risks that it faces in these contracts by purchasing fixed rate bonds with a similar duration and convexity. In other words, the aggregation of risk through market values, even at the portfolio level, does not capture these higher-level risk management policy decisions.

Apart from the wider issue of accounting relevance, a fundamental issue has been how to estimate market values for assets or liabilities that do not have deep and liquid secondary markets, or even worse have no secondary markets at all. The IASB has assumed that if one can estimate future cash flows, one should be able to discount these at an appropriate rate of interest in the same way that the theory of finance suggests. This is easy in principle, but much more difficult in practice. A central issue is how one allows for risk in a way that reflects the capital market risk preferences and is thus consistent with actual market values. Risk can be allowed for either in the cash flows or in the discount rate, but not both in order to avoid double counting.

Allowing for risk in the discount rate means adding an appropriate risk premium (or set of premia) to a benchmark risk free rate of return when determining the value of an asset, or deducting a suitable risk premium (premia) from a risk free rate of return when measuring a liability. Alternatively, one can allow for risk in the cash flows, with an appropriate deduction to net cash inflows for an asset and with an addition to the net cash outflows for a liability. Allowing for risk in the discount rate is more intuitive.

One problem that arises for insurance liabilities, especially non-life liabilities, is that the conventional framework in financial economics for calculating risk premia is based on systematic risk(s) or correlations with the capital market portfolio (i.e. the universe of capital market securities). This framework does not produce realistic risk premia for insurance risks, which being often random in nature, tend to have no or limited positive correlation with the capital market portfolio. For example, the risk premia on an insurance contract providing earthquake risk cover would be low because the insurance risk has a low correlation with capital market price movements. This is a problem with applicability of this theoretical framework. In addition, there are technical problems when calculating risk premia in discount rates over a sequence of future periods. Hence the Steering Committee decided to try to allow for risk in the cash flows.

These risk adjustments to cash flows have been called market value margins (MVM's), and would be estimated from a series of stochastic cash flows generated from a set of external scenarios which would then be discounted at an appropriate risk free rate(s). At the present time the IASB has not given any clear guidance on how to calculate these MVM's; it has devolved the task of determining whether MVM's can be measured to the International Actuarial Association. While some actuaries, especially consulting actuaries, think that can be measured, there are many actuaries and accountants who do not think that MVM's can be measured credibly, without the existence of traded markets as objective benchmarks.

The current discussion of trying to allow for risk in the cash flows of insurance contracts has an historical parallel in debates in the theory of finance in the 1970s and 1980s relating to how risk should be allowed for capital budgeting decisions over a sequence of future time periods. Attempts to measure MVM's are similar to attempts to convert risky future cash flows into certainty equivalents that might be used in these capital budgeting decisions. While these certainty equivalents in capital budgeting can be shown to be theoretically sound, they have never been used in practice because of measurement problems.

It is also important to note that efficient capital market hypothesis on which the fair values approach rests is not as solid as originally thought. The phenomenon of 'bubbles' in asset prices, which has only been studied in more depth in recent times, weakens the support for the efficient market hypothesis, since price bubbles represent persistent, non-random upward deviations from what might be considered to be the intrinsic value of a traded asset or a traded liability, followed by sharp downward correction in price. Hence there is now more caution among financial economists today in assuming that the prevailing market value is necessarily the best estimate of intrinsic value.

The point of raising these issues here is to show that the insurance contracts project still has some difficult problems to solve if it is to evolve into an Exposure Draft, let alone a full accounting standard. In addition, even

if it is possible to come up with meaningful measures of fair value for insurance liabilities, there are issues of consistency with asset measurement under IAS 39 since in the meantime this has moved away from full fair value. And this is not to mention the wider issue of how to allow adequately for risk matching across assets and liabilities within an insurance enterprise.

We have discussed some of the problems of measurement that are being faced by the IASB as it seeks to apply the fair value approach. But we need to address more fundamental problems of the validity of seeking to apply fair values to insurance contracts at all, even if they could be easily measured.

7. Particular features of insurance contracts and insurance company liabilities

The model the IASB has been developing is to define insurance contracts as a particular type of financial instrument, which is consistent with the conventional economic definition. A financial intermediary creates (originates) its own financial instruments and/or invests in financial instruments that have already been created by others, some which have secondary markets. A financial instrument is the contractual right to receive (an asset) or the obligation to deliver (a liability) cash or other forms of payment from (to) a third party over a defined period of time, but excluding the financial instruments (shares) which the financial intermediary itself issues to its own equity holders. Given the transactions approach used in accounting, it is understandable that a financial intermediary might be considered as a bundle or aggregation of financial instruments. But this focus on transactions fails to reflect the economic value that emanates from the process of financial intermediation itself.

A financial intermediary creates economic value because it can exploit the benefits of specialization and the economies of scale in risk diversification, maturing transformation, pricing information and service provision, and these exist apart from the particular competencies of the management of the financial intermediary. Hence the economic value that a financial intermediary provides can only be measured accurately at an aggregate or portfolio level. This additional economic value cannot be easily captured in an accounting system that is transaction based, even one that purports to measure risk.

It is worth noting here that the definition of financial instrument by the IASC/IASB is sufficiently broad so that it applies not only to financial contracts issued by financial intermediaries, although financial intermediaries would clearly be the enterprises most affected. Corporate debt issued on capital markets by any enterprise, for example, would seem to be covered by the definition.

The above comments apply to all types of financial instruments, but insurance contracts have their own particular features. Let us look at these features in more detail.

i) Insurance is a long term business

Life insurance and some non-life insurances are long-term contracts. Life insurance contracts, especially those associated with long term saving and annuities, are very long-term. But a number of non-life insurance contracts are also long-term because the run-off pattern of claims can extend over many years, especially for liability insurances and reinsurance. There are legal and regulatory restrictions on insurance companies from exiting insurance contracts early; so, even if there were a secondary market, insurance companies are committed to their contractual arrangements over long periods of time. There are exit routes, though *ex post* reinsurance arrangements and portfolio sales, but these are restricted in scope by market structure and by regulation.

For annual premium business, life insurance contracts are not only long term in nature because of the obligation of an insurance company to the policyholders but also there are obligations from the policyholder to an insurance company in the form of renewal premiums to keep the contracts in force. Hence an accounting system that seeks to place fair values on long term, non-traded liabilities (claim payments and policy settlements) must also be able to measure consistently fair values for these associated long term, non-traded assets (i.e. renewal premiums), which are also risky.

ii) Insurance risks are difficult to forecast

Insurance contracts entail a payment by consumers in advance for an uncertain level of future financial compensation. Some insurance risks, such as motor insurance and life insurance, are not too difficult to price in advance and thus the amounts that will be paid out by an insurance company on a sizeable portfolio of such risks, and the timing of these payments, can be forecast within a reasonably narrow range. However, some risks, such as natural catastrophes, are much more difficult to forecast, even for a very large, well-managed insurance enterprise. There is inherent uncertainty in these calculations. Despite this uncertainty, insurance companies have limited scope to re-price these risks, if their future loss experience departs from what they have predicted. Hence insurance companies have been allowed by insurance regulators and tax authorities in many countries to set aside additional provisions, viz. catastrophe or equalization provisions, to cover large potential catastrophic losses on a before tax basis because of these major uncertainties.

The IASC and IASB have stated more than once that they do not consider catastrophe and equalization provisions acceptable as provisions and they do not fit into a fair value framework; the uncertainty in the severity, frequency or timing of loss payments is best absorbed by the capital and

reserves of an insurance company, because this is one of the main reasons why capital and reserves are held. Tax issues apart, a case can be made for some prudential reserve to be set aside where there are very large potential losses, if claims (loss) provisions are calculated on a best estimate rather than on a conservative basis. This could be considered as an earmarking of a portion of capital and reserves. However, to be acceptable to the IASB such earmarked reserves must have a clear methodology for their measurement. The taxation issue, although conceptually separate, is not so in reality in many countries, as the profits (net income) published in the financial statements form the basis on which corporate taxation is levied. In the post-September 11 environment, there is a need to ensure that the insurance companies are given, indeed retain, the fiscal incentives which will allow them to build up their internal financial resources to absorb very large and uncertain losses.

iii) Insurance entails the provision of consumer services over time

An insurance contract provides continuous risk servicing support over the contract period. This is different from many other financial instruments where there are one or more payments or receipts at agreed points in time. Because the insurance premium paid by a consumer is usually less than the potential claim payment to the consumer should a loss occur, this difference is covered by the pool of premiums collected and ultimately by the capital resources of the insurance company. Hence there is a continuous capital support service provided by the insurance company over a significant period of time. This capital support service is analogous to a maintenance contract, but where capital is provided rather than labour.

In addition, insurance contracts are not purely financial transactions. Insurance companies provide a wide variety of consumer services. These include pre-sales services, such as product advice and tailoring and risk prevention, and post-sales services, including premium collection, claim settlement and legal services. These integrated services are provided not just over the contract period but over the period that a claim might be made.

iv) Insurance provides risk diversification benefits

Insurance companies are able to pool risks and exploit the benefits of the law of large numbers (portfolio diversification). This pooling reduces the level of risk and permits lower consumer prices in competitive markets. Moreover, this risk diversification is not just across a segment of the population at a point in time, there is also risk diversification over time, especially for high severity/low frequency risk exposures, such as natural catastrophes.

In participating (with-profits) life insurance contracts, there is a smoothing of investment returns over time, with the insurance company absorbing these inter-temporal investment risks from capital markets. This provides the consumer with a choice of lower risk (and possibly a lower

return) savings products in addition to linked-life contracts or mutual funds. Participating life insurance contracts have a significant market share in a number of national insurance markets.

The above discussion outlines the particular features of insurance contracts. Hence any accounting system that does not capture these features will not be reflecting their full economic substance. It is clear that the fair value approach in its pure form fails to do so. This provides one of the explanations why compromises have been accepted into the emerging accounting standard, such as the recognition that insurance contracts should be viewed not as individual contracts but a book of contracts (i.e. a portfolio approach) and the acceptance of the entity-specific value (ESV) approach.

A more general point needs to be stressed. Within the broad definition of a financial instrument by the IASC/IASB, insurance contracts are classified as financial instruments. But insurance contracts, like bank deposits, are not pure financial instruments from the conceptual viewpoint. This is because insurance contracts entail a significant consumer servicing dimension that is provided by insurers over time, often over a long period of time. This point has been stressed in the various letters sent to the IASC/IASB from insurance companies and insurance associations. Hence in terms of their economic substance some insurance contracts could be viewed as long-term service agreements rather than as financial instruments. The general position is that insurance contracts contain both characteristics. In attempting to develop an accounting standard for insurance contracts, care must be taken not to overlook these long-term servicing aspects by treating insurance contracts as pure financial instruments. This was one of the main reasons why insurance contracts were excluded from the scope of the current US accounting standard on financial instruments, FAS 133; the other main reason for its exclusion was that there was no ready market to trade and hence to determine fair values for insurance contracts.

An important aspect of the insurance contract project is the field tests that the IASB is carrying out within insurance companies in various countries. These field tests, which have only recently begun, are to judge whether a fair value measurement system is operational in its present form and whether it needs to be adapted in order to capture the economic substance and commercial realities of the insurance business.

8. The definition of profit (net income) for insurers

In its original form, the fair value framework proposed by the IASC and indeed some national standard setters, was that transactions would not only generate financial assets or financial liabilities that would be recorded in balance sheets at fair values, but that profit (net income) would also be determined as the change in the fair value of assets and liabilities, or the

change in capital & reserves (equity) over a period of time, less any external capital raised and other relevant adjustments. Conventionally in an accounting system, after-tax profits earned over the year is determined first and the amount after deducting shareholder dividends is added to the capital & reserves (equity) of the company. Under the fair value framework after-tax profits is actually defined as the change in capital & reserves (equity). The directional link between a profit and loss account (income statement) is reversed. Hence all the unrealized gains and losses from assets and liabilities based on the fair value would automatically be defined as profit (net income), even though these gains (losses) over time do not accurately reflect the period-to-period fluctuations in the performance of the underlying business. Even in principle, this definition of profit (net income) is open to question. The net income of a company over a period of time, just as the net income of an individual, should not be equated with a change in net worth. In practice, however, the IASC and IASB have modified this strict definition of profit over time. As discussed earlier, under the Exposure Draft for the Proposed Amendments to IAS 32 and IAS 39 issued in June 2002, the IASB is offering greater and clearer choice than previously. This is because enterprises can now designate, within the limits set by the mixed measurement system, the category into which a financial instrument falls and hence has some flexibility on what is reported as profit and its timing. The full picture for insurance companies will not become clear until the project on insurance contracts is concluded and the presentation and disclosure requirements of IAS 32 are finalized.

Under the emerging mixed measurement system, it is unlikely that there will be clear-cut correspondence between balance sheets and profit and loss accounts (income statements), as there would be under a full fair value framework. This should not pose major problems, since balance sheets and profit and loss accounts serve different purposes. Any reconciliation between balance sheets and profit and loss accounts can be captured in either a statement of total recognized gains and losses (comprehensive income statement) or in the notes to the accounts. The notes to the accounts afford a better solution, since they can be used not only to provide the information necessary to effect this reconciliation but also provide additional information to users of accounts, including appropriate risk measures, such as degrees of mismatching of assets and liabilities, and stress (resilience) testing. The notes to the accounts can also be used to disclose the fair values of financial assets and liabilities, where their calculation is feasible.

The profit and loss account (income statement) is the main source of information that is used to assess financial performance of an enterprise over a period of time. Further elaboration of IAS 32 and IAS 39 will depend on the IASB's proposed standard on Reporting Performance. This standard on Reporting Performance, which is a general standard for all industries, has not yet been agreed. A first draft of an Exposure Draft was only discussed at the

Board meeting of the IASB in December 2002, with an Exposure Draft expected at the end of 2003. Hence there will still uncertainty about the final structure of IAS 32 and IAS 39, and indeed the insurance contract project, until the Reporting Performance standard is itself finalised and agreed.

9. Conclusions

The insurance industry is a major industry that not only plays a key role within the financial system but also has an important socio-economic function. In 2001, the global insurance industry had premium revenue of US\$ 2,408 billion, US\$ 1,439 billion from life insurance contracts and US\$ 969 billion from non-life insurance contracts (Sigma, Swiss Re, June, 2002). In addition, it is globally the largest of the institutional investors, with financial assets of about US\$ 12,500 billion in 2001. One of the key socio-economic roles of life insurers is to mobilize long term saving, especially for retirement provision, while non-life insurers and reinsurers are the main private sector providers of risk financing for natural catastrophes and man-made disasters. Hence sound international accounting standards should help, albeit indirectly, to underpin these financial and socio-economic roles.

With the greater globalization of business and internationalization of capital markets, it is generally agreed that the search for international accounting standards is a most desirable objective for both preparers and users of financial statements. It is also broadly agreed that international accounting standards based on sound accounting principles are better than those based on detailed rules which can be too prescriptive. At the same time there are a number of factors that must be kept in mind in designing an international standard, some general in nature and some specific to insurance. These are discussed below.

First, an international standard must be capable of being adopted not just by enterprises in developed economies but also over time by enterprises in emerging economies where local commercial and capital market conditions are still evolving. Standards should establish a framework to which emerging economies can gradually improve their financial statements. This suggests a more evolutionary approach than introducing a new unproven system.

Second, accounting standards are based on transactions and are not enterprise or sector specific. This ensures consistent measurement and comparability across industries. However, there is a weakness in this approach when the economic substance of a set of transactions cannot be captured by a simple aggregation of individual transactions. This is the case for the core transactions of insurance companies, and indeed commercial banks, where there is a decision interdependency between assets and liabilities, which is causal in nature and which cannot be captured fully by measuring correlations through market prices. An accounting system based on fair values alone does

not capture this economic substance, in particular the measurement of profit and its associated risks. Measuring profits on a deferral and matching system is better suited to capturing these interdependencies, even though there is a need to adapt and strengthen the deferral and matching methods currently in use. Economic substance should always take precedence over form. These issues will become more evident to the IASB as it undertakes more field tests on the feasibility of its proposals within insurance companies in different countries.

Third, an accounting standard requires that financial statements provide sufficient standardisation across enterprises to allow existing and potential shareholders, creditors and other users to make meaningful comparisons of key information, such as the level and growth in profits (earnings), balance sheet strength and liquidity. This comparability of information is particularly important to ensure that there is a level-playing field in the access to external capital and from the wider macro-economic perspective that capital as a resource is fairly priced. If all accounting transactions in all industries were measured on a system based on fair values, then one would have a logically consistent framework which would provide this comparability, even though the framework is not as theoretically robust as was sometimes thought, because of the existence of bubbles from time to time in asset prices. Industrial or non-financial services enterprises are not required to value their fixed assets at current or fair values in their core accounts nor are they required to value their corporate borrowings, including their corporate debt that is actually traded, at fair values. The prevailing standards, which will continue for the foreseeable future, mean that industrial firms will operate within a mixed measurement system, based on modified cost values and on accrual and matching principles. Similarly, commercial banks will not be required to report under a fair value system for the foreseeable future and they will continue to measure their profit broadly on an accrual and matching system. It could create an unlevel playing field if insurance companies were required to radically change their reporting such that their financial statements entailed a good deal of measurement noise, some of it irrelevant noise, when their competitors for capital are not required to do so.

Fourth, in the post-Enron and World-Com environment there is a demand for greater transparency and more caution in respect of early income recognition. In recent years there has been more transparency in the financial statements of insurance companies, often through more disclosures in the notes to their accounts, viz. information on embedded values, fair values of assets, risk measures, etc. Some life insurance companies have gone even further and have published detailed Supplementary Financial Statements to complement those in their main Report and Accounts, using a different valuation basis. These disclosures have been more than those required under either accounting standards or the listing requirements of stock exchanges.

Even so there is scope for more insurance companies to follow the example being set by these progressive companies.

This trend towards greater transparency has arisen mainly in response to the growing demands of financial analysts and other users, but also because management have seen the commercial benefit of more disclosure of relevant information since it helps to strengthen the trust on which the insurance business is built. Moreover, as leading institutional investors, insurance companies are well aware of the need to provide relevant and timely information to the capital market.

Under fair value accounting measurement, there is the inherent potential for the capitalisation of future profits, especially on long term insurances. Even though any up-front profit recognition can technically be allowed through an appropriate unwinding of discount rates and risk margins, this is a somewhat artificial adjustment. Best practice actuarial valuation systems achieve more naturally an appropriate pattern of profit recognition over time.

Fifth, there has always been some concern that insurance companies and commercial banks have a degree of prudence in their reporting policies, because of the underpinning role that they play within the financial system. Financial stability within the financial system as a whole depends on sound financial institutions. Having some degree of prudence does not have to be at the expense of transparency. Moreover, one conditioning factor that the IASB must keep in mind when deciding on their final standards is that one of the users of the new financial statements will be insurance and banking regulators and supervisors.

One particular accounting issue associated with prudential reporting is how to allow for inherent uncertainty in setting aside provisions for large scale potential losses in non-life insurance, especially non-life reinsurance. This is because the amounts set aside to cover future claims liabilities, even if based on realistic forecasts, are exposed to very large potential error due to the nature of catastrophic events or uncertainty in estimating the probabilities of rare events. The IASB has so far considered that catastrophe or equalization provisions should not be recognized, but some further attention should be devoted to this issue, including the possible earmarking of capital which could also be easily identified for selective tax treatment.

Sixth, the accounting standard should ideally reflect best practice. It is generally agreed that the internal accounts used by companies to run their business should be broadly the same as published financial statements. Financial statements should be neutral and reflect the underlying business models that are used; compliance with an accounting standard should not influence commercial decisions. Measuring the fair values of insurance liabilities (i.e. a portfolio of insurance contracts) is not a practice carried out by any insurance company, hence the problem that the IASB is currently facing in trying to develop a method of measurement. Because of the

increasing use by insurance companies of risk-based capital systems for financial planning and control purposes, more realistic and market-related valuation models are being used, including embedded value or achieved profit models. But these models are not fair value models. Even if a fair value framework could be developed, it is unlikely that even the most progressive insurance companies would switch from their existing internal accounting systems that they have developed for corporate planning and control purposes. The danger of a mismatch between internal accounting systems and external reporting systems is all too clear. This is that an external accounting standard might over time change internal accounting systems, with the result that the processes and products of insurance companies may be altered so that they are not fully congruent with an optimal competitive strategy.

Having an international accounting standard which is aligned with internal accounting systems is also beneficial to shareholders and other users of accounts; if financial statements reflect the underlying decision-making processes, they will be more reliable in monitoring financial performance over time and in assessing profit forecasts and other financial forecasts of management. Greater insights will be gained on this by the IASB as it progresses with its field tests within insurance companies, especially in discussions with in-house accountants and actuaries.

Seventh, insurance companies will have to adhere in the future to a mix of international accounting standards, but those relating to the financial instruments are clearly the most important. It should be kept in mind that the conceptual framework that has been developed under the amended IAS 39 will be the defining framework when it emerges as an IFRS (International Financial Reporting Standard). The insurance contract project, when complete, will have to dove-tail into this. The financial instruments project has evolved into a mixed measurement system and according to the IASB 'will be in place for a considerable time'. Hence even if fair value remains on the agenda of the IASB, it is now on the long-term agenda. The reaffirmation of the four main classification categories for financial assets in the amended IAS 39 and the decision to allow enterprises to choose to use fair value for those categories of financial assets not defined as being held for trading shows that the IASB is willing to accept a more evolutionary approach. The IASB has clearly been listening to the external opinions of preparers, users, auditors and regulators.

Although not clearly articulated in the amended IAS 39, the inherent logic of these four classification categories is that they should apply not only to financial assets but also to financial liabilities. There is an example of this in the treatment of the corporate debt issued by an enterprise. This can be viewed as being consistently defined within this framework as an originated liability and is thus required to be measured at amortized value, unless the enterprise voluntarily designates the corporate debt as being held for trading or available-for-sale when it would be measured at fair value.

What is the way forward for the insurance contracts project? There is a case for arguing that insurance contracts are long-term service agreements (long-term contracts which entail the supply of services) and hence they should not to be considered as financial instruments. But the more pragmatic view, given the wider standards initiative, is to consider insurance contracts as complex financial instruments, including services and embedded options, but accepting that to calculate their fair values will prove very difficult and subjective. This is because they are non-traded instruments and because the information to benchmark them against traded markets is very limited. Moreover, even if the insurance contracts project could come out with a credible and objective method for measuring the fair value of insurance contracts as financial instruments, any compulsion to use these values would be inconsistent within the framework of the amended IAS 39. This is because insurance contracts are both originated and held-to-maturity liabilities.

Within a scenario that fair values for insurance contracts can be measured objectively and with a sufficient consensus, which is a low probability scenario, the amended IAS 39 framework would imply that insurance companies could voluntarily designate their insurance contracts as available-for-sale or held for trading and thus carry them at fair values, albeit with different treatment as far as profit measurement is concerned. Such a voluntary designation would allow some consistency in the treatment of assets and liabilities. Where investments are broadly duration matched against policyholders' liabilities to reduce interest rate risk, such as for annuity business, these liabilities (insurance contracts) could remain as originated liabilities, with the matching assets being measured at amortized values. Similarly, in other areas where the matching between assets and liabilities is less strong, and where the investments would probably be classified as available-for-sale, the insurance liabilities could also be designated as available-for-sale. The use of the system of voluntary designation would allow insurance companies some flexibility in reporting. This flexibility in reporting would not undermine the ability of the main users of financial statements to make consistent comparisons between insurance companies, providing there is adequate disclosure of relevant information in the notes to the accounts or in supplementary financial statements.

In the light of the above discussion, the suggested way forward is to allow a limited number of valuation methods based on realistic, market-related assumptions that are currently in use and considered to be best practice in liability measurement. These might be viewed as being broadly equivalent to fair value. Some choice, even if limited, of valuation methods would be desirable, as this would be more in line with an accounting standard based on principles rather than on rules. Insurance companies could still be encouraged, or required, to include estimates of the fair values of their policyholders' liabilities (insurance contracts) and those of their financial assets in the notes to the accounts, where this is feasible.

In addition, there is a case to identify a set of principles, if not an alternative framework based on best practice, which would allow more standardization within financial statements in the methods of valuation used to calculate policyholders' liabilities in life insurance companies and those in non-life insurance companies. This should be determined on a portfolio basis and be capable of being used in an appropriate asset-liability framework, but it would need to be designed in a way that could be seen as 'broadly equivalent' to amortized values to be consistent with IAS 39 and its IFRS successor. In addition, there is also a strong case for looking at best practice among deferral and matching systems for profit measurement. Profit and loss accounts (income statements) do not have to be measured on exactly the same basis as balance sheets and, more importantly, they provide different information to the users of financial statements; for example, shareholders and financial analysts are likely to focus more on income statements, with creditors and regulators focusing more on balance sheets. These investigations could be included within Phase 2 of the insurance contracts project, and could run along side further research work on fair values, since there would no doubt be useful insights to be gained from looking at both approaches together.

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- AMERICAN COUNCIL OF LIFE INSURERS, AMERICAN INSURANCE ASSOCIATION, the GERMAN INSURANCE ASSOCIATION and the LIFE INSURANCE ASSOCIATION OF JAPAN sent a further letter to the International Accounting Standards Board on 18 September, 2002, also in response to the Draft Statement of Principles on Insurance Contracts.
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