

International accounting developments: what is on the radar screen for 2005?



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On 1 January 2005, a new set of accounting rules for insurance contracts will be introduced, which will be mandatory for all listed companies in the European Union, Australia and several other countries. The new rules, known as IFRS 4 – Insurance Contracts – were established by the International Accounting Standards Board (IASB). Before these rules were introduced, no guidance on the accounting for insurance contracts existed within International Financial Reporting Standards (IFRS). The new standard constitutes a major step toward IASB's goal of converging formerly disparate methods of accounting for insurance contracts to a common principles-based system.

In issuing IFRS 4, the IASB's stated intent was: "to make limited improvements to accounting for insurance contracts until the board completes the second phase (phase II) of its project on insurance contracts." The importance of IFRS 4 is that it establishes a foundation for consistency by:

- providing the definition of an insurance contract;
- resolving certain well-known insurance liability measurement and recognition inconsistencies; and
- increasing the level of required disclosure on insurance contracts.

Phase II of the project involves measuring assets and liabilities arising out of insurance contracts at their fair values, and is likely to be controversial.

Under IFRS 4, an insurance contract is defined as a "contract where one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder". A key element of the definition includes reference to significant insurance risk, which may lead to more scrutiny of finite risk transfer (re)insurance contracts. Contracts that take the legal form of (re)insurance, but do not contain significant insurance risk, such as financial reinsurance, are excluded from the scope of IFRS 4. These contracts are considered as financial instruments that fall within the scope of IAS 39 – Financial Instruments: Recognition and Measurement – and thus would be reported at fair market value.

One of the more important income recognition inconsistencies resolved by IFRS 4 is the rule that an insurer shall not recognise a reserve for claims not in existence at the balance sheet date. Accordingly, equalisation and pre-funded catastrophe reserves are not allowed. Examples of countries that allow or require these reserves include Belgium, France, Germany and the United Kingdom as well as several Asian countries such as Japan, Korea and Taiwan. Companies within these countries are evaluating the impact of this change on their solvency requirements and potential future income volatility.

The increased disclosure requirements are viewed by analysts as one of the most important aspects of IFRS 4 and are consistent with the global trend to increase the transparency of companies

to interested parties. The principal requirements in this regard are to disclose:

- Information that identifies and explains the amounts in financial statements arising from insurance contracts.

This set of requirements relates to disclosing relevant accounting policies, assumptions and effect of changes in assumptions, among other items. These are similar to current requirements under United States Generally Accepted Accounting Principles (US GAAP) and do not appear to be controversial.

- Information to assist understanding of the amount, timing and uncertainty of cash flows.

These disclosure requirements diverge somewhat from GAAP requirements and essentially require disclosure that will help users evaluate certain key elements of a company's insurance risk profile, such as: risk management objectives; significant insurance contract terms and conditions; profit sensitivity to changes in material variables; concentration risks; historical claim development; and interest rate and credit risk.

The IASB sees phase I as a stepping stone to phase II. In general, phase II requires a fair value approach to recognising assets and liabilities arising from insurance contracts. Although the IASB reached tentative conclusions for phase II in January 2003, the project has officially remained dormant since then, with work expected to resume in the second half of 2004. The IASB has stated that it will regard the past work as a useful resource, but will not be bound by it. The commonly shared view is that phase II will not be completed until 2007 at the earliest.

Significant controversy still exists with respect to the overall desirability of phase II as set out in the IASB's "past work." In light of this lack of consensus, IASB formed a European Consultative Group on Accounting Issues Affecting Financial Institutions.

In addition, accounting and actuarial firms as well as rating agencies are starting to provide views and research related to potential methodologies for arriving at fair market valuations of insurance liabilities and their potential impact on reported financial results. If fair value reporting is adopted, there appears to be some consensus that:

Premiums and expenses will be recognised at the inception of a contract and thus deferred expenses and premiums will be eliminated.

Reserve estimations will start with a present value of expected cash flows and will add some form of margin to cover the additional amount a third party would require for volatility risk and profit.

Although the debate appears to be moving forward, it is still too early to tell what the final principles of phase II will contain. In the meantime, insurers and reinsurers will be adjusting to the changes introduced by the convergent principles enshrined in IFRS 4.

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