Perspective by William C. Freda

International Standards Could Overhaul Insurance Accounting

When it meets later this week, the International Accounting Standards Committee's Insurance Steering Committee is expected to stake out positions that could eventually change the way insurance companies account for their businesses. The goal of the meeting–June 22-24 in Cologne, Germany–is to reach tentative conclusions on the topics to be covered in an Issues Paper slated for release by year-end.

At first glance, those involved in preparing financial statements for U.S. insurers might see little reason to follow these developments. After all, publication of the Issues Paper is just the first major milestone in a process that began two years ago and still has far to go. Further, the Securities and Exchange Commission and the Financial Accounting Standards Board have yet to adopt international accounting standards, and unless they do, the standards will not affect most U.S. companies.

However, globalization, cross-border mergers and blurring of boundaries among insurers, banks and securities firms make this process too important to ignore. U.S. subsidiaries of foreign insurers already using international accounting standards will be among the first U.S. companies affected by the new standard. If the SEC and the FASB eventually permit international standards as an alternative to U.S. GAAP, other U.S. insurance carriers will be close behind.

The steering committee has an aggressive goal: start with a clean slate and determine if there is a set of accounting standards for insurance contracts that can be used around the world. Part of the project's complexity stems from the fact that each country has its own accounting principles for insurance, and many of these practices vary significantly.

For example, Germany allows insurers to establish catastrophe and equalization reserves and carry them on their balance sheets as liabilities. This practice is not permitted in the United States. Another practice generally not applied here–but used in several other countries by property/casualty companies–is the discounting of loss reserves to their net present value.

An overriding principle that has guided the steering committee in its deliberations so far has been consistency with other standards that have been adopted by the IASC. If an International Accounting Standard exists–39 have been approved so far by IASC–it will be adopted by the committee unless it can be demonstrated that the standard does not make sense for the insurance industry. So far, the need to contradict an existing standard has not arisen.

This has not been as simple as it sounds, because some International Accounting Standards are still in development. Consider the issue of fair value. IAS 39, *Financial Instruments: Recognition and Measurement*, has taken the interim step of declaring that certain financial assets and liabilities should be recognized at their fair value, and has defined the term "fair value." But the IASC Board is continuing to pursue the objective of creating a comprehensive standard establishing full fair value for all financial assets and liabilities. This project, which is in the early stages of development, is being pursued jointly by IASC and several national accounting standard setters.

> *Search is on to determine if there is a set of accounting standards for insurance contracts that can be used globally*

Because of this, the steering committee is following two paths with respect to the overall objective of recognition and measurement in accounting for insurance contracts–a fair-value approach and a non-fair-value approach. Most of the discussion to date has focused on the latter, although the committee will likely pay more attention to fair value as IASC gets closer to completing the comprehensive fair value standard.

There are a few particularly significant issues that will be addressed in the Issues Paper. First, the steering committee's preliminary view is that all insurance liabilities–both for life and property/casualty companies–be discounted. The approach is consistent with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, which requires use of present value in measurement of similar liabilities. However, it flies in the face of U.S. practice for property/casualty companies, and has raised concerns among regulators worried about policyholder protection and carrier solvency.

Second, another steering committee preliminary view calls for life insurance liabilities to be measured on a prospective basis. This approach determines liabilities based on future projections of premiums, claims, expenses and investment returns. In the United States, both prospective and retrospective bases are currently used.

The steering committee is also following IAS 37 with respect to catastrophe and equalization provisions with the preliminary view that they not be treated as liabilities on the balance sheet. However, it is exploring alternative ways to convey this information without recognizing a provision.

Other steering committee preliminary views include:

—Immediate recognition of income may result, in certain cases, from the sale of a long-term policy under a fair-value approach.

—Capitalization of policy acquisition costs, which would be reported in the asset section of the balance sheet. However, such costs could not be deferred under a fair value approach.

—Not allowing insurance liabilities to be offset by related amounts due from reinsurers.

—Classification of unallocated surplus for participating policies as a liability when the insurer does not control allocation of the surplus and as equity when the insurer does control allocation.

—Splitting premiums received for investment-linked insurance contracts into risk (revenue) and investment (deposit) components.

Because the steering committee has moved on an accelerated schedule, deliberation to date on the issues has been constrained. However, development of the standards is still in the early stages, and interested parties will be able to comment at each subsequent stage: Issues Paper, Statement of Principles and Exposure Draft.

If the United States adopts international accounting standards, there is great likelihood that U.S. insurers will have to follow significantly different insurance principles in the future. The standards on insurance would change valuations and affect everything from stock price to policy design and premiums.

Given the widespread impact of standardization, the steering committee's proposals are likely to spark great interest–and discussion–among insurers globally. By staying abreast of developments, U.S. insurers will be better able to assess the proposals' impact and to participate in shaping rules that will ultimately govern insurers around the globe. NU

WILLIAM C. FREDA IS NATIONAL MANAGING DIRECTOR AND TRI-STATE MANAGING PARTNER FOR THE FINANCIAL SERVICES INDUSTRIES WITH DELOITTE & TOUCHE. HE IS A U.S. REPRESENTATIVE ON THE INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE'S INSURANCE STEERING COMMITTEE AND HAS SERVED AS CHAIRMAN OF THE AICPA INSURANCE COMPANIES COMMITTEE AND CHAIRMAN OF THE AICPA MUTUAL LIFE TASK FORCE.