GO5 – ACCOUNTING DEVELOPMENTS

1. Introduction

The aim of this session is to cover those accounting developments which will be of both direct and indirect interest to actuaries involved in life assurance. However, issues related to Phase 1 of the International Accounting Standards Board (IASB)'s insurance project (including Exposure Draft (ED)5) and to IAS 32 and 39 are excluded on the grounds that these form the subject matter of other sessions.

2. ABI SORP

The ABI SORP Working Party has been in existence for three years, seeking to reach agreement on amendments to the SORP "Accounting for Insurance Business" dated December 1998. In November 2002, a draft revision was put out to consultation and attendees will be assumed to have read this.

The main reason why the SORP has not yet been finalised relates to debate over the practice of some groups of placing "self generated Value in Force (VIF)" on their consolidated balance sheet (with movements in this item passing through the Statement of Recognised Gains and Losses). The current SORP is silent on this subject, referring only to VIF in respect of business acquired in a business combination.

The Accounting Standards Board (ASB) wishes to see an explicit prohibition on the inclusion of self generated VIF in the balance sheet. The ASB's reasoning is set out in the July edition of "Inside Track", namely that embedded values "usually include future investment margins and management fees thus resulting in the recognition of a profit on the inception of an insurance contract, usually in advance of alternative methods, including those planned for Phase II (of the IASB's insurance project)."

Some members of the ABI, however, are reluctant to change their existing practice at least while the banks use embedded value reporting when consolidating the results of their life subsidiaries in both the income statement and balance sheet. The ASB is understood to be unhappy with the banks too, but may reluctantly have to accept that this practice in bancassurance groups has, by virtue of common usage, become part of UK GAAP. It remains unclear whether this matter can be resolved in time for the new version of the SORP to be adopted for 2003 year-ends.

The Working Party has, however, agreed some changes to the draft SORP circulated in November 2002.

- The use of a gross premium valuation basis as the norm has been reinstated. There is currently no intention to amend the wording in response to the FSA's "Twin Peaks" approach, although this may be an issue to be considered next year. While the realistic liabilities continue to be addressed only through a capital requirement it is not obvious that any changes will be needed.
- The separate life and general insurance sections dealing with reinsurance have been combined, with a resultant improvement in the underlying rationale in dealing with Financial Reporting Standard 5 (Reporting the substance of transactions). Controls over financial reassurance arrangements have been strengthened so that most "cashless" stop loss treaties will be ineffective unless genuine risk transfer can be demonstrated (cash based schemes were already caught by the circulated draft). In addition, where a separately identifiable financing element can be determined, it will not be possible to book a profit from this element at inception; any profit "should be released to the technical account for long-term or general insurance business on a systematic and rational basis over the period of the contract". This latter provision is similar to that proposed in ED5, but relates only to financial reassurance.
- Consequent upon the reinsurance change described above, it is recognised that companies may be able to recognise a higher DAC asset (obligations to repay loans received, or liability reductions from, reinsurers being provided for/ignored). However, in future advertising costs will only be eligible for inclusion in the DAC to the extent that "they directly relate to the acquisition of new business".

Finally, a decision has been taken not to amend the SORP to reflect changes to accounting practice required by ED5. The EU regulation adopting "approved" international accounting standards for the consolidated financial statements of listed companies will automatically over-ride those parts of the SORP which are inconsistent with any IAS/IFRS. Other companies, not reporting on international accounting standards (including the subsidiaries of listed companies), can, for example, continue using the fund for future appropriations and claims equalisation provisions, subject only to the continuing acceptance of these features in the SORP by the ASB.

3. Achieved Profits Reporting

As far as the author is aware, the ABI has no current plans to update the Guidance Note issued in December 2001. There has, however, been increasing criticism from investment analysts to the effect that embedded values calculated using the methodology set out in the Guidance Note are not market consistent. There has also been criticism from the ASB (see Section 2 above), in particular that the approach described in the Guidance Note capitalises investment risk premia and compensates for this in an arbitrary manner through the use of a risk discount rate.

It would seem that the following changes would be needed to meet the criticism that the Guidance Note does not produce market consistent embedded values:

- Future investment returns should be set at risk free rates. Before allowing for tax on BLAGAB business, the risk free rate could be set having regard to swap rates.
- The shareholders' discount rate should be set as equal to the risk free rate as defined above.
- For with-profits business, a market consistent cost of the impact of "burn through" of the estate needs to be estimated. This burn through cost was probably negligible for most companies prior to the 2000-2002 bear market, and may still be negligible for some.
- The cost of capital deduction should be recast, to represent the estimated cost of any taxation on returns from assets representing the market consistent embedded value and any other free assets. There are other costs traditionally associated with a company holding free capital, such as "agency costs", but it seems doubtful that these should form part of an external accounting system.

It is noteworthy that one major insurance group announced with its half yearly results (which were accompanied by a rights issue) that it was writing off the value in force of its two with-profits subsidiaries as a consequence of having seen the results of market consistent valuations. In the author's view, it is to be hoped that the ABI takes action to amend the Guidance Note in the areas outlined above, particularly as this would meet much (but admittedly not all) of the criticisms of the method levelled by the accounting standards setting bodies. It is understood that an unofficial group of major EU listed insurance companies is actively considering adopting similar proposals to those described.

4. Results of the Profession's Survey of Accounting Issues

This is set out in the Note from Chris O'Brien "Life Assurance Accounts: A Survey of Actuaries' Views".

5. IASB Insurance Project – Phase II

Phase II of the insurance project was last discussed in detail by the IASB at its January 2003 Board meeting. At this meeting, the Board reached the following tentative conclusions relevant to long term insurance business:

- The general approach should be one of "fair values" rather than deferral and matching.
- Assumptions used for setting provisions can be entity specific, when market-based information is not available without undue cost and effort. In practice, this appears to permit the use of a company's own expense levels, which seems reasonable.
- The interpretation of "fair value" should be to an "entry" rather than the more usual "exit" value. This has the implication that "a policy issuer would not recognise a net gain at inception of an insurance contract" unless its own premium rates or policy charges are demonstrably higher than market rates. The use of an entry value goes against the normal, prospective, provisioning standard in IAS 37 based on exit fair values. It is also inconsistent with the standard definition of fair value which is reproduced in Appendix A of ED5.
- Except where policyholder liabilities are directly dependent upon investment returns from a defined asset pool, discounting should be at a risk free rate rather than a rate which has regard to backing assets. This appears appropriate for a market consistent approach to valuation subject to the possible inclusion of an allowance for "own credit risk" as described below.
- Fair value should incorporate "market value margins". This is a difficult area but the author believes there are a number of reasons why such margins should be removed from the IFRS. These are:

- — Inclusion is inconsistent with financial economic theory, which would argue that no charge is appropriate for what are diversifiable risks.
- — They are not found in comparable accounting standards, for example that covering post-retirement benefits.
- — They make the accounts more opaque.
- — There are great practical problems in establishing the appropriate level for these margins in a way which ensures consistency across companies.
- — Their inclusion requires the definition of an arbitrary "unit of account" across which any diversification benefit can be assessed.

- ■ Future premiums should be recognised only if (a) policyholders hold uncancellable continuation or renewal rights that restrain the ability of the insurer to reprice the contract and (b) those rights will lapse if policyholders stop paying premiums. This would seem to permit the recognition of future contractual premiums for most policies falling within the definition of insurance contract.

- ■ Fair values should reflect the credit standing of the insurance company, placing a value on the shareholders' limited liability put option. This is another difficult area; a pure proponent of financial economics would support the IASB's stand but the absence of the ability, in most cases, to buy back the liabilities in question leaves many uncomfortable. The allowance for "own credit risk" could be handled in practice by increasing the discount rate from the risk free rate, to reflect the yield on a corporate bond of appropriate credit quality. The IASB did, however, state that the allowance for credit standing should reflect the existence of policyholder protection schemes, but it is not obvious why these schemes should affect the assessment of the company's liabilities to its own policyholders.

It seems clear that if a number of these tentative conclusions are not reversed, there will be a continuing need for supplementary reporting such as achieved profits. This makes consideration of the reforms suggested in Section 3 above of greater relevance.

6. Other Accounting Developments

6.1 Share based payments

The IASB published ED2 on share based payments in November 2002. The UK actuarial profession's response can be found on the Accounting Liaison Group's (ALG's) section of the profession's website. ED2 proposes that costs associated with the issue of shares and share options in payment for services should be expensed in the income statement over the period in which the relevant services are performed. The main area of concern expressed in the profession's response is that the cost of shares and share options for this purpose is to be set at grant date; an earlier discussion document had suggested a vesting date reference point (with "truing up" of the cost over the vesting period) which seems both more practical and logical. It is expected that the IFRS will be operative from 2004.

Appointed Actuaries will need to discuss the implications of any IFRS with their accounting colleagues and in particular the appropriate treatment in the FSA returns. Some groups may not charge subsidiaries with these costs, but at the other extreme some perhaps will seek cash payment compensation even though, at group level, no cash is paid out. Where a company debits in the financial statements expenses which are credited to equity, then the overall solvency position is not impaired and perhaps an Appointed Actuary could justifiably ignore these expenses when setting the valuation basis. However, for with-profits sub-funds there may in future be a greater tendency to charge cash for these options, to ensure that policyholders bear their fair share of a group's overall expenses. Pricing for all products could also change to reflect the new expenses – whether finally charged to the subsidiary or not.

6.2 FRS17 and IAS19

The ASB delayed the compulsory adoption of FRS17 to enable the IASB to deliberate on possible changes to its equivalent standard, IAS19. It seems likely that the IASB will end up changing IAS 19 to bring it into line with FRS17 and indeed Sir David Tweedie is in contact with the Pensions Board on this subject.

FRS17 may, for most groups, still only result in Notes to the accounts but nevertheless it has highlighted the need to "look through" a defined benefit pension fund's assets and liabilities to consider the implications for the sponsoring company. Recently announced changes to winding-up rules have increased the strength of the sponsoring company's obligations to its scheme. Defined benefit pension funds' surpluses and deficits pose special problems for many life companies, because of the need to allocate them equitably to the elements related to with-profits and non profit funds, general insurance funds and possibly other non-insurance businesses.

For deficits allocated to with-profits funds, the need to produce a realistic balance sheet raises some further issues. Where business is operated on a "charges less expenses" basis, any deficits will accrue to the estate or shareholders. For traditional business, a decision will be needed on whether to charge contributions designed to extinguish deficits to asset shares or the estate. For all with-profits business there is, perhaps, a need to consider whether a "market consistent" approach is being applied to pension costs; in practice it would seem that a number of companies are taking little action to reduce FRS17 deficits beyond hoping that a rise in equity markets will do the trick.

6.3 Business combinations

The IASB published ED3 on business combinations in December 2002 with consequential amendments to IAS 36 (Impairment of Assets) and IAS38 (Intangible Assets). The UK actuarial profession's response can be found on the ALG's section of the profession's website.

The most important elements of the proposals are:

- Abolition of merger accounting. Henceforth in all business combinations one party will have to be identified as the acquirer and one as the acquired. This could result in some difficult decisions; recent (genuine) examples of mergers have been those of Commercial Union and General Accident to form CGU, and the subsequent merger of CGU with Norwich Union to form CGNU (now Aviva).

- The abolition of amortisation of goodwill and its replacement by an annual impairment test. The author is very sceptical about the way impairment testing is carried out (or not!), particularly in the case of financial services companies where some very high goodwill values, relating to purchases made at the peak of the 1990s bull market, remain on balance sheets. In any event, ED3 proposes that where an acquired company's business is merged with an existing business the impairment test can be made against the combined value of the new operation, ie pre-existing goodwill can be used to “shelter” acquired goodwill.

6.4 Quarterly reporting

The European Commission has made proposals, in a draft Transparency Directive, aimed at increasing the transparency of the reporting of EU listed companies. It is expected that the Directive will become law by April 2004, to become effective from 2005. It seems very likely that these will require quarterly profit reporting for all such companies – a major change in UK practice.

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