Issues paper

Consolidated Financial Reporting by Insurance Enterprises

31 May 2000

Insurance Working Group of the German Accounting Standards Board (GASB)

Submitted to the International Accounting Standards Committee as comment letter on the Issues Paper by IASC's Steering Committee on Insurance

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Preface

German Accounting Standards Board

The German Accounting Standards Board (GASB) has been mandated to develop principles for financial reporting in consolidated financial statements in accordance with the principles of proper bookkeeping, to advise Parliament on the development of financial reporting and to represent the Federal Republic of Germany on international accountancy bodies. It has seven members appointed by the Administrative Council of the German Accounting Standards Committee e. V. (GASC) as independent experts with proven expertise in the areas of national and international financial reporting.

Note on application

The Standards relating to consolidated financial reporting are adopted at public meetings by the German Accounting Standards Board after careful examination of all relevant circumstances, in particular of the principles of proper bookkeeping, after carrying out hearings and taking account of the comments received. Once the Standards have been published by the Federal Ministry of Justice in accordance with § 342 (2) of the Commercial Code (HGB using its German abbreviation), they are to be presumed to represent proper accounting principles for consolidated financial reporting. Since proper accounting principles are intended to guarantee that statutes are applied in accordance with their intended purpose, they are subject to constant change. Every user is therefore advised to examine carefully on applying the Standards whether their application corresponds to the respective statutory aim, taking account of all the circumstances of the individual case.

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Note

The German Accounting Standards Board is authorised to engage working groups in order to assist in the preparation of standards. The working groups consist of independent experts with a practical understanding of specific accounting areas.

The **Insurance Working Group (IWG)** has the following members:

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Issues paper

Consolidated Financial Reporting by Insurance Enterprises

Introduction

1.
The Insurance Working Group (IWG) of the GASB hereby presents its issues paper on consolidated financial reporting by insurance enterprises.

2.
The purpose of this issues paper is to contribute to the current discussion on the internationalisation of accounting and reporting by insurance enterprises.

3.
At present, accounting and reporting by insurance enterprises on an international basis differs significantly. The IASC therefore decided in April 1997 to include an insurance project in its workplan.

4.
This issues paper of the IWG of the GASB gives its views on the basic issues currently being discussed internationally and in a second step

- identifies recognition, measurement, consolidation and disclosure issues and discusses their treatment and
- presents the initial conclusions of the IWG to the main issues.

5.
Paragraphs 46 to 220 of this paper include a discussion of the basic issues and analyses the current rules applicable under the German Commercial Code, the EU Directives, IAS and US GAAP.

Scope

6.
The issues paper deals with financial reporting by insurance enterprises on a group level.

7.
The IASC Insurance Steering Committee recommends that insurance contracts are accounted for consistently irrespective of the main activities of the reporting enterprise. The IASC Insurance Steering Committee has already pointed out that there is no uniform definition of an insurance enterprise or group. Moreover an increasing number of groups are involved in both insurance and non-insurance business.

8.
In contrast to the situation at an international level, consolidated financial reporting by insurance enterprises in Germany is clearly regulated. §§ 341 i and j HGB apply to insurance enterprises in accordance with § 341 HGB, and to insurance holding companies, which are parent companies, in accor-

dance with § 341 i(2) HGB. Similarly, Article 65 of the EU Insurance Accounts Directive (in conjunction with Article 2) applies in other member countries of the European Union.

9.
The IWG proposes to deal only with specific insurance issues which arise in the consolidated financial statements of insurance enterprises and insurance holding companies.

10.
In addition, specific insurance issues relating to consolidation procedures will be dealt with. This includes the consolidation of enterprises from other business segments in the consolidated financial statements of insurance enterprises as well as the consolidation of insurance enterprises in the consolidated financial statements of non-insurance groups.

11.
The paper does not deal with accounting by insurance policyholders.

12.
The IWG does not rule out the possibility that the special nature of the insurance business may require a different approach to accounting for investments and for financial instruments in general. This paper therefore also deals with the treatment of financial instruments and takes into account the conclusions reached to date by the GASB "Financial Instruments Working Group" as well as considering IAS 39 "Financial Instruments: Recognition and Measurement".

Objective of consolidated financial reporting by insurance enterprises

13.
Consolidated financial statements serve only the function of providing information - a view which has become generally accepted on an international level. Consolidated financial statements provide information on the assets and liabilities, financial position and results of operations of a group and the changes from one year to the next. This information is meant to assist a wide range of users to make economic decisions. These decisions require the users to be in a position to assess the ability of the group to generate cash and cash equivalents and to judge when and with what certainty these will arise.[1]

14.
In order to be able to assess a group's assets and liabilities, financial position and results of operations and the changes from one year to the next, users must be able to compare the financial statements of various groups with each other including those in different lines of business. Comparability requires that the economic effect of similar transactions for groups in different lines of business are measured and presented in a similar fashion.[2] The IWG is of the opinion that this makes it all the more necessary for specific industry issues to be reflected appropriately in consolidated financial statements.

Special features of the insurance business

15.
Insurance enterprises give a commitment to policyholders to make agreed payments if a specific insured event occurs. As a result of this commitment to provide insurance cover, risks are transferred from policyholders to the insurance enterprises. The core business of insurance enterprises, unlike any other industry, is therefore the systematic assumption of risks.

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1 cf. IASC Framework para. 12 and 15, FASB CON 1.43.
2 cf. IASC Framework para. 39, FASB CON 2.111 ff.

16.
The assumption of risk is a stochastic process, involving an accumulation of risks (i.e. the portfolio of insurance contracts) over one or several accounting periods.

17.
The provision of insurance protection covers the whole period set out in the insurance policy (the insurance term). Insurance enterprises are thus responsible for a continuous provision of coverage over a period of time. Life and health insurance contracts generally cover very long periods (on average running for several decades!), during which time the insurance enterprise does not have the right to cancel the contract. In the case of property and casualty insurance long-duration insurance contracts are not so common. However, even short-duration contracts (e.g. for one year) mostly have automatic renewal clauses. From an economic point of view, such property and casualty insurance contracts often represent open-ended, revolving portfolios, especially since cancellations of individual contracts are constantly being replaced by new contracts.

18.
The price for the insurance contract (the premium) is normally payable when the contract is signed, i.e. at the beginning of the insurance period. The insurance enterprise is not required to fulfil its payment commitment until a later date, after the insured event has occurred and depending on the nature of the claim. The cash funds generated by this typical insurance contract must be invested in order for the enterprise to be able to meet the obligations from later claims. The investment of funds can be made to a large extent on a long-term basis since

a) in the case of property and casualty insurance contracts, there is generally a revolving surplus of cash funds and
b) in the case of life and health insurance contracts and with certain property and casualty insurance contracts, the insurance element of the contracts is linked inseparably with the investment element (saving and de-saving).

19.
The insurance business differs therefore from most other business in that:

a) the performance of services (provision of insurance protection) covers a period of time which is generally of long duration.
b) the revenue from the contracts is received before services are rendered (subsequent performance).

20.
The objective of financial reporting must be to present fairly the position of an enterprise taking account of the special features of the insurance business set out in paragraphs 13 and 14.

21.
Given the specific features of the insurance business, the accrual basis of accounting is particularly important for the consolidated financial statements of insurance enterprises when assessing whether an enterprise is in a position to generate cash and cash equivalents. The accrual basis of accounting requires the effects of transactions and events to be recorded in the period in which the services are actually provided and not when cash or its equivalent is received.[3] Income and expenditure must be matched in the appropriate period, such that revenue is recognised in the same period in which the relevant costs are incurred (the matching principle).[4]

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3 cf. IASC Framework para. 22, FASB CON 6.139.
4 cf. IASC Framework para. 95, FASB CON 6.146.

Current discussions

22.
The IASC Insurance Steering Committee principally takes an asset-and-liability-measurement approach to accounting for insurance contracts. Under this approach, only items which qualify as assets, liability or equity may be recognised in the balance sheet. The US GAAP approach to accounting by insurance enterprises is based in contrast on the principles of deferral and matching, in which the most important factor is the correct presentation of the results for a period. This method results in the recognition of deferred items and in the use of divergent measurement criteria. In the meantime, both the IASC and the FASB are considering the requirement that all financial instruments should be measured at their fair value.

23.
Under the fair value approach, insurance contracts involve financial instruments, which for reasons of consistency and in order to avoid arbitrage, should be accounted for as such. It is still unresolved whether the changes in fair values should be included in the profit and loss account or whether they should be accounted for directly through equity.

24.
Under this approach
a) practically all assets and liabilities of an insurance enterprise would be included in the balance sheet at their fair value;
b) there is an argument for recognising unrealised profits on existing insurance contracts at the time when the contracts are entered into. In the case of life insurance policies, this would mean anticipating the expected profits to be earned over the total period of the contract (generally 20 to 30 years). This is the so-called “embedded value” of the contract.
c) it is also being discussed whether future profits on expected new business should be recognised. This represents the “appraisal value” of life insurance contracts and the “renewal value” of non-life insurance contracts.

25.
This treatment would have two major consequences on the consolidated financial statements of insurance enterprises, namely
a) that the disclosed equity would largely correspond to the value of the business (subject to all the subjective assumptions which are necessary for such a valuation).
b) that, if the changes in the fair value of assets and liabilities were all reflected in the profit and loss account, then the result shown in the profit and loss account would represent the change in the value of the business during the reporting period.

Comments on current discussions

Fair value accounting

26.
In contrast to many financial instruments, there are no active markets[5] for insurance/underwriting commitments which can be used as the basis for deriving fair values. One obstacle to fair value accounting of assets and liabilities relating to insurance contracts where there are no active markets is

5 Under IAS 38, para. 7 an active market exists, where all the following conditions exist: a) the items traded within the market are homogenous; b) willing buyers and sellers can normally be found at any time; and c) prices are available to the public.

therefore the issue of the reliability[6] of the financial statements. Even using existing models, it is not always possible to derive reliable fair values due to the uncertainties involved in assessing future cash streams.

27.
Fair value accounting of assets held by industrial enterprises has not yet been seriously discussed, even though, in theory, there is more likelihood that active markets exist in this area. Fair value accounting of insurance contracts would therefore not correspond to the accounting treatment currently applicable for industrial enterprises.

28.
In the IASC discussion paper, dated March 1997, dealing with the accounting treatment of financial assets and liabilities, fair value accounting is justified by the argument that the realisation principle is not relevant to accounting for financial instruments due to the lack of risks relating to the actual performance of services. Even though insurance contracts and financial instruments share some common characteristics, there are still major differences between the two. Insurance enterprises remain exposed to underwriting risks during a period until such time that the insurance contract comes to an end and claims are discharged. In other words, the risks of insurance enterprises do involve the performance of services. In this case the recognition of insurance contracts is more a case for IAS 18, which deals with the rendering of services, than an issue of financial instruments in accordance with IAS 39.

29.
The IWG believes that only assets and liabilities for which there are active markets should be allowed to be measured at fair value. This is not the case with insurance contracts; there are no active markets either for individual insurance contracts or portfolios of insurance contracts.

30.
The IWG is aware that the rejection of fair value accounting of insurance provisions is inconsistent with the valuation of investments at their fair value; however the lack of active markets and the requirement to present fairly the results of operation of an enterprise (cf. paragraphs 84-86) justify this inconsistency.

Profit recognition on insurance contracts

31.
Accounting for insurance contracts at their fair value results in profits being recognised at the time the contract is entered into. This is contrary to the accrual basis of accounting and the need for comparability in consolidated financial reporting across different industries.

32.
Enterprises in other industries, where sales are made before contractual delivery or fulfilment (e.g. in the case of contract production), do not recognise profits when the contract is received, but rather over the period of construction or after delivery of the finished product.

33.
In accordance with the accrual basis of accounting, cash receipts should be recognised as revenue over the period of the contract in the same way that the insurance enterprise provides its services over a period of time. Expenses which relate directly to revenues should also be included in the profit and loss account in the corresponding periods. As a consequence, profits earned on insurance contracts should also be recognised over time as the services are performed.

6 cf. IASC Framework para. 31 ff.; FASB CON 2.58 ff..

34.
Financial institutions are also not permitted to recognise unearned interest on financial transactions. In a similar vein, property owners are not permitted to recognise future profits on rental income.

35.
The rules of IAS 18 do not permit profit to be recognised immediately when a contract is entered into. Under this standard, revenue associated with services rendered should be recognised by reference to the stage of completion of the transaction at the balance sheet date, and then only when the outcome of such transaction can be estimated reliably. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, (in particular during its early stages), revenue should be recognised only to the extent that the expenses incurred are recoverable. As far as the recoverable expenses are concerned, no profit is recognised. Similar rules apply in IAS 11 to the accounting for construction contracts. If profits are to be recognised by insurance enterprises when contracts are entered into, it will be necessary to revise IAS 11 (Construction Contracts) and IAS 18 (Revenue) to re-establish comparability between insurance and non-insurance enterprises.

36.
Recognition of fair value changes in the profit and loss account and immediate recognition of profits when contracts are entered into would put insurance enterprises at a disadvantage to non-insurance enterprises on the capital markets. Due to the significant effect that fair value accounting of assets and liabilities could have on the results of insurance enterprises, the reported results would be subject to significant volatility and would be exceedingly dependant on the state of the economy and share market developments. Revenues and assets of non-insurance enterprises are, of course, also heavily dependant on the development of the economy and commodity markets. However, since non-insurance enterprises do not recognise customer portfolios as assets, which would then have to be measured at their fair values, the effect of fluctuations in the economy on the disclosed results of these enterprises, in comparison with those of insurance enterprises, is likely to be substantially less significant.

37.
The higher level of volatility in the reported results of insurance enterprises would make it more difficult to assess the enterprise's ability to generate cash and cash equivalents in the future. Investors and potential investors would factor in a higher expected rate of return as a result of this uncertainty, thus increasing the financing costs of the enterprise. To eliminate this competitive disadvantage on the capital markets, it would be necessary to extend fair value accounting of assets and liabilities to non-insurance enterprises.

38.
Recognising expected profits on new business is also contrary to the accrual basis of accounting (paragraph 33).

39.
The IWG concludes that profits relating to transactions where performance is made over a period should be recognised in the profit and loss account over that period. Recognition of insurance portfolios and their measurement at fair value are also precluded.

Recognition of expected profits on new business

40.
Fair value accounting of insurance contracts including profits on new business – in other words not only relating to the assets and liabilities linked to the insurance contracts – would entail recognising the future benefit of customer relationships related to insurance contracts. An independent businessman would be willing to pay for the benefit of obtaining customer relationships if the insurance contracts were transferred to him. Customer relationships may also represent a source of future economic

benefits for non-insurance enterprises e.g. trading enterprises. However, due to the lack of control which the enterprise has over such benefits, it is not permitted to recognise these as an asset[7].

41.
In the opinion of the IWG, insurance enterprises, like non-insurance enterprises, should not be permitted to recognise the expected economic benefit of customer relationships as an asset due to the lack of control over these benefits.

Summary

42.
In the opinion of the IWG, fair value accounting of assets and liabilities relating to insurance contracts, and of investments[8] held by insurance enterprises, to the extent that they are not traded on active markets, does not allow a reliable presentation of the assets and liabilities and financial position of insurance enterprises on a comparable basis with non-insurance enterprises.

43.
Fair value accounting of assets and liabilities of insurance enterprises in conjunction with recognition of expected profits in the insurance contract portfolio and recognition of expected profits on new business, has the effect that the disclosed equity is equivalent to the total value of the business (on an earnings basis). The equity disclosed in industrial enterprises represents neither the net assets measured at their fair value, nor the value of the business including future expected profits (paragraphs 23 and 24). In order to achieve comparability between insurance and non-insurance enterprises it would be necessary to change the accounting practices of non-insurance enterprises.

44.
In the opinion of the IWG, it is not the purpose of financial reporting to disclose an equity which reflects the value of a business based on its earnings potential.

45.
For the IWG, the principal objectives of consolidated financial statements are the presentation of results based on the accrual basis of accounting where profits are recorded in the appropriate period and with comparability across different industries. It is on this basis that the following technical basic issues are discussed.

Technical basic issues

Basic issue 1: Earned/unearned premiums

46.
Premiums for insurance policies relating to a period of time should be recognised as revenue on the basis of the services provided up to the balance sheet date. Insurance premiums represent payment for the insurance protection provided by the insurance enterprise. The premiums should therefore be allocated to past or future accounting periods on the basis of the actual services provided.

7 cf. e.g. IAS 38, para. 16; also under US-GAAP it is not permitted to account for the benefits from customer relationships.
8 For details on the accounting treatment of investments held by insurance enterprise refer to basic issue 6.

47.
Where the insurance period does not coincide with the accounting period, premiums received relating to later periods must be deferred. In this case it is necessary to set up an amount for deferred income (unearned premiums). Where the insurance and accounting period coincide, or the insurance period falls within one accounting period, a deferral is not necessary.

48.
Since the services being provided by the insurance enterprise are closely linked to the risks being insured, the measurement of unearned premiums should take into account the development of these risks. If there is a correlation between the passage of time and the probability of incurrence of risk over the period, then the premiums can be allocated to past and future accounting periods on a time-apportioned basis.

49.
The premiums received by the insurance enterprise at the inception of an insurance policy represents the “market value" of the services it must provide in the future. At the inception of an insurance policy, the insurance enterprise therefore has an obligation which has effectively been valued by the market at a level corresponding to the premiums received. The IWG therefore considers that profit should not be recognised at the inception of an insurance policy even where market-based fair-value accounting is applied.

50.
Under fair value accounting based on notional market values, it would be necessary to value the obligation/liability at the reporting date at an amount which a third party would be willing to pay to take over the liability. It can be assumed that any potential third party would only take over the obligation to provide insurance coverage, as at the reporting date, in return for a consideration equivalent to the amounts measured on the basis of the principles set out in paragraphs 49-50.

51.
In addition to the amount deferred as unearned premiums, a provision for onerous contracts should also be set up in the balance sheet for the amount by which the expected costs of providing services (i.e. insurance protection) in later accounting periods, measured as at the reporting date, exceed the amount of deferred unearned premiums and other profit elements in the contract. The critical factor is the period remaining before the insurance enterprise can terminate the contract (remaining contractual term).

52.
The situation is different for life and health insurance contracts. In this case the unearned premiums and the provision for onerous contracts are included in the aggregate provision (see basic issue 9).

53.
The measurement of the provision for onerous contracts should not be related to individual contracts, but should be based on the portfolio taken as a whole using actuarial principles (collective approach). Effectively the risks are being spread across the whole portfolio.

54.
The IWG concludes that premiums must be deferred and recognised as profit over a period as risks develop or on a time-apportioned basis. The amounts deferred must be increased where appropriate by a provision for onerous contracts.

55.
Compliance with EU Directives: The conclusion of the IWG is in line with Articles 25 and 57 of the EU Insurance Accounts Directive.

56.
Compliance with German law: The conclusion of the IWG is in line with § 341 e (2) No. 1 HGB and § 24 of the Government Order on the external accounting requirements of insurance enterprises (RechVersV) with the exception that, due to a requirement of the German tax authorities, premiums which cannot be allocated specifically to later periods cannot be included as unearned premiums; in effect this is the same as capitalising acquisition costs (see basic issue 2).

57.
Compliance with US GAAP: The conclusion of the IWG is in line with US GAAP, in particular SFAS 60.

58.
Compliance with IAS: IAS do not deal specifically with the deferral of premiums. The receipt of premiums and the resulting obligation existing at the reporting date to provide insurance coverage in the future constitute an obligating event or condition for the insurance enterprise. As such it qualifies as a liability as defined in paragraph 49 (b) of the IASC Framework for the Preparation and Presentation of Financial Statements. The procedures described above also comply with IAS 39.66. Under this paragraph, financial liabilities are measured initially at cost, which is defined as the fair value of the consideration received. IAS 37.66 requires recognition of a provision for onerous contracts, where unavoidable costs of meeting obligations exceed the economic benefits expected to be received under such contracts.

Basic issue 2: Acquisition costs

59.
Costs incurred in connection with the rendering of services should generally be matched with the related revenues. Costs incurred to acquire insurance contracts ("acquisition costs") should therefore be capitalised and charged to expense over the period of the insurance contracts.

60.
Acquisition costs should be capitalised if they arise in connection with the acquisition of new or renewal insurance contracts. They should include costs which can be allocated both directly and indirectly to the acquisition .

61.
The IWG concludes that acquisition costs for insurance contracts should be capitalised. Due to their character as prepaid expenses, they should be disclosed separately in the balance sheet.

62.
Acquisition costs should be charged to expense on the same basis that related premiums are recognised. They should therefore be charged to expense over the expected duration of the contracts (taking into account expected cancellations), and at a maximum, however, over the contractual duration. For property and casualty insurance contracts with a duration of one year, it is acceptable to charge costs in the reporting and following year in line with the treatment of unearned premiums.

63.
In the case of life insurance contracts, the acquisition costs should be expensed in proportion to the profits recognised. Where a contract does not require an aggregate provision (see paragraph 52) or this provision is not material, it is acceptable to expense acquisition costs on the basis of the same ratios used for determining unearned premiums.

64.
The deferral of acquisition costs is based on the assumption that the future amounts to be expensed are covered by future revenues. This must be verified at each reporting date. This asset impairment test should also include future investment income, which arises from setting aside funds to cover insurance obligations.

65.
To the extent that acquisition costs are written down due to impairment of value, a provision for onerous contracts cannot be raised.

66.
Whether the value of acquisition costs has been impaired should be determined on the basis of the overall portfolio rather than on the basis of individual contracts (see paragraph 53).

67.
The IWG concludes that capitalised acquisition costs should be charged to expense in later years in line with the recognition of premiums or, if their value has been impaired, immediately.

68.
Compliance with EU Directives: The conclusion of the IWG complies with Articles 18 and Article 58 of the EU Insurance Accounts Directive.

69.
Compliance with German law: Recognition of acquisition costs for insurance contracts does not accord with § 248 (3) HGB. However, the deduction made for certain costs when determining the level of unearned premiums to be carried forward, which is generally made by German enterprises (and required by the tax authorities), and the Zillmer adjustment applied on life insurance contracts, both lead to a similar result as if acquisition costs had been capitalised.

70.
Compliance with US GAAP: The conclusion of the IWG complies with US GAAP, in particular SFAS 60, 97 and 120.

71.
Compliance with IAS: The capitalisation of acquisition costs under IAS is currently being considered by the IASC Insurance Steering Committee. The capitalisation of acquisition costs and the process of charging them to expenses over a period complies with Standards applicable for similar accounting issues in other industries. For instance IAS 11.22 requires that contract costs should be recognised as expenses by reference to the stage of completion of a contract.

Basic issue 3: Provision for estimated cost of settling (claims provision)

72.
A provision should be set up for uncertain liabilities for the future expected cost of settling losses or claims related to insurance contracts .

73.
The claims also includes cases where an insurable event has occurred but a claim has not yet been made (claims incurred but not reported).

74.
The claims provision should be based on a realistic estimation of the cost of settling such claims.

75.
Realistic estimation involves:
a) determination of the expected cost. The expected cost is the mean value of the expected claim payments weighted for the range of probabilities of incurrence on a risk neutral basis.
b) increasing the expected cost by a risk mark-up.
The risk factor is necessary to avoid an understatement of the provision.

76.
Third parties taking over the obligations relating to unsettled claims would also require a risk mark-up, in addition to their expected value, due to the uncertainty relating to the cash flows.

77.
The required risk mark-up reduces as the values can be estimated with greater certainty, i.e. depending on the quality of information available and resulting reliability of the estimation. The required risk mark-up also depends on the probability distribution and the spread of claims in the portfolio of contracts. The risk mark-up is likely to be smaller in the case when the volume of claims is very frequent, and larger when only a few, but then major claims, are expected.

78.
The cost of settling claims should be based on all available information, i.e. using past experience adjusted by current expectations for the future. This includes future price increases, expected changes in legislation and technological developments, which can affect claims payments.

79.
When new information becomes available at a reporting date after the initial estimate has been made or if the assumptions used to make estimates change/are changed, these should be included immediately in the measurement of the provision. It is not considered appropriate for the effect of such changes to be spread over time.

80.
The IWG concludes that the claims provision at any reporting date should be based on a realistic estimation of the cost of settling such claims. The measurement of the provision must take into account the uncertainty and risks involved in estimating the future amounts payable. Prudence does not, however, justify an overstatement of the provision.

81.
The need to allocate claims expenses to the periods in which the corresponding premiums are recognised not only applies to the claims expenses themselves, but also to the costs incurred for loss adjustment (costs incurred to quantify the amount payable under an insurance claim). The claims provision should also include a provision for loss adjustment costs. Loss adjustment and the processing of insurance claims are indivisible components of the overall function of providing "compensation". It is irrelevant whether the costs can be allocated directly to individual insurance claims (direct costs) or whether these can only be measured by means of cost allocations (overheads).

82.
The IWG considers that the measurement of the claims provision should also take into account the full cost of loss adjustment relating to insurance claims.

83.
It is argued by proponents of fair value accounting using the asset-and-liability-measurement approach that the claims provision should be measured on a discounted basis since payment at a later stage represents a lower economic burden than a payment due at the balance sheet date. A third party would be willing to take over the payment obligations in return for a consideration lower than the absolute amounts payable. However, in contrast to marketable securities, for example, there is generally no

active market for provisions for unpaid claims. At the most, whole portfolios of insurance contracts are transferred from time to time, without, however, providing any basis for measuring the market value of provisions for unpaid claims.

84.
Moreover, in the interest of recognising profits in the correct period, it is necessary to measure the claims provision on the basis of absolute amounts rather than with discounted amounts. If amounts were discounted, the cost of claims shown in the profit and loss account in later periods would include the effect of a reversal of the discounting (unwinding of discount), whereas the premiums relating to these claims have already been recognised in an earlier period.

85.
From an economic point of view, the process of discounting means that investment income is effectively being recognised in advance, since resources have been tied up specifically for the purposes of financing the future liability by investing them until such time that the payments are made. In line with the IWG's view that income on invested assets should be treated in the profit and loss account in the same way as income earned on providing capital funds, discounting is not considered to be justified.

86.
It is sometimes argued that discounting is justified by the fact that a part of the claims expenses are covered by future investment income and not by the premiums for the year in which the insured event occurs. Proponents of this view point out that the level of premiums also takes expected investment income into account. Investment income arises, however, independently of any claims. The amount of investment income to be recognised in each period would otherwise have to be based on the level of claims expenses, which fluctuate from year to year. Investment income and claims expenses involve completely separate cash flows, which must therefore be allocated to accounting periods separately.

87.
The IWG rejects the notion of measuring provisions for unpaid claims on a discounted basis.

88.
Compliance with EU Directives: The conclusions of the IWG comply with Articles 28 and 60 of the EU Insurance Accounts Directive .

89.
Compliance with German law: The conclusions of the IWG are in line with German law, in particular with §§ 253 (1), 341 g HGB and § 30 RechVersV with the exception that § 341 e (1) HGB requires insurance enterprises to set up underwriting provisions in such a manner as to ensure that obligations under insurance contracts can be met on a continuous basis. This can be interpreted to mean that an extreme level of prudence should be applied.

90.
Compliance with US GAAP: The conclusions of the IWG are in line with US GAAP, in particular SFAS 60. The procedures for determining a "realistic estimation of cost " complies in the opinion of the Working Group with the US GAAP requirement for the "best estimate".

91.
Compliance with IAS: At present, there are no IAS standards dealing specifically with provisions relating to insurance contracts. The conclusions of the IWG comply with IAS 37, which is not specifically applicable for insurance contracts, with the exception that, provisions should be stated at the present value, where the effect of the time value of money is material (paragraph 45).

Basic issue 4: Catastrophe provision

92.
It is unlikely or it may even not be possible at all to cover all the insured risks inherent in a portfolio of contracts during a single accounting period with the premiums for that period if the probability of occurrence of such risks is relatively low, but the volume of the potential cost of each of these risks is individually high. In such cases, it must be the aim to be able to cover the insured risks over a period of time, i. e. the time span for covering claims expenses with revenue extends beyond a single accounting period into an unlimited period in the future. In other words it is necessary to spread the premiums, using actuarial principles, over several accounting periods in order to finance single catastrophe events.

93.
The necessary coverage of the insured risks over time can only be achieved, if the premiums not used to pay claims are carried forward to later accounting periods. For accounting purposes – at least in terms of the need for a long-term approach to insurance contracts – it must be deemed that the insurance enterprise has a liability at the reporting date.

94.
Provisions for catastrophe risks would typically be required for risks relating to liability insurance policies for nuclear power stations, product liability policies for the pharmaceutical industry and policies for natural catastrophes (earthquakes and other natural disasters).

95.
The IWG concludes that a provision is required for risks of the same type, where the coverage of costs with revenue is not feasible within a single accounting period due to the exceptionally high cost of individually insured risks measured on an actuarial basis, but can only be achieved over several accounting periods, which are themselves not fully definable.

96.
Due to the special character of such an item in the balance sheet, the amount of the provision and the change during the year should be disclosed separately for each reportable primary segment as part of segment reporting.

97.
The catastrophe provision should in principle be increased each year by the premiums not used to cover the cost of claims (below average claims).

98.
The catastrophe provision should be increased until such time that a maximum amount is reached, which should be measured using actuarial principles. The creation of a provision amounting to the value of the expected level of claims which exceeds the premiums received in the past and not used to date to cover claims expenses can, at the most, be justified by an interpretation of the prudence concept which is not accepted on an international level.

99.
The increase to the catastrophe provision should be taken out of unearned premiums brought forward from previous years on an annual basis, if the costs of claims are higher than the expected level of claims (above average claims).

100.
The basis for the measurement of allocations to and from the catastrophe provision should be disclosed in the notes to the financial statements.

101.
Compliance with EU Directives: The conclusions of the IWG are in line with EU Directives, in particular Articles 30 and 62 of the EU Insurance Accounts Directive .

102.
Compliance with German law: The conclusions of the IWG are in line with § 341 h HGB and § 30 RechVersV, the latter of which stipulates an actuarially based method for measuring the catastrophe provision.

103.
Compliance with US GAAP: The approach proposed for the catastrophe provision is only permissible under US GAAP if the criteria for an onerous contract are met.

104.
Compliance with IAS: At present there are no IAS standards dealing specifically with provisions relating to insurance contracts. In order to be recognised in the balance sheet, IAS requires that the definition for liabilities is met as set out in paragraph 49 (b) of the IASC Framework. It appears doubtful to the IWG that the criteria for this definition are met. A provision for onerous contracts may be appropriate in specific circumstances.

Basic issue 5: Claims equalisation provision

105.
Even where an enterprise has a portfolio of insured risks for which premiums and costs are matched in each accounting period on an actuarial basis, at least arithmetically, the actual level of costs for claims will fluctuate more or less around the expected value of claims. This is a result of the aleatory nature of the insurance business. In many countries this factor is taken into account by the use of a so-called "claims equalisation provision".

106.
The occurrence of insured events and the payments made for claims represent a stochastic process taking place over time. This stochastic process does not come to an end at any one balance sheet date. The outcome cannot be definitively realised at any one balance sheet date. It is more the case that the process of equalisation takes place between past and future periods. This process must somehow be reflected in the financial statements. This is the purpose of the claims equalisation provision. Without the allocations to and from the claims equalisation provision, which take account of the volatility of insured risks, it is not possible to depict fairly the equalisation process taking place in the insurance business. In particular, the fluctuating outcome that would result from a single period presentation of this (volatile) process, depending to a large extent on events of chance, would not provide useful information to assess the enterprise's ability to generate profits on a sustained basis. In addition external users of financial statements (mainly investors) also consider short-term issues when making their investment decisions, thus taking account of the volatility of the business. This allows chance fluctuations in the risk process to be made more transparent. For this reason, the outcome of risks (i.e. the result from underwriting activities) should be shown for each class of insurance before and after the changes in the claims equalisation provision. This information is also required to calculate the earnings per share (in accordance with DVFA/GDV), as is usually the case at present.

107.
The IWG concludes that premiums which by chance are not used in the course of a financial year (below average claims) should be deferred in the form of a claims equalisation provision.

108.
Due to its special character, the amount of the claims equalisation provision and the change in the provision during the year should be disclosed separately for each reportable primary segment as part of segment reporting.

109.
The claims equalisation provision should in principle be increased each year by the premiums not used where the actual cost of claims is lower than the expected cost of claims (below average claims). The upper limit for the claims equalisation provision should be based on actuarial principles. Risk premiums brought forward from earlier periods should be transferred to it, if the costs of claims are higher than the expected level of claims (above average claims). Consideration should also be taken where appropriate of any changes in the assumptions used to determine the expected annual cost.

110.
The basis for the calculation and for transfers to and from the claims equalisation provision should be disclosed in the notes to the financial statements.

111.
Compliance with EU Directives: The conclusions of the IWG are in line with EU Directives, in particular Articles 30 and 62 of the EU Insurance Accounts Directive.

112.
Compliance with German law: The conclusions of the IWG are in line with § 341 h HGB and § 29 RechVersV. The appendix to § 29 RechVersV stipulates the actuarial basis to be used for the calculation of the claims equalisation provision.

113.
Compliance with US GAAP: The recognition of a claims equalisation provision is not permissible under US GAAP.

114.
Compliance with IAS: At present there are no IAS standards dealing specifically with provisions relating to insurance contracts. In order to be recognised in the balance sheet, IAS requires that the definition for liabilities is met as set out in paragraph 49 (b) of the IASC Framework. It appears doubtful to the IWG that the criteria for this definition are met.

Basic issue 6: Accounting for investments

115.
In order to account for investments at their fair value, it is necessary that they are traded on active markets and can be sold at any time.

Real estate

116.
Active markets with adequate liquidity, which could provide the basis for reliable fair values for real estate, are often not available. This applies irrespective of whether the real estate is used by the enterprise itself or whether it is rented out. It does not meet the criteria for fair value accounting.

117.
Since fair values of real estate can vary significantly from book values, however, it is necessary to provide information in the notes to the financial statements on the estimated fair values of such assets, in order to ensure a fair presentation of the assets and liabilities.

118.
The IWG considers that, due to the lack of active markets with adequate liquidity, real estate should be measured at its amortised cost. The estimated fair value of the real estate should be disclosed in the notes to the financial statements. The IWG may reconsider the issue in the light of the ongoing international debate, specifically for not owner-occupied property available for sale.

Investment in other enterprises

119.
It is normal international accounting practice to account for investments in associated companies in consolidated financial statements using the equity method. Investments in associated companies as such are not traded on active markets. The fair values of investments in individual associated companies rarely coincide with amounts received on disposal. Information on the fair values of such investments should therefore be limited to the notes to the financial statements.

120.
The IWG concludes that investments in associated companies should be measured at their equity value. The estimated fair value of investments in associated companies should be disclosed in the notes to the financial statements.

Other investments

121.
It is normal international accounting practice at present to account for other investments based on management's objective for holding the investments or on how the investment arose. Measurement of investments depends on which category the investment belongs to, namely:

a) loans and securities where the intention is to hold them to maturity
b) investments which can be sold at any time and are held for trading
c) receivables originated by the enterprise which arise in the ordinary course of business and are not held for trading

a) Loans and securities where the intention is to hold them to maturity

122.
Bonds and other fixed income securities as well as receivables where the intention is to hold them to maturity, serve to finance long-term underwriting liabilities. The computed fair value and any changes in the fair value of such assets are not relevant to the fair presentation of the financial position of an insurance enterprise. Under current international accounting practice, it is possible to measure these assets at their "amortised cost". In order to allow comparability, however, the fair values of these assets should be disclosed in the notes to the financial statements.

123.
In order to account for bonds, other fixed income securities and relevant receivables at their amortised cost it is necessary that the classification of such assets as "held to maturity" is based on an objective and consistent approach. In addition to the intention of management to hold these assets to maturity, the enterprise must also have the demonstrated ability to hold them to maturity. Measurement at amortised cost is not permissible if more than an insignificant amount of assets originally classified to this category have been sold in the past before maturity.

124.
The IWG proposes that bonds, other fixed interest securities and relevant receivables, where the intention exists to hold them to maturity, should be value at amortised cost. The computed fair values of these assets should be disclosed in the notes to the financial statements.

b) Investments which can be sold at any time and are held for trading

125.
It is normal international accounting practice for investments, which can be sold at any time or which are held for trading, to be measured at their fair value. The prerequisite for fair value accounting (existence of active markets) is generally fulfilled.

126.
The IWG concludes that investments which can be sold at any time or which are held for trading should be measured at their fair value.

127.
Investments for which reliable fair values cannot be determined should not be measured at their fair value .

c) Receivables originated by the enterprise which arise in the ordinary course of business and are not held for trading

128.
Receivables held by insurance enterprises which have been created in the ordinary course of business and which are not held for trading also qualify as financial instruments. These include mortgages, real estate mortgages and annuities as well as deposits on reinsurance business assumed. These investments also serve to finance long-term underwriting liabilities and are linked closely with such liabilities.

129.
This category of investments also includes new registered debentures, bonds and loans, which are issued directly by the insurance enterprises and where the receivable item results from the issue of the loan. In practice, it is often not possible to identify these investments separately. In this case, the decision whether to measure these assets at amortised cost should depend on whether the intention exists to hold them to maturity.

130.
The IWG proposes that receivables held by insurance enterprises which have been created in the ordinary course of business and which are not held for trading should be measured at amortised cost. The computed fair values of these assets should be disclosed in the notes to the financial statements.

Accounting treatment of changes in the fair value of investments

131.
Under generally accepted accounting principles, investment income is recognised in the profit and loss account in accordance with the concept of the provision of capital funds. Interest receivable is therefore recorded in the profit and loss account in the period in which the capital funds have been made available. When the period to which the interest relates differs from the reporting period, the appropriate accounting deferrals should be made.

132.
Investments are generally held by insurance enterprises on a long-term basis in order to finance long-term underwriting liabilities. Unrealised gains relating to changes in the value of investments measured at their fair value do not generally provide useful information about an enterprise's ability to generate profits on a sustained basis, since they often result from the short-term volatility of the capital markets and from a snapshot taken at the balance sheet date. Only interest, dividend income and realised gains and losses are definite enough to be recognised in the profit and loss account. Information on potential gains which may be realised in the future as a result of value changes is provided in the notes to the financial statements by way of the disclosure of fair values.

133.
Where insurance enterprises hold investments for trading purposes, value changes relating to these holdings should be treated as a part of the ordinary activities of the business i.e. before they are actually realised. In line with generally accepted international accounting practice, they should be recognised immediately in the profit and loss account.

134.
In some countries it is possible or even normal to spread the effect of realised and/or unrealised value changes, with the consequence that the profit and loss account reflects investment income based on long-term expectations. This approach is particularly useful when assessing the ability of the enterprise to generate income from investments in the future. However, an objective basis for spreading the effects of such changes is difficult unless very specific rules have been put in place.

135.
The IWG considers that unrealised value changes relating to investments should be recognised directly in equity rather than in the profit and loss account or in an extended profit and loss account (i.e. comprehensive income). In the opinion of the IWG, only unrealised gains and losses relating to the value of investments held for trading should be recognised immediately in the profit and loss account.

136.
Compliance with EU Directives: The conclusions of the IWG are in line with EU Directives, in particular Articles 46 ff. and 55 of the EU Insurance Accounts Directive.

137.
Compliance with German law: Fair value accounting of investments contravenes § 253 (1) sentence 1 HGB which stipulates that measurement of investments must be made on the basis of acquisition cost. Where investments are carried at "amortised cost", this is the equivalent of recognising assets at their nominal value and setting up a deferred income item for the difference between acquisition cost and nominal value. Under § 341 c HGB, however, recognition of assets on a nominal value basis is restricted to registered debentures, mortgage loans and other receivables.

138.
Compliance with US GAAP: The conclusions of the IWG comply with US GAAP, in particular APB 18 and SFAS 115.

139.
Compliance with IAS: The conclusions of the IWG comply with IAS 16, 25, 28 and 39. The measurement of real estate at amortised cost proposed by the IWG complies with IAS 40, approved by the Board in March 2000.

Basic issue 7: Provision for deferred premium refunds on life and health insurance policies

140.
Policyholders of life and health insurance contracts often have a significant interest in the success of an enterprise in the form of refunds/ participation in profits. The basis for measuring this success is the profit derived from the statutory financial statements. The application of different recognition and measurement rules in statutory accounts based on national accounting principles and in consolidated financial statements (where these are based on international accounting principles) give rise to different reported results. These differences represent a latent obligation of the enterprise to policyholders in terms of the future participation in the profits. The issue is not unlike that encountered with deferred taxes.

141.
Although the differences do not give rise to legal obligations, since these are based on the disclosed profit in the statutory accounts, the insurance enterprise effectively has a constructive obligation. A constructive obligation is an obligation which derives from an enterprise's actions where
a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities and
b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities[9].

142.
The IWG considers that an enterprise should make a provision for deferred premium refunds, in order to ensure that all obligations are accounted for. The amount of the provision should be disclosed separately either on the face of the balance sheet or in the notes.

143.
The provision for deferred premium refunds could conceivably be based on:
a) the pre-determined minimum share of the so-called profit before premium refunds to which policyholders are entitled by way of insurance contract, insurance legislation or insurance supervision regulations (including statutory instruments and supervision authority orders);
b) the share achieved in the past and expected for the future.

144.
The IWG considers that the provision should be measured at the least with the minimum share of profits that the policyholder will receive as set out in the contract or prescribed by law. A higher amount may only be recognised where this is justified by the fact that the actual share achieved in the past was higher.

9 cf. IAS 37 para. 10.

145.
Allocations to and from the provision for deferred premium refunds should be recognised in the profit and loss account in the periods, in which the related profit and the premium refunds themselves are recognised in the profit and loss account. To the extent that the profit before premium refunds and there fore the related refunds are recognised directly in equity, allocations to and from the provision for deferred premium refunds should be recognised directly in equity too.

146.
Compliance with EU Directives: A provision for deferred premium refunds is not dealt with specifically in the EU Directives. The EU Directive regulations do not, however, conflict with the view taken by the IWG.

147.
Compliance with German law: A provision for deferred premium refunds is not dealt with specifically by either the Commercial Code (HGB) or the Government Order on the external accounting requirements of insurance enterprises (RechVersV).

148.
Compliance with US GAAP: A provision for deferred premium refunds is not dealt with under US GAAP.

149.
Compliance with IAS: A provision for deferred premium refunds is not dealt with under IAS.

Basic issue 8: Accounting for the Embedded Value of life insurance policies

150.
Accounting for the embedded values in life insurance policies entails measuring such portfolio of contracts at fair value at the reporting date. This means that future profits on insurance contracts are recognised in the period in which the contracts are entered into.

151.
The recognition of the embedded value is contrary to the normal practice applied in other industries for similar issues. The recognition of the embedded value is inconsistent with the accrual basis of accounting and means that the financial statements of insurance enterprises would not be comparable with those of enterprises in other industries (see paragraphs 26 to 45).

152.
For the reasons given in paragraphs 26 to 45 the IWG concludes that the embedded value of life insurance contracts and therefore the profits relating to them should not be recognised immediately when the contracts are entered into.

153.
Compliance with EU Directives: Non-recognition of embedded value complies with EU Directives.

154.
Compliance with German law: Recognition of embedded value is not permitted by German law.

155.
Compliance with US GAAP: Recognition of embedded value is not permitted under US GAAP.

156.
Compliance with IAS: The recognition of embedded value is currently being considered by the IASC Insurance Steering Committee.

Basic issue 9: Accounting principles relating to the aggregate provision for life insurance policies

157.
The aggregate provision for life insurance policies is usually calculated on a prospective basis under generally accepted international accounting practices. A retrospective method is only permitted, where the prospective method cannot be applied to a specific type of contract.

158.
Where insurance policies provide guarantees for redemption or surrender values, the aggregate provision for each contract should be measured, at a minimum, at the guaranteed redemption or surrender value. This is the amount that would be required to discharge all contractual obligations towards the policyholder at each balance sheet date.

159.
The use of the prospective method involves taking account of all future costs. If expected future costs are less than the costs considered when initially determining the level of the premium, then the latter should be used to allocate profits to each period. Future expected premiums are reduced by an amount equivalent to the amortisation of capitalised acquisition costs.

160.
It is also permitted to take account of future costs indirectly, e. g. by removing mark-ups for administration costs from premiums (as long as the costs used to determine the level of premiums were appropriate).

161.
The accrual basis of accounting requires that the aggregate provision should be based on the following accounting principles:

a) Non-participating contracts: realistic basis of calculation, including the expected rate of cancellations.
b) Participating contracts/with-profits contracts: the same basis of calculation should be applied which was used to measure the future profit-share payments. If the profit-share amount is based on the distributable profit for a financial year and this distribution is determined in a way which approximates the contribution of each contract to the overall result, then it is also possible to take account of the profit-share implicitly by eliminating it from the future payments (as long as the same basis of calculation is applied as was used for determining the level of the premium); in this case the probability of cancellations is not taken into account.

162.
The calculation should be based on a "best estimate", where this provides a more prudent basis of measurement.

163.
Where policies indicate that a profit-share will be paid, but the level of the profit-share is not guaranteed, the obligation (effectively a constructive liability) does not necessarily have to be taken into account in the aggregate provision since a legal obligation does not exist at the level of each individual contract. In this case, the obligation can also be incorporated into the provision for premium refunds. The provisions set up for profit-shares to policyholders should then be disclosed separately in the notes to the financial statements.

164.
The IWG concludes that the aggregate provision should be calculated as a rule on a prospective basis. A retrospective basis is only permitted where a prospective basis is not feasible. The probability of cancellation should not be taken into account where surrender values are guaranteed; the aggregate provision must be at least equivalent to the guaranteed surrender value for each contract. The

aggregate provision can take account of expected costs either directly or indirectly. Obligations under non-participating contracts should be measured using a realistic basis of calculation. Obligations under contracts with profit-share should be measured using the same basis of calculation applied when determining the future amount to be paid. If the criterion stated in paragraph 161 applies, it is also possible to measure them using the initial basis of calculation of the premiums. The calculation should be based on a "best estimate", where this provides a more prudent basis of measurement.

165.
Compliance with EU Directives: The conclusions of the IWG do not contravene any regulations contained in the EU Directives.

166.
Compliance with German law: German law requires that prudent accounting methods are used. Products of this kind offered by insurance enterprises generally do involve a system of profit-share payments, so that the measurement of the aggregate provision using suitable bases of calculation is permissible.

167.
Compliance with US GAAP: The conclusions comply with US GAAP.

168.
Compliance with IAS: The conclusions do not contravene any existing IAS regulations.

Basic issue 10: Disclosure of premiums for life insurance business

Unbundling of life insurance contracts

169.
In most types of life and health insurance contracts with a premium refund arrangement and in the case of health insurance contracts which are organised on a similar basis to life insurance contracts, the insurance (risk) element is linked inseparably with the investment element (*saving and de-saving transactions)*.

170.
From an actuarial point of view, the insurance and the investment elements are, however, inseparable. This approach is also used internationally to measure the aggregate provision for accounting purposes. The aggregate provision is defined as the present value of the future expected payments (one-off or made over a period of time) for insurance services less the present value of the expected value of premiums to be received, whereby both cash streams have stochastic characteristics. It is impossible to separate the two elements using this model, and consequently it is impossible to separate the amounts involved.

171.
Unit-linked life insurance contracts generally offered in Germany result in the insurance enterprise having a legally enforceable claim against the policyholder for the full amount of the agreed premiums. Such contracts only allow the investment and insurance elements to be separated in retrospect. The amounts relating to each element are not stated in the insurance contract. Outside Germany, the two elements are sometimes quantified separately, and this can therefore be used as the basis for unbundling the premiums relating to unit-linked life insurance contracts.

172.
The IWG concludes that the premiums should be unbundled for disclosure in the profit and loss account, where a part of the premiums is allocated to a special account in accordance with the contract and where all income and expenses for the benefit/charge of the policyholder are also recorded in this account.

Premiums relating to transfers from the provision for premium refunds

173.
Premium payments received should be recognised in the profit and loss account as revenue. The credit entry to the profit and loss account which results from (experience related) transfers from the provision for premium refunds do not, however, represent revenue as such. there is no profit and loss effect overall, since the transfer is matched by an equivalent increase in the aggregate provision.

174.
The IWG concludes that premiums relating to transfers from the provision for premium refunds should not be recognised as revenue in the profit and loss account, but should be treated as a switch between two types of provision.

175.
Compliance with EU Directives: The conclusions of the IWG would not contravene any regulations contained in the EU Directives.

176.
Compliance with German law: The conclusions of the IWG comply with German law, with the exception that:
a) premiums from unit-linked life insurance policies are recognised at present as gross premiums written irrespective of the nature of the contract.
b) premiums derived from the gross provision for premium refunds are disclosed on a separate line in the profit and loss account.

177.
Compliance with US GAAP: The conclusions of the IWG would not contravene any existing US GAAP regulations. Unbundling of premiums is performed under US GAAP for certain types of unit-linked life insurance contracts. Under “statutory GAAP”, however, it is normal for items which are similar in nature to premiums relating to withdrawals from the provision for premium refunds to be recognised in the profit and loss account.

178.
Compliance with IAS: The conclusions of the IWG would not contravene any existing IAS regulations. The necessity to unbundle premiums, in particular those relating to unit-linked insurance contracts, is currently being considered by the IASC Insurance Steering Committee.

Basic issue 11: Financial reinsurance

179.
Financial reinsurance contracts are contracts in which it is the financing aspect of the agreement that is the most important for the ceding insurer and policyholder, and which do not transfer significant amounts of insurance risk. Financial reinsurance contracts can be accounted for in one of two ways:
a) unbundling the financial and risk transfer elements and accounting for each of these elements separately or
b) treating the contract as an indivisible whole depending on the nature of the contract.

180.
One argument for unbundling financial reinsurance contracts is that the financing element of such a contract is not related to the insurance risk and corresponds therefore more to a financial transaction. It is not necessary to define specifically whether the amount of risk transferred is significant when unbundling the contracts.

181.
Due to the complexity of the products involved, however, it is not always feasible to unbundle the various elements of financial reinsurance contracts.

182.
The IWG considers that financial reinsurance contracts should be accounted for as an indivisible whole, i. e. the financial and insurance elements should not be unbundled. The accounting treatment should depend on the magnitude of the insurance risks being transferred.

183.
In the opinion of the IWG, risks only resulting from the uncertainty of the point in time when payments will have to be made, do not constitute underwriting risks.

184.
The assessment of whether the amount of risk transferred is significant or not should take into account:
a) whether it is sufficiently likely that the insurance enterprises will incur a significant loss as a result of the contract and
b) how uncertain the level of the payments actually is.

185.
Contracts which do not transfer a significant amount of underwriting risk should be treated as financial transactions.

186.
Compliance with EU Directives: EU Directives do not contain any rules concerning financial reinsurance contracts.

187.
Compliance with German law: German accounting regulations do not deal with financial reinsurance contracts. The conclusions of the IWG comply with proper accounting principles (German GoB).

188.
Compliance with US GAAP: The conclusions of the IWG correspond to the definition of "insurance risk" dealt with in US GAAP (SFAS 113). Under US GAAP the mere uncertainty of the point in time when payments will have to be made does not mean that underwriting risk has been transferred.

189.
Compliance with IAS: The conclusions of the IWG do not contravene any existing IAS regulations. The accounting treatment of financial reinsurance contracts is currently being considered by the IASC Insurance Steering Committee.

Basic issue 12: Offsetting of reinsured amounts

190.
In various countries it has become normal accounting practice for the portion of underwriting provisions relating to reinsurers to be disclosed as receivables on the asset side of the balance sheet (*gross disclosure*).

191.
It is sometimes argued against disclosure on a gross basis, that this approach can result in the recognition of assets which would not qualify as capitalisable assets under normal circumstances. If disclosure is made on a net basis, however, the non-capitalisable elements are effectively derecognised in the calculation of the provisions.

192.
A net disclosure does not, however, comply with the principle existing under German accounting principles which prohibits the offsetting of assets and liabilities. Disclosure on a gross basis also more appropriately deals with the issue of the potential credit risk of the reinsurer.

193.
The IWG does not consider that the arguments against disclosure on a gross basis are so compelling as to justify departing from the prohibition of offsetting assets and liabilities.

194.
Compliance with EU Directives: The conclusions of the IWG comply with EU Directives, in particular with Article 24 of the EU Insurance Accounts Directive .

195.
Compliance with German law: The conclusions of the IWG do not accord with the net disclosure prescribed by Form 1 RechVersV.

196.
Compliance with US GAAP: The gross disclosure preferred by the IWG complies with the approach normally taken under US GAAP.

197.
Compliance with IAS: The conclusions of the IWG do not contravene any existing IAS regulations. IAS 37 requires disclosure of provisions on a gross basis in the case of expected reimbursements.

Basic issue 13: Balance sheet and profit and loss account presentation

198.
In view of the extensive segment reporting requirements and other information which must be disclosed in the notes to the financial statements, the IWG believes that the level of detail to be shown on the face of the profit and loss account and the balance sheet should be reduced considerably in comparison to that currently prescribed by the EU Insurance Accounts Directive and the RechVersV form sheets. In other words, the profit and loss account and the balance sheet should be designed to be more transparent and all detailed additional information should be provided in the notes to the financial statements.

199.
Due to the close link between the investment and investment elements of an insurance enterprise, the IWG considers that the distinction between the underwriting and non-underwriting account (implicitly required by the classification required by the form sheets) should no longer be made.

200.
The IWG proposes the format shown in the appendix to this paper which is based on internationally accepted principles.

201.
The IWG considers that the format of the profit and loss account and the balance sheet should be extended, where appropriate, when non-insurance enterprises (e. g. banks) are included in the consolidated financial statements of insurance enterprises. More detailed information should be provided in the notes to the financial statements and in conjunction with segment reporting.

202.
Compliance with EU Directives: The format proposed by the IWG for the balance sheet and profit and loss account aggregate certain items which are required to be shown separately by the EU Insurance Accounts Directive. The IWG considers that compliance with EU Directives will be achieved, if the information required by the EU Insurance Accounts Directive is provided in the notes to the financial statements.

203.
Compliance with German law: The format proposed by the IWG is less detailed than the form sheets 1 and 4 prescribed by the RechVersV for the balance sheet and profit and loss account.

204.
Compliance with US GAAP: The format proposed by the IWG is in line with the format of balance sheets and profit and loss accounts generally published in accordance with US GAAP.

205.
Compliance with IAS: The format proposed by the IWG does not contravene any existing IAS regulations.

Basic issue 14: Horizontal Groups

206.
In Germany it is common to find group structures for mutual insurance enterprises and for public sector insurance enterprises, where there are two parent companies under common management, but where neither of these controls the other (horizontal group). The IWG considers it unsatisfactory, that both of the parent companies should be obliged to prepare sub-consolidated financial statements with each parent consolidating only its own subsidiaries. These sub-consolidated financial statements are not suitable for presenting fairly the situation of the horizontal group as though it were a single entity.

207.
The IWG believes that insurance groups should also be required to prepare consolidated financial statements where two enterprises are under common management. This should be the case irrespective of whether there is any shareholding connection or one of the enterprises has control rights over the other or not.

208.
The IWG concludes that consolidated financial statements of a horizontal group which includes all subsidiaries should entitle the group to be exempt from preparing sub-consolidated financial statements as long as all criteria for exemption, currently required from vertical groups, have been met.

209.
Compliance with EU Directives: The conclusions of the IWG are in line with EU Directives, in particular Articles 11 and 12 of the EU Insurance Accounts Directive.

210.
Compliance with German law: The conclusions of the IWG do not accord with §§ 290 and 291 HGB. Under these articles, only the parent company and its subsidiaries can be included in the consolidated financial statements. This restriction on the scope of the reported entities in the group is one of the conditions which must be met for consolidated financial statements of a parent company to have their exempting effect.

211.
Compliance with US GAAP: US GAAP does not deal specifically with horizontal groups.

212.
Compliance with IAS: There are no IAS rules, which would disallow the application of IAS consolidation principles to horizontal groups.

Basic issue 15: Internal group transactions

213.
Under currently valid German regulations, insurance enterprises are required to present the profit and loss accounts with separate disclosure of the different business segments (i.e. form sheet 4 RechVersV). This can lead to inappropriate disclosures, where individual transactions between the segments are eliminated on consolidation. Such an elimination may stand in the way of the objective of consolidated financial statements set out in paragraphs 13 and 14.

214.
In the light of the proposed format dealt with in basic issue 13, which no longer requires disclosure by type of business on the face of the profit and loss account, and the requirement to provide segment reporting information on the different business segments before elimination of inter-segment transactions, the IWG believes that a separate rule entitling enterprises not to eliminate internal group transactions is superfluous.

215.
Inappropriate disclosures can still arise, where the proposed format for profit and loss accounts and balance sheets (see basic issue 13) is extended to take account of specific accounting issues of non-insurance enterprises and where transactions between consolidated insurance and non-insurance enterprises are eliminated. In order to avoid such inappropriate disclosures, transactions between segments are not eliminated for segment reporting purposes. For the same reasons, income and expenses should not be eliminated in the profit and loss account itself, providing that the transactions involved have been entered into on normal market terms.

216.
Where the format for profit and loss accounts and balance sheets is extended to take account of specific accounting issues of non-insurance enterprises (see basic issue 13), it should be permissible in the opinion of the IWG for income and expenses not to have to be eliminated, where the transactions involved have been entered into on normal market terms. In contrast, the elimination of inter-company/segment profits must remain compulsory.

217.
Compliance with EU Directives: The issue of elimination of inter-company income and expenses was not a current issue when the EU Insurance Accounts Directive was issued. The conclusions of the IWG do not conform with Articles 26 (1) a and b 7. of the Directive.

218.
Compliance with German law: The conclusions of the IWG do not comply with §§ 303 and 305 HGB.

219.
Compliance with US GAAP: The conclusions of the IWG do not comply with US GAAP, in particular APB 51.1.

220.
Compliance with IAS: The conclusions of the IWG do not comply with IAS 27.17 and 27.18.

Appendix

Consolidated balance sheet at 31 December 2001

ASSETS		
	2001 Euro million	2000 Euro million
A. Intangible assets		
I. Goodwill	XXX	XXX
II. Other intangible assets	XXX	XXX
Sub-total A.	XXX	XXX
B. Investments		
I. Real estate including buildings on third party land	XXX	XXX
II. Investments in affiliated companies, joint-ventures and associated companies	XXX	XXX
III. Mortgage loans and other loans	XXX	XXX
IV. Other securities	XXX	XXX
1. Held to maturity	XXX	XXX
2. Available for sale	XXX	XXX
3. Held for trading	XXX	XXX
Sub-total IV.	XXX	XXX
V. Other investments	XXX	XXX
Sub-total B.	XXX	XXX
C. Investments held on behalf of life insurance policyholders	XXX	XXX
D. Receivables	XXX	XXX
E. Cash with banks, cheques and cash on hand	XXX	XXX
F. Share of underwriting provisions relating to reinsurers	XXX	XXX
G. Acquisition costs capitalised	XXX	XXX
H. Deferred tax assets	XXX	XXX
I. Other assets	XXX	XXX
Total assets	XXX	XXX

EQUITY AND LIABILITIES

	2001 Euro million	2000 Euro million
A. Equity		
I. Subscribed capital and capital reserve	XXX	XXX
II. Revenue reserves	XXX	XXX
III. Other reserves	XXX	XXX
IV. Unappropriated retained earnings	XXX	XXX
Sub-total A.	XXX	XXX
B. Minority interest	XXX	XXX
C. Underwriting provisions (gross)		
I. Unearned premiums	XXX	XXX
II. Aggregate provision	XXX	XXX
III. Provision for unpaid claims	XXX	XXX
IV. Other underwriting provisions	XXX	XXX
Sub-total C.	XXX	XXX
D. Underwriting provisions for life insurance contracts, where the investment risk is borne by policyholders (gross)	XXX	XXX
E. Other provisions and accrued liabilities		XXX
I. Pension and similar provisions	XXX	XXX
II. Accrued taxes	XXX	XXX
III. Other accrued liabilities	XXX	XXX
Sub-total E.	XXX	XXX
F. Liabilities		
I. Participating certificates and subordinated liabilities	XXX	XXX
II. Bonds and loans payable	XXX	XXX
III. Sundry liabilities	XXX	XXX
Sub-total F.	XXX	XXX
G. Deferred tax liability	XXX	XXX
H. Other liabilities	XXX	XXX
Total equity and liabilities	XXX	XXX

Consolidated profit and loss account
for the year ended 31 December 2001

	2001 Euro million	2000 Euro million
1. Gross premiums written	XXX	XXX
2. Premiums earned (net)	XXX	XXX
3. Investment income (net)		
a) Income from affiliated companies, joint ventures and associated companies	XXX	XXX
b) Other investment income	XXX	XXX
Sub-total 3.	XXX	XXX
4. Other income	XXX	XXX
Sub-total revenues (lines 2 to 4)	XXX	XXX
5. Payments (net) to policyholders		
a) Life/health	XXX	XXX
b) Property/casualty	XXX	XXX
Sub-total 5.	XXX	XXX
6. Underwriting expenses (net)	XXX	XXX
7. Change in technical provisions	XXX	XXX
8. Amortisation of goodwill	XXX	XXX
9. Other expenses	XXX	XXX
Total expenses (lines 5 to 9)	XXX	XXX
10. Result from ordinary activities	XXX	XXX
11. Taxes	XXX	XXX
12. Minority interest	XXX	XXX
13. Net result for the year	XXX	XXX