



Room document

Update on Accounting developments

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European developments

The IAS regulation

On 19 July 2002, the Council adopted a regulation on the application of international accounting standards (Regulation No 1606/2002)¹. According to the regulation, all listed EU companies should prepare consolidated financial statements in accordance with IAS from 1 January 2005. Companies that today use US GAAP rules may continue to do so until 2007. The regulation foresees a two-tier structure for the endorsement of IAS for mandatory use in the EU: one “technical” and one “political” level.

EFRAG

The European Financial Reporting Advisory Group (EFRAG)² is a private-sector body created in order to prepare technical input to the IASB and to give advice on endorsement of IAS to the European Commission and to the political level of the endorsement structure. The Technical Expert Group is the key body of EFRAG, and in addition there is a specific Insurance Subcommittee. The Commission participates as an observer in the Insurance Subcommittee. According to its terms of reference the Insurance Group should liaise with insurance supervisors. The first liaison meeting between the IC Accounting Subcommittee and members of the EFRAG Insurance Subcommittee was held on 24 October 2002. Members of EFRAG have expressed their appreciation for supervisors’ contribution at the meeting.

Accounting Regulatory Committee

The political level of the endorsement structure consists of the Accounting Regulatory Committee (ARC) created by the IAS Regulation. This group – legally a “comitology committee” – had an informal meeting on 17 July 2002 and the first official one on 5 November 2002. During these meetings the committee spent significant time on elaborating its terms of reference.

IAS and SIC (interpretations) must be available in all Community languages before endorsement. This is a very complex and time-consuming task, and it is therefore not possible to finalise all language versions before the original deadline 31 December 2002. According to the revised plans, translations should be available in March-April next year.

In the statement attached to the IAS Regulation it is stated that:

“If an international accounting standard for adoption is of particular importance for banks, insurance companies or securities markets, the Commission will invite, as appropriate, a representative of the Banking Advisory Committee, and/or of the Insurance Committee, and/or of the Committee of European Securities Regulators, as an observer, to the Accounting Regulatory Committee.”

¹ Available on the Commission website:
http://europa.eu.int/comm/internal_market/en/company/account/news/index.htm

² More information available on the EFRAG website: www.efrag.com

It is in fact likely that a representative from the regulatory/supervisory committees will be invited to most meetings. CESR and BAC³ are organised in another way than the IC, and therefore another model for representation would seem necessary.

The IC representation to the ARC can be organised in different ways. Below the Commission Services has listed three possible solutions:

- (1) The IC is represented in the ARC by a member chosen by the committee.
- (2) The IC is represented in the ARC by a representative from the Member State currently ensuring the presidency of the Union, or
- (3) The IC is represented in the ARC by the Secretary of the IC.

Member States may wish to comment on how the IC participation in the Accounting Regulatory Committee should be organised.

Endorsement of IAS – State of play

In a letter dated 24 June 2002, EFRAG recommended that the Commission to propose that IAS 1-41 and SIC 1-33 should be endorsed “en bloc”⁴.

In its June and November meetings, the ARC did only have preliminary discussions on the endorsement issue. The final endorsement decision will be taken in late spring 2003. The endorsement discussion has so far been focused on the issues of the “en bloc” approach as such as well as on implementation problems in the banking and insurance sectors stemming from IAS 32 and IAS 39.

Around half of the Member States stated their support for an en bloc endorsement, including IAS 32 and IAS 39. They acknowledge the existence of certain problems, but pointed out that the IASB is addressing these issues. Other Member States, whilst in principle in favour of an en bloc solution, wanted to assess the situation further before stating their view. One Member State presented strong reservations to an en bloc solution.

Banking and insurance associations have expressed strong concerns over IAS 32 and, in particular, IAS 39 to national prudential authorities as well as to the Commission. The messages have of course also repeatedly been delivered to the IASB. The criticism is primarily that the solutions chosen or proposed by the IASB do not correspond to current practices in their sectors.

The Commission Services are currently reflecting on these issues. As an important point of principle, it would be a strong signal to take the initial endorsement decision unanimously. At the ARC meeting, the Commission Services proposed that a strong message should be conveyed to the IASB that outstanding technical issues relating to IAS 32 and 39 must be addressed and discussed with specialists. For obvious reasons, this must be done swiftly.

³ The BAC is represented by the Chairman (Marc Piqueur, B) of the BAC Accounting Subgroup.

⁴ Letter available on the EFRAG website (see above).

The next meeting of the ARC will be held in late December or in January. *International developments*

IASB

In order to have a *standard on insurance contracts* in place before 2005, the IASB has decided to divide the insurance accounting project into two phases. The first interim phase should be in place for a relatively short period (perhaps until 2007 or 2008), and then be replaced by a more permanent solution.

The interim solution⁵ (phase 1) would contain a definition of insurance contract in order to define the borderline to other standards, such as IAS 39. In principle, insurance companies should be allowed to maintain their national recognition and measurement rules during the first phase. Some accounting practices that are judged to be against the IASB Framework may however be eliminated (for example the use of equalisation provisions). Discounting is unlikely to be required, deferred acquisition costs will be maintained. There will be no attempt to lay down specific rules concerning the borderline between “best estimate” and “prudential margins”. Already in the first phase there will be a significant increase in the amount of items to disclose in the notes to the accounts. An exposure draft could be published during the first or second quarter 2003.

The IASB Board has clearly stated that the interim standard should not slow down the work on developing a permanent solution (phase 2). The Board is since over a year devoting significant time to the discussion of the Draft Statement of Principles (DSOP)⁶, but to this date no major decisions on the direction of the project have been taken. At the same time the IASB staff continues to investigate some areas related to the proposals in the DSOP, for example market value margins. One tentative time planning may be an exposure draft towards the end of 2003, and a standard at the end of 2004.

Two exposure drafts concerning *improvement of a number of existing standards*⁷ have been out for consultation, and the comment periods have just expired. The first document deals exclusively with amendments to IAS 32 and IAS 39, the other with proposed changes to a large number of other standards. EFRAG has commented on both documents. In the comment letter on IAS 32 and IAS 39, EFRAG raises a number of insurance-specific concerns⁸.

⁵ The clearest public summary of measures for phase 1 can be found in the “IASB Update – October 2002”. It is annexed to this note. The full paper can be downloaded from the IASB website.

⁶ This document can be downloaded from the IASB website: www.iasb.org.uk

⁷ Both documents can be downloaded from the IASB website.

⁸ Both documents can be downloaded from the EFRAG website.

IAIS Accounting Subcommittee

The IAIS Accounting Subcommittee closely monitors the work of the IASB, and recently comment letters were prepared on different IASB projects (see above). The Subcommittee is also co-operating with the IAIS Task Force on Enhanced Disclosure in order to provide comments on the IASB proposals for disclosure requirements in the “first phase”. Together with the IAIS Solvency Subcommittee, it has also prepared a document on Quantifying and Assessing Insurance Liabilities. The next meeting will be in Paris on 23 December 2002.

IAA Accounting Committee

The International Actuarial Association (IAA) has created a sub-committee in order to coordinate the IAA's response to the proposed IASB Insurance Accounting Standard. At their latest meeting in Barcelona in October, significant time was spent on revising and commenting on the last generation of IASB texts for “phase 1”. The group has also made progress on analysing issues that would be included in the second phase of the IASB project, but this work has come to a standstill as they await further information on where the IASB project is going.

Extract from “IASB Update” October 2002
on an interim solution for insurance contracts

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Insurance contracts (phase I)

The Board discussed:

- § the definition of insurance contracts for phase I of the
- § project
- § exclusions from the scope of phase I
- § recognition and measurement of insurance contracts for phase I.

Definition of insurance contract

The Board tentatively agreed that an insurance contract should be defined as “a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.”

The Board discussed a preliminary draft of guidance to support the proposed definition. Among other things, this draft guidance states that:

- § insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.
- § insurance risk is significant if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether insurance risk is significant, it is necessary to consider both the probability of the event and the magnitude of its effect.
- § a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire

(even if a significant change in the present value of the insurer's net cash flows is no longer a reasonable possibility). Conversely, if a contract does not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if a significant change in the present value of the insurer's net cash flows becomes a reasonable possibility.

The Board agreed:

- § to use this definition of insurance contracts throughout IFRSs
- § to change all scope exclusions in IFRSs that refer to ‘insurance entities’ to ‘insurance contracts’ (for example in the scope exclusions contained in IAS 18 *Revenue*, IAS 32 *Financial Instruments: Disclosure and Presentation*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IAS 38 *Intangible Assets* and IAS 39 *Financial Instruments: Recognition and Measurement*)
- § to define a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on an insurance contract issued by the cedant
- § to remove from IAS 32 and IAS 39 the scope exclusion for derivatives based on climatic, geological, or other physical variables. Such contracts would then be subject to the IFRS on insurance contracts if payment is contingent on an uncertain future event that adversely affects the contract holder, and subject to IAS 39 in other cases.

Scope exclusions

Some or all of the following items arise under contracts that may meet the proposed definition of insurance contracts, but are also covered by other IFRSs. The Board agreed to exclude them from the scope of the insurance contracts IFRS for phase I:

- § product warranties issued directly by a manufacturer, dealer or retailer

- § employers' assets and liabilities under employee benefit plans (including equity compensation plans), and retirement benefit obligations reported by defined benefit retirement benefit plans
- § contingent consideration payable or receivable in a business combination
- § contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease
- § contracts for which the issuer would be permitted or required to settle its obligations by acquiring new financial liabilities or equity instruments to be issued by the holder of the contract if the insured event occurs.

The staff will research whether scope exclusions are needed for:

- § financial guarantees (including insurance that covers credit risk)
- § contracts for which the issuer would be permitted or required to settle its obligations by issuing equity instruments as defined in IAS 32.

Recognition and measurement

Paragraphs 5 and 6 of [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria that an entity should use in developing an accounting policy if no IFRS or Interpretation applies specifically to an item. The Board agreed that phase I should temporarily exempt an entity that issues insurance contracts from applying those criteria to:

- § insurance contracts issued by the entity
- § reinsurance contracts issued to the entity.

However, an entity should apply those paragraphs to all its other assets and liabilities for which no IFRS or Interpretation applies specifically. Furthermore, an entity should apply those paragraphs to direct insurance contracts issued to it by another entity.

The temporary exemption from the application of paragraphs 5 and 6 of [draft] IAS 8 is intended as a practical concession for a short period only. The Board reaffirmed its commitment to completing phase II without delay.

Paragraph 9 of [draft] IAS 8 prohibits a change in accounting policies, unless the change will result in a more relevant and reliable presentation. The Board agreed that the phase I IFRS should include robust guidance to help insurers assess whether a presentation is more relevant and reliable.

Proposed changes for phase I

The Board agreed that:

- § an insurer should not recognise (i) catastrophe provisions relating to possible future claims beyond the end of the contracts included in the closed book or (ii) equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims.
- § phase I should include a loss recognition test that would apply if an insurer's existing accounting policies do not require the immediate recognition of a loss when current estimates of future cash flows indicate the existence of a loss. If the insurer's accounting policies do not require the recognition of a loss in such cases, the insurer should increase the carrying amount of the liability in question to the amount that would be required under IAS 37. The staff will develop more detailed proposals.
- § offsetting reinsurance assets against the related direct insurance liabilities would be prohibited.
- § an insurer should not change the measurement basis for its insurance liabilities when it buys reinsurance. An example of a change in measurement basis is a change from an undiscounted basis to a discounted basis.

The staff will investigate whether there are any reasons to set derecognition principles for insurance contracts that differ from those used for financial instruments under IAS 39. If no such reasons emerge, the staff will recommend that phase I require the same derecognition principles as IAS 39. If reasons do emerge that require further investigation, addressing derecognition of insurance contracts may have to wait until phase II.

Continuation of some existing practices in phase I

The Board also agreed that phase I should not:

- § require discounting
- § try to define or eliminate excessive prudence
- § preclude an insurer from continuing to use embedded value in its primary statements

§ require an insurer to use uniform accounting policies for the insurance liabilities of all its subsidiaries, as would be required under [draft] IAS 27 *Consolidated and Separate Financial Statements*. The staff will investigate the need for disaggregated disclosure if an insurer's accounting policies are not uniform.

However, the Board decided that phase I should prohibit an insurer to change its accounting policies (either on first-time application of IFRSs or once it applies IFRSs) in a way that (i) switches from discounting to not discounting (ii) creates or increases excessive provisions (iii) includes future investment margins or (iv) switches from uniform to non-uniform accounting policies for the insurance liabilities of its subsidiaries. In the Board's view, such changes would not result in a more relevant and reliable presentation – and would thus, as noted above, be inconsistent with paragraph 9 of [draft] IAS 8.

Areas not addressed in phase I

The Board agreed that phase I should not:

§ prohibit or require the deferral of acquisition costs or prescribe what acquisition costs are deferrable, prescribe the period and method of their amortisation or whether an insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. (The Board will discuss in a later meeting the treatment under IAS 39 of transaction costs for contracts that are not insurance contracts.)

§ require specific methods for dealing with embedded insurance options that do not contain financial components such as interest rate guarantees. A later meeting will address (i) embedded financial options such as interest rate guarantees and (ii) embedded options that contain both insurance and financial components.

§ address special purpose entities (SPEs) used by insurers. The Board has a separate project on consolidation and SPEs.

§ address salvage and subrogation, or amend the existing requirements in IAS 37 for expected disposals of assets and reimbursements; or

§ specify whether an insurer should present policy loans as a deduction from the related insurance liability or as a financial asset.