

3. Background

3.1 Definition of Fair Value

In order to gain insights on the impact and implications of implementing fair value on the U.S. property and casualty insurance industry, we first need to have a good understanding of how “fair value” is defined, and what differentiates it from current accounting practices under generally accepted accounting principles (“GAAP”) in effect in the United States today.

Although there is currently not one standard definition of “fair value,” the definitions proposed by the International Accounting Standards Board (IASB)⁴ and the Financial Accounting Standards Board (FASB)⁵, are among the most commonly quoted. While not identical, the IASB and FASB definitions can be thought of as slightly different variations on the same general concept.

In 1999, the IASB released an insurance issues paper in which it defined “fair value” as:

“The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction.”⁶

The definition above was subsequently codified in IAS 39. FASB, in a Preliminary Views document also released in 1999, proposed the following alternative definition:

“Fair value is an estimate of the price an enterprise would have realized if it had sold an asset or paid if it had been relieved of a liability on the reporting date in an arm’s length exchange motivated by normal business considerations. That is, it is an estimate of an exit price determined by market interactions.”⁷

More recently, FASB has modified its “fair value” definition in an update summary of Board decisions regarding its Fair Value Measurement project, defining fair value as:

“The amount at which an asset or liability could be exchanged in a current transaction between knowledgeable unrelated willing parties when neither is acting under compulsion.”⁸

⁴ According to the IASB web site, “The International Accounting Standards Board is an independent, privately funded accounting standard setter based in London, U.K. Board members come from nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.”

⁵ From the FASB web site, “Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting in the United States. The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.”

⁶ IASC, *Issues Paper* (November 1999), p. A181.

⁷ FASB, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (1999), paragraph 47.

⁸ FASB, *Project Updates — Fair Value Measurement — Last Updated: October 1, 2003* (www.fasb.org, 2003), p. 4.

While not explicitly stated in the previous definitions, the general concept of fair value implies a three-level hierarchy of methods for measurement as originally proposed by the Joint Working Group of Standard Setters (“JWG”)⁹ and subsequently affirmed by FASB and the IASB¹⁰. Within this hierarchy, estimates of fair value should be determined at the highest level that is practically implementable:

- *Level 1:* The estimate of fair value should be determined *directly* — by reference to the current observable (quoted) market prices of identical assets or liabilities, whenever those prices are available in a sufficiently active market.
- *Level 2:* If an estimate of fair value cannot be determined directly, then the estimate of fair value should be determined via *proxies* — by reference to current observable (quoted) market prices for similar assets or liabilities, i.e., those that are reasonably comparable, having similar characteristics and cash flows that would respond similarly to changes in economic conditions, such that any differences are objectively determinable.
- *Level 3:* If an estimate of fair value cannot be determined directly or via proxies, then the estimate of fair value should be determined via *valuation methods* — using generally accepted analytic approaches predicated on theoretical market pricing models. Such estimates should be based on the results of multiple valuation techniques, with the choice of techniques depending on the circumstances and whether the information necessary to apply a particular technique is available. The use of multiple techniques necessitates a reconciliation of differing results, helping to reveal biases in the assumptions and increasing the reliability of the estimate.

Both the IASB and FASB proposals indicate a clear preference for the use of observed market values over valuation estimates. Further, if valuation estimates must be used, the methods for developing those estimates should be consistent with the market. FASB has explicitly indicated that all estimates of fair value should maximize market inputs (observable market prices and market assumptions) drawn from the appropriate reference market, and that, in general, the more market inputs used the more reliable the estimate.¹¹

The critical implementation issue for fair value is the development of market-consistent valuation methods for assets and liabilities for which market values are not observable, either directly or by proxy.

FASB has suggested that valuation methods can take several forms:¹²

⁹ The Joint Working Group of standard setters was formed in 1997 for the purpose of developing a coherent framework for accounting for financial instruments measured at fair value. The JWG consists of nominees of accounting standard setters or other professional organizations in Australia, Canada, France, Germany, Japan, New Zealand, the United Kingdom, the United States, and five Nordic countries; as well as the International Accounting Standards Board. In December 2000, the JWG issued a draft standard for financial instruments and similar items that focused on fair value accounting. FASB news release, *FASB Publishes Special Report of the Joint Working Group of Standard Setters on Financial Instruments* (Jan. 5, 2001).

¹⁰ IASB, *International Accounting Standard 39*.

¹¹ FASB, *op. cit.*, p. 5.

¹² FASB, *op. cit.*, p. 6.

- *Market methods*, for example, valuations based on multiples drawn from transactions involving comparable assets or liabilities;
- *Income methods*, for example, present value techniques or option pricing models;
- *Cost methods*, for example, the replacement or reproduction cost of an asset in comparable condition.

For all of these methods, the valuations should incorporate market assumptions that marketplace participants would theoretically use in pricing (examples could be market interest rates, equity prices, option prices, etc.). An entity may use its own internal assumptions as a practical expedient to the extent that market information is unavailable or too costly. Similarly, the valuation methods used by the preparer should be consistent with techniques used by marketplace participants to negotiate prices for the class of asset or liability being valued. To the extent that there is no generally accepted marketplace method, an internally developed method may be used by the preparer – provided that the method is consistent with accepted economic methodologies and the results are tested against observable market values wherever possible.¹³

Presumably, a litmus test for any valuation method would be whether it produced market values when applied to assets or liabilities where a market value was observable.

Finally, the IASB and FASB have each indicated that valuation approaches based on expected cash flows need to include adjustments for both the time value of money and the risk that is associated with the cash flows. For example, IASB has made the following statements:

- “An undiscounted measure is inconsistent with fair value”.
- “The measurement of fair value should include an adjustment for the premium marketplace participants would demand for risks and mark-up in addition to the expected cash flows”.¹⁴

FASB now refers to these valuation methods as *expected present value approaches*¹⁵, and has clarified that the valuation may adjust for risk either (a) by explicitly adjusting the cash flows for risk (i.e. substituting certainty equivalents) and discounting at a risk-free rate; or (b) by adjusting the discount rate.¹⁶

Risk can be separated between elements that are diversifiable through the “law of large numbers”, and those that are non-diversifiable, or systematic. While there is general agreement that perfectly competitive markets do not reward risk that is diversifiable, there is less agreement as to how this economic principle should be applied in the context of fair value. Some take the view that the only systematic risk that is relevant is the equity risk that an investor faces, and therefore that the systematic risk associated with any portfolio of

¹³ FASB, *op. cit.*, p. 6.

¹⁴ International Accounting Standards Committee, *Insurance Contracts — Phase I* (August 13, 2003).

¹⁵ FASB, *op. cit.*, p. 3.

¹⁶ Presumably FASB would also consider a third alternative approach, by adjusting the probabilities of the cash flows (i.e., making them risk-neutral) and discounting at the risk-free rate, as also consistent with fair value concepts.

financial instruments should be measured by the degree to which that portfolio's performance is correlated with the performance of the equity market. Others take a broader view that equity market risk is but one manifestation of systematic risk. The IASB and FASB have debated whether all types of systematic risk, or only risk that is correlated with equity market risk, should be used in these valuations.

3.2 Fair Value in a Property and Casualty Insurance Context

In addition to understanding the conceptual underpinnings of the fair value proposal, it is important to also understand the application of fair value within the specific context of U.S. property and casualty insurance companies.

Both the FASB and IASB fair value projects have a long-term goal of valuing all financial assets and liabilities at their estimated fair value (subject to the resolution of implementation issues, particularly relating to concerns regarding the reliability of the estimates). In the context of property and casualty insurance, this would include invested assets, insurance policy liabilities, and several other insurance-related asset and liability classes.

Measuring the fair value of invested assets does not pose any special or industry-specific issues for property and casualty insurers, as these types of assets are found on the balance sheets of many other types of entities.

Property and casualty insurance policy benefit liabilities include (a) *claim liabilities*, reflecting the estimated cost of payments directly to claimants under the coverage provided by the policy; (b) *defense cost liabilities*, reflecting the estimated cost of providing contractual services related to the claims, such as legal, investigation, and court costs; and (c) *claim adjusting cost liabilities*, reflecting the estimated administrative costs associated with processing the claims.

Offsetting these policy benefit liabilities are anticipated subrogation and salvage recoveries from third parties, deductible recoveries from the insured, and recoveries from reinsurers.

In addition to policy benefits, assets or liabilities may exist for additional or return premiums on policies where the premiums are contractually adjusted retrospectively based on an audit of the insured's actual exposure during the period, or based on the actual claim experience.

In addition to contractual returns of premiums, some insurers also pay dividends to policyholders after the policies have expired. These dividends have the same economic substance as return premiums, however they are not contractual. Under current U.S. GAAP, insurers typically accrue a liability for the policyholder dividends that they expect to pay.

The major point of difference between current accounting and the proposed fair value approach for property and casualty insurance companies is the valuation basis for policy benefit liabilities. Under current U.S. GAAP, these liabilities are normally estimated using an undiscounted value of the best estimate of future payments, without an explicit discount for the time value of money or a margin that compensates for risk.¹⁷ If the fair value proposal is implemented, then these two elements would need to be explicitly measured and

¹⁷ Alternatively, one could posit that under current accounting these two elements are assumed to precisely offset one another.

incorporated into the valuation of policy benefit liabilities. Depending on the relative magnitude of the two elements, the fair value of these liabilities could be lower or higher than their nominal value.

In current GAAP financial statements, policy benefit liabilities are segregated between liabilities for policy benefits already incurred on coverage already provided, and liabilities for future policy benefits on coverage that will be provided. The former is covered by the *loss and loss adjustment expense reserves*; the latter by the *unearned premium reserve*, which incorporates provisions for underwriting expenses, policy benefit liabilities and return premium liabilities. However, under the proposed fair value approach (as we interpret its application) the segregation of policy benefit liabilities between past and future coverage would end; the policy benefit liabilities associated with all contracts issued would be presented as a unified financial statement element.

Traditional insurance accounting under current U.S. GAAP reflects a deferral-and-matching approach: premiums are earned ratably over the term of the insurance contract, with the associated underwriting expenses and policy benefits incurred as the coverage is provided. As policies are written, an unearned premium reserve equal to the full expected policy premium is established. The unearned premium reserve is then reduced pro rata over the term of the policy to achieve level premium revenue¹⁸. Because the unearned premium is gross of policy acquisition expenses that are front-ended, a deferred policy acquisition cost asset is also established at policy inception and amortized over the term of the policy. The net effect of this approach is to defer the recognition of revenue, expense and profit until the coverage has actually been provided.

The proposed fair value approach represents a radical departure from the traditional deferral-and-matching approach. The unearned premium reserve liability and deferred policy acquisition cost asset would no longer be elements of the balance sheet (under our interpretation). Premiums would presumably be taken into revenue as the contracts are written. To the extent that the fair value of the associated policy liabilities is less than the premium after expenses, an immediate gain would be recognized; to the extent that the fair value of policy liabilities is greater, an immediate loss would be recognized. *In essence, under fair value companies will report on the profitability of the policies issued (i.e., written) during the period, rather than on the coverage provided. This will necessitate greater reliance on pricing assumptions in financial reporting.*

One might argue that the premium (net of policy acquisition and other underwriting costs) is the market value of the associated policy liabilities at the time of issue (assuming the market meets the fair value criteria), such that no gain or loss should be recognized immediately. (The IASB has described this approach as an “entry” fair value system.) However, this argument only defers the question for a short while. At some point after issue, an estimate of the fair value of the policy benefit liabilities must be determined that reflects the claim experience that has emerged subsequent to the issuance of the policy (in other words, the valuation must shift from an “entry” to an “exit” fair value). Those arguing against an “entry” fair value approach point out that most insurers would have an estimate of the policy benefit liabilities, reflecting their view of the adequacy of market prices, at the time of

¹⁸ Technically, the premiums are to be earned over the period of risk, in proportion to the amount of insurance protection provided. While it is often the case that the amount of protection provided is level over the contract period, this is not always the case.

issue. Given the historical cyclical nature of price adequacy in the property and casualty insurance markets, an estimate of the fair value of the policy benefit liabilities that is independent of the premium may be more representationally faithful. Reported income would then reflect management's best estimate of the margins on the business written during the period.

Currently, under U.S. GAAP the claim and defense cost liabilities are typically presented net of anticipated subrogation and salvage recoveries, and anticipated deductible recoveries (except for Workers Compensation deductibles, for which the right of offset does not exist). This presentation approach is considered to be consistent with the entity's focus on the net cost of the claims. However, in contrast, the claim and defense cost liabilities are presented gross of anticipated reinsurance recoveries, with the latter presented as an offsetting asset. It is not clear whether the fair value proposals will require the complete separation of the policy benefit liabilities into gross and recoverable components, or whether the current status quo will continue.

Insurers typically purchase reinsurance to protect themselves against adverse fluctuations in claim experience. In addition, some contracts are shared via reinsurance pools, in which participants take a pro-rata share of the insurance policies placed in the pool. Under current U.S. GAAP, the anticipated recoveries under these contracts are recorded as an asset. Currently, the valuation of reinsurance recoveries is consistent with the valuation of the underlying policy benefit liabilities: both are recorded at their nominal best estimates. With the possible exception of an adjustment for third-party credit risk, we would hope that if fair value is implemented, the valuation of anticipated reinsurance recoveries would continue to be consistent with the underlying liabilities. Inconsistent treatment between the underlying policy liabilities and reinsurance recoverables could be particularly problematic for reinsurance pools.

Presumably, just as premium revenue will shift from an earned to a written basis and the unearned premium reserve will be replaced by a unified policy benefit liability, reinsurance premium costs will be similarly transformed under fair value. Reinsurance premiums paid to reinsurers will be expensed at the time the reinsurance policy is issued, and an offsetting policy benefit asset will be established reflecting the fair value of recoveries anticipated under the contract.

In addition to policy liabilities, many property and casualty insurers enter into contingent commission agreements with third parties involved in the sales of their products. Under these agreements, the producers receive additional incentive payments if they meet certain contractual performance targets as to the volume and profitability of the business they generate. Performance targets may relate to more than the current year. Current accounting practice is to accrue for the expected (nominal) cost of contingent commissions, so as to achieve an approximate matching of revenue and expense. The fair value proposals would presumably require that these liabilities be measured via expected present value approaches (given the absence of any market values), and that accruals be accelerated to coincide with the issuance of the underlying insurance policies. Contingent commissions are also common on reinsurance contracts; in this context they operate much like retrospective premium adjustments.

3.3 Estimating the Fair Value of Policy Benefit Liabilities

We can state unequivocally that there is no secondary market for property and casualty policy benefit liabilities associated with claims that have already occurred¹⁹ — at least not a market with “knowledgeable, willing parties motivated by normal business considerations at prices determined by market interactions”. Policy benefit liabilities are sometimes commuted by mutual agreement between the insured and insurer; however, such commutations inevitably involve special circumstances. Occasionally an insurer will seek to purchase a portfolio loss reserve transfer from a reinsurer, which would indemnify the insurer for the actual settlement costs associated with a defined segment of business or category of claims. These portfolio transfers do not provide an indicated market value because (a) the risk transfer is normally incomplete, because there are aggregate limits on recoveries under the contract; (b) while the contracts may transfer some risk they do not transfer the liability, which remains with the originating insurer; (c) there are usually only a handful of reinsurers quoting on the deal; and (d) the insurer is often in distress, and therefore not motivated by normal business considerations.

Many have asked why a secondary market for property and casualty insurance liabilities has not emerged. Most industry experts would agree that three factors prevent the formation of such a market:

1. *Legal Impediments* – Policy benefit liabilities are generally not transferable from one insurer to another without the express consent of the insureds and/or claimants. While this would not preclude transfer of risk via contracts of indemnity, it does create a serious impediment to the full transfer of liability.
2. *Uniqueness of Insurance Portfolios* – Portfolios of insurance contracts are not homogeneous. Even within a given product line they differ because of differences in company marketing practices, underwriting policies, policy forms, coverage terms, and claim handling strategies. They also differ due to external factors such as the state of jurisdiction. For example, even in a relatively homogenous product line such as Personal Auto insurance, the claim and defense cost liabilities associated with a policy sold to an unmarried youthful operator in New Jersey will be markedly different than one sold to a middle-aged married head-of-household in Iowa. The former policy will typically have lower limits of liability and higher deductibles on physical damage; its claims will be more frequent, and will be settled in a more liberal court environment. These differences are even more pronounced with commercial insurance products than with personal insurance, because the former are more specialized to the business needs of the insured.
3. *Information Asymmetry and Anti-Selection* – Potential purchasers of property and casualty claim and defenses cost liabilities do not have access to an insurer’s private information, from which to gauge its unique characteristics. In theory, such information could be provided, but the cost of producing and analyzing it would make any transaction uneconomic. In addition, most potential purchasers would have legitimate concerns regarding anti-selection, perceiving that the insurer was

¹⁹ Such transactions are referred to within the insurance industry as *retroactive transfers*.

attempting to lay off its most problematic claims. As a result, potential purchasers would feel the need for careful review of private information to protect themselves.

The lack of observable market values for property and casualty policy benefit liabilities necessitates the use of 'Level 3' valuation methods to estimate their fair value. This will require that valuation methods and assumptions consistent with fair value principles be developed and implemented. Since policy benefit liabilities are acquired and held (rather than traded), the estimate of fair value may need to incorporate an element for their illiquidity. A similar (and hopefully internally consistent) approach will be necessary for estimating the fair value of reinsurance recoverable assets. An additional factor in the valuation of reinsurance recoverables will be the credit risk of the counter-party reinsurer.

3.4 Status of IASB and FASB Deliberations

Both the FASB and the IASB have been involved in long-term efforts to develop and implement fair value concepts in the accounting for financial assets and liabilities. While both have made progress in their respective efforts, the move toward fair value has been slowed by complicating factors, including the need to address issues and concerns raised by key stakeholders, as well as the limited resources of the two organizations against the sheer magnitude of the effort. As of the time this paper is being written (March 2004), both organizations remain committed to moving their projects forward -- though both recognize that implementation will not happen quickly or easily.

Financial Accounting Standards Board

The 1980s Savings and Loan crisis served as the impetus for the move to fair value accounting in the U.S. Leading up to the crisis, banks were not required to record their assets at market value, allowing troubled banks to sell those assets with market values higher than their recorded book values while continuing to hold those assets with market values below book value. Many of these banks eventually became insolvent.²⁰

In 1986 FASB embarked on a long-term project concerning the accounting for financial instruments that has evolved into its current fair value project. The FASB's Statement of Financial Accounting Concepts No. 7, released February 2000, addressed how to estimate the fair value of these liabilities.

In October 2002, FASB, with the endorsement of the SEC, signed a memorandum of understanding with the IASB to "seek to reduce the existing differences between International Financial Reporting Standards and U.S. GAAP in order to accelerate progress towards the attainment of global accounting standards."²¹

More recently, in June 2003, FASB decided to add a separate fair value measurement project to its agenda to address concerns preparers, auditors and others have expressed about their ability to apply fair value measurement principles. The preparers' concerns are mainly driven

²⁰ CAS Task Force on Fair Value Liabilities, *White Paper on Fair Valuing Property/Casualty Insurance Liabilities* (Casualty Actuarial Society, 2000).

²¹ Jerry Dickenson, "The Search for an International Accounting Standard for Insurance", *The Geneva Papers on Risk and Insurance Issues and Practice – Special Issue* (International Association for the Study of Insurance Economics, February 2003), p. 17.

by the fact that, to date, FASB has provided only limited application guidance for measuring fair value. The FASB's near-term objective with the fair value measurement project is "to develop a Statement that will establish a framework for measuring fair value under other pronouncements that require fair value measurements, codifying the guidance for measuring fair value in those pronouncements."²² The Statement will be focused on how, not when, to measure fair value; FASB has said it will continue to address the matter of when on a project-by-project basis. The Fair Value Measurement Statement exposure document is expected to be completed by the second quarter of 2004.

Longer term, FASB's objective is to "improve its conceptual framework, developing conceptual guidance for its use in determining "when" to measure fair value that will focus on how the qualitative characteristics of relevance and reliability should be applied in making that determination."²³ At this point, no timeframe has been given for completion of FASB's longer-term objective.

International Accounting Standards Board

The IASC (predecessor to the IASB) commenced its project on the development of an international accounting standard for the recognition and measurement of financial instruments in April of 1997.

In November of 1999, an Advisory Group to the IASC published an issues paper focused solely on insurance accounting, including the IASC's preliminary conclusions. One hundred thirty-eight (138) responses to the issues paper were received -- including a substantial one from the International Actuarial Association. In general, accounting firms and consulting actuaries tended to be broadly in favor of the Board's conclusions, while insurance companies, their in-house accountants and actuaries, and insurance regulators tended to be against.²⁴

The responses to the issues paper were analyzed and incorporated into a Draft Statement of Principles (DSOP), which was not formally published but was placed in the IASB's web site in 2001. The DSOP produced much debate and adverse reaction, especially from the insurance industry and insurance regulators.

Though the IASB had made relatively fast progress with the Draft Statement of Principles, there has been a considerable slowdown since then. However, the project remains an important priority for the IASB -- partly due to a policy decision approved by the EU Parliament in March 2002 that requires listed companies to adopt "EU approved" international accounting and reporting standards ("IAS" / "IFRS") in the preparation of their consolidated financial statements from 2005 onwards. To date, the EU has not approved the two standards on financial statements, IAS 32 and IAS 39, in part because of concerns over fair value accounting.

Notwithstanding the EU deadline, the IASB has accepted that given the many constraints, a comprehensive IFRS on insurance liabilities will not be in place by 2005. In recognition of

²² FASB, "Project Update", *op. cit.*, p. 2.

²³ *Ibid*

²⁴ Dickenson, *op. cit.*, p. 26.

the enormity of the task, in May of 2002 the IASB split the fair value project into two phases, so that some parts of the insurance accounting initiative could be put in place by 2005 without delaying the rest of the project.

Phase 1, a stepping stone to Phase II, will operate as an interim standard and come into effect for financial years ending on or after 1 January 2005. An exposure draft (ED5) of the Phase I standard was published in July 2003, with comments requested by 31 October 2003. The Board plans to complete a final Phase I IFRS by 31 March 2004.

Key issues to be addressed by the IASB during Phase I include:

- i. definition of an insurance contract;
- ii. unbundling; and
- iii. asset classification and asset-liability mismatch.⁷

During Phase I the current local-country GAAP will continue to apply to all contracts that fall within the IASB definition of an insurance contract, subject to certain prohibitions (for example, catastrophe reserves) and requirements. Extensive disclosure requirements are also proposed for Phase I, but these no longer include the fair value of insurance liabilities. For all other contracts (i.e., insurance contracts that contain insufficient risk to qualify as an insurance contract), another IFRS (most probably IAS 39) will apply. IAS 39, first issued in 1998 and revised in December 2003, is similar to U.S. FAS 115 in that it requires “investments in a ‘trading portfolio’ to be held at fair value.” However, unlike FAS 115, it creates an exception to fair value accounting for “any equity instrument...that does not have a quoted market price in an active market and whose fair value cannot otherwise be measured.”²⁵

Phase II will involve the development of a full insurance IFRS; implementation prior to 2008 now appears unlikely. Phase II is expected to include a comprehensive analysis of all aspects of recognition and measurement including disclosure and presentation. In January of 2003, the IASB tentatively agreed on key features of a measurement model to be developed in Phase II. Since then, however, constraints have prevented the IASB from continuing work, though it intends to return to Phase II in the second quarter of 2004 when it will revisit the tentative conclusion reached.

3.5 Considerations in Evaluating the Fair Value Proposal

Implementation of a fair value accounting model would represent a substantial change in financial reporting for property and casualty insurers, entailing substantial effort and cost for preparers, and education of users. To be worthwhile, a change of this magnitude must be shown to be a demonstrable improvement. Both the FASB and IASB have developed a carefully articulated set of precepts to guide them in choosing among alternative presentations of financial information. While the two sets of precepts differ in their language, there is little substantive difference between them. The precepts focus on the purposes, uses, and principles underlying the presentation of financial information.

²⁵ FASB, “The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP” (Second Edition, 1999), Page 6.

The IASB's precept document states that the objective of financial information is

“to provide information about the financial position, performance, and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.”

Elements of financial statements are monetary representations of underlying economic resources, obligations or transactions (i.e., assets, liabilities, revenues, expenses, etc.). Accounting principles and standards define when a financial statement element should be recognized, and how that element should be measured. The choice of measurement attributes should be determined by five considerations: (1) reliability of the measure, (2) relevance of the measure, (3) comparability and consistency with other similar financial statement elements, (4) neutrality of the measure, and (5) the cost of the measurement.

Reliability of the Measure

Reliability connotes representational faithfulness: the degree to which an element of a financial statement corresponds to the underlying set of economic resources, obligations, or transactions. It also connotes verifiability, such that an independent third party could confirm the measurement. Since most assets and liabilities are estimates, reliability does not connote certainty. However, one measurement attribute may be preferred over another because it is subject to less estimation error. The degree to which a measurement attribute is subject to estimation error is important because (a) estimates that involve a high degree of judgment are susceptible to manipulation by management, and (b) estimation methods can introduce spurious volatility into reported income. While income statement and balance sheet presentations necessitate the use of point estimates, reporting the degree of uncertainty in an element of the financial statements may be necessary to achieve representational faithfulness.

Relevance to Users

To be relevant, information must be capable of affecting users' decisions. Information that is untimely generally has little relevance to users because it is not reflective of the current situation of the enterprise. Similarly, information that is not understandable by competent users is not likely to be very relevant to them, because they will be unable to make informed decisions based on it. Transparency is implicit in the relevance criteria; elements of financial statements should be clearly communicated so as to maximize the utility of the information to users.

A test of relevance is whether or not the measurement attribute is consistent with internal management information practices within well managed companies. If internal performance is managed using measurement approaches that are inconsistent with a measurement attribute, then it is likely that external users will not find the information relevant.

Comparability and Consistency of the Measure

Financial statement presentations should be comparable over time and consistent between different enterprises, so that users can discern trends and relative performance. This precept requires that “financial statements provide sufficient standardization across enterprises to allow existing and potential shareholders, creditors and other users to make meaningful comparisons of key information.”

In the absence of any agreed international accounting standard there is little comparability today in the way financial condition and performance are reported among insurance companies operating in different countries. With the globalization of insurance and reinsurance markets and the emergence of multi-national insurers, the lack of comparability is a significant impediment to the usefulness of insurer financial statements.

Additionally, even within countries, the absence of a uniform standard that encompasses the accounting for financial assets has often made it difficult to compare companies across different sectors within the financial services industry (e.g., banks and insurance companies). Finally, there is concern within the insurance industry that if a fair value framework is implemented for insurance companies, but is not adopted consistently across other industries, the insurance industry would be disadvantaged versus its competitors for capital.