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International Accounting Standards

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Summary: The International Accounting Standards Board (IASB) is working to finalize reporting standards for insurance and investment products. Companies domiciled in European Union countries will be required to report financial statements under International Accounting Standards (IAS) in the near future.

MR. WILLIAM C. HINES: We've got a good session today. Joining me on the panel are Martin Sheerin and Sam Gutterman. Sam's going to lead off; he is a consulting actuary with PricewaterhouseCoopers in Chicago. He's been with the organization for a while and has been heavily involved in the IAS arena. He chairs the Insurance Accounting Committee at the International Actuarial Association (IAA) and recently was appointed to the advisory committee for the IASB's insurance accounting project.

Martin will be next on the program; Martin works at the U.S. subsidiary of Aviva. He's been there for a few years. He is an FSA and a fellow of the Institute of Actuaries, has been working in the United States since 1987 and has spent time with some subsidiaries of what is now Protective Life.

I'm William Hines and will finish up the program this morning. I'm a consulting actuary with Milliman here in Boston, and I've spent a fair amount of time with Sam at the IAA working on the development of actuarial standards related to IAS. I'll talk a little bit about that in my presentation. We'll start with Sam.

MR. SAM GUTTERMAN: I'm here to provide some background, which I'll do

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briefly. I'll be going into what is referred to as International Financial Reporting Standards (IFRS) Statement 4, which is entitled "Insurance Contracts"; I'll go over the key elements of that. And then I'll be talking a little bit about some other important standards, IAS Statements 32, 39 and 18, and why we should care about them.

First, I have a question for the audience. How many of you have a lot of knowledge about IAS? I'll try to go over the fundamentals fairly quickly. The second and third speakers will expand your knowledge about what's going on and what will be going on.

First of all, here's the brief background. The IASB and the insurance project were born out of politics and will probably end up in politics. The project started off in the mid-1990s with the Asian financial crisis in the 1997–98 period when a lot of political organizations and regulatory organizations challenged what was then the International Accounting Standards Committee (IASC) to put together a set of transparent global international accounting standards. It was a challenge put to them particularly from the International Organization of Securities and Exchange Commissions, of which the SEC is a member. The G-7 or G-8, or both, identified the need for transparent international accounting standards as being one of the contributing elements to the Asian financial crisis.

The lack of transparency in the accounts was something that was deemed to be a root cause of that crisis, and the political people and the regulators decided that that was something that shouldn't happen again. As a result, they challenged the IASC to develop a comprehensive and rigorous set of accounting standards. To some extent they're succeeding, and that extent will be seen shortly also in the political domain. The IASC is now restructured as a result of many of the actions and the purposes or problems of transparency in its own procedures, but it formulated its plans in 1997 for a complete set of accounting standards by the end of 1999. One of the side purposes and objectives was to implement fair value accounting wherever possible, wherever it could deem it to be worthwhile, but it hit a banking roadblock, and here's where the politics continue to play.

In that same period there was an organization referred to as the Joint Working Group of Accounting Standard Setters, known then as the JWG, which was made up of 10 national accounting standard-setting organizations, plus the IASC. It formed a task group looking at how to measure fair value on nontraded and traded instruments. It put forth a recommendation in the middle of 1999 for full value for all financial instruments. As soon as it came out, it was met with a resounding negative reaction, particularly from the banking organizations around the world, particularly those from the national banks, and probably within a month of that report coming out, it was clear that it was not going to go anywhere. Later on in the discussions there was a major topic that you hear about all the time today, which is convergence.

This is an effort that started around 1999 or 2000 when it realized that the IASC was going to be successfully achieving its initial objective of that rigorous set of standards around the end of 1999. It began a series of joint projects, most of which revolved around fundamental issues, but in 1997 it decided that it was about time to develop an industry-specific standard. The one standard that it picked to start off with was insurance because it deemed it had the worst accounting standards worldwide and used a lot of examples.

First of all, it realized that no one understood whatever insurance accounts were there. Second, they were the most disparate or different among any other industry. It decided to undertake a rigorous set of standards, plus it would undertake insurance. Since then it's also added agriculture and mining. That's the group that we are with. After the JWG effort failed, the IASC and then the IASB began a compromise approach. A compromise approach to us in the United States at least seems fairly recognizable, and that's one that identifies four different measurement bases for assets: trading, available for sale, held to maturity and loans and receivables.

On a split-accounting basis, since the group failed to get fair value for everything, it did say that for trading assets or those designated as trading, you'd hold through fair value. For those available for sale, you would have fair value but with changes going through equity as opposed to the profit and loss. Held to maturity and loans and receivables are mostly banking instruments that aren't traded on an amortized cost basis. It's fairly similar to U.S. GAAP. There are differences in the application, but the principle's the same; but even that formulation has hit a political maelstrom in this last six- or nine-month period. They introduced it at the end of last year and revised what's called IAS 39 but snuck in fair value of derivatives, assuming derivatives were a trading instrument, and that has been a big political fiasco on the part of the European Union, which I'll describe in a minute.

I've gone over the first part of the history. That group that I mentioned when talking about insurance had issued an issues paper in 1999, which was a 400-page, two-volume set that was followed by a six-month period. It had a steering committee that looked over the 150-odd comments and came up with a Draft Statement of Principles. It took about a year and a half to develop that, but it never got completed. The group never got to the chapters on disclosure, presentation and participating contracts. At that time it decided insurance is a hard topic. The IASB now reformulated with a transparent set of due process. It split the project into two parts: the famous Phase I, which was a compromise short-term fix to be able to achieve the objectives of Europe 2005—the European Commission decided to get all of its listed companies on a single, comprehensive set of accounting standards for 2005; and Phase II, which was a more rigorous solution intended to solve insurance accounting once and for all. As William will discuss a little bit later, that is the current and future challenge.

In 2003, Phase II resulted in an exposure draft (ED) referred to as Exposure Draft

5. It decided to switch numbers with another standard, so it came out in March 2004, referred to as IFRS 4. It's interesting that it's changed the term from accounting to financial reporting. I'm not certain why, but I think the reason is because the IASB wanted to be its own separate entity and distinguish itself from the former IASC, and since the IASC referred to everything as accounting, the IASB had to come up with a new name. In fact, as you'll see, it's trying to come up with names for everything to avoid historical labels. Last week I suggested that it rethink the label of fair value, and it might change the debate a little bit, but we'll see.

I bet a couple people a year before that the due date, or adoption date, for IFRS 4 was going to be March 31, 2004, and the reason for that was because that's the last date of adoption of any standard for introduction in 2005. For about two months, it was proposed to be distributed on March 29, and I thought I'd lose my bet, but at the last second, compromises ended up with it being, in fact, the last day of March.

One of the key features of IFRS 4, and I'll mention them all briefly, is the definition of what an insurance contract is. The reason for its being important is that under Phase I, if you had an insurance contract, you can basically use your local GAAP. Therefore, for those companies that were using U.S. GAAP, of which there are many on the European continent, in particular, you could continue using that for an insurance contract. The requirement was to have a significant risk level or amount of risk transfer. Things such as a waiver of surrender charges on death were not sufficient.

This is an interesting item. The board realized that if it had included a waiver of surrender charge as being insurance, it would have folded in a lot of other instruments, banking products and consumer products with a waiver of the remaining amount of payment upon death or disability. Therefore, a lot of the things that you see at least to date have stemmed from the fear of decisions made on insurance contracts being able to be moved to a lot of other products, financial and otherwise.

It purposely included more insurance under the insurance umbrella than other products. It intentionally did that to avoid the problems of having companies change their accounting for Phase I and then potentially having to rechange all of their systems for Phase II. What it did was purposely try to include as much as possible as insurance for that purpose. It was hoping, though, that it was going to be leaving that distinction alone. From what I gather, that may be reopened at some time in the future. Reinsurance risk transfer is generally the same as Financial Accounting Standard (FAS) 113. It's not identified as such, but since most companies utilize 113 or something like it and other accounting systems, that's generally been adopted as being the case in practice.

Something else it decided on at the last minute was defined as a discretionary

participation feature. This is primarily relating to European products where there is a guaranteed element in some countries on their participating products, let's say a minimum of 90 percent of profit to be returned at some point, but there is a degree of discretion. The issue that it looked at, particularly in some products from several continental European countries where there is no guarantee (for example, the Italian case), is how to account for that distinction; otherwise there would be no guidance at all. In general, other than something that I'll mention in a minute, it measured about the same approaches as it had before.

It added one explicit test, which I think the actuaries of the IAA suggested be called the liability adequacy test. The use of the liability adequacy test, I'd say, is the primary reason why it got this insurance contract standard approved in the first place. By the way, for those people who don't know it, the IASB narrowly approved IFRS 4 in the first place. The vote on the board was eight to six. The negative votes were due to several reasons, but there have been indications that a couple of board members would have voted against the whole process of having an insurance contracts procedure if it hadn't included a liability adequacy test, but there are general requirements for this test.

In general the local GAAP loss recognition or loss recoverability tests are acceptable, but the one thing that it did add was a requirement that companies had to consider all future cash flows. That means in the testing of the adequacy of the liability they can't ignore things like options or guaranteed minimum death benefits (GMDBs). If they do, they fail this standard liability adequacy test on the local basis. They had to revert to a test in IAS Statement #37. The reason why companies don't like to revert to this IAS test is that it includes an incorporation of risk. That means it wouldn't be done on a best-estimate basis. You have to include in your reserves or liabilities a provision for adverse deviation or a margin for risk, and companies then would have had to revert from their own local basis of accounting to one that in some cases might be stronger than what they otherwise would have held.

In addition, it can change accounting policies if improved. Here's a note about accounting policy. The whole framework assumes that every company has in place a company-approved and board-adopted accounting policy. It's not enough to say, "We generally follow U.S. GAAP. We don't have to do anything more." You have to include as a board-adopted policy what your accounting practices are. Not only that, but one of the few requirements of disclosure is that you've got to disclose and discuss what your accounting policy is. Once you've established it, that is, upon adoption, and for large, multinational listed European companies, at the end of 2004, you have to have an accounting policy in place at that time or at the time of the opening balance sheet in 2005. This can be changed.

Therefore, you're not stuck with U.S. GAAP, French GAAP or whatever GAAP you're using. You can change it, but you have to meet accounting tests, and the accounting test is that in U.S. GAAP terminology, it's preferable accounting policy.

In IFRS terminology you've got to prove that it's a more relevant or reliable measure. You've got to prove on the whole your change from your given accounting policy at the beginning or previously was more relevant and more reliable.

Maybe *the* most controversial feature that preceded the introduction or adoption of IFRS 4 was the asset/liability measurement base. It has referred to its accounting system as an asset/liability system for all but participating contracts for which the liability or the benefits are directly tied to a set of assets. The issue is that in some cases the assets and liabilities could be derived on a different basis or on an inconsistent calculation basis. The IAA, in conjunction with the ACLI, came up with a research report that pointed out the problems with an inconsistent measurement base whether assets or liabilities are on a book value, market value or however they're determined. It pointed out the increased volatility that was likely if you have an inconsistent basis between the two.

This almost was another political hang-up. Insurance companies across the world, in their comments to ED 5, in an almost universal response said that they didn't like inconsistent measurement. The IASB found no way around it. It was loathe to change IAS 39, which is the basis of their asset measurement basis, because it went through and revised it. It was still a big political problem in and of itself. It didn't want to make any more changes to the asset side. What it did as a partial solution was let companies use shadow accounting for unrealized gains and losses that would fix some of the problems if you're use an accounting basis that allows a treatment or effect on your liabilities of realized capital gains.

For U.S. GAAP, if you use an estimated gross profits basis for realized gains, you could incorporate a shadow or unrealized gains, something that U.S. GAAP people are comfortable with. The second approach is that it would allow a revaluation of the liabilities on a current interest basis. It would allow a book basis of accounting but using current interest rates. Both of those two were put in, I think, as a Standard of Practice (SOP) to the industry, probably assuming that there were not going to be too many takers of it, but it looks as though, at least in discussions with many European companies, various companies right now are thinking about using both of those approaches or one of the two approaches in their IFRS accounts. They're generally moving toward an asset/liability-based system for which the assets are considered separately from the liabilities. One of the things that it did change was that it eliminated equalization or catastrophe liabilities, but those are far more relevant to nonlife.

IFRS requires that noninsurance-based embedded derivatives are to be valued at fair value, but that leaves relatively few because most things such as GMDBs and guaranteed minimum income benefits are insurance-based. Therefore, it's not that big of a deal. It allows profit and loss on purchased reinsurance with disclosure. The initial proposal was not to. In talking to people, and you'll hear about this in a couple minutes, one of the bigger challenges in implementation is disclosures. It did require additional disclosures and made a suggested list, and I know some

companies have started off looking at several hundred pages of disclosures. On business combinations the old treatment of business combinations were basically grandfathered, but new ones had to be fair value based on whatever your accounting policy is.

The last item I'd like to talk about briefly is why do we care about these other accounting standards? IAS 32 is one that's directed toward financial instruments; it partially excludes insurance. The disclosure requirements do not exclude insurance, but IAS 32 does cover all insurers' investment contracts.

IAS 39 is mostly a measurement standard, and, again, these are measurement standards for financial instruments. They do cover only products that are not insurance contracts.

The noninsurance contracts are sometimes termed investment contracts, but they include certain features that have been controversial in the insurance side, and they include a minimum demand deposit floor, inclusion of an own credit standing haircut on financial instruments and a choice of measurement techniques.

IAS 18 is a revenue that sounds strange at first, affecting accounting or balance sheet standards, but it does because it permits at least a limited amount of what we refer to as deferred acquisition cost (DAC). It may turn out to be the first stage of an unbundling exercise where insurance contracts may be unbundled in the future.

IAS 32 and 39 are primarily aimed at assets and traded liabilities, but they generally exclude insurance contracts other than certain elements of disclosure and also exclude investment contracts with discretionary participation features. This is how the French insurance companies and insurance companies in several other countries have avoided the requirements of IAS 39 because they can still use their local requirements.

Many banks wanted the maximum use of hedge accounting even though they don't have effective accounting hedges. This is the big issue this month with respect to IAS because right now it looks as though IAS 39 is not going to be adopted for complete use in the European Union, but it's working on a compromise so that it can allow the banks to have certain exemptions with respect to hedging, particularly of derivatives.

In addition, for financial guarantees for those involved in mortgage guarantee and credit guarantee insurance, there's an ED right now, and it's likely that there will be fair value measurement, whether a financial instrument or an insurance contract in terms of whichever definition it falls under. There are, as I mentioned, two choices: amortized cost or fair value. The amortized cost is through an effective interest method similar to FAS 91 but with the embedded derivatives not closely related to be measured at fair value. If you've got fair value, you're unlocking your

persistency and your amortization of any DAC or transaction cost asset. There's also another option, which was introduced at the end of last year. It's referred to as the fair value option on any contract, asset or liability, as long as you designate it at fair value at the beginning, initiation or purchase of that contract.

This has been controversial particularly with respect to banking regulators who want to restrict banks from using fair value at all because they think it might provide some unreliable measurement in noncomparable results. This was referred to in ED 6 as the fair value option. To use fair value you had to prove that it was a reliable measure. This was interesting. Counting the responses, I think about 95 percent of the respondents have disagreed with the IASB. Some think that it was put out for political purposes, for a sop to the regulators to try and prove that it was being responsive, but that's maybe not something I should put on the tape.

There are some interesting measurement features for the demand deposit floor and own-credit risk, which I'll skip for the moment; we'll cover these later. IAS 18, revenue recognition, in particular was used for contracts such as mutual funds with an investment management service, but it could be applied to something like a mutual fund or contracts that are just service-related such as the use of a group TPA where there is no insurance risk kept with an insurance company. I think the interesting feature in it is that incremental transaction costs can be capitalized subject to recoverability. It goes into methods of recoverability testing. In general, though, because of its relatively small size, people in the banking industry couldn't understand why the insurance industry paid such high up-front commissions.

They assumed that their DAC amount or this transaction cost was going to be a small amount. It doesn't matter how you amortize it. They didn't put any specific rules in place. Now the IASB has got to say there's this other industry, which has much different practices from the bank that it's going to have to react to, but in any event, it's trying to limit the amount of DAC to the incremental marginal commissions that would be paid.

In summary, and as will be mentioned in a couple minutes, this will affect you if you're a subsidiary of a non-U.S. company and particularly a European parent. The IASB's efforts and those of the political groups around will be continuing to push for converged global standards, albeit there will still be areas around the world that will be fighting this, such as we've seen with respect to the French and other continental European countries' banking industries. We also can see some efforts in the United States to fight some of these issues it's raising. The IAA is developing actuarial standards or practice guidelines for assistance and implementation of IFRS 4 and other assorted international accounting standards, and so that's a development that is an upcoming one over the next six months. Even though these may be some seemingly minor changes in the short term, as we'll find next, they can involve a lot of work.

MR. MARTIN SHEERIN: Let's discuss implementation of IFRS. I'm going to go

through a couple of different areas: the background of Aviva, how we went about implementation and the major adjustments we made to go from U.S. statutory to IFRS adjustments. Before I start I have one question for all of you. Why did the auditor cross the road? Because he opened the file, and that's what he did last year. With IFRS there is no last year. You're starting over totally, and you have nothing to go by unless you rely on consultants and various outside people.

Here's some background on Aviva. Aviva Life Insurance Company's based here, just outside Boston. We're the U.S. subsidiary of Aviva plc, which, according to our records, is the seventh-largest insurance company in the world and is quoted on the London Stock Exchange. Hence there's a need for us as a subsidiary here to report on an IFRS basis.

We have about $5 billion in assets, all general account and no variable, and to simplify it a bit further, no par policies. Our product mix is generic. Sometimes I thank the Lord for that because it's made this implementation a lot easier. We have fixed-deferred and immediate annuities, universal life and traditional life, meaning term and whole life. On the asset side of the equation we have bonds and fixed-income and debt securities. We have a small amount of structured product that we use to support the long-term tail liabilities, some immediate annuities (we'll talk about that in a little bit), a small amount of common stock and no actual direct derivatives.

Our current reporting basis is one of the things that keeps us a little bit busy. We report either monthly or quarterly on U.S. statutory, U.S. tax, U.K. GAAP, U.K. modified statutory solvency basis and embedded value (in U.K. parlance that's called "achieved profits"). This year we added the Chief Financial Officer (CFO) Forum in Europe, which came out with new principles for doing embedded value, and the purpose of the new principles was to capture, among other things, the time value of guarantees, which traditional embedded value has ignored. When we have nothing else to do, we do a little bit of unaudited U.S. GAAP for our own internal management purposes. This year we added IFRS.

IFRS is started, but it's not yet complete. So far we've done a balance sheet as of year-end 2003, which we completed in May of this year. At the moment, and they're due I think by September 30, we're working on a balance sheet and an income statement, as well as disclosures for half-year financials (half-year 2004), and we're reporting them in two weeks. The disclosures for the midyear are a lot less than they are for a full year. As yet we have not analyzed the disclosures needed for a full year. We have analyzed them for a half year and are comfortable that we can manage.

We cheated a bit: we didn't have to read all the materials. Our parent company supplied us with a small 400-page manual of how to interpret the rules, and it was for use in all the subsidiaries. Not only did they give it to us once, they gave it to us three times. Each time we had to go back and see what had changed. It's a little bit

messy. We also had a help desk in London that we could rely on for questions. Our reporting manual—I could give it to you, but it would be useless—was an actual "how to go from U.K. GAAP to IFRS," and that was the frame of reference. We had to translate that for our own purposes.

To help us along the way, and probably in response to some of the things Sam talked about in terms of documenting the accounting policy, it had us look at 110 different elements of the balance sheet and income statement, and some of them didn't apply to us because they're nonlife pieces, but probably about 80 did. For each of those elements we have to document and write down what we did for U.S. statutory, U.K. GAAP and IFRS. There was a full paper trail for our home office and ultimately for the auditors. The main steps we did that helped were dealing with the product classification, breaking things between insurance and investment contracts (I'll talk a little bit more about that in a minute), and breaking down the asset classifications among available for sale, held to maturity, trading and other than trading.

On product classification you can classify the products as either insurance or investment contracts, and the key question at least initially was does the contract contain significant insurance risk? As Sam touched on, the definition of significant insurance risk changed over time. Initially a lot of companies were hanging their hats on the fact that there's a slight difference between the death benefit and the surrender value. That was considered a significant risk. I think ultimately at the December 2003 meeting they threw that out and said it had to be a real risk, but to help you they gave a lot of examples, and I'll talk about how that worked for us.

Traditional life and universal life clearly contain significant risk, and they classified those as insurance contracts. Immediate annuities are big for us. We have over $1 billion of life contingent immediate annuities. We consider them to have significant insurance risk and classify those as insurance contracts. Immediate annuities period-certain-only typically follow FAS 91. Despite all our best efforts these are clearly fixed payments with no insurance risk, and they fall into the definition of investment contracts.

On deferred annuities we thought initially that having a surrender charge, like a waiver on that, would be our savior, but that got thrown out. In the examples given last December there were a few examples relating to the guaranteed annuitization option on deferred annuities. We've concluded, and so have our auditors, that the guaranteed annuitization options we provide do have within them reasonable guaranteed mortality tables but that do constitute significant insurance risk. We concluded they were insurance contracts, which simplified the work.

I'm going to go through each of these asset elements: debt securities, common stock, structured products, impairments, nonadmitted assets and DACs. On debt securities, on U.S. statutory the assets are held at amortized cost. For IFRS purposes we elected to hold all our debt securities as available for sale, and as I

mentioned, what that means is that any unrealized gain or loss does not go through the income statement. It goes against equity until it's realized, and then it flows through the income statement. It's a little bit different.

For common stock the assets are held at fair value. Again we elected to hold them as available for sale, and the reason why we elected available for sale for most of our assets is that our liabilities weren't going to move when the asset value changed. It was a matching issue, and we wanted to keep the income volatility as small as possible.

The common stock, as for the bonds, is reported as fair value with unrealized gains or losses running through the change in equity and then realized gains and losses being recognized in the income statement.

We have one structured product that we use to support the long-term tail liabilities. It's a combination of zero-coupon bonds with some spiders. We had a choice for how to treat it for IFRS. On a U.S. statutory basis the asset is classified as a bond, and we hold it at amortized cost. For IFRS purposes we had a couple of choices, but we elected to hold it other than trading, and the reason why is if we didn't, if we held them on the other basis, we would have ended up bifurcating it every time we reported it, which we felt was too much effort. We decided, given its size and its nature, if we held it at other than trading, it wouldn't have too big of an impact, and the result is that the asset is held at fair value with all changes in the fair value going through the income statement. The liability won't change. The asset will fluctuate a bit, but we felt that the volatility wasn't going to overwhelm the parent's results, so we did it.

Regarding DAC, U.S. statutory, as we all know, is pretty easy. On an IFRS basis we followed a variation of what we do for U.K. GAAP, and for U.K. GAAP we do set up a DAC on our balance sheet. It's a lot less than you'd hold for U.S. GAAP, but it's a formula that we use that's based off a certain percent of commissions and a certain percent of acquisition cost. The DAC is considerably lower than it would be under U.S. GAAP, and it's allowed to be held only for insurance contracts. You're not allowed to hold any DAC for investment contracts. In our U.K. GAAP we had DAC types of contracts. That was one difference that we had.

For impairments, under U.S. statutory, you must write down a debt security if the NAIC rating class goes down by two levels or more. In IFRS there is no equivalent to NAIC rating classes, so you write down those in default or those known to be in financial difficulty, which obviously implies judgment. In practice what we've done is follow U.S. statutory rules, except for the ratings drop of two levels.

Nonadmitted assets by definition are excluded from U.S. statutory, but in the IFRS you are allowed to readmit those assets, and generally what we've done is follow similar readmission rules as you would for U.S. GAAP.

On the liability side of the balance sheet, I'm going to cover policyholder reserves, financial reinsurance, asset valuation reserve, interest maintenance reserve, deferred taxes briefly and defined-benefit pension plans.

Let's talk about policyholder reserves. You're at the valuation actuaries' meeting. You should know how to calculate U.S. statutory reserves, I'd hope. This isn't the presentation that we're going to go through, that's for sure. Under IFRS, for insurance contracts, since we don't do audited U.S. GAAP, we hold U.S. statutory reserves for insurance contracts.

For the investment contracts, which were the period-certain-only immediate annuities, we had a choice of amortized cost or fair value, and guess which one we chose. We chose probably the easier path from our point of view. The definition of fair value a year ago was and still is nebulous. We chose to go with amortized cost. We already had a reserving system calculating U.S. GAAP reserves for this block of business, and so it meant a minor modification to how we did it to calculate amortized cost reserves.

For financial reinsurance U.S. statutory surplus relief can increase the company's surplus. Under IFRS we followed the same rules as we do for U.S. GAAP and U.K. GAAP, which is you don't get the benefit of financial reinsurance. It's not considered to have a significant amount of risk transfer. The surplus gets reduced, and just the annual cost of the surplus relief flows through the income statement.

Asset valuation reserve and interest maintenance reserve are easy. They're mandatory on a U.S. statutory basis. Neither is allowed for on an IFRS basis. There are two other differences. For deferred taxes (I'm not a tax accountant and could probably spend 10 minutes on that), suffice it to say it's different, and rely on your accountants to figure it out. On the defined-benefit pension plans side, I will give you a little bit. U.S. statutory calculates only the vested liability: people with benefits and people who are vested. The IFRS calculates the liability on everybody, even people who are not vested, and so it's a little bit higher.

For shareholders' equity, you are familiar with U.S. statutory and how to calculate that. With IFRS, there's a revaluation and some other reserves. The unrealized gains or losses on the available for sale assets flow through here, and it's similar to "other comprehensive income" on your U.S. GAAP basis.

The income statement, after you make all the changes to the balance sheet, is fairly straightforward. The insurance contracts work exactly the same way as they do in U.S. statutory, and investment contracts follow U.S. statutory rules for deposit accounting, except it's for all issues, not just for issues after December 31, 2000.

In conclusion, before we started it, there was a huge fear of the unknown and a huge amount of material to read through, but when we got down to it, to create a

balance sheet we made only 11 accounting adjustments to go from a U.S. statutory balance sheet to an IFRS balance sheet. I think we made 13 adjustments on an income statement. It was a lot simpler than we expected. However, we're still learning what it means. We're working on the half-year disclosures at the moment, and the full-year ones look a lot more comprehensive. IFRS can be complex; I'm not trying to minimize it. We were lucky in terms of the assets we held and the liabilities we had. We didn't have anything that was complex. In essence, we were lucky, and we're done, hopefully.

MR. HINES: I'm going to talk about three topics for the rest of this session. I'm going to diverge a little bit from the accounting standards and first talk about the actuarial standards that Sam briefly mentioned in his talk. I'm going to move back to the IASB standards and talk more about the future. We talked a lot about where we've been and what the standards look like so far, but I'll talk about where we are headed and what the prospect is of non-European parent companies being affected by this. There are several other projects happening at the IASB that insurers would do well to take a look at and follow the activity on because they may have impacts for the insurance project or for the rest of the balance sheet. Martin touched on a few of these types of issues that you wouldn't normally think of in the context of the insurance project.

First I'll discuss the actuarial standards. The IASB standards, the accounting standards, are an attempt to make them principle-based. They try not to provide many rules or much guidance on how you might do these calculations. In fact, there's fairly little in the way of guidance for how actuaries might go about doing calculations in support of balance sheet and income statement items, so the IAA has taken on the task of putting together global Actuarial Standards of Practice. The IAA, if you don't know it, is a global association that has associations as its members and also individual members. I think it covers 95 percent of the practicing actuaries in the world.

The Academy and the SOA are members, and if you're a member of either of those organizations, you're also a member of the IAA. Part of the dues that you pay are in turn paid to the IAA to become members. The objective of the IAA is to interact with other international bodies and represent the actuarial profession in the international arena. It does not get involved, or tries not to get involved, in nation-specific and national-specific issues. It defers to the local organizations to deal with those.

Most of the work of the IAA is done through committees. The IAA has an Insurance Accounting Committee (I mentioned earlier that Sam's the chair of that), and it's under the auspices of that committee that the actuarial standards are being developed. A subcommittee was formed to deal specifically with this issue because it's a big issue, and a drafting group is doing most of the heavy lifting. The numbers here represent the members. There are five members, plus three members to do oversight—the chair and the two vice chairs of the Insurance Accounting

Committee.

Later we added three additional members to supplement our knowledge base in the property and casualty (P&C) arena. We felt that we were fairly heavy on the life side and not necessarily vetting all the issues on the P&C side. The three additional members bring the group's total to 11.

The subcommittee has face-to-face meetings two to three times per year. I think we started this project in 2001. The drafting group has conference calls at least monthly, sometimes several times a month, to develop the guidance and vet the guidance.

There's a fair amount of due process that the IAA requires to go through in the development process of standards. The IAA Council, which is the decision-making body of the IAA, had to approve the development of the subcommittee itself and its mandate to prepare actuarial standards, and it did that a couple years ago. We've recently issued the first group of preliminary exposure drafts with a four-month comment period. I'll talk a little bit more about what those are. There will be a final draft standard developed after that point with an exposure period of up to six months.

What are these standards going to be do? They are going to be giving us guidance for work that we do under IASB accounting rules for insurance contracts, financial instruments and the service-type contracts that Sam mentioned would fall under IAS 18. It's a fairly big bucket, but all the normal types of contracts you might deal with would fall under that. It doesn't apply to the pension obligations of the insurer itself, and our mandate doesn't apply to the valuation of invested assets, although that may be something you're required to go through as Martin was talking about with his company.

We've divided the standards into several categories. This partial list includes actuarial practice, contract classification, measurement, loss recognition testing, derivatives and discretionary participation features. I think we have a dozen standards or so that we are thinking about developing guidance for, and we've issued three, I think, for exposure at this point: actuarial practice, measurement and one that isn't on this list, current best estimates. How do you deal with coming up with current best estimates? Actuarial practice is more of a general guideline that covers the role of the actuary and the role of actuarial practice in terms of working with the accounting standards. Measurement deals not with the insurance contracts but with financial instrument liabilities and service contract liabilities.

We hope to issue several more of these over the coming month. You'll be hearing more about them. Copies of these are available on the IAA Web site, which you can access if you're members of the IAA: www.actuaries.org. It's the plural (*actuaries*), as opposed to the Academy's site, which is singular.

The Academy is going to be reviewing these SOPs from its point of view and providing feedback. That's under the auspices of the Financial Reporting Committee, I believe. The comment period is four months. They were released around September 14, and so the comment period will end sometime in January.

I'm going to move on now to talk a little bit more about the prospect or the future of where the insurance project is headed. I have a quick question for the audience. How many of you are going to be impacted during Phase I in 2005 by the IASB's accounting standards? Quite a few. How many of you are not going to be impacted? A lot of U.S. companies and perhaps consultants make up the rest of it. Many people wonder how this is going to play out in the United States. There's been a lot of talk of convergence, but where are we headed in the United States? Is this something we should be concerned with? Judging from the size of the audience today, I would guess that a lot of you think it is something to take a look at.

The question of whether to converge or not to converge seems to me a moot point. Practically everyone is saying that convergence in and of itself is a good idea. Look at the financial crisis that happened in Asia and the Russian financial crisis that happened a little later on and extended down to South America. Correcting those situations was hindered by the lack of transparent and consistent financial standards, and so you have organizations such as the SEC, FASB, the Federal Reserve, the Treasury and the Organization for Economic Cooperation and Development saying that convergence is good, and we should be moving toward it.

The questions tend more to be what is it going to converge to and when? As Sam pointed out, the insurance project started out at the IASB with politics, or even all of the standards start out with politics, and will likely end in politics. One you don't see at the moment is Congress and how that might play out with the lobbying efforts of the industry. We know what happens when that gets into the mix. We've seen it here in the United States with the stock option issue and Congress getting in the situation of making accounting rules or proposing accounting rules. I can't say where it's going to end up. I never know what the members going to do, but let me talk about where I think it might be headed, ignoring Congress for a moment.
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Will convergence happen? Will it not? It's actually happening. The FASB and the IASB have been meeting together for a while, and in October 2003 they met in Norwalk, Conn., the FASB's hometown, and decided that they would try to coordinate their agendas going forward. This became known as the Norwalk Agreement, symbolic that each organization would not put an item on its agenda without at least discussing it and without the other organization putting it on its agenda, and they identified several short-term items they would like to undertake immediately.

They looked at several areas where their accounting guidance for the FASB and IASB were substantially similar, but there were some minor differences. They decided that they would try to eliminate those minor differences by having the IASB

change some rules and the FASB change some rules. They've gone through a fair amount of work to do that, but few of those impact the insurance arena. Now that the platform for 2005 in Europe has been set, there are a few minor outstanding issues. Sam touched on a few of them, especially with IAS 39, but you're going to see the convergence start now.

The FASB and IASB have agreed to work jointly on several projects that may affect the insurance industry. One is liability extinguishments. When do you get rid of your liability? It may not have a significant impact in the insurance arena, but where do your involvement with an insurance contract and your involvement with a liability end and where do they continue? Another one is comprehensive income. This is also joint with the U.K. board standard setter, and this has been around for several years, trying to identify what an income statement should look like.

Determining the difference between liabilities and equity may be particularly relevant for insurance where you have some of these discretionary participation features that Sam was talking about before or even par products in the United States, where you have maybe a dividend liability that hasn't been declared by the board of directors or a dividend scale or future dividend scales that haven't been declared by the board. How do you take those into account? Do you classify future dividends as liabilities? Do you classify them as equity? Where do you go from there? The insurance contract for Phase II is something that the FASB and IASB have been talking about working on together.

As a sidelight parallel track to this is the FASB's fair value exposure draft. It issued an exposure draft a few months ago identifying how to calculate fair value under FASB accounting rules, and one of the pieces that was included in that draft was to elevate something called Concept Statement 7 to an accounting standard itself, rather than a concept statement. Ostensibly fair value ED is meant to talk about what your hierarchy of coming up with fair values would be and looking at traded instruments, nontraded instruments, etc.

The Concept Statement 7 talks about how you would use present values in accounting measurements. Unfortunately there is precious little in that ED as to how to deal with fair value for liabilities, and I think that was the major complaint from actuarial and insurance organizations. While it may provide some measure of where the FASB would like things to head, it doesn't give us a good indication of how to deal with the liabilities or how the FASB would like to deal with liabilities, especially nontraded liabilities.

The implications of the FASB and IASB working on a project together, especially insurance, are that while it's not officially on its agenda, I think insurance is effectively on the FASB's agenda, and that change is likely to occur. Three years is probably a little aggressive, but more likely it will occur over the next five years to U.S. GAAP accounting for insurance contracts. It's likely to end up in some type of prospective valuation model. That's what it seems most people are talking about,

whether it's on the fair value side or on an amortized cost side, although some proponents are saying, "Let's use U.S. GAAP as is with some minor tweaks," and you could argue that FAS 97 is not necessarily a prospective model. It could center around some form of fair value.

The FASB, separately from the IASB, and the IASB as well have said that the ultimate measure for financial instruments should be fair value. They consider insurance pretty much a financial instrument, though it's scoped out of much financial instrument measure guidance, but that's the starting point from where they're going to go, and they're going to have to be convinced to move off fair value to do something else. It's likely that we're going to see a lot of work around fair value as that project moves on.

I want to touch on my third topic, which is some other projects that are going to be of interest to insurers. I'm going to return to the Phase II project of the insurance contract and talk about that a little bit more because I think there are a number of projects that have some interrelations with the insurance project.

I'm going to talk about six and then move to insurance contracts again. Revenue recognition is one. The question it's trying to answer is how do you define what can be classified as revenue in an income statement? It's also related to the distinction between liabilities and equity.

If it's something that you classify an equity, the related measure doesn't qualify for revenue, and if it does produce a liability, maybe you should classify it as revenue, but this has a big impact in how much is going to be showing up in the top line of your income statement. A lot of people pay attention to that, so a lot of people are going to be interested in how that plays out.

This is a perhaps less practical issue but more of a conceptual issue: the financial instruments project. It's a return to the financial instrument project back in the mid- to late-1990s that Sam was alluding to earlier.

Now that it's got the IASB's reorganization and Europe's 2005 accounting platform out of the way, it wants to move back to exploring why all financial instruments shouldn't be measured at fair value. That's the premise. It's going to go look back and start with the draft issues paper, I think, from the JWG, which it had put aside for a while, and it's formed a small advisory committee to help vet through the issues in this process. Fortunately a member of the IAA was asked to be on that committee. We will have some communication and some input from the actuarial point of view. Frances Wright from ING in the Netherlands is the actuarial representative on that committee.

Another interesting project that's more conceptual in nature is the measurement project, and this is more global in terms of looking not just at financial instruments but all types of measurement of items. What are the principal concepts in setting

the appropriate measurement basis for all items in the income statement and balance sheet? This is also working jointly with the Canadian Institute of Chartered Accountants.

I mentioned comprehensive income. This is one that's been around for a while. The U.K. accounting standard setters have been working on it for a while, and they've come up with several iterations of what they think an appropriate income statement might look like relative to what's out there today. One of the concepts that they had come up with, a more recent draft, is to separate the income statement into essentially two columns: one talking about your income from operations, the thing that you do every day, and then a separate column for the results from how you financed your operations.

That may work fine for a manufacturing firm or an agricultural firm, but what do you do if financing is your operation? How do you make the distinction between those two? In insurance, that's essentially what you do. For banking and financial intermediaries, what you're doing is financing. How do you distinguish between those two? While it may fit for some industries, it's likely that it's not going to be that clearly relevant for other financial institutions like insurance companies, and so that's an ongoing project as well.

Another item that it's split into two phases is business combinations. It did come up with an IFRS trying to converge a little more closely to U.S. GAAP. For Phase I this is in place for 2005. It's also embarked on a Phase II project for business combinations, revisiting the purchase accounting method again and trying to get it much closer to U.S. GAAP and converging with where the FASB is or moving the FASB to where the IASB wants to be.

Also returning to disclosures, the current disclosure document out there, which I think is IAS 32, was issued a number of years ago and has not been updated in a few years. There's been a large development of financial techniques to manage risk, and concepts and new types of instruments are out there, and the current guidance is felt to be wanting in those types of areas. The IASB's come up with a new set of disclosure requirements and issued ED 7, which it's trying to use to catch up. The key element is that it doesn't apply to insurance contracts that are subject to IFRS 4, but it does impact contracts that are classified under IAS 39 or IAS 18, meaning things that are not insurance, such as some of the deferred annuities and GICs.

Let me get back to Phase II and talk about where that project is and where it's headed. Phase II of the accounting project was restarted in July of this year, at the July board meeting at the IASB, with some education. The staff brought to the table a number of questions that it hoped to answer during the course of the project, as well as some additional examples that it hoped to use in terms of going through the project and analyzing the impact of various alternatives that it may choose.

The sequence of events as it moves forward is to continue that education with the September meeting; continue to develop a discussion paper first, not going directly to an ED but developing a discussion paper (probably something similar to what was done with the issues paper for the insurance project back in 1999 or 2000); and then develop an ED and final guidance. The goal, if you look at the IASB Web site, is an ED by June 2005. I don't think there's any way you're going to see an ED by that point. You'll be lucky if you see a discussion paper by that point, but that's much more realistic. An ED perhaps in 2006, a final draft perhaps in 2007 and implementation in 2008 is a much more likely time frame from my point of view.

It's also put together a small advisory group to help analyze some of the issues that will be coming out of the insurance project. The group comprises about 15 to 20 people who primarily are CFOs and insurance industry representatives, but it also includes some actuaries. Sam is on this advisory group. There's another actuary from Australia as well, and there are a couple of what they call users of financial statements. They pulled some people who are Wall Street–type equivalents from the United Kingdom to be on the advisory group, and my understanding is this is not a decision-making body but more of a sounding board to find out what the issues are, vet through some of the issues and provide input to the IASB staff and the board.

The intention at this point is to conduct some type of field visits during the ED stage. This involves going and visiting companies and talking with them about how they think they might be able to implement the guidance and what they view as issues around implementing this accounting guidance. At this point the IASB has not talked about conducting any actual field tests or about having someone implement all this guidance, taking a look at it and seeing what the results look like. This unfortunately has been a major criticism of some of the past work that the IASB has done and will likely be a bone of contention going forward. The idea of an untested system being implemented is something that people are loathe to do, especially when it makes major modifications and especially if it ends up in fair value land. If it comes out from a fair value point of view, we haven't seen any fair value–type frameworks for insurance. It would be helpful from a lot of people's points of view to see some type of testing as to how these would work in practice.

I mentioned the joint project. The process at this point is what the IASB and the FASB have jointly deemed a modified joint approach, which means that there's one lead board that develops the project initially, and in this case it's going to be the IASB, although there will be some sharing of staff members with FASB. The IASB is going to develop the discussion paper, and then both boards would issue that discussion paper for comment. With comments coming back they would hopefully both develop either a joint ED or something substantially similar and then expose the ED and develop the final guidance down the road.

If you're familiar at all with some of the issues and previous discussions about fair value accounting, it's no surprise what some of the issues are that the IASB is

going to be grappling with as we move into Phase II. The move to an untested system is something I've mentioned. The volatility of earnings that a fair value system may produce is something that people are keenly aware of. If you have any dealing with the financial marketplace, you know that surprises in earnings are things that cause your stock price to move significantly, and in a lot of cases it doesn't matter whether it's a positive surprise or a negative surprise. The sheer volatility causes some uneasiness on Wall Street. There's a lot of concern that a fair value type of situation—valuation for the liabilities, for assets, for combinations—will result in significant volatility going forward.

There's always a pull and tug between the principles versus rules type of approach. Congress and the Public Company Accounting Oversight Board and the creation of Sarbanes-Oxley all centered around trying to create a more principles-based approach to accounting so that you don't have so many people trying to game the rules. At the same time, if you don't provide any real guidance as to how to implement the principles, it's hard to figure out how to get consistent and transparent guidance. There's always this tug and pull: "Give me a principles-based system, but then tell me how to apply it at the same time." It's difficult to figure out where to draw the line on that approach.

I think Sam touched on the assets-liabilities mismatches a bit earlier. Especially during Phase I, where you've got several different accounting bases for assets and perhaps a single accounting basis for liabilities, you can potentially have a fair amount of volatility just from the choices you make as to how you classify your assets. It's unclear going forward what the ultimate valuation basis at the IASB is going to be for assets. Could you envision a situation where the liabilities are at fair value, and you still have this choice for a mixed system on the asset side? You may end up again with asset/liability mismatch, an undesirable thing.

Regarding floors on liabilities, this has been known in various incarnations as the deposit floor, demand deposit floor and cash value surrender floor for insurance products. Should there be a floor on liabilities? It depends on what measurement basis you're talking about and what use you're talking about, but in true fair value, would there be a deposit floor on your liabilities? These are some of the questions that the banks are dealing with concerning the hedging issue. Should there be a demand deposit floor on liabilities, or should you be able to take into account the fact that policyholders don't exercise their options efficiently from a financial economics point of view? It's a difficult issue to deal with. The IASB to this point has been of two minds: have fair value and also have a demand deposit floor. It's difficult to get it to move on that. I think it's going to be a big issue going forward as well.

You wouldn't think renewal premiums are such a big issue, but they are. When can you decide to include renewal premiums in your liability valuation? You can't force people to pay a renewal premium on an insurance product. They can choose to pay or choose not to pay. The IASB's framework for accounting says that you can count

as liabilities, or count in your liabilities, items that you have unilateral right to or classify as an asset the unilateral right to force someone to pay. There's been a real question of when you can count renewal premiums. Is it when someone is preserving an option in the contract, not having to go through underwriting, or preserving current pricing or those types of things? There have been some real discussions around when you can include renewal premiums. Imagine a valuation system where you couldn't include renewal premiums. It is interesting.

Should you reflect your own credit standing or someone else's credit standing in your own liabilities—the fact that you may default on your payments? The argument is that when you value a bond—a financial instrument in a marketplace—you take into account some element of default and discount that value for default. Should you do the mirror type of thing when you're coming up with a fair value for an insurance liability? This is probably the issue where I've seen people get the most vehement about whether to include it or not. People are either on one side or the other and have strong opinions about it. People always come up with a perverse issue: "I can lower my liabilities if I just get downgraded, and wouldn't that be a good thing? What's the incentive for me not to do that?"

One of the other key issues is gain or loss at issue. Should you be able to recognize or in what situation should you be able to recognize a gain at issue or a loss at issue? What's the best evidence of a market price for an insurance contract? Is it at the sale of the contract? Should you be able to recognize a gain? Should you be able to recognize a loss? Did you get a better price in the market than your best estimate of that liability? There are a number of issues that we're going to have to be dealing with as we move through Phase II.

FROM THE FLOOR: Martin, you were talking about your classification of the immediate annuities, and you listed certain and life-contingent. Can you discuss the standard that you used for combined certain and life-contingent annuity? On the deferred annuities you mentioned IFRS 4 classification as an insurance contract, which seems to differ from U.S. GAAP, and I'd like you to discuss the reporting issues with that.

MR. SHEERIN: For the immediate annuities, where there's a combination of period-certain and life-contingent, there was mortality exposure in them. We treated them as insurance contracts. It was for period-certain-only that got to investment contracts. On the deferred annuities, what did you ask?

FROM THE FLOOR: Why you classified them all as insurance contracts, which is different from U.S. GAAP. FAS 97 reporting would be different.

MR. SHEERIN: The reason why we classified deferred annuities as insurance contracts was based on, as I said, the December 2003 meeting of the IASB. It listed out examples and had given examples from earlier meetings about what was insurance and what were investments, and in examples given in December it

referred to products that had guaranteed annuitization options with the guaranteed rates in the policy that you couldn't change as being insurance contracts. For IFRS purposes, that's what we relied on.

MR. GUTTERMAN: There's a little interesting wrinkle on period-certain annuities. You would think that it has to be an investment contract, but if a certain portion is a continuation of a deferred annuity, which is characterized as an insurance contract, one of the rules in IFRS 4 is once an insurance contract, always an insurance contract. Therefore, if you annuitize into a certain-only annuity, you could find out that it then remains insurance even though there's no insurance or prospective insurance element.

MR. DAVID ROGERS: I have a couple more questions for Martin. One of the slides indicated that you were using U.S. statutory reserves for your insurance contracts under the IASB, and I was wondering if you're also using U.S. statutory reserves for U.K. GAAP reporting.

MR. SHEERIN: Yes, we are.

MR. ROGERS: If you weren't, would you still have that option available to you?

MR. SHEERIN: For U.K. GAAP purposes we could choose U.S statutory or U.S. GAAP, but since we don't have audited U.S. GAAP, we relied on the audited reserves, which are U.S. statutory. One point I didn't mention was that the DAC we do set up for IFRS and U.K. GAAP purposes is subject to a recoverability test, and we use our embedded value numbers to show that there are sufficient profits within the in-force block to cover the DAC. We do that test annually.

MR. ROGERS: My second question had to do with whether Aviva is considering changing any of the decisions that it's made around applying IASB or IFRS. If so, could you talk a little bit about the areas that are most eligible for consideration?

MR. SHEERIN: I'm not speaking for the corporation, but this is my opinion. It's more focused on the embedded value, the CFO Forum principles, these days, and IFRS is an aside. We have to report them. In terms of giving numbers to analysts to judge the profitability of the company, we will be relying on enhanced embedded value or the embedded value with time value of guarantees when fully revealed. That's where we focus. We're reporting IFRS purely because we have to.

MR. TONY DARDIS: You talked a little bit about the work of the IAA, particularly with reference to the establishment of IAS for valuations performed in connection with IASB requirements. It's interesting to note the fascinating work that's been done by another IAA working party looking at the establishment of a principles-based, true risk-based approach to setting reserves and risk-based capital. Some of the principles involved that are laid out in an excellent document that this working group has put together are relevant to fair value accounting, and I suppose my

question is twofold. First, I trust that this work is also being fed through to the IASB, and, second, I'd be interested in what the response of the IASB has been to this excellent piece of work that's been done by the IAA.

MR. GUTTERMAN: I have a couple of comments. First, that paper, which I agree is good work and also is available from the IAA Web site, is directed toward capital requirement solvency. It doesn't specifically relate to the liability determination. That's an issue that will be coming up for discussion shortly. The IASB is aware of it, but it's related to the insurance regulating audience and therefore hasn't been looking at it directly.

An interesting related project is one that's being conducted by the International Association of Insurance Supervisors (IAIS), of which the NAIC is an active participant now. That group is discussing insurance regulatory reserve requirements and the capital and surplus and solvency-related issues that were the subject of that IAA document and research paper. It's starting a project to try to come up with an international risk-based capital, for which it's working with the IAA Insurance Regulations Committee. It also is studying and trying to put together in the next couple months certain principles that it wants to have in place for insurance accounting standards. It's interesting. The IAIS is the only organization table in the IASB Insurance Accounting Working Group that has two representatives.