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Implications of European Directives in the Assessment of Insurance Companies

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Abstract. *The objective of this paper is to present a vision in the sphere of the problematic of assets and liabilities' evaluation that are reflected in the balance sheet of the insurance companies, inside the theory of the contingent claims, and of the marginal theory inside the insurance sphere. Our references take into consideration all the principles and evaluation norms of a company's liabilities, company operating in the life insurance domain, including the general request introduced by the IFRS. Also, we argument the fact that the making of the new IFRS standards' frame must take into consideration the accelerated globalization of the trading and the internalization of the financial markets, factors that have made pass onto the first place the necessity of a standardized financial reporting system. Because for so long the evaluating inadequacy of the assets at their fair value and the liabilities at their fair cost has persisted for so long, we underline that we find even in this a vast debate subject between the insurance companies' representatives and the IASB, especially in the second step of the IFRS4's implementation in the life insurance contract.*

Keywords: incoherent evaluation; insurance contract; risks; assets/liabilities; balance sheet.

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1. Introduction

The activity of the insurance companies is, by its nature, one of the most complex; the IASB admits its importance, and in May 2002 it has decided to intervene in two steps.

The first step includes the IFRS4 in its vast means, IAS32 (the exposure and presentation of the financial instruments) and IAS39 (presenting and evaluating the financial instruments). The second step concentrates, in exchange, on the much debated subject of balance sheet liabilities' evaluation of the insurer.

The IFRS4 includes also the accounting laws applicable to the companies' insurance contracts that must present more detailed financial report regarding the insurance contracts (for example regarding the sensibilities of the profits varying with the hypothesis its stands on), the reserves for catastrophes and equality no more being admitted, used previously to absorb extraordinary losses.

The most relevant modifications refer to accounting the balance sheet items at their fair value, most of the balance sheet assets therefore being needed to be included in the balance sheet at their market value and not at their historical cost (Taliento, 2004).

2. The necessity of the IFRS implementation in the insurance contracts

The introduction of the IFRS4 produces, therefore, a strong impact not only over the accounting, but also over the management of the assets in the balance sheet of the insurance companies.

The insurers, especially the ones that operate in the life insurances' domain, hold title assets, at present this assets being highlighted in the balance sheet at their nominal value, while, according to the IAS39, most of the assets will be evaluated at their market value. In a context that is characterized by interest rate variation, the value of the assets will be subdued under variations, while the balance sheet liabilities, at least in first phase, stay essentially invariable, from here being derived the volatility of the management not only at an economical result level, determined from the new accounting standards (Chiricosta, 2004).

In order to reduce this volatility and avoid a negative evaluation on behalf of the market operators, the insurers can choose between title volume reduction, in order to be more orientated towards bonds, with the advantage to manage the assets and liabilities in a more effective way; classifying some asset as being held to maturity, and this practice will be due to a normative that penalizes companies that sell assets classified as being held to term; reducing the exposure risk, by insuring assets on a less long term and adequate to the product's structure (Bacinelllo, 2001).

Unlike the damage insurers, the life policies insurers will sense more directly the IFRS being introduced; this is explained also by the nature of the balance sheet liabilities per title, which often get guarantee options.

Based on the IFRS4, some guarantee options will have to be evaluated at their market value. Companies that in the past have not taken into account these options in their taxing models are due to make the necessary adjustments.

The insurers will not only have to intensify the information with the variety of the insurance risks that the portfolio contains, but also varying with the sensibility of own assets of interest oscillation, share prices and mortality.

Realizing the new frame of the IFRS standards means taking into consideration the accelerated globalization of the trading and financial markets' internalization, which have made passed onto first place the necessity of a standardized financial reporting.

Harmonizing of the accounting practices and annual accounts' preparing systems has also been favored by international companies, lots of these aspiring in fact to be listed beyond their own national market in order to access larger markets.

IASB has evolved a normative frame, IFRS, finalized to improve the transparency and compatibility between different domains and companies. The EC has declared, on January 1st 2005, that the enterprises listed in the EU must present consolidated financial situations, by applying only one accounting standards frame, called IFRD, elaborated by the IASB. It is also stipulated a temporary exemption of two years for the companies listed either in the EU, or on a third regulated market, and for making consolidated accounts by the accounting standards recognized internationally.

3. The European accounting strategy regarding the IFRS4 standard implementation

The uniformity of the European entities' balance sheets represent for the EU one of the objectives followed in order to supply their internationalization process. This objective has determined the EC to adopt laws aimed to normative uniformity in its member countries.

Among the directives that the EC has adopted, three have especially referred to the editing of the balance sheet principles in the EU enterprises:

- the 4th directive regarding the annual capital companies' accounts (98/660/CEE);
- the 7th directive regarding the consolidated accounts, afferent to group companies (83/349/CEE);
- the 8th directive regarding the abilities of the individuals tasked with annual accounts' audition (85/253/CEE).

This represents a first tentative towards real uniformity and European balance sheet comparability, be it under the aspect of editing but also under the aspect of patrimonial items' presentation (IASB, 2003, *Exposure Draft: ED 5 Insurance contracts).*

The presented directives have codified the general principles elaborated internationally, but have not been adopted in many of the national European countries regulations. Among these principles we find: the faithful and fair frame, going concern, economical competition, non-compensating the assets with the liabilities or the income with the expense, the prevalence of the economical over the juridical, the continuity of exercise continuation, the permanence of the accounting methods, intangibility of the opening balance sheet, presenting the homogenous and comparable information.

The EC directives leave the possibility of choice between various options that can consent different accounting treatments, determining by that an incomplete harmonization. In the 508/95/CEE document, "The accounting harmonization: a new strategy in the international harmonization process", the Committee has highlighted in fact the way that the EU should act in order to consent to the wanting companies to be listed on the USA markets or other world markets to remain in the EU accounting frame.

The EC has realized in fact that the balance sheets made by the trans national European companies, according to the national law, that was based on European accounting norms, were not compatible with various accounting principles prescribed in other countries of the world from which they must obtain in order to penetrate the international accounting markets. The companies mentioned were constraint to make two series of accounts: one according to the European accounting directives and other according to the requests of the international capital market,

On an European integrated and efficient real estate market, it is necessary for a listed company to make its own balance sheet based on a single set of accounting standards. The EU did not want to make a distinct set of accounting rules, exclusively for the European market- a choice of this type would have been incompatible with the globalization tendency of the financial markets and would have put to risk the capacity of the European companies to find their capital on third party countries' market (Mates, Hlaciuc, Grosu, 2009).

Therefore, a set of internationally recognized standards seemed to be the most adequate basis for the financial information in the EU. In the 35/00/CEE document, called "The EU strategy regarding financial information: the way to follow" , the EC repeats the necessities that appear from re-giving the European entities annual financial situations comparability, based on the standards elaborated by the IASC, ensuring the guarantee of a unique, efficient and steady market.

The committee has proposed, for all the companies in the EU, listed on regulated markets, the obligation to make starting January 1st 2005 the consolidated financial situations by using the IASC standards; the member states, in exchange, have the possibility of extending this obligation also for the non-listed companies (IASB, 2004, *IFRS 4- Insurance contracts).*

The adoption of all of these has been approved in May 2001, by the directive CEE65/2001. On July 17, 2007, the Council of the Finance Ministers has proposed to the EC the introduction of these new rules and founding an adequate mechanisms regarding IAS approval. The communitarian dispositions actually want the 4th and 7th directives modified, aiming towards applying the IAS39 regarding the representation and evaluation of the financial instruments.

In June 2001, the EFRAG takes birth, with the task to assist the EC regarding the acceptability of each document in Europe and emitting commentaries about these documents, made by the IASB. On July 19th, 2002 the EC elaborates the 1606/2002 regulation, through which it is stipulated the adopting, starting 2005, of the IAS for the annual consolidated accounts afferent to the listed companies.

The obligation is valid also for the companies that are preparing to solicit the allowing for negotiation of their shares. It is also stipulated the possibility that the member states impose the application of the IAS to the companies listed in their exercise balance sheet, to the non-listed companies, but also in important divisions, such as the banking and the insurance services, independent of the fact that the companies are listed or not.

Starting July 2003, the EU has introduced the IASs by then adopted, and from that moment, the future ones - IFRS, and the SIC Interpretations. The approval has been made official by the regulation CE 1725 of September 29th 2003, obligatory in each member state.

4. The development of the IFRSs in the insurance services' division

The IAS initiative regarding the fair value dates all the way back to 1997, when the IASC has started developing a model in order to evaluate the financial instruments at their market value. In the year 2001 there has been published a "Draft Statement of Principales on Insurance Contracts"- DSOP, document evolved by a Committee made by the IASC.

This project has raised numerous debates in the insurance division, the most debated aspect being about the approach of the market value for measuring and evaluating the financial instruments and the insurance controls.

In the year 1997, the IASC has made a certain committee, the Insurance Steering Committee, with its goal to treat problems regarding insurance contracts. Taking into consideration that the initial definition presented by the committee excluded several types of insurance contracts, such as credit insurance and security plans for entities and personnel insurance, the international financial groups and the organizations of the insurance services and normative entities have strongly opposed to this proposal.

The IASC committee has been dissolved in June 2000, because of the IASB being created, to which followed the making of a new Insurance Advisory Committee. In the same time with the Insurance Project, the IASB had evolved the IAS39 and the IAS32, which treat different accounting aspects regarding financial instruments (IASB – IAS 32, IAS 39). In December 1998, the IASC had approved the IAS39 standard – Financial instruments, presentation and evaluation. This standard has formally introduced the classification of various financial instruments; in completion of the IAS39, the IAC had successively evolved the IAS2 – financial instruments – presentation, balance sheet and informing, including general presentation principles of the financial instruments, and the accent being put on particularizing the differences between various financial instruments (Mella, 2002).

The DSOP, presented by the IASB in November 2001, proposed making a standard IFRS basis for the insurance contracts. The standards contained in the DSOP had various commentaries and recommendations on behalf of the private and public sector organizations all put together in a document published in 1999.

Taking into consideration the particular situation that usually the insurance contracts are not actively negotiated, the IASB has introduced the concept of entity specific value, as an alternative to approaching the market value.

The DSOP recommends resorting to the entity specific value to all those whom the market information was not available. In July 2003, the IASB has published the so-called Exposure Draft (EDS), an orientation document for passing towards the IFRS, under which the insurers should expose the balance sheet liabilities at their market value, also the final version of the proposal being eliminated,

EDS had consented to the IASB to collect the future commentaries and recommendations came from the organizations from the private and public domain, these serving as a basis for setting the IFRS4 standards regarding the insurance contracts.

In March 2004, the IASB publishes IFRS4 – insurance contracts, but the appliance of the national accounting norms regarding insurance contracts is continued, with several modifications. It is good to remember that the IAS39 and the IASB standards refer to financial instruments held or emitted by the insurer, and the IFRS4 says that the insurer must present more detailed information regarding the insurance contracts.

5. The application sphere of the IFRS4

IFRS 4 is applied to all the insurance and re-insurance contracts (active and passive) that fulfill the definition of the insurance contract. The insurance risk supposes that at least one of these elements is random, being necessary certain conditions for the mentioned contract to be considered eligible for the re-insurance accounting, more than for deposit accounting: event checking, the moment that the event should take place and the economical impact for the insurer.

In the absence of the insurance risk, the contract is not included in the definition of an insurance contract; according to this definition, the contracts for which the insurer guarantees the payment of a sum without a possibility that an adverse event hits the insurer or other beneficiaries does not exist do not contain an insurance risk (Baione, De Angelis, 2004).

The insurance risk is different from the financial risk, which takes place when an entity assumes or transfers to another party one or more of the following risks: exchange risks, risks regarding interest rate, market risks, credit risks, or price variations.

The financial risk is practically the risk of a possible future change of one or more variables: specified interest rate, specified price of the financial instruments, specified price of the merchandise, specified exchange rate, specified index of prices or rates, specified evaluation of client solvability or specified index regarding credit, or other variables, only in the case of non-financial variable not being specific to a contracted party.

The significance of the insurance risk must not be disclosed by the insurer over its portfolio or even him, but contract over contract. The unclassified contracts such as the insurance contracts can be reclassified if a significant variation in the insurer's treasury cash flow takes place.

If the insurer, at the date of the contract stipulation, is capable to evaluate that the probability or the actual value of a significant loss could lead to growth in time, the contract becomes classified as an insurance contract, from the beginning, even if the actual value afferent to the loss is smaller at the moment. Once classified as insurance contracts, these cannot be reclassified.

A significant part of the contracts, that are legally defined as insurance contracts, do not satisfy the current definition of the insurance contract according to the IFRS4, because to these are not applied the contractual standards regarding the insurance contracts (De Angelis, 2001).

The combination between the financial risk and the insurance risk influences therefore the classification and accounting of the contracts. Based on this definition, we can classify the life insurance contracts as follows:

- products with insurance coverage: temporary insurances, permanent health insurance;
- composite products: composite income, composite insurance;
- financial contracts: social insurance forms, investment contracts.

The Implementation Guide offers several contract models that are in the definition of the insurance contract: case of death insurance, immediate annuities, composite contracts with superior payment in case of death, investment contracts that contain participation discretionary components of the beneficiaries (Brennan, 1976).

6. Conclusions

The IAS39 imposes to any insured to separate the incorporated derived instruments that satisfy certain specified conditions in the base instrument which contains them, to evaluate the incorporated derived instruments in the fair value and identify the modifications that occur at their fair value in the profit and loss account.

Still, an insurer is not obliged to separate a derived incorporated instrument that concurs with the definition of an insurance contract.

Nevertheless, the separation and evaluation of the fair value of an incorporated derived instrument of this type is not forbidden if the accounting policies of the insurer solicit this or if the insurer modifies its accounting policies and these policies are in the sphere of the IFRS4 criteria.

The IFRS4 is a first step in defining a reference frame exclusively for making the balance sheet of the insurance companies. Applying this principle regards all the insuring contracts, the insurers not needing to follow the dispositions afferent to the systematic frame or other IAS/OFRS any more, such as the case of incorporated reference derivatives, for which are already stipulated specific evaluation norms. They cannot represent provisions if they refer to events already passed at the date of the balance sheet writing, because it would be contrary to the IAS37 standard, and it is imposed therefore to them annual auditory in order to insure adequate character to the liabilities in the balance sheet.

The modification possibilities of the accounting principles are limited, although it is allowed to introduce a principle to stipulate the non-determination of the value of certain insurer's assets, which in any case cannot be put in the balance sheet if they are not updated so that they would reflect the current market values. The liabilities in the insurer's balance sheet cannot be compensated to the insurance connected assets, and must stay in the balance sheet until they are not out or regulated.

In the end, the IFRS4 does not offer an evaluation for the passive elements connected to the insurance contracts, at their fair value, circumstance in which the risk giving an incoherent evaluation of the passive values with the active of the same company.

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