To: Accounting Standards Board
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From: Chris O'Brien, Centre for Risk and Insurance Studies, Nottingham University Business School

Date: 30th October 2003

ASB Consultation Paper 4
IASB Proposals on Insurance contracts

I wish to comment on one issue raised by ASB in its introductory comments to the IASB exposure draft ED5.

This is that I suggest that ASB prohibits the use of embedded values/achieved profits in statutory financial statements.

ASB and IASB are quite right to be concerned by the deficiencies and inconsistencies in the accounting for insurance contracts. How can alternative approaches all be true and fair?

IASB does not intend to prohibit the use of embedded values under its Phase I proposals. However, it is clear from the IASB papers that it regards embedded values as inconsistent with the valuation of assets and liabilities in accordance with its principles. I would suggest that, similarly, embedded values are inconsistent with ASB's principles.

Indeed, I would also suggest that ASN reviews whether the use of embedded values is inconsistent with the Companies Act - which requires profit to have been realized. Given that the embedded value includes future margins, I cannot see how the "achieved profit" can represent realized profit. I believe it is important for ASB to address this issue.

Banks and others, if required to cease embedded value accounting, may argue that the modified statutory basis is misleading. However, the solution is in their own hands: they can remove excessive prudence in their long-term business provision, and can attribute 10% (say, and minus applicable tax) of the fund for future appropriations to equity.

Banks and others may say that embedded value accounting provides more economically meaningful information to investors. However, many (including myself) are concerned about the subjective nature of the calculations, and question the economic validity of the results. Analysts are also less in favour of embedded values than was previously the case. Now there are attempts to adapt embedded value calculations so as to recognise the effect of options and guarantees in adverse financial conditions (in a way previously not done); but even if such efforts are successful, it still leaves open the inconsistency of embedded values with accounting standards.

If my suggestion that embedded value accounting is inconsistent with the Companies Act is accepted, then its use should cease immediately rather than in 2005. It would be wrong to accept excuses from banks that they need some transitional arrangements.

Please do not hesitate to get in touch if you would like any further clarification.

The comments in this letter reflects my personal views.

Yours faithfully

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