POSITION PAPER

The Fair Value Approach in International Insurance Accounting

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CONTENTS

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Note

This position paper does not contain any original research or findings. It has borrowed ideas and language extensively from the sources cited in the bibliography.

The Fair Value Approach in International Insurance Accounting

I. INTRODUCTION

A proposed new standard for insurance accounting for assets and liabilities would, in case it is adopted, radically change insurance accounting reporting practices.

The increased complexity of insurance-related products and the lack of transparency in the financial reporting of insurance are drawing the attention of regulators. Insurance regulators and accounting bodies agree that universally recognized standards are necessary for an industry that is now global. There is enormous diversity among different countries, and even among individual companies, as to how they present their accounts and accounting has failed to keep up with the complexity of risks now being undertaken. They also believe that insurance is the last great unexplored territory of financial reporting. It seems that accounting for insurance liabilities is one of the few gaps in the armory of international accounting standards.

Work to establish internationally recognized financial accounting standards for insurance started in the late 1990s by the London-based International Accounting Standards Board. Momentum to develop an international accounting standard for insurers increased following a ruling in March 2003 by the European Parliament that all publicly traded companies within the European Union must adopt international accounting standards recognized by E.U. officials by 2005.

Many corporations in a wide variety of financial and industrial sectors use insurance-related contracts. There has been a growing consensus among insurance accounting professionals, regulators, and standard setters that insurance-related reform efforts should focus on the accounting treatment of insurance contracts.

Creating an effective reporting standard that would be applicable and accepted worldwide, though, is a huge and contentious task.

II. MOTIVATION FOR ADOPTING A FAIR-VALUE APPROACH.

Currently, different countries require radically different accounting practices for the insurance industry. This has led to inconsistency and noncomparability of financial statements and operating results across countries. This may result in potential dysfunctional decision-making by the users of insurance financial information.

The problems encountered by standard setters, as well as financial statement preparers, users, and auditors, have led some to argue that financial reporting across all countries should move toward a fair value system, at least for financial assets and liabilities.

Determining the fair value of insurance liabilities on a reliable, verifiable and objective basis presents difficult conceptual and practical issues, because there is generally no liquid secondary market in liabilities and assets resulting from insurance contracts. International Accounting Standards define 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.”

The causal factors for change in accounting for financial instruments are fundamental changes in international financial markets. Global capital markets have continued to experience significant development in the variety and complexity of financial instruments and in the extent of their use by all types of business enterprises. Strides in information technology have led to cost effective use of innovative derivative products and combinations of financial instruments in complex financial arrangements. This has enabled the unbundling, rebundling and transfer of financial risks (including interest rate risk, foreign currency risk, specific price risks, and credit risk.)

Increasingly, business enterprises must be competitive in the global market-place, not only in their primary operating activities, but also in capital financing and investing activities. In today’s global environment few businesses of any size can avoid the volatility of interest rates, foreign exchange rates, and commodity prices resulting from dynamic international economic conditions. Since insurance contracts are argued to be financial instruments, it is imperative that their accounting should be transparent and consistent.

III. THE FAIR VALUE APPROACH

In 1998, the International Accounting Standards Committee (IASC) approved IAS 39, Financial Instruments: Recognition and Measurement, which intends to move existing practice in the direction of fair value accounting. It began working with national accounting standard setters in a Joint Working Group on Financial Instruments. That group was charged to:

> develop an integrated and harmonized international accounting standard on financial instruments. That standard would build on the IASC Discussion Paper, existing and emerging national standards, and the best thinking and research on the subject worldwide.

The IASC first defined some basic terms. These are:

> A <u>financial instrument</u> is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.
>
> A <u>financial asset</u> is any asset that is:
> (a) cash;
> (b) a contractual right to receive cash or another financial asset from another enterprise;
> (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favorable; or
> (d) an equity instrument of another enterprise.
>
> A <u>financial liability</u> is any liability that is a contractual obligation:
> (a) to delivery cash or another financial asset to another enterprise; or

(b) to exchange financial instruments with another enterprise under conditions that are potentially unfavorable.

An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.)

These items present unique estimation problems and are exposed to mis-estimation risk (i.e. the risk that the amounts ultimately payable may be higher than expected.) The problem has been that actuarial methodologies developed for making these estimates have not been consistent with accounting framework concepts and measurement principles. The insurance industry and the accounting and actuarial professions have not yet reached a common understanding about how to estimate the fair value of these obligations.

Some disagree with the conclusions reached by the Financial Instruments Steering Committee. They believe that the risks inherent in an insurance contract are more similar to the risks found in long-term production or service contracts. Generally insurers receive premiums from the insured in advance before providing risk coverage to the insured party and diversifying the risks. The service provided by the insurer occurs over the contract and settlement period. At the inception of an insurance contract, the insurer is at an early stage in the development of economic returns. The amount and timing of future cash flows under the contract is uncertain and the insurer is still exposed to the risk that future claims payments may be higher than expected. They argue that the accounting for insurance contracts should be designed to recognize income as the service is provided, with accompanying adjustments to assets and liabilities. They consider such an approach more relevant to financial statement users than an approach that attempts to estimate the fair value of assets and liabilities.

Tentative Steering Committee View

In the Steering Committee's view, insurance contracts should be considered financial instruments. Insurance contracts may have non-financial attributes. However, any attempt to exclude them from consideration as financial instruments will lead to accounting differences between insurance contracts and other economically similar instruments. The Steering Committee acknowledged that viewing insurance contracts as financial instruments may lead to conclusions that differ from those that follow from a view of insurance contracts as service contracts.

IV. CONCEPTUAL ISSUES IN A FAIR VALUE STANDARD AND RELATED PROBLEMS

Some opponents of the proposed changes argue that introducing fair values, which are always current measurements of assets and liabilities, will lead to reported net profit or loss and equity that are more volatile and less predictable and manageable than the amounts produced by traditional accounting conventions. In their view, insurance is a long-term undertaking and the current fluctuations of financial markets are not representative of that fundamental characteristic of the industry. They maintain that financial statement users will find financial reporting more useful if it reflects long-term expectations rather than current information.

Those who favor use of fair-value measurements observe that financial statements prepared on that basis may be more volatile, but they see that volatility as an economic reality. From their perspective, financial statement users should be told what actually happened – rather than what management hopes will happen over the long-term.

Finally, some suggest that year-to-year volatility produced by a fair value approach is preferable to the large adjustments sometimes produced by long-term approaches. This group observes that a long-term approach requires the use of accounting conventions to defer realized and unrealized gains and losses. Those deferrals can accumulate until the amount is no longer sustainable, even over the long term. The large adjustments that then become necessary often come as a surprise to financial statement users.

Some important conceptual issues related to a fair value approach are:

Ability to measure

Some observe that insurers rarely settle their obligations by transferring those obligations to third parties. Instead, the obligation is usually settled by the insurer's performance of its obligations to the policyholders. This leads some to question whether insurers can develop reasonable estimates of fair value, which is based on settlement of the obligation through transfer to a third party. They argue that the lack of established markets will force insurers to make very subjective judgments about how markets would behave, if those markets existed. They question whether the resulting measurements will be sufficiently reliable for inclusion in financial statements.

Others disagree, and observe that estimation is inherent in all measurements of insurance liabilities. In their view, the estimates required to develop fair value measurements may be different from those used in traditional measurements. However, there is no reason to suppose that the judgments required to estimate fair value are necessarily more subjective. They point out that insurers typically have access to significant market-based information, even though organized markets for settlements of insurance obligations may not exist. Reinsurance prices and the prices of other long-dated financial instruments, for example, can provide information for use in estimating the fair value of insurance obligations. Those who hold this view observe that valuation models have been developed for mortgage-backed securities and similar financial instruments that were once thought to be impossible to value. Finally, they observe that some countries have made significant progress in developing consensus about the approach to developing key assumptions.

Value in Use

Because insurance contracts are usually settled through performance, rather than transfer, some maintain that a measurement based on expected performance over the contract term is more relevant than fair value. They favor an entity-specific measurement or value in use that incorporates the insurer's expectations about future cash flows rather than the market's expectations. In their view, the insurer's internal expectations are more relevant than those of a market that may not, in fact, exist.

Others disagree. They observe that similar arguments could be made for many financial assets and liabilities. In their view, any argument for applying value in use concepts to financial instruments should be applied to all financial instruments, rather than only to insurance contracts. They also contend that observed market prices, when available, are more relevant and useful than a company's internal estimates. They acknowledge that experience may prove that the company's estimates were correct and the market was wrong. However, they suggest that the results of that experience should be recognized when it happens rather than anticipated in an entity-specific measurement of the liability.

Solvency and Confidence

Some argue that introducing fair value measurements may cause the stockholders of insurance companies and insurance consumers to behave inappropriately. This group is concerned that insurance stockholders may conclude that asset gains (whether realized or unrealized) allow them to receive higher current dividends. Insurance consumers may conclude that asset losses indicate that they should terminate or not renew existing insurance contracts, thus creating a "run on the bank." Those who are concerned with solvency and confidence point to situations in which apparently weak companies were able to survive market reverses.

Those who favor use of fair-value measurements argue that financial reporting is one of many tools that managers, stockholders, and consumers use in decision making. Good managers know that investments must provide the cash flows necessary to meet policyholders' claims, and that changes in fair value may not alter the cash flows provided by a particular investment portfolio. However, this group also observes that the failure to use fair value measurements often masks financial difficulty from financial statement users.

V. DIFFERENCES BETWEEN CURRENT PRACTICES AND FAIR VALUE ACCOUNTING

Some current practices are inconsistent with a fair value measurement system. There are significant differences in insurance accounting among U.S. generally accepted accounting principles (GAAP), standards in use in other countries, and the current thinking at the IASC. For example, some accounting practices used by European property/casualty insurers, such as the ability to set aside tax-deferred reserves for future catastrophe losses, are considered by the IASC to be unacceptable.

And while several European companies, particularly those with U.S. stock listings, have adopted GAAP standards, the new proposals are not close to U.S. GAAP. For example, under GAAP, property/casualty insurers do not discount liabilities, whereas the IASC proposal would require liabilities to be discounted to determine a fair market value. Also, under GAAP, acquisition costs are capitalized as an asset, whereas under the proposed IASC system, they would be regarded as an expense.

There would also be very significant differences between GAAP standards and the IASB standard for the life insurance industry. One major difference is that GAAP currently has several standards for various life insurance products, whereas the IASC proposes having just one standard for everything.

Some specific inconsistencies are:

Deferral and Matching Conventions are generally inconsistent with a fair value accounting model. Fair value necessarily uses an asset and liability approach.

Deferred Policy Acquisition Costs as they are currently recorded will probably disappear in a fair value model. However, some maintain that the amount expended as acquisition costs represents the cost of an intangible asset that should be recognized in a fair value model.

Unearned Premiums are no longer used as a device to amortize premium revenues over the policy period. Instead, the measurement focuses on the insurer's obligation for payment of claims that may arise during the unexpired premium period.

Separate measurement of a premium deficiency is unnecessary in a fair value model, because the other assets and liabilities are already measured at fair value, except by coincidence.

The Liability for Future Policyholder Benefits remains a liability in a fair value model, but the assumptions used in measuring that liability must be consistent with its fair value, as opposed to the deferral and matching assumptions used in many measurements of this liability. In particular, some suggest that the Steering Committee's tentative conclusions about discount rates and a minimum value based on the policyholder-deposit method may not apply in estimates of fair value.

Paragraph 37 of IAS 37 describes the measurement of a provision as "the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time." In a fair value context, assumptions about the expected cash flows, future events, risk provisions, and discount rate should be those that an independent marketplace participant would make in determining the amount that it would charge to assume an insurance liability.

VI. U.S. AND OTHER COUNTRIES' RESPONSE TO IASC PROPOSALS

Trade groups representing U.S., German and Japanese life insurers have lobbied the International

Accounting Standards Board in favor of the deferral-and-matching approach, while the U.K. insurance industry has come out in broad support for the fair-value approach. There is mounting criticism in USA against the fair value approach. It is argued that the authority of insurance regulators and the best interests of insurance policyholders are not currently being given enough consideration. Policyholders are very low on the priority list. The direction of the IASC effort is transparency and consistency for shareholders, with not enough emphasis on issues affecting policyholders such as solvency and service. Insurance regulators would not consider writing down the fair value of liabilities because, despite any impairment to assets, there is still a contractual obligation to meet liabilities. Consequently, they could not be written down to fair value. This may not be acceptable to regulators or policyholders because it is so radically different from what is done in the United States.

Many French, German and other insurers argue against an approach that they believe is neither fair nor realistic. This is especially true for an industry that values financial stability and tends to judge performance over the long term. They believe that short-term market fluctuations may over emphasize asset/liability mismatches and may lead to unnecessarily volatile income statements. They also argue that a system that relies on management predictions could be open to serious error, or even manipulation, and would be extremely difficult to audit effectively. In particular, the ability to record a profit at outset and the attention this will receive from analysts could encourage firms into making dangerously optimistic assumptions about future performance. Other companies argue that they will lose the flexibility to invest in equities without the unrealized gains and losses affecting the income account. They suggest that this could lead to overly cautious investment strategies to the detriment of policyholders and shareholders.

The American Council of Life Insurers (ACLI), along with the Austrian Insurance Association (VVO), the German Insurance Association (GDV), the Life Insurance Association of Japan (LIAJ), the National Association of Independent Insurers (NAII), the National Association of Mutual Insurance Companies and the Reinsurance Association of America have sent a letter to the IASB stating their problems with Exposure Draft 5, Insurance Contracts, also known as Phase I of the Insurance Contract Accounting project, which is expected to be finalized in March 2004.

These bodies noted 10 wide-ranging areas that need to be resolved before adopting Phase I, including the timetable to implement the new rules; insurers' apprehension over technical issues; the mismatch of assets and liabilities measured on different accounting bases; and financial disclosures. They are urging the IASB to limit Phase I accounting guidance to distinguish insurance from other financial instruments and establish appropriate financial disclosures, leaving other issues for resolution during Phase II.

By Jan. 1, 2005, IASB accounting is to apply to all companies that want to be publicly traded in the European Union in spite of the apparent piecemeal approach presented in the exposure draft without a clear measurement objective for insurance contracts.

Before this draft release, the ACLI provided IASB a demonstration model of the kinds of problems that would occur if fair-value accounting were applied to a simple annuity product. For comparison purposes, the model also was demonstrated using U.S. GAAP accounting and another proposed accounting method.

The ACLI analysis showed the financial volatility of the fair-value accounting method and the 'financial noise' when assets and liabilities are inconsistently measured. The results seem to misrepresent the business reality. While the demonstration did not change the IASB's conclusions about proceeding with fair-value accounting, it was felt that the IASB is aware of insurers' concerns.

On the other hand, it can be argued that such transparency could enhance decision making and increase the rewards for innovations. In particular, it will make transparent what actually drives or destroys value.

The United Kingdom's financial regulator, the Financial Services Authority (FSA), maintains that improvements are needed in insurance accounting and welcomes the work being done by the IASB. FSA supports the fair-value approach rather than the deferral-and-matching approach.

Some U.S. commentators believe that if the IASB comes up with a model that is clearly superior conceptually and is a real improvement on the U.S. GAAP standards, the FASB might be inclined to do something. In general, accounting standards are moving toward a fair-value approach. Opponents of the fair-value approach are concerned about the increased volatility of earnings, particularly where assets and liabilities are mismatched, as well as tax implications.

Although the FASB favors a "convergence" to standards that are uniform worldwide, it will not necessarily support an IASB standard, because the U.S. companies, including insurers, are content with GAAP standards.

VII. SPECIFIC TOPICS IN FAIR VALUE ACCOUNTING

The IASC Steering Committee studied a number of initial issues related to fair value accounting. Some of those selected topics and the Steering Committees views are reported, almost verbatim, below.

Is Fair Value a Relevant Measurement Attribute for Insurance Activities?

Many industry commentators have remarked on the importance of a consistent measurement approach for an insurer's assets and liabilities. The Steering Committee agreed with that observation. However, some commentators question whether fair value provides the most relevant measurement for either assets or liabilities of an insurance enterprise. They argue that IASC should consider exemptions from fair value accounting. Such exemptions might apply to insurance enterprises, insurance liabilities and related assets or insurance liabilities.

The Steering Committee held the following views, all in the assumed context of a future International Accounting Standard that requires all financial instruments to be measured at fair value:

(a) if the other enterprises use fair value for financial instruments, insurers should not be excluded;
(b) if all other financial assets and financial liabilities of an insurer are at fair value, insurance contracts should be at fair value;
(c) movements in the fair values of an insurer's financial assets and liabilities should be reported in a consistent manner. For example, if some movements in the fair value of assets are excluded from net profit or loss for the period and reported as a component of equity, accompanying movements in liabilities should be reported in the same fashion; and
(d) accounting for insurance contracts at fair value should be covered in the insurance standard, not in the financial instruments standard.

The Steering Committee assumed that, on the completion of this project, IASC will have adopted a comprehensive approach to reporting all financial instruments at fair value, with all movements in fair value reported in the income statement. The Steering Committee considered consistency between the treatment of assets and liabilities of an insurance enterprise a precondition for proper reporting. Therefore, the assets and liabilities arising out of insurance contracts should be measured at fair value, with all movements in fair value reported in the income statement.

The Steering Committee acknowledged that, it is often difficult to estimate the fair value of assets and liabilities created by insurance contracts on a reliable, objective, and verifiable basis. Therefore, the Steering Committee intends to develop further guidelines to address estimation.

Should the Fair Value of Insurance Contracts be based on Individual Contracts of Books of Similar Contracts?

In the Steering Committee's view, any application of fair value to insurance contracts should continue the existing focus on groups of insurance contracts that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions, rather than on individual insurance contracts. Consistent with that view, insurance exposures that are not similar (for example, residential and marine exposures or professional liability and auto exposures) should not be combined.

Should the Fair Value of Insurance Contracts be Estimated using Entry or Exit Values and should the application of Fair Value Measurements result in a Gain or Loss on the Sale of Insurance Contracts?

Some maintain that fair values of insurance liabilities should be based on entry values, that is, the premiums (perhaps net of acquisition costs) that the insurer would charge if it were to issue new contracts that created the same liabilities and exposures. Those who favor entry values maintain that the initial measurement of a financial instrument is not an event that should give rise to recognition of gains and losses, and observe that using entry values would eliminate the possibility of gains on initial recognition. They question the relevance of exit values if the enterprise does not, in fact, intend to settle the insurance obligation in a current transaction and observe that entry values are often easier to determine. They also observe that IAS 39 requires the use of entry values in measurements on initial recognition. Paragraph 66 of IAS 39 reads:

When a financial asset or financial liability is recognized initially, an enterprise should measure it at its cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability) for it. Transaction costs are included in the initial measurement of all financial assets and liabilities.

Those who favor entry values also observe that entry values have a considerable practical advantage over exit values. Insurers and actuaries have significant experience in determining the amount of premium charged for particular risks. Premiums can be observed in the marketplace and a well-managed insurer maintains a continuous review of premium adequacy.

Others maintain that fair values of insurance liabilities should be based on exit values, that is, the amount that the insurer would pay another enterprise to assume all of the risks. In their view, the definition of fair value implies the use of an exit value. That definition uses exit value, "the amount for which an asset could be exchanged, or a liability settled," and makes no reference to entry values. Similarly, IAS 37 refers to exit value, "the best estimate of the expenditure required to settle the present obligation at the balance sheet date."

Those who favor exit values consider the practical advantages of entry values to be limited. They observe that the insurer typically determines the premium at the inception of policies only. Determining the entry value of existing contracts at interim periods may be as difficult as determining the exit value.

The Steering Committee considered exit value to be consistent with the definition of fair value, with the provisions of IAS 37, and with previous conclusions in this paper. The Steering Committee acknowledged that exit values may give rise to gains and losses upon the sale of insurance contracts, and that some may be concerned with that result.

Should the Estimated Fair Value of Insurance Contracts include a Provision for the Risk Inherent in those Contracts?

The Steering Committee observed that the estimated fair value of an insurer's liability should include the premium that marketplace participants demand for bearing the uncertainty inherent in estimated future cash flows. The Steering Committee felt that this premium may be difficult to estimate, however, excluding the adjustment for risk may lead to measurements that make different liabilities, with different risk profiles, appear the same.

Does a Fair Value Accounting System for Insurance Contracts include Deferred Acquisition Costs?

In the Steering Committee's view, the practice of reporting deferred acquisition costs as an asset, while consistent with some traditional accounting models, is not consistent with determining the fair value of the insurer's financial assets and liabilities. That determination is fundamentally a prospective computation unrelated to costs that the insurer may have incurred in selling insurance contracts. However, the Steering Committee observed that cash flow assumptions used in estimating fair value should reflect the fact that other marketplace participants may accept less to assume an insurer’s obligations, because they would likely avoid the acquisition costs incurred by the insurer.

(a) embedded values should not be recognized as assets in financial statements as a means of correcting for inappropriate measurement of insurance liabilities;
(b) an insurer’s rights under an insurance contract should be factored into the measurement of the insurer’s net liability under the contract; and
(c) depending on the measurement basis adopted for insurance liabilities, there may be a need for disclosure of additional information about embedded values.

VIII. CONCLUSION

The adoption of IASC standards would entail a paradigm change in financial reporting for many companies, perhaps resulting in a shake-up and consolidation of the insurance industry. Yet the international standardization of accounting principles is essential because of the increasing globalization of financial services. The orientation of accounting standards toward individual countries made it very difficult for a large number of commercial buyers. The globalization of insurance requires a common language of accounting, a common understanding of what those financial statements mean.

For the U.S. insurance industry the codification of statutory accounting principles was relatively easy compared to adapting to fundamental international accounting issues now being decided. The adoption of International Accounting Standards (IAS) is not just a technical issue for insurers, it requires a decisive shift in value, capital and investor relations’ strategies.

In December 2002, the European Council of Finance Ministers (ECOFIN) agreed that most EU-listed companies should adopt common disclosure standards by 2005. This deadline was extended to 2007 for companies using US GAAP for primary reporting.) Although much of the detail is yet to be finalized, the move to IAS could soon be passed.

The European Commission believes IAS is crucial for the creation of an integrated financial services market. It contends that Standards Regulation will introduce transparency and end the current confusion in financial reporting. It will aid European firms to compete on equal terms when raising capital on world markets. It will also allow investors and other stakeholders to compare individual companies’ performance against a common standard.

The information disclosed by insurers should enable users to compare the financial position and financial performance of insurers in different countries; that information should also be comparable with information disclosed about similar enterprises that are not insurers.

Insurance firms will need to adopt realistic product pricing to ensure that new business is genuinely profitable. To remain competitive, firms will need to combat costs and become efficient. This may encourage them to use specialist outsourcing in areas such as administration and investment management. Also, insurers will need to improve risk and capital management to maximize returns and avoid tying up excessive cash in solvency reserves. In particular, better modeling could enhance the precision and effectiveness of risk mitigation and capital allocation. Cash flow volatility can also be eased through innovations such as securitization, which will eventually lead to a more liquid market in insurance portfolios.

Note

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