SOME CONSIDERATIONS REGARDING THE CAPITAL COST OF THE ROMANIAN INSURERS IN THE CONTEXT OF FINANCIAL REPORTING UNDER GLOBAL ACCOUNTING STANDARDS (IFRS)♦

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The current global financial crisis put the insurance industry at the cross-roads, as many other industries. In this study, we analyze the impact of the IFRS adoption in Romanian business milieu, and more specific, we focus on the insurance industry, which we find to be immature and not correlated yet with the global market yet. We predict that the Romanian insurance market will soon become more competitive if the number of players that announced their intention to activate on it is six time bigger than the present state. In such a scenario, more companies will seek for capital on the financial markets, in order to reduce the costs to obtain it. Being known that IFRS is needed to be listed on the capital markets, we consider being an advantage the early adoption of IFRS by the Romanian Regulator. Currently IASB is jointly developing with FASB, a more specific standard, which will increase the transparency of the insurers financial statements.

Key words:Convergence, Harmonization, Insurance Contracts, Capital Cost, IFRS 4, Current Exit Value

JEL codes: M4, G22

1. Romanian Accounting System background and harmonization with IAS/IFRS

It could be said that a full implementation of the IFRS could promote a country as a newfangled, organized and well regulated place to do business (Jermakowicz, Gornik-Tomaszewski, 2006). In the European Union (EU) and European Economic Area (EEA), there are more than 30 countries with integrated financial markets and more than 7000 listed firms. Since 2005 in EU the adoption of IFRS became mandatory, that makes it the largest regulatory experiments in financial reporting ever undertaken, and probably a vital step towards global GAAP harmonization (Christensen, Lee, Walker, 2007).

As we know, the financial reporting system is the key factor, and if it is supported by strong governance, quality endowed standards and sound regulatory frameworks; we have the ingredients for economic development. As the forces of globalization urge more and more countries to open their doors to foreign investment and as business itself expands across borders, both the public and private sectors are increasingly recognizing the benefits of having a commonly understood financial reporting framework supported by strong globally accepted auditing standards. Globalization of the world's economies, and the companies' wish to get involved in the financial markets, has inevitably brought the need for a single set of financial reporting standard.

Romania can be characterized as an intrant member state of the EU. But in what concerns the accounting system, as some authors stated (Ionaşcu & all, 2007a), "the national regulator tried to harmonize Romanian individual company accounting with the Fourth Council Directive and IAS at a time when the EU did not have any requirements concerning IAS/IFRS for Member States". As one could consider the Romanian initiative as a prochronism regarding the later decision of EU, and ruminate without knowing the real facts behind this, it can conclude that Romania took a wise and strategic decision. But as a "prolepsis" for this case (Ionaşcu & all, 2007a) the authors

♦ This paper is supported by the UEFISCU through the project: "The Benefits of adopting IFRS regulations: an exploratory research regarding the impact of internationalization of Romanian accounting into the capital cost reduction", grant PNCDI II: 1840/IDEI II

concluded that „the harmonization decision of the Romanian accounting regulator did not fit an existing trend in the business milieu, only few companies prepare IAS/IFRS conforming financial statements out of the need to obtain foreign financing [...] this may suggest that the Harmonization Regulations submitted Romanian companies to an unjustified effort". In another recent study (Munteanu, 2009), sustained also by other authors (Ionaşcu 2007a; Ionaşcu, 2007b; Rodrigues and Craig, 2007) it was considered to be a *mimetic* adoption of the IAS/IFRS by most the Romanian companies notwithstanding if they are listed or not.

In other European countries, like Portugal, the companies can voluntarily choose if they want to use or not the IFRS. In a empirical study based on the Portugal economy (Guerreiro & All, 2008), it was ascertained that smaller companies appear to be less inclined to abandon national accounting standards in favour of IFRS. Such companies are likely to feel more comfortable using familiar national standards – ones which will often match their national economic, social and legal backgrounds more closely. In the case of Romania, there has been no study to forego the decision of the Regulator to adopt the IAS/IFRS, so we can conclude that the decision was rushed.

However, even if the benefits of adoption IFRS in Romania are limited for few companies, our expectations are optimistic for the future. Since 2007, the business milieu has encountered a spectacular development, because of the new status of the country, as an EU member state. This of course means that Romanian companies are now in competition with the European companies, and the only way to survive is to make efficient business. First of all, in Romania, the cost of labor is still on a low level when compared with other member states, so many handmade businesses migrated in Romania since 2007 because of this. Secondly, the Eastern border of EU is merged with the Romanian border, and being a member state offer better privilege to attract investors in the market. Meanwhile, a competitive scramble to obtain capital (equity), will lead companies to seek for other options than loans. In such case, a good option could be to acquire it from the stock exchange market, not only the local one, but also foreign capital markets. Of course, there could have been an encumbrance for Romanian companies to be listed on international markets because of the need to reconsider financial information's to made them comparable with other similar firms from those markets. But this hindrance had been scavenged as a prolegomena to this situation, even if we don't believe that the Romanian Regulator forecasted this need. Now, having this background, one should keep in mind that is real economic performance, not financial reporting, that ultimately matters to investors.

2. Insurance Industry a Joint Project of the IASB and FASB

When we choose to go for a specific sector of business, as is the insurance industry, we will find out that such industries are difficult to comprehend by unacquainted information users. That's why, the IASB considered to be a wise decision to issue a standard for the insurance industry, making it a novelty in the financial reporting standards.

Because of the complexity of this industry, IASB decided to develop a match up standard, but this could not have been done, until a deep research and a public debate regarding the subject would have been done. So, the IASB considered being prudent to make it a step by step project. In the first stage of this project, a transition standard had been issued, IFRS 4, in order to make it available at the moment when the 2002 IAS Regulation (Regulation EC No. 1606/2002) required European Union insurers whose securities are traded on a regulated EU market to use the IFRS for financial reporting starting in 2005. The sections of the IFRS dedicated to insurance contracts is hodiernal in the process of a substantially revision, in order to transform them to a market oriented valuation of the contracts. Of course, this constitutes the second stage of the insurance project, developed by IASB.

In the development of the project, there are many voices who claim that the IFRS will increase transparency due to more and better comparable information across companies and countries.

However, it seems possible that because of the reliance of the IFRS on numerous management-set assumptions, such as the proposed Current Exit Value constructions proposed by the IASB to asses the liabilities value, or interest rates, claim rates, mortality forecasting, etc, when calculating the fair values of insurance contracts, transparency will be reduced and the reliability of insurers financial statements more intricate for the users.

The IFRS 4 doesn't contain detailed accounting methods for insurance contracts. This means the insurers continue to value insurance contracts as they did before, usually by using their national specific GAAP's. In the second phase a new concept had been populated, Current Exit Value (Munteanu, 2008). Because normally, insurance contracts are not actively traded on the capital markets and their prices cannot be directly observed, financial pricing had been called. There has been suggested a three building blocks construction of the value. First block envisage that the unbiased estimates of the expected cash flows arising from insurance contracts are to be calculated. Secondly, the expected values are discounted using an interest rate, which is an exogenous factor market related, that should reflect the timing and risk inbuilt in the cash flows. This produces a straightaway recognition of the profit or loss for each contract at the inception.

When confronting the novel market oriented rules for insurers with the national specific GAAP's, some differences shows up. First, profits that outcome from the insurance contracts will be recognized earlier, and secondly, the volatility of an insurer's financial position (equity), and perhaps its profits, will change. It is expected that equity and profit volatility will both rise, but also in some cases the alternate may come about.

One more thing to mention is that FASB decided to get involved in the insurance project, making it a joint project with IASB. The objective of this joint IASB/FASB insurance contracts project is to develop a common, high-quality standard that will address recognition, measurement, presentation, and disclosure requirements for insurance contacts. Specifically, this project is intended to:

- Improve and simplify the financial reporting requirements for insurance contracts.
- Eliminate numerous pieces of current U.S. accounting literature that add to the complexity of accounting for insurance contracts.
- Provide investors with more decision useful information.

This joint project, was not part of the initial memorandum of understanding between the FASB and IASB, but was added relative recently, on 29 of October 2008. The Norwalk agreement issued by US FASB and IASB stated that: "each acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. […] FASB and IASB pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained" [480]

Anyhow, no matter the stage of the development of the standards for insurance contracts, there are several benefits for the moment that are worth to be taken into account.

3. Implication of the IFRS and Insurance Project for Romanian Companies

Currently, we assist on a global financial crisis that affected all the economy sectors, including the insurance industry. We can mention here the case of the giant insurer AIG, the biggest in the world, which activate in all continents, whose serious problems requested billions of USD from the American government to keep it alive. When AIG started its recession, the Romanian AIG Life has publicly stated that the problems of the parent AIG has nothing to do with it. As a confirmation, the Romanian Insurance Supervision Commission confirmed the good working parameters of the Romanian affiliated company at that time. How could that be possible?

480 FASB/IASB Memorandum of Understanding, retrieved from http://www.fasb.org/intl/MOU_09-11-08.pdf

First of all, let's analyze the Romanian insurance market. Nowadays, in Romania, the number of players in the insurance market is still small, 44 companies as can be seen on the Insurance Supervision Commission site. But, as the same organization informs, there are a number of more than 250 insurance companies that requested to fulfill the necessary requirements in order to start the activity in Romania. More to consider, from the small number of 44 companies that are currently active on the market, only 2 are listed on the Bucharest Stock Exchange. As the number of listed companies represent less than 0.05% of all the insurers, it can be considered as insignificant. But this fact, shows us something else, the insurers had searched for the capital mainly on banks, reinsurers or the parent companies.

Considering the insignificant number of insurers listed on Bucharest Stock Exchange, one can say that the insurance industry has not been so affected by the financial crisis. This of course is a false hypothesis, as long as we analyze the insurance business. Insurers are one of the most involved companies in the stock exchange market. They invest their incomes from the premiums in stock portfolios in order to obtain better results, rather than investing all the incomes in the banking system or treasury bonds. As in the last period of time, the capital market has encounter great losses, also the insurers lost from their investments.

In a first step conclusion, we can say that the Romanian insurance industry is not yet mature, not yet correlated with the global markets, but still at the inchoate state. As the prevision shows, the insurance industry will pass through a strong and continuous process of development. As mentioned before, more than 250 insurers are willing to enter the market, this constitute a good proof for the forenamed statement.

As we showed in a recently article (Munteanu, 2009), our prediction is that more and more insurers will choose to obtain capital for development from the capital market, as more and more players will enter the game. This is based on the theory of competition, and consists in the fact that insurers will try to find alternative sources for the capital, in order to obtain it at lower costs, gaining so an advantage over the competitors. The most appropriate source is the stock exchange market, so the insurers will no longer knock at the banks doors, but will consider the other alternative. Of course, from this some benefits ensue, the company will be considered transparent and serious by the entire business milieu.

But there is something else we would like to consider. Romania has harmonized its accounting system with the International Regulations (EU Directives and IFRS). This inspires to the investor that Romania is becoming mature and responsible, and it allows the user of financial information to compare the economic activity with any other country in EU. The rushing of the Romanian regulators who took a step forward, by imposing IFRS adoption to non listed companies, that fulfill some criteria's could be considered a mistake, but maybe on short term.

In the case of the insurance industry, we consider to be a good benefit that facilitates the access to the financial markets for the insurers. To change the financial reporting to the IFRS system doesn't mean the economic performances of an insurer will change. What IFRS intend to do is to change the information investors will receive about an insurer performance. Basically, IFRS may: improve information quality, worsen information quality or have no impact on the information quality.

We believe that first case is most likely, as long as it will deliver additional and more precise information. In this case, investors will have more precise information on the true equity and earnings volatility. This will lead to a reduction of the asymmetry between management and investors, because of the increased transparency. On average, all this facts will reduce the cost of capital. And in addition, if the new information revealed by a specific insurer, shows that the company is in a better shape and more performing than previously ascertained, we can expect an additive decrease in cost of capital for such an insurer.

If the IFRS improve the transparency of an insurer's performance, cushy comparisons between different insurers can be made. Surely, this will influence an insurer's access to capital markets, nurture competition for capital, and result in a concentration of profitable business and knowledge, and make less the underperforming lines of business.

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