Australian Government

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31 October 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
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Dear Hans

IASB Exposure Draft ED/2013/7 *Insurance Contracts*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2013/7 *Insurance Contracts.* In formulating these comments, the AASB sought and considered the views of Australian constituents via comment letters, roundtables and targeted outreach meetings. The comment letters received are published on the AASB's website.

The AASB strongly supports the IASB moving to complete the insurance contracts project in 2014.

We acknowledge that the many jurisdictions that have been applying IFRS and will be applying the revised, comprehensive IFRS on insurance contracts have also been applying various forms of national GAAP (in line with the interim nature of IFRS 4 *Insurance Contracts*). Accordingly, different jurisdictions will be at different stages of development in their insurance contract accounting, and the revised, comprehensive IFRS needs to cater for a variety of jurisdictions without forcing those jurisdictions that are more advanced in their insurance contract accounting to take a backwards step. Although the benefits to users of such an approach would be somewhat less than full comparability between entities, this approach would be a significant advance on current diversity in practice, and would not penalise those jurisdictions with more mature existing requirements. Ways in which this might be achieved by the IASB are reflected in our comments below.

The AASB strongly supports a number of the improvements in ED/2013/7 compared to ED/2010/8 on insurance contracts issued by the IASB in 2010.

In particular, the AASB strongly supports the revised proposals concerning:

- 'unlocking' the contractual service margin (CSM) by remeasuring fulfilment cash flows using current information;
- the principle that there is one measurement model for insurance contract liabilities and that the simplified approach for measuring insurance contract liabilities (i.e. the premium allocation approach or PAA) is a reasonable approximation of the 'full'

approach for measuring insurance contract liabilities (i.e. the building block approach or BBA) and alignment of the related disclosures;
- the way in which the boundary of an insurance contract is determined; and
- requirements on transition.

The AASB strongly supports the IASB's proposal to measure insurance contract liabilities using a current value approach. However, despite this overall support, the AASB has significant concerns about some of the specific proposals. The AASB's most significant concern is in respect of the proposals to use historical discount rates to segregate the result between profit or loss and other comprehensive income (OCI), including:

- the requirement to present in OCI changes in estimates in the present value of insurance contract cash flows due to changes in discount rates compared with the rate that applied when the contract was initially recognised;
- the requirement to track changes in discount rates of contracts from historical rates (in order to achieve the above); and
- the requirement for accretion of interest in profit or loss based on historical discount rates.

Instead, the AASB recommends that the current measurement approach is retained with a conditional option for entities to elect to present amounts due to changes in discount rates in OCI and to accrete interest to profit or loss at historical rates. The AASB recommends that such an option should be available for insurance activities of an entity on transition to the revised insurance contracts standard.

The AASB notes that ED/2012/4 *Classification and Measurement: Limited Amendments to* IFRS 9 states as one of the reasons for proposing fair value through other comprehensive income (FVOCI) for certain financial assets (ie. those that contain contractual cash flows that are solely payments of principal and interest, subject to a business model assessment) is to take into account the interaction of the model for classification and measurement of financial assets and the IASB's Insurance Contracts project (paragraph IN1). However, as noted in the AASB's submission to the IASB on ED/2012/4, feedback from Australian insurers and regulators is that they want the ability to measure insurance liabilities through profit or loss and assets backing insurance contracts at fair value through profit or loss (FVPL).

The AASB also notes that a likely major source of future profits relates to bearing risk in future periods. Accordingly, the AASB recommends that an improvement be made to the proposals relating to the CSM to require the change in the risk margin that relates to future coverage to be recognised in the profit or loss in future periods via the CSM and the change in the risk margin that relates to past coverage to be recognised in profit or loss immediately. There could be a concession to permit entities to recognise all changes in the risk margin through profit or loss immediately if it is impracticable to distinguish between risk margin changes relating to past and future coverage for those entities.

The AASB also recommends that the IASB considers permitting 'mirroring' as a non-mandatory accounting treatment for contracts that involve complexities such as guarantees, delayed profit share allocations and where benefits can be provided to policyholders in a variety of forms. Although the proposals in relation to 'mirroring' seem sound in principle,

the AASB expects that the accounting for mirrored contracts would be overly complex to apply and for users to understand. This complexity has the potential to reduce transparency in financial reporting and to increase the cost burden on users and preparers of financial information.

The AASB is also concerned about the proposed disclosures, which we consider are too detailed and will potentially clutter the financial statements. The AASB supports disclosure of the key amounts underlying the changes in insurance liabilities for the period, including the amount due to change in discount rate and other significant drivers of the result if material. Accordingly, the AASB encourages the IASB to rationalise the disclosures, in particular the extensive requirements for disclosure of reconciliations.

Consistent with our general comments above, we also have a number of concerns on specific aspects of the proposals which are included in the Appendix to this letter.

If you have any queries regarding any matters in this submission, please contact Sue Lightfoot (slightfoot@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman and CEO

AASB's Specific Comments on the IASB Exposure Draft ED/2013/7 *Insurance Contracts*

The AASB's views on the questions in the Exposure Draft are as follows:

ED/2013/7 Question 1: Adjusting the contractual service margin (CSM)

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows, if:

a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

Notes for AASB members

Paragraph 18 of ED/2013/7 proposes an insurance contract be measured initially at the sum of (a) the amount of the fulfilment cash flows plus (b) any CSM. According to paragraph 19 of ED/2013/7, the resulting measurement can be regarded as comprising two elements: (i) a liability for remaining coverage and (ii) a liability for incurred claims.

Fulfilment cash flows are defined as 'an explicit, unbiased and probability weighted estimate (i.e. expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment'.

CSM is defined as 'a component of the measurement of the insurance contract representing the unearned profit that the entity recognises as it provides services under the insurance contract'.

The initial measurement proposed is similar to the proposal in paragraph 17 of ED/2010/8 that an insurance contract be measured as the present value of the expected cash inflows and outflows to fulfil the contract, adjusted for uncertainty of amount and timing, plus a residual margin that eliminates any gain at inception.

A simplified approach, the 'premium-allocation approach' or 'PAA', is permitted to be used under the 2013 proposals if doing so would produce a measurement that is a reasonable approximation of the full approach (also referred to as the 'building-block approach' or 'BBA'), or the coverage period of the insurance contract at initial recognition is one year or less. The PAA would apply only to the component of an insurance liability that is a liability for remaining coverage. It would not apply to the component of an insurance liability that is a liability for incurred claims.

Paragraphs 30-32 of ED/2013/7 propose that, unless the simplified approach is used the CSM should be adjusted for differences between the current and previous estimates of the

present value of future cash flows that relate to future coverage and other future services, provided that the CSM would not be negative. The remaining amount of the CSM at reporting date is determined under the proposals as follows:

Opening carrying amount

Plus	interest accreted on the CSM to reflect the time value of money (accreted at the discount rate that applied when the contract was initially recognised)
Minus	the amount of CSM recognised in the period (for services provided in the period)
Plus/Minus	favourable/unfavourable differences between current and previous estimates of the present value of future cash flows relating to future coverage and future services (provided the CSM does not become negative).

The remaining CSM is to be recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract.

Impact of change in experience

1.1 The AASB supports the proposal that the impact on the CSM of a difference between assumed and actual experience is recognised immediately in profit or loss on the basis that it relates to risks borne in the period. The AASB also supports the proposal that the impact on the CSM of a change in assumptions is recognised as an adjustment to the CSM on the basis that it relates to risks to be borne in future periods and can be regarded as akin to a new policy being written at reporting date for the remaining period of the relevant contracts.

1.2 The AASB supports the proposal that the CSM cannot be negative (paragraph 30(d)(ii)) and that any further projected deterioration is recognised immediately in profit or loss (paragraph 31). However, the AASB recommends that the IASB also address accounting the reversal of circumstances that gave rise to losses. The AASB would expect this to involve reversing the effects of previous loss recognition, which (depending on the extent of subsequent improvements in expected cash flows related to future coverage) could involve recognising gains in profit or loss and 'rebuilding' the CSM. This would be consistent with the requirements for the reversal of impairment losses in IAS 36 *Impairment of Assets* and the requirements for the reversal of provisions in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Discounting

Paragraph 25 of ED/2013/7 proposes that the estimates of the fulfilment cash flows are adjusted for the time value of money, using discount rates that reflect the characteristics of those cash flows. The discount rate is consistent with observable current market prices for instruments with characteristics consistent with those of the insurance contract for timing, currency and liquidity but excludes factors that are not relevant to the insurance contract.

1.3 The AASB supports the IASB's proposals to discount estimates of fulfilment cash flows and also supports the IASB allowing a 'bottom-up' or 'top-down' approach to be used for determining the discount rates to use. Although this may lead to reduced comparability this would enable entities to select a method of determining discount rates which is most reliable and practical for them.

1.4 On the face of it, the requirement to discount cash flows does not seem dissimilar to current Australian requirements[1]. However, the discount rates proposed in the ED are likely to be somewhat different from those currently being employed by Australian insurers. Australian insurers would therefore be likely to require some changes to existing systems in order for them to adopt the proposals. The key difference between the proposals compared to current Australian GAAP on insurance contracts is the explicit consideration of liquidity risk (although the AASB notes that currently some life insurers already incorporate liquidity risk in their discount rate). The AASB supports the IASB's proposal to require liquidity risk to be considered, to enhance comparability between entities.

One measurement model and two approaches

1.5 The AASB supports the proposals that there be one measurement model for insurance contract liabilities and that the simplified approach for measuring insurance contract liabilities (i.e. the premium allocation approach or PAA) is a 'reasonable approximation' of the 'full' approach for measuring insurance contract liabilities (i.e. the building block approach or BBA). The AASB also supports the proposed alignment of the related disclosures.

1.6 However, the AASB has concerns about the IASB also providing a rules-based 'bright line' of a one year or less coverage period as a basis for entities applying the PAA. The reason for this concern is because application of the PAA to contracts that meet the bright line may not always be a 'reasonable approximation' of the result that would have been achieved through application of the BBA.

1.7 Instead, the AASB supports allowing the PAA to be used based on a principle that it achieves a reasonable approximation of the BBA and noting that a coverage period of one year or less is a strong indicator that this would be achieved.

1.8 The AASB understands that a reason for specifying a one year or less coverage period is that entities could apply the approach without further investigation as to whether it provides a reasonable approximation of the BBA. However, the AASB considers that, in common with other similar situations (such as with IAS 19 *Employee Benefits* where estimates, averages and computational short cuts can be used), entities will generally be able to determine whether the PAA provides a

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1 IFRS 4/AASB 4 *Insurance Contracts*, AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts* are the basis for Australian GAAP on insurance contracts. Under both AASB 1023 and AASB 1038, cash flows are discounted for the time value of money using risk-free discount rates based on current observable, objective rates that relate to the nature, structure and term of obligations. To the extent liabilities are contractually linked to the performance of assets, the discount rates are based on market returns on assets backing life insurance liabilities.

reasonable approximation of the outcome of using the BBA based on experience, without having to undertake onerous investigations.

1.9 As a further potential improvement, the AASB suggests that the IASB should refer to 'materiality' rather than 'reasonable approximation' to avoid introducing a new benchmark term that could be open to interpretation.

1.10 The AASB supports the proposal that the simplification is made available as a non-mandatory option, to permit insurers that wish to apply the BBA model instead, for example where similar contracts would otherwise be required to be accounted for using different models. This may avoid the need for some insurers to have two different systems in place for similar contracts and to explain two sets of results to users.

Unlocking the CSM

1.11 The AASB considers that the basis for the CSM in ED/2013/7 (as a margin that reflects obligations to provide future services) probably justifies the CSM to some degree. However, that description is probably only partially true, and the explanation in the IASB's earlier ED/2010/8 that the residual margin is one that eliminates any gain at inception is perhaps a more accurate depiction of the reasoning. However, if we accept that a profit at inception is not to be recognised, and that the CSM facilitates the recognition of those profits as the insurer provides future services, the AASB generally supports the ED/2013/7 proposals**.**

1.12 The AASB notes that a likely major source of future profits relates to bearing risk in future periods. Accordingly, the AASB recommends that an improvement be made to the proposals to require a change in the risk margin relating to future coverage to be adjusted to the CSM. The change in the risk margin that relates to past coverage would continue to be required to be recognised in profit or loss immediately. For those entities that consider it is not feasible to allocate changes in the risk margin between that which relates to past and future coverage, the AASB recommends that the IASB provides an 'impracticability' concession similar to that proposed as part of the transition requirements.

ED/2013/7 Question 2: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the

expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

Paragraph 33 proposes that an entity measures fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items. Fulfilment cash flows that are not expected to vary directly with returns on underlying items would have the ‘normal’ requirements applied to them.

2.1 Conceptually the AASB can understand the rationale for ‘mirror’ accounting, since in some of the limited situations where mirroring is applied accounting mismatches are eliminated where there are no economic mismatches. However, the mandatory nature of the exception could result in insurance liabilities being measured on a different basis from other similar insurance liabilities on the grounds of the specific arrangements in place.

2.2 Currently there are no equivalent ‘mirroring’ provisions in Australian GAAP for insurance accounting other than under AASB 1038 for contract liabilities that are contractually linked to the performance of assets. Under AASB 1038 *Life Insurance Contracts*, to the extent that life insurance contract liabilities are contractually linked to the performance of assets, the discount rates are based on market returns on assets backing the life insurance liabilities. The AASB is not aware of any general insurance contracts, accounted in accordance with AASB 1023 *General Insurance Contracts*, that would be affected by the proposals.

2.3 The AASB expects that significant operational complexities are likely to exist in respect of applying mirror accounting for at least the following:

- for contracts where some cash flows vary directly with the underlying assets and some cash flows do not;
- when contracts include surrender options available to policyholders;
- when contracts have profit participation features and policyholders receive their share of profits on a delayed basis;

- for contracts that provide options for policyholders to receive benefits in a variety of forms, including an increased amount of cover, a longer period of cover and larger surrender values;
- with the interaction of 'mirroring' and the presentation of amounts in 'other comprehensive income'; and
- on transition.

2.4 It is not clear that the cost of mandatory mirror accounting as proposed would outweigh the benefits. The AASB suggests that mirror accounting could be mandated for relatively simple investment-linked insurance contracts or the components of contracts that are clearly investment-linked, but that the other proposed measurement requirements apply to more complex contracts or the more complex components of contracts.

ED/2013/7 Question 3: Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Paragraphs 56-59 propose that an entity presents revenue relating to insurance contracts, incurred claims and other expenses relating to an insurance contract in the statement of profit or loss and OCI. Revenue is to depict the transfer of promised services arising from an insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Insurance contract revenue and incurred claims in the profit or loss and OCI is to exclude any investment components that have not been separated (unbundled from insurance contracts).

3.1 Current Australian GAAP[2] bears some similarities to the ED/2013/7 proposals (at a high level with BBA being analogous to AASB 1038 *Life Insurance Contracts*[3] and PAA being analogous to AASB 1023 *General Insurance Contracts*)[4]. However,

2 Under AASB 1038 premiums received are recognised as revenue and a claims liability (and related expense) is also recognised based on a prospective cash flows approach (similar to BBA under ED/2013/7). Under AASB 1023 premium revenue is recognised over the period of the contract based on the pattern of the incidence of risk expected. The initial claims liability is the deferred premium (similar to PAA under ED/2013/7). Paragraph 9.1 of AASB 1023 imposes a liability adequacy test and, if the present value of expected cash flows exceeds unearned premium, a loss is recognised immediately.

3 AASB 1038 paragraphs 16.1, 17.1, 17.2 and 18.1, require a substantial number of disclosures relating to the statement of income and they are too numerous to list here. Suffice to say, the income statement includes revenues recognised and the focus of most of the note disclosures is on the components of the changes in claims liabilities.

4 AASB 1023 paragraph 17.1, requires the following, and implies that they should be presented on the face of the income statement: premium revenue (direct); reinsurance premium revenue; reinsurance and other recoveries; net claims incurred showing separately: a) the amount for risks borne in current period; and b) the amount for reassessment of risks borne in previous periods; underwriting result; gross claims incurred (undiscounted); and reinsurance and other recoveries (undiscounted).

Australian life insurers would be particularly affected by the proposals as they would need to change their systems to recognise only revenue related to risks borne in the period.

3.2 The AASB supports the proposals as the presentation proposed would generally bring all insurers in line with non-insurers. As noted in paragraph BC76, of ED/2013/7 the proposals should be broadly consistent with the general principles in the IASB's 2011 Exposure Draft *Revenue from Contracts with Customers*, such that an entity would recognise the consideration to which the entity expects to be entitled in exchange for the coverage and other services, as it satisfies its performance obligations. Furthermore, aligning presentation with non-insurers allows diversified financial institutions to present information on a similar basis, rather than presenting insurance related items in a different manner.

3.3 Feedback from Australian constituents indicates that there is broad support for these proposals and this approach is preferred to the 'summarised margin' approach of ED/2010/8.

ED/2013/7 Question 4: Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

4.1 Consistent with many Australian constituents, the AASB has significant concerns with the proposal for conceptual and operational reasons. Although the IASB has indicated that it wishes to have consistent and comparable reporting, the AASB recommends that the IASB 'default' requirement should be a current measurement basis for insurance liabilities with changes recognised in profit or loss (or CSM as applicable). However the AASB could support the IASB providing an option to present changes in discount rate in OCI that insurers could elect to use for insurance activities of an entity on transition to the revised insurance contracts standard.

4.2 The AASB's concerns in respect of the proposals are set out below:

Another measurement basis

4.3 The IASB will further complicate IFRS by introducing another measurement basis, being a hybrid of current value and amortised cost [paragraph BC119 notes the proposed presentation approximates: 'an amortised cost view of the time value of money to be recognised in profit or loss']. This would add to the already complex array of measurement models in IFRS and is inconsistent with the IASB's objective in the context of its financial instruments project to improve the usefulness of financial statements for users by simplifying the classification and measurement requirements.

4.4 The proposal would take one element of price change to OCI and leave all other elements of price change in profit or loss. Those other elements include the impact of changes in inflation assumptions, which in many cases are regarded as providing a 'natural hedge' with the impact of discount rate changes on claims liabilities. Artificial volatility in profit or loss could be the result from applying the proposal.

4.5 In theory, a 'pure' presentation of historical cost in profit or loss would involve applying the PAA in the profit or loss and any other revenues and expenses in OCI. However such an approach would not provide useful information about the current measure of insurance contract liabilities in profit or loss, so the AASB does not support such an approach.

Information value for users

4.6 The value to users of trying to present an amortised cost profit or loss (by excluding one component of the current value in OCI) in what is otherwise a current value measurement model is not clear. It seems likely to cause confusion.

4.7 Some Australian insurers show the impact of discount rate movements based on the current value measurements at the beginning and end of the reporting period, either outside their IFRS financial statements (in analyst briefing materials) or by having profit subtotals before and after the discount rate impact (consistent with paragraph 85 of IAS 1 *Presentation of Financial Statements*). Some Australian users find that disaggregation of 'current' information useful.

Implied link with asset measurement

4.8 Paragraph BC119 also argues the proposal would give a clearer presentation of "underwriting performance and investment performance", implying a link with the FVOCI treatment of some assets proposed in ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*.

4.9 Paragraph IN1(b) of ED/2012/4 explains that the proposed amendments "take into account the interaction of the classification and measurement model for financial assets with the IASB's Insurance Contracts project". However, the connection between the two proposals has yet to be clearly articulated. As noted in the AASB's submission to the IASB on ED/2012/4, feedback from Australian insurers and regulators is that they want the ability to measure insurance liabilities through profit or loss and assets backing insurance contracts at fair value through profit or loss (FVPL).

4.10 A logical extension of the IASB's justification in paragraph BC119 would be to require all assets (both financial and non-financial) backing insurance liabilities to be mandatorily at FVOCI and all movements in insurance liabilities presented in OCI to achieve an amortised cost profit or loss measure. However, even if the proposed IFRS 9 amendments proceed as exposed, it is highly likely that not all assets backing insurance liabilities could be measured at FVOCI (for example non-financial assets).

4.11 A consistent approach to recycling (all or none) would also be needed; however, the current FVOCI debt instrument proposal involves recycling and the IFRS 9 FVOCI equity requirement involves no recycling.

4.12 Furthermore, in the absence of a strong rationale for linking the accounting treatment such as a contractual or other link between them, the AASB considers that particular assets and liabilities should each be measured on their own merits. Where a contractual or other link does apply, this could be dealt with under 'mirror accounting'.

4.13 The AASB also notes that it is not clear what designations for hedge accounting would be available for insurers under the forthcoming chapter of IFRS 9 on general hedge accounting (or macro-hedge accounting project for which a Discussion Paper (DP) is expected by the end of 2013) that might otherwise enable linkage of accounting for assets and liabilities.

4.14 It is also not clear whether a fair value option would be available under the existing or future requirements in IFRS 9. The AASB would support making a fair value option available for measurement of financial assets and insurance contract liabilities of an entity's insurance activities on transition to the revised insurance contracts standard.

Still no basis for OCI

4.15 The IASB's DP *A Review of the IASB's Conceptual Framework for Financial Reporting* is open for comment until 14 January 2014 and the use of OCI is discussed in that DP. The AASB is concerned that the proposal in this ED would prematurely extend of the use of OCI in the absence of a conceptual basis for OCI being discussed in that project.

Tracking

4.16 The proposal would involve identifying and tracking discount rates from contract inception for the life of a policy or claims liability, which could be up to 60 years.

4.17 In theory, the unit of account should be either each contract or a portfolio of similar contracts determined by when the discount rate changes in a manner that would have a material impact, which could be many times within a reporting period. Otherwise, the objective of an amortised cost interest expense would not be met.

4.18 However, presumably, entities would need to take a pragmatic view the unit of account employed for tracking discount rates to make systems costs manageable. That pragmatic view might involve quarterly or half-yearly cohorts. Even so insurers are likely to have hundreds, and possibly tens of thousands, of cohorts of

contracts to track. And different entities are likely to come to different pragmatic solutions creating another source of non-comparability. Depending on how the IASB explains the unit of account for tracking discount rates, the systems issues for insurers could be overwhelming.

Managing the business

4.19 Australian insurers have been unable to identify any lines of business that they manage using historical information.

4.20 The liquidity and solvency of insurers, as monitored by insurers themselves and by prudential regulators (at least in Australia) is not in any way judged by reference to contract inception date discount rates. This monitoring is done by comparing current values for assets and liabilities. Mismatch risk is monitored by comparing current values for assets and liabilities within various maturity categories.

4.21 The information reported to the Chief Operating Decision Maker (CODM) and included in IFRS 8 *Operating Segments* disclosures would not be the same as the information based on the proposals and, under the proposal, could become the chief focus of users as they struggle to understand the IFRS financial statements.

Claims liabilities

4.22 ED/2013/7 is written only from the perspective of discount rates at contract inception differing from subsequent discount rates. It does not seem to have acknowledged the issue as it relates to claims liabilities. It does not explain whether the 'inception discount rate' is based on the date of the contract to which the claim relates, or when an insurer becomes aware of a claim or an occurrence of an event that is expected to give rise to a claim. Nor does it explain what to do for claims development.

Accounting for Business Combinations

4.23 It is our understanding that, under the proposals, the initial recognition date for insurance contracts acquired in a business combination by a consolidated group would be the date of acquisition. For consolidated financial statements the relevant date for tracking changes in discount rate would therefore be different from the date to be used for tracking by the acquired entity in its stand-alone financial statements. Whilst we acknowledge that acquisition date measurement and consolidation adjustments are a feature of business combination accounting and the consolidation process, in this case we think the requirement for duplication of systems and determination of separate stand-alone and group amounts for insurance liabilities is a further reason for not requiring insurers to track inception date discount rates. This problem could be avoided by setting the 'default' requirement as a current measurement basis for insurance liabilities with changes recognised in profit or loss (or CSM as applicable).

ED/2013/7 Question 5: Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not what do you suggest and why?

Paragraphs C1-C13 propose retrospective application (unless impracticable) of the proposed requirements in ED/2013/7 in accordance with IAS 8 *Accounting Policies, Changes in Estimates and Errors*. A simplified approach is proposed for when full retrospective application is not practicable. Under the simplified approach the entity takes into account all objective evidence that is reasonably available without needing to undertake exhaustive efforts.

The IASB proposes in paragraph C11 that an entity is permitted, but not required to redesignate a financial asset measured at fair value through profit or loss if it meets the conditions of IFRS 9 *Financial Instruments* at the date when the new insurance contracts standard is first applied i.e. if it eliminates or significantly reduces a measurement or recognition inconsistency (an 'accounting mismatch').

The ED does not include a specified effective date, but indicates in paragraph C1 that the effective date would be approximately three years from the date of publication with early application being permitted.

Retrospective application

5.1 The AASB supports the proposed transitional arrangements on the grounds that they would provide users with more relevant and useful information than the previous proposals in ED/2010/8 which would have resulted in no CSM being recognised for contracts in force at the beginning of the earliest period presented. Although these proposals are likely to result in significant costs being borne by preparers, the AASB expects that the resulting benefit would be likely to exceed those costs.

5.2 The AASB has also identified a number of operational concerns in respect of retrospective application of the proposals, including:

- determining appropriate historical discount rates, in particular, for long-dated insurance contracts. This would be alleviated if the use of historical rates is not required;
- retrospective application of mirroring. This would also be somewhat alleviated if the use of OCI is not required.

Alignment of IFRS 9 and Insurance Contracts Effective Dates

5.3 The AASB considers that it would be preferable if the mandatory effective dates of the insurance contracts and financial instruments standards are aligned due to the two standards being interrelated, with some interdependent accounting treatments between the two, in particular, the mirroring proposals and for elective designation of items to be measured at FVPL to address 'accounting mismatches'.

5.4 A number of Australian constituents have expressed support for a period of at least three years to be available from publication of a standard to the mandatory effective date.

ED/2013/7 Question 6: The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1-5? How do the costs and benefits compare with any alternative approach you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both initial application and on an ongoing basis.

6.1 The costs for Australian preparers to implement the proposals, and for Australian users to understand the information produced, would be greatly affected by whether all of the ED/2013/7 proposals are retained, in particular, the mandatory use of historical discount rates and mandating 'mirror accounting' could add significantly to the costs.

6.2 The AASB supports the IASB in seeking to formulate a common comprehensive IFRS. However, in doing so, the IASB needs to be mindful of the different starting points of each relevant jurisdiction.

6.3 The AASB believes that its suggested changes to the proposals, particularly with respect to making the recognition of the impacts of changes from historical discount rates in OCI a conditional option, and the changes to the 'mirroring' proposals, would ease the transition to a high quality common IFRS standard for insurance contracts.

6.4 The AASB considers that a post-implementation review of the Standard may well be the appropriate mechanism to determine whether any options included in the final revised IFRS should be retained in subsequent versions of the Standard.

ED/2013/7 Question 7: Clarity of drafting

Do you agree that the proposals are draft clearly and reflect the decisions made by the IASB?

7.1 Clarity of drafting has been highlighted as a concern by a number of Australian constituents. The following have been identified as examples where more clarity of the IASB's intent would be helpful:

- the wording in paragraph 38 of 'premiums received' seems to be too narrow to capture both premiums received and premiums receivable, which we consider should be the basis for determination of the liability for future coverage under the simplified approach;

- we consider that the risk adjustment for reinsurance should be reflective of the net position – current drafting seems to imply that the risk adjustment is calculated for gross claims and reinsurance recoveries separately;
- the relationship between the requirements on combining contracts and separating contracts; and
- unit of account terms, for example 'portfolio' and 'contract' appear to be used in an inconsistent manner.

7.2 A further concern has been raised that ED/2013/7 provides a number of examples for the BBA approach but does not provide sufficient examples to assist in interpreting how the simplified model is expected to be applied.

ED/2013/7 Other issues: Separating insurance contracts from investment contracts ('unbundling')

8.1 Insurance and investment services are often bundled together with investment contracts. ED/2013/7 paragraph 10(b) requires an entity to separate a distinct investment component from a host insurance contract on the basis set out in Appendix B.

8.2 Paragraph B31 sets out a principle that 'unless the investment component and insurance component are highly interrelated, an investment contract is distinct if a contract with equivalent terms is sold, or could be sold, separately in the same market or jurisdiction by the entity or any other entity'. Paragraph B32 goes on to provide indications of when an investment component and insurance component would be considered highly interrelated.

8.3 The AASB supports this proposed principle. However, sub-paragraph 32(b) introduces a proposed rule that overrides the principle – that if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity must treat the whole contract as an insurance contract. The AASB considers that this condition should only be an indicator that helps elucidate the principle.

8.4 The proposed rule would mean that some contracts in Australia that are currently unbundled into their insurance and investment components would not be able to be unbundled. An example is a product that involves an investment account that is charged with the relevant insurance premiums, and when a client terminates the investment contract element there is no longer an account from which premiums are charged. Accordingly, the whole contract lapses and clients wishing to continue the insurance component are sold a 'new' policy. However, for the duration of the bundled policy, there are two distinct components that are quite capable of being separately recognised based on their natures.

8.5 ED/2013/7 paragraph B25 includes a further proposed rule that compounds the problem caused by the rule in sub-paragraph B32(b). The further rule states: a contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished. That would mean a contract that is regarded as an insurance contract at inception must always be treated as an insurance contract, even though there are products that at inception are

substantially insurance contracts which, over time, become substantially investment contracts.

8.6 The proposals have the potential to seriously distort the financial statements of insurers by requiring investment components of contracts to be treated as insurance contracts. This would be a particular problem for entities that have multiple activities such as banking, wealth management and insurance. The same product sold by the entity as a stand-alone wealth management product to one customer and as part of a contract that includes an insurance component to another customer could be treated differently.

8.7 The distortion might be revealed in a reconciliation to segment disclosures (required by paragraph 28 of AASB 8 *Operating Segments*) because Australian entities that sell bundled products generally unbundle them into their insurance segments and wealth segments for management information purposes. However, the AASB considers that it is inappropriate to have potentially misleading accounting in the primary financial statements and then have to effectively correct the picture provided through segment disclosure.

ED/2013/7 Other issues: Disclosure

9.1 The AASB is also concerned about the proposed disclosures, which we consider are too detailed and would clutter the financial statements. The AASB supports disclosure of the key amounts underlying the changes in insurance liabilities for the period, including that due to changes in discount rate and other significant drivers of the result if material. In particular, the requirements for reconciliations in paragraphs 74 to79 of ED/2013/7 seem particularly burdensome.

9.2 The AASB acknowledges that in paragraph 70 of ED/2013/7 there is an explicit statement to the effect that disclosures not relevant in meeting the objective of the disclosure requirements (as set out in paragraph 69 of ED/2013/7) may be omitted from the financial statements. Notwithstanding that intention, there is generally a ‘compliance environment’ towards disclosure such that all identified disclosures are generally made by entities. Therefore the AASB encourages the IASB to rationalise the extent of identified disclosures to alleviate this burden. For example, in paragraph 74, there seems little justification for requiring separate reconciliations for insurance contracts in a liability position and insurance contracts in an asset position. One portfolio might give rise to a small asset and could change from an asset to a liability position from period to period. Also, given the number of portfolios that would be aggregated into a reconciliation in a large insurer, the presentation of two reconciliations would have little or no information value.