Department of Treasury and Finance

1 Treasury Place
GPO Box 4379
Melbourne Vic 3001
Australia
Telephone: (+61 3) 9651 5111
Facsimile: (+61 3) 9651 5298
DX 210759

Mr Kevin Stevenson
Chairman
Australian Accounting Standard Board
PO Box 204
COLLINS ST WEST VIC 8007

Dear Kevin

ED 244 *Insurance Contracts*

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to the Australian Accounting Standards Board's Exposure Draft ED 244 *Insurance Contracts* ("the ED").

HoTARAC supports developing a comprehensive standard for insurance, but is disappointed in the IASB's decision to re-expose limited elements of the 2010 Exposure Draft on insurance contracts and to abandon the joint project with the Financial Accounting Standards Board (FASB).

HoTARAC further believes elements of the ED, particularly the use of the dual margin approach of risk adjustment and residual margin are too subjective and open to management manipulation.

Overall, HoTARAC agrees with the ED's proposals, subject to concerns on:

- possible accounting mismatches where insurers do not use the fair value through other comprehensive income category under IFRS ED 9 proposals (Question 4);
- increase in the complexity of the financial report, which yields little value to users (Questions 4 and 5); and
- clarity of drafting (Question 7).

HoTARAC acknowledges that the IASB is attempting to apply more principle based disclosure requirements, but recommends that IASB avoids mixing principle and rule-based requirements.

The Attachment to this letter sets out HoTARAC's views on the ED and response to the IASB Invitation to Comment and AASB Specific Matters for Comment. Any queries regarding HoTARAC's views and recommendations should be directed to Mr Alastair Higham from the Australian Department of Finance and Deregulation on (02) 6215 2832 or by email to alastair.higham@finance.gov.au.

Yours sincerely

pp Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

10 October 2013

HoTARAC General Comments

HoTARAC supports the International Accounting Standards Board (IASB) in developing a comprehensive standard on insurance contracts.

HoTARAC acknowledges the urgent necessity for the development of a standard for insurance contracts outlined in paragraph BC32 and that the IASB is only seeking input on significant changes to the 2010 ED. However, HoTARAC does not believe that high quality standard setting should be sacrificed by a desire to finalise the project, and disagrees with the decision to abandon the joint project with the Financial Accounting Standards Board (FASB).

HoTARAC notes that the FASB has also issued an ED on this topic seeking feedback on a broader range of issues from constituents with the same deadline for comments as the IASB. HoTARAC strongly recommends that the IASB and FASB should jointly deliberate and consider comments from both sets of constituents.

HoTARAC also reiterates its comments made in response to ED 2010/8 *Insurance Contracts* that it considers the FASB's composite margin approach less subjective and open to management manipulation than the IASB's dual margin approach which uses risk adjustment and a residual margin.

HoTARAC commends IASB in setting more principle based disclosure requirements, in particular the inclusion of paragraph 70, which requires that disclosure not considered relevant may be omitted. This, in HoTARAC's view, will greatly assist IASB's objective to achieve improvement in the quality and quantity of financial reporting disclosure.

<u>Scope</u>

As previously mentioned, HoTARAC does have an issue with financial guarantee like arrangements and investment contracts with a discretionary feature being included in the insurance standard. These arrangements would potentially be more appropriately measured in a manner consistent with that of financial instruments.

Question 1—Adjusting the contractual service margin

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 is:

(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?

HoTARAC comments -

(a) HoTARAC agrees as this fits conceptually with the approach taken in the IASB's project on revenue recognition.
(b) HoTARAC agrees.

Question 2—Contracts that require the entity to hold underlying items and specify

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 (ie 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?

HoTARAC comments -

(a) No comment, it would be unusual for government bodies to enter into such contracts where it would hold underlying assets.
(b) HoTARAC has no comment, but notes that this will result in the insurance liability being measured differently according to whether there is an underlying asset.
(c) No comment.

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?

HoTARAC comments -

HoTARAC agrees.

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?

HoTARAC comments -

HoTARAC has several concerns over the proposal that the impact of movements in discount rates between those applying at initial recognition and current discount rates should be included in OCI and notes:

- This will result in accounting mismatches if insurers do not use the fair value through other comprehensive income (FV through OCI) category under the proposed amendments to IFRS 9.
- The IASB should consider circumstances where the underlying asset cannot be categorised as FV through OCI such as derivatives.
- It may be confusing for the operating statement to effectively include the interest expense relating to insurance contract liabilities at amortised cost while movements in the corresponding assets may be recognised on a different basis.
- Moving the impact of movements in the discount rate to OCI does not add any value yet would significantly increase the administrative burden due to the requirement to:
  - break down the information on an annual contract basis.
  - Restate each contract year for movements between initial recognition and the reporting date.

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?

HoTARAC comments -

While HoTARAC is supportive of the ED's proposal, subject to the other comments in this response (particularly outlined in Question 4 above), HoTARAC does not believe that they can be adopted before the IFRS 9 *Financial Instruments* and the revenue recognition projects are completed.

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 that 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 on initial application and on an ongoing basis.

HoTARAC comments -

(a) Aligning the insurer's revenue recognition with the pending IFRS on revenue from contracts with customers will assist in the comparability with entities that are not insurers. However, the optional treatment of simplifying the measurement of the liability of paragraph 35 would mean that comparability may be impacted in these cases. HoTARAC acknowledges the condition of paragraph 35(a) that the simplified method is only permitted where this would produce a reasonable approximation of the application of the full model would mitigate this impact.
(b) As discussed under question 4, the proposal will significantly increase the administrative burden involved in the reporting of insurance contracts.

Question 7—Clarity of drafting

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

If not, please describe any proposal that is not clear. How would you clarify it?

HoTARAC suggests:

- Paragraph 2(a) should refer to the incorporation of 'all **relevant** available information' [emphasis added] rather than being too broad by referring to 'all of the available information'.
- Defining what would be a 'substantive' obligation referred to in paragraph 23
- Adding guidance to operationalise the criteria of paragraph 37(b) that variability in cash flows increases with the length of the coverage of the contract. Could some indication be given of the length of coverage of the contract (e.g. 2.5 or 10 years) that would significantly vary the fulfilment cash flows to the extent that the premium allocation approach of paragraph 38 cannot be applied?
- That the contract modification of paragraph 49 only applies where there is a significant change in the terms of the contract, rather than simply a change.
- So as not to pre-empt future changes to referred standards, it is recommended that paragraph 68 only refer to IAS 21 and remain silent on how the amount should be recognised under IAS 21.
- That the disclosure requirements avoid mixing principle and rule-based requirements. Paragraph 86 discusses the entity disclosing information on the basis of user needs, but goes on to specify minimum requirements for meeting this objective.
- Clarifying whether the disclosure specified in paragraph 76 (reconciliation of opening and closing balances of liabilities) is to be made on a gross or net basis.
- Clarifying whether the disclosure required in paragraph 89(b) is to be quantitative or qualitative.
- Clarifying the new Liability Risk adjustment in paragraph 27. The ED proposes to replace the current general insurance 75% probability of sufficiency liability risk margin with a new liability risk adjustment but it is not clear how this would be calculated and whether this adjustment would be larger than the current 75% probability of sufficiency risk margin loading.

AASB Specific Matters for Comment

1. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(a) not-for-profit entities; and
(b) public sector entities, including any GAAP/GFS implications

HoTARAC comments –

(a) HoTARAC has no comment.
(b) HoTARAC has not identified any specific public sector issues. HoTARAC notes that the requirements under GFS are less detailed than those currently applied under AASB 4, *Insurance Contracts*, AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts* and the proposed model of this exposure draft, but there are no obvious inconsistencies. HoTARAC also notes that the application of the ED to insurers of last resort, a role that governments often take on, is difficult as this will rarely incorporate any assessment of risk or any consideration being received by the government as the insurer. Accordingly, it might be difficult or even impossible for public sector entities to apply the measurement requirements for risk adjustment of paragraphs B76-B82 for these types of risks.

2. whether, overall, the proposals would result in financial statements that would be useful to users

HoTARAC comments -
Refer to HoTARAC's response to IASB's question 6 above.

3. whether the proposals are in the best interests of the Australian economy

HoTARAC has no comment.

4. unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.

HoTARAC has nothing further to add to the comments made in response to Question 6 of the questions to the IASB exposure draft.