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Dear Peter

## IASB Discussion Paper *Preliminary Views on Insurance Contracts*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the IASB Discussion Paper *Preliminary Views on Insurance Contracts* (the DP). The AASB has consulted widely with its Australian constituents by:

- holding roundtable discussions;
- considering comments received in response to the AASB Invitation to Comment on the DP;
- consulting with the AASB's Insurance Project Advisory Panel; and
- accepting numerous invitations to address and listen to Australian constituents with an interest in the insurance industry.

Issues considered significant hy the AASB, as well as AASB comments on the specific questions posed by the DP, are outlined in the attached submission which is set out as follows:

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|---|---|
| Section 1: | Significant Issues |
| Section 2: | Specific Questions posed in the DP |
| Section 3: | Expected Cash Flows Model |
| Section 4: | Other Issues |

The AASB congratulates the IASB on its DP, which Australian constituents have consistently acknowledged as dealing extremely well with a very complex area of financial reporting. The AASB is very supportive of the project to develop an international standard for insurance contracts, given the wide range of existing practices internationally. In this context, the DP proposals would be a significant step forward in international insurance accounting.

The AASB supports a prospective measurement of both life and non-life insurance contracts, including recognition of renewal premiums under existing contracts. The AASB generally supports the 'current exit value model' proposed for insurance contracts and the three basic building hlocks that are used to determine the current exit value. Australian constituents support the general thrust of the proposals.

However, the AASB has concerns about some of the IASB's specific proposals. The DP attempts to construct a current exit value model within the constraints of the IASB *Framework*, in particular given the recognition requirements for assets and liabilities. The AASB has also been guided by the IASB *Framework*, however, the AASB's proposed current exit value model is one in which all expected renewals under existing insurance contracts are recognised on the basis that they are contractual assets, not on the basis that they are customer relationship assets. The model proposed hy the AASB provides the same outcomes as an expected cash flow model, although only participating benefits that satisfy legal or constructive obligations would be recognised. An expected cash flow model recognises all expected cash flows including all expected participating benefits, and is documented in Section 3 of the attached submission.

An expected cash flow model is based on the recognition of insurance contracts (as opposed to the recognition of assets and liabilities arising under insurance contracts) and the measurement of all expected cash flows under those contracts. An expected cash flow model is based on the economic substance of an insurance contract; it is only an insurance contract that can be transferred and a potential transferee would be concerned with all expected cash flows under the contracts, not with cash flows that meet IASB definitions of assets and liabilities. An expected cash flow model is viewed as appropriate by many members of the AASB, partly because of the confusing results that might arise under the DP's approach, in particular the implications of the guaranteed insurability test. A model similar to an expected cash flow model has operated successfully in Australia for almost ten years.

The AASB acknowledges that a model hased on expected future cash flows causes conflicts with the current definitions of assets and liabilities under the IASB *Framework*, and this is why it is a model that has not received the support of all members of the AASB. Nevertheless, this submission documents the arguments behind such a model in Section 3, for the IASB's consideration. The AASB considers that the IASB should be mindful of the inherent conflict that exists between fair value measurement models, which are characterised by expectations about future cash flows, and the existing definitions of assets and liabilities.

The AASB considers that it should be a key principle of financial reporting, and the responsibility of standard setters, to eliminate accounting mismatch wherever possible. In this context, the AASB urges the IASB to consider a project addressing the measurement of all assets and liabilities, where the related assets or liabilities are measured at fair value. The AASB considers that all assets backing insurance liabilities should be measured at fair value. As a minimum, the IASB should consider requiring all assets backing insurance liabilities to be measured at fair value, where this option is available under applicable IFRSs. The financial impact of accounting mismatches can he significant. In Australia they have led some entities to have to include additional disclosures on the face of the income statement hefore they are considered capable of presenting a true and fair view. The AASB considers that this undermines confidence in accounting standards in the business community generally.

The AASB does not support the DP's approach to diversification. If a current exit value model is adopted, conceptually, the risk margin that should be recognised is the risk margin that the market participant requires. The reference entity appropriate for the majority of insurance contracts in Australia is likely to be a well-diversified, multi-line insurer with a typical reinsurance programme in place.

The AASB emphasises the importance of disclosure under the proposed model. There are many aspects of the model that require significant levels of judgement, and disclosures of key assumptions, changes in estimates and claims development are considered essential for users to understand the financial statements. In Australia, disclosures of non-life insurance liabilities measured at different probabilities of adequacy has accelerated the development of benchmarks, by which to judge the reasonableness of the assessments made, and improved consistency across the non-life insurance industry.

If you have any queries in relation to this submission please contact myself or Christina Habal (chabal@aasb.com.au or +61 3 9617 7626).

Yours sincerely

David Boymal
Chairman

Attachment

# Submission to the IASB on IASB Discussion Paper *Preliminary Views on Insurance Contracts*

Prepared by the
**Australian Accounting Standards Board**

Australian Government

Australian Accounting
Standards Board

# Contents

# Section 1: Significant Issues

## 1.1 Renewal premiums

**The AASB supports the recognition of all renewal premiums under existing contracts on the basis that they are contractual assets, not on the basis that they represent a customer relationship asset.**

The IASB Discussion Paper *Preliminary Views on Insurance Contracts* (DP) notes that an insurer can derive benefits from the exercise by policyholders of rights that they hold under an existing contract, in other words, the DP states as given that an asset exists, the question is: what is the nature of this asset?

The DP takes the view that the right to renewal premiums under existing contracts is not a contractual asset because the policyholder cannot be compelled to pay further premiums. Chapter 4, paragraph 121 states: "many insurance contracts permit, but do not require, the policyholder to continue paying premiums in order to receive continued insurance coverage".

An alternative view is that under an insurance contract a policyholder is obliged or contracted to continue to pay premiums to receive continued insurance, but has the option to cancel. In other words, there is an option to cancel, not an option to renew. In this context, contracted means required or established under the terms of the contract, whether or not the insurer has a practical means of enforcing the contractual requirement. There is a presumption, underlying the economics of the contract, that a high proportion of policyholders intend to pay the premiums set out in the contract and the insurer is bound to accept them.

The question is mostly of relevance to life insurance contracts, which, in Australia, are usually long-term contracts. In entering into the contract, the policyholder has an obligation to pay insurance premiums, over say 20 years, and the insurer is bound to provide life insurance cover over 20 years. The policyholder may cancel the contract; however, cancellation will be at a cost:

- typically, for pure risk life contracts, life insurers are not contractually obliged to refund premiums and, therefore, often would not provide a full, or any, refund to the policyholder;
- the policyholder faces the risk of seeking cover elsewhere and being reassessed as a higher risk. The existing contract, however, restricts the life insurer's ability to alter its terms; and
- for some contracts investment benefits are likely to be paid out net of a penalty charge.

Under this alternative view, all future premiums under the existing contract are considered contractual assets. The right under the contract, that the DP acknowledges, arises directly from the terms of the contract. These contractual rights, namely renewal premiums, could be sold to a third party as part of a business combination.

The DP takes the view that as future premiums are not contractual assets they must derive from a customer relationship. However, under IAS 38 *Intangible Assets*, a customer relationship cannot be recognised if internally generated, and hence the DP acknowledges that it could be argued that the customer relationship asset arising from an insurance contract cannot be recognised. However, the DP concludes that because the existing insurance contract is closely associated with the customer relationship, this close association justifies recognition (Chapter 4, paragraph 142). The AASB has concerns with supporting this line of reasoning; it appears to be based on an attempt to reach a desired outcome, rather than on technical arguments. The AASB would prefer the alternative view to be adopted under which future premiums would be recognised on the basis that they are contractual assets.

The AASB is also not convinced that future premiums under existing contracts could be considered a customer relationship intangible asset. Under IAS 38, an intangible asset is: "an identifiable non-monetary asset without physical substance". Arguably future premiums under existing contracts are monetary assets; the contractual provisions under an insurance contract are such that the renewal premiums are determinable amounts of money. The customer relationship asset in relation to an insurance contract is the asset that arises from expected premiums under future contracts, which might arise as a result of the relationship that is created by the existing contract.

The DP argues that once it is accepted that an insurer should recognise future premiums under existing insurance contracts, it needs to be determined when an existing contract ends and when a possible new contract begins (Chapter 4, paragraph 150). The DP does not support the approach of including all cash flows that are expected to result from the contract because such an approach would need to specify that cash flows are included only if they result from substantive features of the contract. Some criterion would be required to ensure that only substantive features of the contract are reflected. The DP does not propose a notion of commercial substance because of the ramifications for other contracts. The DP notes instead that insurance contracts "typically" permit the policyholder to benefit from coverage for a period at a price that is contractually constrained – as a result, the DP proposes the guaranteed insurability (GI) test for recognising future premiums. The notion of GI has, therefore, arisen as a means of defining the boundary of an existing insurance contract.

The AASB does not support the logic of introducing such a rule. A rule will create a whole new set of grey areas and complexities that it was intended to eliminate, however, in considering these grey areas the user is further removed from the underlying principle (i.e. that the present value of all cash flows that result from the rights under the contract should be recognised).

The AASB's view is that the GI test potentially creates more problems than it solves: not all insurance premiums will pass the GI test, leading to losses that would be expected to be reversed at a later date. It is also unclear what 'contractually constrained' means. For example, for the most common types of life insurance contract sold in Australia, the insurer is able to reprice the contract, but only for a particular group of contracts, not at an individual contract level. It could be argued that at an individual contract level the insurer is constrained, or it could be argued that because there is the ability to reprice the particular group of contracts to which that individual contract belongs, there is no contractual constraint.

The AASB considers that the DP should take a more principles-based approach, supplemented with examples that will address some of the anticipated issues that would arise. The contractual provisions themselves should define the boundary of an existing insurance contract.

The DP's line of argument ultimately leads to the following position:

- where the rights and obligations under an existing insurance contract result in a net liability, the future premiums are included in the overall measurement of the net liability; and
- where the rights and obligations under an existing insurance contract result in a net asset, future premiums can only be recognised where the insurer can compel the policyholder to pay or where the premiums pass the GI test.

However, an insurance contract can give rise to either a net asset or a net liability at different times during its life cycle. It is not appropriate to apply different recognition criteria to the same contract depending on where in the life cycle a contract sits. It is also possible that a contract could give rise to a net asset under one set of assumptions and a net liability given another set of assumptions. Again, it is inappropriate to apply different recognition criteria to the same contract when there are changes in assumptions.

The AASB proposes the alternative approach: it considers all future premiums under existing contracts to be contractual assets. In the same way that the boundary of the contractual liability is not defined in Chapter 3, the boundary of the contractual asset need not be defined. This would be consistent with the approach in IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and*

*Measurement* under which the contract is the basis for determining the boundaries of a financial instrument (an insurance contract is a financial instrument). Examples would assist users in determining when an existing contract ends and a new contract begins. This is effectively what is proposed under the DP in cases where the net position is a liability. The boundary of the contract is only considered in cases where the net position is an asset.

The AASB acknowledges that recognising future premiums arising from existing contracts under an insurance accounting standard could be seen as creating a precedent for other projects. However, such an approach is ultimately justified by the fact that it produces the most useful information for users, and a future standard would need to make this clear. Such concerns should not hamper development of the most appropriate model for measuring insurance contracts, because any extension of the current exit value model would be subject to its own due process. In Australia, a similar situation has existed for many years without any pressure for insurance accounting to be applied to other contracts. Life insurers in Australia recognise renewal premiums under existing contracts even though these payments cannot be enforced, whereas other service contracts would recognise revenue in accordance with IAS 18 *Revenue*.

The AASB notes that the Expected Cash Flows Model described in Section 3 is another approach that addresses the recognition problems in the DP and that the IASB could consider.

*Health insurance contracts*

The GI test may have a significant impact on the treatment of health insurance contracts in Australia. As the AASB understands it, the GI test is intended to capture premiums under long-term contracts, such as a long-term life insurance contracts. However, the GI test could also capture premiums under contracts that are not in substance long-term contracts, but where there is some constraint over pricing, such as Australian health insurance contracts.

Australian health insurance is subject to significant government legislation. Health insurers are subject to community rating, which means that they are not able to underwrite their risks. Each insurer sets its own premium rates (subject to government approval) but cannot distinguish between policyholders. Policyholders are either charged the single person rate or the family rate (if insuring the entire family unit) for any particular insurance product. Health insurers cannot refuse insurance to anybody and cannot refuse renewal. In taking out a health insurance contract, policyholders often have to serve a twelve-month waiting period for pre-existing conditions. Health insurance contracts can be seen as long-term contracts because there is no fixed indemnity period. However, the health insurer, subject to government approval, is able to increase the single person rate or family rate if it can demonstrate that insurance costs have increased.

Insurers are also able to change the benefits for the different insurance products. Policyholders are able to move between health insurers without having to re-serve waiting periods for pre-existing medical conditions, provided there is continuity in the cover. A key issue is whether the renewal premiums would meet the guaranteed insurability test. Under the DP, renewal premiums (and the related liabilities) would be recognised if they meet the GI test.

The premiums could be seen as contractually constrained because they can only be changed for a portfolio of contracts and after government approval. Alternatively, it could be argued that premiums are not contractually constrained and that existing contracts effectively expire on the date of the next annual price review. Also, because policyholders are able to move between funds without a significant change in benefits, and because insurers cannot refuse insurance, it could be argued that whilst future premiums do need to be paid to retain benefits (that is, to avoid re-serving a waiting period), these premiums do not need to be paid to any particular insurer. This is arguably not in the spirit of the GI test proposals.

Under the DP's proposals, therefore, it is not clear whether health insurance contracts would effectively be treated as long-term contracts with a requirement to recognise future premiums (because the premiums meet the GI test) and to provide for expected cash flows over a number of years. The AASB's view is that health insurance contracts are not in substance long-term contracts and, in measuring insurance liabilities, health insurers should recognise all cash flows to the later of the date of the next annual price review and the date paid to.

The AASB notes that similar issues exist for some medical indemnity insurance contracts, compulsory third party insurance contracts and workers' compensation insurance contracts, each of which is written by government agencies and is subject to significant government regulation.

If the GI test effectively treats these contracts as long-term contracts the AASB would not support this outcome. If the IASB continues to use the GI test to determine the boundary of an insurance contract in some situations (and as noted in section 1.3 of this submission the AASB would not support this) the test would need to be reconsidered in the light of the contracts outlined above. The AASB could assist the IASB, by providing examples of contracts for which the GI test could cause concerns.

## 1.2 Profit on inception and revenue recognition

**The AASB supports recognising profit on inception, but considers that the issue of revenue recognition should be addressed more explicitly in the future exposure draft.**

For many constituents the treatment of profit on inception is a key driver in reaching a view on an appropriate measurement model for insurance contracts. In the DP, profit on inception is discussed as a by-product of a current exit value model, but is not given prominence. Some constituents are concerned that the approach in the DP could pre-empt the direction of the revenue recognition project. Given the ongoing revenue recognition debate at the IASB and FASB, the exposure draft should explore the various options for revenue recognition and should justify why the exposure draft takes the view it does. This would provide a useful reference point when the revenue recognition issues are discussed more broadly. There is also concern, among some Australian constituents, that the current exit value model proposed would take many jurisdictions away from an accounting model that gives similar weight to the income statement and balance sheet and toward one that focuses predominantly on the balance sheet. Some of those who support a model that is closer to Implementation A would share this concern. The IASB should justify such a move rather than accept it as an implicit and inevitable aspect of the model.

The AASB notes four main approaches:

1. Implementation A – no profit on inception, 'excess profit' is considered part of the risk margin and is earned as risk is borne, service margin is earned as service is provided;
2. Implementation B – a current exit value model is adopted – 'excess profit' is earned at inception, risk margin is earned as risk is borne and service margin is earned as service is provided;
3. 'Excess profit' is earned as risk is borne but is distinguished from the risk margin (consistent with the CFO Forum's preferred model); and
4. Hybrid model – current exit value model applied to the insurance component of the contract. For the service component of the contract, service margin is calibrated to produce no profit on inception. Some Australian constituents support such a model.

In the AASB's view, under a current exit value model, part of the risk margin is the market rate of return, as this is part of the compensation for bearing risk, that is, for operating as an insurer. However, some might take the view that the risk margin does not include any element of profit. The IASB should discuss this issue explicitly in the exposure draft.

Under the DP, the risk margin is earned as the insurer is released from risk, that is, over the life of the contract as the risk is borne. In the AASB's view, implicit in this model, therefore, is the notion that the market rate of return required by market participants is earned over the life of the contract in accordance with the pattern of risk. This is consistent with IAS 18.

Under the DP, 'excess profits' are recognised in the income statement on inception (Implementation B); however, there are members of the IASB who would prefer that these profits are not recognised on inception (Implementation A). The DP proposes Implementation B because, conceptually, under a current exit value model, it would be inappropriate to include such profits as part of the measurement of the insurance liability, as this would overstate the liability, providing all assets and liabilities have been appropriately recognised and measured. However, such a proposition is counter-intuitive for users accustomed to an income statement approach, where profit is traditionally earned over the life of a contract. Another view is that the 'excess profits' should be recognised over the life of the contract as risk is borne (as noted above, this is arguably implicit in the current exit value model for the 'market profit'). The CFO Forum argues that, since the main service under an insurance contract is the mitigation of risk, entities selling insurance contracts should recognise accounting profits in line with the reduction of risk, and that any profit should not, therefore, be recognised on inception.

The AASB, however, supports the approach taken in the DP and agrees that profit on inception should be recognised in the income statement on inception. This is the most conceptually pure approach because it is consistent with the fair value model and current exit value model, and the AASB supports the adoption of a current exit value model for measuring insurance contracts as it considers such a model most useful to users.

The AASB considers it appropriate for the future insurance standard to include a discussion along the following lines:

> 'In a competitive market the Board would not expect to see significant levels of profit on inception of an insurance contract. However, such profits might arise where, for example, an insurer is operating in a niche market or where the insurance market is hard. Where the insurer applies the current exit value model to its insurance contracts and this generates profit on inception, the insurer should take steps to ensure that such profits can be explained.'

The AASB also considers that, as part of an integrated set of disclosures about the sources of profits on insurance contracts, profits on inception should be separately

disclosed in the notes to the financial statements, together with a statement that explains how such profits have arisen.

The AASB does not support a hybrid model. There is concern that such a model could encourage smoothing of profits and be confusing to users. The AASB supports the conceptual approach of the DP.

### 1.3 Service margins

**The AASB supports the recognition of a service margin but considers that the service margin proposals should be clarified in the future exposure draft.**

The AASB agrees that, conceptually, a current exit value measurement model would incorporate a service margin, being the compensation market participants would require for taking on service obligations. It has been suggested to the AASB that the margins on investment management services witnessed in Australia can be significant and could constitute more than a 'true' service margin as envisaged by the DP. The future exposure draft should emphasise that the service margin that should be recognised under a current exit value model is only that part of the total margin that market participants would require as compensation for taking on service obligations, and any margin in excess of this is recognised as profit on inception.

The AASB notes that some Australian constituents find the service margin proposals unclear, particularly what is meant by 'service'? The AASB believes that the IASB intends to clarify this in the exposure draft and would support such clarification.

The AASB understands that the service margin proposals were principally intended to address investment management services. The AASB notes that premiums under fixed-fee service contracts, such as roadside assistance contracts, could be seen as comprising an insurance component together with a more significant service component. If fixed-fee service contracts remain within the scope of the insurance standard, the IASB needs to consider the service margin proposals in the context of these contracts as well as in the context of contracts that include investment management services. See further discussion of roadside assistance contracts in section 1.10 of this submission.

The AASB notes the differences that will exist between the treatment of service components under an insurance contract and the treatment of service components under IAS 39 and IAS 18 as documented in the DP. Whilst the unbundling proposals will mean that in many cases the service component will be treated under IAS 39 and IAS 18, this

will not always be the case. The AASB considers that the IASB should address these differences as part of a wider review of IAS 39.

## 1.4 Diversification benefits

**Risk margins should reflect the benefits of diversification between portfolios.**

The AASB does not support the IASB's preliminary view that "risk margins should not reflect the benefits of diversification between portfolios and negative correlations between portfolios" (Chapter 5, paragraph 202(b)). If a current exit value model is adopted, conceptually, the risk margin that should be recognised is the risk margin that the market participant, or transferee, requires. That risk margin would be determined by the market participant at the entity level, net of reinsurances. The reference entity appropriate for the majority of insurance contracts in Australia is likely to be a well-diversified, multi-line insurer with a typical reinsurance programme in place.

The AASB considers that such an approach would provide the most useful information for users because it is consistent with the way in which insurers manage their business, the way in which an insurer would measure the compensation required in a transfer of the business, and hence with the economics of the insurance business. Australian constituents have consistently noted that diversification of risk is real and measurable and should be recognised. They consider that a measurement model that does not recognise diversification fully, is fundamentally flawed and of limited value to users. Insurers' business models implicitly include the creation of portfolios that together create diversification benefits. Not allowing diversification benefits to be recognised would create losses, or reduced profits, that would subsequently be reversed or recovered.

## 1.5 Credit characteristics of insurance liabilities

**The AASB supports the IASB's proposals in relation to the credit characteristics of insurance liabilities in principle but has concerns with their application in particular circumstances. The AASB considers that the exposure draft should discuss how credit risk should be reflected and provide guidance to ensure consistency and comparability.**

The AASB agrees that, conceptually, an insurance liability can have credit characteristics. It is possible that the claims paying ability of an insurer can be inherent in the pricing of its insurance contracts, although it seems highly unlikely that this would be material in a prudentially regulated market such as Australia.

In a prudentially regulated insurance market, the AASB does not agree that the current exit value of an insurance liability is always a price that neither improves nor impairs the credit characteristics of the liability. In such a market, an insurer with a low credit rating would not be allowed, by the regulator, to transfer its liabilities to another insurer with a low credit rating. In such a market, the reference entity is not an insurer with the same credit standing, but an insurer that the regulator would allow to take over the portfolio of contracts. If the IASB retain these proposals for the exposure draft, the exposure draft should make it clear that whilst the transfer itself is hypothetical, the market should not be. This has implications for the fair value measurement project generally.

The DP treats credit standing and claims paying ability as if they were synonymous, when they are not. Appendix H, paragraph H10 of the DP states:

> "For the following reasons, in the Board's preliminary view, the current exit value of a liability is the price for a transfer that reflects the credit characteristics of the liability, i.e. a price that neither improves nor impairs the credit characteristics of the liability:
>
> (a) A creditor would not generally permit the debtor to transfer its obligations to another party of lower credit-standing.
>
> (b) A transferee of higher credit standing would not assume the obligations for an amount that implicitly requires the transferee to pay interest at a higher rate: if it can borrow at 5 per cent, why would it pay 6 per cent? To induce the transferee to assume the obligation, the transferor would, in effect, have to buy a credit upgrade. But that credit upgrade does not benefit the transferor, so the transferor has no motive to pay for it."

The credit characteristic of a claims liability is the risk that the insurer will default on the claim when presented by the policyholder, also known as the claims paying ability of the insurer. The DP suggests that credit rating is synonymous with claims paying ability, which is not the case. The credit rating of an entity is attributable to the entity as a whole. An insurer could have a lower than average credit standing and yet have a strong claims paying ability because policyholders rank above shareholders in any liquidation, and because there may be assets that can only be used to settle insurance claims.

The DP does not discuss how an insurer would reflect credit risk in measuring insurance liabilities. Credit risk could be reflected in three ways, by adjusting:

1. the projected cash flows;
2. the risk margin; or
3. the discount rate.

SFAS 157 *Fair Value Measurements* notes in footnote 23:

> "A discount rate that reflects expectations about future defaults is appropriate if using contractual cash flows of a loan (discount rate adjustment technique). That same rate would not be used if using expected (probability weighted) cash flows (expected present value technique) because the expected cash flows already reflect assumptions about future defaults; instead, a discount rate that is commensurate with the risk inherent in the expected cash flows should be used."

The current exit value model proposed by the DP uses an expected present value approach. Therefore it might be expected that the impact of the credit risk would be observed in the projection of future cash flows and not in the discount rate used.

However, Chapter 3, paragraph 69 discusses discount rates and states:

> "the objective of the rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability."

The characteristics of the liability would include the credit characteristics and, therefore, whilst credit characteristics are not listed together with timing, currency and liquidity they could be captured by paragraph 69.

The AASB considers that the exposure draft should discuss the various ways in which credit risk could be reflected and should reach a conclusion on the most appropriate method. This is essential for consistency and comparability.

### 1.6 Assets backing insurance contracts

**The AASB recommends that the IASB consider a project addressing the measurement of assets and liabilities where the related assets or liabilities are measured at fair value. The AASB believes that assets backing insurance liabilities should be measured at fair value to eliminate accounting mismatch. As a minimum, the AASB considers that all assets backing insurance liabilities should be measured at fair value where this option is available under applicable IFRSs.**

The DP includes a comprehensive discussion of accounting mismatch and economic mismatch in Chapter 5, paragraphs 176 to 182. The IASB's preliminary view is that it does not intend, as part of the insurance project, to change existing IFRSs for assets held by insurers. The IASB also does not intend to permit or require insurers to use the fair

value option for assets backing insurance liabilities. This conclusion is reached for two key reasons:

1. In Chapter 5, paragraph 181 it states: "The Board expects that insurers would typically use these (fair value) options to minimise accounting mismatches"; and
2. The IASB has concerns that assets "held to back insurance liabilities" cannot be defined without ambiguity.

The AASB considers that the critical issue is one of eliminating accounting mismatch and notes that it should be a key principle of financial reporting and the responsibility of standard setters to eliminate this mismatch. The AASB considers that all assets backing insurance liabilities should be measured at fair value. As a minimum, the IASB should require all assets backing insurance liabilities to be measured at fair value, where this option is available under applicable IFRSs.

Under current Australian GAAP, assets backing insurance liabilities and investment contract liabilities are measured at fair value where this is an available option under existing IFRSs. Prior to the adoption of IFRSs in Australia, all assets held by life insurers and all assets backing non-life insurance liabilities were measured at net market value. Australian constituents have not had difficulties applying the 'assets backing insurance liabilities' notion under current Australian GAAP and the Australian constituents consulted would support the IASB requiring fair value where this option is available under applicable IFRSs. Many would also support fair value measurement of all assets backing insurance liabilities, even where the option to fair value is not currently available under the applicable IFRS.

The DP prefers to rely on insurers choosing to minimise accounting mismatch, because 'typically' this will be the case, rather than requiring insurers to follow a principles based approach because of concerns over the ambiguity of the expression 'held to back insurance liabilities'. Clearly, application of a notion such as 'held to back insurance liabilities' requires the exercise of judgement, but this does not appear a strong enough concern in this instance to rely on insurers choosing the fair value option. In many jurisdictions, the meaning of this term is likely to be clear because insurance regulators typically require assets of a particular value to be held to meet policyholder claims.

Insurers in Australia are likely to continue to measure assets at fair value to the extent available under IFRSs, but in other jurisdictions (for example, where assets have traditionally been measured at amortised cost) this may not be the case. Some Australian constituents, however, have expressed concern that Australian subsidiaries of overseas insurers are likely to be placed under pressure to align with group accounting policies, where at the group level measuring assets at fair value is not the norm. This would lead

to a reduction in the comparability of financial statements within the Australian market and a step backwards for financial reporting in Australia.

The AASB notes that the IASB should also consider a broader project addressing the measurement of assets and liabilities where the current exit value model, or fair value, is applied to related assets or liabilities. The AASB envisages this project including consideration of IAS 12 *Income Taxes* which does not permit discounting of deferred tax balances.

## 1.7 Entity-specific cash flows

**The AASB supports the proposals in relation to entity-specific cash flows in principle but considers the proposals to be confusing as currently drafted.**

Australian constituents have found the proposals in relation to entity-specific cash flows confusing. These proposals have led most Australian constituents to conclude that, whilst they support the current exit value model at a conceptual level, they have concerns over the practicality of determining market-consistent cash flows for insurance contracts which do not have an active secondary market. These constituents would generally prefer a model based on the same three building blocks but which measures cash flows using entity-specific cash flows, i.e. a model based on a settlement, rather than a transfer, notion. The AASB considers this response to be more a factor of the way in which paragraphs 56 to 62 of Chapter 3 have been drafted, than due to the actual proposals themselves.

As the AASB understands it, the DP proposes that under a current exit value model an insurance liability should be measured using market-consistent cash flows; the AASB considers this to be the conceptually correct approach. However, in practice, unless there is clear evidence that the entity's expected cash flows are out of line with market consistent cash flows, entity-specific cash flows can be adopted. In most instances there is unlikely to be clear market evidence that contradicts the entity's own estimate of cash flows. The AASB considers this approach an appropriate balance of principle and pragmatism. However, the AASB considers that the DP gives undue emphasis to the market-consistency principle without giving enough attention to the practical outcome, which is, that, in most cases, an entity will use its own estimates of future cash flows.

Paragraphs 56 to 62 deal with situations where prices or variables are not observable in the market and they should therefore be linked to the discussion of observed market prices in paragraphs 36 to 38; indeed, the two sections could probably he combined under one heading: *Market-consistent prices* when drafting the exposure draft. If the discussion

were structured in this way the context of the proposals would be clearer. Paragraphs 56 to 62 deal with prices that cannot be directly observed in the market, they can either be derived from the market or they are non-market variables that cannot be observed in or derived from the market at all.

The focus of these paragraphs should be that, consistent with the current exit value model, the liability is being measured from the perspective of the reference entity that might acquire the liability from the insurer – in this way the cash flows are intended to emulate a market price.

The DP argues that a key variable that can sometimes be derived from the market is the servicing costs of an insurance contract. The measurement of the servicing costs should be based on the servicing costs that the reference entity would expect to incur. In some cases, cash flows will be significantly impacted by an insurer's strategy in servicing claims. For example, a motor insurer could set up its own in-house mechanic, or pay third parties to repair motor vehicles. The question to be answered is: how would the reference entity measure the cash flows? Say that the transferor uses in-house mechanics to repair motor vehicles insured, but the rest of the market uses third parties. If the transferor's servicing costs are not significantly lower than the market average, it could be assumed that the reference entity would measure cash flows based on third party repairers, that is, the reference entity would make the assumption that if it were to take over the business it would follow the model used by most in the market, namely, using third party repairers, given the limited benefit of in-house mechanics.

The DP could be interpreted as suggesting that the level of service provided to policyholders is always a characteristic of the insurance contract. Paragraph 61 states:

> "The estimates of servicing costs would need to reflect the characteristics of the contracts being measured, including the level of service provided to policyholders and the approach to claims management".

The AASB disagrees that the level of service is inherently a characteristic of the contract, but agrees that sometimes it could be (for example, in some motor insurance contracts the insurer might specify that cars will be repaired by particular third party workshops). The level of service is arguably more often a factor of the insurer's strategy and this may be an entity-specific factor that a market participant would not factor into the cash flows.

The DP argues that in measuring an insurance liability, by not reflecting synergies with other assets and liabilities, the insurer is excluding entity-specific cash flows. Paragraph 60 states:

> "using estimates of the entity's own servicing costs would incorporate cash flows that relate not to the liability itself but to synergies with other recognised or unrecognised assets or liabilities. Therefore, the Board's preliminary view is that the measurement of the liability should be based on the servicing costs that market participants would incur."

The AASB supports the preliminary view but for different reasons. Using the servicing costs of the market participant is effectively incorporating market synergies into the liability measurement; recognising the synergies is not the issue, rather it is the fact that the entity's synergies may be out of line with those that a market participant would anticipate.

### 1.8 Reference entity

**The AASB considers that the future exposure draft should discuss the factors that need to be considered in determining the appropriate reference entity.**

In determining a current exit value, an insurer needs to determine the appropriate reference entity, that is, the insurer that might take over the liabilities. This is critical to the determination of cash flows, to the determination of risk margins and to the consideration of credit risk. However, the DP does not discuss in enough detail the factors that would need to be considered in determining the appropriate reference entity.

In a competitive market the reference entity can be determined relatively easily; however, the exposure draft needs to consider the nature of the reference entity more closely for those insurance markets that are furthest removed from a competitive market; for example:

- a market that is very diverse: a mixture of for-profits and not-for-profits, for example;
- a market that has restricted entry because of government regulation; and
- a market that has a government-endorsed monopoly.

In the case of a monopoly, it could be argued that there is no reference entity at all. This could have the following implications:

- entity-specific cash flows could be incorporated into the measurement model; and
- the risk margin and service margin could be calibrated to the premium.

The AASB could assist the IASB, by providing examples of the issues that exist in practice.

## 1.9 Disclosure

**The AASB views disclosure as a critical aspect of a current exit value model.**

The DP has not considered disclosure requirements; these are to be considered as part of the exposure draft process. The AASB considers disclosure a critical aspect of the application of the current exit value model. The AASB makes the following observations:

- The current exit value model is a balance sheet approach, the results could be considered less intuitive than those generated by an income statement approach, such as the deferral and matching model used by many jurisdictions today. In addition, the move away from a deferral and matching model may require different approaches to be developed for analysing profit; this will need to be addressed in future disclosures;
- The determination of insurance liabilities is complex and requires the use of considerable judgement. Certain disclosures are considered essential for an understanding of insurance liabilities: key assumptions and changes in estimates and an analysis of claims development; and
- The current exit value model requires assumptions in relation to the reference entity (market participant) and market value risk margin. In the short term, as preparers and users are less familiar with these concepts, there may be significant variations in these assumptions across different entities. Over time, as the concepts become more familiar, there is likely to be more consistency; disclosure can accelerate this process. In Australia, disclosure of non-life insurance liabilities measured at different prohabilities of adequacy has assisted in the evolution of benchmarks and greater consistency across the non-life insurance industry.

However, whilst the AASB believes disclosure to be critical, the AASB would not favour detailed disclosure requirements such as those in IFRS 7 *Financial Instruments: Disclosures*, as these can be confusing to users and unnecessarily lengthy. The AASB favours a principles based approach to disclosure rather than an approach that is overly prescriptive.

## 1.10 Roadside assistance contracts (and other fixed-fee service contracts)

**The IASB should reconsider the definition of an insurance contract as part of the exposure draft process. The AASB does not consider it appropriate that roadside assistance contracts (and other fixed-fee service contracts) remain within the scope of the insurance standard, especially given that certain product warranties are excluded. Roadside assistance contracts (and potentially other fixed-fee service contracts) can be adequately dealt with under IAS 37.**

IFRS 4 *Insurance Contracts* introduced the following definition of an insurance contract:

> "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder".

IFRS 4 states that roadside assistance contracts could meet the definition of an insurance contract. However, roadside assistance organisations have argued that their contracts should not be treated under an insurance standard as they do not believe they transfer significant insurance risk and as these contracts could be adequately dealt with under other IFRSs.

B7 of IFRS 4 states:

> "Applying the Standard to the contracts described in paragraph B6 is likely to be no more burdensome than applying the Standard that would be applicable if such contracts were outside the scope of this Standard.
>
> (a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.
>
> (b) If IAS18 *Revenue* applied, the service provider would recognise revenue by reference to the stage of completion (and subject to other specified criteria). That approach is also acceptable under this Standard, which permits the service provider (i) to continue it's existing accounting policies for these contracts unless they involve practices prohibited by paragraph 14 and (ii) to improve its accounting policies if so permitted by paragraphs 22-30.
>
> (c) The service provider considers whether the cost of meeting its contractual obligation to provide services exceeds the revenue received in advance. To do this, it

applies the liability adequacy test described in paragraphs 15-19 of this Standard. If this Standard did not apply to these contracts, the service provider would apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether the contracts are onerous.

(d) For these contracts, the disclosure requirements in this Standard are unlikely to add significantly to disclosures required by other IFRSs."

Under phase II most of these points are no longer valid and indeed BC 75 of IFRS 4 states: "The Board may need to review this conclusion in phase II".

The IASB should review this conclusion as part of the exposure draft process. The AASB notes that under a phase II insurance standard, the scope of the standard is critical, given that the current exit value model proposed is significantly different from the standards that would otherwise apply (IAS 18 and IAS 37). The current position under IFRS 4 is unsustainable: certain product warranties, which are in substance insurance contracts, are specifically excluded from the scope of the standard, whereas roadside assistance contracts, and other fixed-fee service contracts, that are not in substance insurance contracts, are potentially caught by the definition of an insurance contract. The AASB considers that the IASB should either address all product warranties and fixed-fee service contracts (including roadside assistance contracts) in the context of this project, or should continue to exclude certain product warranties and exclude fixed-fee service contracts as well.

The AASB considers that the definition of an insurance contract needs to be reconsidered as part of the exposure draft process. The current definition is too wide and captures contracts that are not in substance insurance contracts. Roadside assistance organisations operate under a fixed cost model; if there are ten vehicles available to rescue stranded policyholders and eleven policyholders are stranded, the eleventh policyholder has to wait. The substantive cost to the roadside assistance organisation will be the cost of having ten vehicles available to rescue policyholders.

If the IASB does not change the definition of an insurance contract under the exposure draft, it should consider excluding roadside assistance contracts (and other fixed-fee service contracts) from the scope of the insurance standard in the same way that certain product warranties are currently excluded. It could be argued that users would consider treating a roadside assistance contract under an insurance standard to be misleading. In addition, these contracts are not subject to significant levels of uncertainty over the amount or timing of liabilities and could be adequately dealt with under

IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*. If the IASB does not choose to exclude roadside assistance contracts (and other fixed-fee service contracts) from the scope of the insurance standard then it would be inappropriate to continue to exclude certain product warranties.

The AASB also advises the IASB of differing interpretations of the definition of an insurance contract that have arisen under IFRS 4 and that need to be addressed as part of the exposure draft process. In considering whether a roadside assistance contract meets the definition of an insurance contract it is necessary to consider whether there is a transfer of significant insurance risk. It is the AASB's view that this should be considered from the insurer's perspective rather than from the policyholder's perspective. However, some Australian constituents have taken the view that the assessment of whether significant insurance risk is transferred should take place from the policyholder's perspective. These two views can lead to very different outcomes. This should be clarified by the exposure draft.

## Section 2: Specific Questions posed in the Discussion Paper

**Question 1**

***Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?***

**AASB response**

**The recognition and derecognition requirements for insurance contracts should be consistent with those in IAS 39 for financial instruments. However, the IAS 39 requirements were not drafted with insurance contracts in mind and the future insurance exposure draft will need to consider specific issues arising from insurance contracts.**

Chapter 2, paragraph 27 states that an insurance liability should be recognised when the insurer "becomes a party to the contract". This is consistent with IAS 39. We believe that the recognition requirement should make reference to the acceptance of risk, since an insurance contract only exists once risk is transferred. We believe that the following would be appropriate:

> "An insurer should recognise the rights and obligations created by an insurance contract when the insurer accepts the transfer of risk."

We believe such wording is consistent with IAS 39, and addresses the fundamental nature of an insurance contract.

Such wording deals with the recognition of insurance contracts. However, under a non-life insurance contract, an insurer typically makes a renewal offer to the policyholder prior to the inception date of the new contract. At this stage the insurer has made an offer, however, until the policyholder accepts the offer there is no contract in place as no risk has been transferred. The insurer has agreed to accept risk in the future but the policyholder has not transferred it. The insurer cannot recognise the contract but does need to consider whether it has a constructive obligation under IAS 37 (this is akin to measuring a liability under a written option in the context of IAS 39). The insurer has a constructive obligation if it expects the contract to generate a loss. The AASB notes that, whilst IAS 37 provides the principles for determining the recognition and measurement of a constructive obligation, further guidance would be needed to apply these principles to an insurance contract because the circumstances surrounding insurance contracts are not adequately dealt with under the existing IAS 37. For instance, once the policyholder transfers risk by accepting the offer (usually at the time the renewal premium is paid) the

insurer can recognise the contract, which may well take place before the inception of the contract.

To summarise: it is the AASB's view that an insurance contract should be recognised when the insurer has agreed to accept risk and the policyholder has agreed to transfer risk. Where an insurer has made an offer of renewal that has not yet been accepted, the insurer needs to consider whether it has a constructive obligation.

However, the AASB notes that the conclusions outlined above could cause significant practical difficulties for reinsurers who are often far-removed from the underlying risk and who would need to employ significant judgement in many cases to determine insurance liabilities and constructive obligations on this basis. This warrants additional research during the exposure draft process.

The AASB notes that the issue of derecognition for insurance contracts also needs to be considered closely. Claims liabilities are only extinguished when all possible claims are settled. This may not be clearly determinable, for example in the case of third party liability claims. Insurers in run-off may also seek to fully reinsure their remaining liability. In this situation it may not be entirely clear whether the liability has been extinguished.

**Question 2**

***Should an insurer measure all its insurance liabilities using the following three building blocks:***
***(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,***
***(b) current market discount rates that adjust the estimated future cash flows for the time value of money, and***
***(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)? If not, what approach do you propose, and why?***

AASB response

**The AASB supports the three building blocks in principle.**

*Cash flows*
See section 1.7 for the AASB's comments in relation to the entity-specific cash flow proposals. The AASB supports the IASB's proposals to measure insurance liabilities

using explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.

*Discount rates*
The AASB supports the proposal in the DP that discount rates should be: "current market discount rates that adjust the estimated future cash flows for the time value of money". This is because the AASB agrees that the measurement of an insurance liability is independent of the assets that support the liability. This is consistent with the approach in AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*. In Australia it would be seen as a step backwards to use a discount rate based on the underlying assets. However, where the liability measurement is dependent upon the value of the assets backing the liabilities, an appropriate discount rate is a rate based upon returns on the actual assets held. This should be clarified in the exposure draft.

The DP proposes a discount rate that is: "consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity" (Chapter 3, paragraph 69).

The AASB notes that under this proposal there is the ability to exclude liquidity risk from the discount rate where the liability is not payable on demand. For example, certain annuities have fixed settlement patterns, the insurer will know when benefits are to be paid, there may be minimal liquidity risk attached to the liability. The argument is that if the liability is to be adjusted for the time value of money *for this liability* then the time value of money will be different than it would be for a liability that is of uncertain timing but is expected to be settled at the same time. In the context of a fair value model, the AASB supports the DP proposals.

The issue could be seen as controversial because many would interpret the DP proposals to use current market discount rates that adjust the estimated future cash flows for the time value of money as meaning that a 'risk-free' discount rate would be applied, as this is seen as a universal rate for the time value of money. The DP is silent on this issue. The AASB views this as an important issue that should he discussed in the future exposure draft.

*Risk margins*
The AASB supports the recognition of a risk margin in measuring insurance liabilities. IAS 37 currently requires measurement at the best estimate. Some might argue that this is inconsistent with the current DP proposals as it does not require a risk margin. However, best estimate is explained in IAS 37, paragraph 37 as: "the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time".

In the context of an insurance contract, measurement based both on a settlement and a transfer notion would require inclusion of a risk margin. Any insurer taking on an insurance liability would not be comfortable with the central estimate (the statistical mean of the distribution of possible outcomes which is similar to the concept of "best estimate" as commonly understood) because the range of outcomes for an insurance contract can be extremely wide. The extent of the risk margin is related to the basic 'width' of the distribution and partly to the extent of the asymmetry in the distribution of expected outcomes. Similarly, any policyholder settling the liability at the reporting date would be unlikely to accept the central estimate when the actual liability could ultimately be significantly higher.

However, some might argue that the best estimate could be appropriate if it were considered to be the amount that an insurer would need to put aside to settle the liabilities in the normal course of business. However, such a notion contradicts the current exit value notion and the proposed fair value notion which hinge on a transfer. Insurers would also typically price their contacts to include a risk margin to reflect the inherent uncertainty in outcomes, and hence such a notion is also inconsistent with the way in which insurers manage their business.

*Service margins*
See section 1.3 for a discussion of service margins.

**Question 3**

***Is the draft guidance on cash flows (Appendix E) and risk margins (Appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?***

**AASB response**

**Appendices E and F are generally at the right level of detail and the AASB supports the principles based approach of the guidance. However, the IASB should seek feedback from preparers that the level of guidance for determining risk margins is sufficient.**

*Appendix E: Cash flows*
The AASB considers Appendix E to be at the right level of detail.

However, the AASB notes paragraph E26:

> "No pricing or measurement model can guarantee to identify in advance all events that might cause insured losses. In determining an acceptable price for taking over insurance liabilities, market participants would consider the possibility of such unidentified events. Because insurance contracts provide asymmetric pay-offs, such unidentified events tend to result in more large losses than large gains. Therefore, they tend to increase the expected present value of future net cash outflows. However, to deal with the possibility of unidentified events insured by existing contracts, it may sometimes be more practical to increase the risk margin, rather than include additional scenarios."

The AASB considers that E26 could be interpreted as allowing an additional (and probably arbitrary) liability to be added to the 'true' risk margin. The AASB has concerns that the risk margin could be impacted in this way. A key benefit of the approach taken in the DP is that the objectives behind the risk margin are clear and the determination of the risk margin is explicit. Anything that interferes with this approach opens the door to manipulation of financial results. The determination of the risk margin is probably the most subjective aspect of the current exit value model and can have the most significant financial impact. The determination of the risk margin should not be distorted by adjustments such as the one described in paragraph E26. If such potential exposures exist then these are likely to impact the price of risk and become part of the 'normal' risk margin determination.

*Appendix F: Risk margins*

The AASB supports the purpose of a risk margin as an: "explicit and unbiased measurement of the compensation that entities demand for bearing risk." The compensation that entities demand for bearing risk is otherwise known as the market value margin (MVM). The determination of the MVM is currently an area of considerable debate within the actuarial profession and is a concept that is still evolving. We believe that Appendix F needs to address this explicitly and acknowledge that this is an area of considerable judgement which may require specialist expertise.

The AASB supports the view that a future insurance standard should not provide detailed guidance on how a risk margin should be determined but should take a principles based approach. The guidance in an accounting standard should focus predominantly on defining the objectives of the measurement model and a broad discussion of issues that need to be considered in determining cash flows, discount rates and margins. In the context of determining risk margins in particular, the merit of this approach lies in the fact that, because this is a developing area of actuarial expertise a high degree of flexibility is desirable, and such an approach provides such flexibility.

However, whilst Appendix F, provides a clear view of the objectives of a risk margin, it provides only very high level guidance on the issues that need to be considered in determining risk margins, and some preparers might find the guidance insufficient. The IASB should liaise with preparers to ensure that they are comfortable with what is required. Whilst actuaries might prepare the calculations, boards of directors need to approve them; to do this they need to feel confident that they can adequately consider the actuarial recommendations in the light of what is required by the standard.

Chapter 3, paragraph 43 of the DP states: "estimates of cash flows and the associated probabilities should be neither conservative nor optimistic". The AASB supports this notion and notes that it should also be explicitly applied to the determination of the risk margin.

**Question 4**

***What role should the actual premium charged by the insurer play in the calibration of margins, and why?***
***(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.***
***(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?***
***(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.***
***(d) Other (please specify).***

AASB response

**The AASB supports option (c).**

The AASB has several concerns with Implementation A, option (a) above.
Implementation A calibrates the risk margin to the actual premium charged (less relevant

acquisition costs). In other words, the risk margin is said to be equal to premiums less acquisition costs. However, for an insurance contract that includes a service component, part of this balancing figure is a service margin. It is not clear how the service margin and risk margin would be separated. Indeed, under Implementation A, as the determination of the margin is entirely mechanical, any allocation would be arbitrary.

It is not clear how Implementation A would work in practice. The DP appears to favour locking-in the price of risk at inception, on the basis that the original transaction price is the only objective evidence of the price of risk that will ever exist – this is made clear in Table 3.2 in Chapter 3: *Risk margin – calibration*. However, some constituents believe that the recognition of profits is only restricted at inception. The AASB has concerns with any lock-in of assumptions which is inconsistent with a current exit value model. Furthermore, any lock-in of assumptions would be seen as a step backwards for Australian financial reporting.

Under Implementation A, the price would need to be corrected for the state of the insurance cycle; otherwise the price could never be considered a proxy for determining an objective risk margin. This can be done on the basis of the movement of average prices for similar risks, after correction for known trends and changes in economic conditions, however, this clearly creates departures from the key benefit of the model: objectivity.

Whilst the AASB does not support Implementation A for the reasons discussed above, prices do have a role to play; and the AASB supports option (c) which regards prices as one form of evidence of the risk margin. The role that prices should play in setting liability provisions depends on the quality of the other evidence available. As the quality of the conclusions drawn from the experience data weakens, greater reliance is placed on the underwriting judgement underlying the premium. This is more likely to be the case for larger commercial risks.

The AASB supports option (c) (Implementation B in the DP) because of the weaknesses with Implementation A described above, and, because it is the conceptually purer model. Conceptually, under a current exit value model, it would be inappropriate to restrict the recognition of profits on inception, providing all assets and liabilities have been appropriately recognised and measured.

**Question 5**

***This paper proposes that the measurement attribute for insurance liabilities should be 'the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity'. The paper labels that measurement attribute as 'current exit value'.***
***(a) Is that measurement attribute appropriate for insurance liabilities. Why or why not? If not, which measurement attribute do you favour, and why?***
***(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?***

**AASB response**

**"The amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity" is an appropriate measurement attribute for insurance liabilities, and 'current exit value' is an appropriate label for this measurement attribute. However, the model described in the DP is not consistent with this attribute.**

The AASB considers the measurement attribute: 'the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity' an appropriate attribute for measuring insurance contracts. The AASB views this model as consistent with the way in which the insurance industry is managed and views the outcome of the model as providing the most useful information for users as it reflects the uncertainty of the cash flows and reflects the economic substance of the contracts. Current exit value is considered an appropriate label for this attribute.

However, such a model is arguably not entirely consistent with the definitions of assets and liabilities in the IASB Framework. (The definitions of assets and liabilities are deterministic, whereas an exit value is based on expectations of future cash flows; see Section 3 for a more detailed discussion of this issue). The model proposed by the DP is not consistent with the measurement attribute outlined in Question 5 above, despite the fact that the DP asserts that it is. The measurement attribute actually described by the DP is: "the amount the insurer would expect to pay at the reporting date to transfer the assets and liabilities arising from the remaining contractual rights and obligations immediately to another party".

The DP seeks to build a measurement model that meets the definition of current exit value, outlined in the DP, but is restricted by the definitions of assets and liabilities in the IASB Framework. For example, participating benefits that are expected to be paid to

policyholders are not recognised as a liability if the cash flows do not satisfy a legal or constructive obligation that exists at the reporting date (insurers would consider the guidance in IAS 37 to determine this). Given the legalistic nature of the IASB's current views on constructive obligation under the proposed changes to IAS 37, there are likely to be participating benefits that are expected to be paid to policyholders that cannot be recognised as a liability in several jurisdictions. This is contrary to the notion of current exit value and is contrary to the measurement attribute purported by the DP.

The measurement attribute described in Question 5 above is consistent with an Expected Cash Flows Model described in Section 3.

**Question 6**

***In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:***
***(a) incorporate them in the current exit value of a separately recognised customer relationship? Why or why not?***
***(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?***
***(c) not recognise them? Why or why not?***

**AASB response**

**The AASB supports (b).**

This question needs to be considered more broadly than suggested.

Implicit in the DP, and the question, is the fact that cash inflows are already recognised and netted off against cash outflows where the net position is a liability.

Perhaps the two inter-related questions that should be asked are:

1. Should future cash inflows under existing contracts be recognised (irrespective of whether the contract as a whole generates a net asset or net liability)? This is addressed by question 7 below.
2. What is the appropriate unit of account? Are the cash inflows separate assets and the cash outflows separate liabilities or is the appropriate unit of account all cash flows under the contract as a whole?

Under the DP, the unit of account, for recognition purposes, is either the asset that arises from the rights under an insurance contract, or the liability that arises from the obligations under the insurance contract. The DP, in the first instance, discusses these two elements separately for the purposes of recognition. However, the final measurement proposals combine the asset that arises from the rights under an insurance contract and the liability that arises from the obligations under the insurance contract to a net amount as follows:

- Where the net position is a liability, all expected contractual cash flows are recognised. All expected future renewals are caught as they are seen as assets arising from a customer relationship, but closely related to the contract, and all insurance liabilities that meet the definition of a liability or constructive obligation are caught; and
- Where the net position is an asset, all insurance liabilities that meet the definition of a liability or constructive obligation are caught and only those renewal premiums that meet the guaranteed insurability test or that the insurer can compel the policyholder to pay are caught.

However, Chapter 4, paragraph 173(c) states: "The insurer need not separate that asset from the liability for *recognition*, measurement or presentation". The issue of unit of account is therefore not clear or consistently handled in the DP.

What is the appropriate unit of account for an insurance contract? To answer this it is necessary to consider:

- the IASB *Framework's* objectives and qualitative characteristics;
- the principles surrounding determination of the unit account in the suite of IFRSs;
- the measurement model proposed; and
- the nature of the item being measured – the rights and obligations under an insurance contract.

For the following reasons it could he argued that the appropriate unit of account for recognising and measuring an insurance contract is the net cash flows arising from a consideration of both the rights and obligations under an insurance contract:

- The measurement attribute is current exit value, it is not possible to transfer the rights or obligations alone, it is only an insurance contract that can be transferred;
- The rights and obligations under an insurance contract are interdependent; the obligations will not materialise without the insurer first benefiting from the rights;
- The unit of account should include all items that are integral to the item being measured and not separable from each other. Under IAS 38 'separable' means: "capable of being separated or divided from the entity and sold,

transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability";

- The unit of account should faithfully depict real-world economic phenomena;
- The unit of account adopted should provide the most decision-useful information; and
- Users are interested in estimating future cash flows; this underpins the key objective of financial reporting. A unit of account is the lowest level for which cash flows are largely independent of cash flows from other assets or groups of assets.

On this basis, the AASB considers that the appropriate unit of account for recognising and measuring insurance contracts is the net cash flows arising from the rights and obligations under the insurance contract. The AASB supports option (b) above; this is also supported by the response to Question 7 below.

**Question 7**

***A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?***
***(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained.***
***(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?***
***(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows).***
***(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, to (i) bear insurance risk or financial risk, or (ii) provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.***
***(e) No cash flows that result from beneficial policyholder behaviour.***
***(f) Other (please specify).***

## AASB response

**The AASB supports criterion (b). The AASB considers that the contractual provisions themselves should define the boundary of an existing insurance contract.**

The question asks, in cases where the net of cash inflows and cash outflows under the contract generate an asset, on what basis should those inflows be recognised.

The GI test proposed by the DP only impacts cash inflows where the overall net position is an asset. There is an inherent inconsistency in the approach to renewal premiums in the DP. Where, under a contract, the net position is a liability, all cash inflows are recognised and there is no discussion of the boundary of the contract. Where the net position is an asset, the GI test is applied. The GI test is introduced because of concerns with relying on the notion of contractual cash flows, despite the fact that this already applies in the case of a contract that is a net liability.

To answer the question, under the DP, future cash inflows are recognised under option (b) in cases where the net position is a liability. For consistency, the same criterion should apply to future cash inflows in cases where the net position is an asset. This is consistent with a current exit value model.

In section 1.1 of this submission, the AASB outlines its view that future premiums under existing contracts should be recognised on the basis that they meet the definition of a contractual asset. Based on this view and the arguments outlined above, the AASB supports criterion (b).

The question also asks, if option (b) is favoured, how would existing contracts be distinguished from new contracts? The AASB considers that the contractual provisions should define the boundary of the contract. It can be difficult to determine when an existing contract ends and a new contract starts: it is not uncommon for example for insurance contracts to contain options to extend or change insurance cover. The future exposure draft should include examples that provide guidance on how to determine the boundary of an insurance contract.

## Question 8

***Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?***

### AASB response

**An insurer should recognise acquisition costs as an expense when incurred.**

Under a current exit value model acquisition costs should be immediately recognised as expenses because the ongoing economic benefits they might represent are recognised elsewhere in a current exit value model.

Measuring these economic benefits using an expected value approach, as proposed hy the DP, is considered preferahle to using a model which measures the economic benefits based on costs, such as in a deferral and matching model, where acquisition costs are deferred and recognised as an asset.

## Question 9

***Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?***

### AASB response

**The AASB supports the DP proposals in relation to the treatment of insurance contracts acquired in a business combination or portfolio transfer.**

The AASB supports the approach taken by the DP in paragraph 173(e) to retain the expanded presentation if any significant differences remain between current exit value and fair value.

Where an insurer acquires a portfolio of contracts the consideration received is likely to he equal to the current exit value of the liabilities less the fair value of any assets acquired. However, where this is not the case, how should the transferee recognise any remaining difference? The DP considers three possihilities:

1. Recognise the difference as goodwill. However, the DP concludes that this would not he representationally faithful if the transferee acquires only separately recognisahle assets and liabilities. The AASB agrees with this conclusion;

2. Include the difference in the initial measurement of the liability. This would be a departure from the principle of measurement at current exit value. The AASB agrees that this would distort the current exit value measurement; and
3. Recognise the difference as income or expense. The DP concludes that this is the only faithful representation of the transaction. The AASB supports this conclusion.

**Question 10**

***Do you have any comments on the measurement of assets held to back insurance liabilities?***

**AASB response**

See section 1.6 for a discussion of this issue.

**Question 11**

***Should risk margins:***
***(a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?***
***(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?***

**AASB response**

See section 1.4 for a discussion of this issue. The AASB supports (b).

**Question 12(a)**

***Should a cedant measure reinsurance assets at current exit value? Why or why not?***

**AASB response**

**A cedant should measure reinsurance assets at current exit value.**

Reinsurance assets should be measured consistently with the measurement of the underlying insurance contract, that is, at current exit value.

**Question 12(b)**

***Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?***
***(a) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.***
***(b) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.***
***(c) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.***

**AASB response**

**The AASB agrees that (a), (b) and (c) are consequences of applying a current exit value model to reinsurance assets.**

Consequence (c) alludes to the fact that in most instances the underlying direct insurance contract and the reinsurance contract protecting it will have non-coterminous periods of cover.

The DP has not considered situations, which will commonly arise, where an insurer has a pre-claims liability and where the claim is expected to be incurred after the expiry date of the reinsurance contract that exists at the reporting date. The reinsurance contract would, if it were renewed, mitigate the liability. Under current Australian GAAP and regulatory reporting, an insurer is able to assume that reinsurance cover will be renewed, providing there are no reasons to believe this will not eventuate. This is considered a pragmatic response to this issue and is consistent with an expected cash flows approach and the notion of current exit value. The AASB would support such an approach under the future IFRS insurance standard.

The exposure draft needs to consider this issue as it can have a significant impact on the measurement of insurance liabilities. Clearly such an approach conflicts with the recognition criteria for assets under the IASB *Framework*, as it effectively involves recognising an asset arising from a reinsurance contract that does not exist at the

reporting date. However, not recognising the 'asset' would lead to spurious volatility in the income statement, with an overstatement of the insurance liability that would subsequently be reversed once the reinsurance contract is renewed.

**Question 13**

***If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?***

**AASB response**

**If an insurance contract contains deposit or service components, the insurer should unbundle them for presentation purposes. It would be preferable to eliminate the need to unbundle for measurement purposes.**

The AASB considers it appropriate to unbundle premiums into income and deposit components for presentation purposes, where this reflects the substance of the contract. Unbundling for measurement purposes is only required where there are mixed measurement models in existence. It would be preferable to eliminate this need for unbundling. The AASB considers, therefore, that the unbundling issue is more an issue of the most appropriate presentation of revenue and expenses. This is considered further in response to question 18.

Under AASB 1038, life insurers have split premiums into income and deposit components for presentation purposes, where this split is practicable, for many years. AASB 1038 takes this approach because splitting the premiums for presentation purposes reflects the substance of the cash flows. Prior to the implementation of IFRS 4, AASB 1038 dealt with the recognition and measurement of both life insurance and investment contracts issued by life insurers, and both types of contract were, therefore, measured consistently. There was, therefore, no need to unbundle these contracts for measurement purposes.

If unbundling of deposit components for measurement purposes is required, the deposit components should be measured as at fair value through profit or loss, under IAS 39, and should not be able to be measured at amortised cost. This will ensure that income and deposit components are measured consistently (except for the impact of the demand deposit floor under IAS 39). When Australian standards were updated to reflect the requirements of IFRS 4, it was an Australian requirement that deposit components that were separated and treated as a deposit were required to be measured at fair value through

profit or loss under IAS 39. Allowing measurement at amortised cost would be seen as a step backwards for Australian financial reporting.

The AASB notes that there are potential concerns with the proposed approach to unbundling. The DP proposes that when the deposit component and insurance component are interdependent, but can be measured on a basis that is not arbitrary, the components are measured as follows:

1. The deposit component is measured under IAS 39;
2. The whole contract is measured under the insurance standard; and
3. The insurance component is the difference between the first two measurements.

Such an approach may be appropriate where the deposit component is measured using the fair value option under IAS 39, but not otherwise. If the fair value option under IAS 39 is not used, the difference between the fair value of the deposit and the measurement option actually chosen applied to the deposit, becomes part of, and thereby distorts, the value of the insurance component, so that this component no longer gives meaningful information.

Even where the fair value option under IAS 39 is applied to the deposit component the result may not be meaningful. The demand deposit floor may effectively prohibit recognition of beneficial policyholder behaviour wbich is incorporated into the current exit value of the overall contract. A further measurement inconsistency can also occur due to the different approach to transaction costs under IAS 39 and IAS 18. These limit recognition to incremental expenses and require deferred acquisition costs to be treated as an asset separate from the liability.

Where an amount is derived as a difference hetween two other amounts, it is essential, therefore, that the two amounts are measured consistently.

To avoid these problems, the insurance component should either be measured independently or, if a difference approacb is to be used, the insurance component should be measured as the difference between the current exit value of the contract and the current exit value of the deposit component.

**Question 14(a)**

***Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why, or why not?***

**AASB response**

**The AASB agrees that conceptually, in a deep and liquid market, in most circumstances, the current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics. However, the AASB is not convinced that this is always true in practice.**

The presupposition that the current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics appears to be the basis of the credit characteristics proposals. This is based on the concept of a deep and liquid market made up of knowledgeable and willing parties. The AASB accepts this argument at a conceptual level. However, the AASB is not convinced that this argument always holds true in practice.

In a prudentially regulated insurance market an insurer with a low credit rating would not be allowed, by the regulator, to transfer its liabilities to another insurer with a low credit rating. In such a market, the market participant is not one with the same credit standing, but one that the regulator would allow to take over the portfolio of contracts. Whilst the transfer itself is hypothetical, the market should not be. In practice, the market for insurance contracts is not always a deep and liquid market made up of knowledgeable and willing parties. In any transfer of contracts, the price agreed is likely to be the result of a process of negotiation between the transferor and transferee – it is artificial to think that for every insurer there is a market of other insurers with the same claims paying ability who would be potential transferees, and that those with lower claims paying ability or higher claims paying ability would never become party to a transfer. In reality, in many cases, the transferee will be financially stronger than the transferor. The transferee will demand a price that maintains their claims paying ability, not one that reduces it.

**Question 14(b)**

***Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?***

**AASB response**

See discussion of this issue in section 1.5. If it is accepted that an insurance contract has credit characteristics, under a current exit value model, the model must reflect subsequent changes in the effect of credit characteristics.

**Question 15**

***Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?***

**AASB response**

**Changes to the treatment of financial liabilities should only be considered as part of a broader review of IAS 39 and fair value measurement generally.**

It would be preferable for the inconsistencies between the proposed treatment of insurance liabilities and the existing treatments under IAS 39 of financial liabilities to be eliminated; however, this should only be considered as part of a broader review of IAS 39 and fair value measurement generally.

However, the AASB notes the significant inconsistency in fair value measurement under IAS 39, with its demand deposit floor, and current exit value under the DP. The deposit floor is inconsistent with the notion of fair value and with current exit value, both of which are based upon expectations of future cash flows.

**Question 16(a)**

***For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?***

**AASB response**

**The AASB supports the DP proposals in relation to participating contracts.**

The AASB considers that for participating contracts, the cash flows for each scenario should incorporate an unbiased estimate of the policyholder dividends payable in that scenario that satisfy a legal or constructive obligation that exists at the reporting date.

An alternative view is that, to be consistent with a 'true' current exit value model, the cash flows should also include any additional cash flows that are expected to be paid to policyholders, but that do not satisfy a legal or constructive obligation. This would be consistent with an Expected Cash Flows Model discussed in Section 3 and current Australian requirements under AASB 1038.

Under the Australian Life Act (which applies to all Australian life insurance contracts) all expected payments to policyholders are expected to satisfy a legal or constructive obligation that exists at the reporting date. However, the AASB is aware that in some jurisdictions there will be some expected payments to policyholders that will not satisfy a legal or constructive obligation and that would therefore be recognised in equity. This presentation would be misleading to users, and it is the AASB's view that the IASB should either:

- Make a departure from liability recognition requirements, and present expected payments as a separate component of insurance liabilities, on the basis that such information is more useful to users; or
- Present such amounts as a separate component of equity ('policyholder equity').

**Question 16(b)**

***An Exposure Draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?***

**AASB response**

**The future insurance standard should discuss the issue of constructive obligations in relation to participating contracts.**

The issue of constructive obligation in relation to participating contracts is complex and specific to these types of contracts. It would be most appropriate to include a discussion of constructive obligation in relation to participating contracts in a future exposure draft, rather than directing insurers to IAS 37.

**Question 17**

***Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why, or why not?***
***(a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).***
***(b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).***
***(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).***
***(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).***

**AASB response**

**The IASB should consider these asset issues as part of a broader review of asset and liability measurement where related assets or liabilities are measured at fair value. The AASB considers that all assets backing unit-linked liabilities should be**

**measured at fair value as this reflects the economic substance of these contracts and therefore provides the most useful information to users.**

As discussed previously, it is the AASB's view that accounting mismatches should be eliminated. Under a unit-linked contract the value of the liability is dependent upon the fair value of the assets supporting those liabilities. Unit-linked liabilities should be measured at current exit value as should the related assets; this is the only treatment that provides meaningful information to users and reflects the economic substance of the contracts. However, given the current suite of IFRSs, the AASB acknowledges that the IASB would need to consider these asset issues as part of a broader review of asset and liability measurement where related assets or liabilities are measured at fair value.

Where the assets concerned are backing unit-linked liabilities, the AASB supports:

- the recognition of treasury shares as financial assets, measured at fair value, where these shares are held purely for the beneficial ownership of policyholders;
- the recognition of internally generated goodwill of a subsidiary if the investment in that subsidiary is held purely for the beneficial ownership of policyholders (this is consistent with the treatment under AASB 1038, before it was updated to reflect IFRS requirements);
- measuring all assets at fair value through profit or loss if the assets are held purely for the beneficial ownership of policyholders (this is consistent with the treatment under AASB 1038, before it was updated to reflect IFRS requirements).

All of the above are seen as consistent with an exit value measurement approach.

The AASB does not support adjusting the liability measurement as this compromises the integrity of the liability measurement and is not consistent with the current exit value model.

The AASB notes the difficulties that have arisen as a result of accounting mismatches for unit-linked contracts in Australia. The financial impact of the mismatches can be significant and they have led some entities to have to include additional disclosures on the face of the income statement before they are considered capable of presenting a true and fair view. The AASB considers that this undermines confidence in accounting standards in the business community generally.

The AASB also notes that similar issues exist for participating contracts as, for these contracts; the liability to participating policyholders will also be linked to the value of the supporting assets.

## Question 18

***Should an insurer present premiums as revenue or as deposits? Why or why not?***

## AASB response

**Deposit components that have been unbundled should be presented as deposits and all other premiums should be presented as revenue.**

The treatment of premiums should follow the unbundling requirements. Where a contract is unbundled, the premium for the insurance component should be treated as revenue, while that for the deposit component should be treated as a deposit. Where there is no unbundling, the insurance premium should be treated as revenue. To do anything else would be less relevant and understandable for users.

The discussion of presentation in the DP takes a very broad view of the notion of a 'deposit' when discussing presentation; a view that is not consistent with the, commonly accepted, notion of a deposit used when discussing unbundling. Using the term 'deposit' in two different ways in the same DP is confusing and could lead to a misunderstanding of the unbundling proposals.

The DP takes the view that the premium paid by a policyholder could be seen as a deposit, on the basis that payment is received prior to the provision of service. The AASB does not agree with this view and considers that it would add unnecessary complexity to the measurement model. The policyholder who buys a motor insurance contract is not likely to consider the premium that he has paid to the insurer as a deposit that will be returned if a claim arises. The premium paid is an expense for transferring risk. The policyholder is most likely to receive nothing back from the insurer and even if he does the cash flows that he receives will bear no relationship to the premium that he paid.

The AASB notes that the issue of presentation is part of a wider debate that needs to take place in relation to how revenue and expense is presented in a fair value measurement model. In a fair value measurement model the income or expense is the change in fair value, however, the critical issue is the way this is to be analysed in the income statement to provide the most useful information for users. As well as involving determining whether premium is revenue or a deposit, if the premium is considered to be revenue, the insurer needs to determine the amount of revenue presented in the income statement for a reporting period. The IASB should address this in the exposure draft.

**Question 19**

***Which items of income and expense should an insurer present separately on the face of its income statement? Why?***

**AASB response**

The following insurance income and expense items should be presented on the face of the income statement:

- gross written premium;
- reinsurance premium ceded;
- gross claims incurred, including movement in gross liability provisions, but net of salvage and subrogation;
- reinsurance recoveries due, including movement in recovery provisions;
- commissions paid;
- management expenses paid, net of exchange commission; and
- investment income.

The notes to the financial statements would need to include an analysis of the movement in insurance liabilities.

**Question 20**

***Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?***

**AASB response**

**It is the AASB's view that the income statement should include all income and expense arising from changes in insurance liabilities.**

Under a current exit value model the income statement must include all income and expenses arising from changes in insurance liabilities.

**Question 21**

***Do you have other comments on this paper?***

**AASB response**

See sections 1, 3, and 4 for other comments.

## Section 3: Expected Cash Flows Model

The DP proposes a current exit value model for measuring insurance contracts. However, when considering the building blocks that are used to determine current exit value (given the absence of an observable price for insurance contracts), the DP uses the IASB *Framework's* asset and liability recognition rules to justify recognition of cash inflows and outflows arising from the rights and obligations under an insurance contract. However, under a 'true' current exit value model, the existence of the contract itself justifies recognition of all expected future cash flows. The reference to asset and liability recognition rules creates inconsistencies with the conceptual current exit value notion. An Expected Cash Flow Model (ECFM) is a model that is consistent with the current exit value notion. An ECFM is based upon recognition of insurance contracts and measurement of all expected cash flows expected under the insurance contracts. As demonstrated below, it is also consistent with the direction of the IASB's project to improve the IASB *Framework* and with the developments in fair value measurement.

Chapter 3, paragraph 31 states: "The Board's objective is to select a measurement model that gives users useful information about the amount, timing and uncertainty of the future cash flows resulting from the contractual rights and contractual obligations created by insurance contracts".

Chapter 3, paragraph 92 states: "the measurement that results from using those three building blocks will be most helpful to uses if it represents faithfully a real-world economic attribute of the asset or liability being measured".

Chapter 3, paragraph 93 states that the DP proposes a current exit value model defined as: "the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity".

All of the statements above are consistent. However, the actual model described in the DP is not consistent with these statements because it does not, for example:

- recognise certain participating benefits that are expected to be paid (because these do not meet the definition of a liability or constructive obligation), despite the fact that these are obligations under the contract, albeit, obligations whose amount or timing may be at the insurer's discretion; or
- recognise certain renewal premiums that do not pass the guaranteed insurability test, despite the fact that these premiums are, arguably, contractual assets, arising from the insurer's contractual rights under the contract, albeit, rights that cannot be enforced.

A 'true' current exit value model will measure all the expected cash flows that arise from existing insurance contracts. However, such a measurement would include the internally generated goodwill that arises from the customer relationship that is created when an insurer writes a contract. For the purposes of financial reporting, therefore, the current exit value model should measure the expected cash flows that arise from the rights and obligations under existing insurance contracts.

An ECFM is based on the unit of account being the combined cash flows arising from the rights and obligations under the contract. These cash flows are interdependent and can only be transferred as a single unit, not separated into inflows and outflows. The cash flows give rise to a net asset or a net liability.

An ECFM would differ from the model proposed in the DP as follows:

- all expected future premiums under existing contracts are included in the liability measurement; and
- all expected payments under participating contracts are reflected in the liability measurement.

As discussed above, under an ECFM it is the existence of the rights and obligations under a contract that satisfies the recognition requirements; everything else is a matter for measurement. Hence, a participating contract obliges the insurer to provide both guaranteed and discretionary benefits to the policyholder over the life of the contract. The amount of the discretionary benefit (which in some periods could be zero) is an issue for measurement not recognition.

The expected cash flows model is guided by the notion of current exit value and the developments in fair value accounting, and the IASB Framework, given that the insurance project is being developed in parallel with the development of a fair value measurement standard[1] and an improved conceptual framework[2].

Whilst the fair value project is in its early stages, it is clear that where there is a current market price for an asset or liability that is traded in a deep and liquid market, this market price is the fair value. Prices in deep and liquid markets are based on the cash flow expectations of participants in those markets. Hence, where an asset or liability is not traded in a deep and liquid market, the cash flow models that the fair value hierarchy employs to measure those assets and liabilities, should emulate those market prices, that is, they should be based on expected future cash flows. A current exit value model is a

[1] Discussion Paper *Fair Value Measurements* published November 2006

[2] Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* published in July 2006

fair value type model, and, therefore, the model should be based on expected future cash flows.

That view is also supported by the IASB's preliminary views on an improved conceptual framework that the objective of financial reporting is to: "provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocations." To achieve this objective, financial reports should provide information: "to help present and potential investors and creditors and others to assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows".

The views described above are inconsistent with the existing recognition requirements for assets and liabilities and these have generated problems in the DP. The determination of future cash flows is inherently stochastic and gives equal weight to inflows and outflows, whereas the recognition rules for assets and liabilities are inherently deterministic and are not the same for assets and liabilities sometimes leading to misleading results. A model that is based on expected future cash flows addresses these problems. The AASB notes that the IASB should be mindful of the inherent conflicts which exist between fair value measurement and the existing definitions of assets and liabilities.

An ECFM is supported by the following:

- provides a coherent basis for a measurement model;
- consistent with a true current exit value notion;
- consistent with the current notion of fair value, and the preliminary views on the improved conceptual framework;
- consistent with current valuation methodologies which are based on expected cash flows;
- reflects the economic substance of insurance contracts;
- consistent with insurers' pricing methodologies; and
- consistent with the current approach under AASB 1038, which has operated successfully for almost ten years in Australia.

# Section 4: Other Issues

## 4.1 What is an insurance liability?

The DP is inconsistent in the way in which it describes an insurance liability and the cash flows that should be incorporated into a measurement model, that is, whether the measurement incorporates obligations alone or both obligations and rights under an insurance contract. The following examples of such inconsistencies are noted:

- The current exit model proposed in the DP is defined as: "the amount the insurer would expect to pay at the reporting date as consideration for transferring its remaining contractual rights and obligations immediately to another entity."
- Chapter 1, paragraph 19 of the DP states: "insurance liability refers to an insurer's obligations under an insurance contract, insurance asset refers to an insurer's rights under an insurance contract";
- Chapter 3, paragraph 31 of the DP states that the Boards objective is to select a model that "gives users useful information about ... the future cash flows resulting from the contractual rights and contractual obligations created by insurance contracts"; and
- Appendix E, paragraph E24 of the DP states that estimates of cash flows should include "cash flows arising ... from the contractual rights and contractual obligations associated with the ... insurance contracts".

## 4.2 Application of current exit value model to other IASB projects

Chapter 1, paragraph 11 of the DP discusses the interactions of the insurance project with other IASB projects and states: "The Board expects that the work on insurance contracts will proceed in parallel with these other projects and will not wait for their outcome. Also, this work may generate useful inputs for those other projects".

A current exit value model is appropriate for insurance contracts for the following reasons:

- Insurance contracts are subject to significant uncertainty, and in many cases several possible outcomes, and outcomes can be significantly asymmetrical;
- The economic rationale for an insurer is that by insuring large numbers of similar risks and/or different types of risks, risk is diversified and outcomes can be predicted with a reasonable degree of certainty; and
- The model is consistent with the way in which insurers manage their business and the way in which market participants would, therefore, price the liability.

Based on all of the above, it is therefore believed to provide the most useful information to users.

For example, an insurance contract has the following expected losses:

5% probability of a $1,000 loss
55% probability of a $200 loss
40% probability of a $0 loss

The expected value of the loss is $160 ($50+$110+$0).

If the insurer had a portfolio of 1,000 contracts it could feel reasonably confident that the actual outcome will be close to $160,000. However, if the insurer wrote just one risk the expected value of $160 is arguably not the most appropriate value for the liability. The mode of $200 might be considered more appropriate. This is analogous to other non-insurance liabilities held by other entities, for example a liability for legal litigation. Whilst the current exit value is appropriate for the measurement of insurance contracts it might not be appropriate for the measurement of other liabilities, although it might be useful as a disclosure as it indicates the extent of uncertainty in the cash flows.

### 4.3 Unearned premium a proxy for current exit value

Chapter 3, paragraph 112 states:

> "The Board's preliminary view is that current exit value is the most relevant and reliable measurement attribute for all insurance contracts. For many short-duration contracts, unearned premium may often be a reasonable approximation to current exit value. However, an insurer should not make this assumption without testing it, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception."

In most jurisdictions the existing accounting model for non-life insurance contracts is a deferral and matching model. For these jurisdictions the DP proposes a significant change in the measurement of pre-claims liabilities, from a simple model to a complex one. Some might question the benefits gained from this increased complexity. This appears to be the main reason behind the concession in paragraph 112 above. As stated in paragraph 111(a):

> "For many short-duration contracts, the pre-claims period is short (six months on average for an annual contract). If an insurer identifies significant changes in that short period, the changes are much more likely to lead to losses than to gains. If any material losses exist, a liability adequacy test would detect them. For these contracts,

> unearned premium may be a reasonable proxy for current exit value, but obtainable with less cost and effort."

Whilst the AASB acknowledges the views expressed in paragraph 111(a), it does not consider paragraph 112 to be workable in practice. A high level review of future cash flows (akin to many existing liability adequacy tests) would probably not be sufficient to ensure that the unearned premium liability is a reasonable proxy for current exit value. It could also mean that the measurement model may change from year to year depending on the stage of the insurance cycle. Paragraph 112 may be designed to appease those who are resistant to change, however, the IASB should not allow the unearned premium model to be used at all if it is to adopt a current exit value model.

The AASB notes that, in any case, in the context of the concept of materiality, preparers could choose to use approximations to determine current exit value; the future standard need not encourage such approximations.