

## Draft Comment Letter

Comments should be submitted by 18 October 2013 to [Commentletters@efrag.org](mailto:Commentletters@efrag.org)

### *Note to constituents*

*EFRAG will field-test the revised proposals during its consultation period. The field-testing activities, and their role, are further explained in Appendix 3. The views expressed in this letter do not yet reflect the results of the field-test.*

XX November 2013

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir/Madam,

### **Re: Insurance Contracts**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the revised Exposure Draft *Insurance Contracts*, issued by the IASB on 20 June 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the IASB's decision to re-expose the initial Exposure Draft *Insurance Contracts* that was issued in July 2010 (the '2010 Exposure Draft'). We note that changes to the 2010 Exposure Draft have been proposed based on the comments received from constituents, including EFRAG. EFRAG appreciates the effort with which the IASB has considered its requests to address the accounting mismatches that may arise from the application of different measurement models to financial assets and insurance liabilities, to distinguish short-term volatility from performance of an insurer, to review the proposals relating to the adjustment of the contractual service margin and to introduce retrospective application of the future standard.

We provide below a summary of EFRAG's position on the revised proposals together with our main concerns that remain unaddressed.

Regarding the general measurement and presentation requirements, EFRAG agrees with the IASB's proposal to segregate the effects of changes in the discount rate in the insurance contracts liabilities in OCI. However, we are concerned that the IASB's proposals in the ED in combination with the classification and measurement requirements in other standards are not helpful in eliminating accounting mismatches and would result in reporting the insurance performance split across Profit or Loss and OCI.

EFRAG believes that applying different measurement and presentation requirements for assets in which the entity has invested to match its insurance liabilities is neither helpful in the elimination of accounting mismatches, nor best in depicting the long-term investment business model of insurance activities.

EFRAG tentatively believes that the IASB should acknowledge the long-term investment 'liability driven' business model as supporting the measurement of assets at fair value and recognising in OCI the effects of revaluation other than impairment, with recycling of realised gains and losses. In principle, the use of fair value through OCI should cover all assets involved in the asset-liability management when it aims at matching stable liabilities and would therefore include debt instruments that do not meet the contractual cash flow characteristics, equity shares and property. In the course of its own due process, EFRAG will consider if and how the asset-liability management practices can bring the necessary objective evidence of such a long-term 'liability driven' business model. For these assets, involved in asset-liability management, we tentatively believe that entities should present in Profit or Loss (i) returns on assets, (ii) gains and losses on realisation and (iii) impairment losses, which together with the interest cost of the period provide the primary indicator of performance for these activities, i.e. net return on assets and capital gains; while outstanding gains and changes in them would be recognised in OCI<sup>1</sup>.

We note that the IASB's proposals include a measurement and presentation exception for contracts that require the entity to hold the underlying items and specify a link to the returns of those items. EFRAG agrees with the IASB's objective to eliminate accounting mismatches when the terms of the contract mean that the entity will not suffer any economic mismatches, as this is consistent with our view that accounting mismatches should be avoided, while all economic mismatches should be faithfully represented. EFRAG supports 'mirroring' as a principle and some aspects of the approach proposed by the IASB. However, EFRAG has concerns on several aspects of the proposed approach, namely: a) In EFRAG's view, 'mirroring' should start from the liabilities side and not from the assets side; b) The proposed measurement and presentation exception will only apply to limited types of contracts. If the IASB proposal is retained, EFRAG believes the scope should be wider; c) Part of the insurance liability will be measured on a basis different from the present value of the fulfilment cash flows; and d) Presenting the effects of changes in the discount rate partly in other comprehensive income and partly in Profit or Loss would make financial statements difficult to understand and would impair comparability of contracts with similar economic features. EFRAG supports the proposal that the discount rate used to measure asset dependent cash flows shall reflect the extent of that dependence.

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<sup>1</sup> Notes to constituents: EFRAG acknowledges that such a decision would require to determine a second impairment model in IFRS 9. EFRAG is not ready at this stage to formalise a recommendation as to what this impairment model should be.

In the context of the contracts referred to above, EFRAG understands that the European insurance industry and other global insurers are developing an alternative to the IASB's 'mirroring approach', which is based on the present value of the fulfilment cash flows for all insurance contracts and results in one consistent approach to measure all insurance liabilities.

Appendix 5 provides an overview of the key elements of the alternative approach and the main differences with the IASB's proposals for contracts with cash flows that are asset-dependent.

EFRAG has not yet formed a view on the alternative approach and has not yet assessed its technical details, operational complexities or conceptual/technical merits. However, EFRAG has tentatively expressed several concerns on the 'mirroring approach' proposed by the IASB as mentioned above. In the finalisation of its comment letter, EFRAG intends to consider whether the alternative approach, wholly or partly, can address these concerns and which views, if any, EFRAG will express in respect of this alternative approach. It is of the utmost importance to EFRAG that the final requirements lead to providing useful and understandable information to users.

In relation to the proposals for adjusting the contractual service margin, EFRAG agrees with the IASB's proposal to adjust the contractual service margin, as differences between the current and previous estimates of cash flows that relate to future coverage or services will affect the profitability of the contracts. EFRAG believes that the contractual service margin shall represent the unearned profit in an insurance contract as this would result in decision-useful information. Accordingly, EFRAG believes that this margin should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage.

Regarding the proposals on transition, EFRAG agrees with the proposed modified retrospective approach as we understand that in many circumstances entities would be able to make a reasonable estimation of the remaining contractual service margin based on historic public and internal information about the various portfolios. However, if the IASB were to require different effective dates for IFRS 9 and the new insurance contracts standard, EFRAG recommends that for all entities where insurance forms a significant part of the entities' activities:

- a) The effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the new insurance contracts standard should be permitted, so as to facilitate the concomitant application of IFRS 9 and the new standard on insurance contracts at the earliest possible date; and
- b) Entities should be permitted to reconsider designations of hedges and the fair value option and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard. EFRAG further recommends a three year implementation period from the date of publication of the new insurance contracts standard.

At present, EFRAG does not express a view about the proposals in the ED in relation to insurance contract revenue and expense and has provided the arguments for and against the IASB's proposals taking into account the concerns raised by many insurance industry constituents. EFRAG's response will be finalised once the results of the field-test have become available, taking into consideration views and arguments expressed by constituents.

The re-exposure will allow constituents to assess whether the revised requirements would provide information about insurance contracts, which is useful, comparable and easy to understand by users and could be implemented without unjustified costs or difficulties by preparers. To support the IASB's effort in developing a robust standard for

insurance contracts, EFRAG, in addition to its usual analysis and due process, is organising field-test activities in cooperation with national standard setters of Germany, France, Italy and the UK, and the IASB with participants from the insurance and reinsurance industry. In particular, we are testing the IASB's proposals to present insurance contract revenue in Profit or Loss.

We appreciate the joint collaboration with the IASB staff in the field-test activities and the possibility to participate in the forthcoming IASB outreach activities carried out with users of financial statements.

Our detailed responses to the questions in the ED are set out in the Appendix 1. The remarks included in this Appendix focus on the specific questions raised in the ED. In addition, our letter also contains the following:

- Appendix 2 includes additional comments for the IASB's consideration;
- Appendix 3 describes the field-testing activities which EFRAG is carrying out in cooperation with the national standard setters as mentioned above and the IASB staff. The final letter will present the results of those activities.
- Appendix 4 provides suggestions for clarifying a number of proposals in the ED;
- Appendix 5 summarises the alternative approach suggested by the insurance industry for contracts with asset-dependent cash flows.

If you would like to discuss our comments further, please do not hesitate to contact Ralitza Ilieva, Richard Van der Pluym or me.

Yours sincerely,

Françoise Flores

**EFRAG Chairman**

## APPENDIX 1

The comments included in this Appendix are focusing on the specific questions raised in the ED and implementation issues identified by the activities described in the cover letter on the topics subject to re-exposure.

### EFRAG's responses to the questions raised in the exposure draft

#### ADJUSTING THE CONTRACTUAL SERVICE MARGIN

##### Question 1

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if:

- (a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
- (b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in Profit or Loss?

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

#### Notes for EFRAG's constituents

- 1 *The ED proposes that the contractual service margin shall represent the unearned profit in an insurance contract.*

##### Initial measurement

- 2 *At initial recognition, unless the portfolio of insurance contracts that the contract belongs to is onerous, the sum of the contractual service margin and all the cash flows included in the measurement of the insurance contract equals zero. Those cash flows include the fulfilment cash flows at initial recognition and any cash flows received or paid before the date of initial recognition.*

- 3 *The fulfilment cash flows referred to above would include the initial intrinsic and time value of options and guarantees embedded in insurance contracts that are not accounted for separately under IFRS 9 Financial Instruments. The initial measurement of these features would be considered when an entity estimates at inception the contractual service margin, irrespective of whether the contract is measured under the general requirements in the ED or the proposed measurement and presentation exception for contracts that require the entity to hold the underlying items and specify a link to the returns on those underlying items.*

##### Subsequent measurement

- 4 *The ED proposes that differences between the current and previous estimates of cash flows should be:*
  - (a) *Added to, or deducted from, the contractual service margin if those changes relate to future coverage or services;*

- (b) *Recognised immediately in profit and loss if those changes relate to coverage or services in the current or past periods.*
- 5 *Under the general measurement requirements, the ED does not distinguish the cash flows arising from options and guarantees for the purpose of subsequent measurement from the total expected cash inflows and outflows when those features are embedded in insurance contracts. Although the ED is not explicit on the issue (please see Appendix 4 that includes suggestions for clarification in the drafting), EFRAG understands that the subsequent changes in the intrinsic and time value of options and guarantees would be recognised:*
- (a) *In Profit or Loss as changes in cash flows, provided that the options and guarantees do not relate to future coverage or other future services provided under the contract (in which case the changes in their value would adjust the contractual service margin), and*
- (b) *In OCI to reflect the effect of changes in the discount rate in the intrinsic and time value of these options and guarantees.*
- 6 *Under the measurement and presentation exception for contracts that require the entity to hold the underlying items and specify a link to the returns on those underlying items, the treatment of the cash flows arising from options and guarantees differs, as is explained under question 2.*
- 7 *The proposal above changes the IASB's conclusion in the 2010 Exposure Draft, which stated that all changes in estimates should be recognised immediately in Profit or Loss.*
- 8 *The ED requires that an entity accretes interest on the carrying amount of the contractual service margin, and the rate used for this accretion of interest should be the discount rate of the liability determined at initial recognition (i.e. a locked-in rate).*
- 9 *An entity shall recognise the remaining contractual service margin in Profit or Loss over the coverage period in the systematic way that will best reflect the remaining transfer of services that are provided under the contract.*
- 10 *The ED proposes that an entity shall determine the contractual service margin at inception at a level of a portfolio. When releasing this margin to Profit or Loss, entities should determine a level of aggregation such that once the coverage period has ended, the contractual service margin has been fully recognised in Profit or Loss.*

#### **EFRAG's response**

**EFRAG believes that the contractual service margin shall represent the unearned profit in an insurance contract, as it considers that this results in decision-useful information.**

**As a result, EFRAG agrees with adjusting the contractual service margin as differences between the current and previous estimates of cash flows that relate to future coverage or services which will affect the future profitability of the contracts. Such accounting would also avoid counterintuitive results of immediate recognition of adverse changes in estimates when contracts are profitable, and bring consistency with how the margin is determined at inception.**

**However, considering that the contractual service margin represents the**

**unearned profit in an insurance contract, EFRAG believes that it should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage.**

*Contracts accounted for using the general measurement requirements in the ED*

Changes in estimates of the present value of future cash flows

- 11 In its comment letter in response to the 2010 Exposure Draft, EFRAG highlighted as a main concern the fact that the proposals did not result in the contractual service margin representing the unearned profit that entities would recognise by providing services when this approach would provide the most useful information. EFRAG therefore agrees with the ED proposal that differences between current and previous estimates of the present value of future cash flows should be added to, or deducted from, the contractual service margin if those changes relate to future coverage or services, provided that the margin does not become negative.
- 12 In our view, adjusting the contractual service margin for the changes in estimates referred to above would provide a faithful representation of the remaining unearned profit as those changes affect the future profitability of the contracts. More particularly, we agree with the rationale in paragraph BC31 of the ED that this measurement would avoid counterintuitive results of immediate recognition of adverse changes in estimates when contracts are profitable, while it would bring consistency between the initial and subsequent measurement of the contractual service margin.
- 13 EFRAG acknowledges that the distinction between differences in estimates that relate to future coverage and other future services under the contract and experience adjustments relating to past coverage may lead to complexity in practice, as entities would need to identify separately the cash flows that would adjust the contractual service margin and those that would be recognised immediately in Profit or Loss. However, we believe that this increase in complexity would be outweighed by the more transparent and relevant information on the effects of changes in estimates in the notes.

**Question to constituents**

- 14 Do you believe that the distinction between changes in estimates relating to future coverage or other future services and experience adjustments would involve a significant amount of judgement? If so, do you believe that the proposed guidance provides sufficient explanation on how entities make this distinction?

Changes in the risk adjustment

- 15 Considering EFRAG's view that adjusting the contractual service margin would provide relevant information about the effect of changes in estimates after initial recognition, we do not agree with the IASB's proposal that the effect of changes in the risk adjustment should be fully recognised in Profit or Loss in the period of the change.
- 16 The IASB argues in paragraph BC32(e) of the ED that changes in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time. However, as noted in paragraph BC36 of the ED, changes in the risk adjustment contain three components: (i) a release from risk as the

coverage period expires, (ii) changes in risk that relate to future coverage, and (iii) changes in risk that relate to incurred claims.

- 17 Considering that the contractual service margin represents the unearned profit, EFRAG believes that it should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage. We understand that one of the reasons why the IASB did not propose to adjust the contractual service margin is the difficulty inherent in the disaggregation between components in each reporting period. However, EFRAG believes that such split would be more consistent with the principles underlying the general measurement model and would not require additional efforts by preparers. In particular, EFRAG understands that insurers are used to determine separately the part of the risk adjustment that relates to a particular reporting period and the part that refers to future coverage.

Recognition in Profit or Loss of the contractual service margin

- 18 EFRAG agrees with the ED proposals that the contractual service margin should be recognised over the coverage period in a pattern that reflects the provision of services as required by the contract, as we believe that insurance coverage would be the primary service provided once entities would have identified and accounted for separately any distinct investment components and goods and services embedded in the contracts. In the case that the premiums charged to policyholders include payments for other services not accounted for separately, like asset management, we still believe that entities should recognise the contractual service margin over the coverage period, because this is the period over which entities would provide the insurance coverage and other services promised in the insurance contracts.
- 19 We acknowledge that entities may also provide a service to policyholders in the settlement period; however, we agree with the IASB's view that the settlement of insurance liabilities should not be considered as a service that is promised in the insurance contracts. In effect, the definition of an insurance contract focuses on the transfer of significant insurance risk rather than on the provision of services necessary to settle the obligations arising from the insured events. We further note here that the risk adjustment that entities would recognise for bearing risk would be recognised in Profit or Loss as they are released from risk in both the coverage and settlement period.

Accretion of interest on the contractual service margin

- 20 The ED requires the contractual service margin to be adjusted for the time value of money through accretion of interest using the interest rate determined at the inception of the contract. We understand that the main objective of accreting interest is to reflect the change in value that occurs when the premium is received before the related services are provided rather than reflecting the current price that the entity would charge at the reporting date to provide the remaining services.
- 21 EFRAG agrees with accreting interest on the contractual service margin given that the margin is the difference at inception of the various components all of which are discounted and it would convey more useful information about the entity's progression on providing the promised services under the contract. We further note that if interest was not accreted on the contractual service margin, the amount recognised as income in future periods would be understated, in particular for long-term insurance contracts.



*Contractual service margin for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items*

- 22 As explained in our answer to Question 2 below, EFRAG has some concerns about the measurement and presentation exception that the IASB is proposing for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. Please refer to Question 2 for more detailed explanations regarding EFRAG's position.

**CONTRACTS THAT REQUIRE THE ENTITY TO HOLD UNDERLYING ITEMS AND SPECIFY A LINK TO RETURNS ON THOSE UNDERLYING ITEMS**

**Question 2**

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

- (a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
- (b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
- (c) recognises changes in the fulfilment cash flows as follows:
  - (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in Profit or Loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
  - (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in Profit or Loss; and
  - (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in Profit or Loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

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

**Notes for EFRAG's constituents**

- 23 *The ED proposes a measurement and presentation exception, which would apply if the contract:*
- (a) *requires the entity to hold underlying items; and*

- (b) *specifies a link between the payments to the policyholder and the returns on those underlying items.*
- 24 *The proposed exception is often referred to as ‘mirroring approach’ and is an exception to the general measurement requirements (i.e. an exception to the ‘building block approach’).*
- 25 *If the criteria in paragraph 23 above are met and the fulfilment cash flows are expected to vary directly with returns on underlying items, the entity should at initial recognition and subsequently measure the fulfilment cash flows by reference to the carrying amount of the underlying items.*
- 26 *Changes in the fulfilment cash flows would be recognised in Profit or Loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items which the entity holds.*
- 27 *If the two criteria in paragraph 23 above are met and the fulfilment cash flows are not expected to vary directly with returns on underlying items, the entity should at initial recognition and subsequently measure the fulfilment cash flows in accordance with the general measurement requirements (i.e. using the expected value and taking into account risk and the time value of money). Examples of such cash flows are fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated.*
- 28 *Changes in the fulfilment cash flows would be recognised as follows:*
- (a) *If they are expected to vary indirectly with the returns on the underlying items, they would be recognised in Profit or Loss; and*
- (b) *If they are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (e.g. with mortality rates) and those that are fixed (e.g. fixed death benefits), they would be recognised in Profit or Loss and in other comprehensive income in accordance with the general requirements.*

*Although the ED is not explicit on the issue (please see Appendix 4 that includes suggestions for clarification in the drafting), EFRAG understands that the subsequent changes in the intrinsic and time value of the options and guarantees that are not unbundled would be wholly recognised in Profit or Loss as if they were a bifurcated embedded derivative accounted for under IFRS 9 Financial Instruments. That is, these features are considered to vary indirectly with the returns on underlying items. Accordingly, no amounts would be presented in Other Comprehensive Income or adjusted in the contractual service margin.*

- 29 *An entity shall determine whether the contract specifies a link considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation.*
- 30 *Underlying items may include specified assets and liabilities, an underlying pool of insurance contracts or the assets and liabilities of an entity as a whole.*
- 31 *This exception has been introduced to eliminate accounting mismatches between the cash flows from an insurance contract and underlying items when the terms of the contract are such that the entity will not suffer any economic mismatches. The 2010 Exposure Draft did not propose such an exception to the general measurement and presentation requirements, instead the 2010 Exposure Draft*

*proposed that entities measure underlying items at fair value through Profit or Loss in order to avoid accounting mismatches.*

- 32 *In order to apply the above exception, an entity shall decompose the cash flows in a way that maximises the extent to which the measurement both:*
- (a) Expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and*
  - (b) Maximises the minimum fixed payment that the policyholder will receive.*
- 33 *The ED also proposes (paragraph 26(a)) that to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depend wholly or partly on the returns on underlying items, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows shall reflect the extent of that dependence. Paragraph BC44 notes that the dependence is reflected regardless of whether the relationship between the cash flows of the contract and the underlying items is specified by the contract or whether the relationship arises because the entity has discretion over the amount and timing of payments in any given period but expects to pass on returns on underlying items.*
- 34 *The ED also proposes (paragraph 60h) that for cash flows that are expected to vary directly with the returns on underlying items, but where the contract does not specify a link to underlying items, the interest expense recognised in Profit or Loss is measured using the discount rate that reflects the characteristics of the liability that is measured at initial recognition, and that discount rate is updated if there are changes in payments to policyholders that arise from changes in the underlying items.*

#### **EFRAG's response**

**EFRAG supports 'mirroring' as a principle and some aspects of the proposed mirroring approach, but has also concerns on the following aspects:**

- In EFRAG's view, 'mirroring' should start from the liabilities side and not from the assets side;**
- The proposed measurement and presentation exception will only apply to limited types of contracts. If the IASB proposal is retained, EFRAG believes the scope should be wider;**
- Part of the insurance liability will be measured on a basis different from the present value of the fulfilment cash flows; and**
- Presenting the effects of changes in the discount rate partly in other comprehensive income and partly in Profit or Loss would make financial statements difficult to understand and would impair comparability of contracts with similar economic features.**

**EFRAG supports the proposal that the discount rate used to measure asset dependent cash flows shall reflect the extent of that dependence.**

**EFRAG understands that the insurance industry is developing an alternative to the proposed 'mirroring' approach, which is based on a consistent approach to measure the liabilities for all insurance contracts at the present value of the fulfilment cash flows. EFRAG has not yet formed a view on this alternative approach.**

- 35 In its comment letter in response to the 2010 Exposure Draft, EFRAG expressed concerns on the accounting mismatches, which arise from the differences in the measurement bases of insurance liabilities and directly related financial assets. EFRAG noted that in order to avoid an accounting mismatch, insurers should be able to designate the measurement classification of financial assets in a way that best reflects their relationship with insurance liabilities. EFRAG also agreed with the proposed amendments to IAS 16 *Property, Plant and Equipment* and IFRS 9 *Financial Instruments* (regarding property and own shares, respectively) for unit-linked contracts to avoid accounting mismatches. However, EFRAG considered that the accounting mismatch issue might not be limited to unit-linked contracts only, as this issue also arises in connection with participating contracts that have substantially the same characteristics. Therefore, EFRAG recommended that the IASB consider expanding the scope of the amendments to include other types of insurance contracts.
- 36 EFRAG supports 'mirroring' as a principle to address accounting mismatches for contracts with cash flows that are dependent on the assets returns, but has some reservations about its application. EFRAG comments below on the aspects which EFRAG supports and those on which EFRAG expresses concerns.

Scope

- 37 The ED proposes to eliminate any accounting mismatches in measurement and presentation when there is no possibility of economic mismatches. More specifically, the ED notes that there is no possibility of economic mismatch if the contract:
- (a) Requires the entity to hold the underlying items; and
  - (b) Specifies a link between the payments to the policyholder and the returns on those underlying items.
- 38 EFRAG agrees with the IASB's approach to eliminate accounting mismatches when the terms of the contract mean that the entity will not suffer any economic mismatches, as this is consistent with our view that accounting mismatches should be avoided, while all economic mismatches should be faithfully represented.
- 39 However, the IASB approach can only be applied when both conditions mentioned in paragraph 37 are met. Although EFRAG understands the reasons for this scope limitation, EFRAG believes that the IASB's proposals are expected to be applied to a limited set of contracts and thus leave unresolved the mismatch issue in many other situations that are economically quite similar.
- 40 EFRAG notes that there are many other contracts for which the cash flows are dependent on the asset returns. For some of these contracts there is a contractual link; however, others do not have such a contractual link; and not all these contracts require the entity to hold the underlying items. Contracts with similar economic features will be treated differently because some of them will meet the measurement and presentation exception criteria and others not. EFRAG does not support this consequence of the IASB's approach and believes that the scope of the approach should be wider.
- 41 EFRAG believes that the scope should be extended to other contracts that provide an investment return to the policyholder that is affected by the performance of underlying items. In our view, a measurement and presentation approach for contracts with a performance-sharing mechanism should work for any type of insurance contracts and not only to contracts such as unit-linked types of contracts

where all of the benefits delivered to the policyholder are directly determined by value of the underlying items, i.e. the price of units in an internal or external investment fund.

Segregation of cash flows arising from insurance contracts

- 42 The IASB's proposal would require entities to decompose the cash flows arising from insurance contracts in a way that maximises the extent to which the measurement both:
- (a) Expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and
  - (b) Maximises the minimum fixed payment that the policyholder will receive.
- 43 EFRAG agrees with the IASB's underlying reasoning to propose such a split in order to eliminate accounting mismatches to the maximum extent possible and perform the split in a way that matches the economic features of the insurance liability with the economic features of the underlying items.
- 44 However, as a consequence of setting up the above requirements, entities need to distinguish between different sets of cash flows for measurement purposes. Such split will result in some parts of the insurance liability being measured under the general measurement requirements and another part being measured on a basis which is driven by the basis on which the underlying items are measured.
- 45 Applying the split will result in part of the insurance liability being measured on a basis different from the present value of the fulfilment cash flows that an entity expects to pay to the policyholder and hence might not represent the true estimate of the ultimate probability-weighted expected cash flows. In the cases where the underlying items are not measured on a fair value basis but the entity is required (or chooses) to disclose their fair value, the ED requires the entity to disclose the extent to which the differences between the fair value and the carrying amount of the underlying items would be passed on to policyholders. Such disclosure would be useful to inform users of financial statements that the policyholders have an economic interest in the difference between the fair value of the underlying items and their carrying amount. However disclosures of the current value of an insurance contract would not be required if disclosures of the fair value of the underlying items are not required, e.g. in the cases of deferred tax or goodwill.
- 46 Consistent with our views on the 2010 Exposure Draft, EFRAG believes that for all types of contracts, including contracts with cash flows which are dependent on the returns of underlying items, the present value of the fulfilment cash flows that an entity expects to pay to the policyholder would more faithfully represent the entity's contractual obligations and rights, and convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Therefore EFRAG believes that the accounting mismatch issue should be dealt with by starting from the liabilities side, and not from the assets side.
- 47 EFRAG also believes that the split of the cash flows is not consistent with the key assumption that the entity should measure the insurance contract in a way that portrays a current assessment of the combined package of cash inflows and cash outflows generated by both financial and service elements.

Discount rate used for cash flows which vary with the returns on the underlying items

- 48 EFRAG supports the IASB's proposal in paragraph 26(a) of the ED that to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly on the returns on underlying items, the discount rate used to measure those cash flows shall reflect the extent of that dependence. EFRAG agrees that this should be the case regardless of whether the relationship between the cash flows of the contract and the underlying items is specified by the contract or whether the relationship arises because the entity has discretion over the amount and timing of payments in any given period but expects to pass on returns on underlying items. In both cases the cash flows are expected to vary with returns on underlying items and the characteristics of the liability should include that dependence.

Presentation of interest expense in Profit or Loss for cash flows that are expected to vary directly with returns on underlying items

- 49 Regarding the presentation of interest expense in Profit or Loss, entities would recognise the following under the IASB's proposals:
- (a) If the insurance contract specifies a link to returns on underlying items and requires the entity to hold those underlying items, an entity shall recognise:
    - (i) Changes in the fulfilment cash flows in Profit or Loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items;
    - (ii) Changes in the fulfilment cash flows that are expected to vary indirectly with those returns on underlying items in Profit or Loss; and
    - (iii) Changes in the fulfilment cash flows that are not expected to vary with those returns on underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), in Profit or Loss and in other comprehensive income in accordance with the general requirements.
  - (b) In other cases, the interest expense recognised in Profit or Loss is measured using the discount rate that reflects the characteristics of the liability that is measured at initial recognition, and that discount rate is updated if there are changes in payments to policyholders that arise from changes in the underlying items.
- 50 Although EFRAG's understands the underlying reasoning for the suggested approach to present interest expense, EFRAG is concerned about the complexity of the approach, which would reduce the usefulness of the financial statements. Applying the proposals would lead to effects of changes in the discount rates for similar contracts or even for the same contract (i.e. due to the split in the cash flows) partly recognised in other comprehensive income and partly in Profit or Loss, which would be difficult to understand and would impair comparability of contracts with similar economic features (i.e. contracts with asset dependent cash flows).
- 51 Furthermore, the proposals may introduce significant costs for preparers as they would be required to apply different measurement and presentation to the same contract due to the requirement to split the cash flows.

*Alternative approach*

- 52 EFRAG understands that the European insurance industry and other global insurers are developing an alternative to the IASB's 'mirroring approach', which is based on the present value of the fulfilment cash flows for all insurance contracts and would result in one consistent approach regarding the measurement of the insurance liabilities.
- 53 Appendix 5 provides an overview of the key elements of the alternative approach and the main differences with the IASB's proposals for contracts with cash flows that are asset dependent.
- 54 EFRAG has not yet formed a view on the alternative approach and has not yet assessed its technical details, operational complexities or conceptual/technical merits. However, EFRAG has tentatively expressed several concerns on the 'mirroring approach' proposed by the IASB, as described before. In the finalisation of its comment letter, EFRAG intends to consider whether the alternative approach, wholly or in part, can address these concerns and which views, if any, EFRAG will express in respect of this alternative approach.
- 55 To support this process, EFRAG invites constituents to provide feedback on the alternative approach by answering the following questions on this approach. EFRAG is more particularly interested in assessing whether such an approach, or a variant thereof, would be conducive to understandable and useful information for investors and their advisors.

**Questions to constituents – please provide your answers considering EFRAG’s recommendation in our response to question 4 and in the context of the currently proposed limited amendments to IFRS 9 in respect of classification and measurement**

- 56 Do you believe the alternative approach described in Appendix 5 will lead to financial statements that provide relevant information that faithfully represent the entity’s financial position and performance for contracts with asset dependent cash flows? Why or why not? If not, what would you recommend and why? Please consider whether the alternative approach eliminates or reduces accounting mismatches while reporting consistently contracts with similar economic features (i.e. contracts with asset dependent cash flows). Do you support the alternative approach wholly or partly? Please explain, which parts you support and which you do not?
- 57 Do you believe that for contracts with asset dependent cash flows, the effect of changes in financial assumptions should be accounted for in the contractual service margin resulting in a fully prospective contractual service margin? If so, why and how this should be done?
- 58 Do you agree that interest expense should be recognised in Profit or Loss based on a yield as proposed in the alternative approach (please refer to paragraphs 21 – 25 of Appendix 5 for a description of the yield curve under the alternative approach)? Why or why not?
- 59 What should be the pattern of release of the contractual service margin for contracts with asset dependent cash flows?
- 60 Do you believe the alternative approach is operationally more or less complex than the IASB’s ‘mirroring approach’?
- 61 Do you believe that the alternative approach, or a variant thereof, would be conducive to understandable and useful information for investors and their advisors?

**PRESENTATION OF INSURANCE CONTRACT REVENUE AND EXPENSE**

**Question 3**

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

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

**Notes for EFRAG’s constituents**

- 62 *The ED proposes that entities present revenue from all insurance contracts consistently with the presentation of revenue in accordance with IFRS for other transactions. This proposal responds to feedback that gross performance should be measured in a similar way to the revenue presented from non-insurance contracts with customers.*
- 63 *As a result, the IASB proposes that an entity should present as insurance contract revenue the consideration for insurance services provided under the insurance contract. As for other types of contract, an entity would not present as revenue*



amounts deposited by customers. The IASB also proposes that the expenses related to an insurance contract should be presented in the period incurred and exclude repayments of deposits. The operating result is unchanged from that in the 2010 Exposure Draft. Only the presentation of revenue and expenses has been changed.

- 64 Insurance contract revenue and incurred claims presented in the statement of profit and loss and other comprehensive income shall exclude any investment components that in accordance with paragraph 10(b) have not been separated. Paragraph 10(b) of the ED requires the separation of an investment component from the host contract and that it should be accounted for in accordance with IFRS 9 if the investment component is distinct.
- 65 Appendix A of the ED defines an investment component as 'the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur'.
- 66 Paragraph B31 of the application guidance requires an entity to separate a distinct investment component from the host insurance in terms of paragraph 10(b) of the ED unless the investment component and the insurance component are highly interrelated.
- 67 According to the application guidance in paragraph B32 of the ED an investment component and insurance component are highly interrelated if:
- (a) The entity is unable to measure the one without considering the other; or
  - (b) The policy holder is unable to benefit from one component unless the other is present.
- 68 For many insurance policies the investment components are not distinct as referred to in paragraph 64 and are highly interrelated as defined in paragraph 67. For these types of insurance contracts there would be no unbundling for measurement of the insurance liability but disaggregation would still be required for presentation in the statement of profit and loss according to the principle defined in paragraph 65 above. As mentioned in paragraph BC91 of the ED some respondents are concerned that it would be too complex to separate interrelated cash flows and exclude them from insurance contract revenue and incurred expenses.
- 69 The 2010 Exposure Draft proposed a summarised margin approach for presentation in the statement of comprehensive income. A summarised margin approach would require presentation of the sources of change in the insurance liability, but would not require presentation of premiums, claims or benefits. This approach would have treated all premiums as receipt of deposits and all claims and benefit payments as returns of deposits.
- 70 Respondents to the 2010 Exposure Draft, including many users, requested a statement of Profit or Loss that would include premiums, claims and other expenses.
- 71 The IASB mentions in the Basis for Conclusions that the summarised margin approach would be a significant change from current practice and also that it was widely criticised in the comment letters received in response to the 2010 Exposure Draft. At the time many respondents felt that although information about net margins was useful, it was best placed in the notes to the financial statements. Additionally the IASB notes that:

- (a) *The summarised margin approach would not faithfully represent the extent to which services are provided under an insurance contract;*
  - (b) *The summarised margin approach reduces comparability across the financial reporting for insurance and other contracts; and*
  - (c) *The summarised margin approach does not provide a gross performance measure and many who report, use and quote financial measures expect this. If such a measure which is consistent with the principles for measuring revenue from contracts with customers is not provided, preparers and users might substitute other measures for them.*
- 72 *The ED proposes that entities should present insurance contract revenue and expense in Profit or Loss that would be consistent with the general revenue recognition principles that the IASB is developing in the revenue recognition project. In particular, insurance contract revenue:*
- (a) *Is recognised when the entity satisfies its obligation to provide coverage or other services over the coverage period; and*
  - (b) *Excludes amounts that will be paid to policyholders in all circumstances, regardless of whether an insured event occurs.*
- 73 *Claims and other expenses would be presented based on an incurred basis.*
- 74 *Insurance contract revenue is the sum of:*
- (a) *The latest estimates of the expected claims and expenses relating to coverage for the current period excluding those recognised immediately in Profit or Loss for losses on initial recognition and subsequent changes in estimates, and excluding any repayments of investment components that are included in the latest estimates of the expected claims;*
  - (b) *The change in the risk adjustment recognised in the period;*
  - (c) *The amount of the contractual service margin recognised in Profit or Loss in the period; and*
  - (d) *An allocation of the portion of the premium that relates to recovering directly attributable acquisition costs.*
- 75 *The entity allocates the part of the premium relating to the recovery of those directly attributable acquisition costs to each accounting period in a systematic way that best reflects the transfer of services provided under that contract.*
- 76 *For an entity applying the premium allocation approach (the ‘simplified approach’), the revenue for the period will be determined as the amount of the expected premium receipts allocated over the period. These expected receipts will be allocated as insurance contract revenue to each accounting period in a systematic manner best reflecting the transfer of services that are provided under the contract.*

**EFRAG’s response**

**[To be completed based on the field-test results and recommendations from constituents]**

- 77 In its comment letter in response to the 2010 Exposure Draft, EFRAG was in favour of a summarised margin presentation combined with volume information on the face of Profit or Loss. That is, EFRAG considered that volume information, such as premiums written, claims expenses, and claims handling expenses, should be presented on the face of Profit or Loss for all insurance contracts together with the underwriting margins.
- 78 After issuing EFRAG's comment letter on the 2010 Exposure Draft, EFRAG staff explored different presentations of Profit or Loss, so as to combine volume and margin information, which were shared with the IASB staff. In this regard, we appreciate the IASB's effort in considering those alternatives throughout the re-deliberation process. The resulting proposals in the ED, however, are different from EFRAG's proposals, and our view on them is discussed in more detail in paragraphs 81 and 82.

*Arguments for and against the IASB's proposals for revenue and expense presentation*

- 79 In EFRAG's view, the arguments in favour of the IASB's proposals are the following:
- (a) The current IASB's proposals will provide *comparability* between insurers and entities in other industries which provide services, because the revenue will be recognised when the services are provided.
  - (b) Additionally *comparability* will be provided between insurers and other deposit taking institutions because the investment components will be disaggregated and excluded from the revenue number. There would also be comparability between the 'simplified approach' and the approach under the general measurement requirements.
  - (c) The IASB's proposals will also provide *useful* information to the users of financial statements about the revenue and expense split, at the end of the financial reporting period, between the insurance coverage provided and investment activities undertaken for policyholders.
  - (d) The *understandability* of the financial statements will be improved as measures of the activity undertaken by an organisation will be based on commonly understood notions of revenue and expenses.
  - (e) The IASB's proposals are *conceptually* sounder than the previous 'summarised margin' approach because revenue is measured as the change in the insurance liability over the financial reporting period, while the previous proposals do not measure revenue on this basis.
  - (f) Many respondents to the 2010 Exposure Draft stated that margin information was useful, but would be suitable in the notes and not necessarily on the face of the financial statements.
  - (g) The 'summarised margin' approach does not faithfully represent the extent to which services are provided under an insurance contract while the IASB's proposals do.
  - (h) The IASB's proposals unlike the 'summarised margin' approach provide a gross measure of performance which is consistent with the principles of measuring revenue from contracts and it has been requested by those who report, use and quote financial measures.

- (i) The proposals also require the reconciliation of the movement schedules of the balance sheet components based on information that is generated by the general measurement model, so if this information is available it would not necessarily require significant additional work to derive appropriate revenue and expense amounts.
- (j) Many respondents to the 2010 Exposure Draft have indicated that the information from the measurement model discussed in (i) above would be useful and the IASB has concluded that the benefits of the information provided would outweigh the costs involved.
- (k) The IASB's proposals are similar to the presentation of revenue and expenses for other long-term construction contracts which is also based on a notional allocation methodology.

80 On the other hand, the arguments against the IASB's proposals are the following:

- (a) The current IASB's proposals of projecting all expected future premiums over time is based on a theoretical notional allocation of the insurance liability and therefore the revenue generated from these insurance liabilities is also based on a theoretical notional concept.
- (b) It is believed that the current proposals do not meet the cost/benefit criteria and would be burdensome to calculate in practice, while the tracking of different components making up the revenue measure will add additional complexity for preparers and may be costly to implement operationally.
- (c) It is also mentioned that the current proposals provide artificial comparability of information and this information will not be useful to the users of the financial statements.
- (d) The IASB's proposals would result in information that is very different from that currently used in the insurance industry and provided to the users of financial statements.
- (e) The presentation of the revenue and expenses as proposed by the ED would present significant operational challenges to the insurance industry.
- (f) A fundamental concern with the proposals is that the principle of accounting for an insurance contract as a single transaction is not considered, especially when taking into account that different components are packaged and priced together.
- (g) The IASB's proposals result in the presentation of information that is similar to revenue and expenses for other long-term contracts, however, such information is currently not used as key information by management of entities with insurance activities.

*EFRAG's view*

81 At present, EFRAG does not express a view about the proposals in the ED and has provided the arguments for and against the IASB's proposals taking into account the concerns raised by many insurance industry constituents. EFRAG's response will be finalised once the results of the field-test are available, taking into consideration views and arguments expressed by constituents.

- 82 The Basis for Conclusions of the ED discussed two other possible alternative views which the IASB does not support, namely:
- (a) Current industry practice of showing premium revenue as the written premiums for the period. This view is not supported by EFRAG either, as it is a measure of the new business written rather than a measure of the revenue as determined using the general measurement approach which measures the change in the insurance liability during the period; and
  - (b) Premiums due presentation which allocates the total expected insurance contract revenue to periods in which the premiums become unconditionally due to the entity. EFRAG also does not support this view as it is not consistent with commonly understood concepts of revenue and uncertainty would be reflected in claims and benefits presented.

*Disaggregation of the investment components*

- 83 The IASB's proposals for revenue and expense presentation would exclude investment components from insurance contract revenue and incurred claims, despite the fact that they have not been unbundled because they are not distinct and are highly interrelated with the insurance component.
- 84 The investment component amounts excluded from the revenue and expenses represents the amount that is built up over time and is owed to the policyholder. For example, the investment component would be repaid if the policy lapses or is included in the benefit paid upon death of the policyholder. The amount included in this death benefit could then be calculated as the amount that is due to the policyholder if he did not die, but rather surrendered the insurance policy.
- 85 An investment component that is not separately unbundled should be excluded from the premiums and claims presented in the statement of profit and loss. In contrast, there is no requirement for the investment component part of the insurance liability to be calculated and disclosed separately in the opening or closing balance sheet at the financial reporting date.
- 86 EFRAG intends to test how difficult and costly it is to disaggregate these investment components and to prepare and present 'revenue'. In the field-test activities, EFRAG will also investigate whether additional application guidance is necessary. EFRAG will consider the findings when finalising its comment letter. The intended field-test activities are explained in detail in Appendix 3. Participants' views will also be sought on how the proposals relate and interact with the management of the business and the way Key Performance Indicators are determined. We also plan to gather feedback from users throughout the IASB's outreach activities with users of financial statements.

**Question to constituents**

- 87 Do you believe that the investment component amounts would be difficult and costly to compute because they are not distinct and are highly interrelated with the insurance component with the insurance component?
- 88 Do you believe that additional application guidance is necessary to determine these amounts on a portfolio level?
- 89 Do you believe that preparing and presenting revenue under the ED proposals would be difficult and costly?

**INTEREST EXPENSE IN PROFIT OR LOSS**

**Question 4**

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

- (a) recognising, in Profit or Loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
- (b) recognising, in other comprehensive income, the difference between:
- (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
- (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

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

**Notes for EFRAG's constituents**

- 90 *The 2010 Exposure Draft proposed that the effects of changes in discount rates should be presented in Profit or Loss.*
- 91 *Respondents to the 2010 Exposure Draft suggested that presenting all changes in current value measurement of the insurance contract liability in Profit or Loss could have a significant impact in this statement and make it difficult to assess underwriting performance.*
- 92 *The ED proposes to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:*
- (a) *Recognising in Profit or Loss, the interest expense determined using the discount rate that applied when the contract was initially recognised. For*

*cash flows that are expected to vary with the returns on underlying items, entities would update those discount rates when they expect any changes in those returns to affect the amount of those cash flows;*

- (b) *Recognising in other comprehensive income (OTHER COMPREHENSIVE INCOME), the difference between:*
  - (i) *The carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and*
  - (ii) *The carrying amount of the insurance contract measured using the discount rates as described in (a) above.*

93 *The proposals above would apply to contracts accounted for under the general requirements of the ED and to those cash flows that do not vary with the underlying items for contracts that require the entity to hold underlying items and specify a link to those underlying items.*

94 *Considering the interaction with the IASB's Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9, the proposals in the ED are expected to reduce accounting mismatches if financial assets are both managed within the 'hold and sell' business model and result in payments of principal and interest only. In those cases, they would be measured at FV-OCI.*

95 *However, if financial assets are managed under a different business model or do not qualify for FV-OCI due to their contractual cash flow characteristics (e.g. equity instruments, derivatives, some hybrid contracts and non-financial assets such as investment properties), a mismatch will still arise either in OCI (if the assets are measured at amortised cost) or both in OCI and Profit or Loss (if the assets are measured at FV-PL).*

## EFRAG's response

**EFRAG agrees with the IASB's proposal to segregate the effects of changes in the discount rate in the insurance contracts liabilities in OCI. However, we are concerned that the IASB's proposals in the ED in combination with the classification and measurement requirements in other standards are not helpful in eliminating accounting mismatches and would result in reporting the insurance performance split across Profit or Loss and OCI.**

**We believe that presenting changes in the insurance liabilities consistently with how changes in the related assets are reported is necessary to convey relevant information about the insurance performance and the underlying business model. This is also supported by the findings of EFRAG's consultation on financial reporting for long-term investing activities business models, in which insurers noted that (i) the insurance liabilities' profile drives the portfolio of related investments and (ii) the insurance business model is primarily supported by active asset-liability management.**

**If the asset-liability management brings objective evidence that the business model of entities with insurance activities is based on active asset-liability management strategies, EFRAG believes that those entities should be required to:**

- **Segregate the underwriting performance in Profit or Loss so that this statement is not obscured by short-term movements in discount rates and other short term market price changes; and**
- **Measure at FV-OCI the assets that relate to the insurance liabilities – including in particular debt instruments that do not meet the contractual cash flow characteristics assessment, equity shares and property – presenting in Profit or Loss (i) return on the assets, (ii) gains and losses on realisation, (iii) impairment losses; and other gains and losses in OCI.**

96 In its comment letter in response to the 2010 Exposure Draft, EFRAG stated that the IASB should further explore the issues around what constitutes the performance of insurers and how it should be presented in the financial statements. Among other recommendations, EFRAG suggested that the IASB should specifically consider the impact of differences in accounting for financial instruments under IFRS 9 and the future standard for insurance contracts and the need to distinguish between short-term volatility and long-term trends in understanding the performance of an insurer. In this respect, EFRAG continues to believe that financial statements should provide relevant and transparent information about the insurance performance consistently with the activities that entities carry out.

97 In November 2012, the IASB issued the Exposure Draft *Limited Amendments to IFRS 9: Classification and measurement* (limited amendments to IFRS 9). One of the objectives of that Exposure Draft was to take into account the interaction of the classification and measurement model for financial assets with the IASB's project on insurance contracts. In this context, the IASB proposed to introduce a fair value through other comprehensive income measurement category (FV-OCI) for financial assets (i) whose contractual cash flows are solely payments of principal and interest, and (ii) that were held within a business model in which financial assets are managed both in order to collect contractual cash flows and for sale.

98 EFRAG stated in its response to the limited amendments to IFRS 9 that introducing FV-OCI measurement is necessary as part of a solution to address



constituents' concerns about accounting mismatches and performance reporting. However, EFRAG was concerned that the definition of the underlying business model supporting FV-OCI measurement was not robust enough. As noted by some constituents, assessing the financial assets that would meet the proposed definition was difficult. However, other constituents, including the insurance industry and long-term investors, indicated that the IASB was heading in the right direction in its effort to identify an additional business model, but failed to characterise it appropriately.

99 In this context and that of the European Commission consultation on a green paper considering possible ways for supporting long-term investment,<sup>2</sup> EFRAG launched in June 2013 a public consultation on whether there was a need for specific financial reporting for long-term investing activities business models. The findings of the public consultation indicate the following:

- (a) The insurance liabilities' profile drives the portfolio of related investments. Insurance liabilities are to a large extent long-term and predictable, with stable cash-flow profiles. As a consequence, insurers are substantially able to match long-term liabilities with investments held for the long-term;
- (b) The insurance business model is primarily supported by active asset-liability management. Entities manage the insurance liabilities, the guarantees and the related financial and non-financial assets together. Asset-liability management allows entities to meet their obligations towards policyholders and maximise returns to shareholders; and
- (c) The primary performance indicators for the assets that form part of the asset-liability management are (i) return on assets, (ii) gains and losses on realisation, (iii) less impairment losses.

100 Based on the above findings, EFRAG believes that any accounting requirements applicable to entities with insurance activities should not ignore the interaction between the insurance liabilities and the related assets when portraying information about the insurance performance. We note here that the IASB's proposals in the ED together with the classification and measurement requirements in other standards would result in reporting the insurance performance split across Profit or Loss and OCI. In this regard, we believe that presenting changes in the insurance liabilities consistently with how changes in the related assets are reported is necessary to convey relevant information about the insurance performance.

101 Subject to further work to be done by EFRAG during its due process, we believe that if the asset-liability management brings objective evidence that the business model of entities with insurance activities is based on active asset-liability management strategies, those entities should be required to:

- (a) Segregate the underwriting performance in Profit or Loss so that this statement is not obscured by short-term movements in discount rates and other short-term market price changes; and

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<sup>2</sup> Green paper *Long-term financing of the European economy*, European Commission, COM (2013) 150 final, 25 March 2013.

- (b) Measure at FV-OCI the assets that relate to the insurance liabilities, presenting in Profit or Loss their primary performance indicators and other gains and losses in OCI (as referred in paragraph 99(c)).

102 Accordingly, we agree with segregating the effects of changes in the discount rate in the insurance contracts liabilities that are expected to unwind over time from other gains and losses and present them in OCI as proposed by the IASB.

**Questions to constituents**

103 Under the IASB's proposals, the difference to be reported in OCI is determined by comparing the discount rate to measure the liabilities and, depending on the type of cash flows, the locked-in discount rate at inception of the insurance contract or an updated rate. Under IAS 19 *Employee Benefits*, the difference is determined by comparing the discount rate at the beginning of the reporting period and the rate at the end of the reporting period. Some, including IASB Board member Stephen Cooper, hold the view that only the latter difference (i.e. the effect of changes in discount rates in the period of the change) provides relevant information (as is described in paragraphs AV5 and AV6 of the Basis for Conclusions), and that, therefore, only this difference should be reported in OCI.

104 Do you support the approach in the ED or should the interest expense recognised in profit and loss be based on a current discount rate for all type of cash flows? If so, should the discount rate be the rate at the beginning of the period, as in IAS 19, or that at the closing date?

105 EFRAG tentatively believes that the IASB should extend the scope of the use of OCI to cover a broader range of assets – other than debt instruments that meet the contractual characteristics and business model tests as proposed in the limited amendments to IFRS 9 – that relate to insurance liabilities. In summary, this would mean reporting the following:

	Amounts presented in:	
	Profit or Loss	OCI
<i>Debt instruments</i> (irrespective of whether they meet the contractual cash flow characteristics assessment)	<ul style="list-style-type: none"> <li>- Interest income using the effective interest rate (which could include compensation for components other than time value of money and credit risk)</li> <li>- Gains and losses on realisation</li> <li>- Impairment losses (in accordance with IFRS 9 and to be defined for instruments that do not meet the contractual cash flow characteristics assessment)</li> </ul>	<ul style="list-style-type: none"> <li>- Changes in fair value less amounts recognised in Profit or Loss</li> </ul>
<i>Equities</i>	<ul style="list-style-type: none"> <li>- Dividends</li> <li>- Gains and losses on realisation</li> <li>- Impairment losses (to be defined)</li> </ul>	<ul style="list-style-type: none"> <li>- Changes in fair value (irrespective of whether they are measured at FV-PL or FV-OCI under IFRS 9)</li> </ul>
<i>Property</i>	<ul style="list-style-type: none"> <li>- Rental yield less impairment (in accordance with IAS 36)</li> <li>- Gains and losses on realisation</li> </ul>	<ul style="list-style-type: none"> <li>- Revaluation gain or reversals (for all items irrespective if they are under the scope of IAS 16 or IAS 40)</li> </ul>

106 EFRAG has heard criticism of its suggested approach as some regard it as:

- (a) *Requesting de facto an industry standard* – EFRAG disagrees with this criticism, as it considers, based on the findings of its consultation on financial reporting for long-term investing activities business models, the suggested

approach valid for all “liability-driven” long-term investment activities, i.e. when investments are managed to match stable liabilities. In addition, the suggested approach would not require to determine whether the reporting entity is, or is not, an insurance company; and

- (b) *Breaking from the IASB’s axiom of considering assets and liabilities separately* – EFRAG believes that financial reporting requirements should help depicting an entity’s business model. In particular, given the liability-driven strategy of insurance contract related investment activities, measurement and presentation requirements must be such that financial statements best depict this relationship.

#### **Notes to constituents**

107 *EFRAG intends to further explore the approach described in the paragraphs above during its due process. Next to obtaining a better understanding of existing asset-liability management strategies of insurers, the focus will be on the identification of appropriate ways to avoid or mitigate accounting mismatches in profit and loss and in OCI. At this moment, EFRAG envisages its efforts to be focused on the following areas:*

- (a) *Objective evidence on active asset-liability management strategies – EFRAG is interested in obtaining a better understanding of the strategies that are currently put in place by entities with insurance activities, including (i) whether there are any circumstances under which measuring both insurance liabilities and the related assets at FV-OCI would not provide useful information and measuring both at FV-PL would, and (ii) how the assets related to insurance liabilities are identified.*
- (b) *Presentation of changes in the fair value of derivatives and other assets in OCI – EFRAG believes that derivatives should ideally follow the same accounting treatment as the other assets that relate to insurance liabilities; however, we have not yet formed a view on whether changes in their value other than the amounts recognised in Profit or Loss should be presented in OCI. This conclusion also applies to assets other than those included in the table in paragraph 105 (e.g. investments in associates) that may also relate to insurance liabilities.*
- (c) *Distinction between financial assets that relate directly or indirectly to insurance contracts and those that do not – EFRAG is aware that some entities may not specifically allocate their assets to different types of portfolios or products.*
- (d) *Development of an impairment model for certain types of assets – EFRAG acknowledges that the proposals would imply further development of the principles in existing standards; in particular, for debt instruments that do not meet the contractual cash flow characteristics assessment and for investments in equities that would be measured at FV-OCI it would be necessary to develop an appropriate impairment model.*
- (e) *Recycling – EFRAG will assess the interaction between the recycling of realised gains and losses to profit and loss and the accounting treatment of contracts for which the cash flows are dependent on the asset returns.*
- (f) *Changes in the time value of option and guarantees not separated from the insurance liabilities – EFRAG is aware that some have the view that these*

*changes should be recognised in profit and loss, and others argue that they should be recognised in OCI.*

#### **Questions to constituents**

- 108 Do you believe the suggested approach described above will lead to financial statements that provide relevant information that faithfully represent the entity's financial position and performance for contracts? Please consider whether the suggested approach eliminates or reduces accounting mismatches in Profit or Loss and OCI.
- 109 Are you aware of any circumstances in which, from your point of view, measurement of both insurance liabilities and the related financial assets at FV-PL might be needed instead of, or combined with, measurement at FV-OCI? If so, please provide a description of the portfolios of insurance contracts concerned and how the asset-liability management strategy differs from other portfolios.
- 110 Do you believe that EFRAG should suggest how the assets related to insurance liabilities should be identified? If so, what would you recommend and why?
- 111 Do you believe that derivatives should also be accounted for using OCI? If so, how could objective evidence be gathered in respect of derivatives that only play a role in matching insurance liabilities?
- 112 Should any other assets apart from those included in paragraph 105 be measured at FV-OCI? Please explain why.
- 113 Do you agree that following EFRAG's approach, the IASB would need to develop an impairment model for debt instruments that do not meet the contractual cash flow characteristics assessment and investments in equities that would be measured at FV-OCI and potentially other assets? If so, what impairment model would you recommend and why?
- 114 Do you see any problems in recycling realised gains and loss on investments related to contracts with asset-dependent cash flows (that are not under the scope of the IASB's measurement and presentation exception as discussed in Question 2)? If so, what solutions would you recommend? Please explain your answer.
- 115 Where should changes in the time value of options and guarantees not separated from insurance liabilities be recognised? Please explain your answer.

#### **EFFECTIVE DATE AND TRANSITION**

##### **Question 5**

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

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

#### **Notes for EFRAG's constituents**

- 116 *The ED proposes that entities should apply the future standard on insurance contracts retrospectively in accordance with IAS 8 Accounting Policies, Changes*

in Accounting Estimates and Errors *when it is practicable*. When it would not be practicable, the ED proposes a modified retrospective application which aims to simplify the transition requirements while maximising the use of objective information.

- 117 More specifically, when it is impracticable to apply IAS 8, the ED proposes that entities should, at the beginning of the earliest period presented:
- (a) Measure an estimate of the remaining contractual service margin using the information about the entity's expectations at initial recognition of the contract. Entities need not undertake exhaustive efforts to obtain objective information but shall take into account all objective information that is reasonably available and:
    - (i) Assume that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition; and
    - (ii) Assume that the risk adjustment at inception is equal to that at transition date.
  - (b) Estimate, for the purposes of measuring insurance contract revenue after the beginning of the earliest period presented, the carrying amount of the liability for the remaining coverage excluding any losses on the date of initial recognition and any subsequent changes in the estimates between the date of initial recognition and the beginning of the earliest period presented that were immediately recognised in Profit or Loss.
  - (c) Determine, for the purposes of measuring the interest expense to be recognised in Profit or Loss, the discount rates that applied when the contracts in a portfolio were initially recognised considering:
    - (i) An estimate of the discount rates that applied at the date of initial recognition using an observable yield curve that, for at least three years before the date of transition, approximates the yield curve estimated in accordance with the requirements in the ED;
    - (ii) If the observable yield curve in (i) does not exist, entities should estimate the discount rates by determining an average spread between an observable yield curve and the yield curve estimated in accordance with the requirements in the ED and applying that spread to that observable yield curve. The spread shall be an average over at least three years before the date of transition.
- 118 Entities would recognise the cumulative effect of the changes in the accounting policy at the beginning of the earliest period presented, as an adjustment to the opening retained earnings and, if applicable, to the opening balance of the accumulated other comprehensive income.
- 119 Other requirements related to transition included in the 2010 Exposure Draft continue to apply, in particular, entities should derecognise, with a corresponding adjustment in retained earnings, any existing balances of deferred acquisition costs relating to insurance contracts and any intangible assets that were assumed in previous business combinations that do not meet the definition in IFRS.
- 120 Regarding the interaction with IFRS 9, the IASB decided that insurers should follow the reclassification guidance in IFRS 9 except that the insurer should be:

- (a) *Permitted to designate eligible financial assets under the fair value option where new accounting mismatches are created by the application of the new insurance contracts standard;*
- (b) *Required to revoke previous designations under the fair value option where the accounting mismatch no longer exists because of the application of the new insurance contracts standard; and*
- (c) *Following earlier application of IFRS 9, permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.*

#### **EFRAG's response**

**EFRAG agrees with the proposed modified retrospective approach for transition as we understand that in many circumstances entities would be able to make a reasonable estimation of the remaining contractual service margin based on historic public and internal information about the various portfolios.**

**Regarding the effective dates of IFRS 9 and the new insurance contracts standard, if the IASB were to require different effective dates, EFRAG recommends that for all entities where insurance forms significant part of the entities' activities:**

- **The effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the new insurance contracts standard should be permitted, so as to facilitate the concomitant application of IFRS 9 and the future standard on insurance contracts at the earliest possible; and**
- **Entities should be permitted to reconsider designations (of hedges and the fair value option) and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard.**

**EFRAG further recommends a three year implementation period from the date of publication of the new insurance contracts standard.**

121 In its comment letter in response to the 2010 Exposure Draft, EFRAG's two main concerns were that:

- (a) The residual margin for contracts in-force at transition would be set to zero; instead of requiring retrospective application in accordance with IAS 8; and
- (b) In order to minimise the operational burden it would be crucial that insurance companies have the opportunity to apply IFRS 9 and the final insurance contracts standard at the same time. The ability to redesignate financial assets at the time of adoption of the new standard on insurance contracts was less preferable but it should be allowed.

122 EFRAG believes that our concern expressed in paragraph 121(a) has been addressed in the ED; however, we are still concerned about the interaction between IFRS 9 and the future standard on insurance contracts as explained in paragraph 121(b).

#### *Retrospective application*

123 EFRAG supports the proposed modified retrospective approach that would require entities to estimate the residual margin on transition using specified simplifications,

as entities would apply retrospective application when required by IAS 8. Such approach would allow insurers to report a potentially significant part of the profits on existing contracts through Profit or Loss and it would enhance comparability between the results of existing and new business.

- 124 The retrospective application is also supported by users. It would facilitate their analysis of the margin balance and on the earnings trends over time. It would also allow them to project future earnings in a consistent way for all contracts and to compare entities that previously used different accounting models.

*Balance between comparability and verifiability*

- 125 EFRAG is aware of the subjectivity inherent in the estimations when retrospective application is impracticable due to the use of hindsight. For contracts issued a long time ago, retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information.

- 126 As a consequence, entities would have to estimate what the contractual service margin would have been had they been able to apply the new standard retrospectively. In such cases, the ED states that entities would not need to undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available. EFRAG notes that these estimates of the contractual service margin may not be easy to verify.

- 127 We note here that in the re-deliberation process the IASB asked its staff to consider developing a constraint or set of constraints on the estimated amount of the residual margin. However, as noted in paragraph BC173 of the ED, the IASB concluded that there is no need to constrain the amount of contractual service margin because the proposed requirements to use all of the available information to approximate retrospective application would be sufficient to ensure that the contractual service margin is not overstated.

- 128 EFRAG understands that in many circumstances entities would be able to make a reasonable estimation of the remaining contractual service margin based on historic public and internal information about the various portfolios (e.g. embedded value calculations and actuarial assumptions specified in the technical descriptions of the insurance contracts). Therefore, we would expect this information to provide enough evidence to regulators and auditors when verifying the estimates made by entities.

*Effective dates of IFRS 9 and insurance contracts standard*

- 129 EFRAG is aware of the high level of complexity that arises from the interaction between (i) IFRS 9, including the limited amendments to the classification and measurement requirements which are being currently re-deliberated by the IASB, and the future insurance contracts standard, and (ii) their respective mandatory effective dates.

- 130 EFRAG believes that entities that issue insurance contracts need to be able to make accounting policy decisions on insurance liabilities and designations of financial instruments simultaneously to enhance the relevance and comparability of their financial statements. Both IFRS 9 and the insurance contracts standard will have a significant impact on the way entities with insurance activities report the performance of their core business with a pervasive effect on the financial statements. In addition, the implementation of these standards in two separate

rounds would lead to significant one-off costs and would be operationally burdensome.

- 131 However, EFRAG notes that the impact on comparability and relevance of the financial statements and the costs for preparers depends on the activities undertaken. Those effects depend on whether or not insurance forms a significant part of the entities' activities.
- 132 Therefore, if the IASB were to require different effective dates for IFRS 9 and the insurance contracts standard, EFRAG recommends that for entities where insurance forms significant part of the entities' activities the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the future insurance contracts standard should be permitted, so as to facilitate the concomitant application of IFRS 9 and the future standard on insurance contracts at the earliest possible.
- 133 EFRAG disagrees with the IASB's proposal not to permit full redesignation and reclassification under IFRS 9 as this could lead to significant accounting mismatches. EFRAG believes that entities for whom insurance forms a significant part of their activities, should be permitted to reconsider designations (of hedges and the fair value option) and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard.
- 134 EFRAG recommends that entities should be allowed a three year implementation period from the date of publication of the new insurance contracts standard.

#### Questions to constituents

- 135 Considering EFRAG's recommendation for entities where insurance forms a significant part of their activities (i.e. the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard), do you believe that:
- (a) Those entities should always be required to apply the impairment proposals earlier than the other parts of IFRS 9; or
  - (b) Those entities should be allowed early implementation of the impairment proposals compared to the other parts of IFRS 9.
- 136 Do you believe the scope of the redesignations and reclassifications when the new insurance contracts standard is applied for the first time by entities for whom insurance forms a significant part of their activities, should be extended beyond IFRS 9 (e.g. investment properties)? If yes, please explain what items should be within that scope?

#### THE LIKELY EFFECTS OF A STANDARD FOR INSURANCE CONTRACTS

##### Question 6

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?



How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

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

- (a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
- (b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

#### **Notes for EFRAG's constituents**

137 *As noted in the invitation to comment of the ED, the IASB believes that the revised proposals would result in a more faithful representation and more relevant and timely information about insurance contracts compared to 2010 Exposure Draft proposals and with IFRS 4.*

138 *EFRAG's response will be based on the findings of the field-testing activities and the feedback which EFRAG will receive from constituents.*

#### **Question to constituents**

139 Do you believe that the IASB's response to the comments on the 2010 Exposure Draft balance the costs of applying these proposals with the benefits of the resulting information provided?

#### **CLARITY OF DRAFTING**

##### **Question 7**

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

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

#### **EFRAG's response**

140 EFRAG is aware that it will always take time to understand a new principles-based standard. In some cases, however, we consider clarification to the ED needed either because we think the drafting in the standard is unclear or it does not reflect what we understand is the intention. Appendix 4 summarises our suggestions to clarify the drafting of the revised ED.

#### **Questions to constituents**

141 Do you agree with the areas/paragraphs identified by EFRAG in Appendix 4?

142 Have you identified any other areas/paragraphs that need clarification? Please explain.

## APPENDIX 2

### Additional comments

- 1 In addition to commenting on the specific questions raised in the ED, EFRAG would like to comment on the issues below.

#### CHANGE FROM A TOP-DOWN TO A BOTTOM-UP DISCOUNT RATE

##### Notes to constituents

- 2 *The ED allows both top-down and bottom-up methods for determining the discount rate. An issue with this approach is whether a change in the approach to determining the discount rate from one reporting period to the next will be treated as a change in an accounting estimate or as a change in an accounting policy.*
- 3 *Paragraph 14 of IAS 8 mentions when an entity shall change an accounting policy. Paragraph 5 of IAS 8 defines a change in an accounting estimate. Changes in accounting estimates result from new information or new developments and are not corrections.*

##### EFRAG's response

- 4 EFRAG believes that a change from a top-down approach to a bottom-up approach is a change in an accounting estimate rather than a change in an accounting policy. The accounting policy is to apply a discount rate to the measurement of insurance liabilities while the estimate is how to calculate the discount rate using either a top-down approach or a bottom-up approach. The change in the calculation of the discount rate will not provide more relevant information relating to the measurement of the insurance liability's financial position, performance or cash flows.
- 5 EFRAG believes that the IASB should provide guidance in the final standard explaining that such a change in the discount rate is to be treated as a change in an accounting estimate rather than a change in an accounting policy.

#### DISCLOSURE OF CONFIDENCE LEVEL

##### Notes to constituents

- 6 *The IASB confirmed in the ED that the confidence interval disclosure is required.*

##### EFRAG's response

- 7 EFRAG does not agree with the decision to retain this disclosure requirement. This disclosure was regarded as being inconsistent with the IASB decision on the unrestricted available techniques and with a study done by actuaries, which concluded that the confidence level was the least appropriate technique for measuring the risk adjustment.
- 8 EFRAG disagrees that the confidence level to which the risk adjustment corresponds should be disclosed. EFRAG also believes that the insurer should generally be required to explain the level of prudence applicable in measuring the risk adjustment.

**INTEREST EXPENSE IN PROFIT OR LOSS FOR THE LIABILITY FOR THE INCURRED CLAIMS FOR CONTRACTS UNDER THE PREMIUM ALLOCATION APPROACH**

**Notes to constituents**

- 9 *The ED proposes that entities should discount/accrete the pre-claims liability only where there is a significant financing component which is consistent with the revenue recognition proposals. The discount rate at inception of the insurance contract should be used to measure the liability for remaining coverage, when discounted or accreted. Consistently with that approach, interest expense in Profit or Loss for the liability for incurred claims would be measured using the rate that applied when the contract was initially recognised. Entities would not need to discount liabilities for incurred claims that are expected to be paid within one year.*

**EFRAG's response**

- 10 EFRAG understands that the premium allocation approach represents an approximation of the general building block model. Accordingly, using the same discount rate for the liability for remaining coverage and the liability for incurred claims is meaningful. However, in certain circumstances, such as when a claim is discovered after the coverage period, the use of the rate when the claim is discovered, rather than the rate at the inception of the contract, would provide more useful information for contracts under the premium-allocation approach. Therefore, EFRAG recommends that the final standard requires the liability for incurred claims to be discounted/accreted using the discount rate when the claim is discovered and not the discount rate at inception of the contract.

**GAINS AND LOSSES ON BUYING REINSURANCE**

**Notes to constituents**

- 11 *The 2010 Exposure Draft proposed that entities should recognise a gain when buying reinsurance. The IASB proposed this to create symmetry with the underlying model and to be consistent with the IASB's conclusion that the contractual service margin for the underlying contract should not be negative.*
- 12 *Such gain arises when the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. Such gain (negative contractual service margin in the reinsurance held) represents a net gain in purchasing reinsurance.*
- 13 *The most likely causes of such a negative difference would be either of the following:*
- (a) *An overstatement of the underlying direct insurance contract(s). A cedant would evaluate this by reviewing the measurement of the direct contract(s).*
  - (b) *Favourable pricing by the reinsurer, for example, as a result of diversification benefits that are not available to the cedant.*
- 14 *The ED proposes that entities recognise the negative difference (i.e. the gain over the coverage period of the reinsurance contract held). The net expense of purchasing reinsurance (i.e. positive contractual service margin) should also be recognised over the coverage period as services are received unless the reinsurance coverage is for events that have already occurred.*

## EFRAG's response

- 15 EFRAG is aware that representatives from the European insurance industry argue that the IASB's proposals on measurement of the reinsurance contractual service margin do not fully reflect the economics of reinsurance transactions and could potentially result in accounting arbitrage. These constituents believe that day one gains and losses from reinsurance contracts should be recognised immediately in Profit or Loss.
- 16 However, EFRAG's view is that when an insurer buys reinsurance coverage, the insurer is not in a position to derecognise the underlying insurance contract and the ultimate responsibility for fulfilling the contract is for the primary insurer. Considering that fact, it would not be prudent or appropriate to recognise a 'day one' gain or 'day one loss' unless the latter relates to an event that has already occurred, when buying reinsurance coverage. It would be appropriate to recognise the reduction in the cost for the cedant over the coverage period as services are provided. EFRAG agree with the proposals in the revised ED.

### Question to constituents

- 17 Do you agree with EFRAG's conclusion that day one gains and losses on buying reinsurance should be recognised over the coverage period? If not, please explain how those should be accounted for and what the supporting arguments for a different accounting treatment are.

## DISCLOSURES OF MINIMUM CAPITAL REQUIREMENTS

### Notes to constituents

- 18 *The 2010 Exposure Draft proposed that an entity should disclose the effect of the regulatory frameworks in which the entity operates, for example, minimum capital requirements or required interest rate guarantees. The ED retains this proposal (paragraph 88).*
- 19 *In response to users' desire, the IASB also considered whether to introduce additional disclosures, such as:*
- (a) Information about how much regulatory capital an entity will need to hold for the new contracts written in the period, and when that capital will cease to be required; and*
  - (b) Information about the amount of equity generated in a reporting period that is not needed to service the regulatory capital requirements. That amount is sometimes referred to as 'free cash flow'.*
- 20 *However, the IASB considered that such disclosures do not arise only for insurance contracts, but could be useful for all entities operating in a regulated environment. The IASB was concerned about developing such disclosures in isolation in a project on accounting for insurance contracts, and believed that a better approach would be to develop such disclosures as part of other work that it may undertake on disclosures more generally.*

## EFRAG's response

- 21 EFRAG agrees with the rationale underlying paragraph BCA232 of the ED that disclosures about the effects of the regulatory frameworks in which an entity operates should be applied consistently for all entities operating in a regulated

environment and should not be developed separately in a project on accounting for insurance contracts. Such disclosures should be part of the IASB's work on disclosures more generally.

- 22 However, EFRAG has some concerns on the requirement in the ED that entities should disclose the effect of minimum capital requirements to which the entity is subject. EFRAG notes that a similar requirement was proposed when IFRS 7 *Financial Instruments: Disclosures* was developed and was implemented through the requirements of IAS 1 *Presentation of Financial Statements*, paragraph 135 (d). This requires information whether or not the entity complied with any externally imposed capital requirements to which it is subject. EFRAG believes that IAS 1 already covers the issue of disclosures of externally imposed capital requirements. EFRAG also notes that disclosures about minimum capital requirements may be prohibited in certain situations by law or local regulation, creating a situation where an entity would be considered as not complying with the requirements in IFRS. Thus, EFRAG recommends that the requirement for disclosure of the minimum capital requirements is deleted in the final standard. However, this should not prevent the IASB to consider such requirement as part of the IASB's work on disclosures more generally to secure consistency with entities operating in a regulated environment.

**Question to constituents**

- 23 Do you agree with EFRAG's recommendation that the requirement to disclose information about the effects of each regulatory framework in which entities operate should be deleted in the final standard? Please explain your answer.

## APPENDIX 3

### Field-testing activities

- 1 In addition to issuing its draft comment letter for comments, EFRAG is carrying out field-testing activities with National Standard Setters ANC, ASCG, FRC and the OIC in coordination with the IASB staff.
- 2 EFRAG's final comment letter to the IASB on the ED will incorporate the results of the field-test activities as completed before finalisation of the comment letter. The results of the field-test activities completed after finalisation of the final comment letter, if any, will be communicated to the IASB separately.
- 3 The purpose of the field-test activities is to:
  - (a) Test the operationality and practicability of the IASB's proposals, i.e. whether the new requirements will operate as intended by the IASB;
  - (b) Assess the main impacts of the IASB's requirements, compared to the current accounting, to different types of insurance contracts;
  - (c) Assess the understandability and usefulness of the information, including disclosures, that will result from applying the requirements; and
  - (d) Evaluate the costs and benefits of the proposed requirements and estimate the effort required to implement and apply them.

In addition, participants are also encouraged to identify any areas of the future standard where they believe the drafting of the proposals is insufficiently clear or does not reflect the IASB's intentions.

- 4 The field-test activities are based on a questionnaire and asks participants to apply the IASB's proposals to a number of selected portfolios, as of the financial reporting date they select, and to extend the field-testing to the financial instruments and non-financial assets related to the portfolios being tested, if any.
- 5 Insurance companies (life and non-life), reinsurance, bank-insurers and conglomerate groups are expected to participate as they are most likely to be affected by the IASB's proposals.

## APPENDIX 4

### Suggestions for clarification in the drafting

1 EFRAG provides below suggestions for clarification in the drafting of the ED.

*Areas/paragraphs in the revised standard:*

- On page 10 just above Q5 – The IASB states that estimates of the contractual service margin may not be verifiable. We believe the text could be improved if the IASB explain the supporting reasons.
- Paragraph 4 – This paragraph specifies that all references in the standard apply to a reinsurance contract held and an investment contract with a discretionary participation feature. EFRAG wonders why this paragraph is needed if both types of contracts are already mentioned in paragraph 3.
- Footnote to paragraph 7 – EFRAG recommends the IASB to clarify whether any further changes in the light of the finalisation of the revenue recognition project would be part of the normal due process of the IASB.
- Paragraph 13 – It should be clarified that the beginning of the coverage period commences when any pre-coverage cash flows are incurred such as *directly attributable acquisition costs*, so that a prepayment asset does not need to be established for these cash outflows before coverage begins.
- Paragraph 27 – It does not specifically mention the remeasurement of the risk adjustment. EFRAG understand that this margin is remeasured by reference to paragraph 29(a). The treatment of the difference is only dealt with in paragraph 60(b). This link could be drafted more explicitly and clearly.
- Paragraphs 29 to 34 – These paragraphs deal with subsequent measurement under the general approach and for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. The subsequent treatment of options and guarantees under both approaches could be clarified in the drafting under both approaches.
- Paragraph 34 – This paragraph deals with the split of cash flows and the wording would be clearer if it explicitly mentions that this has to be done.
- Paragraph 82 – As explained in the Basis for Conclusions, the IASB is the view that it is not possible to identify the assets backing insurance liabilities. EFRAG wonders whether such view is consistent with the required disclosure about investment returns on the related assets that an entity holds.
- Appendix A – This appendix defines the ‘contractual service margin’ as unearned profit. EFRAG notes that such description would be clearer to understand if ‘unearned profit’ is better described.
- Paragraph B32 – This paragraph of the application guidance deals with investment components that cannot be split at inception because they are highly interrelated with the insurance component. If the idea is that the investment component is not known in advance, but known once the transaction has happened (i.e. at the reporting date) then the text should clearly explain this fact.

- Paragraph B61 – This paragraph explicitly prohibits the entity to take into consideration future events, such as a change in legislation. This is not consistent with the requirements in IAS 12 *Income Taxes*, paragraphs 46 – 47, which take into consideration legislation that is 'enacted or substantially enacted'. EFRAG suggests this should be amended to make it consistent with IAS 12.
- Paragraph B87 – This paragraph of the application guidance could be clearer if the IASB mentions that the entity must also hold the assets.
- Paragraph C3 – We recommend moving 'derecognise' from first sentence to paragraph C3(a).

*Areas/paragraphs in the Basis for Conclusions:*

- BC26 - The text gives the impression that the contractual service margin relates to asset management and other services only, not to the profit margin on insurance coverage.
- BC32 – If contracts become onerous, there is a loss recognised in the income statement. The IASB should clarify how the subsequent recovery would be reported. There could be first a reversal of the previous loss in the income statement, or the full amount could be adjusted in the contractual service margin.
- BC127(b) – This paragraph explains that there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items. This paragraph should better articulate the differences on the treatment of options and guarantees under the ED.
- BCA69 – The IASB should clarify whether the impact of discounting is disclosed separately.
- BCA105 to 109 – BCA105 mentions providing service, BCA109 mentions coverage and services. We recommend the IASB to address the drafting inconsistencies.
- EA8 – The IASB should clarify whether the investment component is also excluded in the premium allocation approach. There is no exception mentioned in the main text of the ED.



## Appendix 5

### Consideration of an alternative approach of the insurance industry for participating contracts or contracts with discretionary participation features

#### Background

1. EFRAG has been informed that European and other global insurers are discussing an alternative to the IASB's proposed 'mirroring approach', which applies only to the measurement and presentation of contracts that require the entity to hold the underlying items and specify a link to returns on those underlying items. These proposals have been developed during the last eighteen months. Its key principles are considered to be complete and stable, although work is continuing to improve and refine the proposals, and some details are still under discussion within the industry.
2. This Appendix has been prepared with the assistance of representatives of these insurers and sets out EFRAG's understanding of the key principles and specific mechanics underlying the insurance industry proposals (the 'alternative approach'), and of the main differences with the IASB's proposals for contracts with cash flows that are asset dependent.
3. EFRAG has not yet formed a view on the alternative approach and has not yet assessed its technical details, operational complexities or conceptual/technical merits. However, EFRAG has tentatively expressed several concerns on the 'mirroring approach' proposed by the IASB, as described in appendix 1. In the finalisation of its comment letter, EFRAG intends to consider whether the alternative approach can address (wholly or partly) these concerns and which views, if any, EFRAG will express in respect of this alternative approach.
4. To support this process, EFRAG invites constituents to provide feedback on the alternative approach by answering the questions on this approach included in appendix 1. For constituents' convenience, these questions are repeated in the next section.

**Questions to constituents – please provide your answers considering EFRAG’s recommendation in our response to question 4 and in the context of the currently proposed limited amendments to IFRS 9 in respect of classification and measurement**

- 5 Do you believe the alternative approach described below will lead to financial statements that provide relevant information that faithfully represent the entity’s financial position and performance for contracts with asset dependent cash flows? Why or why not? If not, what would you recommend and why? Please consider whether the alternative approach eliminates or reduces accounting mismatches while reporting consistently contracts with similar economic features (i.e. contracts with asset dependent cash flows). Do you support the alternative approach as a whole or in part? Please explain, which parts do you support and which you do not?
- 6 Do you believe that for contracts with asset dependent cash flows, the effect of changes in financial assumptions should be accounted for in the contractual service margin resulting in a fully prospective contractual service margin? If so, why and how should this be done?
- 7 Do you agree that interest expense should be recognised in Profit or Loss based on a yield as proposed in the alternative approach (please refer to paragraphs 21 – 25 below for a description of the yield curve under the alternative approach)? Why or why not?
- 8 What should be the pattern of release of the contractual service margin for contracts with asset dependent cash flows?
- 9 Do you believe the alternative approach is operationally more or less complex than the IASB’s ‘mirroring approach’?
- 10 Do you believe that the alternative approach or a variant thereof, would be conducive of understandable and useful information for investors and their advisors?

**The alternative approach proposed by the insurance industry**

*Scope*

- 11 Contrary to the IASB’s proposals in paragraphs 33 and 34 of the ED, the alternative approach would not establish an exception for the measurement of participating contracts or contracts with discretionary participation features but proposes a fully prospective current fulfilment value for all insurance contracts in accordance with the general measurement model as defined in the ED.
- 12 By defining how to apply the general measurement approach of the ED to these contracts, the alternative approach aims to measure economically similar contracts in a consistent way. The alternative approach builds on the existing general principles of the ED and attempts to faithfully present the economic value and performance of all insurance contracts with asset dependent cash flows. This is in contrast to the IASB’s proposed ‘mirroring approach’, which would apply only to contracts that require the entity to hold the underlying items and specify a link to returns on those underlying items. The alternative approach would apply to a broader scope of contracts with dependency on asset returns.

*Key principles*

- 13 Under the alternative approach, all insurance liabilities would be measured at current fulfilment value on the face of the balance sheet to ensure a consistent measurement basis. Profit would be recognised in accordance with the fulfilment of the contract in line with release from risk, in accordance with general revenue recognition principles.
- 14 The insurance liabilities and the related assets would be measured and presented in a consistent way, reflecting their interaction. The starting point for the measurement of insurance liabilities is their current fulfilment cash flows, as opposed to the measurement basis of the assets backing those liabilities, which is the case in the mirroring proposal of the ED.
- 15 The contractual service margin would always reflect the unearned profit of shareholders arising from the insurance contracts and be determined on a fully prospective basis with current financial and non-financial assumptions. Changes in future gross profit expectations should be deferred through the contractual service margin.
- 16 The insurance liability is prospectively calculated under the general measurement model and includes all contractual and discretionary expected future cash flows. The contractual service margin follows the principle of prospective measurement. In contrast to the ED, it also is adjusted for changes in financial assumption for participating contracts whose cash flows significantly depend on the asset returns, including reinvestment assumptions.

*Specific mechanics*

Measurement of insurance liabilities at inception and subsequently (excluding the contractual service margin)

- 17 The insurance liabilities are calculated in the general measurement model as the amount of the fulfilment cash flows in accordance with paragraphs 18-27 of the ED. The exceptions in paragraphs 33 and 34 would not apply.
- 18 In line with the requirements of the ED, entities would consider all contractual and discretionary expected future cash flows. When the policyholder participates in the investment returns of underlying items, entities consider both (i) expected cash flows from existing assets, which would be reflected in the expected cash flows of the insurance liability, and (ii) expected cash flows from future reinvestments, which would be considered in the measurement of the liability using current market rates.
- 19 Options and guarantees embedded in the insurance contracts which are not unbundled are reflected at current value determined under a set of stochastic scenarios, in order to reflect the potential effects on the liability. This is in line with the IASB's general measurement requirements, which apply to all cash flows arising from insurance contracts without distinguishing the cash flows that specifically arise from options and guarantees. The time value of options and guarantees are therefore included in the liability at current value.
- 20 In summary, the measurement of the expected present value of future cash flows in the balance sheet under the alternative approach does not differ from the general measurement model proposed in the ED. However, in the ED the IASB proposes to not apply this model but requires to bifurcate the cash flows for certain types of participating insurance contracts according to paragraphs 33 and 34, and a measurement in accordance with the asset measurement. This would lead to a different measurement basis compared to the alternative model.

Interest expense in profit and loss

- 21 For the purposes of unwinding the current insurance liabilities on the balance sheet to recognise interest expense in Profit or Loss, entities would use a discount rate as defined by the ED in paragraphs 25, 26 (a) and 60 (h).
- 22 That includes the reflection of the dependence of the liability cash flows on the returns of assets which the ED has defined in paragraph 26(a):
- (a) For the portion of the contract's duration that is matched with the assets' duration (asset-liability matched part), the yield of the assets that back the insurance contract (for bonds this is the yield net of adjustments for credit defaults; for real estate, equities and derivatives the yield is determined as the current risk-free returns); and
  - (b) For the portion of the contract's duration that is not matched with the assets' duration (asset-liability unmatched part for which entities are exposed to reinvestment risk), the expected reinvestment yield based on current market-consistent rates and the existing asset allocation.
- 23 The Profit or Loss is driven by the unwinding of the discount rate. As the cash flows for participating contracts are expected to vary directly with returns on underlying items, paragraph 60(h) applies. This requires an unlocking of the discount rate when changes in underlying items change the expected future cash flows of the liability.
- 24 To the extent that the expected liability cash flows for participating contracts also change when there is a change in the reinvestment assumptions, the update of the discount rate should reflect such changes as well.
- 25 As a result, the discount rate used for the alternative approach is in line with the requirements of the ED, specifically paragraphs 26(a) and 60(h). This requires, however, that the term 'underlying items' is applied in a broad sense and that reference can be made to the actual portfolio of assets when there is no asset-liability mismatch, and to expected reinvestment rates when there is such mismatch.

Adjusting the contractual service margin

- 26 The ED defines the contractual service margin as unearned profit that the entity recognises as it provides services under the insurance contract. For the subsequent measurement, paragraph 30 requires an adjustment to the remaining amount of the contractual service margin for a difference between the current and previous estimates of the cash flows that relate to future coverage and other future services. The alternative approach builds on the definition of the contractual service margin as unearned profit and the unlocking principles of paragraph 30.
- 27 Under the alternative approach, the contractual service margin is adjusted each reporting period to represent the whole of the remaining unearned profit arising from the insurance contract. This requires that all assumptions underlying the calculation of the contractual service margin as the present value of future profits are updated. As a result, the contractual service margin under the alternative approach is defined consistently at initial recognition and for subsequent measurement, as it is calculated on a fully prospective basis, as is the case for the other building blocks of the current fulfilment value concept.
- 28 The alternative approach takes the view that asset management activities, i.e. crediting asset returns to the policyholder, are explicit services under the insurance contracts. The level of these services changes over time because expectations on future asset returns which impact the liability cash flows are changing with the change of the investment portfolio and with the changes in

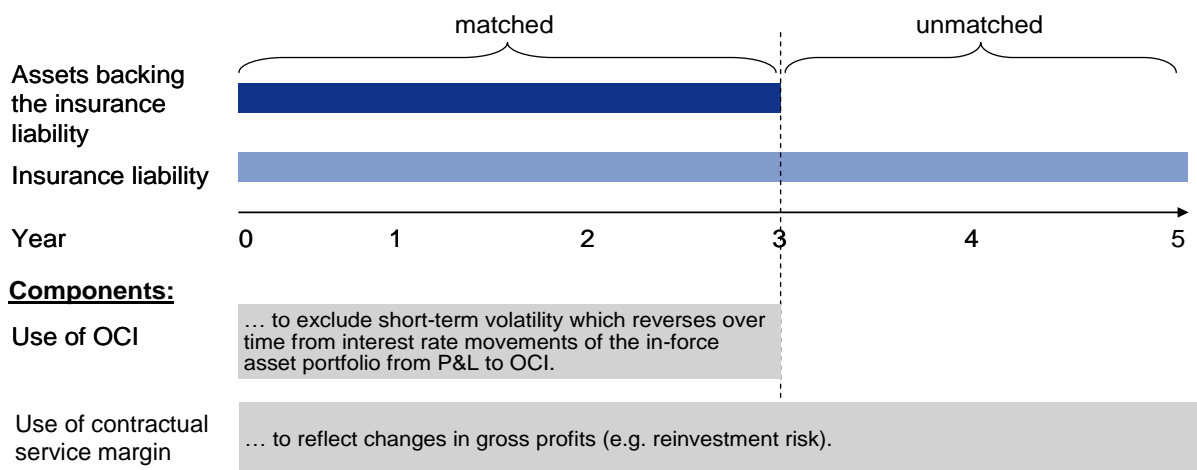
reinvestment assumptions in case of an asset-liability mismatch. Therefore, the contractual service margin should be adjusted for such prospective changes of the profitability of the contract as required by paragraph 30.

- 29 However, the ED contains guidance, which could lead to an interpretation that unlocking the contractual service margin is not allowed for changes in the estimates relating to the returns of assets backing insurance contracts (BC41).
- 30 Under the view that the contractual service margin represents the remaining unearned profit at each reporting date, entities would release this margin based on the changes of the present value of expected future profits. The release would be driven by how gains and losses arising from underlying items are realised and allocated to the policyholders. The amount of asset returns credited to the policyholders could serve as a proxy for the services provided in that period, because asset management services are the main service provided under a participating contract.
- 31 Regarding this pattern of release, it should be noted that the ED is quite open, as it requires entities to release the contractual service margin in the systematic way that best reflects the remaining transfer of services that are provided under the contract, and does not prescribe a specific pattern of release.
- 32 Under the alternative approach, entities would accrete interest on the contractual service margin based on the updated discount rate, consistently with how interest expense is recognised in Profit or Loss for the other components of the insurance liability. The use of such unlocked discount rate would allow the contractual service margin to reflect future gross profits expectations, as those expectations are calculated based on the present value of future profits considering assumptions on reinvestment rates.
- 33 In contrast, the IASB's proposals would accrete interest on the contractual service margin based on the locked-in discount rate determined at inception. The differences between both approaches would impact the amounts recognised as insurance contract revenue in Profit or Loss.
- 34 To be able to present the contractual service margin on a fully prospective basis with the same definition at initial recognition and at every subsequent reporting date, the contractual service margin should be adjusted for changes in the risk margin related to future coverage as well. However, the ED does not allow this.
- 35 In summary, the contractual service margin under the alternative approach reflects the remaining unearned profit of the insurance contract, and this profit would be earned as it emerges over time. In contrast, the contractual service margin under the IASB's approach would represent the unearned profit arising from the insurance contract as estimated at the inception of the contract, adjusted to reflect the time value of money by accreting interest with a locked-in rate and to reflect changes in estimates of cash flows relating to future coverage or other future services.

*Illustration of how OCI and the contractual service margin are used under the alternative approach for insurance liabilities*

- 36 The chart below illustrates how the asset-liability mismatch impacts performance reporting under the alternative approach. In particular, entities would use OCI to report changes in the insurance liability arising from changes in the current discount rate in the period in which the duration of the insurance liabilities and related assets are matched (asset-liability matched period). Accordingly, the amounts reported in OCI would reflect short-term movements in the discount rates that reverse automatically over time and that do not affect performance.

- 37 However, interest rate movements will impact the performance of the entity if the entity is exposed to reinvestment risk after the matched period (i.e. if there is an asset-liability mismatch period). In that case, the present value of the future profits will change and entities would adjust the contractual service margin to reflect a higher or lower expected reinvestment yield in the gross profits arising from the portfolio. The reinvestment yield would be measured based on market assumptions.



### Comparison with the IASB's proposals

- 38 The tables below compare the alternative approach proposed by the industry with the IASB's general requirements and the measurement and presentation exception proposed in the ED for contracts that require the entity to hold the underlying items and specify a link to the returns on those underlying items (the 'mirroring approach').

#### Initial measurement

	IASB's mirroring approach	IASB's general requirements	Alternative approach
Insurance liability (excluding contractual service margin)	<ul style="list-style-type: none"> <li>Bifurcation of cash flows into asset dependent, fixed cash flows and option components.</li> <li>Cash flows arising from the insurance contract that vary directly with returns on underlying items are measured by reference to the carrying amount of the underlying items.</li> <li>Other cash flows are measured at current fulfilment value.</li> </ul>	<ul style="list-style-type: none"> <li>Measured at current fulfilment value.</li> <li>The cash flows arising from options and guarantees are treated in the same way as any other expected cash flows.</li> </ul>	<ul style="list-style-type: none"> <li>Measured at current fulfilment value, including current reinvestment assumptions.</li> <li>The economic value of options and guarantees is included using stochastic valuation.</li> </ul>
Time value of money to determine the insurance liability presented in balance sheet	No differences for determination of current discount rate.		

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Risk adjustment	No differences for determination of risk adjustment.		
Contractual service margin	Difference between premiums and above components.	Difference between premiums and above components.	Difference between premiums and above components.

*Subsequent measurement*

	IASB's mirroring approach	IASB's general requirements	Alternative approach
Insurance liability (excluding contractual service margin)	<ul style="list-style-type: none"> <li>Asset-dependent cash flows measured by reference to the carrying value of the underlying items.</li> <li>Fixed cash flows measured at fair value through OCI with locked-in discount rate.</li> <li>Option components measured at fair value through P&amp;L.</li> </ul>	<ul style="list-style-type: none"> <li>Measured at current fulfilment value. The cash flows arising from options and guarantees are treated in the same way as any other expected cash flows.</li> <li>Unwinding of the insurance liability based on locked-in discount rate at inception and updated discount rate for cash flows that are expected to vary directly with returns on underlying items.</li> </ul>	<ul style="list-style-type: none"> <li>Measured at current fulfilment value, including current reinvestment assumptions. The current economic value of options and guarantees is included using stochastic valuation.</li> <li>Unwinding of the insurance liability based on the yield of the existing assets backing the contract in the matched period (see paragraph 20(a)) and the expected yield for reinvestment assets in the unmatched period (see paragraph 20(b)).</li> </ul>
Time value of money to determine the insurance liability presented in balance sheet	No differences for determination of current discount rate -		
Risk adjustment	<ul style="list-style-type: none"> <li>Changes are recognised in Profit or Loss.</li> <li>No unlocking of contractual service margin.</li> </ul>		<ul style="list-style-type: none"> <li>Changes related to past coverage are recognised in Profit or Loss.</li> <li>Unlocking of contractual service margin for changes related to future services.</li> </ul>
Contractual service margin	<ul style="list-style-type: none"> <li>Accretion of interest using locked-in discount rate.</li> <li>Margin released as service is provided.</li> <li>Margin only adjusted for changes in estimates of future cash flows that relate to future coverage and other future services.</li> </ul>		<ul style="list-style-type: none"> <li>Prospective measurement of this margin that represents unearned profit of the contract at each reporting date consistent with initial measurement at day one. (*)</li> </ul>

(\*) At this point in time, there are two views how to treat the changes in the time value of option and guarantees:

View 1: Changes in time value of options and guarantees are offset by a corresponding unlocking of the contractual service margin; and

View 2: Changes in time value of options and guarantees are recognised in OCI. Thus, the contractual service margin deviates from the margin in view 1.

39 The alternative approach would require a disclosure of the changes in the contractual service margin in the reporting period. This would show a reconciliation of the unearned profit of the insurer due to changes in financial assumptions

(reinvestment assumptions), changes in non-financial assumptions, and, under view 1, changes in the time value of options and guarantees. In this way, all changes are clearly and transparently disclosed to the users of financial statements.

- 40 The alternative approach would also be applicable to a portfolio of insurance contracts and the related assets that are managed on a fair value through profit and loss basis. A measurement at fair value through profit and loss would be most appropriate and would be required under the alternative approach for unit-linked contracts where 100% of the investment risk is passed on to the policyholders or for insurance contracts where derivatives are used to hedge the investment risk

*The insurance industry view in respect of the advantages of the alternative approach*

- 41 The alternative approach would provide decision useful information for participating contracts as it provides a current fulfilment value for the insurance liability in the balance sheet, while reflecting the long-term nature of the insurance business when recognising profit. The alternative approach builds on existing principles in the ED as it is in line with:
- (a) A consistent measurement of assets and liabilities as reflected in the definition of cash flows and the determination of the discount rate;
  - (b) The general objective of measuring all insurance contracts at current fulfilment value and having one consistent accounting model (the exceptions in paragraphs 33 and 34 of the ED are not required);
  - (c) The definition of the contractual service margin as it presents “unearned profit” at current assumptions, instead of proposing a mixture between locked-in assumptions and unlocking; and
  - (d) The concept that insurance contracts provide a service over time resulting in the deferral of expected future gains at inception via the contractual service margin and applying the same rationale also for subsequent measurement.
- 42 The alternative model enables current value measurement while reducing the complexity of the ED as bifurcation of asset cash flows is not needed and actuarial systems can be applied.
- 43 In addition, the alternative approach might reduce the need for non-GAAP measures: it provides updated information on the future profitability of a portfolio of insurance contracts using fully current input parameters. Such a model could probably lead to a situation where non-GAAP performance measures like embedded value information are not anymore required to inform analysts.
- 44 The alternative approach leads to a profit pattern which reflects the long-term nature of the insurance business, and distinguishes between realised returns for services provided reflected immediately in net income and changes in the future expected profits which are captured in the contractual service margin.
- 45 Finally, the alternative approach is based on a fully prospective measurement. As such, it would eliminate the need to recalculate elements with past data upon transition to the future IFRS on insurance contracts.