

STAFF PAPER

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Project	Insurance contracts		
Paper topic	Feedback from users of financial statements		
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Purpose of the paper

1. This paper summarises the feedback from 44 discussions with 159 users of financial statements conducted between June and December 2013 and the views in the 5 comment letters received from users of financial statements on the 2013 Exposure Draft *Insurance Contracts* (2013 ED).
2. This paper supplements Agenda Paper 2A *Outreach and comment letter analysis* for this meeting. This paper does not ask any questions.

Structure of this paper

3. This paper summarises comments from users of financial statements in the following categories:
 - (a) overall comments on the accounting for insurance contracts, in paragraphs 5-13; and
 - (b) comments related to topics on which the IASB was specifically seeking feedback, in paragraphs 14-35.
4. The Appendix provides statistical information about the discussions with users of financial statements by type of respondent and by region.

Overall comments on the accounting for insurance contracts

Need for change

5. Most users of financial statements recognise the need for change to the accounting for insurance contracts. This theme is observable mostly among those that follow insurance companies that have operations in different jurisdictions or those that try to compare different types of businesses, for example life vs. non-life, or insurance vs. banks or any service business. They highlight the following issues:
- (a) There is a lack of comparability between financial statements of entities issuing insurance contracts. This is the case:
 - (i) Between insurance contracts in different jurisdictions, as a result of using different accounting requirements. This is especially important for those that analyse financial statements of companies that account for insurance contracts using IFRS 4 *Insurance Contracts*, which permits the use of a variety of accounting bases to measure insurance contracts.
 - (ii) Between different types of insurance contracts within the same company, because many accounting practices today use different accounting models to account for different contracts.
 - (b) There is a lack of transparency about insurance contracts in financial statements. This is because:
 - (i) It is difficult to understand the source of profit for an entity that issues insurance contracts.
 - (ii) For many contracts, information is not provided on a timely basis because the assumptions underlying the measurement of insurance contracts are not updated or not updated on a timely basis.
6. However, there are some users of financial statements that think that the existing accounting for insurance contracts does not need significant change. In addition, some users of financial statements are not convinced that the proposed changes are an improvement to the existing accounting or that the cost of implementation of the proposed Standard would outweigh the benefits. They are especially concerned that the accounting for insurance contracts has been established for a long time in their

individual jurisdiction and they will lose trend data if the accounting changes. Those concerns are mainly highlighted by:

- (a) users of financial statements who focus primarily on entities in one country, especially from USA or Australia; and
- (b) users of financial statements of entities that issue primarily non-life insurance contracts.

Views on current, market consistent information

7. Most users of financial statements support the model proposed in the 2013 ED, which is based on current, market-consistent information. However, some users expressed the following concerns:

- (a) Some believe that an accounting model based on market-consistent information would not represent faithfully the business model for insurance entities. They believe that the business model is based on long-term risk management and is thus relatively stable. Therefore they do not think the accounting should reflect the short-term fluctuations in a market-based interest rate. Such short-term fluctuations could be difficult to use for projections, or result in changes of share price, even when market conditions are unusually good or bad and are not expected to persist (sometimes referred to as pro-cyclicality). As a consequence, some think that the insurance liability should be discounted using a locked-in interest rate at inception (often referred to as cost accounting) with changes in the interest rate highlighted in the notes. Others propose that the interest rate should be updated less frequently than changes in market interest rate (for example, annually, not quarterly) or should be updated at management’s discretion. These views are most common in the USA and Canada.
- (b) Some think that there may be many unintended consequences of the separate measurement of financial assets and insurance liabilities, such as accounting mismatches or volatility, which could otherwise be avoided. This issue is highlighted especially in Canada.

- (c) A few analysts from USA doubt whether discounting of short-term contracts would be beneficial. They believe that discounting adds complexity without additional benefit because the main purpose of those contracts is insurance protection not investment activities.
8. Those who support current value accounting emphasise that it would result in the more timely delivery of more objective information about any forthcoming risks, because providing that information would not depend on management's assessment of when changes in estimate should be reflected in the financial statements.
9. However, some are still concerned about the extent to which the accounting would depend on subjective estimates and assumptions used, because this would impair comparability. For example:
- (a) Some doubt whether a separate risk adjustment would be beneficial. Most do not dispute that such information has value, but they think that in practice lack of comparability might diminish the usefulness of this information.
- (b) Some are concerned about the comparability of the discount rate used; in particular, a few think that allowing two methods for estimating the discount rate (ie the top-down and bottom-up approaches) could impair comparability in practice.
- (c) Those who are concerned about use of assumptions emphasise the importance of disclosures that would enhance the understandability of assumptions used.
10. One user was concerned that in countries with less liquid markets, entities would be unable to match the durations of cash flows from insurance liabilities with those from the assets, and would be at a competitive disadvantage because of the economic mismatches that the model would report. Another user expressed the view that if the effect of these economic mismatches had been reported on a timely basis in the past, the management of companies that might have been forced to address these real economic risks before it became too late.
11. The 2013 ED proposes to show the effect of the underwriting activity separately from the investment activity. Many users of financial statements highlighted the usefulness

of such separation. They think that this information would help them to understand sources of earnings and to compare insurance with other businesses. Further details are discussed in paragraph 16(b).

Disclosures

12. Most users of financial statements emphasise the importance of disclosures. In particular they supported:
 - (a) disclosure of the reconciliation of changes in the balance sheet amounts and amounts recognised in the statement of comprehensive income. They stated that this would be of particular importance for understanding changes related to expected cash flows that are accounted for as a change in the contractual service margin (please refer to the section related to unlocking the contractual service margin in paragraph 14);
 - (b) disclosures about assumptions used in the measurement and the sensitivity of the results to changes in those assumption (please refer to paragraph 9); and
 - (c) disclosures at a granular level because they would provide more information about different businesses. A few proposed that there should be a standardised way of providing more detailed information (based for example on the type of risk). However others noted that for different entities different reconciliations might provide better information (for example based on geographic region).
13. Some users of financial statements are concerned that entities would provide, in addition to IFRS financial statements, different information to comply with US GAAP or Solvency II. They would like to see reconciliations between such information and amounts based on the IFRS requirements to understand the sources of difference between them.

Comments related to the topics on which the IASB was specifically seeking feedback¹***Unlocking the contractual service margin***

14. The 2013 ED proposes that changes in cash flows related to future services should be accounted for as a change in the contractual service margin (representing the unearned expected profit in the contract) rather than a change in profit or loss for the period. Most users of financial statements agree with this proposal but note the importance of disclosing the amounts of changes in estimates in the period that are adjusted in the contractual service margin. The main reasons for the agreement are:
- (a) They believe that change in estimates of profits relating to future services should be reflected in profit or loss when the future services are provided. In particular, when changes in expected cash flows (for example from unfavourable changes in mortality assumptions) are so severe that the contract is loss-making, they disagree that the entity would report profits in the future periods during which it delivers the loss-making service.
 - (b) Unlocking would be more consistent with the results of applying the premium allocation approach and other IFRSs, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
 - (c) Unlocking makes profit or loss less volatile and it is therefore easier to see trend information that is useful in making projections.
 - (d) There is less incentive to manipulate change in assumptions related to future service because any such change would affect profit or loss in a future period rather than in the current period.
15. Some preferred that the effect of any changes in assumptions should be recognised immediately in profit or loss. Those with this view emphasised that such changes represents important economic events that would be omitted from the financial statements. They believe that showing such information only in the notes would not provide sufficient transparency. This view is shared especially by some European

¹ Not all 5 topics that the IASB was seeking feedback on were discussed with all users of financial statements because of the time restrictions, or because some topics were not relevant, for example mirroring if there were no participating contracts issued by analysed companies.

users of financial statements who support embedded value² measurement, some buy-side users of financial statements that also follow other financial institutions and some credit users of financial statements.

16. Users of financial statements also commented on the following related issues:
- (a) Many users of financial statements think that it is important to understand the pattern of recognition of the contractual service margin in profit or loss. They would like to know how the contractual service margin is expected to be recognised in profit or loss in future.
 - (b) The 2013 ED proposes that an entity should report as an investment activity any changes in the discounting effect of any event and therefore the contractual service margin is unlocked for the present value of cash flows using the rate at inception rather than the rate at the reporting date. Some users of financial statements were concerned that as a consequence of such an approach, the effect of the same economic event might be presented in different places. For example, if interest rates changed after inception of the contract, a change in the mortality assumptions that would cause the delay or acceleration of a payment of claims would cause a change in the investment activity that is mainly presented in other comprehensive income. Some users of financial statements would prefer to see all the effects of the same economic event reported in one place.
 - (c) A few users of financial statements suggested that the contractual service margin should be unlocked for the changes based on the expected persistency of the event rather than the type of cash flows. For example, if the change is expected to be a one-time event, such changes should be recognised in profit or loss immediately (for example, the invention of a medicine for cancer). However, if the change is expected to repeat in future (for example, a change in mortality rates) then such a change should be offset in the margin.

² Embedded value is a method of placing a value on a life insurance company. It is calculated as the present value of expected net future cash flows to a shareholder arising from in-force insurance contracts (as opposed to new business), using best estimate assumptions of future cash flows, plus the shareholders' net assets.

Mirroring: exception to the measurement model

17. The 2013 ED proposed a measurement and presentation exception for some types of participating contracts. Participating contracts promise to pay to policyholders amounts based on the return on underlying items. For such contracts, part or all of the risk related to the underlying item is transferred to the policyholder. As a result, to the extent that the cash flows from the contract vary directly with the cash flows from those underlying items, no economic mismatch could be possible. To reflect this fact, the IASB proposed that cash flows that vary directly with the underlying items would be measured and presented the same way as the underlying items.
18. This topic was discussed only with users of financial statements who analyse companies that issue participating contracts. Many of those users agreed with this proposal, because they think that it reflects better the economics of those contracts because an accounting mismatch should not be reported where no economic mismatch could occur.
19. Some users of financial statements disagreed with this proposal because they think that any exceptions to the measurement for some insurance contracts would impair comparability between them. Some also disagree with measuring components of insurance contracts in different ways ie one component might be measured using amortised cost and another using current value.
20. Many users of financial statements were concerned about the treatment of options and guarantees that are very often part of participating contracts. Most agree that options and guarantees should be measured using a current value approach. They noted that measuring options and guarantees in this way would be a significant improvement to the existing accounting requirements that often do not require recognition of the value of the options and guarantees on a timely basis. However, views differed as to how the changes in the value of options and guarantees should be presented:
 - (a) Some thought that those changes should be presented the same way as changes in estimates of other cash flows. However, a few others noted that such a presentation would cause accounting mismatches when the risk of options and guarantees is hedged because for example some changes in

hedging instruments might not be presented in OCI (see also paragraph 30(a)).

- (b) Some noted that presentation of all changes in the current value of options and guarantees would make profit or loss too volatile and they would prefer to avoid this.

Presentation of revenue and expenses for all insurance contracts

- 21. The 2013 ED proposed that insurance contract revenue and expense would be presented for all insurance contracts in a consistent and similar way. Applying the proposals:
 - (a) insurance contract revenue would reflect the amount of the service that the entity provided for the period. For long-term contracts, this service would be measured explicitly as the decrease of the measured obligation to provide service in future (reflected as the liability for remaining coverage).
 - (b) insurance contract revenue and expense would exclude the investment component that reflects the amounts that the entity is obliged to pay regardless of whether the insured event would occur (ie any accumulated account balance or cash surrender value).

- 22. Many users of financial statements agreed with the conceptual merits of the proposal. The support for the proposals was mainly from buy-side analysts, and those who cover non-life insurance business, composite insurers or conglomerate companies. They emphasised the advantages of:
 - (a) comparability between short-term and long-term insurance contracts (especially for composite insurers); and
 - (b) the simple-to-understand presentation format that could be used to discuss results with non-specialists.

- 23. On the other hand, sell-side analysts or those that analyse mostly long-term insurance contracts and other financial institutions generally disagreed with the proposals. They think that different presentation approaches for different types of insurance contract is reflective of the different economics of those contracts. In addition, they emphasise

that there has been a very long history of different presentation formats for different types of insurance contracts so users of financial statements do not expect such comparability. Instead, they propose the IASB should require the summarised margin presentation as proposed in 2010 ED, because they believe it provides the most important information for understanding the performance of long-duration insurance contracts.

24. In general, credit analysts have less interest in presentation in the statement of comprehensive income, because they focus their analysis mostly on the balance sheet evaluation.
25. Those who agree and those who disagree with the proposals are both concerned about the understandability and usefulness of the proposed insurance contract revenue (however, the degree of this concern is different):
 - (a) Some note that if the IASB pursues this proposal, it will need to educate users of financial statements, because the proposed top line (insurance contract revenue) is different from the premium information presented today. In addition, they are unclear as to what insurance contract revenue represents, and whether and how it will be used. Specifically many note that they would need to reassess how they interpret the new ratios currently based on premiums. This view is common for both those that use existing top line numbers as well as those that do not use them because existing amounts do not provide useful information.
 - (b) Some doubt that the proposed requirements would meet the needs of users of financial statements, because they use revenue:
 - (i) to project expected future profits. In the proposed accounting model, expected future profits are already known through the explicit margins recognised in the insurance liability; or
 - (ii) as a proxy for the amount of new business in the period, including the increase in deposits. The proposals would report as insurance contract revenue the amount of service provided in the period regardless of whether that service relates to contracts written in the current or previous periods. In

addition, the amount of insurance contract revenue would also exclude deposits.

- (c) Some are concerned that insurance contract revenue might be too subjective (especially compared to cash flow information) and too volatile when assumptions change. Those with this view regard revenue primarily as a useful proxy for the cash information.
26. Most users of financial statements emphasise the need for both the information provided by the summarised margin presentation and the information about activity measures such as volume information. However, as described above, they have a different view of whether volume information is important enough to be presented on the face of the financial statement or whether it is enough if such information were to be provided in the notes.
27. All users of financial statements who commented on this topic emphasised that deposits included in the premium should not be presented as revenue. As a consequence, some supported the proposal. Others thought that excluding the deposits from revenue might be too subjective or too difficult, and therefore preferred a summarised margin presentation.

Presentation of some of the investment result in other comprehensive income (OCI)

28. The 2013 ED proposed that the amounts presented in profit or loss as interest expense on the insurance contract liability would be based on the discount rate calculated at inception of the contract. The difference between that interest expense and the interest expense measured using the discount rate calculated at the reporting date would be presented in OCI.
29. The views expressed on the use of other comprehensive income for presenting the effect of changes in discount rate were correlated to views on the use of market-based model for measuring those liabilities (those views are described in paragraphs 7-8).
- (a) Those who do not generally use market-consistent information often agreed with the proposal because it continues to provide them with cost-based information. In addition:

- (i) some think that both types of information (current value and amortised cost) are useful and that the proposals would be an improvement to current accounting.
 - (ii) a few think that the usefulness of each piece of information might depend on the type of the contract.
- (b) Those that generally use market-consistent information often agreed with the proposal because they think that the geography of the presentation does not matter if all information is provided and if there is sufficient education provided to ensure that users know where information is presented. In this context, some think the proposal is an ‘elegant solution’, which is good enough because it allows a step in the ‘right direction’ ie towards current value for insurance contracts.
- (c) Some, particularly in Australia, disagreed with the proposal mainly because they already receive current value information and they are used to understanding its effects. Those with this view would prefer all changes in the insurance contract liability to be recognised immediately in profit or loss. They believe splitting the investment performance between two places—profit or loss and OCI—is artificial and adds unnecessary complexity to the reporting.
30. Many are concerned about mismatches that would be created by the proposed mandatory use of OCI, if assets would be measured other than at fair value through other comprehensive income (FVOCI). In addition:
- (a) Some think it would be inappropriate that the extent of accounting mismatch would increase as an entity hedges the risk by asset-liability management.
 - (b) Some think that accounting mismatches should be presented in OCI.
 - (c) Some think that accounting mismatches should be reduced by allowing an option for presenting some interest changes in profit or loss.
31. Other concerns noted by those who agreed and those who disagreed with the proposals for presenting the interest expense include:

- (a) The possibility of manipulation of result in profit or loss by structuring sales of the financial assets. However, some note that this is a common issue with cost accounting.
- (b) The lack of transparency of information about the effect of changes in interest rates because currently most users of financial statements do not systematically use information in other comprehensive income.
- (c) Profit and loss would still be volatile because of the requirement to reset the discount rate for example for universal life contracts.

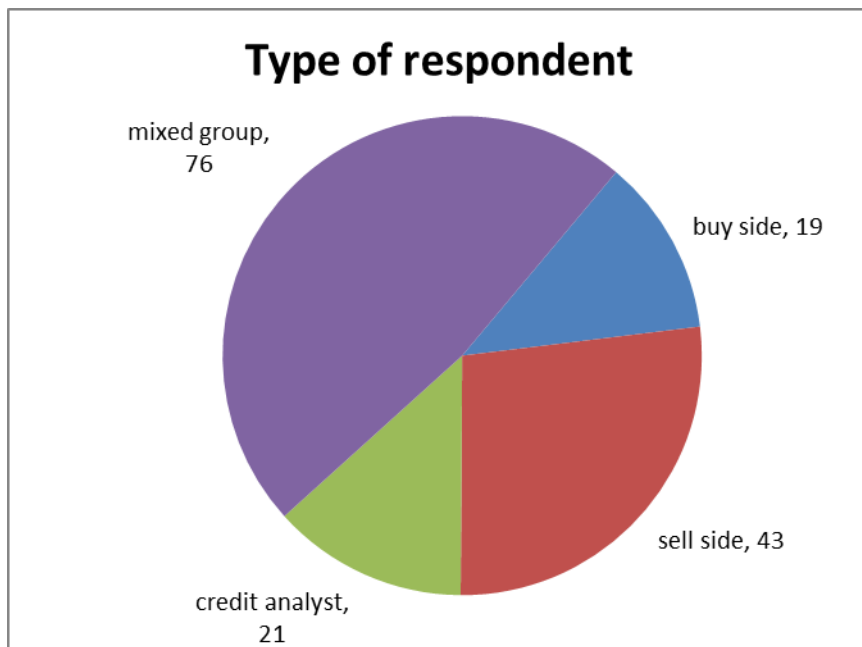
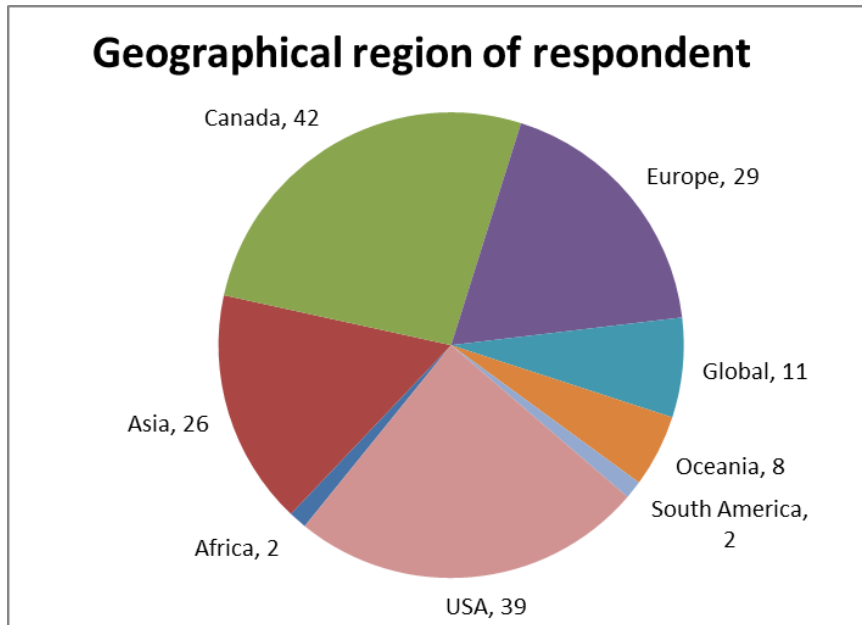
Transition to the Standard for the first time

- 32. The 2013 ED proposed an approach which would require retrospective determination of the amount of contractual service margin and the accumulated OCI that results from the change in the discount rate since inception. In addition, because of the duration of the contracts, the ED also proposed some practical simplifications for estimating those amounts when retrospective application is not practicable.
- 33. All users of financial statements agreed with the proposed approach to transition because they think that proposed approach:
 - (a) is the best conceptual answer, and pragmatic solutions are added for situations where retrospective approach is not practicable;
 - (b) will allow comparisons between contracts written before and after transition date, to the best extent possible; and
 - (c) will preserve trend information.
- 34. Because the amounts using the proposed simplifications would not be fully comparable with amounts determined if the entity had applied the Standard retrospectively, many supported the proposals for disclosures that:
 - (a) explain the assumptions and simplifications used; and
 - (b) disclose the amounts in the financial statements determined using those simplifications, both on transition and in subsequent periods.
- 35. Notwithstanding their agreement with the proposal, some expressed concerns about:

- (a) operational complexity and possible lack of data for the proposed approach;
- (b) the possible outcome that, at transition, entities will recognise accumulated losses on investment activities in OCI even though those losses would be offset in the future by the profits recognised when the contractual service margin established at transition is recognised in profit or loss. Those concerns are most common in Asia region; and
- (c) possible non-alignment of the effective dates of IFRS 9 *Financial Instruments* and IFRS 4. They note that such major changes to the accounting during a short period of time could impair the understandability of financial statements. However, one user noted that alignment of the dates would be good to have but not at the cost of further delaying implementation of IFRS 9.

Appendix: Statistical information about discussions with users of financial statements by type of respondent and by region

This paper summarises the feedback from 44³ discussions with 159 users of financial statements conducted between June and December 2013. Not all topics targeted in the ED were discussed in all meetings.



³ This number of meetings includes only those meetings conducted specifically with the users of financial statements and it does not include meetings with mixed groups even if users took part in those meetings.