European Financial Reporting Advisory Group

Insurance Contracts DP Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

22 February 2008

Dear Sir/Madam,

IASB Discussion Paper *Preliminary Views on Insurance Contracts*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IASB Discussion Paper *Preliminary Views on Insurance Contracts* (the DP). This letter is submitted in EFRAG's capacity as a contributor to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive standard when it is issued.

Currently, there is diversity in the accounting practices that are applied in accounting for insurance contracts: similar contracts are accounted for differently and insurers and other sectors account for similar things differently. There is also room for improvement in the way insurance contracts are accounted for. The IASB issued an interim standard (IFRS 4 *Insurance Contracts*) in 2004 to make some limited improvements, and the objective now is to develop a comprehensive high-quality standard on the subject. The DP is the first step in that process.

EFRAG welcomes the publication of the DP, which it believes represents a very important step in the development of a much-needed accounting standard. We are very pleased that the IASB has taken on the leadership of this project so enthusiastically and has committed so much time and energy to it. In our view the DP is a good paper that makes a significant contribution to the debate and represents an excellent basis on which to debate the accounting treatment of insurance contracts.

At the centre of the DP are the IASB's tentative proposals for the measurement of insurance liabilities. We discuss those proposals in appendix 1 of this letter. In appendix 2 we answer the other questions raised in the IASB's Invitation to Comment. Our main comments are summarised below.

1 We agree that insurance liabilities should be measured at an amount that comprises the discounted value of an unbiased estimate of the future cash flows plus *some sort* of margin.

2 However, we have some concerns about the DP's detailed proposal.

- In particular, we are not persuaded that entity-specific cash flows should be ignored when determining the unbiased estimate of future cash flows. We recognise that this focus on market-based data (rather than entity specific data) is consistent with the proposals that the IASB is developing, and in some cases has issued, in a number of its other projects, but we are not persuaded that market data are superior to entity-specific data there either.

- Similarly, we are not persuaded that the appropriate margin to include in the liability measure is the amount of consideration that a market participant would demand to carry out the services promised under the contract. We agree that the liability measure should include a 'pure' risk margin, but are undecided about the rest of the margin included in the DP's proposals. This is a fundamental issue because this is essentially a debate about what gains recognition model is appropriate for an insurer.

  The DP's proposals about margins raise lots of issues, and we have struggled to find in the paper criteria we can use and arguments that are persuasive enough to enable us to reach conclusions. Part of the reason for that is because of the links that exist between this project and certain other major projects currently being worked on by the IASB. We do not think there is anything inherently different about insurance—yes it can be very long-term, but we are not convinced that should make a difference to the accounting. It follows therefore that we tend to start from the position that the principles that should be applied generally should be applied to insurance. Thus, in our view many of the issues that this DP raises can be addressed properly only by considering them in their wider context. Unfortunately, those linked projects are not sufficiently advanced, and the discussion in the DP is not always sufficient, to do that.

  In this context we have found it frustrating that in key places the paper does not explore more fully some alternatives to the approaches being proposed—in places it reads more like a position paper than a discussion paper—and in some other places we would have preferred the discussion to have included some tentative conclusions. But, having said all that, we still think the paper is a major contribution to the debate.

3 We have two concerns about the proposed treatment of participating contracts.

- We believe that it would be preferable for the liability to be measured by reference to the expected cash flows, rather than by focusing on legal and constructive obligations (the approach proposed in the DP). We think such an approach would provide the most useful information, and would also address the practical problems that would arise in trying to implement the DP's proposal. It is perhaps worth mentioning in this context that we would be very concerned were the revisions being made to IAS 37 to result in the narrowing of the constructive obligation notion, because that would have significant consequences for the treatment of participating contracts and would take the accounting even further away from the approach that we favour; and

- An implication of the proposals in the DP is that unallocated funds made up of unclaimed dividends and other payouts and undistributed amounts relating to policies that have lapsed (so-called orphan estates) would be classified as equity, and any subsequent allocation of that orphan estate would be treated as an expense. Although this is not ideal, we have no better suggestion. Some commentators have suggested that there should be a third category (equity, liabilities and 'other').

4 We have some concerns about the DP's proposed approach to policyholder behaviour, although we have not so far identified a problem-free alternative approach. We think this is an area that would benefit from further analysis.

5 The DP proposes that a prepaid insurance contract should be disaggregated into two components (a deposit component and an insurance component) and each of those components should be accounted for separately, unless in effect that cannot be done. As there appears to be no reason why insurance contracts should be treated differently from any other type of contract, an implication of this proposal seems to be that, whenever a reporting entity receives a payment in advance, it ought really to treat that prepayment as a deposit component and account for it separately if possible. EFRAG is not persuaded that this is an appropriate thing to do.

6 EFRAG believes that a very important part of the work the IASB is doing to improve the accounting treatment of insurance contracts should be to eliminate—and to the extent that it is not possible to eliminate, to mitigate—the effect of accounting mismatches. The accounting mismatches currently created by the deposit floor in IAS 39 and by contracts being accounted for partly under IAS 39 and partly under IFRS 4 need to be addressed if insurance accounting is to be improved significantly. We also think the DP's approach to the unit of account issue needs to be re-examined because we think it could prove to be the source of additional accounting mismatches. We think the unit of account should be the insurance contract as a whole.

Finally, we would encourage the IASB to field-test its proposals and to carry out some suitable form of impact assessment before issuing the exposure draft. The DP represents an important step towards a much-needed comprehensive standard on insurance and it would be a pity if that progress faltered because practicality or cost-benefit issues had not been taken sufficiently into account.

If you would like further clarification of the points raised in this letter, Nico Deprez or I would be happy to discuss the letter with you further.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1—Comments on the general principles for liability measurement proposed in the IASB's Insurance Contracts Discussion Paper

INTRODUCTION

A1.1 Taking on and managing for profit insurance risk and liabilities is the essence of what insurers do, so it is no surprise that the key proposals in the paper relate to the accounting treatment of insurance liabilities. We discuss these proposals in this appendix. At the end of the appendix we answer the questions in the IASB's invitation to comment that relate to the issues discussed in this appendix. (The other questions are answered in appendix 2.)

GENERAL COMMENTS

Measurement—The three building blocks

A1.2 The basic approach the paper is proposing should be adopted for the measurement of insurance liabilities involves three 'basic building blocks':

(a) an explicit unbiased probability weighted estimate of the future cash flows;

(b) the effect of the time value of money; and

(c) an explicit margin of some sort.

A1.3 EFRAG has no difficulty with (a) or (b). In particular, although we understand that some stakeholders have doubts about requiring all insurance liabilities to be based on discounted amounts, we are strongly of the view that it is the conceptually correct approach.

A1.4 The third building block—"an explicit margin of some sort"—has caused more debate amongst EFRAG members, but we have eventually concluded that indeed *some sort* of margin should be included. In reaching this conclusion, EFRAG members have noted that paragraph 36 of IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* states that "the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date". Paragraphs 42 and 43 go on to explain that "the risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision" and "a risk adjustment may increase the amount at which a liability is measured." Finally paragraphs 45 and 47 explain that "where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation" and "the discount rate shall be a … rate that reflects current market assessments of the time value of money and the risks specific to the liability." In other words, the amount of the liability recognised should be greater than an explicit unbiased probability weighted estimate of the future cash out flow discounted at the risk free rate. Thus, IAS 37 already require*s some sort of (albeit implicit) margin for risk to be a*dded when measuring a provision—and the only difference between the building blocks as described above and the existing approach for non-insurance liabilities is that the DP is proposing that formal, explicit and separate estimates shall be made of future cash flows and of the margin.

A1.5 Furthermore, EFRAG believes that requiring the use of explicit margins is preferable conceptually to requiring the use of implicit ones.

A1.6 Conceptually, therefore we agree with the proposed insurance liability model as we have described it in paragraph A1.2 above. However, as explained below, as we move from that high-level description to a more detailed description of the proposal, issues arise that cause us to be concerned about how the building blocks will be—and whether they can be—implemented in practice and, for example, exactly what margin should be included in the liability measurement.

The measurement objective

A1.7 We will, in the next sections, discuss which cash flows should be included in the estimate of future cash flows and what the explicit margin should represent, but at the heart of those discussions is an issue that we think needs to be addressed and dealt with persuasively before all other issues can be resolved: what is the measurement objective that should be applied in measuring liabilities. The DP proposes that it should be transfer value; in other words, the market-based current market exit price. Yet it does not explain why that should be the objective; why that results in more useful information for users than any other measurement objective. Because that issue has not been resolved, we found ourselves, in trying to comment on more detailed measurement issues, returning again and again to the questions "what is it we are trying to do and why".

A1.8 This issue is of course also at the heart of a number of other major projects that the IASB is working on. We think our inability to reach a conclusion on a whole raft of measurement issues discussed in the DP illustrates why it is so important that the IASB accelerates the work it is carrying out in linked projects on various cross-cutting issues so that a comprehensive debate can take place in a proper context, and a broadly-based decision can then be taken.

Estimate of future cash flows

General approach

A1.9 Paragraphs 34-62 of the DP explain the proposed approach to arriving at an explicit unbiased probability weighted estimate of the future cash flows. To summarise briefly:

(a) A proper estimate needs to be made.

(b) The inputs used, such as interest rates and equity prices, should be as consistent as possible with observed market prices.

(c) The estimate should incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all the cash flows arising from the obligation. That means each possible scenario should be identified; the present value of the expected cash flows from the scenario estimated and a probability weighted average estimated.

(d) The estimate should be based on currently available information; in other words, they should take fully into account conditions at the balance sheet date. In the past it has not been uncommon for insurers to 'lock in' (ie establish at the outset and then leave unchanged, subject to a kind of liability adequacy test) certain or all assumptions in arriving at such estimates.

(e) The estimate should exclude entity-specific cash flows; in other words, it should not capture cash flows that are specific to the insurer and that would not arise for other market participants holding an identical liability.

A1.10 We support the proposals in (a) to (d). (We note that (c) will mean the estimates will in many cases be subject to significant degrees of judgment and therefore subjectivity. This makes it important to devise a disclosure (and perhaps even presentation) regime that will help users to understand the degree of estimation and uncertainty involved and to enhance the comparability of the information.) However, as discussed in the next section, we are not persuaded that (e) is right (in other words, that the DP is right when it concludes that the conceptually correct approach is to use non-entity specific cash flows). We also have concerns about two other issues:

(a) The treatment of future policyholder dividends (or bonuses) when contracts with discretionary participating features are involved. That issue is also discussed below.

(b) A second issue is the treatment of future premiums and of policyholder behaviour. We discuss this issue in appendix 2 in our answer to question 7. Put simply, we do not like the proposal in the paper, but recognise that our preferred approach is also problematical.

A1.11 As a result, we think further work is necessary on detailed proposals about the cash flows to be indicated and, primarily because of our concerns about the 'entity specific v non-entity specific cash flows' issue, we are not able to support the detailed proposal in the paper.

Using non-entity specific cash flows

A1.12 As mentioned above, the proposal is that the estimate should exclude entity-specific cash flows; in other words, the measurement should not capture cash flows that are specific to the insurer and that would not arise for other market participants holding an identical liability.

A1.13 Although that is the principle, the DP goes on to accept (in paragraph 62) that in practice an insurer would use estimates of its own servicing costs "unless there is evidence that the insurer is significantly more or less efficient than other market participants." Furthermore, in paragraph 58 the DP states that many of the variables involved cannot be observed in or derived directly from market prices and as a result there is "rarely, if ever, persuasive evidence that the insurer's own estimates differ from the estimates that other market participants would make. For these variables, the distinction between entity-specific estimates and market-estimates has little practical significance."

A1.14 We welcome the DP's acknowledgement that in practice entity-specific cash flows can generally be used. We believe it is nevertheless still very important to establish what the principle should be.

A1.15 As far as we can see, the DP advances only two arguments in favour of using non-entity specific cash flows:

(a) In paragraph 56, it argues that non-entity specific cash flows should be used because the objective in measuring an insurance liability should be to "represent faithfully the economic characteristics of that liability"; cash flows that are specific to the insurer arise from synergies between the insurance liability and the insurer's other assets and liabilities and are not part of the economic characteristics of the liability.

We do not accept this argument, for two reasons. Firstly, the argument seems to suggest that it is somehow possible to separate the "economic characteristics" of a liability from an entity's ability to settle that liability efficiently or inefficiently ("the synergies between the insurance liability and the insurer's other assets and liabilities"), and we do not believe that is in fact the case. Using non-entity specific cash flows does not remove those synergies, it simply replaces the synergies that the reporting entity has with the synergies present in a hypothetical market participant. Secondly, and building on that first argument, if the choice is between incorporating in the measurement the synergies that the reporting entity has—and which therefore are likely to affect the actual future cash flows of the reporting entity—and incorporating into the measure the synergies of market participants, which are highly unlikely to affect the actual future cash flows of the reporting entity, we would have thought that the former is preferable (because the resulting financial statements seem more likely to provide information that is useful to users in, inter alia, making assessments about the entity's future cash flows). If experience shows that the insurer's claims management policies and skills mean that it will pay out €100 in respect of a particular insurance obligation, why is more useful information provided by recording a liability of €90 or €110 simply because that is what a hypothetical insurance market participant would payout?

(b) As already mentioned, the DP also argues that in practice there is often little difference between entity-specific and non-entity specific cash flows. In our view this is not an argument in favour of using non-entity specific cash flows, because it is when there *are* differences that it is important to get the right principle.

A1.16 There are some other arguments that, though not mentioned in the paper, are sometimes used to justify the use of market-based data.

(a) Entity-specific data is inherently more subjective, and therefore less reliable, than market-based data. EFRAG has made it clear in earlier comment letters that it does not accept this argument in the context of measurement generally; and in the case of insurance—where there will usually not be liquid markets and much of the market-based data will be hypothetical—it is simply not a credible argument.

(b) The conceptually correct approach is to determine how to proceed when there are perfect markets, and then apply that approach in all circumstances; market imperfections will raise practicality issues, but no conceptual issues. EFRAG does not accept this argument. Imperfect markets are not some sort of exception, they are the norm—the real world—and in EFRAG's view it is illogical to develop accounting solutions that ignore conditions in the real world. After all, it is only when there are market imperfections that differences between the different approaches emerge and the difficult conceptual questions get asked.

(c) The measurement model chosen does not affect the aggregate gain or loss recognised in respect of a transaction; it merely determines the accounting periods to which that gain or loss should be allocated. Using market-based measures means in effect benchmarking each stage of the reporting entity's operating cycle against the market and recognising gains (or losses) if the entity performs that stage better (or worse) than the market. Such an analysis of performance maximises the predictive value of the information. EFRAG believes however that in practice things are not as clear cut as that, and market and measurement imperfections create noise that obscures the entity's performance at each stage in its operating cycle. Bearing that in mind, it is not yet convinced that this is a valid argument.

A1.17 In our view neither the arguments in the paper nor those others that we have heard persuade us that the conceptually better approach is to use non-entity specific cash flows. Therefore, if the IASB continues to believe that is the best approach it needs to explain its rationale more persuasively than it has hitherto.

Discretionary participating contracts and the estimate of future cash flows

A1.18 The proposal in the paper is that, when one measures an insurance liability arising from a participating contract, the cash flows that should be taken into account are those policyholder dividends that are payable to satisfy a legal or constructive obligation that exists at the reporting date.

A1.19 We think this proposal raises two related issues. The first concerns whether an approach based on existing obligations is appropriate, or whether it would be better to focus on expected future cash outflows; and the second concerns the meaning of the term "legal or constructive obligations".

A1.20 The approach outlined in the DP is of course in line with existing IFRS. However, it is sometimes argued that the financial statements would be more useful were participating contract insurance liabilities to be measured at the discounted value of expected future payments on existing contracts, rather than on the existence of present obligations. Those favouring this approach argue that it results in movements into and out of equity that are very easy to understand (because they relate more to changes in expectations), results in very transparent reporting, and provides users with the information that they want.

A1.21 There is also the issue of practicality. Relying on the notions of legal and constructive obligation mean, because of the nature of insurance contracts with participating features that the amounts recognised would depend on the legal and regulatory regime in each jurisdiction. It is also clear that there is genuine uncertainty in many jurisdictions as to whether (and to the extent to which) constructive (and even legal) obligations exist.

A1.22 After much consideration—and largely for the reasons described above—we have concluded that a focus on expected cash flows is preferable to the approach proposed in the DP. We recognise that we have argued elsewhere in this letter that the principles that apply to insurance contracts should be the ones that apply generally. This again illustrates why it is so important to bring forward the completion of aspects of the linked projects (in this case IAS 37) so that key cross-cutting issues can be resolved at the earliest opportunity.

A1.23 One implication of the DP's proposal is that unallocated funds made up of unclaimed dividends and other payouts and undistributed amounts relating to policies that have lapsed (so-called orphan estates) would be classified as equity, and any subsequent allocation of that orphan estate would be treated as an expense. Whilst we do not think this is ideal—the orphan estate is fundamentally different in many ways to what we usually think of as equity—we currently have no better suggestion. We note that some commentators have suggested that there should be a third category (equity, liabilities and 'other').

Time value of money

A1.24 The proposal in paragraphs 69 and 70 of the DP is that the discount rate used should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and uncertainty. This is also the principle that the IASB is adopting when it discusses discounting in other projects. Although the paper states that the IASB "does not intend to develop detailed guidance on how to achieve that objective", the *Fair Value Measurements Discussion Paper* contains a 7-page appendix on present value techniques and that appendix states that the time-value of money is represented by the risk-free interest rate for an instrument of similar duration.

A1.25 We have heard a number of commentators argue that the most appropriate discount rate to use is one based on the expected returns on the assets held. However, we do not accept that argument; an insurer's liabilities do not change in value simply because the assets that back the liability now have, say, a greater or lower equity content than hitherto.

A1.26 We therefore support the proposals in the paper on discounting and how to take into account the time value of money.

Margins

The proposal explained

A1.27 The third building block is the margin. As already mentioned, EFRAG agrees that some sort of margin should be added to the discounted unbiased estimate of future cash flows, but has concerns about what that margin should represent. The DP's proposals in this area can be summarised as follows:

(a) To all insurance liabilities should be added a risk margin. That risk margin should be an explicit and unbiased estimate of the amount of compensation market participants demand for bearing risk. Thus:

(i) the risk margin would be calculated on a market participant basis rather than an entity-specific basis;

(ii) the risk margin that should be included in the liability amount is in effect a wholesale risk margin. To the extent that this differs from the retail risk margin, this difference will be recognised in the income statement on day one;

(iii) the risk margin is not a buffer, therefore if things do not turn out as expected the risk margin may need to be adjusted to reflect any new understanding of the risk involved, but it will not be adjusted to take up some of the unexpected shortfall or excess.

(iv) by the end of the contract the whole of the risk margin will have been recognised in the income statement as a profit.

(b) If the contract requires the insurer to provide additional services, the liability measure should include a service margin that represents the compensation that a market participant would typically require. Thus, the whole of the service margin is, just like the risk margin, profit.

A lack of clarity

A1.28 We do not find this part of the paper very clear, particularly the material on the service margin. There has for example been a good deal of confusion as to what is meant by services other than insurance, and some are reading the paper to mean there is no profit element in the risk margin.

Gains recognition

A1.29 Our understanding is that (implicit) margins are included in the initial pricing of insurance policies. Clearly at the end of the policy after all the liabilities arising from the policy have been identified and settled, no liability—and therefore no margin—will be recognised. The issue is what margin should be included in the liability measure on day one and how should that margin be released. Bearing in mind that the margins included in the initial price represent the insurer's expected profit, this is a debate about what gains recognition model is appropriate for an insurer.

A1.30 Under the proposals in the paper the difference between the amount that the insurer has charged for the insurance services to be provided and amount that a market participant would charge to provide those same services would be recognised as a day one profit or loss; with the amount that a market participant would charge being released to profit or loss over the life of the contract. A similar approach would be adopted in respect of the profit expected to be earned on any additional services provided.

A1.31 IAS 18 does not necessarily apply to insurance contracts by virtue of IFRS 4, but it does apply to investment management services and the approach proposed in the DP is different from IAS 18's approach. As paragraph 88(g) of the DP explains, some of the differences are as follows.

(a) IAS 18 does not result in the recognition of day one gains, and recognises day one losses only if the contract is onerous.

(b) Applying IAS 18 subsequently, the revenue recognised is the margin that was implicit in the contract, not the margin that market participants require.

(c) Applying IAS 18 subsequently, the liability measure does not change if it becomes apparent that market participants require a higher margin.

A1.32 We believe that the gains recognition model that is appropriate for an insurer should be the model that is applied generally. Therefore, in an ideal world general principles would have been developed in the joint IASB/FASB revenue recognition project and the Insurance DP could then have focused on the application of those general principles. However, that is not possible because the joint revenue recognition project has not advanced sufficiently—and is currently not expected to be completed before the insurance project.

A1.33 Of course, we are where we are and we fully understand that the IASB has no choice but to do its best in the circumstances it finds itself in. This is discussed in more detail under the heading 'Links to other projects'.

Measurement

A1.34 Under the asset/liability approach that underpins the IASB's Framework and all the work the IASB does, gains recognition is the result of asset and liability recognition and measurement and not vice versa. Therefore, rather than ask whether the proposals result in an appropriate gains recognition model, the focus of the DP is on establishing an appropriate liability measurement model.

A1.35 As already explained, the proposal in the paper is that insurance liabilities should be measured at the discounted unbiased estimate of future cash flows plus a risk margin that is an explicit and unbiased estimate of the amount of compensation market participants demand for bearing insurance risk plus, if the contract requires the insurer to provide any other services, a service margin that represents the compensation that a market participant would require for providing that service.

A1.36 The paper then goes on to suggest that "an informative and concise name" for a measurement described above is 'current exit value'. Finally, it suggests that the current exit value could be defined as the amount that the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.

A1.37 We have a number of concerns about these proposals.

(a) The proposal is that the margins should be determined on a transfer value basis, rather than say a settlement basis. We are not convinced that is appropriate.[1]

(b) The proposal is that the margins should be market-based rather than entity-specific. We are not persuaded that market-based measures are preferable to entity-specific measures.

(c) The proposal is that the measurement basis described should be labelled 'current exit value'. We are not persuaded that, where there is a difference between current exit value and current entry value, that current exit value is preferable. Furthermore, in this case we think the measurement basis described is both an entry value and an exit value and that therefore 'current exit value' is an unhelpful label.

In the sections below we expand on these concerns.

<u>Transfer value or settlement basis, and market-based or entity-specific?</u>

A1.38 EFRAG has already made it clear in its earlier comment letters on measurement papers issued by the IASB that in its view it is not self-evident why it is better to measure a liability at its transfer value than at its settlement value, particularly when it is unlikely that the liability will be transferred. For example, assume that an entity receives something worth €100 and in exchange incurs a liability that it intends to settle (by making payments with a net present value of €100) in the next reporting period, but which had a transfer value on initial recognition is €110. If transfer value were to be used to measure the liability:

(a) the liability would be measured on day one at €110, even though the entity is going to settle it for €100: It is not clear to us why, if the objective is to provide information that is useful in making assessments about future cash

[1] The recent IASB *Fair Value Measurements* Discussion Paper proposed that the fair value of a liability is its market-based transfer value. In responding to that Discussion Paper EFRAG explained that we were not convinced that the fair value of a liability should necessarily be its market-based transfer value. However, that is not necessarily relevant here because we are not discussing what fair value is; we are discussing whether insurance liabilities should be measured at market-based transfer value.

flows and transferring the liability is either not an option for the entity or is not the exit route the entity will use, transfer value would be more relevant than measures based on the exit route that the entity is likely to take (in this case the settlement value).

(b) a loss of €10 would be recognised in the current period and a profit of €10 (in effect the reversal of that loss) would be recognised in the next period. Again it is not clear to us why the information provided by the financial statements is more useful if those gains and losses are recognised.

A1.39 EFRAG understands that some commentators have suggested that there might not necessarily be a difference between transfer value and settlement value in the case of insurance liabilities. Those commentators argue that an insurance liability's settlement value should include a margin for risk and that risk margin should be based on similar factors to those that underlie the transfer value risk margin. However, we are not convinced; although a case could be made for including a margin in the settlement value to reflect the degree of uncertainty involved[2]; we see no reason why any such risk margin would necessarily represent the amount that a market participant would require to provide the same services. However, we do accept that the term 'settlement value' means different things to different people and could be used to describe, for example, what it would cost to settle now or what is the present value of the cost to settle at the settlement date. It could also be based on entity-specific amounts or market participant-based amounts. For that reason, the debate should put labels to one side and instead focus on considering the measurement objective, within the context of the building block approach.

A1.40 EFRAG has similar concerns about the use of market-based measures rather than entity-specific measures. Our concerns here are those mentioned above in our comments on entity specific versus non-entity specific cash flows (see paragraphs A1.13 - A1.18), so we will not repeat them here. Suffice it to say, we are not persuaded that market-based measures are better than entity-specific measures when market imperfections exist.

A1.41 These issues about transfer value or settlement value and market-based or entity-specific measures are at the centre of the ongoing debates that the IASB is currently leading on measurement and on fair value measurement. As in our earlier discussion on gains recognition, we believe these issues should probably be resolved in the same way for all (or at least the vast majority) of liabilities. Unfortunately however the projects in which the IASB is developing those general measurement principles (its fair value measurement project, and the joint IASB/FASB Framework work on measurement) are still in their early stages. This creates the same sort of problems and frustrations that we mentioned in our discussion about gains recognition. This is discussed in more detail under the heading 'Links to other projects'.

<u>The current exit value label</u>

A1.42 The IASB has suggested that it would be helpful to develop a clear and concise label for the measurement basis on which insurance liabilities are measured. We agree.

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[2] So, for example, the settlement value of a liability with an expected cash outflow of €100 but little uncertainty is lower than a liability with the same expected value but much greater uncertainty.

A1.43 However, we do not agree with the IASB's suggestion that that label should be 'current exit value'. In our view, the measurement basis that is described in the DP could be both an exit value and an entry value,[3] and in such circumstances it does not seem helpful to label it as 'exit value' because that puts emphasis on an aspect of the measurement debate that appears not to be relevant in this case.

A1.44 For the avoidance of doubt, we have stated in past comment letters that we are not persuaded that current exit value is preferable to current entry value. That comment applies equally to the measurement of insurance liabilities. Therefore, were it to be shown that we are wrong to say that the measurement basis described is both an exit value and an entry value, we would encourage the IASB to explain persuasively why current exit value results in more useful information than current entry value.

Links with other IASB projects

A1.45 We have mentioned on several occasions that some of the key issues that are addressed in the DP are also the subject of other major projects the IASB is carrying out. This includes, for example, measurement, fair value measurement, revenue recognition, and IAS 37. Most of those other major projects are not currently expected to finish before the Insurance project. This creates some difficulties.

(a) We believe that, generally speaking, the principles that apply to insurance liabilities should be the ones that apply generally. However, we do not know whether that is what is being proposed.

(b) Furthermore, assuming that is in effect what is being proposed, EFRAG needs to consider the applicability of the principles proposed in the DP not only for insurance liabilities but for liabilities generally. However, we do not think that the DP enables us to do that. For example, there are many different ways in which an entity's financial performance and financial position can be portrayed in its financial statements and, in order to choose between those different ways, it is necessary to understand which way will result in the most useful information for users. This, we assume, is what the IASB's projects on measurement and revenue recognition in particular are seeking to do; certainly it is not something that the IASB has consulted on to date or that the DP addresses.

For example, in the Framework work that is being carried out on measurement, the IASB and FASB have identified and defined the possible measurement bases, and are now testing those candidate measurement bases against the qualitative characteristics of financial information to determine which basis or bases best meets those characteristics—and is therefore the most appropriate. However, it seems to us the qualitative characteristic of relevance for example cannot be used to assess the appropriateness of any particular measurement basis unless we fully understand which way of portraying the financial performance and financial position will result in the most useful information for users.

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[3] Whether one agrees with this comment depends in part on your view on whether (and if so how) the risk margin on initial recognition should be calibrated against the premium charged (see DP, paragraphs 78-86). Some would argue that Implementation A results in a current entry value, but not a current exit value. Others would argue that it results in a more accurate current exit value.

A1.46 On the other hand, we think everyone agrees that there is an urgent need for a comprehensive high-quality standard on insurance, so it is important that the strategy adopted towards linked projects does not delay completion of the Insurance project. The issue therefore is how to avoid the Insurance IFRS developed from the DP being another interim solution (because the linked projects have not yet been completed) without delaying the project. We wonder whether it might be possible to bring forward the consultative process on some of the key cross-cutting issues—by publishing single issue consultative papers—so that those cross-cutting issues can be addressed in advance of the other project work. For example:

(a) we mentioned earlier in this appendix the concerns we have about the effect that applying the legal and constructive obligation notions might have on the usefulness of the information provided about participating contracts, particularly if the constructive obligation notion was to be narrowed. Might it be possible therefore to carry out this part of the IAS 37 review work—including the issuance of an exposure draft on the subject—in advance of the rest of the work?

(b) the Framework work on measurement apparently has several years still to run. However, a short consultative paper could be issued on the criteria to be used to assess the candidate measurement bases, thus ensuring that an early conclusion to the debate about which portrayal of the entity's financial performance and financial position will result in the most useful information for users. A second paper at the end of that Framework work on the relative merits of the various candidate measurement bases could similarly perhaps enable us to move forward with confidence on issues such as transfer value v settlement value and market-based v entity-specific measures.

Some additional comments

A1.47 In addition to the relatively high-level comments made above, we have some more detailed—but still important—points and they are set out in the paragraphs below.

A1.48 We have heard several commentators argue that it is not appropriate to include 'future profit' in the liability measure. We wonder whether the proposals would be clearer were they to deal with what insurance liabilities arising in respect of the unexpired portion of risk coverage (which the paper sees as pre-claims liabilities and some others might see as prepayment liabilities) separately from claims liabilities.

A1.49 We agree with the statement in paragraph 8 of the DP that, "to the extent that the same information can meet the common needs of supervisors and other users, it would be desirable for the information reported to supervisors to converge with the information reported in general purpose financial statements." We understand that there is a difference between the IASB's proposals on margins and the approach being adopted in Solvency II, partly because the IASB's proposals will, unlike Solvency II, require a service margin to be included in the liability measure, thus resulting in the liabilities being bigger in the financial statements than in the prudential returns. We understand that the industry is concerned that this will cause the Solvency II rules to be revised, forcing insurers to in effect carry capital reserves to cover 'future profits'.

A1.50 The detailed risk margin proposal (see paragraphs 71-86 and Appendix F of the DP) is that the risk margin should be calculated by assessing how market participants would measure the quantity of risk involved; using the cash flow scenarios to estimate the number of units of risk present in the liability; estimating a margin per unit of risk; and multiplying the estimated number of units present by the margin per unit. The risk margin thus calculated would then be tested for "possible errors and omissions by reconciling the change in the risk margin to changes in the number of units of risk and the margin per unit".

(a) It seems to us that the risk margin estimated will therefore allow significant flexibility, which could have a significant effect on consistency and comparability. Bearing in mind that these estimates will play a fundamental role in determining the profits that will be reported, it is thus very important that a disclosure package is developed that will help users to understand the degree of estimation involved and to enhance comparability.

(b) In practice the risk margin will often be calculated at the level of the portfolio. It would be helpful if the wording could acknowledge that.

A1.51 As already mentioned, the proposal in the DP is that the risk margin included should be an estimate of the amount of compensation market participants would demand for bearing risk. Insurers generally refer to this as the wholesale risk margin. Under the proposals, the difference between the wholesale risk margin and the margin actually included in the premium will be recognised in the income statement on day one.

(a) It would appear that the IASB has assumed that the difference between the wholesale risk margin and the margin actually included in the premium, entity-specific factors apart, is not significant. If an item is not significant, it is natural not to analyse and think about it as much as an item that *is* significant. That concerns us because our understanding is that the assumption is not correct—the difference can often be significant.

(b) It seems to us to be a bit strange that the IASB is, on the one hand, proposing that only a wholesale risk margin should be included in the liability measure whilst, on the other hand, discussing (in paragraphs 78-86) whether to calibrate the margin included in the liability measure on day one to the premium actually charged. This seems to involve comparing apples and pears, unless we have misunderstood the type of margin the DP is proposing to include in the liability measure. It may be that this approach is proposed because it is thought to be pragmatic. If that is the case, it would be helpful to make that clear, so that constituents can separate the concepts being proposed from the way it is proposed they should be implemented.

(c) One possible reason why the DP proposes the inclusion of a wholesale risk margin in the liability measure is as follows:

(i) The difference between the premium actually charged and the retail premium that a market participant would charge (in effect, a market participant-based retail risk margin) is a gain or loss derived from selling effort and should be recognised in the income statement on day one.

(ii) The difference between the market participant-based retail risk margin and a market participant-based wholesale risk margin (which is the margin the DP proposes should be included in the liability measure) relates to branding, packaging, portfolio building etc and other day one efforts, and again therefore should be recognised in the income statement on day one because those day one activities are complete.

However, as we have already said, there needs to be a comprehensive debate in the widest context as to whether this results in the most useful information

An alternative argument might be that the wholesale risk margin has to be used because insurance liabilities are to be measured at their transfer value. However, we think that puts things in the wrong order; we need first to decide which margin is most useful, and then decide what that means for the overall measurement basis.

A1.52 In paragraphs 78-82 the DP discusses whether it is appropriate to use the contract price to calibrate the margins recognised on day one in some way. The paper discusses either calibrating the margins at inception to the contract price (so-called 'Implementation A') or testing them for reasonableness against that price (so-called 'Implementation B').

(a) The paper seems to suggest that the two approaches will produce similar results at inception (assuming the insurer's pricing reflects the pricing that other market participants require). However, we are not convinced that that is the case; in our view they will usually produce different results.

(b) Our view on day one profits is that the key issue is determining what the appropriate measurement basis is in any particular circumstance. Having done that, that measurement basis should be applied regardless of whether it results in day one profits and any day one profits that arise should be recognised in the income statement immediately. If one is uncomfortable recognising the day one profits, that suggests you should not be comfortable with the measurement basis either.

ANSWERS TO QUESTIONS 2, 4, 5 AND 16

Question 2—Should an insurer measure all its insurance liabilities using the following three building blocks:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,

(b) current market discount rates that adjust the estimated future cash flows for the time value of the money, and

(c) an explicit and unbiased estimate of the margin that market participants require for bearing the risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

A1.53 We agree that all insurance liabilities should be measured at the discounted value of the explicit, unbiased, market-consistent, probability-weighted and current estimate of the contractual cash flows, plus some sort of margin. We further agree that the discount rate used should be current market discount rates that adjust the estimated future cash flows for the time value of the money. However:

(a) As explained in paragraphs A1.10 - A1.23 and question 7, we do not agree in all respects with the proposals as to which cash flows should be included in the estimate and which should be excluded. In particular, we are not persuaded that using non-entity specific cash flows is conceptually the right approach.

(b) As explained in paragraphs A1.27- A1.52, we have a number of concerns about the proposals as to what the margin included in the liability measure should represent and how it should be released to the income statement over the life of the contract.

Question 4—What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurer contract.

(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.

(d) Other (please specify).

A1.54 In our view, the general approach that the IASB should adopt to the calibration of initial measures to the transaction price is as follows. First of all, the appropriate measurement basis should be determined. Having done that, that measurement basis should be applied regardless of whether it results in day one profits (or losses), and any day one profits or losses that arise should be recognised immediately in the income statement. If one is uncomfortable recognising the day one profits that arise from the application of a measurement basis, one should not be comfortable with the measurement basis itself.

A1.55 Consistent with this, if it is decided that the appropriate measurement basis for insurance liabilities is something other than transaction price, we would support alternative (c) because it is the only alternative that does not introduce exceptions to the application of the measurement basis that is considered to be appropriate.

Question 5—This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

A1.56 Until the paper started talking about current exit value, the proposal was that insurance liabilities should be measured at the present value of an explicit unbiased probability weighted estimate of the future cash flows; plus the amount of compensation market participants demand for bearing risk inherent in the contract and for providing any other services required under the contract. Although we do not agree with that proposal (see above), we think it is very clear. The paper then refers to that measurement basis as current exit value, and defines that as the amount that the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. We question whether that description is as clear as the first description.

A1.57 Furthermore, although we agree that it would be helpful to develop a clear and concise label for the measurement basis on which insurance liabilities are measured, as explained in paragraphs A1.42 – A1.44 we do not believe that 'current exit value' is the best label.

Question 16

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

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

A1.58 For the reasons set out in paragraphs A1.18 - A1.23. we believe that, in order to measure the insurance liability arising from a participating contract, the unbiased estimate of future cash flows should be based on the expected future cash flows rather than the estimated policyholder dividends that will be payable under each scenario to satisfy the legal or constructive obligations that exist at the reporting date under that scenario.

Appendix 2—EFRAG's response to the questions asked in the IASB's Insurance Contracts Discussion Paper

A2.1 In answering the questions in this appendix, although we have not generally repeated the concerns we raise in appendix 1 about using transfer value or current exit value to measure insurance liabilities, none of the answers we have given should be read to imply that we support the use of those measurement bases.

A2.2 There is one general comment that we wish to make before answering any of the questions posed in the DP. We think the issue of the unit of account is of fundamental importance to insurance accounting, yet it seems to be an issue that is not dealt with at any length in the paper. That is a pity because we think that selecting the right unit of account can help greatly in reducing the potential for accounting mismatches. In our view, the unit of account should be the insurance contract in its entirety, rather than the individual cash flows arising from contractual rights and obligations flowing from the contract. That will ensure a symmetrical and even-handed recognition and measurement approach to rights and obligations that will capture the inter-dependencies that often exist. It also reflects the way insurance contracts are, we understand, managed by insurers and viewed by users. We recognise that the unit of account is an issue that is being considered in the Framework project, but its central role in much of the DP again illustrates the importance of addressing various cross-cutting issues as soon as possible.

Question 1—Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

A2.3 The proposal in the discussion paper is that the recognition principle for insurance assets and liabilities should be exactly the same as for financial assets and liabilities: the rights and obligations created by an insurance contract should be recognised when the reporting entity becomes a party to the contract. It goes on to propose that an insurer should recognise rights and obligations created by an insurance contract when it becomes a party to the contract.

A2.4 Insurance contracts are often entered into in advance of the period for which insurance cover is provided. In such a case, the proposal in the paper would mean, we think, that an insurer would be required to recognise the rights and obligations created by its insurance contracts before risk coverage commences. We think this is appropriate when an insurance contract has similar characteristics to a financial instrument but is not necessarily appropriate otherwise. We see insurance contracts in much the same way as any other non-financial instrument contract and therefore believe that the same accounting should generally be applied to all such contracts. For that reason, we are currently of the view that, until risk coverage commences, there is only an executory contract. We would not therefore expect the rights and obligations created by such an insurance contract to be recognised until risk coverage commences (unless, of course, it is an onerous contract).

A2.5 Having said that, as we have discussed this issue we have come to realise that it is much more complex than it is portrayed in the DP. For that reason, we recommend that the IASB carry out further research into the issue before finalising its proposals. And, in doing so, we think it is particularly important that the IASB considers if there is really a strong reason why insurers should adopt a different accounting approach to other industries.

A2.6 The paper also proposes that the derecognition principle that should apply to insurance liabilities should be the same as the one that applies to financial liabilities: the liability (or a part thereof) should be derecognised only when it has been extinguished—in other words, when it has been discharged or cancelled or expires. We support this proposal.

A2.7 Finally, the paper argues that, "because derecognition of financial assets is a complex topic and the subject of another project" (the IASB's derecognition project), the discussion paper does not address the derecognition of insurance assets. Whilst we understand why the IASB has decided to defer consideration of this issue for the time being we note that this was not viewed as a constraint when considering measurement or revenue recognition (see comments in appendix 1).

Question 3—Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

A2.8 Bearing in mind that IFRSs are intended to be principles-based and written at a fairly high-level, we believe that the level of detail at which the guidance in appendices E and F is written is generally speaking the right level of detail. Any further guidance that is needed to support insurers in preparing financial statements in accordance with the IASB's proposals is probably best left to stakeholders to develop.

A2.9 Having said that, we have the following detailed comments on the guidance provided in appendices E and F.

(a) We are of the view that the guidance in Appendix E is not sufficient to clearly explain the meaning of "probability-weighted". We believe the intention is that existing models, such as the use of mortality tables, can continue to be used, and it would be helpful if the guidance on probability-weighted estimates could make that clear. There is also some uncertainty as to whether anything other than stochastic modelling is allowed; we think the IASB does not intend to permit stochastic modelling only, and it would be helpful if the final standard could also make that clear.

(b) There seems to be some debate as to the exact meaning of the guidance in paragraphs E24 and E25 on which cash flows should be included and which excluded from the best estimate. This is a consequence of specific local market practices or other contract features.

(c) It will be important to reconsider the illustrative cash flow listings once there is greater clarity as to which future payments to policyholders under participating contracts should be included in cash flows.

(d) It is unclear why E24(c) refers to costs that "market participants would incur" given that the market participant principle underlies the proposed basis of measurement.

Question 6—In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

(a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?

(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?

(c) not recognise them? Why or why not?

A2.10 The treatment of policyholder behaviour is fundamental to getting insurance accounting 'right', because it is one of the important factors underpinning the amount, timing and uncertainty of future cash payments. We think the IASB's objective ought to be to develop an approach that:

(a) results in the assumptions used to identify and measure future cash outflows also being used to identify and measure future cash inflows. (It would, for example, be absurd to assume that a contract continues for the purpose of estimating future cash outflows, but takes no account of the premiums that would be received were that contract to continue.) We think this objective is not controversial.

(b) reflects the economics of insurance activity. We suspect that, whilst no one would disagree with this statement, it means different things to different people.

(c) is either consistent with the Framework or is inconsistent only because it has been concluded that the Framework needs to be refined in a way that would eliminate the inconsistency. We would hope that this objective is also not controversial.

A2.11 We believe future policyholder behaviour should be taken into account. The main reasons for this view are as follows:

(a) In paragraph (c) of the question it is suggested that perhaps no account should be taken of future policyholder behaviour. We think that, if the eventual IFRS were to adopt such an approach, objective (a) would be met only if the IFRS also allows insurers to assume, for the purpose of estimating future cash *outflows*, that contracts that require future premiums to be paid if they are not to lapse will lapse. However, in our view that would also mean that the numbers in the balance sheet would bear no resemblance to the expected outcome even if renewals and new business were ignored, which we think would not reflect the economics involved.

(b) Policyholders make decisions based on personal circumstances, including their own need for insurance and desire to maintain protection without further underwriting, which often results in behaviour that is counter to the general economic environment. For example, although theory might tell us that policyholders will exercise a contractual option only if it is of value to them (and therefore a liability to the insurer), policyholders take a very broad view of 'value' and as a result may exercise contractual options in circumstances in which they have value, in the pure sense, to the insurer. An approach that ignores such behaviour cannot reasonably be expected to reflect the economics of insurance activity.

A2.12 Having rejected the approach described in question (c), the issue is whether expected future cash flows resulting from beneficial policyholder behaviour should be recognised as an asset or included as part of the insurance liability. Although EFRAG would not object to the approach described in (a), we are of the opinion that cash flows from future premiums are intrinsically related to the liability value and hence should be shown as part of the liability (in other words, we favour the approach described in (b) of the question).

Question 7—A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?

(c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).

(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

(e) No cash flows that result from beneficial policyholder behaviour.

(f) Other (please specify).

A2.13 As we have already explained in our answer to question 6, we believe that it is important to take expected future cash flows resulting from beneficial policyholder behaviour into account. For that reason we do not support option (e).

A2.14 We mentioned in our response to question 6 that we believe it is important that the chosen approach treats all future cash flows in a consistent way, reflects the economics of insurance activity and is consistent with the Framework (or is inconsistent only because it has been concluded that the Framework needs to be refined in a way that would eliminate the inconsistency). We think that in many ways a pragmatic way of meeting these objectives would be to focus on all the cash flows reasonably expected to arise from existing contracts—in other words, option (b).

A2.15 However, the question asked by the IASB in respect of that approach ("How would you distinguish existing contracts from new contracts?") is an important one, because EFRAG accepts it would not be appropriate to include cash flows arising on contracts not yet in existence.

A2.16 Although we recognise that those difficulties could push us back in the direction of the approach currently favoured by the IASB (option (a)), we believe that option (a) as currently drafted does not reflect the economics of insurance activity and is not consistent with other parts of the DP.

(a) In getting to best estimate cash flows, expected lapses would be taken into consideration. That suggests to us that, if we are to adopt a consistent approach to future cash flows, all expected future premiums arising from the contracts already entered into should be included in the calculation. Option (a) may result in exclusion of some cash flows that should be reflected in the measurement of insurance liabilities to best reflect the economic value of an entity's insurance contract.

(b) The DP proposes that insurance liabilities should be measured at their transfer value, in other words at an amount that takes into account all (and only) the cash flows that would be taken into account by a transferee. Option (a) does not do that. On the other hand, option (b) *is* consistent with the transfer value and market exit value approaches favoured by the DP. This is evidenced in two ways. Firstly, it is our understanding that an acquirer of a portfolio of insurance contracts will pay for all expected future premiums under those contracts. Secondly, the commission paid to an agent or broker upon inception of the contract will be priced on the expectation that these future premiums will be collected.

A2.17 We also have some specific comments on the approach that the IASB is currently favouring (option (a)).

(a) We think that the IASB proposal to determine where an existing contract ends and where a new contract begins based on a policyholder's need to continue to pay premiums in order to ensure guaranteed insurability will fail to take into account future premiums expected to be received in respect of a variety of existing contracts, such as deferred annuity contracts in Germany, unit linked policies in Holland or some pension policies in the UK. According to these contracts the policyholders may take a premium holiday (ie policyholders are permitted to cease to pay premiums for a period then recommence premium payments without further underwriting). For these contracts we would consider that guaranteed insurability is provided through entering into the contract, not through payment of future premiums. Similar features arise in relation to other products offering additional flexibility for policyholders.

(b) If option (a) is to be adopted, an accounting mismatch will arise unless some sort of adjustment is made to reflect the value of the customer relationship. Although this might be the long-term direction in which accounting should go, we would not be comfortable about insurers recognising such assets at the present time because a number of important related issues (for example, how should that relationship be measured and should customer relationships be recognised in analogous situations) have not yet been addressed.

(c) We understand that the IASB has introduced the guaranteed insurability concept in order to try to overcome the restrictions that the Framework places on the recognition as assets of unenforceable rights. However, we think that projects like the Insurance project help us to explore aspects of the Framework in more detail than before and, as a result, can help us to understand how the existing Framework can be improved. For that reason we think it is important to try first to work out what is 'right' approach rather than what approach might best fit with the existing Framework.

A2.18 Finally, a point of (important) detail. When contracts lapse, insurers may be able to recover a proportion of the initial acquisition costs from agents, brokers or other intermediaries. When considering policyholder behaviour, the estimation of future cash flows should also include the potential recovery of initial acquisition costs from third parties in respect of lapsing policies consistent with the measurement of other cash flows arising in respect of insurance contracts.

A2.19 So, to summarise, although EFRAG understands why the IASB favours option (a) over option (b), we think option (b)—despite its faults—reflects the economics better than option (a). We suggest the IASB continues to search for approaches that are consistent with its measurement objective and reflect the economics of insurance activity.

Question 8—Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

A2.20 In our opinion the costs incurred by an insurer to sell, underwrite and initiate a new insurance contract (ie acquisition costs) should be recognised as an expense when they are incurred.

A2.21 Having said that, as will already be apparent, we place great emphasis on the need for the financial statements of an insurer to reflect properly the economics of insurance activity. In our view this objective would not be fulfilled if the eventual IFRS would require immediate expensing of acquisition costs whilst at the same time not allowing valuation of insurance contracts to reflect future premiums under existing contracts—because of the implications such accounting would have for reported performance. Insurers expect to recover their initial acquisition costs from future premiums for long term contracts and if the valuation of such contracts does not take into account the future value of the existing business there will be a loss reflected in the financial statements that is not a consequence of the economics of the transaction—something that is important to avoid. On the other hand, we recognise that acquisition costs sometimes cannot be recovered and thus can in part represent losses. So we are not arguing that a day one loss will always be inconsistent with the underlying economics.

Question 9—Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

A2.22 As the DP explains:

> 167 IFRS 3 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination. IFRS 4 does not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement.* IFRS 4 permits, but does not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:
>
> (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues.

> (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). …
>
> 168 The main purpose of the expanded presentation was to maintain the requirement to measure at fair value the identifiable assets and liabilities acquired, while permitting insurers to continue using existing measurement approaches for insurance liabilities. The Board did not wish to force insurers to make systems changes that could become obsolete in phase II of the project on insurance contracts.
>
> As noted in chapter 3, it is too early to conclude whether current exit value is the same as fair value. The Board will review that question as work proceeds on this project and on its project on fair value measurements. If any significant differences remain between current exit value and fair value, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant.

A2.23 We agree with this approach, particularly as we believe the liability measurement basis described in the DP *is* different from the fair value that will be used in applying IFRS 3 (Revised) and the fair value described in the *Fair Value Measurements* Discussion Paper.

A2.24 We also support the proposal to revisit the need for expanded presentation in case of differences between current exit value and fair value in relation to portfolio transfers.

A2.25 However in our opinion, the distinction between business combinations and portfolio transfers has to be defined in a clearer way—either in the insurance contracts standards or in IFRS 3—since the proposed treatment is different for the two types of transaction: in a business combination any excess consideration paid will be treated as goodwill, whereas under a portfolio transfer such excess will be expensed through the income statement.

Question 10—Do you have any comments on the measurement of assets held to back insurance liabilities?

A2.26 We believe that it is very important for the success of this project that the eventual IFRS does not cause any material accounting mismatches, because material mismatches create volatility that can obscure the messages that users should take from the financial statements. It has been frustrating to hear users criticise the IASB and IFRS in general and insurance financial statements in particular because of the mismatches created by IFRS 4.

A2.27 This mismatch problem is discussed in paragraphs 176-182 of the DP. The discussion agrees that an ideal measurement model would report all economic mismatches that exist and would not cause any accounting mismatches. It then considers how that might be done. The DP first considers cost-based approaches that use cost-based measurements for insurance liabilities and extend the use of cost-based measurements for assets held to back those liabilities. It concludes however that current estimate approaches are better, arguing that:

(a) accounting mismatches for insurers arise today more from unsatisfactory measurements of insurance liabilities than from deficient measurements of assets;

(b) cost-based approaches might eliminate some accounting mismatch, but only at the cost of obscuring some economic mismatch between assets and liabilities;

(c) a cost basis for assets permits entities to manage profit by selling selected assets;

(d) any extension of cost-based measurements of assets would need some discipline on its use. Such discipline might include rigorous designation and documentation at inception, continuous monitoring, procedures to identify the effect of economic mismatches, and restrictions (perhaps similar to the 'tainting' rules in IAS 39) for disposals. However:

  (i) such disciplines would inevitably be arbitrary and complex;

  (ii) assets 'held to back insurance liabilities' cannot be defined without ambiguity; and

  (iii) if tainting rules are involved, they would restrict an insurer's flexibility to sell assets in the light of changing demographic and economic conditions;

(e) the cash flows from an asset do not depend on the purpose for which it is held. Therefore, the purpose is not relevant to a measurement of the asset; and

(f) extending the use of amortised cost would be inconsistent with the IASB's long-term objective of requiring all financial instruments to be measured at fair value, and would, in the shorter term, create an inconsistency with US GAAP.

A2.28 EFRAG notes that the long-term objective described in (f) has not been the subject yet of any due process. We think it needs to be.

A2.29 We nevertheless agree with the IASB's conclusion that the most prominent reason for accounting mismatches in Phase I is the basis used to measure insurance liabilities and the best way to eliminate (or minimise the significance of) accounting mismatches is to adopt a current estimate approach. However, that will not eliminate all the accounting mismatches and we urge the IASB to find a principle-based solution to the other accounting mismatches as well.

A2.30 One possibility discussed in the DP to tackle accounting mismatches is to create a new category (assets held to back insurance liabilities) and require those assets to be measured at cost-based amounts.

(a) We agree with the DP that it will probably not be easy to develop a clear principle on what is meant by 'assets held to back insurance liabilities'.

(b) We note that the assets an insurance company holds to back insurance liabilities will mostly fall under IAS 39 and IAS 41 *Investment Property*. if an asset is accounted for under IAS 39, it will often be possible to use the fair value option to avoid accounting mismatches—except for own credit risk—and if it is accounted for under IAS 41 the allowed alternative measurement basis could be used to avoid as much as possible the accounting. However, not all assets held to back insurance liabilities will fall under IAS 39 or IAS 41. For example:

(i) own equity instruments are also held to back insurance liabilities, so to avoid an accounting mismatch the IASB would need to allow an exception to the IAS 32 requirement that own equity instruments held shall be deducted directly from equity—and, if that is allowed, a similar reasoning could be made for own equity instruments held for backing a share based payment program.

(ii) even if the asset is accounted for under IAS 39, the criteria for applying the fair value option may either not be met or will be very burdensome to meet. We encourage the IASB to consider further how restrictions on the use of this option work for insurance activities. It might be helpful to discuss this matter further with the industry itself.

(iii) It will be important to include transitional provisions in the revised IFRS 4 to allow insurance companies to redesignate some or all of its financial assets 'at fair value through profit or loss' on implementing the revised standard. In that respect, we refer to paragraph 45 of the existing IFRS 4.

For all these reasons, we do not believe the Discussion Paper should tackle the issue of assets held to back insurance liabilities.

Question 11—Should risk margins:

(a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?

(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

A2.31 We agree with the proposal in the paper that risk margins should be determined on a portfolio basis. This is consistent with the fact that part of the business model of an insurer is to build portfolios that enable it to diversify the risk it takes on.

A2.32 We have debated at some length whether IFRS 4's definition of a portfolio needs to be refined. We agree that whether contracts are managed together is important, but the issue we have been discussing is whether it is really necessary for the contracts to have broadly similar risks. For example, it might be that an insurer manages as part of a single portfolio some contracts that are all subject to one particular risk but also subject to a wide variety of other risks. Some EFRAG members believe that such a group of contracts should be a portfolio for the purpose of determining risk margins, as long as they are managed together. However, although the majority believe IFRS 4's definition is broadly satisfactory, we also recognise that broadening the definition might be the best way of addressing the concerns we have about the proposed treatment of diversification benefits between portfolios.

A2.33 We note that the IASB argues (in paragraph 201 of the DP) that diversification between portfolios should not be taken into account because such diversification would not be reflected in the current exit value of the portfolios involved. We are not convinced that the current exit value of the portfolio would not reflect any diversification benefits that arise between the entity's portfolios. We think that a market-based value would probably reflect some sort of typical intra-portfolio diversification benefit.

A2.34 The issue is therefore whether the diversification benefits that exist within the reporting entity should be taken into account in measuring the liability or whether the diversification benefits a market participant would have should be taken into account; in other words, it is the entity-specific v market-based debate again. Including the diversification benefits that exist between the reporting entity's portfolios will, we believe, more faithfully reflect how the business is being managed. We think therefore this is an issue that should be further investigated before the IASB reach a conclusion. We understand that the IAA is doing some work in this area. .

Question 12

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

(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract

(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

A2.35 In response to (a) and b(i), on the one hand we recognise why it is very important that, if accounting mismatches are to be avoided, a cedant should measure reinsurance assets on the same basis that it measures the underlying insurance liabilities. This implies that the risk margin will typically increase the measurement of the reinsurance assets. On the other hand, however, not all EFRAG members are convinced by the arguments in paragraphs 206-210 of the DP as to why this is appropriate conceptually nor why the resulting number is the current exit value. For example, bearing in mind that two different market environments are involved, it is not clear why market participants on one market would demand the same consideration for bearing risk as market participants on the other market would demand.

A2.36 Paragraphs 211-214 of the DP discuss the approach to default risk that a cedant should adopt. The DP explains that IAS 39 adopts an incurred loss approach to the impairment of financial assets and IFRS 4 adopts the same approach to reinsurance assets. Nevertheless, the DP's preliminary view is that an expected loss model is more appropriate for reinsurance assets.

A2.37 We suspect that the IASB is probably right to conclude it is that more consistent conceptually to use the expected loss approach rather than the incurred loss approach. However, we think there are practical considerations to take into account if it is to be applied to reinsurance assets. In particular, although the expected loss model works well for large portfolios of insurance risks due to the law of large numbers (ie it is possible to estimate with reasonable confidence the total number of deaths, lapses etc that are likely to occur next year), it works less well when applied to the relatively few number of reinsurers involved, especially as each reinsurer is likely to be quite different in nature to any other. Insurers would therefore in effect have to estimate for each reinsurer the probability that the reinsurer would not pay claims when due. Such probabilities will be very subjective and hard to estimate.

A2.38 As such we think greater consistency and transparency can be achieved by applying an incurred loss approach to reinsurance; in other words to recognise an "impairment" to reinsurance assets only when there is objective evidence that payments may not be received from a reinsurer. It would also be less burdensome for insurers.

A2.39 In response to (b)(iii), we do not believe that this contractual right should be included within the current exit value of the reinsurance asset because the reference transaction for determining the current exit value of the reinsurance asset is a simultaneous transfer of both the reinsurance contract and the related underlying contracts (as described in paragraph 209 of the discussion paper).

Question 13—If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?

A2.40 Our understanding is that the principle that is applied to accounting in general is that 'things' should be accounted separately unless accounting for them together has no material effect on the accounting overall, in which case they can be accounted for together. But what is 'a' thing? If we have a portfolio of contracts, is the thing that should be accounted for separately (unless it makes no difference) the portfolio, the contract or a component of the contract? As far as we can tell, neither existing IFRS nor the existing Framework give a very clear answer to this question.

(a) IFRSs seem generally treat the unit of account as being the individual instrument, contract, asset or liability involved, rather than the portfolio.

(b) However, there are several instances in existing IFRS where the unit of account is a component of a contract. For example:

(i) IAS 18 requires "in certain circumstances" the separately identifiable components of a single transaction to be accounted for separately. And in certain other circumstances it requires two or more transactions to be accounted for together;

(ii) IAS 32 requires that, if an instrument issued by the reporting entity contains both an equity component and a liability component, those components should be accounted for separately; and

(iii) although most parts of IAS 39 use the financial instrument as the unit of account, embedded derivatives are required to be accounted for separately in many cases. (The principle is that they should always be accounted for separately but, as a practical expedient, the standard allows an embedded derivative not to be separated if it is regarded as closely related to its host contract.)

(c) As we have just seen (see question 11), the DP proposes to treat a portfolio of insurance contracts, rather than each of those contracts individually, as the unit of account for some purposes.

A2.41 Looking at the three examples in (b) above, it appears that the underlying principle is that a contract, asset or liability should be broken into components (ie unbundled) when that is necessary to ensure that the financial statements reflect the substance of the transaction. So the question being asked is whether it is necessary to disaggregate an insurance contract into an insurance service component and a savings deposit component in order to ensure that the economic substance of the contract is appropriately reflected in the financial statements. It is of course possible to construct an 'insurance contract' that is a savings deposit contract with a small insurance contract attached. However, existing IFRS 4 already requires such contracts to be treated as financial instruments. Therefore, what we are discussing here are contracts that involve significant insurance risk and could also be characterised as having a deposit component (because the premiums are paid in advance or perhaps even include an explicit deposit element). Do such contracts need to be disaggregated if their substance is to be appropriately reflected in the financial statements?

A2.42 The proposal in the paper is that, if the components are so interdependent that they can be measured only on an arbitrary basis, the contract should not be disaggregated; otherwise the contract should be disaggregated and the components accounted for separately. The implication seems to be that the IASB's tentative view is that contracts should be unbundled unless unbundling cannot really be done. As there appears to be no reason why insurance contracts should be treated differently from any other type of contract, an implication of this proposal seems to be that, whenever a reporting entity—not just an insurer—receives a payment in advance, it ought really if possible treat that prepayment as a deposit component and account for it separately.

A2.43 EFRAG is not persuaded that this proposal is appropriate.

(a) Because the issues involved are of general applicability, we would like to see a more general debate about the desirability of treating every prepayment as a deposit component before reaching conclusions that insurance prepayments are deposits. This is important because it is not obvious in this case why it is necessary to unbundle in order "to ensure the financial statements reflect the substance of the transaction. Indeed, sometimes the concern when one is considering disaggregating a contract is that the linkage between the two components means that accounting for them separately will not capture their combined effect. The IASB's proposals deal partly with this by saying that if the components are so interdependent that they can be measured only on an arbitrary basis, the contract should not be disaggregated. However, it is proposed that disaggregation should still be required when the components are interdependent, but not so interdependent that the measures would be arbitrary. EFRAG's concern is that, by accounting for the components separately, the effect of the interdependence could be lost.—and as a result the substance of the transaction will not be reflected

(b) There is no doubt that disaggregating a contract and accounting for each component separately will be more burdensome than accounting for the same contract as a single component. It is reasonable therefore to ask what additional benefit will arise by incurring the additional costs to disaggregate the contract. The IASB would presumably argue that it is better accounting, but the test of this is whether the information provided is more useful as a result. The discussions we have had to date with users have not suggested that the resulting information will be more useful.

(c) Our understanding is that, if applying the three building blocks would result in a liability measure of €80 but the surrender value is €100, an implication of these proposals is that the insurer should recognise a liability of €100 and an asset of €20. This seems to us to be a very unsatisfactory outcome, because the insurer would have to recognise a liability that is not measured on the same basis as other liabilities and an asset amount that seems to be little more than a 'plug'. If we are to achieve significant improvements in the financial statements of insurers, we must not require them to put 'plugs' into their accounts.

A2.44 We also have some concerns about the proposal as currently worded.

(a) Some of the wording used—for example 'arbitrary' and 'interdependent'—is rather abstract and seems likely to result in inconsistent application.

(b) The paper does not discuss how to split the risk margins when a contract is to be disaggregated. There is also the question of how the acquisition costs should be accounted for—in accordance with this Discussion Paper or with IAS 39/IAS 18.

(c) It is possible for the nature of an insurance contract to change over time. This makes it important to know if the assessment as to whether to unbundled is to be made only on initial recognition or on an ongoing basis. On the one hand continual re-assessment can be burdensome, but on the other hand it is not clear whether the IASB's objective in requiring unbundling would be met if the assessment is done only on initial recognition.

Question 14

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

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

A2.45 Focusing first on question (a), we understand that the IASB's logic is that a policyholder would not consent to a transfer that impairs the credit characteristics of the debt and the transferor would not pay the price that a willing transferee would require for a transfer that improves those characteristics. We agree that a policyholder would not allow a transfer to take place if it resulted in a credit deterioration. The position as regards credit improvements is most easily discussed using an example. Assume that Insurer A owes Policyholder B €100 but, because of solvency issues, is likely to pay only €60 of that liability. Our understanding is that Insurer A would not be willing to pay more than €60 for another insurer (Insurer B) to take over the liability; however, Insurer B would be willing to accept as little as €60 only if it too expected to be able to pay only €60 of the liability. Therefore, we agree that if the current exit value is to take into account changes in credit risk, conceptually the current exit value of a liability would be the price for a transfer that neither improves nor impairs its credit characteristics.

A2.46 Turning now to issue (b). EFRAG has previously stated in its responses to the two measurement discussion papers the IASB has issued that is not convinced that a reporting entity should take changes in its own credit risk or in the credit risk attached to any instrument it has issued into account in measuring its liabilities for financial statement purposes. There are various reasons for this, but perhaps the one that EFRAG finds most convincing is that users tell us that they usually try to adjust the balance sheet and income statement amounts to eliminate the effects of such changes; and in our view if the numbers are not useful, they should not be provided. We this applies to all types of liability, including insurance liabilities.

Question 15—Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

A2.47 We believe that in general opportunities to reduce the inconsistencies between accounting standards should be taken advantage of, because eliminating such inconsistencies makes the bright lines that some standards draw less important and represents a step towards a truly principles-based financial reporting system.

A2.48 We would particularly support efforts to reduce the differences in the standards that apply to insurance and investment contracts, because those differences are a major reason for some of the accounting mismatches that arise at present. Reducing the differences would also we hope convince the IASB that it is not necessary to disaggregate insurance contracts, which would greatly simplify the proposals in the DP and the application of IFRS 4.

A2.49 Given that the measurement model that should apply to insurance liabilities is still being debated, it is a bit early for us to make detailed comments on the amendments that we believe should be made to IAS 39's liability requirements—and indeed to IAS 18. There are nevertheless two aspects of IAS 39 that are clearly in need of reconsideration if inconsistencies are to be avoided.

(a) Paragraph 49 of IAS 39 states that the fair value of a financial liability with a demand feature (for example, a demand deposit) will not be less than the amount payable on demand (the "deposit floor"). We think this provision is inconsistent with the measurement basis that is proposed in the DP and with the economics of insurance activity, and will lead to significant inconsistencies, particularly if financial and non-financial components of insurance contracts are to be unbundled.

(b) We think that, if significant accounting mismatches are to be avoided, it is important that all aspects of insurance contracts, particularly those with discretionary participation features, are accounted for on a consistent basis. In this regard we are concerned the DP proposes that the discretionary participating feature of an insurance contract will be accounted for under the revised IFRS 4, with the remainder of the contract valued under a different measurement model. Bearing in mind that the cash flows relating to the participation feature are likely to be interdependent with the other cash flows, they need to be accounted for on a consistent basis if accounting mismatches are to be avoided.

Question 17—Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

(a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).

(b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).

(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).

(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

A2.50 As we mentioned in our answer to question 15, we would in general support efforts by the Board to reduce or eliminate the accounting mismatches that currently occur. We agree furthermore that the amendments suggested in (a) to (d) above would in each case eliminate the causes of some of the mismatches that arise presently. However, we question whether they are the most appropriate way of eliminating those causes.

(a) We would much prefer the underlying principles to be re-examined with a view to refining them in ways that will alleviate the problem, rather than introducing rules and exceptions for unit-linked insurance contracts—and for the other types of insurance and non-insurance contracts where accounting mismatches arise. One of the problems with rules and exceptions is that they can cause as many new anomalies as they address.

(b) Having said that, whilst we could support the approaches outlined in (a), (b) and (c) above—although we would probably expect the treatments to be *required* treatments, not just *permitted* treatments—we could not support approach (d) because it would result in an inappropriate measurement of the liability.

Question 18—Should an insurer present premiums as revenue or as deposits? Why or why not?

A2.51 This is a complex issue that we think is deserving of a much more thorough analysis of the issues involved than is set out in the DP. We also think it is difficult to reach conclusions on the issue before the project on revenue recognition has progressed further. Therefore, we suggest that the IASB carries out further analysis into the issue and accelerates its work on revenue recognition.

Question 19—Which items of income and expense should an insurer present separately on the face of its income statement? Why?

A2.52 We are a bit reluctant to comment on presentation matters in advance of the IASB's proposed discussion paper on Financial Statement Presentation, because we believe it is important to develop an overall presentation approach that optimises the usefulness of the information provided. Our comments below are therefore not intended to pre-empt that wider debate in any way.

A2.53 We also observe that mandating lines that should be shown by insurers on the face of the income statement could result in the presentation of amounts that for some insurers are not significant in understanding their performance or do not fully reflect how management view the business. For that reason, we like the approach in existing IAS 1, which requires additional line items where such presentation is relevant to an understanding of an entity's financial performance. That would enable each reporting entity to assess what information should be given on the face of its income statement or in the notes to the financial statements. Furthermore, IFRS 4 already includes some disclosure principles which do not require explicit disclosures but can lead to detailed analysis tailored to an entity's individual circumstances.

A2.54 We would therefore suggest that the IASB maintain the current principle-based disclosure requirements and provide an illustration as to how these might be applied in the context of IFRS 4 (Revised) like the example already included in IFRS 4.IG 26 (in which the IASB suggests a list of items that an insurer might need to include either on the face of the income statement or in the notes to the financial statements). We would encourage the IASB to consult widely with user and preparer groups on this issue before drawing any detailed conclusions.

Question 20—Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

A2.55 In responding to question 19 we mentioned the IASB's proposed discussion paper on Financial Statement Presentation and explained that we did not want to pre-empt in any way that wider debate. That comment applies equally to this question. In general, we see no reason why the presentation principle that is developed for general use should not be applied to insurance.

A2.56 It follows that, if current IFRS is to continue to allow or require changes in the value of certain assets to be recognised outside of the income statement, we think a strong case could be made for the revised IFRS 4 to permit or require changes in the value of certain insurance liabilities to be recognised outside of the income statement (in order to minimise the effect of accounting mismatches that it does not prove possible to eliminate through IFRS 4 (Revised)). As a last resort, perhaps IFRS 4 could require or permit insurers to present the effects of any accounting mismatches in a separate part of the income statement. Our preference remains though that accounting mismatches are eliminated completely.