IAA (19 October DRAFT) Response to IASB Discussion Paper on Preliminary Views on Insurance Contracts

POSSIBLE ISSUES TO BE DISCUSSED IN THE GENERAL SECTION OF COMMENTS
(not yet discussed within the Insurance Accounting Committee)

1. General agreement with the major thrust of the Discussion Paper, those reflecting unbiased estimates of the present value of expected cash flows of insurance contracts.
2. Many specific comments and suggestions regarding factors that the Board should consider in its deliberations on the development of an exposure draft of a standard for insurance contracts, including:
   a. The use of entity-specific expense assumptions
   b. Reflection of all relevant contract and contract-related cash flows associated with the rights and obligations of the contract, due to their inter-related nature
   c. The risk element of service to be incorporated into the risk margin that we suggest might be referred to as a “market value margin”
   d. Clarity regarding treatment of non-guaranteed elements, e.g., participating bonuses/dividends and universal life charges
   e. Treatment of inter-pool diversification
   f. Offer to assist the IASB staff in further research regarding accounting treatment for universal life insurance
   g. Unit of account in recognition and measurement needs further clarification
IAA Response:

(a) Recognition: There are three possible choices for the time at which an insurance contract should be recognized: (1) the date the contract is agreed to by the affected parties, (2) the date the premium is paid, and (3) the date of insurance risk contract inception, usually the effective date of the contract.

Those who view an insurance contract as primarily a financial instrument tend to favour option (1), while those who view it as primarily a service contract tend to favour option (3). In fact, most insurance contracts have features of both, which makes the answer to this important question difficult, yet important. To complicate things, the first two date choices can be either before or after the effective date of the contract.

In practice, a liability should be recognized at the earlier of (1) and (2) -- if (2) is prior to (1), the liability is simply the equivalent of a prepaid asset (equal to the net amount received). When (1) occurs, the liability should be the liability for an insurance contract (under the principle of once an insurance contract always an insurance contract). However, as risk is only accrued beginning at the later of (1) and (3), revenue is recognized at the later of (2) and (3). This is broadly similar to IAS 39 practice. However, if a significant amount of day-one gain or loss is expected, the complicated calculation of an insurance contract's liability may not have to be calculated at least until the effective date of the contract.

Note that current insurance industry practice for most of the world is to delay recognition of the premium (and related expenses) until the period that contractual insurance risk protection has begun. If a premium is paid in advance of the risk inception date, it would not take the form of an insurance contract, even though it would be appropriate to reflect a liability until (1) or (3) occurs. How this is resolved may have significant systems implications for insurers.

The advantage of the above approach is that revenue would not begin to be recognized until the earlier of the agreement and effective date, while a liability for the insurance contract would begin at the time the contract is agreed upon or pre-paid. It would also result in a logical application of both service and option elements in the contract, as well as with reinsurance contracts whose coverage periods do not line up with the underlying reinsured contracts.

An issue that needs to be addressed is recognition (and derecognition of contractual modifications, i.e., whether a revision to an existing contract would be treated as a new one). Circumstances and issues related to these situations include:

- The exercise of certain policyholder options to modify an existing contract might be deemed to result in an extinguishment of the current contract and recognition of a new one. Examples of this arise when exposures change. One such example in the areas of group health and workers compensation is the hiring of additional employees in the middle of a contract. Another in commercial automobile insurance is adding to a company's auto fleet that would be covered under an existing contract, but which would also require additional premium that may or may not be at a guaranteed rate. In many cases, this would be the case under U.S. GAAP (AICPA SOP 05-1). Nevertheless, we suggest that the exercise of these types of options result from existing features of current contracts and thus should not result in the recognition of new contracts.

- Paragraph 218 discusses a reinsurance contract whose contract period does not line up exactly with the contract period of a reinsured contract. The DP
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attempts to avoid the problem of valuing a ceded amount, despite a prohibition on recognizing the corresponding direct amount, by stating that an option exists (under the IAS 39 recognition criteria), but likely with an immaterial value. This argument appears to be more a rationalization of a desired outcome rather than the application of a principle. We suggest that any profit on the reinsured contract should not be recognized until the insurance becomes effective unless it is an onerous contract, in which case it should be recognized when the underlying option is granted through the reinsurance treaty.

• The concept of asset delivery under IAS 39’s discussion of trade versus settlement date is unclear when applied in the case of many property/casualty (and other short-duration) insurance contracts wherein either party can cancel the remaining portion of the contract (with a specified notice period or upon non-payment of premium, although in certain cases these may be subject to regulatory approval). The issue is whether the unexpired portion of such a unilaterally cancellable policy should be considered not-yet-delivered, as per the settlement date notion under IAS 39. The answer should be based on a principle whereby it can be determined whether an instalment premium or something close to the unearned premium can be returned at any time at the request of the policyholder. We are somewhat uncomfortable with the practical situation where recognition/derecognition could occur every month on a contract which has a regularly scheduled monthly premium payable.

• Under certain reinsurance contracts, guaranteed coverage is provided with respect to certain direct insurance contracts yet to be written. It is appropriate under the principle of a stand-ready obligation with respect to these contracts that an obligation be recognized at the time the reinsurance contract is recognized. Although in many cases, the liability for these contracts will not be material, this result should not be generalized.

(b) Derecognition. It is not uncommon for insurers to offer existing policyholders the opportunity to replace or modify existing contracts for various reasons, such as increasing or decreasing benefit needs or premium paying abilities, or upon reinstatement (e.g., certain circumstances in which SOP 05-1 is effective) as a bilateral contract change. Under the criteria in IAS 39.40, the cancellation or substantial modification of an existing contract results in derecognition. Although this should apply equally to insurance contracts, it may imply significant calculation issues under Implementation A (requiring the price for the margin to be determined afresh at the time of modification. In addition, a contract classification process may be needed, to determine whether a significant degree of insurance risk remains, and that may be inconsistent with a prior classification. It an unconstrained contractual option that can be exercised unilaterally should be treated as the execution of the current contract and not as a modification of the existing one or a new contract.

With regard to derecognition, we are somewhat uncomfortable with the use of the current rule-based 10% floor required for derecognition given in IAS 39.AG62. We prefer a principle-based approach for use in this type of situation, rather than one based on such a rule, although in practise such a rule might provide guidance.

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,
IAA Response: The measurement principle underlying current exit value is that it is an estimate of an exit (or transfer) price for the remaining rights and obligations of a portfolio, referencing relevant observations in the most appropriate exit market, but recognizing that there is normally no market from which to observe such prices reliably. This implies that measurement should look first to observable prices for identical or relevant portfolios of insurance contracts transacted in an active and relevant market. However, since it has been demonstrated that the reinsurance, business combination, and transfer markets do not currently represent markets from which relevant observable prices can be obtained, this currently is not a reliable source of inputs.

When these prices are not reliably observable for relevant portfolios or contracts, priority should be given to the use of rights and obligations or other observable inputs that are observable. For example, a combination of the first two building blocks may be able to be replicated by certain assets in the capital markets. However, these present values may already include a part of, or the entire, risk margin.

Nevertheless, to the extent that reliable prices for relevant contracts, components, inputs or cash flows can not be observed, the application of the building block approach is reasonable. For many current insurance contracts, there will be a lack of supportable information regarding how market participants would value operating expenses or service margins. Neither will there be information regarding estimation error in the current estimate or the risk margin. In these cases, we support paragraph 62, which indicates that an entity would use estimates of its own (servicing) costs, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants. In addition, this would have to include factors such as future changes in the risk exposure or what appears to be irrational policyholder behaviour.

One approach to the mark-to-model measurement approach that could be applied is consistent with the hierarchical logic described in FAS 157 and measures level 3 inputs in a building block approach. However, we consider the basic building blocks to be secondary in importance to the measurement attribute objective (see our comments to Question 5).

The key to the acceptability of the three building blocks is their application and any constraints placed on them. We do not believe that the imposition of arbitrary constraints, such as a limitation on recognition of expected premiums, a deposit floor (a cash value floor for insurance contracts) or the restriction of the recognition of future premiums that the insurer expects to collect to those premium payments required to guarantee continuing insurability, is consistent with information needs of financial report users, since neither the buyer nor seller would consider such constraints when negotiating a transaction price.

It is important that there be proper integration of building blocks (a) and (b). Each separate scenario may be associated with a unique interest rate path representing the financial circumstances of that scenario if that scenario is sensitive to prices in the capital markets. In addition, it is important that the underlying assumptions relating to the building blocks be, to the extent possible, internally consistent. It is, therefore, important that the cash flows of a scenario be discounted using discount rates from the yield curve associated with that scenario. Then, the discounted cash flows from each of the scenarios should be weighted by the probability of occurrence of the scenario and then totalled to derive appropriate present values.
Considerable confusion has arisen regarding the purpose and practicality of the service (contract related expense) margin approach described in the DP. The measurement elements of the service component of an insurance contract include the following:

1. Expected expense (servicing costs). Building block 1 would provide for this.
2. Persistency and timing risk of the expected expense -- this element is not different in concept from insurance cash flows. This is particularly important in an insurance contract in which the contract or claim period is lengthy. Building block 3 would provide for this.
3. Measurement risk of the expected expenses (corresponding to the uncertainty associated with estimating the expected value for the contract until derecognition occurs). Building block 3 would provide for this.
4. The profit portion of a third party purchaser or provider of the service.

We believe that element 4) is the component that led the Board to include a separate margin for services in a manner consistent with the current accounting for a service contract. It appears that this is an attempt to incorporate a service based rule into an insurance contract whose insurance, financial instrument and service components are unbundled. We do not believe that in a hybrid insurance contract that this is an appropriate approach. The primary problem is that in most cases element 4) is indistinguishable from servicing risks 2) and 3) above and can only be split in an arbitrary manner from insurance risk incorporated in the risk margin. In any event, a profit margin for the service aspect of an insurance contract is not related to a plug margin which may be the practical implication of the DP approach.

To address the problem that the preliminary views is attempting to resolve, we encourage the Board to include in the standard a requirement to measure a combined insurance and service margin, reflecting all related service expense risks and not just investment management.

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?

IAA Response: We believe that the description of expected cash flows and risk margins included in a future IFRS should be principle-based and not incorporate specific measurement guidance. We note that much of the discussion in Appendices E and F is useful in a discussion paper, but does not have a place in a financial reporting standard.

If reference is to be made to specific measurement techniques, it should be made clear that they are only for the purpose of providing examples and do not constitute requirements. This will tend to encourage the development of future methodologies and adaptation of existing ones to new types of contracts.

(a) Cash flow guidance. With respect to expected cash flows, a discussion of the objectives and overall accounting attributes, together with more detailed actuarial guidance provided by the IAA and on a regional or local level relevant to local products and features, would be a useful model for use in the overall approach taken, and it would be consistent with the underlying principles provided. We consider that the combination of experience with the system once it is adopted and transparent disclosure will serve to narrow the range of results to an acceptable range.

We have several additional comments:
1. Clear statement of objectives. To improve the clarity of the description of liabilities, paragraph E5 should state the objectives. It is not to “develop a single ‘best’ estimate of future cash flows,” but rather to develop a current
estimate of the expected (probability weighted mean) value of the discounted future cash flows.

2. Terminology. Enhanced clarity would be achieved by removing the words “best estimate” in paragraph E5 and define the objective as obtaining the expected value as defined, based on probabilities. This would be a better description of measurement as an estimate of the expected value by determining the expected value of the estimated probability distributions as applied to a range of scenarios.

3. "Probability-weighted" terminology. There has been some confusion regarding the use of the term "probability-weighted." In some cases, probability distributions do not exist and cannot be developed in a cost-justified manner. However, we believe that what is meant by this phrase is that an unbiased expected value, in contrast to a median or mode, is the measurement objective. Clarification of this point would be helpful.

4. Constraints not consistent with the measurement objectives. For example, paragraph E2 states “incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations,” while paragraph 154c) states that “future premiums (and resulting additional benefit payments to policyholders) should be included… if, and only if, any of the following criteria is met: … (c) including the premiums and the resulting policyholder benefits will increase the measurement of the liability.” While E2 is consistent with the measurement of market observable prices that are unbiased in nature, paragraph 154c introduces a bias.

5. Unit of measurement. For measurement purposes, it is common and sound practice to group contracts according to sub-portfolio characteristics, e.g., age for life insurance or geographic area for property insurance. These should continue to be permitted as appropriate.

6. Requirement to consider each possible scenario explicitly. In certain cases, it is impractical to consider every scenario. Nevertheless, the variation in possible results and any bias that a non-symmetric probability distribution creates should be considered in measurement.

The IAA suggests that an appropriate principle that should be included is that all expected cash flows associated with the contract should be reflected. In establishing the amount of the cash flows to take into account, expected policyholder behaviour would be incorporated. If this principle were followed, current exit value would be consistent with fair value.

Paragraph 61 indicates that the characteristics of the applicable contracts held by the reporting entity should be reflected in determining assumptions. This implies that the portfolio is the applicable unit of account. This is important in several aspects of measurement; for example, when assessing the extent to which the entity's expected legal costs should be included in the expected cash flows. Further, it is consistent with the underlying nature of the insurance provided.

Paragraph 186 indicates that the unit of account does not affect the measurement of building block 1. In the case of operating expenses, this is not appropriate, since the unit of account is an important factor in this type of expense.

(b) Risk margin guidance. With regard to risk margins, we believe that, in an accounting standard, the guidance for risk margins should, to ensure reliability of results, identify the goals to be achieved, the principles to be applied and any limitations to be considered. In addition, the IAA believes that, in particular, the
description of risk and service margins should be clarified by emphasizing the underlying objectives and principles involved, but not by including specific rules or methods (also see our response to Q2).

We consider the following to represent appropriate characteristics of an unbiased measure of a risk margin:

1. Consistency with the risk margin that a transferee would require to assume the liability.
2. The unit of measurement is portfolio-specific, consistent in size with a relevant reference entity. This would imply that an addition to the liability to reflect lack of size in the portfolio would not be appropriate.
3. Consistent with the nature of the portfolio, the transferee would be an entity that is a large, multi-line, diversified and highly rated insurer. If, for example, by law the portfolio could only be offered by a mono-line insurer, then this general principle would be modified accordingly.

The question of reflection of the effects of inter-portfolio diversification is an important one. We believe that it is more important for users of this information to be able to compare values of individual portfolios (and product segments), rather than consider the net effect of the diversification of the entity. Therefore, diversification effects should be reflected to the extent that market participants would do so, consistent with a reference entity. Further, to ignore these effects would not represent a real exit value approach.

While recognising that the insurance industry currently uses several different techniques, the IASB should be principled in its approach. Acceptable criteria (or characteristics), together with emerging experience during and after implementation of an insurance contracts standard for a risk margin should facilitate the development of unbiased estimates of these margins, and at the same time should narrow the range of acceptable risk margin approaches or the assumptions used in such approaches.

We do not believe that the wide range of methods discussed in F9 need be included in the standard because, based on the experience of certain of our member associations, such an enumeration will not likely narrow a reasonable range to meet the IASB objective of reliability and, in fact, might impede efforts to develop new approaches and techniques. Inclusion of a specific method without appropriate caveats may effectively imply IASB approval of the technique. We believe the criteria for selecting the risk margin approach are more important in a financial reporting standard. Selection criteria have been recommended in the IAA Exposure Draft on Measurement of Liabilities for Insurance Contracts. This should be achieved by expanding the appropriate criteria outlined in F3 and F4 and deleting the sections after F4.

The use of a reference entity could provide a consistent base for comparable entities to establish their risk margins.

The IAA observes that estimating risk margins for insurance products is complex and is an emerging practice. Therefore, we have prepared a draft paper on this subject and we expect to prepare a model international actuarial standard of practice for this purpose in conjunction with the adopted IFRS on insurance contracts.

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<th>Question 4: What role should the actual premium charged by the insurer play in the calibration of margins, and why?</th>
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<td>(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.</td>
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<td>(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</td>
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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).

IAA Response: Conceptually in most cases we believe that the role described in paragraph (c) is the most appropriate choice provided. Although in many cases premium can be useful for this purpose, it is certainly not the only factor to be considered. It is more important that the building blocks, as applicable, be estimated in a sound and rigorous manner.

Depending on the situation, premiums may play one of several roles. However, we note that (1) the use of the actual premiums charged assumes that the reporting entity's pricing model and pricing decisions are reasonably consistent with those of other market participants, (2) actual premiums are often subject to retail market competitive pressures that may differ from that experienced in an exit market or from expected cash flows, and (3) any constraints placed on the measurement of the liability for the entire contract to which the premiums relate would also be consistent with both the entity's pricing and current exit values.

None of these assertions may be true. For example, pricing and contractual current exit values are based on the recognition of all expected cash flows relating to a contract, without such restrictions as those proposed on renewal premiums or dividends/bonuses that are consistent with assumptions regarding the portfolio, if the pricing process of both the insurer and market participants reflect them. Further, the liability would be based on a before income tax basis while market premiums are usually determined on an after income tax basis. As well, the market for insurance contracts often reflects a higher discount rate than that consistent with market interest rates. In addition, depending on the responsiveness of renewal prices, the initial premium may bear limited resemblance to market transaction prices after issue.

The DP proposes that a number of constraints be imposed on the expected cash flows that enter into the measurement of liabilities of insurance contracts. Examples of these constraints include limitations on which premiums can be included in expected cash flows and the fact that the calculation is to be performed on a before income tax basis. The liability should be established in accordance with market pricing principles that take into account all cash flows without application of these constraints.

We consider option (c) to be preferable, since it better recognizes the underlying principles and it can be applied consistently throughout the term of the liability. A greater degree of arbitrary measurement may result from other approaches. Note that margins on renewal business of longer duration contracts are usually more significant the longer they are in existence, in part because they usually represent the aggregation of several cohort years and incorporate more uncertain cash flows. As a result, in these cases benchmarks of premiums are certainly more important.

Please note that there is little, if any, role that premiums play in calibrating margins for liabilities associated with claims. Therefore, it is not relevant in this case. In addition, since many insurance contracts are not of a single premium nature, this question is better phrased in relation to the present value of premiums, rather than the initial premium. An additional issue relates to the fact that in an insurance contract, being a bundled product incorporating financial instrument, service and insurance risk
characteristics, the premium usually provides for all three of these features. As such, it can be difficult to assess the relationship between the premium (the cash considerations provided by a policyholder) and the expected cash flows under a contract, with different elements of the premium.

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?

IAA Response: We believe that the liability for insurance contracts should be based on the current economic value of the rights and obligations of the insurance contracts, represented by their expected future cash flows reflecting economic reality. The characterization of such a liability that corresponds with the attribute as described is a reasonable basis for the measurement of this liability. “Current exit value” approach as defined, without rule-based constraints, thus, is a reasonable measurement attribute for insurance liabilities, since this captures conceptually what a market participant would charge for assuming the liability. Not only is this consistent with economic reality, but also it will forestall others from creating products or entering into reinsurance deals that take advantage of deviations from reality and that are not based on sound economic reality. Nevertheless, since insurance contracts are not traded in an active marketplace, to a large extent measurement has to reflect the application of models of expected future conditions and their probabilities.

It is unfortunate that the current Framework does not provide an adequate basis from which to develop appropriate measurement guidance. We hope that the revised Conceptual Framework will do so.

If fair value is defined in a manner consistent with current exit value and becomes the general measurement attribute for financial and hybrid instruments, the estimate of current exit value for insurance liabilities will best ensure that the financial reports of insurance companies are as consistent as possible with financial reports of other types of entities. We encourage the movement toward a consistent balance sheet within a reasonable timeframe to accomplish this.

At the present time, accounting rules for certain financial assets and service contracts allow, or require, valuation at other than current exit value (e.g., amortized cost). As long as this is the case, insurance contract liabilities and other financial liabilities held by an insurer and the financial assets that back those liabilities should be valued in a consistent manner. To the extent that this is not achieved, financial statements will not be measured on internally consistent bases and thus may not provide completely useful financial information to the users of the accounts and, in fact, could result in spurious gains or losses that are not related to economic reality.

While recognising the problems of comparability between entities, we also point out that, since transfers are unusual for most insurance contracts, a current measure of the value to settle contracts with policyholders over time may provide the best (current) estimate of what would be the value to a user in making decisions as described in paragraph 14 of the Framework. Thus, the measurement attribute for insurance contracts should not be such as to preclude the possibility of adopting the value to settle contracts over time. We note that since any transferee must settle the obligation over time, the transfer (exit value) price will reflect the ultimate settlement with the policyholder.

However, in respect to expenses as stated in our response to Q2, we agree with the comments in paragraph 62 that, in large part for the practical reasons of the lack of reliable external information, the expenses associated with a portfolio may need to be those of the current entity (the current entity’s strategies and efficiencies rather than
an estimate of that of a hypothetical market-participant). Thus, using the three building blocks as a basis, the expected cash flows would be portfolio based considering economic reality, while discounting and risk assessment would be consistent with current market prices.

On balance, we are more in favour of Implementation B of current exit value rather than Implementation A, in part this is due to it being consistent with the definition of current exit value. Operationally, implementation A seems more in line with an entry value approach and inconsistent with the settlement of the obligations of an insurance contract or a prospective view of the rights and obligations under a contract. Although not as easy to calibrate, Implementation B is far more practical for pre-claims liability (both in gather historical experience that is needed to apply it and upon recognition on contract modifications when a new contract is required).

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

IAA Response: First and foremost, we believe a consistent set of soundly based and relevant measurement objectives is far more important than the label. The Board is currently considering a definition of fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition, which is taken from SFAS 157 Fair Value Measurements, is not distinguishable from the definition of current exit value.

However, it is important to note that, based on this accounting approach, in practice the DP does not include in the measure of a contract's liability certain types of cash flows related to the contract, e.g., all expected renewal premiums, policyholder dividends (bonuses) and other non-guaranteed elements, all of which would be expected to be included in the price to transfer the insurance contract. This difference is due to a different basis for the unit of measurement, which for the definition's purpose is the contract (with certain clear exceptions, e.g., separable riders that on a standalone basis could constitute a different type of contract that would be measured on a different basis).

If, based on the comments received, the Board decides that current exit value is fair value, then it should consider how the insurance contracts standard fits within its fair value measurement concepts. This may require the Board to have substantially completed its fair value measurement project before it issues a final insurance standard.

If the Board favours the measurement concepts in the DP but decides that they do not constitute a fair value, then for the purpose of application to business combinations, it should articulate the distinction between the two measurement bases.

We are concerned about a measurement that is not fair value but that purports to be a current exit value. It appears, conceptually, to be ambiguous and users may not understand why it is not fair value. We recommend that the Board decide earlier rather than later if it is pursuing a fair value measurement and that it either develop the insurance contracts standard as an application of fair value measurement or that it articulate and adopt an altogether different measurement concept. The term to be use to describe the method selected should be based on the substantive objectives of measurement included in the final standard. These decisions can feed into the Conceptual Framework project with a better focus on measurement objectives.

We believe that the Board should decide on the objectives of the measurement base for insurance contracts. Only after that should it decide the label to be used.

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?

IAA Response: Our reasons to support the incorporation of cash flows resulting from policyholder behaviour into the current exit value of insurance liabilities are given in our response to question 7.

We believe that the question about presentation, (a) versus (b), is better addressed after the Board has decided, for the purposes of a financial statement, whether insurance contracts should be categorized as financial instruments or, in whole or in part, as service agreements.

If insurance contracts are treated as financial instruments, the measurement of liabilities should be based on the value of the bundle of future contractual cash flows. All economic rights and obligations, including the benefits of beneficial and non-beneficial policyholder behaviour, should be reflected in the measurement. This approach, often referred to as a “unitary” measure, would incorporate the cash flows resulting from beneficial policyholder behaviour in the current exit value.

In contrast, the Board may decide that the service component of insurance contracts should be separated as is currently the practice for many investment contracts. If so, the costs associated with the customer intangible should be reflected separately as a contra-liability and amortised against its corresponding revenue (on a stage of completion methodology considering the expected reward of being at risk to be the financial effect of the service) consistent with the guidance provided in IAS 18.

We would like to note that in some cases, the distinction between beneficial and non-beneficial policyholder behaviour is difficult to assess. For instance, for a certain life insurance contract, a policyholder termination can be beneficial, while the same termination a year later can be non-beneficial (when the contract is "lapse-supported"). For that same contract, depending on the circumstances and expectations, whether termination is beneficial or non-beneficial may depend on the circumstances or assumptions at the time. We do not believe that this distinction is particularly useful or meaningful, while at the same distinguishing between these conditions

In fact, except when the components are independent of each other, we do not favour unbundling the contractual components. To that end, we encourage the IASB to reduce wherever they exist the difference in measurement approaches for these components.

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 modifying significantly the risk, amount or timing of the cash flows).
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(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).

IAA Response: Our view is closest to criterion (c). Insurance contracts are bundles
of inter-related cash flows for which separation for recognition and measurement
purposes would result in divergence of accounting from common pricing practices.
Thus, placing such a constraint on the inclusion of cash flows will neither relate to
economic reality nor be representationally faithful.

Take, for example, a single premium contract that includes an option to cancel the
contract before its maturity. The liability of the contract on surrender (voluntary
termination) may be less than the discounted value of the contract held to maturity, in
which case a decision by the contract holder to cancel the contract is favourable to
the insurer.

In a transaction involving a portfolio of such contracts, the exit price should be
calculated using the probability that a certain number of the contracts will be
cancelled by the policyholders. In this case, a calculation that assumes that no
contracts will be cancelled can result in a value greater than the amount that would
be paid on a transfer of the rights and obligations of the contracts.

The difference between these two amounts, the second with the assumption of no
cancellations and the first assuming expected cancellations, should not be
characterised as an embedded asset. Rather, it is a reflection in the measurement of
the liability that the contracts are not executed in an efficient market. In an efficient
market, a policyholder who wishes to monetarise the contract would sell the rights to
the maturity value for an amount greater than the cancellation value, and the contract
would not be cancelled.

The concern that the cancellation rights represent an intangible asset of the insurer,
the writer of the option, stems from the focus on the cancellation option in isolation.
An equivalent contract could be written that would create a deposit with the right to an
insurance benefit if the deposit is left with the insurer. In this case the accounting
would be focused on the proper measurement of the insurance obligation rather than
being concerned about the recognition of an asset. The most appropriate, probability
weighted, and explicit approach to measurement in either case is an unbiased
projection of expected cash flows reflecting policyholder behaviour.

An additional insight can be gained in the context of a 100% quota share reinsurance
arrangement. There it would be inconsistent to recognize the expected value of
future premiums in the calculation of the ceded reinsurance asset, while not being
able to recognize that in the measurement of the directly written premiums. A
consistent approach to the treatment of the rights and obligations of an insurance
contract is necessary in order to create a standard that stands up to economic and
business reality.

The Board’s concerns with future premiums, premiums that typically are intended to
include amounts to recover acquisition costs, are apparently based on the insurer’s
lack of control of the premiums, even though they are an inter-linked part of the
contract and the insurer stands ready to accept them. The DP states that IAS 38
prohibits the recognition of internally generated customer relationships. IAS 38 refers
to customer lists, which are qualitatively different from the relationship an insurer has
with a policyholder. As we interpret it, the customer relationship inherent in a contract
with substantive and inter-linked rights and obligations and with predictable cash
flows, is simply not analogous to a customer list. The cash flows are identifiable and
it is probable that both the economic benefits and costs can be measured reliably and hence their realisation is likely. The costs generally include commissions, fees, direct acquisition costs and other related expenses, all of which can be measured reliably. Hence, we conclude that the intangible asset for the customer relationship should be recognised.

The tentative decisions in the DP, along the lines of criterion (a), seem overly prescriptive and rules-based rather than principles-based. The Board does not appear to want the insurer to recognise an asset for the portion of future premiums that relate to a customer intangible unless future premiums are needed to retain a right to insurability or to some other contractual guarantee. This indicates that, to ensure that an insurability option is recognised, it may be necessary to allow insurers to recognise the intangible asset that would not otherwise be recognised. It is important to note that both the rights (the receipt of the premiums) and corresponding obligations should be recognized; to do otherwise would not only produce a biased estimate of a current exit value, but it also would have little to do with economic reality. It is not clear how the existence or absence of guaranteed insurability changes the attributes of the asset (or negative liability) to make it recognisable.

The effect of a guaranteed insurability option can be measured separately without reference to future premiums; its recognition does not depend upon also recognising the intangible asset. Nevertheless, we do not favour separate consideration of inter-related subsets of cash flows for consideration of recognition and measurement. Rather, we believe that market participants calculate current exit value by considering the bundle of cash flows based on realistic expectations for policyholder behaviour, and that the measurement of liabilities should be consistent with these pricing practices.

We believe that a principle-based boundary can be constructed that, based on the concept of commercial substance, differentiates those premiums that relate to an existing contractual relationship from those that do not. For short duration contracts (e.g., those of a twelve month period), premiums that relate insurance benefits beyond the current contract terms should not be considered when measuring liabilities whenever there does not exist pricing or underwriting constraints subsequent to that period. For longer duration contracts (generally those whose expected duration is greater than a twelve month period), premiums that create new obligations, but do not substantively relate to existing rights and obligations, should not be considered. Although stated somewhat differently, they follow the same underlying principle. Based on this approach, expected future premiums on universal life contracts would form part of the contracts' measurement, whereas additional future deposits on many flexible premium deferred annuity contracts would not be included in projected cash flows when measuring liabilities. In addition, although it would be possible to calculate liabilities for universal life insurance without reflection of such obligations to accept such premiums, we believe the results would not reflect the commercial substance and economic reality of the contract. In addition, the calculations required under a) for universal life insurance contracts would be quite complex, possibly requiring several iterations of calculations.

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

IAA Response: Yes acquisition costs should be recognised as an expense when incurred. The approach to recording such costs is less important than the consistency with the recording of the pre-claims liability or stand-ready obligation. If the pre-claims liability or stand-ready obligation is established gross of such expenses, then such acquisition expenses should be an allowed pre-paid asset. If such pre-paid expenses are not allowed to be reflected as an asset, then the related pre-claims liability or stand-ready obligation should be established net of such expenses.
Although we believe that the application of a prospective building block approach is sound, because of practical considerations we recommend that, for cancellable non-life (or other short-duration) insurance contracts, the pre-claims liability should be permitted to be based on a current unearned premium liability accounting model. Under it, the liability should be based on an approach that defers recognition of revenue over the unexpired portion of the contract (assuming that premium is revenue), an annual re-estimation for those contracts whose terms are longer than 12 months would be appropriate. Of course, if expected costs are not expected to be level over the contract period, that characteristic of the expected cash flows would have to be recognized accordingly. This practical, rule-based approach is, at best, a surrogate for a more refined calculation based on the three building blocks (or reliable observed prices). For it to remain appropriate, a regular demonstration would have to be conducted. Certainly, a calculation performed on the basis of the three building blocks prospective approach should also be acceptable.

The proposal to expense acquisition costs differs from the current treatment of origination costs incurred to secure investment contracts as described in IAS 18, A14(b)(iii). See our response to question 15 for further discussion of this correspondence.

Note that the liability value of many insurance contracts can be negative (equivalent to an asset) at its start and turn positive later on. We have no problem with this outcome because it is consistent with a current exit or settlement approach. In part because of the definition of an asset, we do not believe that it would be appropriate to report such values on other than the liability side of the balance sheet.

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

**IAA Response:** Currently IFRS 4 does not permit an exemption from the requirement of IAS 3 Business Combinations that assets and liabilities be measured at fair value as of the closing date of the acquisition. Absent specific guidance on the measurement of fair value for level three inputs, currently insurers primarily use methods consistent with their valuation of the contracts as applied in the transaction process. These calculations may have attributes that differ from the tentative decisions in the DP; for example, they often reflect future premiums that would not be considered to be included under the proposed DP guidance.

The insurance contracts standard should make clear whether the final measurement objectives applied are applicable for business combinations and portfolio transfers. If the measurement objective in the insurance contracts standard is fair value or its equivalent, then its use in a business combination would be understood. If it is not a fair value standard, then the differences from a fair value measurement should be delineated so that measurement in a business combination can be made to comply with IAS 3; otherwise, there should be an exemption from IAS 3 that permits use of the insurance standard in business combinations.

The main differences are that under IFRS 3 the total acquired asset or liability is measured, including all intangible assets including goodwill, and that the measurement equals the amount paid (i.e., no initial gain is permitted, but of course such is due to the recognition of other intangibles). Under the Discussion Paper approach, only the rights and obligations of the contract are measured.

As the Discussion Paper notes, internally generated customer intangibles are recognised in a business combination. Any exclusion from the measurement of liabilities of premiums that do not provide guaranteed insurability and of anticipated favourable policyholder behaviour in the estimation of future cash flows in directly written business would not apply to portfolios acquired in a business combination or a
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portfolio transfer. Hence, the fair value of acquired portfolios would be measured differently from the current exit value of directly written contracts. After purchase, such an artificial distinction is not consistent with the definition of a liability and is unrelated to economic reality. In contrast, generally, the fair value of financial instruments is the same regardless of whether they are entered directly or traded.

If the measurement principle for insurance contracts is current exit value, we do not believe that there is a reason for the introduction of a difference between the measurement of insurance contracts directly acquired from that of those acquired in a business combination. An adverse consequence of a different measurement model would be that the difference creates an opportunity for accounting arbitrage. Insurers may perceive an accounting advantage in buying and selling portfolios or enter into other financial arrangements in order to get a more faithful representation of their economic rights and obligations, rather than doing so for economic reasons.

In summary, Consistent with a current exit value objective, we do not believe that the value of a directly written insurance contract should differ from the identical insurance contract obtained from a business combination. As such there would be no difference between current exit value and fair value; if there was, the difference would have to be reflected in goodwill, whose value would remain the same unless the impairment test would be adverse.

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

IAA Response: Conceptually, as stated in prior IAA comments and research, we believe that assets and liabilities should be measured in a consistent manner. In addition, the business of insurance relates to the transfer of insurance risk, resulting in obligations that result in liabilities. As a result, the key focus should be on the measurement of insurance liabilities. The valuation of assets backing these liabilities should be consistent with the valuation basis for the liabilities. Any different approach would not recognize the economic reality of the insurance contracts.

Thus, any difference in measurement bases may result in artificial accounting mismatches that do not reflect economic reality. We believe that the underlying principle should be that similar if not identical measurement objectives be applied to the measurement of assets held to support insurance liabilities as for other assets held as investments by insurers. In addition, we believe it to be a very important measurement principle that accounting mismatches should not arise in circumstances where there is a direct relationship between the value of the liabilities and corresponding assets. To the extent that guidance deviates from this principle, any differences should be disclosed.

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?

Response: Conceptually we believe that risk margins should be determined considering the risk mitigation provided through the use of a pool (portfolio) of risks cash flow probability distributions of which have a similar shape. Nevertheless, we would like to point out that it is not always clear that a portfolio can be identified based on a simple principle as grouping "similar" contracts. It should be noted that the mere existence of insurance relates to the ability of insurers to assemble a portfolio of similar risks. Portfolios for pooling purposes are assembled without the need to specifically identify them, although their assembly is certainly a service provided by an insurer. Insurers design products and underwrite risks in a manner so
that the different inherent risks contain certain characteristics which are common in
the portfolio.

The determination of risk margins should be based on the actually observed degree
of pooling effects in the insurer. It is important to clarify that it is not the type of risk
(e.g., death, third party liability, theft etc.), but the expected shape of the probability
distribution function that is relevant for the determination of to what being similar
refers. Practically, any pooling effect observable between uncorrelated risks in the
same organizational structure should be considered conceptually. If “managed
together” is understood in an organizational sense, we agree with the use of this
phrase.

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

IAA Response: We believe that the benefits of diversification arise from the
combination of risks that are not completely correlated. The measurement of a risk
margin should be made on the basis of a relevant reference portfolio. In most cases
it would be a large, well diversified and financially secure entity; exceptions include
risks' markets which are monoline in nature.

In the case of a reinsurance cession, i.e., if one risk directly refers to the effect of
another risk to the insurer in an off-setting manner (e.g., in the case of reinsurance),
the cession should be recognised and measured consistently with the ceded risk.

As previously outlined in our response to question 3, we believe that risk margins
should be determined reflecting portfolio characteristics. The description of a
portfolio should be described carefully, since it has sometimes been treated in an
inconsistent manner. Often, current insurance practice applies this concept to a block
of similar products sold through a particular distribution system. In other cases, it has
been used to represent the entire entity due, in part, to the fact that the risks are all
insurance, managed by the overall entity's management team in the same manner.
In part, this is due to the use of combination contracts, e.g., with different risks like
homeowners and automobile coverages, or property and liability contracts that have
very different loss development patterns.

The purpose of using a portfolio is to bring together groups of risks that reflect the
pooling of risks. This pooling or sharing of risk is the very essence of the insurance
business and provides the ability of insurers to offer insurance coverage at an
affordable price. This is also the basis for setting premiums, taking into account the
use of large numbers of reasonably homogenous risks to share in the cost since not
all will experience such events. This is usually done by separately aggregating a
block of property risks, of liability risks, of early death risks or of survivorship risks.
This is closer to the manner in which claims are managed, although some of these
blocks may be sold through the same distribution channel.

The IAA recommends risk margins be established on a portfolio basis. This implies
that risk margins would not reflect only the potential benefits that may be obtained
from diversification of multiple portfolios consistent with market practice and the
manner in which the business is managed. The size of the portfolio is not relevant in
the determination of the risk margin. The liability of contracts within a portfolio will
benefit from the diversification effects achieved through the pooling of similar risks.

In measuring risk margins, we consider that the essence of how insurance risks of a
group of contracts are managed and priced is appropriate for the selection of the
portfolio. The recognition of how a company has combined various risks in its
marketing, product design or entity organization structure is not directly related to the
characteristics of the liabilities considered and hence should not be reflected.
(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?

**IAA Response:** As a matter of principle, a cession (a contract transferring a set of expected economic consequences from one entity to another) should be recognised and measured in a manner consistent with direct written business and on the basis of identical principles. As far as a reinsurance asset is concerned, this measurement should reflect the way an entity measures the ceded risk. In this context it is essential to recognize that the measurement of reinsurance assets needs to be based on an assessment of the extent of the risk relief provided to the reinsured by the reinsurance contract. The reasoning of paragraphs 208 - 210 of the DP is sound.

In fact, that set of arguments serves as a prototype to solve other insurance related problems or cessions in general, where cash flows and risks that refer to seemingly distinct issues can only be assessed be treating them together and offsetting the net effect. This may apply, for example, in measuring policyholder participation rights as well as in measuring insurance contracts from a policyholder’s viewpoint.

The approach presented in the Discussion Paper is different from the effect of mirror accounting, where accounting of a reinsurance asset in the cedant's balance sheet would follow the accounting of the related insurance liability in the reinsurer's balance sheet. Such an approach would not reflect the economics of the relationship, in particular, the asymmetry of risk between the two parties, and should not be considered as appropriate to be incorporated in an IFRS standard.

This argument does not imply that the measurement of reinsurance assets needs to be based on the current exit value under any interpretation of that value. The measurement of a ceded reinsurance asset, as in case of any other form of cession, should be consistent with the measurement approach for the corresponding ceded item. However, the current exit value is the appropriate measurement basis for reinsurance asset assuming that insurance liabilities are measured on the basis as proposed in the Discussion Paper fails to properly reflect the remaining net position. As far as this is concerned, please refer to our response to Question 5.

12 (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.

**IAA Response:** Buying reinsurance enables the direct insurer to reduce the risk of (adverse) variances from the expected value. Consequently, the risk charge for the cedant should be reduced by an offsetting asset reflecting the additional value provided by the reinsurance. Since the reinsurance contract refers explicitly to, and is directly related to, the ceded cash flows, such contracts cannot be considered in isolation from the underlying business.

Comparing the risks of the underlying portfolio with and without reinsurance provides the natural valuation for the margin in the reinsurance asset. The difference of the risk margin on the liability, gross and net of reinsurance, gives the appropriate value to be reflected in the measurement of the reinsurance assets. This concept is particularly relevant for reinsurance programs with a significant asymmetry in assessing the risk between the direct business and the parts ceded to a reinsurer. Hence, the approach outlined in paragraph 210 of the DP is not only applicable for non-proportional reinsurance contracts (e.g. for stop-loss) but may be considered as general guiding principles for measuring reinsurance contracts. This would reflect the fact that most reinsurance contracts have special features which give rise to a certain risk asymmetry between cedant and reinsurer. Among such features are retention limits and reinsurance commissions.

It is important to note that the direct contract and the ceded reinsurance contract are not always recognized at the same time. Any such timing asymmetry should be reflected in a manner consistent with general recognition principles.
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12 b(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

**IAA Response:** In general, the reinsured bears the risk of bad debts and disputed coverage (non-performance risk) that might be reflected in the measurement of the reinsurance asset. Hence, we recognise that it is appropriate to diverge from the existing impairment rules for reinsurance assets according to IFRS 4.20 and IAS 39 as far as the assessment of the risk of default and disputes are concerned. This is also consistent with the overall measurement principle that the expected value of cash flows is an appropriate basis for measuring any set of insurance cash flows.

However, for practical reasons and for reinsurance assets that relate to a very high quality international reinsurer, an incurred loss model may be sufficiently close to permit its use. In this case, only when there are clear indications for a need to change the default risk estimate, which may be reflected in a different market assessment of the credit standing of the reinsurer, would the default risk be reflected in the measurement of the reinsurance asset.

(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.

**IAA Response:** A general feature of reinsurance contracts is that they contain two elements of risk transfer: one refers to the risk transfer for contracts the direct insurer already has on its books and the other refers to the anticipated risk transfer for direct insurance contracts that may be issued in the future. The DP argues that, in principle, under a current exit value approach, one might need to measure both elements.

In this context, one can imagine the following cases:

- the underlying business is expected to be profitable and parts of the expected profit will be shared with the reinsurer, i.e., future new business will reduce the reinsurance asset if the direct insurer has higher initial gains from future business. There is no need to anticipate the potential reduction of the reinsurance asset if conditioned on future (higher) gains. Such reductions should not be recognised in advance.
- the underlying business is expected to be unprofitable and parts of the expected loss will be shared with the reinsurer, i.e., the future new business will increase the reinsurance asset, but that is contingent on the direct insurer having initial losses from future business. It should not be anticipated that the insurer will write loss-making business.
- the underlying business is expected to be unprofitable and in combination with the reinsurance contract a total expected loss will be even higher. That would result in a reduction of the reinsurance asset. However, it should not be anticipated that the insurer will write loss-making business in the future.
- the underlying business is expected to be profitable and in combination the reinsurance contract a total expected profit will be even higher. However, it should not be anticipated, that the insurer is able to write future contracts with an initial gain under a current exit value measurement.

For all these cases, a similar argument to that presented under question 5 (a) applies. Since a reinsurance contract can never exist “out of its own” but only with relation to the underlying direct insurance contracts, it should be measured in a corresponding manner. Hence, we suggest that the general concept of measuring the reinsurance assets with reference to the underlying direct insurance liability be considered for those contracts which the cedant has already issued.
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Question 13: If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?

IAA Response: We do not believe that an insurance contract that contains deposit and service components needs to be unbundled, except when it is required by means of substance-over-form situation. An example of an exception is where two sets of benefits have been provided by a single contract through a rider, and for which there is no interaction of expected cash flows and where the measurement objective is different. Therefore, unless the components are independent of each other, we do not favour unbundling. However, as time goes on, we believe that the IASB should strive to reduce the differences in measurement between the components, to make unbundling even less necessary.

The following supports this position.

Unbundling should not be necessary in the long-term, since both IAS 18 and IAS 39 are expected gradually to converge to a recognition and measurement basis that may be similar to the method proposed in the Discussion Paper, a convergence that in general we support. Further, the measurement approach for insurance contracts is sufficiently similar to those of IAS 39 and IAS 18. The resulting implementation costs associated with introducing unbundling, namely the costs to the insurance industry arising from significant system changes, outweigh the limited benefits of such a requirement. Due to their size, such costs are eventually only borne by policyholders. In DP225(b), a similar argument is used for unbundling: to avoid sharp discontinuities in the accounting between a contract that transfers just enough insurance risk to be an insurance contract, and another contract that falls marginally on the other side of the line. However, we do not expect to see such discontinuities over time. Any short term differences could be provided for by disclosure requirements. A similar line of argument can be found in IAS 39.11(c).

The IAA agrees with the requirement in DP228(b). However, we believe this is already covered by the Framework (35) through "substance over form" and hence we do not see a particular need to emphasise this in the standard for insurance contracts. The scope for unbundling can be described as follows: A legal contract should be divided into two or more contracts as defined in IAS 32.13 for accounting purposes, if it is simply a bundle of separable rights and obligations that also could be sold as individual contracts without any economic difference.

DP226(b) mentions pricing, management and regulation as arguments for unbundling. We believe that these are particularly valid arguments for not unbundling the contracts. For example, measurement of the unbundled components based on rational policyholder behaviour may lead to a different result than measurement of the whole contract reflecting rational policyholder behaviour.

The DP proposes that contracts with interdependent components that can only be measured on an arbitrary basis should not be unbundled (DP228(a)). However, the DP does not provide any further information as to how the term "arbitrary" should be interpreted. This is crucial in distinguishing between unbundling in DP228(c) and in DP228(a). Below we provide some examples to illustrate the related issues.

- Example 1. A pensions contract
  A deferred annuity contract with regular payments made to the insured beginning upon retirement and with a disability cover until retirement occurs. The separate measurement of the investment component and the disability component would lead to a higher liability than the contract as a whole. Measurement of the contract as a whole would reflect the reluctance of policyholders to surrender the contract when they also take the renewal underwriting into account.

- Example 2. A traditional endowment contract
A single premium endowment contract with a premium of 100 and a death benefit of twice the maturity value. Assuming that the current exit value measurement of the components is 80 for the deposit component, 10 for the insurance component and 8 for the service component, the allocation of the profit margin of 2 is arbitrary unless a rule for measurement priority is given. Thus, the small amount cannot be allocated to the components other than in an arbitrary manner. However, if arbitrariness is measured, for example, in terms of significance compared with the total cash flows, that would not be seen as arbitrary prohibiting the approach in c).

The results would be:

a. The total current exit value would be minus 2, which means the contract would create an initial gain of 2.

b. If the contract is unbundled and 2 is allocated entirely to the deposit component, according to IAS 39.AG 76, and the deposit component would probably not show an initial gain. Hence, the liability is measured at 82 and the outcome for the insurance component would be 8.

c. If the 2 would be allocated entirely to the service component, the liability would be 10 and the insurance component would again be 8.

d. If the 2 is allocated entirely to the insurance component, according to the DP, there would be an initial gain.

As a result, the arbitrary decision would significantly affect the initial measurement.

In general it is quite difficult to see how ordinary contracts like those with bundled services, participating features or reinsurance (for example, quota share) can be unbundled without making assumptions about the split between the components that were not made when pricing the contracts. Further, in making such assumptions, the uncertainty associated with allocation to the various components may be greater than the expected profit margin. Hence, the split may display a spurious degree of accuracy that is not actually realizable and could lead to different liability measurement for different entities for the same type of contracts, and that would not necessarily improve the information provided for users of accounts to make economic decisions.

Under the assumption that insurance contracts are not generally unbundled and would not normally be transferred or priced separately on an unbundled basis, we emphasise that, in case of cash flows or risks for which observable market prices are available, these would be measured at these prices rather than applying the three building blocks approach. In such cases we would rather see measurement based on observable market input, for example the market value of funds for a unit linked contract. However, that applies here only to those units which are expected to be ultimately paid to the policyholders, not to units needed later to finance fees or risk premiums. Application of the three building blocks for such a contract would lead to a lower value than the observable value of the units.

We recognize that it would be ideal that comparisons to financial instruments and service contracts (particularly for revenue purposes) be separated. However, although unbundling an insurance contract into its component parts sounds good in theory, nevertheless in practice it may result in misleading results because of the bundle of components provided. We believe that the best approach to solving this problem is to make the approaches to measurement of the elements that make up insurance contracts consistent so that there is no advantage from unbundling. In addition, it should be recognized that the most significant concern regarding comparability between financial services entities (e.g., between insurers and banks) can be achieved by separation of insurance and investment contracts.

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?
IAA Response: To the extent that market participants reflect the credit characteristics of the contract, they should be reflected. However, where they are not so reflected, i.e., where measurement is determined on a mark-to-model basis, such an approach is not appropriate.

Where reflection of credit standing of the contract is required, discounted cash flows should reflect any potential change in its credit standing. The following should be noted:

1. This has been a controversial issue.
2. Applying asset valuation approaches to liabilities presumes consistency in measurement approaches between assets and liabilities. The owner of an asset has the option of accepting impairment or the credit risk of an asset, especially where liquid. For insurance liabilities, there are no such options, and thus this may not apply.
3. The question arises as to what base should be used to determine the credit characteristics. Some commentators believe that it would be appropriate to use a AA or AAA risk (rather than a risk-free rate), since that would represent the hypothetical purchaser in a market, rather than that of the individual contract.
4. When an insurance contract is first issued, it has been argued that it was priced to reflect its credit standing. This is only to some extent supported by observed pricing, although its effect is often mitigated by the effect of regulatory sponsored guarantee funds and the lack of price sensitivity in many insurance markets. The situation that seems most obvious is when a particular entity (rather than the contract) is on a credit watch, where there may be an observable shift to more financially sound insurers, even where their comparable products are priced higher. Some have observed that this only arises in extreme cases and thus should be considered in measuring liabilities only in these cases.
5. The IAIS has been quite adamant that it will not allow credit risk adjustments in regulatory liabilities. The preliminary position of the IASB is that there will be an explicit adjustment, possibly accompanied by disclosure of the adjusted amount. Since we consider convergence of general purpose and regulatory accounting to be quite important, we welcome a resolution of this difference in views.
6. In most cases, such an adjustment would not be significant, in that the expected effect of a guarantee fund would be reflected to mitigate this effect. Note that it may be difficult to assess the expected effect of this guarantee. In the market place when an entity's credit standing changes, the likelihood of the amount expected to be paid regarding an obligation may also change. However, even when implementing the expected risk of non-performance in a cash flow model, non-performance may not equally apply to all components of cash flows, e.g., the expected non-performance on death benefits would likely be less than the non-performance on surrender benefits, while the likelihood of acceptance of renewal premiums might be problematic. This is another situation in which the unit of recognition should be the entire contract rather than treating its components separately.
7. The major effect of this issue in most cases results from the effect of changes in the market assessment of risk. This will likely cause more volatility in liability measurement than changes in the contract's credit standing (e.g., measured through changes in the market yield spread). This difference can be quite significant; since it is unrelated to the performance of the entity or its insurance contracts, its separate disclosure may be appropriate.

Most of the concern regarding this issue has been raised regarding the apparent effect of a change in the credit characteristics of a contract. Where there has been
an observable shift in the credit characteristics of a contract, we believe that values elsewhere in the balance sheet will likely also be affected, in part mitigating such a change. Nevertheless, the practical problems of measuring the effect of such a change may be such as to make such measurement unreliable. If it is deemed reliable and this is required, it is suggested that the amount of this adjustment be disclosed separately, with its effect in comprehensive income rather than through profit and loss.

**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?

**IAA Response:** The Board should move toward the elimination of the inconsistencies that are identified in Appendix B of the DP. This should primarily be accomplished by undertaking changes to IAS 39 (and other standards as appropriate) that eliminate the availability of a mixed measurement approach for financial instruments and other financial items.

We believe that financial liabilities currently measured on the basis of fair value should be measured at “current exit value” or its equivalent, and that corresponding financial assets should be measured at their “fair value”. Under the current definitions of these terms, this will result in an enhanced degree of consistency between the measurements of assets and liabilities within a financial entity, a condition that would reduce the emergence of misleading financial information. Adopting these protocols and applying them in IAS 39 will promote both consistency and comparability in financial reporting not only for insurers but for other financial institutions as well.

To the extent that amortized cost is required for some IAS 39 contracts and that a fair value option does not exist for recognition of service revenue, certain of these differences will continue. We suggest that a subgroup of the Insurance Working Group and the Financial Instruments Working Group and other interested parties be convened to evaluate the desirability and the effect of these differences to ensure a minimum of unintended consequences.

The following is a brief discussion of each of the major factors that differ:

1. Initial measurement. To the extent that contracts included are not measured by an amortized cost objective, the difference can be eliminated by changing the IAS 39 approach to day 1 gains and removing the deposit floor.
2. Gain at inception. We suggest that this be permitted in principle if supported by relevant market and other information.
3. Subsequent measurement. Although a direct comparison is only valid for instruments measured at fair value through income, the elimination of amortized cost for certain of these instruments would be appropriate.
4. Surrender value floor and policyholder behaviour. Removal of the floor constraint that we consider an inappropriate rule and recognition of expected policyholder behaviour that can be reliably measured should lead to enhanced presentation of economic reality and representationally faithful results. It has been argued that this change would recognize an internally generated customer intangible. However, as discussed above, we believe that this does not reflect an internally generated customer intangible where there is a direct inter-linking of contractual rights and obligations, since it is generated by a benefit that is paid for by the customer and it is more appropriate to be consistent with the IASB Framework on this issue.
5. Unit of account. Unit of account guidance in IAS 39 is somewhat unclear for other than instruments quoted in active markets. Where relevant to measurement, bases in both standards should reflect a portfolio of similar risks or instruments.
6. Revenue recognition and presentation. Any difference should be addressed in the Revenue Recognition project. Until we are certain of the objective of revenue, we cannot comment on this.

7. Service fee revenue. We believe that IAS 18 service contracts and service components should be permitted to be measured at their fair value. Although further thought would have to be given to this suggestion, the underlying thought is that insurance components measured under IAS 18, IAS 39 and Insurance Contracts measurement should result in more consistent measurement among contracts.

8. Investment management origination costs. These should be expensed as incurred in IAS 39.

**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?

**IAA Response:** This question should be broken down into its two parts. First, it should ask whether policyholder dividends/bonuses/non-guaranteed elements should be recognized, exclusively based on whether they constitute legal or constructive obligations. Second, it should ask whether their measurement should be based on cash flow expectations consistent with the corresponding expected scenarios.

Regarding recognition, we believe that a contract should be the unit of recognition rather than the individual feature within it and that all of the cash flows arising from the contractual terms should be included in the measurement of the liability to the extent that they have commercial substance. This approach has the advantage of being consistent with the views of relevant market participants. We believe that most users of financial statements are interested in the total expected contractual cash flows, even if they do not represent a legal or constructive obligation as currently defined in IAS 37, but nevertheless comply with the definition of a liability given in Framework, paragraph 60.

The entity's historical experience and dividend/non-guaranteed element policy should be considered in determining whether a liability exists. Thus, we believe that a participating contract should be viewed as a single unit of measurement and that all of its expected cash flows should be reflected. This would be consistent with CON 6 (U.S. GAAP).

If the IASB opts to apply Implementation A, to the extent that expected policyholder dividends/bonuses/non-guaranteed elements are anticipated in the premiums and charges in a contract, they would implicitly be reflected in measurement in the premium margin to the extent that they are considered in the premiums. If the IASB opts to apply Implementation B, market participants not intending to run off the business (unless they are already in run off mode) would be expected to continue the current participating/non-guaranteed element approach.

Regarding measurement, we agree that all assumptions for measurement of the insurance contract should be consistent, especially appropriate in the case of performance-linked assumptions. Due to diversity in practice worldwide, facts and circumstances should determine whether expected dividends/bonuses/non-guaranteed elements should be recognized or, where applicable, the measurement should be based on policyholders' share in the currently reported performance.

We see the contents of the DP to be less clear than that previously expressed in prior Board decisions. In particular, to be useful it should emphasize principles. The different measurement approaches based on expected cash flows or recognized performance should be clarified. The contractual nature of the obligations should be considered, reflecting the variety of existing features on a worldwide basis. They can be categorized as:
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1. Guaranteed benefits, according to a premium or benefit adjustment clause, or as a required share of distribution, expected to be paid in the normal course of events, but for which in certain scenarios be subject to alteration. The appropriate measurement technique should be based on the three building block approach. Note that special investigation is needed to adequately consider those scenarios which would result in alteration in low probability scenarios (financial distress).

2. Benefits in excess of those guaranteed. These would be paid in the normal course of events as a certain share of performance, according to contract or law or other reasons requiring recognition of that obligation as a liability. The amount may be subject to deviations from that share in performance depending upon future conditions and contractual or legal guarantees, but the expected amount would be treated as analogous to a cession, i.e., the measurement of the obligation would reflect that share in performance recognized under IFRS until the reporting date, considering a margin for asymmetry caused by contractual or legal minimums or maximums.

3. Borderline cases between 1) and 2) might use approaches currently required under U.S. GAAP, except that the existence of dividends and other non-guaranteed elements would also affect the size of the liabilities' risk margins. Both approaches would be expected to converge, except for consequences of accounting mismatches. We recognize that deviations might result in times of the financial distress of the insurer, but to the extent that this can be estimated, this would also be reflected.

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

IAA Response: We believe that this IAS 37 guidance, accompanied with specific insurance-oriented guidance similar to that in the DP for participating and universal life insurance contracts, would be adequate. We especially refer to the criterion in DP 251(b), which would constitute an applicable criterion in most, if not all cases. However, the extreme variety of such contract features world-wide dictates more principle-based guidance, especially to describe more precisely the terms of the Framework in defining liabilities.

We also believe that the issues associated with accounting for participating contracts are linked with the definitions and classifications of liabilities and equity. The use of constructive obligations would introduce a new model for this classification. The Board’s deliberation on this separate project would also appropriately be incorporated into their consideration of its liabilities and equity project.

We believe that IAS 37 should be changed to allow reflection of settlement in due course of obligations.

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).
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| 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). |

**IAA Response:** Where the obligation refers directly to the performance of the insurer (or a given set of assets), a more indepth description of the items involved is appropriate. In those cases, the measurement of that performance or the associated investment returns should not be affected. In any case to the extent possible, the measurement of the liability should be consistent with the measurement of the linked items. That is, alternative (d) is appropriate. The purpose of accounting is not to provide current exit values, although that may be an objective for insurance contracts, but rather, to provide useful information. A cession of items, relevant because such a situation can be viewed as a special form of a cession, not themselves reported at fair value, cannot reasonably be reported at fair value.

In cases where, because of the overall legal construction, the effective situation is similar, (e.g., since the contract refers to the fair value of specific investments without specifying whether they are held by the insurer, but there is a legal requirement to own them and they are held in a separate (ring-fenced) account, which is protected against bankruptcy and theft) the same solution should apply.

In cases where the contract is merely index-linked, referring to an external index and the insurer holds matching assets just for risk-related purposes, the situations should involve normal asset-liability matching considerations. However, we believe that, similar to hedge accounting and the application of the fair value option, it would be appropriate to require a demonstration of the matching position by a consistent measurement of assets and liabilities. There might be good reasons for not allowing recognition or even fair value measurement for certain items. However, the question is whether those reasons should also apply to an obligation to forward exactly the same items or amounts to another party. If, for example, the IASB typically does not allow recognition of internally generated goodwill, mainly for the reason of the subjectivity of the measurement involved, the same subjectivity would apply for measuring an obligation in that regard. Further, in that case the obligation can only be a cession, since the self generated goodwill is, by definition, an asset of the insurer. Hence, (d) should apply in that special case.

In case of treasury shares, it is possible to forward to a policyholder any change in value of the entity’s own shares. To that extent, the policyholder is in the same position as a stockholder; the question arises whether that “obligation” should not be treated alike, i.e. as equity rather than as a liability, disregarding whether the insurer actually holds the treasury shares or not. To the extent that the insurer holds the shares, recognition of the linked treasury share and the related insurance obligation should again be consistent. Otherwise, that part of the insurance obligation should also not be recognized. However, since we believe that the measure of the obligation should always be recognized and the treasury shares will be distributed if called upon, we believe that the fair value of the treasury shares should also be recognized.

We believe that the IASB may have focused too much attention on these extraordinary cases that affect only a limited number of jurisdictions, rather than discussing the underlying principle, where the participation feature has the character of a cession referring to normal investments and other performance of the insurer.

We believe that it may be appropriate for the IASB to revisit the underlying questions involved, as we would prefer not to make a rule-based exception for insurance contracts.

Similar issues involve participating business where the same arguments apply.
IAA Response: In its DP, the Board suggests that an insurance premium can be split into three elements, to (a) meet policyholder benefits (claims) including claim handling costs, (b) cover the acquisition costs, and (c) cover risk and service margins. Its usefulness as revenue will depend on the outcome of the Revenue Recognition project. Assuming that the conclusion of this project will be useful to users of financial statements of financial services industries, including insurers, a consistent approach should be used.

The DP suggests that some might view payments under (a) as repayments of deposits and thus there might be an argument for presenting the premium in respect of (a) as a deposit. The (unstated) implication is that the premiums in respect of (b) and (c) would then be accounted for separately in a meaningful manner.

While many might implicitly consider premiums in this manner, few (if any) currently report premiums split in this manner. This approach also ignores the reality of “cross” subsidisation between the three elements in a bundled contract undertaken, in part, because of marketing pressure. That is, there is no clear methodology to allocate between the uses of the premium, even though one approach may be in common use.

We, therefore, believe that, for reporting purposes, the premium should be considered as a whole and not split into the three indicated elements.

In deciding whether premiums should be considered as revenue or deposits, we believe the following issues need to be addressed:

(i) Must there be a consistent (i.e., similar) treatment between life and non-life insurance?

(ii) Must there be a consistent (i.e., similar) treatment across all product types?

(iii) Should there be unbundling, i.e., to apply different accounting standards to each part of the contract?

(iv) Is it more appropriate to have consistency with treatment of financial instruments or of service contracts?

In our opinion, the aim of the financial statement presentation should be to provide users the ability easily to compare company’s presentations, while also minimising undue complexity for preparers.

With these aims in mind, we believe that

(i) There should be a consistent presentation for life and non-life insurers. Bearing in mind the definition of an insurance contract, which has had the effect of “removing” savings/investment contracts from these considerations and having them accounted for in line with similar financial instruments offered by other entities, there appears to be little argument for treating any “insurance” contract differently from any other just because of the nature of the insured event. There might be an argument for different treatment based on the longer term nature of life insurance, but then the same considerations might apply for certain longer tail non-life business as well.

(ii) There should be consistency in presentation between all product types. To do otherwise would, as the Board argues, undermine comparability and also the risk of different interpretations by auditors of statements with some firms potentially would allow treatment of contracts in a manner different from others. This would assist neither users nor preparers of the statements.

(iii) There should not be a split of the premium purely for presentation purposes, since this would merely add cost and provide no practical advantage. In addition, technical questions arise, for instance, whether a rule-based order of calculation would have to be specified to ensure consistent results.
Paragraphs 317 and 318 suggest that presenting all premiums as deposits would be consistent with how banks and fund managers account for customer funds. While that may be a valid argument in respect of savings/investment contracts, the premiums under discussion here relate to insurance contracts which banks and fund managers are not offering and thus the argument may not be relevant.

As the Discussion Paper acknowledges, for most insurance contracts, premiums are currently accounted for as revenue with claims being accounted for as expense. Such a presentation does allow easy comparison/construction of important ratios such as expense (claim) ratio etc. It also allows a reader quickly to assess the size and success of companies.

The DP suggests that example 15 (the margin presentation) is similar to the Embedded Value presentation adopted by many insurers around the world. While correct, that information tends to be provided in addition to the premium and expense presentation shown in examples 10 and 11. We believe that this presentation provides valuable additional information, but may not be suitable for the face of the income statement, since no revenue information is provided therein.

Bearing all of this in mind, we believe that insurers, both life and non-life, should present premiums as revenue for all insurance contracts. As well as being consistent with how many currently construct their financial statements, this gives meaningful information to users on the face of the accounts. It also distinguishes insurance business from savings/investment (deposit) business.

Nevertheless, from a purely conceptual viewpoint and with a goal to achieve consistency with the reporting approach of other financial services industries, each premium payment could be considered an advance payment and that the actual related services are provided later. Hence, the entire premium could be seen as a deposit up to the time when the insurer is actually obliged to provide the services. The “price”, based on the assumptions underlying current exit value, for each service is released at the beginning of each accounting period in which the service is to be provided. Then, in the income statement, “price” is compared with the actual cost of providing the service, and the unwind of discount is compared with actual investment income. However, currently there are few countries applying such an approach, e.g., Germany and to some extent the Netherlands, but in both of these cases this is done for regulatory purposes only, and experience has shown that such approaches require an extreme effort of both the preparers and users. Any movement of the portfolio within the period has to be analyzed considering the current exit value assumptions to be applied. We do not believe that the information resulting from that will generally justify the effort.

Although a margin presentation can provide meaningful information, it would better be presented as a source of earnings analysis in the notes on a product segment basis. However this is decided, premium can be a very useful metric, as it has served a useful purpose in many areas -- it should be provided, whether in a cash flow statement or in disclosure, in order to permit such a useful indicator to be available for users.

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

IAA Response: In paragraph 325, the Board asks whether it should require insurers to present separately any specific components of the change in carrying amount of the insurance liabilities. As was the case for question 18, we believe consideration needs to be given to:
  (i) the need for consistent (i.e., similar) treatment between life and non-life insurance, and
  (ii) the need for consistent (i.e., similar) treatment across all product types?
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Additionally, consideration should be given to whether the detail provided should be grouped (and if so how) by product or be provided for each individual product.

As always, consideration should be given to ensuring the right balance between the needs and capabilities of users and preparers. Additionally, care should be taken that any disclosure do not result in sensitive (competitive) information being disclosed widely.

While including a lot of information on the face of the accounts (e.g., the level of detail implied by paragraph 325) might provide users a better understanding as to how the entity is performing, it might well, through the use of prescription and rules, end up making the statement “cluttered” and even less transparent as a result.

Although an alternative would be the use of a “single line” item “change in insurance liabilities” together with a detailed disclosure note in financial statements, we do not favour this approach. This could provide the information envisaged in paragraph 325, which is akin to information provided in EEV presentations as envisaged by the CFO Forum. This also allows a degree of freedom (within defined principles) to enable relevant information that may differ for different types of business to be disclosed. In any case, a comparison of the unwind of the discount rate and investment earnings is needed.

If the latter approach is adopted, consideration then should be given to “how much” information is to be provided and at what level of detail. This could range from a full analysis of earnings by product down to broad headings across the company as a whole. Users indicate the need for basic cash flow information. We would strongly favour the use of disclosure principles rather than specific rules, both because of our general philosophy regarding standard setting and because such rules are ill-adopted to the dynamic nature of the insurance business and its contracts.

Additionally, the Board should develop, as part of its project on the presentation of financial statements, principles on the disclosure required for changes in insurance liabilities. In any event, it is important that the Exposure Draft present the principles that the Board believes appropriate for insurance contracts, along with specific implications for the income statement and disclosure.

We recommend that information be shown separately for life insurance (with perhaps a split between participating, unit linked and other) and non-life insurance (perhaps also split between certain discrete lines) and that preparers provide information about the change in insurance liability arising from:

- Actual experience differing from expected experience – split between economic and other
- Change in demographic (for life) assumptions
- Change in “experience” assumption (appropriately defined for non life)
- Change in economic assumptions
- Change in calculation methodology
- Change in value of embedded options and guarantees, if measured separately
- Change in (risk and service) margins
- Change in risk characteristics of the contracts if any
- New business written and gain at issue
- Claims made
- Other
- Required interest / unwind of discount.

Although it may not be appropriate to include a source of earnings analysis in the entity’s income statement, something similar should be included where it would provide useful information, possibly as part of disclosures.
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**Question 20:** Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

**IAA Response:** Overall, we agree with the Board’s conclusion. We believe that the income statement should include all income and expenses arising from changes in insurance liabilities.

We think that one of the purposes of this question relates to shadow accounting in the case of participating features, where changes in the fair value of assets are reflected directly in changes of the obligations to policyholders. If those changes are in the fair value of assets, they are not reported in income. Thus, we do not believe that shadow accounting is relevant.

The same reasoning should apply to the cession of those assets, not only because the outcome would not be particularly useful, but also because there is not really any economic difference between an item and its cession.

In paragraphs 329 to 335, the Board set out its thoughts on the extent of the amount of profit and loss that should be presented in financial statements, in contrast with some being taken into equity through the use of shadow accounting. This might in part arise because of changes resulting solely from a change in the value of the assets backing the liabilities.

The Board concludes in paragraph 337 that “Profit and loss should include all changes in the carrying amount of insurance liabilities.” We note that if the effect of credit characteristics of the liability are included in the measurement of the liability, the change in this item should not flow through profit and loss.

Any change in the movement in insurance liabilities solely arising from the change in underlying asset value could be determined from appropriate disclosure following from question 19, allowing users to determine for themselves the extent to which that aspect had contributed to the profit/loss in the reporting period. However, we believe that where there is a direct linkage of the obligation and the corresponding cession, these should move in tandem. For example, if the changes in the fair value of an asset are assumed not to be income, the cession of that change should also not be assumed to be an expense.

**Question 21:** Do you have other comments on this paper?

**IAA Response:** Possible additional issues to discuss further:

- **Scope of an insurance contracts standard and definition of insurance contracts.** We suggest that it is very important for the IASB to confirm the scope of the upcoming accounting standard for insurance contracts as well as the definition of insurance contracts early in its deliberations leading up to an Exposure Draft. Discussions of phase II should be held recognizing the types and scope of the contracts covered. For instance, the Board previously indicated that it would consider the approach to be taken to account for financial guarantee contracts in this project. This expansion of the scope should be understood earlier rather than later in the project's lifetime.

- **Unit of account.** The use of the "unit of account" has proven, in the context of this and other financial reporting discussions, to be confusing at best. It may be useful to discuss this issue separately and decide upon the most useful unit of recognition (the contract) and the unit of measurement (the portfolio in the case of insurance contracts). We suggest that it be applied carefully, both in an insurance contracts standard and in other IASB projects, including discussions regarding its application as part of the Conceptual Framework.
Universal life, particularly its non-guaranteed elements (although non-guaranteed elements also apply to certain other contract types). Universal life insurance contracts in many parts of the world are very important. Proper treatment of various factors underlying universal life insurance contracts, such as a treatment of flexible premiums, non-guaranteed insurance and expense elements, can be treated separately or specifically for universal life insurance, with other contracts and contract features in mind. Additional consideration should be given to how to address variable features in insurance contracts, consistent with the participation feature. The IAA would be pleased to work with IASB staff to move this forward.

Specific service margin issues. As in our comments regarding question 2, we recommend that risk (e.g., estimation risk, persistency risk, counter-party risk) associated with service should be combined with insurance risk margins.

Treatment of participating investment contracts. We believe that the financial reporting principles underlying the recognition and measurement of insurance contracts with participating features also apply to other contracts (primarily financial instruments) with similar participating features. If treatment of a contract as the unit of recognition is also applicable to investment contracts, question 16 with policyholder dividends/bonuses/non-guaranteed elements also applies to those contracts.

Discounting of future tax balances (if exit value is determined on a before tax basis). Part 2 (page 20) of the DP indicates that “The DSOP proposed that an entity whose primary business is issuing insurance contracts should use discounting in measuring its deferred tax assets and deferred tax liabilities. However, the Board decided tentatively in February 2002 not to consider in this project whether discounting is relevant for deferred taxes.” To the extent, if any, that time value has not been appropriately reflected in deferred tax assets and liabilities, it should be.

Some insurance liabilities have an extremely long duration and in some jurisdictions tax timing differences are material. Failure to discount deferred taxes appropriately could result in a material distortion of the financial statements (in many cases this would simply be a multiplication of the tax effect and the difference the current exit value; if both values are discounted, then there is no need to further discount anything). However, we certainly are not be in favor of double counting the discount.