2 August 2010

To: Members of the Hong Kong Institute of CPAs
All other interested parties

INVITATION TO COMMENT ON IASB EXPOSURE DRAFT OF *INSURANCE CONTRACTS*

Comments to be received by 15 November 2010

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Exposure Draft which has been posted on the Institute's website at: http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/.

The exposure draft proposes a single International Financial Reporting Standard that all insurers, in all jurisdictions, could apply to all contract types on a consistent basis.

When the IASB was established in 2001 there were no international financial reporting requirements for insurance contracts. In 2004 the IASB introduced IFRS 4 *Insurance Contracts* as an interim standard that permitted many existing international accounting practices to be retained, whilst beginning a more comprehensive review of insurance accounting as a second phase of the project. The proposals published today are the result of that review.

--- A summary prepared by the IASB on the Exposure Draft is set out in the attached Appendix.

In accordance with the Institute's Convergence Due Process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the proposals contained in the IASB Exposure Draft.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IASB Exposure Draft to be considered, they are requested to be received by the Institute on or before **15 November 2010**.

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

July 2010

APPENDIX

Exposure Draft

Snapshot: Insurance Contracts

This snapshot is a brief introduction to the exposure draft *Insurance Contracts*. It provides an overview of the main proposals published for public comment by the International Accounting Standards Board (IASB).

Project objectives:	The IASB aims to improve financial reporting by issuing a high quality standard for insurance contracts that provides a consistent basis for accounting for such contracts. The IASB expects the implementation of these improvements to make it easier for users of financial statements to understand how insurance contracts affect an insurer's financial position, financial performance and cash flows. The proposals would also enhance comparability across entities, jurisdictions and capital markets.
Project stage:	In July 2010 the IASB published an exposure draft (ED) containing proposals on the recognition, measurement, presentation and disclosure of insurance contracts. The exposure draft is part of the second phase of the IASB's project on insurance contracts.
Next steps:	The IASB invites comment from all interested parties and will undertake further outreach, including a second round of field tests, to seek views on these proposals before finalising the new standard in mid 2011.
Comment deadline:	The proposals are open for public comment until 30 November 2010.

IFRS™

Why is the IASB undertaking this project?

Insurance contracts often expose entities to long term and uncertain obligations. However, current insurance accounting does not provide investors, analysts and others with the information they need to understand an insurer's financial position and performance and make meaningful comparisons between insurers. Many users describe insurance accounting today as a 'black box', especially in life insurance.

- Insurers today bear an increased cost of capital because the accounting does give users of their financial statements a clear insight into the economics of insurance contracts.
- Accounting practices for insurance contracts are diverse and differ from those used by other financial institutions, such as banks and fund managers.
- Difficulties are exacerbated by the patchwork of different accounting models that exist today.
- In 2002 the IASB decided to address accounting for insurance contracts in a two-phase project.
- In 2004 the IASB completed the first phase of this project by issuing IFRS 4 *Insurance Contracts*.
- Although IFRS 4 addressed some of the more urgent issues in insurance contract accounting, it was only a temporary solution. It permits a wide variety of existing accounting practices to continue, hindering comparability for users.
- In 2004 the IASB established a working group of senior financial executives to help it analyse accounting issues related to insurance contracts.
- In 2008 the US Financial Accounting Standards Board (FASB) joined the IASB's project with a goal of developing a common standard for Insurance Contracts. Many of the decisions on the main features of the model were made jointly with the FASB.

How are we addressing the issues?

The exposure draft proposes to replace IFRS 4 with a high quality standard that better meets the needs of users.

Building on the proposals in the discussion paper
The exposure draft has been developed following a rigorous and comprehensive due process.

The exposure draft builds on proposals contained in the IASB's discussion paper *Preliminary Views on Insurance Contracts* published in May 2007. In developing the exposure draft the IASB considered input from:

- more than 160 comment letters received on the discussion paper
- the Insurance Working Group
- targeted field tests
- extensive consultation with interested parties, including users, preparers, auditors and regulators.

Unified accounting for all insurance contracts
The proposed standard would apply to all insurance contracts (ie both life and non-life) that meet the existing definition in IFRS 4, which is based on the transfer of significant insurance risk.

Improvements to financial reporting
The proposals would improve financial reporting by:

- providing more understandable and relevant information for users
- eliminating accounting mismatches that arise today because assets reflect current market rates, while liabilities often reflect 'locked-in' rates
- enhancing comparability across entities, jurisdictions and capital markets.

In addition, the ED proposes a modified measurement approach for short-duration contracts. The modified model combines the advantages of the proposed model with the benefits of existing practice.

A principle-based standard that reflects the economics of insurance contracts
The exposure draft proposes:

- a measurement model that focuses on the drivers of insurance contract profitability and uses current estimates of cash flows
- presentation of information about insurance contracts that reflects changes in those drivers
- consistent accounting for embedded options and guarantees in insurance contracts
- consistency with market prices for financial market inputs, such as interest rates
- a coherent framework for dealing with more complex insurance contracts, including those that might be developed in the future.

IFRSs and US GAAP
Most of the conclusions reached by the IASB and FASB are consistent. However some differences are yet to be resolved in the areas of how to portray risk and uncertainty in insurance contracts.

The IASB proposes an explicit risk adjustment to cash flows and an additional residual margin, whilst the FASB proposes a single composite margin.

The FASB intends to publish a discussion paper on Insurance Contracts during the third quarter of 2010. Feedback from this consultation will inform both the FASB and the IASB in their deliberations.

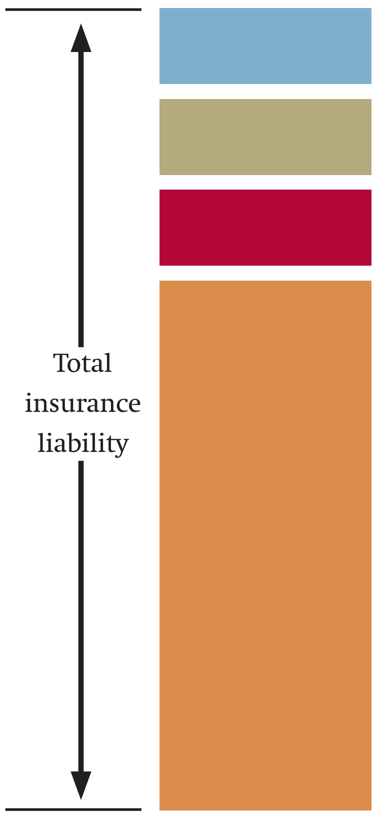
What is the IASB proposing?

Measurement

The exposure draft proposes a single measurement model that focuses on a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate as it fulfils them.

The proposed measurement model uses 'building blocks' to measure an insurance liability.

The building blocks of the new measurement model



Residual margin
Contract profit (reported over the life of the contract)

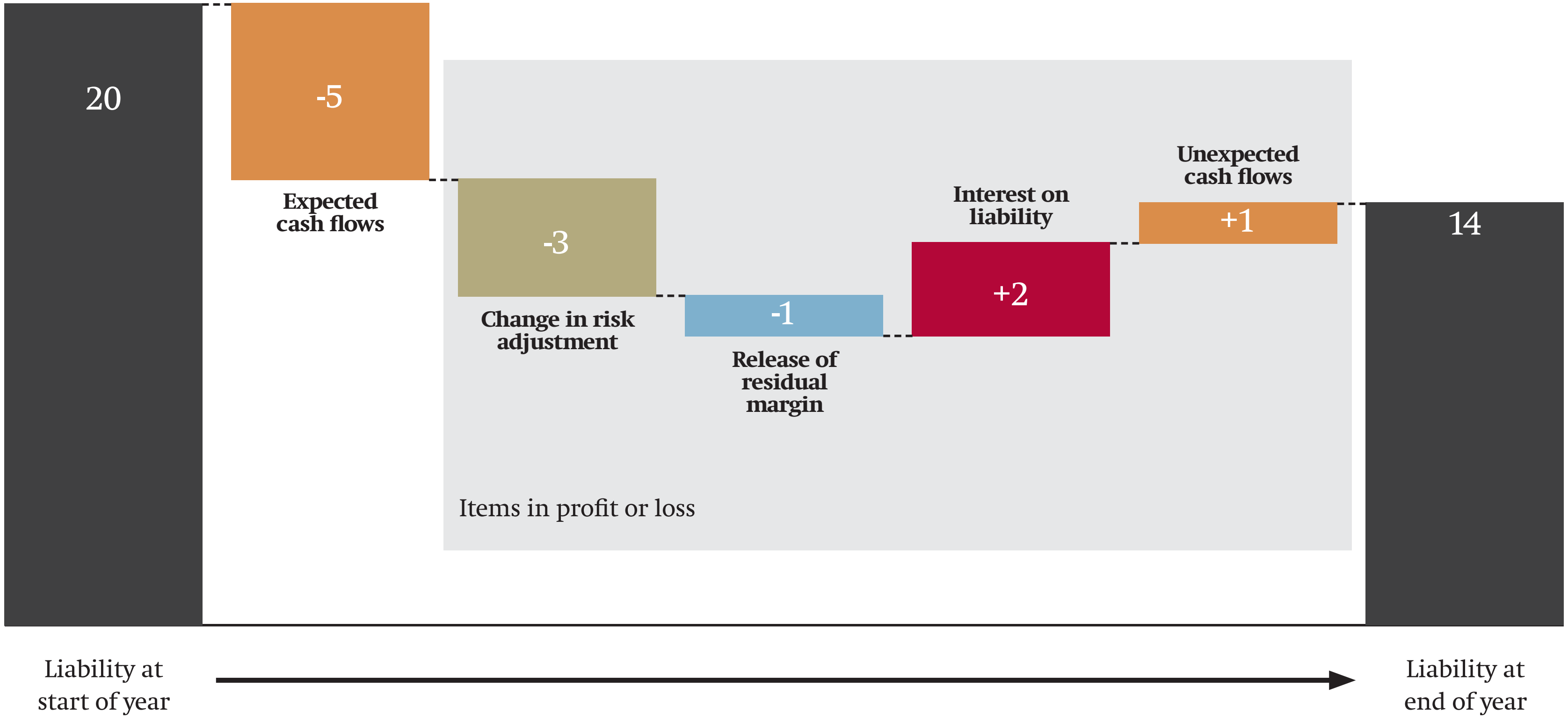
Risk adjustment
An assessment of the uncertainty about the amount of future cash flows

Time value of money
An adjustment that uses an interest rate to convert future cash flows into current amounts

Current estimates of future cash flows

The amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information

The building block approach generates information about the changes in the insurance liability and its performance during the period



Non - P&L changes

Expected cash flows
Actual cash receipts and payments that were expected

Changes that go through profit or loss

Change in risk adjustment
Changes in the uncertainty about the amount of future cash flows

Release of residual margin
The reduction in the residual margin during the current period

Interest on liability
Interest on the liability in the current period

Unexpected cash flows
Actual cash receipts or payments that were not expected, as well as changes in the estimate of future cash flows

What will change?

Accounting practices vary widely, both for different types of insurance contract and across jurisdictions. Therefore, the effect of the proposals will vary from insurer to insurer.

Understandability

Current problem

Users find it difficult to understand insurers' financial statements. Accounting methods are complex and vary by product and country.

Proposed change

- The measurement model focuses on the key drivers of insurance contract profitability, and would provide users with a clearer insight than they gain from today's patchwork of different models for different types of contract.
- The same model would apply to all insurance contracts.
- A modified version would apply to most short duration insurance contracts.
- Insurers would present information in the financial statements that focuses on the drivers of performance, ie:
  - release from risk, as the risk adjustment decreases
  - what insurers expect to earn from providing insurance services
  - investment returns on invested premiums, and the investment returns provided to policyholders (either implicitly through pricing or explicitly)
  - differences between expected and actual cash flows and
  - changes in estimates and the discount rate.
- This information would be supplemented by disclosures of important headline indicators, such as premiums, claims and expenses.

Cash flow estimates

Current problem

Many insurers use 'locked in' estimates which do not provide current information about insurance liabilities.

Proposed change

- Changes in cash flow estimates would be reflected in profit or loss in the period in which they arise. This would enhance transparency and provide more relevant information for users.

Accounting mismatches

Current problem

Assets backing insurance liabilities are often measured at current value (often fair value). However, many existing accounting models for insurance liabilities do not reflect all changes in economic circumstances. This can result in accounting mismatches.

Proposed change

- Insurance liabilities would be measured in a way that reflects all changes in economic circumstances. This will eliminate many accounting mismatches between liabilities and the assets held to back them.

  This should reduce the burden for insurers of explaining the volatility caused by accounting mismatches.

- The Board is considering aligning the effective dates of the insurance contracts standard with IFRS 9 *Financial Instruments*, so that earlier adoption of IFRS 9 causes no accounting mismatch. The proposals allow the assets to be re-designated, on adoption of the Insurance Contracts IFRS, to avoid any accounting mismatch.

Discounting

Current problem

Many insurers do not adjust for the timing of estimated cash flows on the non-life insurance claims. As a result, they report a claims liability to be fulfilled tomorrow in the same way as a claims liability to be fulfilled in ten years.

Some life insurers use discount rates that reflect the characteristics of the assets backing the insurance liabilities, not the rates that reflect the characteristics of the liabilities. In effect, that means the insurer takes credit immediately for investment performance that it hopes to achieve in the future.

Proposed change

- Life insurance liabilities and non-life (property and casualty) claims liabilities would be discounted using a current, risk-free discount rate, adjusted for liquidity.
- That discount rate reflects the characteristics of the insurance liability better than asset-based discount rates.
- The discount rate will be lower than the asset-based rates that some insurers currently use. That will increase the measurement of some insurance liabilities.

Risk adjustment

Current problem

Many insurers do not incorporate an explicit risk adjustment. Accordingly, important information about risk and risk management that is an integral part of the insurer's business model may not be reported clearly.

Proposed change

- All insurers would include a risk adjustment in the measurement of the liability and disclose information about that adjustment.
- The risk adjustment would be remeasured at the end of each reporting period.

Embedded options and guarantees

Current problem

Insurers do not always account for the full value of all the options and guarantees contained in some insurance contracts, particularly in life insurance.

Proposed change

- All embedded options and guarantees would be treated in the same way, on a basis consistent with market prices.

Acquisition costs

Current problem

Accounting for acquisition costs is not uniform across countries.

Proposed change

- Incremental acquisition costs would be included in the cash flows arising from the contract. Non-incremental acquisition costs would be recognised as an expense.
- Some insurers defer acquisition costs, often including non-incremental acquisition costs. These insurers may report larger losses at inception under the proposals than they do today.
- Other insurers recognise acquisition costs as an expense immediately. These insurers would report smaller losses at inception than they do today.

What did respondents tell us about the discussion paper?

DP proposal	Feedback received	How we responded
Current exit value	• Respondents stated that a current exit value based on the notion of transfer is not appropriate because insurance liabilities, typically, are not transferred to third parties.	• Not carried forward to ED. • The ED replaces the exit value notion with an approach that considers the cash flows that will arise as the insurer fulfils the contract. This acknowledges that insurers generally fulfil their contracts directly over time by paying benefits and claims to policyholders rather than by transferring the contracts.
Building block approach to measurement of insurance contracts	• Generally supported by respondents, with some reservations on particular points. • Some respondents questioned the benefits of applying discounting and risk adjustments to short-duration contracts and argued that the current accounting for such contracts meets users' needs and is simpler and less costly to apply.	• Carried forward to ED. • The ED confirms the IASB's view that discounting and risk adjustments are relevant for all insurance contracts. • The ED now proposes a modified version of the building block approach for most short-duration insurance contracts: – during the coverage period, the approach would be similar to the unearned premium approach used today. – the building block approach would apply to the claims liability.
Use of expected value (ie probability-weighted average) rather than a single outcome	• Generally supported by respondents. Some expressed concerns about practical implications.	• Carried forward to ED. • The draft guidance clarifies that the amount of detail required to implement the approach will depend on the circumstances.
Use current estimates of cash flows	• Generally supported by respondents.	• Carried forward to ED.

What did respondents tell us about the discussion paper? (cont.)

DP proposal	Feedback received	How we responded
Use the estimates of cash flows that market participants would use. For financial market inputs, such as interest rates and equity prices, use market prices.	• For financial market inputs, generally supported by respondents. • For other inputs, such as expenses, respondents stated that the insurer's own inputs would be more relevant.	• For financial market inputs, carried forward to ED. • For other inputs, the ED modifies the DP proposals and proposes that insurers should use their own inputs.
Guaranteed insurability test for inclusion of future cash flows, coupled with an onerous contract test.	• Most respondents suggested including all cash flows arising from the contract, on an expected value basis. • Some respondents expressed concerns about including future premiums.	• The ED proposes a test that determines which cash flows arise within the boundary of the contract. • All cash flows arising within the contract boundary would be included.
Include policyholder dividends, but only if the insurer has an obligation	• Respondents suggested a broader approach that includes all policyholder dividends, on an expected value basis.	• Carried forward to ED, but broadened to include all policyholder dividends on an expected value basis.
Acquisition costs should not result in a loss at inception	• Generally supported by respondents.	• Carried forward to ED, though using a slightly different mechanism. • The ED proposes a more precise, and perhaps narrower, definition of the acquisition costs that qualify for this treatment.
Explicit risk margin	• Most respondents favoured the inclusion of an explicit risk margin. • Concerns were expressed about the lack of comparability that may arise from allowing insurers to choose the calculation method and asked for more guidance on how the risk adjustment should be determined.	• Carried forward to ED. • The ED limits to three the number of permissible techniques to determine the risk margin and provides guidance on how to apply these techniques.

DP proposal	Feedback received	How we responded
Service margin	• Most respondents did not understand the rationale for a separate service margin and did not think that users would find it beneficial.	• Not carried forward to ED.
Non-performance risk	• Most respondents opposed the inclusion of ‘non performance’ risk ie the risk that the insurer will not fulfil its obligation to perform under the contract.	• Not carried forward to ED.
Consider whether to permit profits at inception • Views in the IASB were mixed.	• Views were mixed.	• The ED does not permit profits at inception.
Income recognition in line with the release from risk.	• Generally supported by respondents because it reflects how the insurer performs under the contract within the insurance business model.	• Carried forward to ED.
Recognise all income and expense from insurance contracts in profit or loss	• Generally supported by respondents, although a few suggested using other comprehensive income for some items.	• Carried forward to ED.

What happens now?

The deadline for comments is 30 November 2010.

During the comment period the IASB will discuss the proposals with a wide range of interested parties.

Outreach activities will include:

- discussions with preparers, users, auditors, regulators, representative groups, national standard-setters and other interested parties;
- field tests;
- webcasts and presentations.

How can I comment on the proposals?

The exposure draft includes questions on the proposals. Respondents may choose to answer all or just selected questions and are also welcome to comment on any other matter that they think the IASB should consider before finalising the proposals. Comment letters will be posted on the IASB's website.

The IASB will consider carefully all feedback and, as usual, discuss responses to the proposals in public meetings. The IASB plans to issue the new standard in mid-2011.

Stay informed

The Board will announce on their website the dates of any meetings at which they discuss the feedback on the exposure draft.

To stay up to date about the project, you can also subscribe to email alerts.

To view the exposure draft, submit your comments or subscribe to an alert on this project - visit www.ifrs.org.

Notes

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