Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

25 October 2013

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

Dear Sirs,

IASB Exposure Draft of Insurance Contracts

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Exposure Draft (ED). Our responses to the questions raised in your Invitation to Comment are set out in the Appendix for your consideration.

We welcome the release of the revised proposals for insurance contract accounting, which aim to eliminate the current diversity that exists in practice. We appreciate the IASB's effort in making several key changes in response to the comments received for its 2010 Exposure Draft.

Although the proposals aim to improve transparency and consistency in insurance contract accounting, we are concerned they may not result in financial information with reasonable understandability. Management may still need to incorporate a significant amount of narrative information in both financial statements and management discussion and analysis section of the annual report to describe its operating performance and financial position. Such circumstance is not desirable and affects the relevance of the proposals in both financial statements preparer and user perspective.

We are also concerned that certain aspects of the proposals may not match with how the insurance business is typically managed. This may in turn add burden to the financial statements preparers but without enhancing the usefulness of the financial information. Please refer to the Appendix for further information.

We understand that the IASB developed the proposals jointly with the US Financial Accounting Standards Board and noted that the Boards have reached different conclusions in some important areas, most notably on some aspects of the scope and measurement model. We consider the convergence in guidance on accounting for insurance contracts is critical to supporting well-functioning global capital markets and have concerns on the current situation.

If you have any questions regarding the matters raised in our submission, please contact Ambrose Wong, our Associate Director of Standard Setting at ambrose@hkicpa.org.hk

Yours faithfully,

Simon Riley
Director, Standard Setting

SR/AW

Encl.

Hong Kong Institute of CPAs

Comment on IASB Exposure Draft of Insurance Contracts

Question 1 - Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) **differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and**

(b) **differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?**

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

We generally consider the contractual service margin should represent the unearned profit in an insurance contract as this would result in information relevant to decision making.

We note that the unit of account for the risk adjustments is not specified under the proposal. We recommend IASB to consider tightening the definition and provide additional guidance on this matter to minimize diversity in practice.

The contractual service margin is measured at the level of the portfolio. However, the level for amortisation of the contractual service margin is not specified and is to be released according to the services provided under the contract. The determination of which pattern faithfully represents the remaining transfer of services provided under the contract may be complex especially for smaller insurers, we therefore recommend IASB to consider introducing a simplified fall back option (for example straight line amortisation) if there is a suitable approximation for the pattern of services.

Question 2 - Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

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

(a) **measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?**

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

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

We understand the conceptual rationale for the mirroring approach as in some circumstances this approach can help eliminate accounting mismatches. However, we expect there would be significant complexities when applying mirror accounting when transactions are more sophisticated, for example to contracts where some cash flows vary directly with the underlying assets and some cash flows do not. Accordingly, we consider the cost of mandating mirror accounting as proposed would outweigh the benefits. We recommend that IASB could consider mandating mirror accounting for relatively simple investment-linked insurance contracts or the components of contracts that are clearly investment-linked, but that the other proposed measurement requirements apply to more complex contracts or the more complex components of the contracts.

In addition to the above recommendations, we consider that mirroring should start from the liabilities side and not from the assets side to better reflect how an insurance business is typically managed. We would recommend IASB to consider providing more detailed guidance on the adoption of the approach, especially in the unbundling of components for measurement of insurance contract liabilities that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items.

The Exposure Draft provides an exemption where an entity is permitted to determine whether a contract specifies a link considering all of the substantive terms of the contract, whether they arise from the contract, the law or regulation. The underlying items may include specified asset and liabilities, an underlying pool of insurance contracts or the assets and liabilities of an entity as a whole.

When applying such an exemption, an entity would disaggregate the cash flows in a way that maximizes the extent to which the measurement both (i) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and (ii) maximizes the minimum fixed payment that the policyholder will receive.

This exception is intended to eliminate accounting mismatches between the cash flows arising from an insurance contract and the underlying items, when the terms of the contract are defined in such a way as to avoid any economic mismatches. We consider that the exemption criteria are overly restrictive, and therefore may not capture all types of contracts that would be intended. Our constituents have indicated that it is unlikely that many Hong Kong contracts would be able to meet these criteria. The IASB may consider to provide guidance on the applications and interpretations of the underlying principle, instead of making the exemption criteria overly prescriptive.

We also consider the proposed requirement to disaggregate the cash flows of participative contracts into different components would be overly complex and would be difficult to apply in practice. We consider that additional guidance is required if such requirement is to be included in the final standard.

Question 3 - Presentation of insurance contract revenue and expenses

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

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

It is our understanding that this proposal is in response to constituents' feedback on the 2010 Exposure Draft that gross performance should be measured in a similar way to the revenue presented from non-insurance contracts with customers. While this is desirable, we have concerns that the requirement to split all contract movements into an investment component and non-investment component would involve significant complexity and costs that may outweigh the benefits.

We consider it could be difficult for insurers to explain the movements in revenue as a result of multiple key drivers, including but not limited to the estimated claims, expenses, change in risk adjustment and amortization of contractual service margin.

We acknowledge that volume-based measures of business performance are widely used and understood by most users of financial statements and entities may therefore needed to provide and reconcile, in the notes of the financial statements, income and expenses from insurance contracts to volume-based key performance indicators for better understandability. This would in turn provide preparers with additional compliance costs in applying the proposals - over and above any benefits we see arising from these proposed requirements. Moreover, the cost of initial implementation can be even higher when administration systems of many insurers are not yet able to provide the required detailed movement schedules and therefore generally require multiple runs.

As the current proposal may present a significant change to current measurement and presentation of premiums and claims, we would recommend IASB to consider providing further explanation and additional examples for the purposes of consistent application of principles for insurance revenue recognition and disaggregation.

Question 4 - Interest expense in profit or loss

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

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

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

It is our understanding that the proposed segregation of the effects of underwriting performance from the effects of changes in discount rate aims to address concerns expressed on the 2010 Exposure Draft, which suggested that presenting in profit or loss all changes in current value measurement of the insurance contract liability could have a significant impact in the income statement and make it difficult to assess underwriting performance.

We have reservations on the proposal to split the effect of the movement in the discount rate so that the income statement shows as part of operating profit the effect of the unwind of the liability using the original discount rates determined at the inception of the contract.

Under this proposal, the effect of movements in the discount rate (difference between the current rate and the rate determined at inception) would be accounted in OCI. Whilst this attempts to isolate business performance from short-term market fluctuations and achieve a degree of "matching", it may not work in practice when derivatives (not eligible for FVOCI classification – for example, structured notes or derivatives) are used to manage interest rate risk, or interrelated embedded derivatives are involved which cannot be bifurcated. If a portfolio of insurance contracts is matched with assets and a discount rate has been managed/hedged economically, the effect of the movement in discount rates cannot be accounted consistently with the results of hedging. Hedge accounting will also not enable this. At the same time, it may also be difficult for insurers, especially for smaller insurers to quarantine assets related to such portfolios. We recommend the IASB can consider making the proposed treatment an irrevocable choice at transition or on inception of a portfolio, hence allowing insurers to remove accounting mismatches where that is possible, while not forcing new accounting mismatches (e.g. for derivatives).

Some constituents believe that presenting all changes in current value measurement of an insurance contract liability in profit or loss. results in information which is more relevant to decision making by users of financial statements. It may be easier for management to explain the potential higher degree of earnings volatility as compared with the proposal in the current Exposure Draft. A constituent of our jurisdiction also commented that the proposal may lead to even greater overall volatility over the life of a portfolio than with a pure P&L approach.

Question 5 - Effective date and transition

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

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

Under the proposed transition, an entity could elect to apply the practical expedients for determining the discount rate at initial recognition and the contractual service margin at transition when retrospective application of the standard is impracticable. We agree with this proposal since it is practical and does not penalize insurers with a zero contractual service margin.

We consider the level of change and the complexities associated with implementing the proposals are significant and we therefore consider that the implementation period should not be less than three years to facilitate smooth transition by entities. We consider it would be preferable if IFRS 9 and the new insurance contract accounting standards become effective at the same time.

While insurers could adopt IFRS 9 based on the existing standard for insurance liabilities, in reality the linkage between the assets and liabilities is so intertwined that the accounting for financial assets will need to be revised once the new accounting model for insurance contracts is introduced. In case IFRS 9 and the new insurance contract accounting standards are not becoming effective at the same time, we suggest an alternative to allow entities that issue insurance contracts a second opportunity to revisit the decisions in adoption of IFRS 9 when the finalized insurance standard become effective. This will allow for a more holistic view of how the entity issuing insurance contracts manages its business and will provide enhanced information to users of the financial statements.

We also recommend IASB to consider expanding the application guidance and illustrative example to assist preparers in interpreting "reasonably available" and "without exhaustive efforts" in the estimation of expected cash flows, risk adjustment, discount rates and observable yield curve that would apply retrospectively at the date of transition.

Question 6 - The likely effects of a Standard for insurance contracts

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

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

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

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Although the proposals aim to improve transparency and consistency in insurance contract accounting, we are concerned that the proposals may not enhance users' understanding of insurers' financial statements. Whilst each individual proposal in isolation appears a sensible response to individual concerns with the 2010 Exposure Draft, overall it is creating a complex measurement model that will be more difficult for smaller companies to implement and for users to understand.

The additional disclosures that would be required by the standard, especially reconciliations of movements between opening and closing balances for virtually each item presented on the statement of financial position and the disclosure of confidence level information as a "comparable benchmark", will not necessarily help users of financial statements better understand the performance of insurers. Management may still need to include a significant amount of narrative information in both financial statements and management discussion and analysis section of the annual report to describe its operating performance and financial position.

We consider compliance with the proposals would be challenging, especially for the smaller companies, as entities may have to contemplate major changes to data and systems, education and communication to stakeholders, and changes to asset-liability management. Entities' profit profiles and offerings may be impacted, and in many cases entities would need to incur significant additional compliance costs in resourcing finance and actuarial functions.

Question 7 – Clarity of drafting

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

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

We are unsure whether the wording of the contract boundary in paragraph 23(b)(i) is intended to be restricted to the "portfolio", as defined in the proposed standard. In many cases, the right to re-price exists at a different level than the portfolio and is often subject to external regulatory constraints. We consider the proposed requirements may be overly restrictive and we suggest removing the reference to the "portfolio of insurance contracts" and instead refer to a group of contracts. In Hong Kong, many insurance contracts are priced and managed with the expectation that they will remain in-force for many years though the right to re-price exists; we believe that the contract boundary should be consistent with the underlying economics of these contracts.

We believe that the amended contract boundary wording in paragraph 23(b)(i) will have unintended consequences. We understand that the rationale for this change was to allow health insurers that currently account for certain types of health insurance contracts as short duration contracts to continue to do so. For some types of group contracts that are priced, sold and managed as long term contracts, the insurer has the right to re-price contracts. In practice this right may be restricted by regulation or economic considerations to the extent that the insurer does not have the practical ability to re-price the contract. The proposed wording may mean that contracts that are priced, sold and managed as long term contracts may be treated as short term contracts. Such contracts would be loss making in the first year (write-off of acquisition expenses), but highly profitable in subsequent years, which would be inconsistent with economically similar contracts. We suggest that the wording of paragraph 23(b)(i) be revised to refer to the 'right and practical ability' to avoid such unintended consequences.

~ End ~