



19 June 2009

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

Email: CommentLetters@iasb.org

Dear Sir/Madam

LONG-TERM INSURANCE SUBMISSION ON PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

In response to your request for comments on the IASB's discussion paper on *Preliminary Views on Revenue Recognition in Contracts with Customers*, attached is the joint comment letter prepared by the Life Assurance Committee of the Actuarial Society of South Africa and the Long-term Insurance Project Group of the South African Institute of Chartered Accountants (SAICA). This submission was prepared based on the input of preparers of financial statements from the long-term insurance industry in South Africa in order to assess the impact of the proposals in the discussion paper on their financial reporting as well as to determine whether the proposed accounting treatment was in accordance with the risks and substance associated with long-term insurance contracts and the principles embodied in the Insurance Project.

We have attached our joint comment letter submitted to the IASB on 15 November 2007 in response to the discussion paper on *Preliminary Views on Insurance Contracts*. Many of our previous comments contained therein have been referred to in our response to various questions set out in this discussion paper.

We have, in addition to our responses to the questions raised, also included general comments on aspects not specifically dealt with in the questions and, where relevant, alternative views have been included.

We thank you for the opportunity to provide comments on this document. Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

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Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers

GENERAL COMMENTS

The Boards' proposal is to develop a single revenue recognition model. However, the IASB, with the issue of this discussion paper, appears to be departing from its stated desire to move to a common set of accounting principles that will apply to all industries and transactions.

For example, the preliminary views contained in the revenue recognition discussion paper are in conflict with the principles stated in the discussion paper on insurance contracts.

As previously commented on in a joint letter from the Life Assurance Committee of the Actuarial Society of South Africa and the Long-term Insurance Project Group of the South African Institute of Chartered Accountants (SAICA), submitted as a response to the *Preliminary Views on Insurance Contracts* discussion paper, we broadly support the concept of the three building blocks to measure contract obligations discussed in that paper. This in turn results in revenue recognition that is directly related to the completion of contract obligations but measured at current values, which we would submit results in far more relevant performance reporting and financial position.

Obligations therefore would be measured at the amount that would be the cost of fulfilling obligations to policyholders, or alternatively the amount to be paid to release an entity from that obligation, i.e. use of (1) explicit, unbiased, market consistent, probability-weighted and current estimates of all cash flows, (2) current market discount rates that adjust the estimated future cash flows for the time value of money, and (3) an explicit and unbiased estimate of the margin for the cost of bearing risk in addition to the value calculated using the first two building blocks.

Under this approach we do acknowledge there might be certain practical considerations that will have to be addressed regarding contract terms, in particular legal obligations and policyholder behaviour (e.g. the probability of term extensions). This approach also allows for the recognition of day 1 profits as opposed to the spreading of contract consideration suggested in the discussion paper.

The discussion paper has referred to insurance contacts and, whilst not excluding them, has stated that the proposed principles might not provide decision-useful information for all insurance contracts. This implies that they could be scoped out in the future.

IAS 39 recognised contracts (financial instruments) also appear to be destined to be excluded due to "volatility in the value of those contracts". Lease contracts, which are subject to a separate IASB project, have also been excluded.

We understand the urgent need for revenue recognition guidance relating to customer contracts, particularly in non-financial institution entities that make up a considerable

majority of publically traded entities. However, we motivate that revenue recognition, as well as the directly linked remaining contractual liability, is such a fundamental cornerstone to conceptual accounting that the key debate on measurement and recognition should rather be settled in the conceptual framework before further segmentation by industry type occurs.

The current discussion paper motivates a revenue recognition principle of spreading the contracted consideration in proportion to when the contract obligations are met. Onerous contracts will require recognition of potential losses immediately when identified. Whilst application of this approach is probably reasonably practical (and is currently widely applied) it does introduce another version of measurement that can be very different to fair value, exit value or amortised cost.

The recommendations under this discussion paper are in conflict with the fair value concept which recently has been firmly and seemingly successfully defended by the IASB.

Our main concern therefore is that these proposed revenue recognition changes do not result in reducing complexity and increase divergence in the ability to compare profit and loss from one company or industry to another.

In summary, our first preference would be for one revenue recognition base, using appropriate measurement principles, to apply to all industries as we believe this would provide the most decision- useful information.

If this is not currently feasible, and the proposed principles as they stand are adopted, then we strongly recommend insurance contracts be scoped out of the revenue recognition standard.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Do you agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Yes, we agree with the proposal to have one single revenue recognition principle which is not industry specific and is applicable to all contracts. Preferably this principle should be embodied in the conceptual framework. This will ensure comparable information for economically similar transactions as well as understandability of revenue for users of financial statements.

We do, however, disagree with the measurement criteria proposed in this discussion paper. We do acknowledge that various industries have differing measurement models that currently are applied and, as such, a consistent measurement approach may be difficult to achieve.

Question 2

Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

With regard to the measurement basis we are advocating as a general principle the remeasurement of remaining contract obligations with the total consideration recognised in full at point of sale. We believe this principle would provide more relevant decision-useful information as both the comprehensive income statement and financial position would accurately reflect the economic activities undertaken by the organisation.

It should be noted this approach suggests all premiums go through the income statement as revenue. An alternative view was provided in our IFRS 4 phase 2 comment letter, which is that revenue be recognised on a fee basis (i.e. fees charged for risk underwriting, administration, asset management, etc).

Therefore we disagree that the measurement principles in the current discussion paper would provide the best decision-useful information for all contracts. These principles would not be satisfactory, for example, when accounting for insurance contracts. We note that the scope paragraph S11 (b) states that "the proposed revenue recognition model might provide decision-useful information for some contracts that the insurance project is considering, but not all of them".

Representing the long-term insurance industry in South Africa, we request that, if the proposed measurement principles in this discussion paper are adopted, that insurance contracts and financial instruments (including investment contracts) are **entirely** excluded from the scope of this standard. We would disagree if application of this standard would

require some insurance contracts to be measured under these revenue recognition principles and others to be measured under an alternative standard or framework. We note again that these preliminary views contradict with the measurement approach in the insurance contracts project.

Lastly, it is our opinion that re-measurement of remaining contract obligations is not that difficult to apply and therefore reject the practicality debates. In any event, this calculation would be required in determining whether any contract has become onerous.

Question 3

Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Yes, we broadly agree with the Boards' definition of a contract.

However, the definition refers to enforceable obligations and therefore implies this would not include customer behaviour, e.g. contract extensions without resale, even if highly probable. It makes reference to legal rights, which arguably would only include the specific contractual cash flows. In reality, in certain industries, a number of contracts automatically extend beyond legal term and are managed on statistical probability of extension despite no legally enforceable right to insist upon extension. This is a very common industry practice in, for example, the application of insurance and cell phone contracts where the original contract arguably creates a customer relationship with implicit rather than legal terms of contract.

We therefore recommend that, although the contract should have legal substance, the probability of term extensions on existing contracts (without renegotiation of terms and conditions in the original contract, i.e. not the creation of a new contract) should be allowed for in determining future obligations and revenue as this is likely to be a key component of the decision to enter into that contract.

We propose the definition of a contract should be amended as follows: 'A contract is an agreement between two or more parties that creates enforceable obligations **and rights**'. We believe the term 'rights' will factor in certain implicit behaviours that are highly probable to occur on contract inception at the initial transaction date.

We also note that the term enforceability should include both explicit and implicit obligations – refer Question 4.

It should be noted that IFRS 4 defines an insurance contract as "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". Therefore, as it stands, an insurance contract is a sub-set of a contract.

Question 4

Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Broadly speaking we do agree because the proposed definition supports the necessity to differentiate an obligation that provides goods or services vs. any other possible obligations in the contract.

In instances where business practice has established a precedent which is not legally enforceable, for example, where a cash retailer may provide cash returns despite legally stating otherwise, we agree that any implicit contract obligations should also be identified and recognised under this kind of practice.

We note the deliberate use of the word 'promise' to support the understanding of implicit and explicit obligations, but the word 'promise' may not be consistently understood and it may be necessary in the definition to include the words 'implicit and explicit' before 'promise' to remove any possible ambiguity.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

In terms of the proposed measurement criteria of the discussion paper, we do agree that an entity should separate the performance obligations in a contract on the above basis.

However, in respect of insurance contacts, we strongly recommend the measurement of the entire contract obligation using the portfolio approach. Therefore it may not be necessary to separate performance obligations in this manner in order to determine the current value of the obligation.

We re-iterate our position in our reply to the insurance contracts discussion paper that we do not agree with unbundling of insurance contracts into components.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Yes, because it is a promise to a contracting party, i.e. the customer. The customer is reliant on that promise, which in turn influences their decision to contract with that entity and therefore that specific obligation is an integral part of ongoing activities of the entity. We therefore believe that, in the long-term insurance industry for example, the probability of cash

back bonuses and cancellations during cooling off periods should be included in the revenue recognition calculations.

Question 7

Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Yes, we believe sales incentives give rise to performance obligations as they are effectively acquisition costs associated with that customer contract and the granting of is directly related to that contract. We would exclude any incentives not directly linked to the entering into of that specific contract. The measurement criteria as recommended in our approach would, however, factor in the probability of these incentives being realised when calculating the probability weighted current estimates of all cash flows.

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Meeting of obligations should be in reference to the substance of contract application (both legal and business practise) in each jurisdiction. We support alignment to control and receipt of service and recommend that definitions of control be broadly consistent to other IFRS standards, where applicable.

Ouestion 9

The Boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

In essence we agree with this; however we are advocating that revenue recognition measurement be in reference to current value of future obligations and not a pre-determined systematic allocation against specific obligations set at the commencement of the contract.

Using these criteria, where contracts are entered into on an advantageous or disadvantageous basis relative to the market, an entity will not recognise a day one gain or loss as no obligations have been met. Conceptually we disagree with this – if the market participants are prepared to assume contract obligations at less or more value on day one, then this is a specific economic event that the particular entity should recognise.

Question 10

In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

We do not agree with the above proposal. As commented on above, we believe that one should measure the entire contract obligation at either the value one would have to pay to be released from that obligation or the cost of fulfilling obligations to policyholders. This would result in revenue recognition that is directly related to the completion of contract obligations but measured at current values which we would submit results in far more relevant performance reporting and financial position. We do acknowledge that entity specific experience regarding, for example, customer behaviour and entity specific expense assumptions, should be more persuasive in the modelling than unverified and often unavailable market information.

(b) Do you agree that a performance obligation should be deemed onerous and re-measured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

This would be implicit under our proposed measurement approach. We advocate that remeasurement should apply to all contracts, not just those that are considered onerous. Under the proposed model, users will not be aware of changes in the profitability of a contract until it becomes onerous, whereas such changes will immediately be evident, and recognised, under our re-measurement model. This would result in more decision-useful information.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

Yes, in many instances this would not recognise the current value of obligations remaining under that contract. For insurance contracts, where the probability of death may change over the period of the contract, the current approach would not recognise this unless the contract becomes onerous.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

IFRS 4 already includes another measurement approach, being the liability adequacy test. However, we repeat that all remaining obligations should be re-measured at each reporting date as articulated in our attached response to the insurance contract discussion paper.

Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

Yes, as these costs are part of the customer's obligation to the entity and included in the settlement value in terms of the contract.

The essence of the revenue recognition model that our insurance industry is motivating is the recognition through accounting that acquisition costs are factored into the expected contract implicit revenues (i.e. is specifically allowed for in the pricing of products), which include policyholder behaviour related extensions and automatic increases in premium revenue. Therefore, to not recognise the component of revenue expected to recover or compensate for the acquisition cost would, in our opinion, take away from the relevance of comprehensive income reporting and would not reflect the economic reality of contracts. The recognition of this could be achieved either through the creation of a customer relationship intangible, deferred acquisition cost accounting or initial measurement of the contract liability. The method used will be dependent on the final contract measurement model adopted.

(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

In principle we agree that origination costs should be expensed as incurred. However, if additional costs relating to that contract are contingent upon a possible obligation, the probability of that cost should be anticipated in the calculation of the remaining obligations.

For example, in an agency incentive scheme where an agent receives commission for each contract sold, and in addition, if the agent were to sell a target number of contracts over a fixed period he would receive a further lump sum payment, that payment should not be recognised as incurred (i.e. when the last contract meets the target), but included in each prior contract written on a probability basis.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

This proposal is irrelevant in terms of our recommended measurement principle. However, entity specific information is often more relevant and available, as well as accurate. This aspect has also been specifically addressed in the attached response to the insurance contract discussion paper.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

This proposal is irrelevant in terms of our recommended measurement principle. We believe that the entire contract should be measured as a whole using portfolios, and not unit of account, where relevant.

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16 November 2007

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Dear Peter

LONG-TERM INSURANCE SUBMISSION ON PRELIMINARY VIEWS ON INSURANCE CONTRACTS

In response to your request for comments on the Discussion Paper *Preliminary Views on Insurance Contracts*, attached please find the joint comment letter prepared by the Life Assurance Committee of the Actuarial Society of South Africa (ASSA) and the Longterm Insurance Project Group of the South African Institute of Chartered Accountants (SAICA). This submission was prepared based on the input of preparers of financial statements from the long-term insurance industry in South Africa in order to assess the impact of the proposals in the discussion paper on their financial reporting and also to determine whether the proposed accounting treatment was in accordance with the risks and substance associated with long-term insurance contracts.

We thank you for the opportunity to provide comments on this document. We have, in addition to our responses to the questions raised, also included general comments on aspects not specifically dealt with in the questions. Where relevant, alternative views have been included for clarity.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

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GENERAL COMMENTS

There is general agreement in the South African long-term insurance industry that the building blocks proposed in the discussion paper are theoretically sound. Overall we support the three building blocks although we believe that the use of market consistent assumptions for expenses and the calculation of a service margin are inappropriate. We also recommend that the measurement attribute be termed "current portfolio exit value".

The specific questions have been answered assuming that we agree with the three building blocks, modified by our response to question 2.

More clarity is required around the margin for risk and uncertainty and further guidance will be necessary especially regarding the calculation of the margins. However, we agree that the standard should be principle-based and that any guidance that is provided regarding the implementation and application of those principles should not form part of the standard.

The following two comments are relevant throughout our responses to specific questions:

- That the unit of account should be at a portfolio level and not at a contract level. The financial statements should reflect the way that the insurance business is managed, which is normally on a portfolio basis of broadly similar risks.
- <u>All</u> contractual cash flows should be considered <u>together</u>. A transferee in a hypothetical transfer would look at the contract as a whole, therefore isolating certain cash flows (for example to derive separate assets and liabilities) is not appropriate.

Some of the most pertinent issues for long-term insurers are accounting mismatches that currently arise between the recognition of income and expenses in the income statement.

In our view it would be appropriate to provide relief to insurers where assets are held to back linked liabilities. The application of these concessions should be wider than just unit-linked liabilities and should include all policyholder liabilities where the economic benefit of the assets influences the value of policy benefits. This should therefore also be applied to participating contracts.

There are two views in the industry regarding the treatment of treasury shares. The first suggests that the concession should apply to all participating contracts where the insurer holds its own shares to back the policyholder liabilities. The second view suggests that where the insurer has discretion over purchasing its own shares, those shares should be accounted for as treasury shares, but that this treatment is not appropriate where the insurer is required to hold its own or holding company shares as a consequence of a specific policyholder mandate in relation to a contract.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

In line with our view that all contractual cash flows should be considered together, only one set of criteria should apply irrespective of whether the measurement model results in an asset or a liability. We therefore recommend that the recognition and derecognition criteria should be included in the insurance standard instead of a reference to the criteria under IAS 39 – *Financial Instruments: Recognition and Measurement*. This would also avoid any unnecessary changes should changes be made to IAS 39 that are not appropriate for the insurance standard.

Similar wording to that currently used for the liability recognition and derecognition criteria in IAS 39 would be most appropriate for insurance contracts.

Question 2

We agree that an insurer should measure all its insurance liabilities using the three building blocks. However, it is not entirely clear what is intended by certain of the terms used to describe the model.

We have commented on each component of the proposed model below, identifying issues we believe require clarification:

Explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows

Explicit

We agree with the principle of using explicit estimates. However, all measurement models require some degree of approximation. Practically, not all factors can be allowed for and require some degree of implicit estimation, for example immaterial rider benefits. While the concept of 'materiality' is applied throughout IFRSs, we believe there would be value in reiterating this fact where explicit estimates are required. (As, for example, has been done in paragraph 68 of the discussion paper in the context of discounting).

Unbiased

We agree with the principle of using unbiased estimates. However, we would like to note the practical difficulties in determining whether estimates are biased or not. The primary source of evidence for bias comes through time where there is a pattern of variances in experience in one direction. We recommend that it be clearly stated that unless there is evidence of bias in an estimate, it should be treated as unbiased.

Market-consistent

We agree with the principle of using market-consistent estimates from a theoretical perspective. In practice, however, we believe it would be appropriate for the insurer to use entity-specific assumptions as a starting point and then test these assumptions against the market to see if they are consistent. This becomes particularly relevant for non-financial assumptions where there is not an observable market. Management are able to influence the contractual cash flows, for example through underwriting, risk management and claims management. We request that this be clarified in the standard.

We are concerned about the use of non-entity-specific estimates of the cost of administering contracts – especially by less efficient insurers. A further concern is that industry information is not available.

We accept there may be some value in recognising the deviation in the insurer's expense experience relative to the market over time; however we have a concern that an inefficient insurer could present a reduced liability that would not reflect the true cost to that insurer. We believe this will not provide relevant information to the users of an insurer's financial statements without significant supplementary disclosure.

It may be possible to capture some of this 'understatement' in the risk margin, however this is dependent on the risk margin being determined on a cost of capital basis using a comprehensive economic capital model.

The use of non-entity specific service cost estimates could lead to incorrect conclusions as to the profitability of the business. For example, say the typical market cost of performing certain investment management services may be 50 basis points which is passed on to policyholders typically for a charge of 60 basis points. Consider an insurer, whose internal asset management unit may provide the services (due to economies of scale or other reasons) at a cost of 30 basis points to the insurer. If the insurer passes on some of the benefit of this reduced cost by only charging 45 basis points whilst reflecting in its financial statements a service margin based on the market-consistent 50 basis point cost level, the contract will give rise to a loss at inception using the guidelines of the discussion paper, when in fact it is more profitable than the typical market contract.

A further consideration is that in practice a portfolio of insurance contracts of a more efficient insurer is unlikely to be transferred to a less efficient insurer unless the efficiencies could be retained.

We believe that entity-specific estimates should be used for the cost of servicing contracts. Alternatively, we recommend that disclosure be required of the difference between the liability on an entity-specific cost basis and the market-consistent cost basis.

Probability-weighted

We agree with the principle of using probability-weighted estimates of the present value of cash flows, especially where the distribution of outcomes is asymmetric. We believe a literal interpretation of the current wording in the discussion paper suggests that in practice stochastic simulations of <u>all</u> model parameters, including demographic assumptions, will be required. This is not practical from a time or cost perspective. In many cases, especially in the life insurance environment, a symmetric distribution is a reasonable approximation and a deterministic point-estimate provides a materially correct result. Furthermore, while there may be adequate data to fit credible distributions to certain contingencies such as mortality, in many cases, there is insufficient data to do so, and a stochastic approach would suggest a misleading degree of accuracy.

We recommend that when the standard is drafted, the wording in paragraphs 39 to 41 of the discussion paper be replaced with the wording used in paragraphs E4 to E6 of Appendix E.

In particular the following wording from paragraph E6 should be included in the standard: "In some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions, for example if the cash flows reflect a series of interrelated implicit or explicit options. In such cases, more sophisticated stochastic modelling is likely to be needed."

If the current wording used in the discussion paper is kept in the standard further guidance will be necessary.

Current estimates

We agree with the use of current estimates.

Contractual cash flows

We do not agree with the use of the word 'contractual'. The building block should be reworded as follows: "Explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual all cash flows with commercial substance relating to the portfolio of existing insurance contracts."

The word 'contractual' implies certain restrictions on what premiums and policyholder behaviour should be allowed for.

Current market discount rates that adjust the estimated future cash flows for the time value of money

We agree with the principle of using current market discount rates.

Where the cash flows of the liability depend on the cash flows from the underlying assets (for example, in participating business), the use of a consistent (asset-based) figure for the projection and the discounting of the cash flows will yield a market-consistent result.

We therefore recommend that this building block be reworded as follows: "Current market discount rates that adjust the estimated future cash flows for the time value of money and create a market consistent price for that cash flow.

We support the Board in allowing for liquidity in setting the current market discount rate.

An explicit and unbiased estimate of the margin that participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin) Risk margin

We agree that the concept of a risk margin is appropriate, however the terminology should be clarified. We believe that the risk margin is the <u>cost</u> associated with taking on the risk and uncertainty inherent in an insurance contract, rather than <u>compensation</u>

received for that risk. Where the expected compensation received exceeds the expected cost plus the risk margin, there will be a profit realised at the date of the sale. The wording in paragraph 33(c) should be replaced by the wording of the third building block used throughout the discussion paper to ensure that, throughout the standard, it is clear that the risk margin is the **cost** associated with taking on risk and uncertainty.

Service margin

We do not agree with the concept of a service margin because, in our view, it is inconsistent with a current portfolio exit value approach. Life insurers do not typically separate life insurance contracts into various components, but instead, treat contracts in their entirety. The determination of the current portfolio exit value should reflect this. If we follow the principle of including all cash flows relating to the insurance contracts, a single margin should be calculated encompassing all the compensation required by market participants.

We recommend therefore, that this building block be reworded as follows: "An explicit and unbiased estimate of the risk margin that participants require in addition to the value calculated using the first two building blocks for bearing risk (a risk margin) and for providing other services, if any (a service margin)."

Question 3

As noted previously, we believe that the standard should be principle-based. We therefore agree that the guidance should be kept at a minimum to avoid it becoming prescriptive.

Should further guidance be developed it should not form part of the standard and does not necessarily have to be produced by the IASB.

The discussion paper does not deal with tax. We appreciate that tax is the subject of a separate standard, as noted in paragraph E25(e) of Appendix E, however, to the extent that the taxation is on cash flows relating to the policyholder portfolio we believe that this should be addressed in the insurance standard to avoid meaningless liability measurement. The tax on the component of income less expenses in the South African tax calculation does not result in a temporary difference and is therefore not dealt with in IAS 12 – *Income Taxes*. We propose that the policyholder liability should be net of policyholder tax cash flows because a transferee in a hypothetical transfer would look at the contract as a whole including the relevant tax cash flows. We further recommend that IAS 12 be revisited to allow for the discounting of future tax cash flows, in order to provide meaningful liability information.

Question 4

We support alternative (c).

We believe the actual premium charged by the insurer plays an important role in the calibration of margins, but is not the sole determinant. As noted in paragraph 81(a), the premium is a directly observable market variable and should be considered. However, in our view the arguments provided in paragraph 82 outweigh those in paragraph 81.

We believe there are few, if any, sufficiently efficient markets where a unique price for a specific risk set exists, and from which basis one may correctly infer the market risk margin from the observed premium.

Accordingly we believe it is incorrect to calibrate the risk margin to the observed premium in all cases as argued in paragraph 81. Furthermore, to do so, we believe, would be a move away from the principle of using a current portfolio exit value approach based on current estimates of the cash flows relating to the portfolio of insurance contracts.

Instead, we believe the potential for profit to be recognised at inception if all assets and liabilities have been recognised and measured appropriately exists and that, as argued in paragraph 82(a), it would be inappropriate to include this deferred profit item in the liability. We believe that the profit margin is likely to be more significant than suggested in the views presented in the discussion paper. If alternative (c) is adopted, the standard should not make reference to the likelihood or not of significant profits arising at inception.

The ability to take into account the existence of an insurance cycle (82(e)); the fact that insurers may at times knowingly charge different premiums for identical risks to balance a portfolio (82(b)); and the greater transparency (82(d)) and consistent treatment of profits and losses (82(e)) achieved by not forcing zero profit or loss at inception provide more economically useful information.

A particular concern we have regarding alternative (a) is that it may imply/require the cohort-based lock-in of margins. This is, in our view, inconsistent with a current portfolio exit value approach and will have a significant impact on the complexity (and therefore, the practicality) of the calculations, particularly in life insurance business. A particular problem exists because of the variability in actual acquisition costs from year to year, which might require materially different margins for different cohorts under alternative (a). This approach will impact materially on the cost of preparing financial information with no commensurate increase in the relevance of the information produced under alternative (a) as compared to alternative (c).

We do not support alternative (b). We believe the "rebuttable presumption" in option (b) would in practice lead to the adoption of alternative (a) in most instances. We believe profit or loss may arise at inception in more than a small minority of cases. In some of these cases the profit or loss may be small and it may not be possible to provide overwhelming evidence of its existence and hence in some cases alternative (a) will be applied when we believe alternative (c) is more appropriate.

Ouestion 5

(a)

We support the measurement attribute in principle except as discussed in our response to question 2. It is appropriate as it takes into account all the economically relevant information regarding the contracts.

(b)

We do not have a particularly strong opinion on the label given to the measurement attribute.

From the discussion paper it is clear that exit value must be viewed from the entity's perspective, but a user of the financial statements may interpret exit from the policyholders' perspective, i.e. the amount payable on surrender of the policy. Current exit value may therefore be confused with 'settlement value' or may be interpreted as 'surrender value'.

Also, in our view it would be appropriate to emphasise that the measurement attribute is applied to a portfolio of insurance contracts and therefore a possible alternative name could be "current portfolio exit value".

Question 6

As noted previously, in our view all cash flows should be considered together, because a transferee in a hypothetical transfer would look at the contract as a whole. Our preferred alternative is therefore (b) because all cash flows would be reflected together on the balance sheet.

We do not agree with alternative (a). In addition to the reasons outlined in the previous paragraph, splitting the asset and liability could result in a more complicated measurement model. To raise a "customer relationship" intangible asset goes against the principles in paragraph 63 of IAS 38 – *Intangible Assets*.

Alternative (c) is not appropriate. If an insurer does not show these cash flows, in our view the measurement basis would stray too far from a current portfolio exit value approach.

Ouestion 7

In our view, alternatives (b) and (c) are equivalent because under both alternatives commercial substance would be applied in practice. We support either alternative.

We consider it appropriate to allow for the consideration of lapses and options. It also follows on from our answer to question 6 which argues for the incorporation of all cash flows in the contract. We recommend changing the wording to explicitly exclude cash flows relating to a second contract, for example where the compulsory purchase of an annuity is effected at the end of a deferred annuity contract.

We acknowledge that the application of these alternatives would probably require further disclosure around cash flows (for example for contracts that provide for annual premium increases).

We do not agree with alternatives (a), (d) and (e) because a transferee would consider more information than is included in these alternatives.

Ouestion 8

We agree that acquisition costs should be expensed when incurred provided that all cash flows relating to the portfolio of insurance contracts are taken into account in the measurement attribute. This approach is consistent with a current portfolio exit value approach.

Ouestion 9

The measurement of the contracts in accounting for a business combination or portfolio transfer should be consistent with the measurement of the contracts under the insurance standard. If the same basis is not applied, it will result in inconsistencies in financial reporting with a profit or loss recognised in the income statement immediately after recognition of the business combination or portfolio transfer. We are therefore also of the opinion that IFRS 3 - Business Combinations would need to be amended to provide for the valuation of insurance contracts acquired in a business combination on acquisition date consistent with the requirements of the insurance contracts standard.

Question 10

We believe that the measurement of assets held to back insurance liabilities should be valued at 'fair value through profit and loss' to reduce the potential for accounting mismatches.

The discussion paper proposes that insurance contract liabilities be valued on a current exit value basis. Our understanding of this is that the liability for participating, market-related and unit-linked business will take into account the current fair value of the backing assets because the projected benefit payments in the various scenarios included in the expected present value of the liability will do so.

The use of any measurement approach other than fair value for the backing assets would result in an accounting mismatch, which is contrary to the proposal in paragraph 179 of the discussion paper that an ideal measurement model would report all economic mismatches that exist but would not cause any accounting mismatches.

Accounting mismatches result in less relevant and potentially misleading financial statements that do not present the economic reality of transactions, to the potential detriment of users of the financial statements.

Accounting mismatches also increase the cost of financial reporting, as it requires of management to explain the true performance of the entity in supplementary disclosure. This also contributes to the complexity of insurers' financial statements.

Some of the most relevant mismatches that arise in the South African long-term insurance industry include the following:

Treasury shares

Please refer to our response to question 17(a) regarding this mismatch.

Owner occupied properties

The fair value adjustment on the revaluation of owner occupied property is taken directly to equity. This results in an accounting mismatch where the owner occupied property is held specifically for the benefit of, or to match the obligation to, policyholders as the change in the policyholder liability value is accounted for through the income statement.

The application of the principles of shadow accounting in IFRS 4 – *Insurance Contracts* addresses this mismatch for insurance contract liabilities, but not for investment contracts. We are concerned that if shadow accounting is removed in phase II of the insurance project, the mismatch may remain for both insurance and investment contracts.

In our view an approach similar to that in paragraph 32A of IAS 40 - Investment Property could be allowed for other assets that back linked liabilities such as owner occupied properties.

Foreign currency translation reserve (FCTR) arising from consolidation of foreign subsidiaries which are held to back policyholder liabilities

An accounting mismatch arises on the consolidation of foreign subsidiaries that are designated/held solely to hedge or match policyholder obligations. Typically these subsidiaries are investment holding companies and the mismatch occurs when the foreign exchange differences on retained earnings in equity are taken directly to an FCTR whereas the policyholder liability is measured at fair value using the foreign exchange closing rate and the total fair value movement in respect of the liability is accounted for in the income statement.

We agree that these special purpose foreign subsidiaries, which exclusively support policyholder liabilities, be fully consolidated, but recommend that all exchange differences be reflected in the income statement.

Policyholder investments in listed property fund subsidiaries

A mismatch occurs where policyholder funds are invested in a separately (to the insurer) listed property fund that is also a subsidiary of the insurer. The reason for this is that while the policyholder liability of a fully linked contract reflects the listed market value of the property fund, the consolidated financial statements of the insurer only reflect, as an asset, the fair value of the properties owned by the property fund. Any premium or discount between the listed valuation of the property fund, and the underlying value of the properties, represents a mismatch.

We recommend that in respect of listed subsidiaries that have a market value used in the valuation of policyholder liabilities that the premium or discount be reflected as an adjustment to the underlying asset values within the subsidiary.

Question 11

(a)

Yes, risk margins should be determined for a portfolio of insurance contracts and the portfolio should be defined as in IFRS 4 – *Insurance Contracts*. We believe the accounts should reflect how the company manages the business. This is normally on a portfolio

basis of broadly similar risks and therefore we believe a portfolio as defined in IFRS 4 is the most appropriate unit of account for risk margins.

(b)

No. To the extent that for the standards the unit of account is the portfolio, the benefits between portfolios should not be reflected. Within the portfolio diversification benefits should be reflected.

Reflecting the benefits of diversification between portfolios of an insurer would result in insurers with different mixes of business showing different values for the same book of business. We believe this result is inconsistent with the concept of current portfolio exit value which assumes there is a unique market price that an insurer would expect to pay to transfer its remaining contractual rights and obligations of the portfolio to another entity.

The benefits of diversification should be taken into account in the insurer's capital requirements. It is important to note that where diversification has been taken into account in determining the insurer's statutory or internal capital requirements there are practical implications for the risk margin. If the cost of capital approach is used to determine the risk margin for measurement purposes, the capital used to determine the risk margin will need to be at portfolio level and will need to exclude diversification benefits in the capital calculation.

There is an alternative view that although performance is generally managed and measured on a portfolio level, most insurers would manage solvency capital and risk at an entity level. For this reason there is a view that the portfolio is not necessarily the most appropriate unit of account for the risk margin.

We therefore recommend that the Board considers a principle to incorporate diversification benefits (similar to the principle used to incorporate non-performance risk) that produces a value that neither improves nor impairs the diversification benefits that the insurer has achieved at the measurement date.

This view is based on the assertion that the benefit of diversification between portfolios is an economic reality that should be reflected in the accounting for insurance contracts. As an example, consider the difference in capital requirements between an insurer covering only one specific risk and an insurer exposed to multiple risks (e.g. an insurer only exposed to mortality risk versus an insurer exposed to both mortality and longevity risk). We believe that second company would be able to hold less economic (and solvency) capital than the first and that this should be reflected in the risk margin.

We do support the view that the risk margin should reflect market inputs, rather than entity specific parameters. However, we believe that the reference entity used in determining the risk margin should have a similar portfolio of business to the reporting entity. In the example above, we believe it is not appropriate for the company exposed only to mortality risk to take into account diversification risk of a reference entity exposed to both mortality and longevity risk.

Assuming that the reporting entity does take diversification effects into account in its pricing basis, a portfolio-based margin not taking diversification into account will possibly produce initial losses. These losses would be reversed on subsequent measurement when the entity recognises the actual cash flows and the actual degree of uncertainty of cash flows arising from the entity's combined portfolios emerges. Such initial loss and subsequent gains do not reflect the economics of the transaction and would not provide users with information relevant to the insurer's performance.

Not allowing for the diversification benefit will also require insurers to calculate two sets of capital and liabilities, one for financial reporting and one for solvency purposes (under the proposed Solvency II framework, the risk margin will be calculated allowing for diversification between portfolios, using a diversified reference entity). We believe that this creates unnecessary cost and complexity in the financial reporting process.

Question 12

(a)

Yes. For consistency with the measurement of liabilities, and hence reduce the possibility of accounting mismatches.

- *(b)*
- (i) Yes. We agree that this reflects the true value as being the net position.
- (ii) Yes. We agree that the credit risk of the reinsurance asset is better reflected by using an expected loss model.
- (iii) Yes. In principle we agree that any contract could have an economic value.

Ouestion 13

We do not support mandatory unbundling because of the complexity and inherent approximations required for most insurance contracts.

In this context, we believe most universal life contracts cannot be unbundled because of their inter-relatedness. Whilst components such as risk-premiums can theoretically be separated and accounted for separately from the deposit component, we believe some components of the measurement model become arbitrary. In particular, identifying a split of acquisition, administrative and service costs for the components, and the calibration of the risk and service margins would become arbitrary. Furthermore, some companies would need to make significant system changes to achieve this split with, in our view, little added value for users of the financial statements.

Insurers could however be allowed to unbundle contracts if the components are managed separately and the cash flows are separately identifiable and would add value to users of the financial statements.

In our view, unbundling should occur relatively infrequently. We do not see the value of including alternative (c) in paragraph 228, given that it will result in the same total liability as treating the policy in a bundled manner. This split might even lead to the

insurance component having a negative value in some cases whereas it would be positive if valued independently.

Question 14

(a)

Yes, we agree. A current portfolio exit value approach is intended to consider the probability weighted average of all scenarios, including those where the contractual cash flows do not occur. In principle it is possible for a portfolio to be transferred and the probability of different scenarios to change as a result. The current portfolio exit value could therefore change on transfer of a portfolio of contracts. However, we agree that a rational transferee would not willingly pay for a credit upgrade, and similarly, rational creditors (policyholders) would not generally permit a transfer that would reduce their rights (assuming creditors have a right to influence the transfer in the particular jurisdiction). Therefore, in our view, a transfer between willing buyer and willing seller would in practice neither improve nor impair credit characteristics of the liability.

In practice we believe adjustments to the credit characteristics of insurance liabilities on transfers may be seen when business is transferred from an insurer in distress. However we believe this will usually occur under the compulsion of a regulator and is not usually performed on a willing buyer/willing seller basis as envisaged under the current portfolio exit value model. We therefore do not believe this invalidates the conclusion in the previous paragraph. (Some might argue in this scenario that there should not actually be a change in credit characteristic as the measurement before transfer should have taken into account the possibility of regulatory intervention. However, once the intervention has been made, a number of scenarios that were previously legitimately included in the measurement, such as scenarios where the regulator does not intervene, are no longer valid and the expected present value will change.)

We are concerned that that the term "credit characteristics of the insurance liability" may be misunderstood, and recommend that the standard reinforce the fact that the credit characteristics contemplated relate to the credit characteristic of the portfolio of insurance liabilities and not the credit risk/characteristics of subordinated debt (or the assumed credit risk of subordinated debt if no debt has been issued).

(b)(i) and (ii)

The measurement of an insurance liability should reflect its credit characteristics at inception and subsequent changes in their effect. A current portfolio exit value requires the same measurement process to be followed at all points throughout a contract's life and there should, therefore, be no difference in treatment between inception and at subsequent points during the life of the contract.

We believe the current portfolio exit value approach is intended to consider the probability weighted average of all scenarios, including those where the contractual cash flows do not occur. We agree with the argument that it is universally accepted that the measurement of debt issued for cash should reflect the credit characteristics of the debt and that there is no obvious reason to treat insurance liabilities differently. Therefore, in

our view, the measurement of an insurance liability should reflect the credit characteristic of that liability.

Most insurers are regulated and typically hold additional capital which reduces their probability of defaulting. However, we believe this merely indicates that the impact of allowing for the credit characteristic may be small, but does not change the underlying principle.

Whilst we agree that the measurement of an insurance liability should take into account the credit characteristic of that liability, we do not believe this can be completely separated from the entity. As noted in Appendix H11(e), the credit characteristics of a liability depend on the creditworthiness of the issuer, which is specific to the entity. We note Appendix H12(e) argues that creditworthiness of the issuer is not an entity-specific input, "but a screen to identify the pool of potential transferees." We are not convinced by this argument.

The classification into the correct credit pool requires knowledge of the specific issuer and its credit standing (as well as various other factors affecting the credit characteristics of the liability). The same result may then be achieved for the liability irrespective of which entity in this credit pool has issued the contract, however it is incorrect to say the measurement is completely separate from the entity.

The principle of excluding entity-specific cash flows stems from the higher level principle stated in paragraph 56, that "a measurement of an insurance liability should represent faithfully the economic characteristics of that liability". It could be argued that the above point is somewhat inconsistent with the principle of excluding entity-specific cash flows. However, we believe that the higher level principle of faithfully representing the economic characteristics of the liability is met by reflecting the credit characteristics of the liability, and our conclusion therefore remains the same.

Question 15

We agree that there are some inconsistencies between the proposed treatment of insurance liabilities and the treatment of financial liabilities. In our view, some of the principles addressed in the discussion paper are relevant for other entities and extend to other projects of the IASB. We believe that other standards should be aligned with the insurance standard over time.

Question 16

(a)

Yes, all obligations for future cash flows should be included in the liability measurement to be consistent with current portfolio exit value.

(b)

Yes, as described in the exposure draft. However, if the definitions of 'constructive' and 'legal' obligations are changed in the new standard we may no longer agree. We recommend that the guidance be included in the insurance standard so that it will not be

subject to potential changes in IAS 37 – Provisions, Contingent Liabilities and Contingent Assets.

Question 17

(a)

Yes. In our view, however, the application should be wider than just unit-linked liabilities and should include all policyholder liabilities where the economic benefit of the assets influences the value of policy benefits. This should therefore also be applied to participating contracts.

There are two views in the industry. The first suggests that the concession should apply to all participating contracts where the insurer holds its own shares to back the policyholder liabilities. The second view suggests that where the insurer has discretion over purchasing its own shares, those shares should be accounted for as treasury shares, but that this treatment is not appropriate where the insurer is required to hold its own or holding company shares as a consequence of a specific policyholder mandate in relation to a contract.

- (b) Yes. As with (a), this should be extended to participating contracts.
- (c) Yes. As with (a) and (b), this should be extended to participating contracts.
- (d) We support the main principle that accounting mismatches should be eliminated. Our strong preference is that the assets should be recognised and measured appropriately (as indicated in (a) and (c) above), but that it should also be extended to other instances of accounting asset mismatches (e.g. on owner occupied property).

We however acknowledge the Board's preference not to allow exceptions for the accounting treatment of these assets for insurers and if this view carries through to the standard we recommend that the measurement basis for the insurance liability be adjusted in these specific cases to address this accounting mismatch.

This could be done by reporting a liability on the balance sheet after deducting the difference between the fair value and recognised accounting value of the relevant assets and disclosing the original liability and the deduction made in respect of the assets, separately, in the notes to the financial statements. We appreciate that this proposal is not technically consistent with the definition of a liability in the Framework and might introduce some complexity because it might be difficult to define when it would apply. However, we believe that eliminating unnecessary accounting mismatches overrides these practical considerations. The overriding objective of financial statements prepared in accordance with IFRS is to faithfully present the financial position and performance of an entity. The current requirements that result in a mismatch are in our opinion not in line with these principles and objectives. Although arguably not technically sound, we prefer

to rather value a liability inconsistent with the Framework than report a financial position and performance that do not reflect economic reality.

Question 18

We were unable to decide on a preferred view and therefore have included two views:

The first view is that the income statement should reflect what the shareholder is entitled to. Therefore the full premium should be shown as a deposit and only charges and fees relating to risk underwriting and other services (as applicable) should be presented in the income statement as revenue. Risk underwriting benefits, administration costs and other expenses incurred in respect of insurance contracts must commensurately be recognised as expenses in the income statement.

The second view is to show premiums as revenue simply because it is considered an easier approach and is the approach of most insurers currently.

Question 19

It was felt that we should provide a traditional income statement and a "sources of profit" analysis because they both contain relevant information. The main components outlined in the three building blocks should be addressed in the sources of profit analysis (i.e. expected profits, experience variances and assumption and model changes.) In addition, profit on new business should be reflected separately.

In our view, the standard should require sufficient detail relating to the movement of insurance liabilities to enable a meaningful analysis of the insurer's results.

Ouestion 20

Yes, provided that all relevant asset movements are included.

Ouestion 21

Counterparty risk – cedants

In determining the portfolio exit value for a reinsurance agreement between a reinsurer and a cedant, the reinsurer will estimate future cash flows expected to be received from and paid to the cedant. To the extent that the current portfolio exit value results in an asset (present value of future income is expected to exceed future outflows), the reinsurer has a credit exposure to the cedant, from whom it is expecting to receive the future cash flows. No allowance for credit risk of the underlying policyholders is assumed for a direct insurer. For a reinsurer, we would like clarity as to whether an allowance should be made for the credit risk of the cedant in the same way that the cedant makes allowance for the credit risk of the reinsurer in determining their reinsurance asset.

Solvency II

In our view, the IASB should align the principles in the standard with developments in Solvency II, where applicable.

Field testing

We recommend that the IASB conduct extensive field testing before and after the exposure draft is issued.