KSR

KOMITET STANDARDÓW RACHUNKOWOŚCI

31 October 2013

IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: **Exposure Draft *Insurance Contracts ED/2013/7***

The Polish Accounting Standards Committee (PASC) is pleased to respond to the request for comments on the revised Exposure Draft of proposals for the accounting for Insurance Contracts, published on 20th June 2013 (referred to as ED thereafter).

The PASC is generally supportive of the direction and principles articulated in the ED, which are the "building block approach" for measuring insurance contracts and the unlocking of the Contractual Service Margin. However, the PASC has some concerns regarding other aspects of the ED, including the "mirroring approach", the insurance revenue and the calculation of the discount curve.
The answers to the questions raised in the ED and conclusions regarding other aspects of the ED are attached in the Appendix.

Yours sincerely,

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Chairman of the Polish Accounting Standards Committee

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cc. EFRAG

Appendix: The detailed conclusions and answers are listed below:

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?

The PASC supports the concept of Contractual Service Margin (CSM) representing a margin that reflects the profitability of the insurance contract over the coverage period. We agree that CSM should be re-measured in order to reflect the changes arising from the re-estimate of future cash flows. The CSM should be adjusted for differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services. However, this should only be appropriate if the CSM is not negative, and if, in cases of future changes in estimations, there is a possibility to re-set the CSM back from zero.

Moreover, more clarity and examples are needed to understand the concept of "services" to be captured in the CSM. With respect to transfer of services, it is not clear from the ED and the Basis for Conclusions which definition of "services" should be used.

Additionally, PASC supports the concept that CSM should be measured at the level of portfolio, however, the PASC notes that it is inconsistent with other standards e.g. Revenue from contracts with customers.

PASC notices that there are no guidelines about the level of granularity that is required for calculation of the CSM. This could result in different calculation of profit or loss. Furthermore, it could affect comparability of financial statements and encourage earnings management. Regarding question 1b, the PASC agrees that differences between current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services should be recognised immediately in profit or loss.

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 (i.e. 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?

The PASC does not fully support the newly introduced "mirroring approach". It seems that although this approach will reduce accounting mismatches in the statement of the financial position and profit or loss items arising from the changes in liabilities and assets, it introduces complexity. It is also unclear what impact on financial statements it would have. This may be the case in particular when there is no 100 per cent passing-through of assets held and the entity needs to decompose cash flows and apply different valuation assumptions for cash flows arising from one insurance contract).

Moreover, the PASC notes that, having taken into account the requirements for the "mirroring approach", the range of insurance contracts to which this approach could be applied is very narrow. As a result, not all accounting mismatches will be covered.

The PASC believes that users would gain better understanding of the overall impact of the "mirroring approach" on financial statement if the IASB could prepare an example showing the statement of financial position items and profit or loss of an entity which has contracts that require it to hold underlying items and specify a link to returns on those underlying items.

Additionally, the "mirroring approach" will complicate and increase changes that will need to be done for Solvency II purposes, as it provides a completely different methodology of valuation of insurance liabilities for such contracts.

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?

In general, the PASC agrees with the view presented in the ED that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity presents, in profit or loss, insurance contract revenue and expenses

To increase transparency in the profit or loss account, the PASC recommends presenting the acquisition costs, administrative expenses and other technical income and expenses in separate lines. Such treatment will help users of financial statements to better understand the financial situation of entities.

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?

The PASC sees merit in reflecting interest rate changes in OCI and can agree that, in some cases, this could reduce volatility in the profit or loss (particularly for long term contracts).

However, we think that the proposed OCI solution increases complexity of the model and does not necessarily help users to better understand the economic characteristics of all insurance contracts. In particular, the mandatory use of OCI for insurance liabilities not falling under the mirroring approach introduces an accounting mismatch when the corresponding assets are being measured at fair value through profit or loss. It will be worth to allow the optional use of OCI on the liability side to address this accounting mismatch. In the case of unit-linked contracts, which are managed on a fair value through profit or loss basis and when the mirroring approach applied, the PASC agrees that the presentation of both the insurance liability and the linked assets at fair value through profit or loss would correctly reflect economic reality.

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?

The PASC supports the approach to present the "building block" components for insurance contracts as non-zero at transition date. Although some costs will be borne by insurers, both the users of financial statements and the insurers will benefit from this proposal. The transition proposal, inter alia:

- helps the users of financial statements to assess the performance of the entity,
- introduces greater comparability between entities over time,
- reflects better economic dynamics in the financial statement just after applying new standard,
- increases and deepens understanding of the new methodology by insurers (when they need to apply retrospective approach) and should decrease future errors in valuations.

The PASC agrees that the simplified approach for retrospective calculation of "building block components" is a better way to appropriately reflect reliability of financial statement rather than to set CSM to zero at transition date. However, the PASC notes that it would be useful to provide more guidance in the standard itself on what kind of simplifications could be used and what should be done if there was a business combination in previous years.

Moreover, we recommend that IFRS 9 and the new standard for insurance contract be applicable at the same time, in order to decrease operational costs and avoid problems with methodological complexity. Additionally, for the same reasons, the new standard for insurance contract should be applicable at nearly the same time as the Solvency II regime.

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.

In our opinion, the proposed standard as a whole would have a positive effect on transparency of the financial statements, in particular by introducing the concepts of fulfillment cash flow, risk adjustment, contractual service margin and insurance contract revenue. The new standard will also reduce the inconsistencies in insurance accounting.

However, at this moment it is very difficult to estimate the total cost of implementation of the new standard and to tell if the costs of complying with the proposed requirements are fully justified by the benefits that the information will provide. Some of the proposals will probably will be very costly to implement (e.g. preparing models for building block valuation, transitional phase valuation, insurance contract revenue valuation). Aside from significant implementing costs to be incurred by insurers, one must not forget about the costs to the users of financial statements stemming from their efforts to understand the information produced (especially "building block" concept, effect of applying "mirroring approach", or interest expense in profit or loss proposal). Nevertheless, in our opinion, the costs are justified by the potential benefits in a long term perspective.

However, the PASC is not convinced if the benefits from the “mirroring approach” concept would justify the costs of implementing a complex methodology and the costs of educating the users in proper understanding of the information included in the financial statement (taking into account possibly reduced comparability among products).

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?

The PASC would welcome more detailed examples in the following areas:

- valuation and recognition of cash flows that vary with asset returns but are not eligible for the mirroring approach.
- the way in which an entity chooses to decompose cash flows and determines the underlying assets for the mirroring approach.
- the recognition of changes in the statement of the financial position and profit or loss items when the insurer applies the mirroring approach,
- recognition of premium receivables are recorded under IFRS 4,
- recognition of “pre-coverage” cash flows in the financial statement,
- recognition of cash flows arising from reinsurance in the financial statements,
- measurement of the liability for incurred claims under the Premium Allocation Approach

Additional comments regarding the Exposure Draft.

(1) Risk adjustment: Diversification benefits

The PASC notes the change from the 2010 ED. The revised ED does not limit the recognition of diversification benefits, that could result in different risk adjustment calculations with potentially material impact on the value of insurance liabilities.

We recommend to establish a reasonable set of restrictions on diversification benefits for the risk adjustment calculation, taking into account:

- policy inception date,
- insurance coverage term,
- type of risks identified in the insurance contract,
- estimated volume of risks identified in the insurance contract.

(2) Discount Curve to adjusting for the time value of money

The PASC notes that the current ED provides an option for entities to apply either a top down or a bottom up approach to measure the discount rate, even though in reality these two approaches will not give the same result. Such flexibility could be an incentive for insurers to choose a discount rate that will give better financial results of the entity, especially as the ED does not forbid to change approaches. We think that this will again reduce comparability between entities. The comparability will be also reduced because entities will apply different methods in the calculation of discount rate under both approaches.

In our opinion, the IASB should determine the requirements as for when the entity could change the previously chosen approach for the calculation of the discount rate. Any change of the approach should be recognised as a change in the accounting estimates.

(3) Disclosure of the Confidence level

The PASC does not agree with the provision in paragraph 84 of the ED, which requires insurers to disclose implicitly the confidence level to which the value of the risk margin calculated by other technique corresponds. It could indirectly encourage insurers to use the confidence level method and by this avoid the requirement to perform additional calculations. The PASC notes that this requirement indirectly suggests that the confidence level approach is the default method and is superior to all other methods.

(4) Contract boundaries

The PASC acknowledges the need to introduce a more detailed restriction and examples in relation to contract borders. Based on Solvency II experience, we predict that there will be many misunderstandings and much confusion in this regard.

(5) IFRS4 *versus* Solvency II

As ED and Solvency II use the same definitions of some elements used for calculating of the insurance liabilities (e.g. "best estimated", "risk margin") but the way of calculation is different we see a risk in possible misunderstanding of the statement of the financial position and profit and loss that can contain both figures.