

30 January 2004

The Director – Accounting & Professional Standards  
Institute of Chartered Accountants of New Zealand  
P O Box 11 342  
WELLINGTON

Dear Sir

**Exposure Draft FRS-34A: *Life Insurance Activities***

**Introduction**

The New Zealand Society of Actuaries (the Society) welcomes the opportunity to comment on the Exposure Draft FRS-34A.

The Society is a professional body to which all qualified actuaries in New Zealand belong. Actuaries have a close involvement with all aspects of the life insurance industry including a number of legislated responsibilities under various Acts governing life insurance companies.

The Society generally supports the proposals of FRS-34A. There are, however, a number of instances where we feel the requirements of FRS-34A are at odds with the framework for international accounting standards as set down by the International Accounting Standards Board or that the Exposure Draft could be improved. These are discussed below.

We are aware that the Exposure Draft FRS-34A has been produced in the light of the requirements of Exposure Draft ED5: *Insurance Contracts* issued by the International Accounting Standards Board. As FRS-34A refers to ED5, along with other International Financial Reporting Standards, we comment on provisions of these standards where we consider it necessary.

**Comments on FRS-34A**

1. In general we are supportive of the aims and proposals of FRS-34A.
2. Throughout FRS-34A (and ED5) there are references to the word “significant”. How this is to be interpreted is not obvious in all cases. Although there are generally accepted accounting interpretations that are applied in regard to materiality, we believe more guidance should be provided on the interpretation of “significant”.
3. At present FRS-34 allows discounting of deferred tax assets and liabilities. This will be removed under FRS-34A. We do not support this proposed treatment. Under ED5, and the framework set down by the IASB, assets and liabilities relating to insurance contracts are to be measured at fair value. To not allow discounting of deferred tax assets and liabilities is to value them at other than fair value. Other assets and liabilities are being valued, in theory, as the present value of future cashflows. Taxation should be treated in exactly the same manner.

We are aware that the accounting treatment of taxation will be approached from a balance sheet perspective. It has been argued that this supports a no discount approach to tax assets and liabilities as other assets and liabilities are already discounted. So, the argument goes, applying tax to the movements in the balance sheet will produce a discounted taxation position. This argument is mathematically false. The issue for discounting of tax assets and liabilities is turnover of assets (in effect, a company has accrued tax in relation to unrealised capital gains or losses up to the reporting date – how long will it be before that gain is realised and the associated tax becomes payable?). An assumption regarding turnover rates of assets is not required to value any other assets or liabilities, so it is not possible that the appropriate discount has been applied to tax through the valuation of other assets and liabilities.

We acknowledge the difficulty in assessing turnover rates of assets. This is not, however, a reason to set the discount period to zero, which is what is achieved under a non-discounted approach. An assumption is being made, it is just at one extreme end of the range of possible assumptions.

This issue has been raised in Australia. We believe that the solution within New Zealand should be consistent with that adopted in Australia.

4. At present FRS-34 requires subsidiary investments to be valued at net market value. Under FRS-34A it is proposed that whilst this will be permitted for the life insurer entity itself, any excess over net assets will be required to be eliminated on consolidation. We have two concerns with this treatment:

(a) Under ED5 assets and liabilities relating to insurance contracts are to be measured at fair value. The proposed treatment for subsidiaries is inconsistent with this requirement.

(b) To the extent that the investment in the subsidiary relates to liabilities where the value of the liability is linked to the value of the underlying assets, such treatment will lead to, on consolidation, an inconsistency between the measurement of the assets and the liabilities.

There are a number of possible solutions. One is to allow subsidiaries to be valued at fair value to the extent that they relate to liabilities whose value depends on the value of the underlying assets. Whilst this does not deal with (a) above, it would remove the problem noted in (b). We note, however, that this will potentially allow companies to manage the value of their assets by allocating them to particular contract types. Alternatively, liabilities could be adjusted on consolidation by an amount consistent with the required adjustment to the value of the assets.

We note that the corresponding section of AASB ED 122B requires the use of fair values for investments in subsidiaries. However concern has been raised over the creation of differences between parent and consolidated accounts under the Australian approach. A consistent approach to the problem is recommended.

5. Paragraph 8.5 (c) of FRS-34A has been altered such that the requirement to capitalise the effect of changes to the discount rate no longer applies to contracts that are not participating or where the amount of the liability is not dependent upon the amount of the assets that support the liability. We do not agree with this change. Under the framework, the fair value of a liability should be determined with reference to discount rates applying at the time. The change noted forces a smoothing of the effect of changes to the discount rate applying to risk products over the remaining lifetimes of those policies. This is neither consistent with the valuation of the assets nor the wider fair value framework.

To illustrate, consider an annuity portfolio matched with government bonds. Clearly the value of the assets and liabilities should move in harmony. The proposed change will not allow this, effectively introducing a mismatch profit or loss where no mismatch exists.

6. We harbour concerns over the level of detail contained in the paragraphs dealing with discount rates. We note that much debate is still occurring regarding discount rates, even how to determine what a risk-free discount rate is. Further, there are significant questions about the appropriate treatment of investment expenses and taxation when risk free rates are being applied. Given this, the level of detail contained in these paragraphs seems excessive. We would prefer this to be removed. The reference to actuarial guidance on this topic is appropriate.

We note that currently the draft standard includes a detailed description of the discount rates to be adopted and then refers the reader to actuarial guidance in adopting discount rates. It appears unnecessary to have both. Thus we recommend that no reference be made to risk-free or other discount rates. The reference to actuarial guidance and standards on this topic should be sufficient.

This section is quite different to the corresponding section of the Australian draft standard. We believe these should be harmonised.

7. We harbour concerns over the disclosure requirements contained in ED5 which are required by FRS-34A. Whilst in principle we support more full disclosure, the requirement to disclose the quantum of all material assumptions would force companies to disclose information that many would consider to be highly confidential. For example, we do not believe many companies would happily disclose their unit expense assumptions. We are unaware of any other industry in New Zealand where such disclosure is required.

Further, when FRS-34 was first applied, companies made significant disclosures as required, but this has gradually given way to less and less disclosure over time. Given this, and the nature of some of the additional disclosures required by ED5, we recommend that guidance as to the disclosures required be incorporated to remove doubt and help achieve consistency across the industry. In particular we consider that the requirements of paragraph 28 of ED5 are unclear.

8. Investment contracts are to be accounted for under IAS 39. Whilst we agree with this in principle, we have concerns regarding the treatment under IAS 39:

- (a) IAS 39 does not permit the deferral of full acquisition costs.
- (b) Fair value is subject to a minimum of the surrender value under the contract.

These requirements will act to cause companies to report losses on sale, regardless of the inherent profitability of the contracts sold. Further, the treatment of acquisition costs here is inconsistent with that under FRS-34A as applies to insurance contracts. We are not able to discern a viable argument for this inconsistency.

9. Financial instruments with discretionary participating features are, under ED5, to be accounted for under insurance accounting policies. Whilst we support this, we note the required application of IAS 39 to the fixed element of such financial instruments. Again this is in principle supported, but we do not support the application of the IAS 39 measure as a minimum on the full instrument. This effectively places a form of surrender value minimum on the insurance element of the contract which, as is noted in point 8 above, we are opposed to. We further note the technical difficulty of applying such a contract based minimum under MoS, which is a portfolio based valuation approach (profit margins are not set at individual contract level but rather at related product group level).

10. We note a number of areas where the wording in FRS-34A differs from that of the Australian equivalent standard AASB ED 122B. We consider it to be in the best interests of both users of financial reports and the industry that these differences be removed.

### Specific Matters for Comment

You have asked for comment on a number of specific matters. The Society is pleased to respond to that request, using the same numbering as in your discussion paper.

1. **Scope.** The Society agrees with the scope as detailed in FRS-34A. In particular we support the proposal that all insurance contracts issued by a life insurer be accounted for under FRS-34A.
2. **Assets.** The Society agrees with the proposals to require all assets to be measured using the fair value option in the relevant standards. We agree with the proposal referenced in (a). We agree in principle with the proposal referenced in paragraph (b), although we do not agree with the requirement for the application of the surrender value minimum to investment contracts contained in IAS 39. We believe this should be raised with the IASB. In terms of (d), we refer you to our point 4 above.
3. **Discount Rate.** The Society agrees in principle, but notes that there is continuing debate regarding this issue, including over the definition of risk-free rate. We would prefer that reference to risk-free rate was removed and the requirement to adhere to actuarial guidance and standards was made mandatory.
4. **Deferred Tax.** The Society disagrees with the proposal not to discount deferred tax assets and liabilities. The proposal is inconsistent, in that it is not fair value, with the measurement of other assets and liabilities.
5. **Life Insurance Consolidation.** We refer you to our point 4 above.
6. The Society considers that the transitional arrangements will provide sufficient guidance.
7. The Society is not aware of any reason to have any additional material in respect of public benefit entities.
8. The Society is not aware of any regulatory or other issues arising in the New Zealand environment that may affect the implementation of the proposals.
9. Such issues are identified above and in 10 below.
10. The Society in principle supports the adoption of FRS-34A, subject to the concerns raised above. We harbour, however, significant reservations regarding the direction of the international debate on fair values. If the debate continues in its current direction, then we question the usefulness of the results that will be produced. In particular we are strongly opposed to fair values being subjected to a minimum of the surrender value under a contract, which appears to be a strong likelihood. If this is the case, we will revert to the situation where companies selling profitable business will report a loss on sale. This is not an aid to the users of general purpose financial reports and will represent a retrograde step for New Zealand accounting standards. We are thus opposed to the adoption of international accounting standards without resolution of this issue.

As has been noted in a number of places above, there are a number of differences between the Australian draft standard and FRS-34A. We do not believe it to be in the best interests of the users of financial statements to allow these differences to continue.

### **Further information or consultation**

The Society would welcome the opportunity to meet and discuss our submission or provide any further information required. To arrange this please contact:

Herwig Raubal  
Convenor, Life Insurance Committee  
New Zealand Society of Actuaries

Direct Dial      (04) 498 5459  
e-mail            [herwig.raubal@nz.towerlimited.com](mailto:herwig.raubal@nz.towerlimited.com)