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To: Andrea Pryde, IASB

17 October 2013

Dear Andrea

Further Exposure Draft on Insurance Contracts

I am writing to meet your deadline of 25 October for comment on the further Exposure Draft issued in June 2013. This letter complements the letters I wrote on 30 November 2010 about the earlier Exposure Draft on Insurance and on 21 October 2010 about the Exposure Draft on Revenue Recognition (as the issues are intimately interlinked).

Since then the working paper I referred to there has now been published as:

> Horton, J., Macve, R.H. and Serafeim, G. (2011), ' "Deprival value" vs "fair value" measurement for contract liabilities: how to resolve the "revenue recognition" conundrum?'. *Accounting & Business Research*, Vol. 41 (December) Issue 5, p491-514.

I am pleased to see that the new ED's proposals on presentation of insurance contract revenue and expense (Snapshot p.5; p.9) more closely reflect the arguments in that paper; and that the proposals on determination and presentation of interest expense largely reflect the arguments in:

> Horton, J. and Macve, R., (2000) ' "Fair value" for financial instruments: how erasing theory is leading to unworkable global accounting standards for performance reporting', *Australian Accounting Review* (July), pp.26-39

and in:

> Horton, J. and Macve, R. (1996), 'The "Amortized Cost" Basis for Fixed-Interest Investments: A Note on Economic, Actuarial and Accounting Concepts of Value and Income', in I. Lapsley (ed.) *Essays in Accounting Thought: A Tribute to W.T. Baxter* (Edinburgh: ICAS), pp.127-155. (ISBN: 1-871-250439)

However, there is still much conceptual confusion between the approaches proposed in the insurance project, the revenue recognition project, the fair value measurement project, the leasing project and the measurement phase of the conceptual framework project. While these all have common issues about liabilities that are still to be resolved, that project has been suspended. So we have here a 'fix' that revisions to estimated profit margins are now to be 'spread' over the remaining policy life, without any clear theoretical basis (cf. Horton *et al*., 2011). I therefore still believe that a fresh start is needed to remove the bafflement that must currently face many of your constituents. Academics, with no vested interest in the final outcome of the Board's deliberations,

may well be the only ones who lose no face by protesting that they simply cannot make sense of both Boards' overwhelmingly voluminous and inconsistent pronouncements.

As argued in our *ABR* 2011 paper, a principles based approach to insurance accounting needs to start from rigorous micro-economic analysis of how markets behave. Now that the constraint of ensuring agreement with FASB's proposals has been lifted, this IASB insurance project, which rightly abandons fair value (FV) in the terms in which it has previously been narrowly defined by FASB/IASB, now needs to go back to the drawing-board (alongside the other projects) to give proper consideration to the broader concept of 'deprival value' (= 'relief value' for liabilities), which the Boards have so far failed adequately to address. This would enable removal of a lot of the confusing 'conceptual' argument paraded in the various Exposure Drafts and other papers on related projects. [The brief, dismissive discussion of deprival value (at 6.42-43) in the July 2013 *Conceptual Framework* Discussion Paper is at a very low level, and ignores liability measurement, while paradoxically that same DP (CF Snapshot p. 6) argues that selection of an appropriate measurement basis should require consideration of 'how the asset contributes to future cash flows or how the entity will fulfil or settle the liability', for which deprival value/relief value must be the closest fit.][1]

While many difficult issues remain, it would also provide a sound conceptual basis, which is currently lacking, for continuing with much of present GAAP and in particular with much of the current format of income statement presentation for insurers (Horton *et al*., 2011).

However it is important to note that the value to users of developing a new, more complex (Snapshot p. 4) insurance accounting standard—that attempts to retain traditional accounting approaches as far as possible while adapting them to more market oriented factors—is limited and may not be worth the learning and transition costs. Indeed, as argued in our commentary on the 2007 Discussion Paper,[2] the case has not been made by IASB that 'fair value' is materially different from the full-blown Market Consistent Embedded Value basis developed by the CFO Forum in their insurance reporting guidelines and now widely adopted around the world (except in the US): http://www.cfoforum.nl/downloads/MCEV_Principles_and_Guidance_October_2009.pdf . The stock market evidence is that it is this reporting basis that investors find useful in reducing information asymmetry between preparers and investors,[3] so it is not clear that a new insurance standard would have any comparative advantage.[4]

Happy to discuss further.
Please acknowledge.

Best regards

(signed electronically)

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[1] Following Baxter, deprival value may be defined as 'the adverse consequence of deprival on the present value of all future cash flows, given the optimal response decision' (e.g. Macve, R. (2010). 'The case for deprival value'. In 'Wanted: foundations of accounting measurement', EAA Symposium, Tampere 2009. *Abacus*, 46(1): 111-119).

[2] Horton, J., Macve, R. and Serafeim, G. (2007), *An Experiment in 'Fair Value' Accounting? The State of the Art in Research and Thought Leadership on Accounting for Life Assurance in the UK and Continental Europe* (London: Centre for Business Performance, ICAEW).

[3] Serafeim, G. (2011) "Consequences and Institutional Determinants of Unregulated Corporate Financial Statements: Evidence from Embedded Value Reporting." *Journal of Accounting Research* 49, no. 2 (May).

[4] See e.g. Macve, R. (2010). 'Conceptual frameworks of accounting: some brief reflections on theory and practice'. *Accounting and Business Research*, Vol.40. No.3: 303-308.