

Ms Françoise Flores
Chair of the
European Financial Reporting Advisory Group
35 Square de Meeûs
B - 1000 Brussels
BELGIUM

Ref
F 2

Phone extension
-5430

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**EFRAG Research Paper:
The role of the business model in financial statements**

Dear Ms Flores

As the German Insurance Association (GDV) we welcome the opportunity to comment on the Research Paper "The role of the business model in financial statements" which we consider to be a valuable contribution to the ongoing debate regarding the Discussion Paper DP/2013/1 "A Review of the Conceptual Framework for Financial Reporting" ("the DP") published by the IASB on 18 July 2013. We encourage the EFRAG to share the outcome of the final TEG's deliberations on comments received on this Research Paper with the IASB for consideration when working on the upcoming Exposure Draft of a revised Conceptual Framework.

The objective of IFRS financial statements is to provide relevant information about financial position and financial performance of the reporting entity. Especially an appropriate performance reporting is of utmost importance for long-term oriented insurers. We appreciate the considerable efforts undertaken by EFRAG to make evident that an appropriate consideration of the underlying business model is essential for IFRS standards to achieve financial statements being relevant for investors.

The Conceptual Framework is of strategic importance as basis for consistent development of principle-based IFRS standards. While we respect the strategic decision of the IASB to *not* develop industry specific standards, we believe that **the business model concept should play an essential role in financial reporting**. Therefore, the revised Conceptual Framework should explicitly consider this matter and should make a conceptual distinction to management intent. We acknowledge that further work still needs to be undertaken with regard to what exact role the business model should play from the perspective of preparers regarding recognition, measurement, presentation and disclosure. In general, we do not believe that business model should become an 'overriding character'.

Gesamtverband der Deutschen
Versicherungswirtschaft e. V.

German Insurance Association

Wilhelmstraße 43 / 43 G, D-10117 Berlin
Phone: +49 30 2020-5000
Fax: +49 30 2020-6000

51, rue Montoyer
B - 1000 Brussels
Phone: +32 2 28247-30
Fax: +32 2 28247-39

E-Mail: h.saeglitz@gdv.de

www.gdv.de

In more general, we appreciate the proactive work of EFRAG as an important European contribution with the objective to achieve a high-level and consistent Conceptual Framework as a stable conceptual basis for globally applicable principle-based IFRSs. In addition, we consider the EFRAG's contribution to be fully in line with the objectives of the new 'Regulation (EU) No 258/2014 of the European Parliament and of the Council of 3 April 2014 establishing a Union programme to support specific activities in the field of financial reporting and auditing for the period of 2014-2020 and repealing Decision No 716/2009/EC'. In particular, the Article 9 (4) of the Regulation requires the European Commission to evaluate on year-by-year basis whether IFRS standards take due account of **different business models**, reflect the actual consequences of economic transactions, are not overly complex, and avoid artificial short-term and volatility biases.

Regarding the specific Question 3.3 on Insurance Example we believe that it describes certain significant modifications of **a unique stable business model of insurers**. Our rationale is provided in appendix (attached).

We hope that our comments will help EFRAG in reaching final conclusions with respect to the issues raised in the Research Paper. If you would like to discuss our comments further we would be delighted.

Yours sincerely,



Dr. Axel Wehling
Member of the Board
German Insurance Association



Hans-Juergen Saeglitz
Head of Accounting
German Insurance Association

1. The importance of the business model consideration in IFRS financial reporting

The revision of the 'Conceptual Framework' is a project of strategic importance for the future of IFRS accounting. In particular, the defined role of fundamental accounting principles and the conceptual foundation of approaches for recognition, initial and subsequent measurement, presentation and disclosure will be decisive for the interaction between the Conceptual Framework and particular standards or specific interpretations.

While respecting the strategic decision of the IASB to not develop industry specific accounting requirements, we strongly believe that the inherent interaction between the requirements of different standards requires sufficient consideration. The business model concept can be seen as a valid basis for such assessment. The main question in focus is if the produced financial statement at large is faithfully representing the underlying economics of the reporting entity (e.g. an insurer) as the objective of financial reporting in IFRS is to provide decision-useful information (through fair presentation and compliance with IFRSs' requirements). In general, the traditional approach of the IASB to focus primarily on single items in isolation (e.g. financial instruments) might not always ensure that presented information at large reflect the underlying economics. To achieve the objective of fair presentation the underlying business model should be reflected in the financial statement. Therefore, the IASB must explicitly apply the business model thinking when developing specific standards. Especially, the business model notion included in the Conceptual Framework only would not be sufficient enough as the fair presentation principle does not constitute a general 'overriding principle'. The exception of IAS 1 paragraph 19 can be used only in 'extremely rare circumstances'.

We believe that the revised Conceptual Framework should not artificially limit the possibilities of the IASB to reflect different business models across industries. The aim of the Research Paper to clarify which key characteristics can be used as criteria on the standard level to identify different business models is the approach the GDV supports. We especially appreciate the extensive systematic survey regarding the current (explicit and implicit) use of business model notion as it demonstrates its established importance in IFRS accounting.

In our view, the revised Conceptual Framework should also provide support to preparers when exercising judgment. Therefore, we support the explicit consideration of the linkage between the concept of relevance and the business model concept. We understand that the business model notion is not intended to allow users for overriding the requirements of specific standards. We believe however that the financial statements can be made relevant only if taking into account the underlying business model. Thus, both concepts are supplementary but only the IASB should be entitled to decide how the different business models would be considered when developing specific accounting provisions.

2. The consideration of different business models within a single IFRS

As explained above, the business model should play an essential role in defining the specific accounting requirements as different measurement of similar items might be necessary when considering different strategies for business activities or regulatory circumstances. Therefore, the revised Conceptual Framework should not recommend measuring all assets and liabilities on the same basis as assets might not contribute to future cash flows in the same way and liabilities might be settled or otherwise fulfilled depending on the underlying business model.

The GDV supports the mixed measurement approach which includes the use of cost-based measures and current measurement approaches (e.g. current market prices or current fulfilment values) when appropriate. The “appropriateness decision” regarding the applicable measurement basis should be taken at the standard level. We agree however with the IASB’s preliminary view in the DP that the number of different measurement basis used should be limited to the smallest number necessary to provide relevant information. The number of different business models must be also limited; the conceptual granularity of different business models must carefully considered.

The following two cases demonstrate that explicit consideration of specific circumstances within a particular IFRS is essential to achieve an understandable depiction of financial performance and to ensure a faithful presentation of financial position of the reporting entity:

- IFRS 9 Financial Instruments

IFRS 9 is a non-industry specific standard. Therefore, it needs to cover the needs of all industries (i.e. insurers, banks, general industry). The GDV supports the Board’s decision to allow the fair value through other comprehensive income (FVOCI) category. Irrespective of its narrow scope the FVOCI category robustly fills in the gap which existed before the *limited Amendments* ED on IFRS 9 was implemented. The revised mixed measurement approach in IFRS 9 makes it acceptable, although further adjustments would make it even more robust. The business model reference as a basis for the accounting for financial instruments in IFRS 9 needs however an appropriate conceptual foundation to avoid the misleading conclusion that IFRS 9 creates an exception required by the insurance industry rather than a consistent application of the business model thinking.

- IFRS 4 Insurance Contracts (Phase II)

It is not appropriate to treat every option or guarantee as a stand-alone derivative and to recognise any value changes immediately in profit or loss in every case. In particular, the options and guarantees

embedded in insurance contracts represent a future service to policyholders which is represented by the contractual service margin (CSM). Consequently, changes in value of options or guarantees should be offset against changes in the CSM to achieve a faithful presentation in the balance sheet.

Furthermore, it is obviously not appropriate to recognise artificial short-term volatility in profit or loss when it is not in line with the underlying business model. Consequently, the IASB decided to use the other comprehensive income (OCI) presentation as an essential element to ensure a suitable performance reporting in profit or loss (i.e. without market noise). As the OCI presentation is not appropriate for every type of insurance contracts, the IASB decided to allow for an optional use of OCI presentation, designed as an accounting policy choice.

These specific examples above make evident that any non-industry specific IFRS shall consider the different business models different industries might have. In addition, the appropriate depiction of the economic reality can be only achieved if the requirements of particular standards are consistently designed.

Furthermore, the examples above demonstrate also that measurement provisions for the balance sheet cannot be considered in isolation. It is essential to consider how the remeasurements influence the income statement and statement of other comprehensive income. *For example*, the FVOCI-category combines the current exit value measurement in the balance sheet with the amortised cost view within the income statement where the cumulative effect between the both approaches is reflected in the OCI. The holistic view ensures a high level of transparency in information provided.

3. The consistent interplay between different IFRSs is decisive

We acknowledge and appreciate the efforts regarding the exploring of the relevance of the business model consideration in single standards. However, the Research Paper does not contain an explicit consideration of how to ensure an appropriate accounting treatment of business models where two or more different non-industry specific IFRS standards apply. Their consistent interaction might be crucial to achieve a faithful presentation of financial position and a meaningful presentation of financial performance on reporting entities.

We highly appreciate the EFRAG's outreach activities and deliberations regarding the need for a holistic accounting solution for long-term investment business models (i.e. *liability-driven* versus *asset-driven* business models) as a useful conceptual contribution to the IASB's deliberation on the Conceptual Framework. Nevertheless, we continue to be concerned that the measurement or presentation inconsistencies might continue to exist when the inherent interaction between different standards are not considered appropriately by the IASB. We encourage EFRAG to accompany the IASB in related efforts as a simple inclusion of some discussions on the relevance of business model consideration in the Conceptual Framework would not be sufficient.

We recommend further advanced conceptual considerations as unaligned accounting provisions which do not take the existence of asset-liabilities management strategies sufficiently into account would lead to significant accounting mismatches. Insurers will have to apply current measurement model for insurance contracts (IFRS 4 Phase II) and a mixed measurement model on the asset side (e.g. IFRS 9 Financial Instruments, IAS 40 Investment Property), and would be forced to use either the full fair value approach (to stabilize the equity) or the amortised cost measurement (to stabilize the income statement).

The highly appreciated IASB's decision to allow the FVOCI category for simple debt instruments in IFRS 9 only approaches the most significant part of missing consistency with IFRS 4 Phase II. In our letter from 29 January 2014 we have shared our concerns with EFRAG regarding the IASB's decision to close the Board's deliberations on IFRS 9 although we had clearly demonstrated that:

- Explicit FVOCI option for simple debt instruments in amortised cost category in IFRS 9 is necessary to avoid accounting mismatches and equity volatility.
- Recycling for equities measured at FVOCI in IFRS 9 is necessary, especially to avoid distorted income statement presentation.

Regarding both cases we kindly refer to our detailed rationale provided in our letter to EFRAG. In our view, holistic business model thinking might help to avoid neglecting valid concerns in the standard setting process.

4. The insurers' business model and inherent interplay between IFRSs

The key characteristic of insurance business model is that insurers are providing risk protection to policyholders in exchange for premiums. Insurers manage the risk by following the law of large numbers which allows spreading the risks over policyholder ('group-balance concept') and over long periods of time. For this primary reason insurers are managing portfolios of financial assets with the objective to meet the obligations towards policyholders which are to large extent long-term and predictable with stable cash flows profiles.

Question 3.3 - Insurance Example

In our view the Insurance Example does not describe different business models. It refers to **one unique stable insurance business model with certain variations** (i.e. life or non-life; with or without participation in investment returns, administrative cost savings or risk result). All the possible (more or less significant) modifications of the unique insurers' business model have one common ground which is the existence of core underlying characteristic of the insurance business: *risk protection* and *group-balance concept*. They both constitute the observable, identifiable and distinguishable insurance business model as a matter of fact.

Furthermore, the unique insurers' business model is independent of the legal form or if provided by the same entity or group. The regulatory provisions might however require separating the different variations of the same business model in different classes of business. Also the regulatory requirements might influence the way if and which of the potential participation features are to follow and which particular products are not allowed.

In general, we advocate that all insurers should have the ability to appropriately reflect their business model with existing more or less significant modifications regarding products (e.g. regarding participating features). Otherwise unnecessary distortions in profit or loss and/or equity presentation will appear.

We want to note that the appropriate consideration of the business model does not require industry specific standards. The Business model thinking would allow IASB however to detect inadequateness of not industry specific requirements, especially when consistency of standards' provisions is crucial. As highlighted in section 3, especially two standards are of crucial relevance for insurers: IFRS 4 Phase II and IFRS 9. Although the significant shortfalls of the initial exposure drafts were already observable when considering them in isolation, the clear rationale and the urgent need for significant adjustments became obvious when considering their inherent interplay. The crucial need for consistent interrelation of these two standards exists because of the specific nature of the business model of insurers and the relevance of an appropriate performance presentation.

5. The predominant relevance of performance reporting

The objective of financial statements is to provide reliable information about financial position and financial performance of the reporting entity. Especially the financial performance needs to be presented in line with the nature of the business model and character of related business activities. We support the view that 'primary financial statements' should be looked at together. Nevertheless, the income statement continues to have a special relevance for investors and other users of financial statements. This observation might be the main outcome of the controversial discussions in the past regarding an appropriate presentation of financial performance of long-term oriented business models like the insurers' one. In particular, the overwhelming majority of constituents explicitly disagree that the 'full fair value accounting' is the preferable approach to implement.

Therefore, for example, current fulfilment value measurement of insurance contracts (IFRS 4 Phase II) needs to be accompanied by appropriate presentation of current value changes in other comprehensive income (OCI). The desirable consistency in current accounting treatment for financial assets can't be achieved via forcing insurers to use the full fair value approach as it would result in artificial market driven volatility in the income statement. As not in line with the stability of the long-term perspective of the underlying business model, economically inappropriate volatility should not distort the statement of profit or loss. It needs to be presented transparently in OCI. The IASB made a conceptually consistent decision to explicitly acknowledge this aspect and allowed the FVOCI-category for debt instruments in IFRS 9 and OCI presentation for interest rate driven volatility in insurance contracts current valuation in IFRS 4 Phase II.

Unfortunately, as mentioned in section 3, there are still some critical adjustments to be made to achieve a more consistent reflection of the insurers' business model: the need for recycling for equities measured at FVOCI becomes obvious when considering the required accounting for policyholders' participation (i.e. to expense the policyholders' share when the gains are realised). Also the need for a FVOCI option for financial instruments categorized at amortised cost becomes evident when considering the requirement for current measurement in IFRS 4 Phase II.

We continue to argue that current measurement in the balance sheet leads in many significant cases to inappropriate volatility in profit or loss which would not provide useful information about the underlying economic performance of the reporting entity. In addition, the 'full fair value approach' leads unavoidable to too much focus on short-term and/or market-driven volatile results. We favour an accounting approach which allows a meaningful presentation of underlying economic performance without market noise in the income statement. The transparent OCI presentation is suitable to be utilized for this purpose, i.e. to address the significant concerns regarding economically inappropriate volatility in income statement.

6. The essential role of the OCI presentation when accounting for long-term oriented business models

We share many observations as expressed by EFRAG in letters towards IASB and European Commission regarding long-term investment business models in financial reporting (25 October 2013). And we expect the IASB to consider this valuable contribution when deliberating the Exposure Draft on the revised Conceptual Framework. In our view, any accounting requirements should consider the specific characteristics of long-term oriented businesses. And any unintended negative consequences for the economy and stability of financial system should be avoided in line with the spirit of the 'Regulation (EU) No 258/2014 of the European Parliament and of the Council of 3 April 2014 establishing a Union programme to support specific activities in the field of financial reporting and auditing for the period of 2014-2020 and repealing Decision No 716/2009/EC' (Recital 12). In particular, the Regulation requires the Commission to especially consider on year-by-year basis whether IFRS standards take due account of different business models, reflect the actual consequences of economic transactions, are not overly complex, and avoid artificial short-term and volatility biases (Article 9 (4)). We fully support this specific requirement.

In general, accounting requirements based solely on the full fair value approach and leading to market noise in income statement is not in line with stable insurers' business model. The short-term volatility created by current measurement for items in the balance sheet is not useful for users and thus decreases the quality of performance reporting. The OCI presentation creates an added value for users as it helps to transparently identify sustainable components of the return in profit or loss and provides transparent information about the other influences in OCI. Irrespective of the conceptual approach in the final Conceptual Framework the IASB might agree on, the OCI presentation should remain available as a key element to achieve a meaningful and transparent presentation of insurers' financial performance. In particular, the income statement must reflect the long-term nature of insurance business by reporting only realised returns for services provided. The related fair value changes of underlying assets need to be reported in OCI and should not destroy the profit or loss presentation until the moment of their realisation. Therefore, the GDV continues to support the both-side approach for consistent OCI presentation as crucial in a current valuation environment; it combines a transparent presentation of financial position in the balance sheet and appropriate presentation of financial performance in the income statement.

The recent IASB's conclusions on insurance contracts project and introduction of the FVOCI category for debt instruments demonstrated that consequences of the current measurement approach are taken into account by the IASB. It is appreciated as only consistent consideration of inherent interaction between assets and liabilities can ensure that acceptable solutions without artificial accounting volatility are developed.

7. Consequences of the business model consideration for disclosure requirements and their enforcement

Reporting financial information imposes significant costs on preparers. It is essential that those costs are justified by the benefits of providing that information to users. We welcome the efforts undertaken recently by the IASB to address the significant concerns regarding the continuously growing disclosure requirements being developed by the IASB in isolation on a standard-by-standard-basis. The 'information overload' is a very important issue which needs to be addressed in the near future.

In our view, to successfully address the 'information overload' issue it is crucial to define what the objective of the notes within IFRS financial statements is. This would allow specifying the relevant disclosure requirements. We believe that the main purpose of notes is to supplement the primary financial statement by providing additional information.

Furthermore, the disclosure requirements should consider the specific characteristics of different business models, different users' expectations and different environments in which the reporting entities are operating. For example, insurers are a highly regulated industry. Thus, any additional burden with regards to disclosure requirements should take into consideration what kinds of information are already available from other sources (e.g. regulatory disclosure requirements).

We are however concerned about the potential unintended consequences regarding how the business model based disclosure requirements might be enforced by statutory auditors or public authorities (e.g. like the European Securities and Markets Authority, ESMA). The recent Consultation Paper "ESMA Guidelines on Alternative Performance Measures" as from 13 February 2014 (ESMA/2014/175) demonstrated the potential direction of excessive disclosure requirements if IASB's requirements are not standardised enough. Especially and also for this reason the conceptual granularity of different business models should not be too low causing potential concerns regarding comparability of information provided.

Regarding our critical views on the ESMA [draft] Guidelines on the use of Alternative Performance Measures in more detail we kindly refer to our comment letter to EFRAG from 25 April 2014.