

2 February 2016

Mr John Stanford  
The Technical Director  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
529 Fifth Avenue, 6th Floor  
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Dear John

## **Consultation Paper: Recognition and Measurement of Social Benefits**

The New Zealand Treasury welcomes the opportunity to provide comments to the International Public Sector Accounting Standards Board on the Consultation Paper: Recognition and Measurement of Social Benefits.

IPSASB is to be commended for its efforts in tackling this project that is a very important aspect of public sector accounting, covering issues that are often contentious.

Since its previous consideration of this issue, the IPSASB has developed its conceptual framework, including its views on the users of financial reports and their information needs. We encourage the IPSASB to make use of this work; it is reflected in many of our comments.

We have attached our responses to the specified matters for comment.

Yours sincerely



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## ATTACHMENT

### 1. In your view:

- (a) Is the scope of this CP (i.e., excluding other transfers in kind, collective goods and services, and transactions covered in other IPSASs) appropriate?
- (b) Do the definitions proposed for Social Benefits, Social risks, Social Benefits in Cash, Social Benefits in Kind, Reimbursements, Social Security and Social Assistance provide an appropriate basis for an IPSAS on social benefits?

Treasury appreciates the efforts of the IPSASB to ensure that the project is not too unmanageably wide, and that alignment occurs as much as possible with the GFS. However, we believe that the proposed scoping is:

- Insufficiently clear
- Creates boundary issues with other standards (both current and proposed)
- Invites the possibility that transactions with similar economic substance will be treated differently.

### *Insufficiently Clear*

Clarity issues in the scope of the proposed definitions involve:

- reliance on the term "social risks" which means that only benefit payments made to address "events or circumstances that may adversely affect the welfare of individuals and households" (per GFS definition) are included within the scope. There seems little rationale to exclude benefit payments being made to take advantage of opportunities. Such a distinction would require preparers and auditors to debate this distinction, for example whether a job seeker benefit provides an opportunity to the recipient or reduces their risk. Such debates have little merit in affecting accounting treatment.
- the distinction is unclear between social benefits in kind (in scope) and other transfers in kind (not in scope).
- the proposed definition of social benefits being limited to benefits being provided to individuals and households, whereas the proposed definition of social benefits in kind brings into scope the reimbursement for the costs incurred for the provision of benefits in kind, which may be paid to corporates.
- the distinction between collective i.e. benefit payments related to public goods and services, and households i.e. benefit payments for the benefit of households is conceptual rather than an operationally practical distinction. Most public goods have private aspects and vice versa.

### *Boundary Issues*

As a consequence of the insufficient clarity of the definitions, if they stand, preparers and auditors will be trapped into resource wasting debates as to whether items are in or out of scope, and thus whether the putative Social Benefit standard applies, in contrast to IPSAS 19, or the standard that results from the non-exchange expense standard or some other standard.

### *Possibility of dissimilar treatments*

Not only are such avoidable costs unwelcome, the risk is exacerbated that transactions with similar economic substance will be treated differently and that transactions with dissimilar



economic substance will be treated the same, leading to reduced reliability and understandability of the financial statements.

In seeking a way to meet the IPSASB's desire to have a manageable project, the Treasury suggests that it would be helpful to focus less on the community purpose of the expenditure, and more on the economic impact of the expenditure on the entity reporting, i.e. on the rights and obligations for the entity arising from social benefit. It seems to the Treasury that this would be more in accordance with IPSASB's own conceptual framework.

There are a limited number of possibilities under this approach:

- Social benefits may be distributed with no residual rights retained by the public sector entity. Most income support payments will be in this category. If the *ex ante* criteria is met, the benefit is income to the beneficiary and the public sector entity has no rights or controls over how the beneficiary will spend it.
- Social benefits may be distributed with implicit *ex post* residual rights retained by the entity. This is most often effected through grant payments. If the grant is not used as intended, then the relationship between the grantor and grantee may change in the future, but any resulting consequences are not explicit at the time of the grant.
- Social benefits may be distributed with some explicit *ex post* residual rights retained by the entity. This is most often effected through a voucher system. The *ex ante* criteria are required before a voucher is issued, but only if the voucher is used *ex post* as intended, will the voucher be reimbursed by the public sector entity.
- Social benefits may be distributed without transferring any rights to the recipient. The individual recipient has little or no say in what services are provided, when or at what price. In such cases the in-kind services are controlled directly by the public sector entity. This may for example be the case with health and education services (and provides a much better basis for their exclusion if that is what IPSASB desires).

The economic substance of these four sets of transactions is different. It is feasible and practical to differentiate them. The IPSASB could clearly and validly decide which of these transactions should fall within this "Social Benefits" project and which of these transactions should be covered by the "Non-exchange expenses" project.

In terms of alignment with GFS, the Treasury suggests that the distinctions made in the GFS literature (e.g. to respond to social risks or to encourage social benefit, between social assistance and social security, between households and sectors supporting households etc) are matters of classification of items that may have a similar economic impact on the reporting entity. Consistency with the classification system of GFS should certainly be encouraged, but consistency with the classification decisions that statisticians make should not drive the scoping of IPSAS projects.

If the approach we are recommending is taken, then a revised title, to better reflect the IPSASB's scope, would be suggested. e.g. Transfer Expenses

## 2. Do you support?

- (i) The obligating event approach;
- (ii) The social contract approach; and
- (iii) The insurance approach.

**With reasons for your views, including the conceptual merits and weaknesses of each option; the extent to which each option addresses the objectives of financial reporting; and how the different options might provide useful information about the different types of social benefit.**

Treasury supports the inclusion in the statement of financial position of enforceable legal claims. Treasury also supports the inclusion in the statement of financial position of non-legally binding obligations where the nature of the promise, and the existence and effectiveness of commitment devices sufficiently reduce the reporting entity's discretion to avoid future outflows of resources, so that the reporting entity is effectively asserting that benefit recipients currently have a valid present expectation of receiving the benefit and the entity has a current obligation to them.

Treasury's view this is that long term fiscal reports provide information on current policies, and the balance sheet provides information on current resources, and current claims to those resources. In essence, it is the Treasury's position that the long term fiscal report provides information on the state of the "social contract" whereas the statement of financial position should limit itself to reporting the current financial position.

The Treasury considers there are grave dangers to the credibility of the information on the statement of financial position if its scope is expanded to provide information on future obligations (or outflows) based on current policies. Simple recognition of a social obligation in accordance with a broadly defined set of criteria in an international accounting standard is likely to provide a misleading view the impact of social benefits on the entity's financial performance and financial position.

Such a misleading view of the financial position arises because of scope issues which mean there would likely be inclusion of long term liabilities for some but not all social benefits, because of the complexity of different structural arrangements internationally and because of the exclusion of future taxation revenues expected to fund the future social benefit payments.

The Treasury considers that insurance accounting should be used where there are significant cash contributions in respect of a scheme, and these can be reliably measured, where the substance of the scheme is that the public sector entity accepts an obligation to provide compensation if risks crystallizes from those contributions, and where there is a clear link (although not necessarily a one-for-one relationship) between the benefits paid by a social security scheme and the revenue that finances the scheme.

Therefore, the Treasury considers elements of each option, should be applied as appropriate in the financial statements and in long term fiscal reports.

We address the conceptual merits and weaknesses of the options; the extent to which they address the objectives of financial reporting; and how the different options might provide useful information about the different types of social benefit, in our responses to the specific matters for comment below.



3. Are you aware of any social benefits transactions that have not been discussed in the CP, and which could not be addressed by one or more of the options set out in the CP?

No

4. At what point should a future IPSAS specify that an obligating event arises under the obligating event approach? Is this when:

- (a) Key participatory events have occurred;
- (b) Threshold eligibility criteria have been satisfied;
- (c) The eligibility criteria to receive the next benefit have been satisfied;
- (d) A claim has been approved;
- (e) A claim is enforceable; or
- (f) At some other point.

If, in your view, a future IPSAS should consider that an obligating event can arise at different points depending on the nature of the social benefit or the legal framework under which the benefit arises, please provide details and the reasons for your views.

The Treasury considers that the IPSASB's approach in determining the event that creates a present obligation should be guided by its recently published Conceptual Framework.

That framework states that "A present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid. Obligations are not present obligations unless they are binding and there is little or no realistic alternative to avoid an outflow of resources."

If the benefit is payable under law (i.e. a legal obligation), then it should be recognised as a present obligation at the point it becomes legally enforceable. In the case of income support being paid to beneficiaries, this would be at point (e) in the Consultation Paper. We note that depending on the legal or statutory documentation, this may in fact happen at point (b), (c) or some other point.

If the benefit simply arises from government policy (i.e. a non-legally binding obligation), under the Conceptual Framework it becomes important to determine the point at which the reporting entity has little or no realistic alternative to avoid the obligation.

The challenging issue in the public sector is that **current** policies establish **future** obligations; policies simply set criteria that, if met, will result in an outflow of resources.

The financial position of an entity whose policy provides for a \$10,000 pension is not substantively different where the eligibility criteria are met either one day before or one day after the reporting date. This was the problem encountered in ED 34, which sought to differentiate between the costs of those who had already met the threshold eligibility criteria, and those that had not. Any proper consideration of the financial effect of the policy requires all the costs that are expected to arise from the policy to be taken into account. The interest of users, whether

they were resource providers or service recipients was the cost of the policy, not the cost of a contrived obligation. The proposals in ED 34 were therefore correctly rejected.

The further challenging issue in the public sector is that current policies are subject to change.

As a consequence of the very power of government, it is not possible for a current government to bind a future government. In most situations therefore the government has leeway to avoid at least part of the obligation. To address what the institutional economic literature describes as the "commitment problem" of governments, there have developed a number of commitment devices aimed at reducing the government's flexibility. The Conceptual Framework refers to two of these in paragraph 5.25

- The nature of the promise can be made in such a way that makes a policy change less likely (e.g. permanent legislative authority, requiring a super majority to change, is much less able to be changed than an annual budget determination)
- The establishment of funding arrangements can make it more difficult for a government to make changes, or at least to divert money contributed or set aside for the benefit, to other purposes.

Other constraints on policy change include:

- The premium placed on the reputation for credible and consistent policy making, and for not exercising the power to change in an arbitrary manner
- The use of contracts between government and individual households where some performance or consideration can be ascribed, enforced by the courts.

A critical point to note about these commitment devices is that they reduce rather than eliminate the government's discretion to avoid future outflow of resources. Their effectiveness in part depends on the operation of political, legal, economic and social institutions within the country.

The way the question is framed suggests there is one 'standard' recognition point where the discretion is so reduced that the government has in fact "little or no discretion" and a liability should be recognised. However, given the varying power of the commitment devices available, and the fact that the efficacy of countries' political, legal, economic and social institutions may vary considerably, the Treasury is doubtful that it will be possible to get to a generally accepted international position on such a recognition point. The difficult history of this project, as outlined in section 1 of the Consultation Paper supports such a view.

Treasury therefore takes the view that "a future IPSAS should consider that an obligating event can arise at different points depending on the nature of the social benefit or the legal framework under which the benefit arises".

The recognition point will depend on the nature of the promise, and the existence and effectiveness of commitment devices that reduce the government's discretion to avoid future outflow of resources. This suggests that, for material social benefit categories, the financial statements should disclose the nature of the promise and the existence of commitment devices to increase the likelihood that future outflows will occur. On the basis of those disclosures, the reporting entity should report whether it takes the view that service recipients currently have a valid expectation that they have a **present** right to resources and the government has a **present** obligation to them. When, but only when, the reporting entity asserts that point has been reached should a social benefit liability be reported.

If the IPSASB does not accept these arguments, the Treasury would still caution the IPSASB against using (d) as a recognition point. That would open the way to the entity influencing its expense recognition by speeding up or slowing down its approval processing. This would not be countenanced for any other activity, and should not be countenanced for social benefits.



Recognising this, the Treasury has prepared some internal guidance on this issue which is repeated below for consideration by the IPSASB. It is predicated from the view that recipients have met eligibility criteria when they have no further substantial acts to complete before receiving the assistance.

"Determining whether there are "substantial acts to complete" may require judgement. Some types of assistance may involve a series of substantial events. For example, funding may increase as other financial support for a project is obtained. If a grant recipient has raised \$75,000 externally at the reporting date and has a deed of agreement from the Government for one-for-one funding up to \$100,000, then the Government should only recognize an obligation for its \$75,000 at the reporting date, even if it is likely that \$100,000 will be raised, and an additional \$25,000 will become owing. Conversely, if the only act required prior to receipt of the assistance, is the completion of necessary paperwork, this should not be regarded as a "substantial act to complete".

**5. Does an obligating event occur earlier for contributory benefits than non-contributory benefits under the obligating event approach?**

Treasury does not consider that the means by which a liability is funded necessarily changes the nature and timing of the liability. It would be a strange policy that recognised liabilities earlier if there is an income stream set aside to pay for them. That would lead to all manner of perverse outcomes.

However we consider that contributory arrangements may act as a commitment device, reducing the discretion to avoid outflows. Where contributory arrangements exist, we believe it would be worthwhile to identify their existence, and their impact on the government's discretion to avoid outflows, as a required disclosure in explaining the accounting policy adopted as to when the obligating event occurs.

**6. Should a social benefit provided through an exchange transaction be accounted for:**

- (a) In accordance with a future IPSAS on social benefits; or**
- (b) In accordance with other IPSASs?**

Treasury observes that

- (a) Social benefits are currently proposed to be defined as benefits provided to individuals and households, in cash or in kind, to mitigate the effect of social risks (IPSAS Consultation Paper), and
- (b) Insurance is a contract under which one party accepts significant risk from another party by agreeing to compensate the second party if a specified uncertain future event adversely affects that party. (from IASB ED ED/2010/8 Insurance Contracts).

It follows therefore that if a contract is an exchange transaction, then social benefit provided through an exchange transaction is insurance. That would lead to the conclusion that social

benefits provided through an exchange contract should be reported under an insurance standard. Treasury considers this to be appropriate.

If the IPSASB wants to establish the accounting for benefit provided through an exchange transaction with a future IPSAS on social benefits, it must provide a reason for breaking out of that logic. It would either need to develop a different definition for insurance in the public sector to the private sector, or to provide a reason why the exchange should not be treated as an exchange. Treasury submits that there is little benefit in pursuing either of those paths. Rather Treasury would welcome a separate Social Benefits (or Transfer Expenses) standard and an Insurance Standard out of this project.

**7. When should scheme assets be included in the presentation of a social benefit scheme:**

- (a) In all cases;**
- (b) For contributory schemes;**
- (c) Never; or**
- (d) Another approach?**

To the extent a liability is reported for future outflows, both the expected gross outflows (particularly for service recipients) and the expected net outflows (particularly for resource providers) will provide useful information. This suggests that scheme assets should be included to the extent they exist.

Treasury observes that the term "scheme assets" may need consideration. The Consultation Paper simply notes that "in some cases a separate fund exists or there are earmarked assets". We note that both New Zealand and Australia have established sovereign wealth funds intended to be used to defray a part of expected future costs due to demographic changes. Such funds are of a different nature than funds of contributors money, held in trust for their use, that are similar to the scheme assets covered by IPSAS 25 *Employee Benefits*.

Treasury notes that one of the difficult issues discussed in the Consultation Paper is the measurement of the liability, and the related assumptions over the present value of both the outflows and the inflows from scheme assets. We would urge the IPSASB to ensure a consistent approach is followed for pensions, insurance and any other long term liability measurement.

**8. Under a social contract approach, should a public sector entity recognize an obligation in respect of social benefits at the point at which:**

- (i) A claim becomes enforceable; or**
- (ii) A claim is approved?**
- (b) Measure this liability at the cost of fulfilment?**

Treasury's assessment of the IPSASB's discussion of the Social Contract approach is that it has considered the analogy of using an executor contracts approach, has identified some difficulties with this approach, and has therefore rejected it.



Treasury acknowledges the difficulties raised: that the social benefit recipient group is not the same as the resource provider group, the challenge of portraying the government as an agent of taxpayers when the government controls the taxation process, and that the relationship between social benefits and taxes is insufficiently robust to determine whether an onerous contract exists.

Nevertheless, in considering the best approach to providing information on the rights and obligations between a government and its citizens, the Treasury suggests that the nature of their relationship (often described as the social contract) warrants serious attention beyond the narrow determination as whether an executor contract notion can be applied. We consider that rather than looking just at previous literature on executor contracts, the IPSASB should also look to best apply its own conceptual framework. Only by doing so, can the IPSASB best determine how the financial statements and long term fiscal reports can best be integrated to inform the government, and its resource providers and service recipients as to the state of its redistributive activity.

The IPSASB has released a recommended practice guideline on long term fiscal reports that has the objective of providing "information on the impact of current policies and decisions made at the reporting date on future inflows and outflows ... The aim of such reporting is to provide an indication of the projected long-term sustainability of an entity's finances over a specified time horizon in accordance with stated assumptions."

On the other hand, the IPSASB's conceptual framework states that "Information about the financial position of a government or other public sector entity will enable users to identify the resources of the entity and claims to those resources at the reporting date. This will provide information useful as input to assessments of such matters as:

- The extent to which management has discharged its responsibilities for safekeeping and managing the resources of the entity;
- The extent to which resources are available to support future service delivery activities, and changes during the reporting period in the amount and composition of those resources and claims to those resources; and
- The amounts and timing of future cash flows necessary to service and repay existing claims to the entity's resources."

The IPSASB needs to reflect on how such statements should interact together, to best provide users with information on the performance and sustainability of the public sector's redistributive activity, and the liquidity, solvency and capacity of that redistributive activity to adapt (paraphrasing para:2.11 of the Conceptual Framework).

In Treasury's view this is best achieved if the long term fiscal reports provide information on current policies, and the statement of financial position provides information on current resources, and currently enforceable claims to those resources. In essence, it is the Treasury's position that the long term fiscal report provides information on the state of the "social contract" whereas the balance sheet should limit itself to reporting the current financial position.

The Treasury considers there are grave dangers to the credibility of the information on the statement of financial position if its scope is expanded to provide information on future obligations (or inflows) based on current policies:

- Reporting requirements will be regarded as unbalanced if only part of the redistributive impact of current policies is reported (e.g, transfers but not taxes, current recipients but not future recipients)
- The ability of the statement of financial position to reflect the extent to which resources are available to support future service delivery activities would be significantly impaired.

- Social policies are constantly being amended as changes in the 'social contract' occur, impacting the likely range of outcomes. The statement of financial position would no longer be able to be regarded as being reliable.
- The financial performance statement would tell a less understandable and coherent story of financial performance. Financial results would be driven primarily by changes in actuarial assumptions rather than management actions and decisions (e.g. through changes in discount rates and other changes in assumptions). As a result, assessments of the financial performance of the reporting entity would be more difficult.

**9. Do you agree with the IPSASB's conclusions about the applicability of the insurance approach?**

Treasury understands from the Consultation Paper that IPSASB's conclusions about the applicability of the insurance approach are:

- It is not appropriate to apply insurance accounting to unfunded social assistance schemes.
- If contributions received are to be treated by governments as general taxation, accounting for such schemes using the insurance approach may still provide useful information.
- Where contributions are for several schemes and there is no appropriate basis for allocating contributions to individual schemes and any allocation would be arbitrary, the use of the insurance approach would not be appropriate.
- The insurance approach may be appropriate where there are significant cash contributions in respect of a scheme, and these can be reliably measured.
- The insurance approach may provide useful information in respect of:
  - Schemes where imputed contributions involve a cash transfer;
  - Schemes where there is a low level of imputed contributions not involving a cash transfer; and
  - Schemes involving contributions treated as general taxation where there is a reliable basis for allocating the contributions to individual schemes.
- The insurance approach will not provide useful information in respect of:
  - Schemes involving contributions in kind;
  - Schemes where there is a high level of imputed contributions not involving a cash transfer; and
  - Schemes involving contributions (including those treated as general taxation) where there is no reliable basis for allocating the contributions to individual schemes.

The Treasury is in agreement with those views for the purpose of general purpose financial reporting, for the reasons stated in the Consultation Paper.

We note that where future expected outflows under current policies can be used as a proxy for social harm that a government wishes to reduce, an insurance accounting approach can provide



a useful measure for performance management purposes. The New Zealand government currently prepares such a measure to assess the outcome of its efforts to reduce working age welfare. In this case however, the measure of the "liability" is determined as a way of quantifying or providing a proxy for the social harm outcome, rather than as a determination of an entitlement or obligation. We would note, for example, that in our measurement an allowance is made for jobseekers who have recently accepted a job, given our experience that a portion is recycled back into welfare. Such individuals would not be currently eligible for any job seeker benefits.

Thus some information the IPSASB regards as not useful, can in fact be useful for management performance purposes. Treasury agrees however, that it would not be useful for reporting current rights and obligations.

**10. Under the insurance approach, do you agree that where a social security benefit is designed to be fully funded from contributions:**

- (a) Any expected surplus should be recognized over the coverage period of the benefit; and**
- (b) Any expected deficit should be recognized as an expense on initial recognition?**

The Treasury sees no reason for there to be a different treatment for social insurance than for other insurance. Therefore we consider that adopting the same approach as the IASB is proposing has merit.

Further, as noted in question 13. below, Treasury notes that it is common for insurance schemes to determine the liability at a greater level than the mean expectations (e.g. at 75% likelihood of adequacy), and then to fund on that basis so as to increase the likelihood of solvency. This might be regarded as a circumstance where the contribution is designed to exceed the expected benefits paid. If a risk adjustment is allowed or permitted, then again it would be appropriate to recognise any surpluses over the coverage period.

However as discussed below, we do not believe such risk adjustments are appropriate.

**11. Under the insurance approach, what is the appropriate accounting treatment for the expected deficit of a social security benefit that is not designed to be fully funded from contributions:**

- (a) Recognize an expense on initial recognition;**
- (b) Recognize the deficit as an expense over the coverage period of the benefit;**
- (c) Offset the planned subsidy and the liability only where this is to be received as a transfer from another public sector entity;**
- (d) Offset the planned subsidy and the liability irrespective of whether this is to be received as a transfer from another public sector entity or as an earmarked portion of general taxation; or**

Treasury considers that offsetting the liability is tantamount to a misrepresentation of the liability and accordingly rejects those two options outright. Consistent with the private sector, and as a representation of the claims expected to be incurred against the contributions received, Treasury prefers option (a).

**12. Under the insurance approach, should an entity use the cost of fulfilment measurement basis or the assumption price measurement basis for measuring liabilities**

The Treasury supports the cost of fulfilment approach as the most appropriate basis for insurance liabilities. This is consistent with the measurement of most other liabilities.

We note that the main difference in these approaches occurs as an assumption price would require the addition of a risk margin to the cost of fulfilment. Effectively, the cost of fulfilment should provide a best estimate of the net present value of the costs that will be met whereas the assumption price adds a prudential margin that inflates that estimate, to an amount another party would require to assume the liability.

We understand the importance of this prudent approach in the private sector, particularly given the criticality of the solvency of private sector insurers to their going concern assumption. We believe that for state-owned or guaranteed insurance schemes a more appropriate amount to use in assessing the financial position of the scheme is a 'best estimate' rather than (for example) an estimate that is designed to be greater than the actual outcome in 75% of cases. If additional funding to cover underestimated liabilities is needed, and if that funding can be recouped through increasing the level of future taxes/levies/fees, then an accounting approach driven by going concern based on solvency at any point of time is no longer appropriate.

If this approach is taken, then it follows that any accounting for unearned premium deficiencies to reflect unexpired risk premiums would also no longer be required. Not only would that be helpful, it would make insurance obligations more understandable, and better able to be budgeted and reported against.

**13. Are the following criteria for determining whether the insurance approach appropriate, in those cases where the link between contributions and benefits is not straightforward:**

- The substance of the scheme is that of a social insurance scheme; and
- There is a clear link between the benefits paid by a social security scheme and the revenue that finances the scheme.

Treasury agrees with IPSASB's views that the insurance approach should only be used where that is the substance and the link is clear.

This is based on our understanding that a clear link is established when:

- The revenue financed from the scheme comes from the recipients covered or from exacerbators of the risk that is being covered
- The scheme ensures that revenue generated by the scheme is used for the purposes of the scheme.



Treasury does not consider that the link has to be so strong that only contributors to the scheme can receive benefits from the scheme.

**14. Do you support the proposal that, under the insurance approach, the discount rate used to reflect the time value of money should be determined in the same way as for IPSAS 25?**

As noted previously, Treasury considers it important that a consistent approach is followed for pension obligations, outstanding insurance claims incurred, and any other long term liability measurement.

**15 Under the insurance approach, do you support the proposals for subsequent measurement?**

Yes.