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Technical Director
File Reference No.2013-290
The Financial Accounting Standards Board
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Dear Sir or Madame,

Comment on the Proposed Accounting Standards Update—*Insurance Contracts* (Topic 834)

The Accounting Standards Board of Japan ("ASBJ" or "we") appreciates the many years of effort the Financial Accounting Standards Board (FASB) has put into the Insurance Contract project, and welcomes this opportunity to provide comments on the proposed Accounting Standards Update, *Insurance Contracts (Topic834)* (the "ED").

General Comments

1. We support the objective of the ED to improve, simplify and enhance the financial reporting requirements for insurance contracts, thereby providing investors with decision-useful information.

2. Most of the FASB's discussions on the insurance contract models were jointly conducted with the International Accounting Standards Board (IASB) from 2008. However, we note that differences still remain between core parts of the insurance accounting models presented in the FASB's ED and in the IASB's second Exposure Draft *Insurance Contracts* issued in June 2013 (the "IASB's Re-ED"). We are of the view that global consistency in insurance contract accounting is critically important for improving the comparability of financial statements. Accordingly, we strongly encourage both boards to continue their efforts to reach agreement on a converged outcome.

3. Therefore, in this comment letter, we focus on issues that relate to the core parts of the insurance accounting model as well as selected issues where differences still remain between the ED and the IASB's Re-ED. In addition, based on the feedback received from our stakeholders, we have provided our comments on areas where

there will be a large impact on Japanese entities preparing consolidated financial statements in accordance with US GAAP. Specifically, we provide comments on the following areas:

(a) Scope of the ED (Question 1 of the ED):
(b) Treatment of the changes in estimates of cash flows (Question 13 of the ED):
(c) Presentation of the effects of changes in discount rates (Questions 16 and 19 of the ED); and
(d) Presentation of insurance contracts revenue (Questions 31 and 32 of the ED).

4. Within the above four areas, we believe the following matters are highly important, and we encourage the FASB to carefully consider them in its redeliberation process.

   (a) We do not agree with the proposal in the ED that the effects of changes in estimates of future cash flows on the fulfillment cash flows should be immediately recognized in net income. Instead, we suggest that the effects of changes in estimates of future cash flows related to future coverage and other future services should be adjusted (or unlocked) by the margin and recognized in net income over the contract period.

   (b) The ED proposes that changes in the fulfillment cash flows due to changes in the discount rate should be recognized in other comprehensive income (OCI). However, an accounting mismatch may arise as a result of application of this requirement, even when there is an economically matching relationship. For example, we are concerned that an accounting mismatch may arise, even when an entity's asset and liability positions (including derivative contracts) are effectively matched.

5. Our responses to the specific questions in the ED are provided below.

<u>Responses to the specific questions and other comments</u>

I Scope of this ED (Question 1 of the ED)

Question 1: Questions for All Respondents Do you agree with the scope and scope exceptions of this proposed guidance, including its applicability to contracts written by noninsurance entities? If not, what types of contracts or transactions also should be included or excluded from the scope and why?

6. We generally agree with the scope proposed in the ED. However, the ED proposes that the accounting requirements specified in the ED be applied to financial guarantee insurance contracts [1] as defined by the Accounting Standards Codification *Financial Services – Insurance* (Topic 944), as well as to insurance contracts issued by insurance entities. We do not agree with the proposal that the requirements in the ED be applied to all financial guarantee insurance contracts.

7. We generally believe that the measurement requirements proposed in the ED would better reflect the risks and uncertainties of cash flows arising from insurance contracts. In addition, financial guarantee insurance contracts are considered to have similar characteristics to insurance contracts. Therefore, when an entity issues both insurance contracts and financial guarantee insurance contracts (that is typically the case for insurance entities), we agree that it is appropriate to apply the same accounting requirement to both types of contracts.

8. However, there are other situations where financial guarantee insurance contracts are issued and their economic characteristics are often similar to transactions where an entity extends credit exposures (in that case, other accounting requirements are applicable.) For example, economic characteristics are similar whether a bank underwrites a loan to a borrower directly or issues a financial guarantee insurance contract to the same party as part of the funding arrangement from the third party, because the bank nevertheless bears the credit risk of the borrower in both cases.

9. In such a situation, we believe that the economic reality of the entity would be better represented if the same accounting requirements were required for both contracts. Simultaneously, considering the complexities of the accounting model

[1] Financial guarantee insurance contract is "a contract issued by an insurance entity that provides protection to the holder of a financial obligation from a financial loss in the event of a default."(Paragraph 20-20 of Accounting Standards Codification *Financial Services-Insurance* Topic 944)

proposed in the ED, it would be highly challenging for preparers of financial statements to properly understand and apply all the proposed requirements of the ED. Therefore, where there are other accounting pronouncements that can better reflect the economic reality of an entity, we believe that the application of the proposed requirements in the ED would not be justified from a cost benefit perspective.

10. Therefore, in line with the proposal in the IASB's Re-ED, we suggest requiring an entity to follow other applicable accounting pronouncements when accounting for financial guarantee insurance contracts unless an entity has previously asserted explicitly that it regards such contracts as insurance contracts and has applied the accounting requirements for insurance contracts to the contracts.

II Treatment of the changes in estimates in cash flows (Question 13 of the ED)

Question 13 : Questions for All Respondents
Do you agree with the approach in this proposed Update to recognize changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rates) in net income in the reporting period? If not, what do you recommend and why?

11. We do not agree with a proposal in the ED that changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rates) be recognized immediately in net income in the reporting period. Instead, we are of the view that the changes in estimates of future cash flows related to future coverage and other future services should be adjusted (or unlocked) by the margin[2] and should be recognized in net income over the future contract period.

12. We believe that the margin should represent the unearned profits of insurance contracts, and therefore that the changes in estimates of future cash flows related to future coverage and other future services should be adjusted by the margin. This, in

[2] In our analysis, the following two accounting treatments would be considered under the unlocking approach.

(a) To adjust the margin prospectively for changes in estimates of future cash flows. (This approach is consistent with the proposal in the IASB's Re-ED.)

(b) To recognize the margin covering the entire period of an contract in net income reflecting the pattern of how a performance obligation of the insurance contract is expected to be satisfied (in other words, in accordance with the progress towards complete satisfaction of that performance obligation) (This approach is consistent with paragraph 38 and 49 of the Accounting Standard Update Revenue Recognition Topic 605.*)*

our view, would provide users of financial statements with useful information on profits generated from insurance contracts.

13. In contrast, the proposal of the ED would require that the margin be recorded in order not to recognize a day one gain on initial recognition of insurance contracts, and that the effects of changes in future cash flow be immediately recognized in net income. The margin would not be adjusted (locked) for changes in estimates of future cash flows related to future coverage and other future services. Instead, the margin would be recognized in net income as an entity is released from exposure to risks. Under this approach, the profit estimated at initial recognition would systematically be allocated over the period, while the effects of changes in estimates would immediately be reflected in net income in the period of the change. This might provide more transparent information by showing both the release from the margin estimated at the initial recognition (relatively stable profits) and the effects of subsequent changes in estimates (volatile profits) in the statement of comprehensive income.

14. However, we have concerns that the margin balance would no longer represent unearned profits based on the latest estimates under this approach. We believe that if what the margin represents at initial recognition were inconsistent with that at subsequent periods, it would be difficult to explain the nature of the margin.

III Presentation of the effects of changes in discount rates (Questions 16 and 19 of the ED)

Question 16: Question for all Respondents Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.
Question 19: Question for all Respondents Do you agree that interest expense generally should be based on the discount rates determined at the date the portfolio of contracts was initially recognized? Why or why not? If not, what do you recommend?

15. An insurance contract is often characterized as a promise by an insurer to fulfill a performance obligation to make payments according to the contractual terms over a relatively long period of time. Thus, the amount, timing and uncertainty of cash flows of insurance contracts, including the receipt of the premiums and the payment of claims, are expected to fluctuate greatly in line with the changes in the environment after initial recognition. Having regard to such characteristics of insurance contracts, we are of the view that remeasuring those cash flows at current value at each reporting date is appropriate to properly reflect the financial position of insurers. However, we do not necessarily think that presenting all of the changes in the fulfillment cash flows in net income would properly present the financial performance of insurers.

16. In particular, when cash flows are not expected to vary largely (including due to the effect of changes in interest rates), the effects of changes in discount rates (which are inputs to the measurement of fulfillment cash flows) are expected to unwind over the period in which those cash flows occur. In addition, considering the relatively long term nature of insurance contracts, the effects of changes in discount rates are expected to be large when measuring the fulfillment cash flows. Therefore, presenting all of the effects of changes in discount rates immediately in net income may mislead users of financial statements about the performance of underwriting and investment activities of insurers. Consequently, we believe that the proposal to recognize in net income the interest expense determined using the discount rate that applied when the contract was initially recognized, and to present the effects of changes in the discount rate in OCI is a reasonable approach.

17. However, it was pointed out that the proposed requirement to present the effects of the changes in discount rates in OCI would give rise to an additional accounting mismatch. For example, if an entity were to reduce the duration mismatch between its assets and insurance contract liabilities with the use of derivative contracts (such as interest rate swaps), part of the change in carrying amounts of the fulfillment cash flows would be presented in OCI, while derivatives contracts would be remeasured at FV-NI. In such a case, an accounting mismatch would arise even when assets and liabilities are economically matched.

18. In order to address the accounting mismatch, the effects of changes in discount rates on fulfillment cash flows could be presented in net income when certain conditions are met, so as to eliminate or reduce the accounting mismatch. We encourage the FASB to debate how it can address the accounting mismatch as part

of its redeliberation.

IV Presentation of insurance contracts revenue (Questions 31 and 32 of the ED)

Question 31: Question for all Respondents Do you agree that users of financial statements would obtain relevant information that faithfully represents the entity's financial position and performance if, in net income, for all insurance contracts, an entity presents insurance contract revenue and incurred expenses, rather than only information about changes in margins (that is, the net profit)? If not, why not?
Question 32: Question for all Respondents Do you agree that, for all contracts, revenue should exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and that expenses should exclude the corresponding repayment of those amounts? If not, what do you recommend? Please specify whether your view depends on the type of contract.

(Presentation of insurance contract revenue)

19. Generally, we support the proposal to present volume information about insurance contract revenue and expenses because it would help users of financial statements to understand the financial performance of insurance contracts and enhance comparability of financial statements across entities.

20. We also support the proposal to present insurance contract revenue as the performance obligation of the insurance contract is satisfied, in line with the general principle described in the proposed Accounting Standards Update *Revenue recognition* Topic 606.

21. However, the ED seems to assume that the change in the liability for the remaining coverage during the period would represent the cover and other services that would be provided during the period. This would result in insurance contract revenue being presented as the sum of incurred claims and expenses during the period. Under this approach, insurance contract revenue would increase when there is an increase in payment of claims. We do not necessarily believe that this approach would represent the pattern in which the performance obligation of the insurance contract is actually satisfied.

22. An alternative approach could be developed presuming that the performance obligation of the insurance contract is to *provide the stand ready obligation* to pay

claims when insured events occur during the coverage period, and to recognize insurance contract revenue as that stand ready obligation is satisfied. Under this approach, insurance contract revenue would be presented in a manner that reflects the transfer of the remaining services specified by the contract. The concept of this approach is consistent with the pattern in which the margin is recognized in net income as proposed in paragraph 32 of the IASB's Re-ED, and therefore the insurance contract revenue would be recognized systematically over the coverage period.

(Exclusion of estimated returnable amounts)

23. We generally support the proposed requirements to (i) separate the investment components of insurance contracts that are distinct at initial recognition and measurement, and to (ii) exclude some of the remaining investment components (estimated returnable amounts) when presenting insurance contract revenue.

24. During our deliberations, a view was expressed that if there is a problem with the presentation of financial statements, we should reconsider the recognition requirement to ensure consistency between the requirements for recognition and presentation. However, when the investment components are not distinct, separating the investment components from the remaining components would further increase the complexity and make the separation arbitrary. Therefore, if the investment components are not distinct, we believe it is appropriate to measure them in combination, consistent with the proposal in the ED.

25. On the other hand, in the case of estimated returnable amounts for which an insurance contract requires the entity to repay a policyholder even if an insured event does not occur (such as surrender value), the essential characteristics of the estimated returnable amounts are similar to bank deposits. In our view, presenting the estimated returnable amounts as part of the insurance contract revenue is not necessarily appropriate to properly present the financial performance. Therefore, we are of the view that excluding certain types of estimated returnable amounts from insurance contract revenue when presenting the statement of comprehensive income would allow users to better understand the performance of insurance contracts.

26. Nevertheless, we think that the proposed definition (that is, the estimated amount of the component of an insurance contract that the entity is required to repay the policyholder or the beneficiary that does not depend on whether an insured event

occurs[3]) is too broad, and that even a prepayment of an premium for future coverage might be considered as an estimated returnable amount. Preparers of financial statements pointed out that this is not consistent with how insurance contracts are internally controlled and that the costs of excluding the estimated returnable amounts exceed the benefits of doing so. Therefore, we are of the view that the scope of the estimated returnable amounts which would be excluded from insurance contract revenue should be limited to a reasonable extent so as to strike the appropriate balance between costs and associated benefits.

27. Specifically, we propose that a contract which has estimated returnable amounts should be excluded in presentation only for "a contract in which an explicit account balance is separated[4] or which has a feature similar to a deposit." This is based on the feedback we received from financial statement users that they typically separate components of contracts in which an explicit account balance is identified or which has a feature similar to a deposit when analyzing financial statements because the profitability of these contracts would be seen very different from other contracts, unless the estimated returnable amounts are separated. We suggest excluding such estimated returnable amounts from presentation, so as to clarify the scope of application and to strike the right balance between the benefits and associated costs.

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We hope that our comments will contribute to the forthcoming deliberations in the project.

Yours sincerely,

Take Arai

Takehiro Arai
Vice Chairman of the Accounting Standards Board of Japan and
Chairman of the Insurance Contract Technical Committee

[3] Please refer to Glossary of the ED.
[4] Please refer to the Staff Paper of the FASB and the IASB meeting for November 2011, for how to identify the explicit account balance.