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ASBJ FASF

1 November, 2013

The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir or Madame,

Comment on the Exposure Draft ED/2013/7 *Insurance Contracts*

The Accounting Standards Board of Japan (the "ASBJ" or "we") appreciates the many years of efforts made by the International Accounting Standards Board (IASB) in relation to the Insurance Contract project, and welcomes the decision to re-expose the revised proposals in the Exposure Draft, *Insurance Contracts* (the "Re-ED") for public comment, following the 2010 Exposure Draft *Insurance Contract* (the "2010 ED").

General Comments

1. We support the objective of this project to improve the transparency of the effects of insurance contracts on an entity's financial position and financial performance, and to improve the consistency in accounting for insurance contracts. We are of the view that the Re-ED has undergone considerable improvements since the 2010 ED, especially in the areas of the treatment of the contractual service margin (CSM), the presentation of insurance contract revenues and the presentation of the effects of changes in discount rates.

2. However, we are of the view that further enhancements are necessary particularly in the following areas:

    (a) Key principles and critical terms are not sufficiently articulated in the Re-ED, which will make it difficult for preparers and auditors of financial statements to properly understand what is intended by the proposed standard, thereby making it difficult for them to exercise the appropriate judgement when applying the proposed standard. Specifically, it is not sufficiently clear how to account for a contract that requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items. It is also not clear how to account for cash flows that are expected to vary

directly with returns on the underlying items. In addition, as for the recognition of the remaining CSM in profit or loss over the coverage period of insurance contracts, we question if a consistent application of the proposed standard may ever be possible, unless specific guidance is provided as to the manner in which the remaining CSM is recognised in profit or loss over the coverage period. We are concerned that the comparability of financial information across entities could not be ensured if the Re-ED were to be finalised without making improvements in these areas. (For specific suggestions, please refer to our comment on Questions 1, 2, 4 and 7.)

(b) The proposed standard may give rise to an 'accounting mismatch,' even where there is economic matching relationship between assets and liabilities. For example, even when an entity's asset and liability positions (including derivative contracts) are effectively matched, accounting mismatches may arise where the effect of changes in discount rates on the carrying amount of the insurance liability is recognised in other comprehensive income (OCI), and the change in the fair value of the derivative is recognised immediately in profit or loss. (Please refer to our comment on Question 4.)

(c) Even when each of the proposed requirements in the Re-ED is considered appropriate individually, when considered altogether, some of these requirements may make the practical application of the proposed standard excessively complex. For example, although we conceptually support the approach proposed in the Re-ED requiring that changes in estimates of future cash flows that relate to future covers and other future services be adjusted by the CSM, we wonder if this approach maintains the appropriate cost-benefit balance when applied to a great number of insurance contracts whose coverage periods are long. We feel that it would create significant practical challenges for the retention of relevant data and make accounting treatments excessively complicated. (Please refer to our comment on Questions 1 and 6.)

3. In addition, nevertheless of the fact that most of the IASB's discussions were jointly conducted on this project with the Financial Accounting Standards Board (FASB) from 2008, we note that there still remain significant differences in core parts of the respective insurance accounting models, which includes the treatment of the CSM. We are of the view that ensuring global consistency of insurance contracts accounting is critically important in light of improving the comparability of financial statements. Accordingly, we strongly encourage both boards to continue

their efforts to reach agreement on a converged outcome.

4. Lastly, at the end of the letter we have appended an attachment which includes strongly held comments received from members of the Insurance Contract Technical Committee which are not included in the main body of this letter. The Technical Committee was established under the ASBJ in order to provide technical inputs to the ASBJ in formulating this comment letter.

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

Responses to the specific questions and other comments

Question 1: Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

(Accounting treatment relating to changes in estimates of the present value of future cash flows related to future coverage and other future services)

6. We generally support the approach proposed in the Re-ED that changes in estimates of future cash flows related to future coverage and other future services should not be immediately recognised in profit or loss, but should be adjusted (or 'unlocked') by the CSM.

7. We are of the view that the CSM should represent the 'unearned profits' of insurance contracts. Under the 'locking approach' which requires that the changes in estimates of future cash flows be recognised immediately in profit or loss, the CSM would be recognised in profit or loss over the coverage period of the insurance contract in accordance with the pattern established at initial recognition of the contract, even if the initial estimates are subsequently changed. Under this

approach, what the CSM represents would be inconsistent over the initial recognition and the subsequent periods, making it hard to explain the nature of the CSM.

8. The Re-ED explains that the unlocking approach is consistent with the measurement of contract liabilities proposed under the revised Exposure Draft, *Revenue from Contracts with Customers* issued in 2011 ("the revised Revenue ED")[1]. However, in our analysis, the following two accounting treatments are consistent with the unlocking approach.

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

    (b) To recognise the CSM covering the entire period of an insurance contract in profit or loss reflecting the pattern that 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.[2]) (This approach is consistent with paragraphs 38 and 49 of the revised Revenue ED).

9. We are of the view that under both approaches, the CSM would represent the unearned profits of the insurance contracts. During our deliberations, some stakeholders stated that approach (a) combined with the proposed requirements of adding to and deducting from the CSM the changes in estimates of future cash flows ("the adding and deducting method") under the Re-ED, would require onerous record keeping relating to the CSM and would make the implementation excessively complex. It was also noted that under this approach profit or loss for the remaining periods might fluctuate greatly when there are changes in estimates during the period immediately before the end of the coverage period. Others noted that approach (b) which is consistent with paragraphs 38 and 49 of the revised Revenue ED would result in a greater practical burden than approach (a) to implement when combined with the adding and deducting method.

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[1] Please refer to paragraph BC33 of the Re-ED.

[2] This approach is based on the idea that the changes in estimates of future cash flows related to future coverage and other future services would affect the profitability of the contract for the entire period. Under this approach, an entity would recognise in profit or loss of the current period the portion of profit that is considered to be attributable to current and prior periods, based on the progress towards complete satisfaction of the performance obligation of insurance contracts.

10. Based on this discussion, the question was raised from our stakeholders as to whether it would be possible to permit re-measurement of the CSM at the end of each reporting period as a practical expedient. Although this might be an application matter rather than a matter for consideration in the accounting standard itself, we think that this is nevertheless important when implementing the proposed standard. We therefore suggest that the IASB consider when and how remeasurent method is expected to produce reasonably approximate outcomes compared with the adding and deducting method as proposed in the Re-ED, and describe the effect either in the basis for conclusions or the educational material to the final standard, drawing on feedback obtained through future field work process.

(Accounting treatment relating to changes in estimates of the present value of future cash flows that do not relate to future coverage and other future services)

11. The Re-ED proposes to distinguish (i) future cash flows that relate to future coverage and other future services from (ii) those that do not relate to future coverage and other future services. It then proposes not to adjust the CSM for the latter component, but to recognise it immediately in profit or loss. We are of the view that the distinction of the future cash flows is critical to properly apply the accounting treatment for the CSM. However, in our view, the distinction between the two situations is not necessarily clear in the Re-ED, and further clarification on this distinction would be necessary.

12. For example, changes in estimates of future cash flows that do not relate to future coverage and other future services include changes in estimates of incurred claims (that is explained in paragraph B68(a) of the Re-ED). Considering that the insured event has already occurred in this situation, we think that the proposal in Re-ED to recognise the effects of changes in estimates of the incurred claims immediately in profit or loss is consistent with the treatment stipulated in paragraph 36(a) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* and is therefore appropriate.

13. Paragraph B68 of the Re-ED illustrates practical situations regarding how to distinguish future cash flows that relate to future coverage and other future services from those that do not. However, in our view the situations illustrated in the paragraph are not clear, except for the case explained in the previous paragraph. We provide further details in our comments on Question 7 in this letter.

(Patterns in which the CSM should be recognised in profit or loss)

14. Paragraph 32 of the Re-ED requires that the remaining CSM be recognised in profit or loss over the coverage period. It also requires that the CSM be recognised in profit or loss *in the systematic way that best reflects the remaining transfer of services that are provided under the contract* [Emphasis added].

15. However, the Re-ED does not provide specific guidance as to what "the systematic way that best reflects the remaining transfer of services" means. The CSM represents unearned profits for the entire remaining period of the insurance contract and the way in which it is recognised in profit and loss will have a significant impact on the financial performance of an entity. Although there are various patterns in which different services are provided under insurance contracts, making it difficult for the accounting standard to single out a definite recognition pattern, we believe that the general principle described in the Re-ED would be insufficient. This is because the proposal leaves too much leeway for entities' discretion and different entities would select different recognition patterns, such that financial statement users may find it difficult to compare financial performance across entities.

16. Therefore, while acknowledging various types of insurance contracts, in order to ensure the comparability across entities, we propose that the IASB illustrate common factors that entities should consider when deciding the recognition pattern of the CSM (drivers for recognition). The common factors may include the following:
    - The lapse of time;
    - The number of insurance contracts in effect;
    - The insured amount stipulated in insurance contracts (this may apply to the case when the insured amount would fluctuate during the coverage period); and
    - The amount of insurance in force.

Question 2: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
(c) recognises changes in the fulfilment cash flows as follows
   (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items
   (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
   (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

(General consideration for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items)

17. We are of the view that the measurement bases for an asset and a liability should be determined based upon their nature or characteristics. The IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* issued in July 2013 proposes that the measurement basis for a liability should be determined based on the way in which the liability is settled or fulfilled. The Re-ED proposes that for a contract that requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, the liability be measured by reference to the carrying amount of the underlying items. In our understanding, this proposed requirement seems to

presume a liability and its associated assets as a single unit of account. We consider this to be an exceptional accounting treatment, as it is uncommon under the general principle of liability measurement.

18. If a contract requires an entity to hold underlying items and it is certain that the payments that are linked to the returns on those underlying items would be distributed to the policyholders (for example, it is the case of variable insurance contracts), it is clear that there is a relationship between the cash flows of the insurance contract liability and those of the underlying items. Having considered such an economic relationship, it would be considered inappropriate if an accounting mismatch would arise from adopting different measurement bases for assets and the liabilities in light of properly presenting the financial performance of an entity. Therefore, we generally support this exceptional treatment as proposed in the Re-ED.

19. However, having considered that its exceptional nature, we are of the view that the scope of this treatment should be clearly articulated in the proposed standard. We think that the Re-ED is not sufficiently clear on this and therefore, we recommend that the IASB provide clarification in the following respects:

    (a) The Re-ED proposes that the underlying item includes “specified assets and liabilities,” “a pool of insurance contracts,” and “the assets and liabilities of the entity as a whole.” In case of “specified assets and liabilities,” we understand that the typical examples include the case where an insurer is expected to distribute returns on the investments to its policyholders in accordance with the investment contract. In addition, as for the case when the underlying item is “a pool of insurance contracts,” we understand that the typical situation is where an insurer distributes the entire profits or surplus amounts in the pool to its policyholders. In case of the situation where the underlying item is “the assets and liabilities of the entity as a whole,” we are of the view that the applicability of the paragraph should be limited to an exceptional case, for example, where a special purpose company holds assets and liabilities. However, the Re-ED is unclear about the scope of application.

    (b) The Re-ED proposes that the contract need to specify a link between the payments to the policyholder and the returns on those underlying items in order to meet the proposed requirement. However, the ED does not explain the extent of the link required to qualify for the proposed requirement.

(Measurement of the fulfilment cash flows that are expected to vary directly with returns on underlying items, and presentation of the effect on remeasurement)

20. As for the fulfilment cash flows that are expected to vary *directly* with returns on underlying items, there is a direct correlation between the underlying items and the insurance contracts and the economic matching relationship existing. Therefore, we support the proposal requiring that the measurement of the insurance liabilities be determined by reference to the carrying amount of the underlying items, and the changes in the measurement of the liabilities be recognised in profit or loss or OCI on the same basis as the recognition of changes in the value of those underlying items. This helps eliminate or reduce the accounting mismatch. However, when the underlying items consist of items whose measurement bases differ (this might include a case, where a pool of insurance contracts consists of real estate measured at cost under IAS 16 *Property, Plant and Equipment*, equity financial instruments measured at FV-OCI under IFRS 9 *Financial Instruments* and debt financial instruments measured at amortized cost under IFRS 9), the Re-ED is unclear about how the liability might be measured by reference to the carrying amount of the underlying assets, and how the changes in the insurance contract liability might be presented. Therefore, we recommend that the IASB clarify the measurement requirements and the accounting treatment in such situations.

(Measurement of the fulfilment cash flows that are not expected to vary directly with returns on underlying items, and presentation of the effect on remeasurement)

21. As for the fulfilment cash flows that are *not* expected to vary directly with returns on underlying items (for example, fixed payments specified by the contract), there is no direct correlation between the underlying items and insurance contracts. Considering that there is no economically matching relationship for these types of cash flows, there should be no need to provide exceptional treatment to eliminate or reduce an accounting mismatch. Therefore, for these types of cash flows, we believe it is appropriate to follow the general accounting requirements regarding insurance contracts.

22. For the fulfilment cash flows that are expected to vary *indirectly* with returns on underlying items, the characteristics of the cash flows are considered to be similar to those of option contracts. Therefore, we generally support the proposed requirements in the Re-ED requiring that the changes in insurance contract

liabilities be recognised immediately in profit or loss, consistent with the accounting requirements for derivative contracts under IFRS 9. However, in our deliberation, preparers raised the concern that decomposing cash flows would be very complex and impose a significant practical burden. Also, the question was raised as to if it would ever be appropriate to decompose the components which are not required to be separated at initial recognition.

Question 3: Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?
Why or why not? If not, what would you recommend and why?

(Presentation of insurance contract revenue)

23. 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.

24. We also support the proposal to present insurance contract revenue as a performance obligation of the insurance contract is satisfied, in line with the general principle described in the revised Revenue ED.

25. However, the Re-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.

26. 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 cover period, and to recognise insurance contract revenue as the 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 CSM is recognised in profit or loss as proposed in paragraph 32 of the Re-ED, therefore, the insurance contract revenue would be recognised systematically over the coverage period taking into account the common factors (or drivers) as shown in paragraph 16 of this letter.

(Exclusion of investment components)

27. We generally support the proposed requirements to (i) separate the investment components of insurance contracts that are not highly interrelated with the insurance components at initial recognition and measurement, and to (ii) exclude some of the remaining investment components when presenting insurance contract revenue.

28. During our deliberation, a view was expressed that if there is a problem about 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 highly interrelated with the insurance components, separating the investment components from the remaining components would further increase the complexity and make the separation arbitrary. Therefore, if the investment components are highly interrelated with the insurance components, we believe it is appropriate to measure them in combination, consistent with the proposal in the Re-ED.

29. On the other hand, in the case of investment components 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 investment components are similar to bank deposits. In our view, presenting the investment components 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 investment components from insurance contract revenue when presenting the statement of comprehensive income would allow users to better understand the performance of insurance contracts.

30. Nevertheless, we think that the proposed definition (that is, amounts an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur[3]) is too broad, and that even a prepayment of a premium for future

[3] Please refer to Appendix A *Defined terms* of the Re-ED.

coverage might be considered as an investment component. 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 investment component exceed the benefits of doing so. Therefore, we are of the view that the scope of the investment component which would be excluded from insurance contract revenue should be limited to a reasonable extent, so as to strike the appropriate balance of costs and associated benefits.

31. Specifically, we propose that a contract which has an investment component 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 upon the feedback we received from financial statement users that they typically separate components of contracts in which an explicit account balance is identified from components which have a feature similar to a deposit when analysing financial statements, because the profitability of these contracts would be seen very different from other contracts unless the investment components are separated. We suggest excluding such investment components from presentation, so as to clarify the scope of application and to strike the right balance between the benefits and associated costs.

32. In addition to the comments stated in the preceding paragraphs, we provide further comments about how to separate investment components at initial recognition and on measurement of insurance contract liabilities. Please refer to our comments in paragraph 47(c) of this letter.

Question 4: Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect

[4] Please refer to the Staff Paper of the Boards meeting for November 2011, for how to identify the explicit account balance.

the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between

   (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

   (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

(Presentation of the effects of the changes in the discount rates in OCI)

33. An insurance contract is often characterised as a promise by an insurer to fulfil 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 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 insurance contract liabilities 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 carrying amounts of insurance contract liabilities in profit or loss would be appropriate to properly present the financial performance of insurers.

34. 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 current measurement of insurance contract liabilities) 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 effect of changes in discount rates are expected to be large when measuring the current value of insurance contract liabilities. Therefore, presenting all of the effects of changes in discount rates immediately in profit or loss may mislead users of financial statements about the performance of underwriting and investment activities of insurers. Consequently, we believe that the proposal to recognise in profit or loss the interest expense determined using the discount rate that applied when the

contract was initially recognised, and to present the effects of changes in the discount rate in OCI is considered reasonable.

35. 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 changes in the carrying amounts of insurance contract liabilities would be presented in OCI, while derivatives contracts would be remeasured at FV-PL. In such a case an accounting mismatch would arise even when assets and liabilities are economically matched.

36. In order to address the accounting mismatch, the effects of changes in discount rates on insurance contract liabilities could be presented in profit or loss when certain conditions are met, so as to eliminate or reduce the accounting mismatch. We think that the project on macro hedge accounting has the potential to address this problem. Nevertheless, we encourage the IASB to deliberate how it can address the accounting mismatch as part of its redeliberation.

(Treatment for cash flows that are expected to vary directly with returns on underlying items)

37. We support that proposal in the Re-ED to require that the discount rate should reflect the characteristic of liabilities. We are also of the view that for cash flows that are expected to vary directly with returns on underlying items, updating the discount rate in the situation described in paragraph BC121(b) of the Re-ED is consistent with the general concept about how discount rates should be determined.

38. However, it is not clear what is meant by "cash flows that are expected to vary directly with returns on underlying items." In addition, depending on the circumstances, updating discount rates might not be appropriate. Therefore, we believe that the IASB should endeavour to clarify the scope of this treatment through careful consideration, so as to ensure consistent application in practice.

Question 5: Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability? Why or why not? If not, what do you suggest and why?

39. Considering that contractual periods of insurance contracts are often long, estimating insurance contract liabilities at initial recognition and determining the effects of changes in estimates in the subsequent periods would be considered as impracticable in most cases when simply requiring an entity to follow IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and requiring the retrospective application of the proposed standard. Therefore, we agree that the application of IAS 8 without modification is not appropriate.

40. However, the 'modified retrospective approach' as proposed in the Re-ED would still requires various estimates for the transactions conducted in past periods. Normally, a portfolio of insurance contracts consists of a myriad of contracts whose durations are long. Thus, preparers of financial statements expressed the views that the retrospective application to the previously issued contracts would impose a significant practical burden, and the cost of the retrospective application would outweigh the benefits. Therefore, consistent with our comments on Question 1 in this letter, it was suggested that the remeasurement method should be made available as a transitional arrangement to maintain the appropriate costs and benefits. The use of the remeasurement method may respond to the concerns from some financial statement preparers that the modified retrospective approach would give rise to unreasonable consequences as it requires the effects of changes in cash flows to be adjusted by the CSM, while those effects would be recognised in profit or loss if the retrospective approach were used unmodified.

Question 6: **The likely effects of a Standard for insurance contracts**

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1-5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft? Please describe the likely effect of the proposed Standard as a whole on

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing

basis

41. We have not carried out quantitative analysis as to whether costs to comply with the proposed requirements may outweigh the benefits. However, based on the feedback received from our stakeholders, it seems that when considered as a whole, the cost of complying with the proposed requirements would outweigh the resulting benefits in the following areas:

    (a) The proposed requirement of how to account for the CSM after it is initially recognised and measured (Please refer to our comment on Question 1.);

    (b) The proposed requirement to exclude investment components (Please refer to our comment on Question 3.); and

    (c) The transitional arrangement (Please refer to our comment on Question 5.)

42. In addition, we were not able to judge whether the cost of complying with the requirements would outweigh the benefits of the information for the following areas, because we found that the proposed requirements are not sufficiently clear.

    (a) The proposed requirement for a contract that requires an entity to hold the underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items (Please refer to our comment on Questions 2 and 7); and

    (b) The proposed requirement for cash flows that are expected to vary directly with returns on underlying items (Please refer to our comment on Questions 4 and 7.)

43. In addition, if the IASB requires an entity issuing insurance contracts to disclose every single item stipulated in the Re-ED, the appropriate balance between costs and benefits would not be maintained, making it difficult for users of financial statements to understand the financial statements due to unnecessary disclosures. Having recognised that the IASB has been working to address these concerns as part of the project to review the *Conceptual Framework for Financial Reporting* and to review IAS 1 *Presentation of Financial Statements*, it would be helpful, for example, if the IASB clarify that an entity need not disclose items that are immaterial to the entity.

44. As for specific disclosure requirements, paragraph 84 of the Re-ED proposes that if an entity uses a technique other than the confidence level technique for determining

the risk adjustment, that the entity disclose a translation of the result of the technique into a confidence level. Having considered that various techniques could be used in measuring risk adjustment, users of financial statements expressed the view that this disclosure would be useful as it would enhance the comparability of financial statements and may encourage an entity to improve its measurement techniques. On the other hand, financial statement preparers expressed strong opposition to the proposed requirement for the following reasons:

(a) Assumptions made in using the confidential level technique such as the shape of a distribution curve, may vary depending on the types of insurance contracts being measured, and disclosing the figure using the technique that may not be suitable for particular types of contracts may be misleading to users.

(b) For entities using a method other than a confidence level technique, the proposal would substantially require them to measure the risk adjustment based both the confidence level technique and the alternative method. This would impose a significant practical burden and the resulting benefit would not outweigh the costs.

45. We encourage the IASB to reconsider the matter, taking into account the feedback to be received through outreach with stakeholders.

Question 7: Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB ?

If not, please describe ant proposal that is not clear. How would you clarify it ?

46. We think that the IASB's intention is not clear in the Re-ED in the following respects:

(a) **Definition of 'underlying items'** (Paragraphs 33, 60 and B68 of the Re-ED):

The term "underlying items" is used in paragraph 33 of the Re-ED (relating to "a link between the payments to the policyholder and the returns on those underlying items"), paragraph 60(h) (relating to "cash flows that are expected to vary directly with returns on underlying items") and paragraph B68(d) and (e) in the Re-ED. This term is critical for properly applying the accounting treatment as proposed by the Re-ED, but the actual definition of the term is unclear. We also provide our comments

in paragraphs 19 and 38 of this letter, where we suggest related clarification.

(b) **<u>Distinction between items that would be adjusted by the CSM and those that would be recognised immediately in profit or loss</u>** (Paragraph B68 of the Re-ED)

Paragraph B68(b) through (e) illustrates examples to be considered when deciding which items should be adjusted by the CSM or be recognised immediately in profit or loss. However, the proposed guidance is difficult to understand. For example, although paragraph B68(c) states that the delay or acceleration of investments components should be recognised immediately in profit or loss, what is intended by this example is unclear. Paragraphs B68 (d) and (e) refer to “underlying items,” but the scope of the underlying items is not sufficiently clear, including whether a participating contract is included in the scope. Since the above distinctions are critical in the application of accounting for insurance contracts, enhanced explanation in the application guidance or further explanation in the basis for conclusions is necessary.

(c) **<u>Items to be discounted</u>** (Paragraph 64 of the Re-ED)

Paragraph 64 of the Re-ED proposes that the difference between the ‘carrying amounts of insurance contract liabilities’ measured using two different discount rates be presented in OCI. However, considering that paragraph 25 of the Re-ED proposes that estimates of future cash flows be discounted for the time value of money, we believe that the items to which discount rates should be applied are ‘estimates of future cash flows’ rather than the ‘carrying amount of insurance contract liabilities.’ We believe that paragraph 64 should be amended so that these paragraphs are consistent.

(d) **<u>Accounting treatment of the CSM</u>** (Paragraph 30 of the Re-ED)

It is not clear whether the CSM should be recognised again, when there are favourable changes in estimates of future cash flows, after the CSM is reduced to nil. We believe that clarification is necessary in this respect.

Other Comments

47. In addition to our comments on Questions 1 through 7, we believe that improvements would be necessary in the following areas:

(a) **Discount rates that should be applied to recognise interest expenses on liabilities for incurred claims when the premium-allocation approach is used** (Paragraph 60 (h) of the Re-ED)

The Re-ED proposes that an entity use the discount rate applied when the contract was initially recognised, to recognise interest expenses on the liabilities for incurred claims. However, considering that the liability for incurred claims is recognised when insured events occur, we believe that the discount rate applicable when an insured event occurs should be the rate that is used.

(b) **Measurement of reinsurance contracts held when the underlying contracts are onerous** (Paragraph 41 of the Re-ED)

In accordance with the proposed requirements of the Re-ED, an accounting mismatch would arise when reinsurance contracts are entered into, where the underlying contracts are onerous. This is because the initial losses that arise from underlying insurance contracts are recognised in profit or loss, while the initial gains that arise from the corresponding reinsurance contracts that are ceded are recognised in the CSM. In practice, the corresponding reinsurance contracts ceded are usually entered into at the same time as the underlying insurance contracts are issued, creating an accounting mismatch due to the different accounting treatments. This would not be appropriate so as to properly present financial performance of insurers. Therefore, in light of eliminating accounting mismatches, we are of the view that the initial gain that arises from reinsurance contracts should be recognised immediately in profit or loss.

(c) **Separation of investment components** (Paragraphs 10(b) and B32 of the Re-ED)

The Re-ED proposes that the investment components that are included in the insurance contracts be separated from the host insurance contract and be accounted for in accordance with IFRS 9, if the investment component is distinct. Paragraph B31 of the Re-ED states that the investment

component is not distinct if the investment component and the insurance component are highly interrelated. Paragraph B32 of the Re-ED explains that two components are *highly interrelated* if either of the following conditions is met.

(i) The entity is unable to measure the one without considering the other; or

(ii) The policyholder is unable to benefit from one component unless the other is also present (including the case in which the lapse or the maturity of one component in a contract causes the lapse or maturity of the other).

We are of the view that meeting either of the two conditions above would not necessarily illustrate the situations where investment components and insurance components are so highly related that the two should be accounted for jointly. For example, in Japan there is a practice that insurers underwrite loans to policyholders as part of their operation. Normally, an insurer underwrites loans at the amount not exceeding the surrender value of the insurance contract so that it can ensure the repayment of the loan through offsetting the surrender value when the underlying insurance contract lapses or expires. Under the Re-ED, the condition (ii) of paragraph B32 would be met for such a lending arrangement and therefore, the Re-ED proposes that this lending arrangement be accounted for jointly with the host insurance contract.

However, the pricing of the insurance contract is determined independent of the lending arrangement, and insurers do not provide concessions on interest rates to borrowers in exchange for insurance contracts. Thus, such lending arrangements can be considered as simply a lending arrangement to policy holders with the surrender value as collateral. Therefore, although the loan could be repaid when the insurance contract expires or lapses, we think that such lending arrangement should be separately accounted for in accordance with IFRS 9 rather than treating them jointly so as to better reflect the economic reality. We therefore propose that the IASB clarify the reason why the two components should be accounted for jointly when the investment component and the insurance component are *highly interrelated*. We also propose to change the criterion (ii) of paragraph B32 of the Re-ED to a supplemental factor when assessing the

criterion (i) of the paragraph.

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We hope that our comments will positively contribute to the future deliberations on the project.

Yours sincerely,

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

(Attachment) Other comments that were expressed by the members of the Insurance Contract Technical Committee

We established the Insurance Contract Technical Committee to deliberate proposals in the Re-ED. The Technical Committee consists of Japanese stakeholders including users, preparers and auditors. Various views were expressed by the Technical Committee members, and not all comments are included in the letter. The following views were strongly expressed by members of the Technical Committee, but are not included in the main body of the letter because they are not consistent with the proposals in this letter. Nevertheless, we decided to include the following comments as an attachment to the letter because they are considered to be useful for the IASB's future deliberation. We note that both of them relate to the proposed requirements that future cash flows be recognised as an adjustment to in the CSM (liability), while the effects of changes in discount rates be recognised in OCI.

- The proposal in the Re-ED would require that the effects of changes in estimates of future cash flows (such as, gains or losses relating to changes in estimates of insurance-related expenses or of mortality rates) would be recognised in the CSM (that is, in the liability section), while the effects of changes in discount rates would be recognised in OCI (that is, in the equity section.) During our deliberations, it was suggested that the cumulative effects of these changes would have enormous impact on the financial position of insurance companies at the time of transition. Where the interest rates at the time of transition are significantly lower than the level at their initial recognition (such as the case in Japan), there are cases where the cumulative negative effects of the changes in discount rates are compensated by the positive effects on gains or losses relating to changes in estimates of insurance-related expenses or of mortality rates. For insurers holding a large number of such insurance contracts, the proposed requirements would have huge impacts on the equity section of the statement of financial position. Therefore, the need for careful consideration was suggested, including the aspect of transitional arrangements.
- The proposal in the Re-ED requires that the effects of changes in estimates of future cash flows be recognised in the CSM (liabilities), while the effects of changes in discount rates are recognised in OCI. In the case of interest sensitive contracts, their cancellation rates would fluctuate with changes in interest rates. It was pointed out that the effects of changes in cash flows resulted from changes in interest rates and the effects of changes in discount rates are often monitored jointly in as part of

interest rate risk management practice. Some stakeholders expressed their views that in such a situation, the effects of changes in the cash flows and the effects of changes in discount rates should be presented jointly so that an entity's financial performance would be properly presented.