List of Submissions to ED 244 *Insurance Contracts*

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12	PricewaterhouseCoopers	√

Insurance Australia Group

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007
Australia

27 September 2013

Dear Sir

Response to the International Accounting Board (IASB) Exposure Draft ED/2013/7 *Insurance Contracts* (the ED)

Insurance Australia Group Limited (IAG) is pleased to provide its response to the Request for Comment on the IASB Insurance Contracts Exposure Draft. IAG is supportive of the IASB's continued efforts to produce a standard that provides a comprehensive set of recognition and measurement criteria for insurance contracts. We also recognise the support being given by the Australian Accounting Standards Board to this process.

As a large underwriter of general insurance, IAG operates in numerous jurisdictions, including Australia, New Zealand, Thailand and Malaysia. We have more than 16 million policies in force and have about 13,000 employees. IAG is listed on the Australian stock exchange.

IAG has responded to each of the question in detail, except for question 2. In addition the Group wanted to highlight some key areas.

We observe positively that the ED maintains the fulfilment value measurement model together with a simplified Premium Allocation Approach (PAA) for certain contracts. We also observe that in response to the comments arising from the 2010 ED, a number of significant improvements have been made. We appreciate the IASB's efforts in considering our feedback and welcome these changes, in particular:

1. **Eligibility for using the Premium Allocation Approach (PAA)**

   IAG strongly agrees with the proposal that expands the criteria for using the simplified PAA to measure the liability. The addition of paragraph 35(a) should enable the majority of general insurance contracts to be recognised under PAA when using the PAA would produce a measurement that is a 'reasonable approximation' to those that would be produced when applying the Building Block Approach. It would ensure consistent reporting within similar businesses and improve usefulness and comparability of financial reporting.

2. Risk adjustment

IAG strongly agrees with the proposal for measuring the risk adjustment at the level of aggregation that reflects the degree of diversification benefit, rather than the portfolio level. This will allow insurance entities to recognise diversification across portfolios. The current proposal more faithfully represents insurance business, the overall risk management and pricing practices. We do have some additional comments regarding the risk adjustment. Please refer to our response to question 7.

IAG also welcomes the proposal in the ED to remove the previously prescribed three techniques to determine the risk adjustment, being the confidence level, conditional tail expectation and cost of capital techniques.

3. Unlocking the contractual service margin

IAG agrees with the proposal that the contractual service margin would be unlocked and adjusted for changes in estimates of the cash flow related to future coverage. Please refer to our response to question 1.

It is important to express IAG's concerns about the proposal that the impact of discount rate changes on insurance liabilities between inception and the reporting date is to be presented in other comprehensive income (OCI). We observe that:

- The proposal creates accounting mismatches;
- The proposal creates a disconnect with the underlying economic substance;
- The use of OCI in this manner does not appear to provide useful information and adds significant complexity; and
- Current disclosure practices provide adequate information on the effect of changes in discount rates to users of the accounts.

Whilst we are supportive of the IASB's aim to bring this project to a close, we encourage the IASB to reconsider alternative options. It is our view that a more suitable option would be to permit, but not require, changes that arise from movements in discount rates to be recognised in other comprehensive income. This point is covered in detail in our response to question 4.

If you require any additional information, please contact myself or Andrew Kitchen, Group Financial Controller on +61 2 9292 3012.

Clayton Whipp
Group General Manager Finance
+61 2 9292 1104

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?

IAG supports the proposal to unlock and remeasure the contractual service margin (CSM) at each reporting date to reflect differences between the current and previous estimates of the cash flows related to future coverage and other future service.

We believe the proposal for adjustment of the CSM is consistent with its determination at initial recognition and is also reasonably consistent with the IASB's revenue recognition proposal. It would provide a faithful representation of the remaining unearned profit in the contract after inception. It would also avoid some counter-intuitive effects that may arise from 'locking' the CSM.

It is also noted that the current ED does not include changes in risk adjustment relating to future coverage as part of re-measurement of the CSM. We believe this is inconsistent with the definition and overall purpose of the CSM. The CSM is defined via paragraph 28 as being inclusive of the risk adjustment (RA) at initial recognition (as a RA is included as part of the fulfilment cash flows). Holistically, the CSM exists in order that no profit is taken to the bottom line on commencement of a contract, and to ensure that this expected profit is appropriately spread over the life of the contract. As such, it appears inconsistent to allow re-measurement of the CSM due to changes in one component of the fulfilment cash flows (the present value of future cash flows) and not another (the RA). This may create accounting volatility that is not a fair representation of the economic substance of a contract at the point of re-measurement. This will hinder users of the accounts in assessing the performance of an insurer.

We recommend the IASB to broaden the ability of re-measurement to include the risk adjustment.

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

No comments

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?

IAG is supportive of the proposed presentation of gross performance, which is referred to as 'insurance contract revenue'. This approach has been widely used in the general insurance industry and a consistent measure of gross performance would also increase comparability between entities that issue insurance contracts, which would enhance the usefulness of the financial statements.

However, we do not agree with the proposal to present the effect of changes in the discount rates in other comprehensive income (OCI). A detailed explanation of our position and proposed alternative presentation is covered in our response to question 4.

We also think the proposed presentation and disclosure for the PAA can be further improved in the following areas:

- Under the proposal, insurance contract revenue would be an allocation of revenue across periods, rather than a metric that provides information on business written and bound in the current period. We note the omission of Gross Written Premium (GWP) information from the profit and loss statement and related disclosures. GWP is a key metric in the general insurance industry providing users of the accounts with a view of the contractual obligations entered into using current pricing approaches. GWP is also a point of reference for investors and other stakeholders looking to future performance. We recommend that GWP be required to be disclosed in the financial statements.

- The intention of paragraph 38 may present a backward step from the general accepted accrual accounting concept.

  Under the premium allocation model, the measurement of the liability is made with reference to the premium received but excluding premium written but not yet received. This approach results in insurance liabilities for future coverage to be driven by the pattern of premium receipt and acquisition cost paid. This is a cash accounting rather than accrual accounting and will result in different accounting outcomes for policies which are economically identical but with different payment terms.

  The current, and generally accepted, approach is to determine an unearned premium based on the total gross written premium, including business for which the entity has accepted risk but where final terms and conditions are being negotiated or business is simply not yet processed and the business has therefore not yet closed i.e. unclosed business. The unclosed business is currently recorded in 'premium receivable' to

recognise the counterparty risks to which an insurer is exposed. This amount is also recognised in 'unearned premium'.

Although estimation of unclosed business is highly judgemental, we believe there is significant value to users of financial statements to identify a liability for future coverage which includes all expected premium within the contract boundary rather than a volatile balance sheet amount that fluctuates based on a pattern of premium receipts.

We propose that paragraph 38 be reworded to refer to expected premiums rather than premium receipts and disclose the unearned premium and premium receivable separately.

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 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?

IAG does not agree with the proposal in the ED for recognising certain gains and losses on insurance contracts in other comprehensive income (OCI) and recognising in profit or loss an interest expense to reflect the time value at inception of the contract. In our view it would be most appropriate to recognise the changes that arise from movements in discount rates in profit or loss for the following reasons:

1. The proposed disaggregation creates accounting mismatches

   The proposal does not appear to be adequately justified, in particular, when considered alongside the accounting for assets backing liabilities under the proposed changes to

IFRS 9 *Financial Instruments.*

An accounting mismatch would arise if the assets are not categorised as FVOCI, i.e. if the assets do not satisfy the 'business model' test and 'solely payments of principal and interest' test.

An accounting mismatch would arise even when an insurance liability is perfectly matched by related asset and the asset is sold and replaced with an equivalent asset to maintain duration match for assets and liabilities. Evidently, there is no change in the entity's economic position arising from this transaction. However, accounting mismatches would arise when the accumulative gain or loss on the asset is presented in profit or loss at that time in accordance with IFRS 9, whereas there is no equivalent reclassification in respect of the insurance liability.

An accounting mismatch would also arise where cash outflows under an insurance contract are affected by inflation because changes in inflationary expectations in society are generally correlated with changes in nominal discount rates. It would be misleading to users of the accounts to report the changes in insurance liabilities due to inflation in profit or loss with the offsetting effect to be recognised in OCI.

An accounting mismatch could also arise in a more subtle way. Under the proposal, the amount included in OCI would only reflect changes in the discount rates. Any changes in liability cash flows influenced by changes in assumptions about market interest rates are excluded from OCI when the fair value change in asset would include such components.

2. The proposal creates a disconnection with the underlying economic substance.

   Under the proposal, the amount reported in OCI includes two components. One is the effect on the insurance contract liability of changes in discount rates in the period. The other is the difference between interest accretion at inception using a locked-in rate and interest accretion in the period using a current rate.

   When the discount rate changes in a particular period, any gain or loss arising from this change is meaningful. However, if in the following period the insurance liability discount rate remains the same, there would still be a gain or loss reported in OCI because of the continued use of a locked-in rate at inception, even though no real economic changes occurred.

   Hence it is our view to present the effect of changes in discount rates in OCI creates a disconnection with the underlying economic substance.

3. The use of OCI in this manner does not appear to provide any additional information and adds significant complexity.

   The proposal requires measurement of the interest expense to be recognised in profit or loss, using a historical locked-in discount rate. IAG is of the view that such historical rates

have no relevance to the business at the following reporting dates. In addition, the requirement of accounting for the effect of changes in discount rate in OCI would make it more complex for users of financial statements to understand performance.

The recognition of the effect of changes in discount rates in profit or loss has been widely understood and accepted by users of the accounts. Based on feedback from users of the IAG accounts, the segregation of discount rates in both profit or loss and OCI is likely to be reversed by users of the accounts when assessing insurance performance.

The proposal is also likely to increase operational complexities. That is, the need to track discount rates over the life of a contract, to apply different historical rates to different cash flows, and to identify investment components backing liabilities would likely introduce significant costs for the preparation of financial reports. It is our view that the additional costs anticipated in compliance with the Standard should be justified by identifiable benefits, and as noted above we do not consider this proposal to be beneficial to users of the accounts.

4. Current disclosure provides adequate information on the effect of change in discount rates to users of the accounts.

   There are a number of disclosure requirements either proposed in the ED and/or in the Australia jurisdiction in respect of the effect of change in the discount rate. We consider it adequate for users to quantify the effect of change in discount rates, if required. The current disclosure requirements include:

   - Discount component in the claim expense;
   - Discount component in the outstanding claim liability;
   - Movement in discount as part of reconciliation of movement in outstanding claims liability;
   - Actuarial assumptions, normally including discount rate;
   - Sensitivity of changes in actuarial assumptions, normally including discount rate; and
   - Sensitivity of change in interest rate applied to financial asset.

We recommend that the Standard should permit, rather than require, the effect of discount rate changes to be presented in OCI. This is in line with the 2010 ED proposals that changes in insurance contract liabilities should be recognised in profit or loss. We suggest that this accounting policy choice should be made on an entire entity basis, not at a portfolio or disaggregated level.

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?

IAG agrees that the proposed approach to transition appropriately balances comparability with verifiability. Compared to the 2010 ED, the current proposal seems quite workable and represents a vast improvement in terms of complexity of implementation, as pre and post transition contracts would be treated more consistently.

We also support the proposed modified retrospective approach. The approach is not only consistent with IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors,* but also provides a reasonable and practicable method when establishing the contractual service margin on transition.

Despite these improvements, it would still be a complex exercise to establish contractual service margins on transition. In particular, under the ED appendix C3(e), the requirement to recognise a separate component of equity for the cumulative effect of the difference in discount rate, will be quite challenging for many insurers. Changing the approach as per our response to question 4, will significantly reduce the cost of transition and will improve the usability of the accounts.

In addition, we strongly recommend that the IASB should align the effective dates of IFRS 9 *Financial Instruments* with the proposed insurance contract standard. This would allow entities to manage the transitions simultaneously to minimise business disruption, operational complexity and implementation costs.

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.

Refer to our response to question 3 in respect to financial statement presentation in achieving

comparability between different insurance entities.

Some of the proposals may be costly for general insurers, such as the requirement to recognise the effect of change in discount rate in OCI. This would mean that most insurers will have to record additional data, track changes and model a range of business scenarios to satisfy the reporting requirement, as we have discussed above as part of our response to question 4.

In relation to the PAA eligibility criteria, we acknowledge the IFRS's improvement to expand the criteria for using the simplified approach. It will mitigate the arbitrary distinction between contracts purely based on time when these contracts could share similar economic substance. It will also help most general insurers to implement the ED so that a separate data system can be avoided for certain contracts with the coverage period longer than 12 months, if assessment indicates that the PAA is appropriate. This will lead to a lower cost of implementation.

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 any proposal that is not clear. How would you clarify it?

IAG considers that particular aspects of the ED in relation to the risk adjustment are unclear. Specifically, we believe that paragraph B81 will create confusion.

Paragraph B81 lists a series of characteristics that the risk adjustment shall have. The use of the word 'shall' appears that compliance is compulsory – there are no circumstances in which the risk adjustment can fail to comply with the list of sub-points. This is reinforced by the repeated use of the word 'will' within the sub-points.

However, there are examples of insurance contracts where a risk adjustment based on a probability of adequacy approach in line with the ED would fail the requirements of the sub-points. For example, consider the following (simplistic) scenario:

- Consider a policy that pays $100 with a 80% probability and $200 with a 20% probability. Then the central estimate of the cost is $120. The worst case scenario is $200. A risk adjustment at a 90% probability of adequacy is $80.

- Consider a second policy that pays $100 with a 77.5% probability, $180 with a 21.5% probability and $380 with a 1% probability. Then the central estimate is, again, $120. There is a greater range of outcomes, but a much smaller chance of the most severe outcome. A risk adjustment at a 90% probability of adequacy is $60.

B81 (a) states: 'risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity'. In the simple example outlined above, the risk

adjustment is lower for the second contract, yet it has risks that are of lower frequency and higher severity than the first contract. It will lead to non-compliance to B81 (a).

This example illustrates several characteristics of skewed distributions, and demonstrates, albeit simplistically, areas in which this skewness could leads to lack of compliance with B81. IAG notes that virtually all general insurance contracts exhibit skewness in their risk distributions, and as such this is likely to be an issue for a large number of general insurance contracts.

IAG proposes that B81 should be removed in its entirety – its existence is not critical to the requirements of the Standard; it serves to illustrate the correct operation of the Standard, and as noted above there are circumstances where this will lead to inappropriate outcomes. Alternatively, IAG proposes that within this paragraph, the word 'shall' is to be replaced by 'should normally', and 'will' is to be replaced by 'will normally', to allow for exceptions to occur in legitimate circumstances.

ANZ

25 October 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

Re: ED/2013/7 'Insurance Contracts'

Australia and New Zealand Banking Group Limited (ANZ) is an AA-rated bank listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.9 billion and total assets of US$672 billion.

We acknowledge the progress the International Accounting Standards Board (the Board) has made in relation to the development of an insurance contracts standard. We note that a large number of the issues that we raised in our previous submission have been addressed by the Board and we consider the revised ED to be a significant improvement on the previous ED. In particular, we support the proposals to unlock the contractual service margin and to exclude financial guarantees from the scope of the standard.

However, we do have two areas of concern: the presentation of the financial impacts of changes in discount rates in the Statement of Other Comprehensive Income (OCI); and the contract boundary.

Presentation of the financial impacts of changes in discount rates in OCI

We do not support the proposals in the ED to mandate the presentation of the financial impacts of discount rate changes in OCI because of the complexity of this proposal as well as the potential to create accounting mismatches for some insurers. We propose that insurers are *permitted* (but not required) to present the financial impact of *changes in discount rates in the current period* in OCI, where this presents useful information to users.

The proposal to present the financial impacts of discount rate changes in OCI will require insurers to maintain two measurement bases for each cohort of insurance contracts: one using locked-in discount rates; and one using current discount rates[1]. This will create significant complexity in the actuarial models required to calculate the financial impact and additional burdens for external auditors and those involved in financial governance, including non-executive directors.

ANZ currently presents both statutory profit and cash profit (a non-IFRS measure) in its annual report. One of the adjustments to statutory profit is the financial impact of changes in discount rates in the current period. We believe this is useful information to our users as it disaggregates market-driven impacts (which otherwise drive significant

1 the amount presented in OCI includes two components: the impact of changes in discount rates in the current period (the bulk of the financial impact); and the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate

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P&L volatility) from underlying underwriting profit. As it only relates to the current period, it is an adjustment that is relatively simple to determine and to explain to our users. Including the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate in the adjustment would add significantly to the complexity of the determination and would substantially reduce the usefulness of the information presented. The movements in this second component do not move in line with market conditions and are difficult to understand and explain. For example, even if discount rates do not change in a particular period, a gain or loss would be recognised in OCI because of the continued use of a locked-in rate for interest accretion. We therefore propose, to reduce complexity and to provide useful information for users, that if changes in discount rates are presented in OCI that it should only be the component that relates to changes in discount rates that arise in the period presented.

Furthermore, we believe that it should be an accounting policy choice to present this impact in OCI, depending upon whether or not, given the asset measurement bases and product mix of the insurer, this would provide useful information for users. For some insurers, presenting the financial impact of discount rate changes in OCI will create accounting mismatches, for example, where the insurer has a large number of assets measured at fair value through profit and loss.

Contract boundary

We are concerned about a lack of clarity in the drafting of the current contract boundary proposals that could result in diversity in the accounting for contracts of a similar nature.

The ED introduces amended requirements to determine the boundary of an insurance contract. These requirements impact whether a contract can be measured using the simplified approach, as the simplified approach can be applied to contracts with coverage periods of twelve months or less. Under the contract boundary proposals, coverage ends: either when the contract can be repriced, or, when the portfolio can be repriced and "when pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account risks that relate to future periods" (para 23(b)(ii)). We understand that paragraph 23(b)(ii) was introduced to prevent certain contracts such as certain level premium contracts from being accounted for as annual contracts as this would result in the recognition of revenue (and hence profit) being accelerated relative to the provision of service (or expiry of risk).

In Australia, yearly renewable terms (YRTs) contracts are common in the life insurance market. At ANZ, they are prevalent in both our Retail and Group life business. For these contracts, the insurer may not cancel the contract, but it may reprice the portfolio of contracts annually. While the insurer, in pricing the contract prior to inception, will reflect expectations of renewal and/or lapse beyond the first twelve months (if all insureds were to lapse after one year the first year's premium would often not cover acquisition costs) it will reprice all risks such as lapse, mortality and disability risk at each annual renewal.

There are differing views in Australia as to whether YRT contracts would be considered annual contracts or long-term contracts under the ED. Given that lapse risk, for the first twelve months and into the future, is anticipated in the original pricing, does this mean that the pricing takes into account future risk? Given lapse rates can be such a significant contributor to ultimate underwriting profit some believe that YRT contracts would not be considered annual contracts. We believe that as all risks can be repriced annually the contracts should be considered annual contracts. We also believe paragraph 23(b)(ii) would be difficult to substantiate as the insurer would need to be able to demonstrate that it was only incorporating risk, and expectations about changes in that

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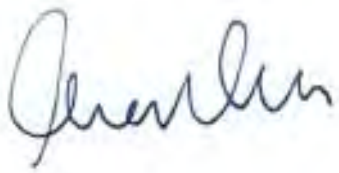
risk, for the following twelve months and that it is not reflecting risk, or changes in that risk, beyond the next twelve months.

We would therefore encourage the Board to reconsider the current drafting of 23(b)(ii) to avoid diversity in the accounting for contracts such as YRTs.

Detailed comments on the questions raised in the ED are attached as an Appendix to this letter. Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely



Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

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APPENDIX

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?

We are supportive of the Board's decision to unlock the service margin as we had significant concerns with the previous ED, which required a locked-in residual margin. A locked-in margin would create spurious volatility. For example, a reassessment of the fulfilment cash flows might indicate that the contract is expected to remain profitable over the remaining 15 years, however, the expected profits are reduced. Under the proposed model a loss will be recognised in the profit and loss to reflect a reduction in profits that is expected to emerge over the next 15 years, however the residual margin, which is an indicator of future profits will remain unchanged and will continue to run off as before.

We agree with the different accounting treatment for assumptions relating to future coverage and assumptions relating to coverage that has expired as we believe that this will ensure that profit is recognised as it is earned, which is as the insurer is released from risk.

There are two aspects to the service margin proposals we would like to comment: on the reversal of previous losses and impacts of changes in the risk margin.

Loss reversals
We note that the ED does not allow losses that have been recognised in profit and loss (because the service margin has been exhausted) to be reversed, where there is a subsequent change in estimates (such that the service margin is reinstated). The current life insurance accounting model in Australia (the Margin on Services model, or "MoS") allows for the reversal of losses. Experience in Australia has shown that, for contracts that can continue for 20 years, it is not unusual for losses to be recognised and subsequently reversed. Indeed this is one of the reasons that the planned margin under MoS absorbs changes in estimate and does not recognise them in P&L. We understand that the IASB has not allowed for the reversal of losses in its model because of the additional complexity this brings to the model. While we would regard this as a conceptually better approach, we do support the approach of minimising complexity. We would recommend that the Board reconsider its position on this treatment, as it is the view of some actuaries in Australia that the degree of complexity introduced here is not significant.

Changes in risk margins
Under the ED, changes in the risk margin assumption are recognised immediately in profit and loss; this includes experience gains and losses, as well as changes in assumptions about future risk. This is inconsistent with the accounting treatment proposed for changes in other actuarial assumptions, such as mortality, where experience gains and losses are recognised in profit and loss, but changes in assumptions relating to future periods are adjusted against the service margin.

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Conceptually, changes in the risk margin should affect the current measurement of the service margin in exactly the same way that changes in future cash flows do, as remeasurements of risk impact the expected profit. It is our view that the financial impact of changes in the risk margin assumptions should be recognised in profit and loss, where they relate to the current period, or remeasured through the service margin where they relate to future periods, as this approach is consistent with the treatment for other actuarial assumption changes. Under this approach, the user has visibility of changes in all experience gains and losses (an indicator of how accurate estimates have been) and all changes in assumptions relating to future periods.

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.

As ANZ does not have a material involvement in participating business, we do not have any comments to make with regard to this question.

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?

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Why or why not?

If not, what would you recommend and why?

We support the approach of the IASB to produce a single model for both life and general insurance contracts and a single model for presentation of revenue and expenses. We also support the IASB's intention to bring the insurance contracts standard in line with the revenue standard, and to propose a concept of revenue under an insurance contract that is consistent with the approach that will be applied to all other types of revenue.

ANZ (along with all of the Big 4 Australian banks) is involved in providing banking services, issuing life insurance contracts, general insurance contracts and life investment contracts and a single approach to presentation of revenue and expenses across all of our products will result in financial statements that are of greater use to users, and will reduce the volume of disclosures.

We support the ED's approach on the basis that:

- It is an improvement on the margin analysis proposed in the previous ED;
- It proposes a consistent presentation model for both life and general insurance contracts; and
- While the 'revenue' balance that will be presented is different to that currently presented, the components of that number are readily determined as part of the measurement of the insurance contract.

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 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?

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We do not support the proposals in the ED to mandate the presentation of the financial impacts of discount rate changes in OCI because of the complexity of this proposal as well as the potential to create accounting mismatches for some insurers. We propose that insurers are *permitted* (but not required) to present the financial impact of *changes in discount rates in the current period* in OCI, where this presents useful information to users.

The proposal to present the financial impacts of discount rate changes in OCI will require insurers to maintain two measurement bases for each cohort of insurance contracts: one using locked-in discount rates; and one using current discount rates. This will create significant complexity in the actuarial models required to calculate the financial impact and additional burdens for external auditors and those involved in financial governance, including non-executive directors. We note that the amount presented in OCI includes two components: the impact of changes in discount rates in the current period (the bulk of the financial impact) and the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate.

ANZ currently presents both statutory profit and cash profit (a non-IFRS measure) in its annual report. One of the adjustments to statutory profit is the financial impact of changes in discount rates in the current period. We believe this is useful information to our users, as it disaggregates market-driven impacts (which otherwise drive significant P&L volatility) from underlying underwriting profit. As it only relates to the current period, it is an adjustment that is relatively simple to determine and, therefore, explain to our users. Including the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate in the adjustment would add significantly to the complexity of the determination and would reduce the usefulness of the information presented. The movements in this second component do not move in line with market conditions and are difficult to understand and explain. For example, even if discount rates do not change in a particular period, a gain or loss would be recognised in OCI because of the continued use of a locked-in rate for interest accretion. We therefore propose, to reduce complexity, and to provide useful information for users, that if changes in discount rates are presented in OCI that it should only be the component that relates to changes in discount rates in the current period.

Furthermore, we believe that it should be an accounting policy choice to present this impact in OCI, depending upon whether or not, given the asset measurement bases and product mix of the insurer, this would provide useful information for users. For some insurers, presenting the financial impact of discount rate changes in OCI will create accounting mismatches, for example, where the insurer has a large number of assets measured at fair value through profit and loss. Within the ANZ Group, for example, our insurers are impacted differently by changes in discount rates. For one, changes in discount rates introduce significant volatility into the profit and loss, for the other, because of the measurement bases of assets backing the liabilities and because of an inherent hedge within the portfolio (with discount rates impacting annuity and risk portfolios in opposite directions) the impact is less significant.

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?

We support the changes made to the transition proposals since the previous ED.

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Given that the MoS model requires the recognition of a planned margin (which is similar in nature to the service margin under the ED); we were not supportive of the proposals in the previous ED, which required existing planned margins to be derecognised on implementation of the new insurance standard.

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.

For Australian entities the impact of the proposed ED is less significant than for entities in many other jurisdictions, and therefore, for ANZ, the benefits of the proposals, in particular the increased consistency it will bring to global accounting practices for insurance contracts, justify the costs of implementing the proposals.

One area where believe transparency may not be achieved is in relation to implementation of the contract boundary proposals. Note our comments in response to Question 7 below. We believe that contracts that are in substance the same could either be accounted for as long-term contracts using the full building blocks approach, or could be measured using the simplified approach.

One area where we believe the costs of implementation do not justify the benefits is the presentation of the financial impact of discount rate changes in OCI (see our response to Question 4).

The ED lists extensive disclosures, but allows the disclosures not considered relevant to be omitted from the financial statements. While we welcome this ability to omit certain disclosures, we would nevertheless encourage the Board to take a more principles based approach to disclosure. Including very extensive disclosures in a standard, but allowing entities to omit certain disclosures, may still lead to unnecessary levels of disclosure as entities include disclosures to bring disclosure in line with peers and external auditor views.

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 any proposal that is not clear. How would you clarify it?

There is one significant area where we believe the proposals are not clearly drafted.

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We are concerned about a lack of clarity in the drafting of the current contract boundary proposals that could result in diversity in the accounting for contracts of a similar nature.

The ED introduces amended requirements to determine the boundary of an insurance contract. These requirements impact whether a contract can be measured using the simplified approach, as the simplified approach can be applied to contracts with coverage periods of twelve months or less. Under the contract boundary proposals, coverage ends: either when the contract can be repriced, or, when the portfolio can be repriced and "when pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account risks that relate to future periods" (para 23(b)(ii)). We understand that paragraph 23(b)(ii) was introduced to prevent certain contracts such as certain level premium contracts from being accounted for as annual contracts, as this would result in the recognition of revenue (and hence profit) being accelerated relative to the provision of service (or expiry of risk).

In Australia, yearly renewable terms (YRTs) contracts are common in the life insurance market. At ANZ, they are prevalent in both our Retail and Group life business. For these contracts, the insurer may not cancel the contract, but it may reprice the portfolio of contracts annually. While the insurer, in pricing the contract prior to inception, will reflect expectations of renewal and/or lapse beyond the first twelve months (if all insureds were to lapse after one year the first year's premium would often not cover acquisition costs) it will reprice all risks such as lapse, mortality and disability risk at each annual renewal.

There are differing views in Australia as to whether YRT contracts would be considered annual contracts or long-term contracts under the ED. Given that lapse risk, for the first twelve months and into the future, is anticipated in the original pricing, does this mean that the pricing takes into account future risk? Given lapse rates can be such a significant contributor to ultimate underwriting profit some believe that YRT contracts would not be considered annual contracts. We believe that as all risks can be repriced annually the contracts should be considered annual contracts. We also believe paragraph 23(b)(ii) would be difficult to substantiate as the insurer would need to be able to demonstrate that it was only incorporating risk, and expectations about changes in that risk, for the following twelve months and that it is not reflecting risk, or changes in that risk, beyond the next twelve months.

We would therefore encourage the Board to reconsider the current drafting of 23(b)(ii) to avoid diversity in the accounting for contracts such as YRTs.

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25 October 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear Sir

Exposure Draft ED/2013/7 Insurance Contracts

We are pleased to have the opportunity to provide our comments on the draft IFRS for Insurance Contracts, Exposure Draft ED/2013/7.

National Australia Bank (NAB) is one of the four major banks in Australia. Our operations are predominately based in Australia, New Zealand, the United Kingdom, the United States and Asia. Through our wealth management division, MLC, we provide investment, superannuation and insurance solutions to corporate and institutional customers. MLC is a leading provider of life insurance in Australia.

Overall we are supportive of many of the requirements of this Exposure Draft and welcome the improvements from the 2010 ED, including the unlocking of the residual margin and the revised transition requirements.

We support the move towards a uniform IFRS that will apply across many jurisdictions, however we do have a reservations regarding some of the proposals which we believe will inappropriately impact reported results if the draft IFRS is not amended. In our opinion, the major areas to be addressed are as follows:

- The use of other comprehensive income for the impact of changes in the discount rate – we believe this approach is overly complex, particularly the requirement to use interest rates applicable at initial recognition of the contract. The proposal also does not eliminate all accounting mismatches where the assets backing policy liabilities will not be classified as fair value through other comprehensive income. We believe a better approach would be to require all changes in policy liabilities to be recognised in profit or loss, except where the other comprehensive method is more appropriate, based on business model.
- We do not agree with the proposal to measure fulfilment cashflows by reference to the carrying value of underlying items on the basis that the practical application of the approach could result in the decomposition of contractual cashflows into components with multiple accounting treatments. We believe the resulting complexity outweighs potential benefits.

Our detailed response is attached to this letter.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at marc.smit@nab.com.au.

Yours sincerely

Stephen Gallagher
General Manager, Group Finance

Laura Ribeiro
Manager, Group Accounting Policy

Detailed Answers to Questions

Question 1 – Adjusting the Contract 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?

We agree with the revised approach regarding the contractual service margin set out in this Exposure Draft. We agree that financial statements will provide more relevant information if differences between current and previous estimates of cashflows relating to future coverage are deferred to future periods.

In our view this approach improves the relevance of profit or loss as changes in expected future profitability are excluded from current earnings, and this will allow users of financial statements to better assess the profitability of the business.

We also consider that this approach could be applied to changes in the risk margin which relate to future coverage and future services as these also relate to future profitability and should be excluded from current earnings. We understand that the approach in the Exposure Draft was put forward on the basis of simplicity, however we consider that it would be relatively straightforward to differentiate between differences in the risk margin relating to future periods and differences relating to current and previous periods.

We also recommend that the Exposure Draft be revised to confirm that subsequent changes in assumptions that result in a reversal of previously recognised losses be taken to profit or loss rather than deferred to future periods.

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?

Whilst we support the view that accounting mismatches should be eliminated for contracts which require the entity to hold underlying items and specify a link to returns on those underlying investments, in our opinion the proposed approach is unduly complex.

Issues would arise on products which are backed by a mixture of instruments with diverse accounting treatments. The requirement to decompose cashflows on the basis of underlying assets could result in the valuation of a single portfolio of insurance contracts reflecting multiple accounting treatments, including fair value through other comprehensive income, fair value through profit or loss, and historical cost for example. This is in addition to any component which is not linked to returns on underlying items.

It is expected that for some products the valuation of the policy liability resulting from such an approach would not be representative of actual fulfilment cashflows. For this reason, the expected complexity is not justified by expected benefits.

In order to eliminate accounting mismatches without introducing significant complexity, it is our view that a better approach would be to allow the assets underlying the contract to be valued at fair value through profit or loss.

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?

We agree with the proposal to present insurance contract revenues and expenses in profit or loss.

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 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?

We do not agree that an entity should be required to recognise the difference between the carrying amount of the insurance contract measured at the discount rate at reporting date and the carrying amount of the insurance contract measured at the discount rate at first recognition through other comprehensive income.

Our specific concerns are as follows:

- The requirement to use interest rates applicable at the initial recognition date of the insurance contract will be difficult to apply in practice and does not provide relevant information to users of financial statements. It will be particularly difficult for insurers to identify and apply the interest rates at inception on older insurance contracts and we consider this to be a costly requirement for no real benefit.
- Many insurance contracts are backed by assets which will not be designated as fair value through other comprehensive income under IFRS 9. These include equities and complex debt instruments and often represent a significant component of the pool of assets used by insurers to back policy liabilities. Accounting mismatches will continue to exist if the entity is required to present the impact to policy liabilities of changes in discount rates through other comprehensive income, and the impact of changes in discount rates on the underlying asset is presented through profit or loss (where the asset is fair value through profit or loss).

We note that the IASB has not developed its conceptual framework with regards to other comprehensive income and it is our view that this should be finalised before additional items are allocated to other comprehensive income.

We propose the following alternative to this approach:

- The ED should require changes to the carrying amount of insurance contract liabilities to be recognised through profit or loss, with an option to allow for the use of other comprehensive income based on the insurer's business model or other circumstances;
- Under the current drafting of IFRS 9, this approach would allow for financial instruments backing policy liabilities to be designated as fair value through profit or loss as it would eliminate an accounting mismatch;
- In our view this would allow for those who had a business model which would be better represented by adopting the other comprehensive income approach to do so;
- We would also recommend that any amounts that are recognised in other comprehensive income represent the difference between interest rates at the start of the period and interest rates at the reporting date, removing the requirement to report using interest rates applicable at the initial recognition of a contract.

Question 5—Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

We agree with the current approach to transition and see it as a significant improvement to the previous Exposure Draft.

We do recommend that the IASB align the mandatory application dates of IFRS 4 and IFRS 9.

Question 6 – the likely effects of a standard for insurance contracts
Considering the proposed standard as a whole, do you think the cost 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.

In our view the costs associated with transitioning to the new standard will be substantial. Whilst we support of the requirement to implement a global accounting standard for insurance contracts and recognise that certain costs must be incurred in achieving this result, we believe there are areas where the associated cost is not justified by the benefits provided.

One particular area of concern is the requirement to use interest rates applicable at the initial recognition date of an insurance contract. In our view this does not provide meaningful information to users of financial statements and is expected to be costly to implement. In this case we do not consider the costs associated with the particular requirement to be justified by the benefits provided.

The proposed approach for contracts which require the entity to hold underlying items and specify a link to those underlying items is considered to be overly complex and in our view the cost of implementing this approach is not justified by the benefits provided.

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 any proposal that is not clear. How would you clarify it?

We have no comments in relation to the drafting of the Exposure Draft.

Building a better working world

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The Chairman
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30 October 2013

Dear Mr Stevenson

Ernst & Young's global submissions to the IASB on the Exposure Drafts ED/2013/7 – *Insurance*

Please find enclosed Ernst & Young's global submissions to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

Encl:

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28 October 2013

Dear IASB members

Invitation to comment – Exposure Draft Insurance Contracts

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the revised Exposure Draft, *Insurance Contracts* (ED).

The revised ED contains several changes made in response to comments received on the 2010 proposal and many of these changes are consistent with our recommendations in response to the 2010 ED. Notwithstanding that the IASB responded to many of our previous concerns, and our support for the general direction of the revised ED, we continue to believe that additional changes are necessary to improve the proposal in the revised ED. We are concerned that the Board may not have struck the right balance, in some areas, between enhancing the usefulness of financial reporting versus the costs of applying the proposal. The increased complexity of the proposal in the revised ED could also lead to reduced transparency and reliability of the information provided to users. Additionally, some aspects of the proposal may be difficult for companies to implement and explain, or for users to comprehend.

A global insurance standard

We continue to believe in the importance of a single set of high-quality global accounting and financial reporting standards and we strongly support the convergence of IFRS and US GAAP. However, with regard to accounting guidance for insurance contracts, the IASB and FASB (collectively, the Boards) have not been able to fully converge their respective proposals. We encourage the Boards to continue to work together to minimise the differences in their respective insurance contracts standards, thereby making them more comparable. However, we are concerned that the time necessary to jointly re-deliberate and fully converge may result in a further delay of the issue of a final IFRS standard on insurance contracts. Such a delay would mean that there will continue to be inconsistency in how companies report insurance contracts under IFRS. Therefore, the insurance project should remain a priority for the IASB and we believe the IASB should, as soon as possible, issue a revised IFRS 4 standard, even if this were to mean that the IASB has to issue a new insurance contracts standard within a timeframe that differs from that of the FASB.

Whilst we believe the IASB should proceed to revise IFRS 4, we believe that the Boards should utilise the feedback received from respondents to their respective proposals to identify those areas where their proposed guidance differs. The Boards may be able to jointly re-deliberate and eliminate differences that require limited effort to be resolved. We acknowledge the foregoing approach is likely to result in some differences between the IASB's and FASB's respective standards.

We have responded to the specific questions raised in the ED to provide suggested improvements to the proposed accounting. Those responses are set out in Appendix A to this cover letter. We have also responded separately to the FASB with respect to their proposal (attached as Appendix B to this letter).

Preparers have a variety of concerns about the IASB's proposed standard. The nature of these concerns appears to be driven by geography, past practice based, in part, on local regulation, and differences in the insurance products offered. We also notice divergent views among users. As mentioned, we support the Board's goal to achieve a consistent global accounting model for insurance contracts. At the same time, the existing diversity creates challenges in completing the project on the basis of one particular measurement and presentation approach. Considering the widespread diversity that currently exists and the urgent need for a solution for the longer term, we would be willing to accept a standard that, while eliminating most of the diversity seen in today's practice, would allow for some differences between companies by permitting a limited choice for measurement and/or presentation. Such choices would give companies the ability to decide how best to reduce accounting mismatches for the different types of contracts they issue, and how they manage their business to fulfil their obligations.

Accounting mismatches

The development of a global standard for insurance contracts has had many challenges due to the complexity of some of the insurance products issued, differences in how companies run their businesses to enable them to fulfil their obligations under the insurance contracts they issue, and regulatory restrictions within the insurance industry. A key issue that was raised in the comment letters on the 2010 ED, and which continues to be raised in response to the revised proposal, is volatility in both profit or loss and equity, whether caused by accounting mismatches or for other reasons. We agree with the principle that, where an economic mismatch cannot exist, accounting mismatches should be avoided. At the same time, the model should reflect the impact of economic events on a company's results in a transparent way. We acknowledge that the Board deliberated at length (in response to concerns raised in the comment letters to the 2010 ED) how to distinguish between accounting and economic mismatches and proposed a solution, principally utilising Other Comprehensive Income (OCI), to align the presentation of impacts of changes in interest rates for assets and liabilities. However, we believe that the Board's recommendation only addresses one dimension of a company's assets. That is, the fixed income portion of assets that are invested until they are needed to pay obligations. Many of the longer-term products that insurers issue are complex and offer benefits directly or indirectly linked to long-term returns based on diverse investments (e.g., debt, equity, real estate and derivatives). Whilst we believe that the

accounting for insurance liabilities should not depend on the types of assets that a particular insurer holds, we are concerned about inconsistent measurement and presentation of insurance liabilities and assets that back those liabilities, resulting in accounting mismatches. We describe possible ways to address our concerns below.

Optional use of OCI

The proposed model requires the effect of changes in interest rates on the measurement of the liability for most insurance contracts to be reported in OCI. This proposed accounting was changed from the 2010 ED to address the insurance industry's concern that profit or loss volatility occurs when all changes in the insurance portfolio are reported through profit or loss. The required use of OCI was linked to a proposed change to IFRS 9 *Classification and Measurement*, which requires the impact of changes in fair value of certain assets to be reported in OCI. Because the types of assets for which fair value changes are recognised in OCI are limited to those that satisfy the 'characteristics' criterion, the Board's decision to require interest rate changes for insurance contracts to be recognised in OCI is likely to create accounting mismatches. We believe that companies should be able to choose to eliminate such accounting mismatches by permitting them the option to report interest rate changes on selected portfolios of insurance contracts through profit or loss. Providing such an option would mean that full comparability between insurers would not be possible, but we believe that appropriate disclosure of how the interest rate changes impacting insurance liabilities are reported would provide users with sufficient information to understand and, if necessary, adjust for the lack of comparability.

Generally, we concur with the Board that offering accounting choices in a standard should be avoided where possible. However, where there is a clear underlying rationale, for example, avoiding accounting mismatches, this optionality would be an acceptable alternative and, in the light of the insurance project, would reduce barriers to completing the standard.

Insurance contracts that offer a link to investment results

We agree with the IASB's view that when the risks are borne by the policyholder, the accounting model should reflect who is retaining that risk (i.e., the policyholder). In situations where an economic mismatch cannot exist between the terms of the participating feature in an insurance contract and the underlying items, the Board proposes to achieve this objective by measuring (a portion of) the liability by reference to these underlying items. This exception to the building block model is combined with a consistent presentation of changes in that (portion of the) liability and the underlying items (the so called 'mirroring' approach). Using such a mirroring approach to align the measurement of the insurance liability to the assets held is one way to reflect (in the insurance model) the fact that the policyholder is retaining most of the risk.

The proposal to eliminate accounting mismatches that would otherwise arise from the application of the building block approach when the liability measurement model is not aligned with that of the underlying items, according to the applicable IFRSs, is based on a conceptually sound objective. However, the proposal introduces many challenges that may make the application of the proposal potentially less transparent because of the inherent

complexity and the need for arbitrary determinations about the decomposition of the cash flows. For example, an insurance contract contains provisions that extend beyond the mere return of investment results on the underlying items. To isolate one aspect of the overall contract requires the decomposition of the contract. We believe this decomposition results in complexity and arbitrariness similar to that which the Board noted for separating a contract that is deemed to be an integrated arrangement within the context of the insurance contracts standard. If the Board decides to proceed with the mirroring approach, we believe revisions will be necessary to explain how to separate the cash flows. We are not confident that such changes will result in a mirroring approach that is sufficiently transparent, comparable and not subject to a significant degree of arbitrariness.

The Board may therefore consider dealing with participating contracts without decomposing the cash flows. We suggest the Board considers using the building block model for all participating contracts, and provides specific guidance on how to determine the discount rate. We describe this further in our response to Question 2 in Appendix A.

For participating contracts that do not qualify for the mirroring approach, the Board proposes to use the building block measurement model with an update of the discount rate for interest accretion in profit or loss for those cash flows that vary directly with the underlying items. Whilst we agree with the Board's rationale in seeking to update the discount rate when expected future cash flows to policyholders change on the basis of changes in the underlying items, we have concerns on how this concept should be applied under the proposed guidance in the ED. For example, the requirement to update the interest rate in profit or loss for some components, but not for others, results in decomposition issues that are similar to those we identified for the mirroring approach (see above).

We believe the approach we suggest in our response to question 2 in Appendix A could be applied to all participating contracts, i.e., both for those that do and those that do not qualify for the mirroring approach. This would avoid having multiple models based on bright line criteria and would result in a consistent basis for both participating and non-participating contracts.

Unlocking the Contractual Service Margin (CSM)

As noted in our 2010 comment letter, we believe that the CSM should not be 'locked in' on initial recognition. Although we conceptually agree with unlocking the CSM, as set out in the proposal, we have some concerns about which changes in cash flows result in the unlocking of the CSM. For example, the ED and its illustrations do not provide sufficient guidance to determine which changes in cash flows result from changes in future cash flow expectations and which relate to changes in current period experience. Without sufficient guidance, we believe that diversity in practice on the application of CSM unlocking could emerge, resulting in a lack of comparability of reported profit between insurers.

The Board proposes not to unlock the CSM for changes in the risk adjustment. The risk adjustment measurement interacts with the potential variability in future cash flows. Therefore, we believe having changes in the future cash flows impact the CSM whilst changes

in the risk adjustment flow though profit or loss is inconsistent. We do agree that disaggregating the overall change in the risk adjustment in each period into a portion that relates to the current period and one that relates to the future would come with challenges. However, we believe it is important to treat the components of the movement in liabilities relating to future coverage consistently, regardless of whether they relate to the estimate of future cash flows or the risk adjustment on those cash flows.

Insurance contract revenue

We agree that the introduction of an insurance contract revenue measure based on the proposed 'earned premiums' approach for all contracts would bring consistency with the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time, and in which elements of premiums are reported as revenue. Within the building block model, the earned premium approach introduces a revenue measure for contracts that may contain a significant investment component measured on a current value basis not dissimilar to the fair value basis used to measure certain financial instruments under IFRS 9. Even though the Board proposes to eliminate the investment component from the reported revenue figure in a practical way, we question whether an allocated customer consideration approach produces a meaningful revenue figure for a contract with a significant investment component measured on a current value basis.

We believe that a summarised margin presentation would offer a reasonable presentation approach for contracts accounted for under the building block approach. Whilst this would result in companies not recognising revenue for contracts under the building block approach, it would, at least, present a simple and understandable approach. Traditional volume measures like premiums due, and claims and benefits, could be shown through note disclosures to the financial statements.

Notwithstanding the preference for a summarised margin approach, if users express the view that an earned premium figure would be useful to them, the Board should evaluate whether the additional benefits from providing such a figure outweigh preparers' costs of calculating this amount.

We acknowledge the fact that using a summarised margin presentation would result in the use of two different presentation models under the standard, notably the summarised margin approach for contracts accounted for under the building block approach and an earned premium approach for contracts accounted for under the simplified model (premium allocation approach). This would create some incomparability and inconvenience for composite insurers, but the other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. To the extent that this creates different presentations in the Statement of Comprehensive Income, the Board could investigate dealing with those different presentations through disclosures.

Transition

Measurement and CSM

We agree with the Board's proposals to include a CSM representing unearned profit in existing insurance contracts on transition to ensure that the treatment of business written before transition is consistent with that of business written after transition. We also agree that the introduction of simplifications is necessary, because preparers may conclude in many cases that it is not practicable to apply the general retrospective approach to some portion of their existing policies. We have some concerns regarding the Board's decision to select a retrospective approach with simplifications where applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is considered impracticable.
We believe the transition guidance could create additional complications for auditors given the subjective nature of this guidance. The IASB acknowledges in the introduction to the ED that some aspects of the estimates on transition may not be verifiable. As a result, auditors would be charged with validating management's view on unearned profit at a date in the past based on information that may have been obtained from sources that were not previously captured in the audit process and/or may have been maintained outside the data subject to the company's internal control procedures.

Effective date

We agree with the Board that insurers will need a reasonable amount of time to implement the necessary changes to their processes and systems to be able to produce accurate and timely financial information under the new standard. We believe that a minimum of a three-year period after the issue of the revised IFRS 4 standard will be necessary.

The transition guidance provided by the Board would allow companies impacted by the insurance contracts standard to revisit the classification of their assets accounted for under IFRS 9 if the implementation of the new insurance standard were to create an accounting mismatch. We would prefer to have the effective dates for the insurance contracts standard and the revised IFRS 9 aligned in order to avoid companies having to go through two rounds of changes. However, we do not think the Board should delay the effective date of IFRS 9 solely to be in alignment with the effective date of the insurance contracts standard.

Consideration and incorporation of recent field testing results

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and also that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend that it carefully considers the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with

users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

The Board has limited the questions asked of respondents to five specific topics mentioned in the ED. After considering the changes made to the 2010 ED, the Board concluded these five topics are the most important. We agree that these five topics are crucial areas of the proposal in the ED. Consequently, we focus the responses in our comment letter on these five topics in order to help the Board to resolve the conceptual and application issues around these topics. Notwithstanding this focus in our letter, the proposal in the ED may contain other items, such as drafting issues that will emerge as in-depth discussions take place around the application. During the Board's redeliberation period, companies, users and others may seek further practical understanding of the requirements in the ED. We therefore believe that once the Board finalises the concepts, it should allow for a review period which enables companies, users and others to assess the clarity of the guidance in the draft standard.

Our responses to the questions in the ED are set forth in Appendix A to this letter. Our letter to the FASB has been attached as Appendix B and includes responses to a variety of questions about the overall proposed insurance contracts standards. We believe the observations and concerns included in that letter may be useful for the IASB when re-deliberating its proposal.

Should you wish to discuss the contents of this letter with us, please contact Richard Lynch at +1 212 773 5601.

Yours faithfully

Ernst + Young Global Limited

- Appendix A: Responses to specific questions raised in the Exposure Draft, *Insurance Contracts*
- Appendix B: EY's letter to the FASB's Proposed Accounting Standards Update, *Insurance Contracts*

Appendix A

Responses to specific questions raised in the Exposure Draft *Insurance Contracts*

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?

Comments:

As set out in our 2010 comment letter, we agree with the principle of unlocking of the contractual service margin ('CSM') for changes in future cash flows. We also agree with having a floor of zero and not having a limit on the maximum amount ('ceiling'). However, we believe that previous period incurred losses recognised in profit or loss due to the application of the floor of nil should be reversed through profit or loss before the CSM is replenished. Using a floor without a ceiling will align the insurance contract unearned profit concepts with the similar concepts included in the new revenue recognition guidance. In that guidance, a loss will be recognised under IAS 37 only when the profit in the contract has been reduced to nil and the contract is considered to be onerous.

We agree that the objective relating to unlocking the CSM should result in a liability that is the 'remaining unearned profit' expected from the future cash flows and services between the insurer and contract holder/beneficiary. In other words, the CSM should reflect the remaining unearned profits that flow from the expected consideration and the outflows to

fulfil the obligations under the portfolio of contracts, as well as the related risk adjustment. Consequently, the CSM should not reflect profits the insurer expects to earn through sources that are not part of the measurement of the insurance contracts (e.g., an interest rate spread between earning on investments and accretion of interest on the insurance contract portfolios).

The impact of CSM unlocking depends on whether portfolios are maintained on an open basis or closed basis. An open portfolio combines previous period contracts with current period contracts, which allows expected profits from the current period contracts to offset losses that might arise from the prior year contracts. We recommend that, if the Board believes an open portfolio is acceptable, the guidance should be clarified and additional guidance will be needed to explain how an open portfolio should be applied in relation to the Board's definition of a portfolio and on unit of account.

We note that the ED indicates that, at initial recognition, the unit of measurement is at a portfolio of contracts level. However, we believe the ED includes conflicting guidance regarding the unit of account for the CSM after initial recognition. Specifically paragraphs 32 and B37(d) could be read as indicating that the unit of account should be set at a more granular level than the portfolio level referred to in paragraph 28.

In addition, paragraph B36 indicates that the same present value of cash flows will be arrived at whether determined at portfolio level or by the aggregation of cash flows at the individual contract level. We do not believe this is necessarily true with respect to the CSM. Insurance is based on spreading the risk of individual contracts through assembly of portfolios of multiple contracts. The amount of CSM release may therefore differ depending on whether the total CSM is determined at the portfolio level or as an aggregation of CSMs at a more granular level (e.g., vintages or perhaps even individual contracts). Therefore, the Board may have assumed companies might initially allocate and subsequently reallocate a portion of the CSM at a more granular level than the portfolio for recordkeeping, but for the purpose of releasing the CSM over time, insurers would base the amortisation on the entire remaining CSM and would not simply recognise the entire amount allocated to a particular contract if that contract terminated during the year. We suggest that the Board clarifies the application of CSM unlocking in the guidance accompanying the final standard.

We have identified four other areas that, without further guidance, could result in diversity in practice in how the CSM is established and released over the coverage period. Whilst we acknowledge that including further guidance in the standard could restrict the application of the principle somewhat, we believe it would make the Board's intentions clearer and achieve better consistency.

- How should increases in the CSM be accounted for following periods where the CSM was reduced to zero?
    - The ED does not explicitly mention how a company should account for favourable changes in future cash flows when it previously recognised losses in profit or loss because the unlocking of CSM was limited (i.e., the CSM cannot be negative). We

think that insurers could first reverse the losses previously recognised through profit or loss before re-instating the CSM. However, the guidance, as currently drafted, implies that the CSM is reinstated without regard to those prior losses. We believe the Board has drafted the guidance in this manner because it would simplify the application of unlocking. We believe that first reversing any previously recognised losses would prevent the total CSM reported in profit or loss from exceeding the actual profit in the contract. This approach would, in our view, also achieve better consistency with the treatment of onerous contracts within the context of the revenue recognition proposals. Regardless of which approach the IASB selects, we believe the Board should clarify this by providing guidance on how to treat favourable changes following periods where losses have been recorded in profit or loss.

- When are current period changes in assumptions that impact future coverage recognised in profit or loss rather than being offset against the CSM?
    - The Board proposes that the CSM should only be unlocked for changes in estimates of future cash flows that relate to future coverage. We are unable to determine from either the application guidance or the illustrative examples how to unlock for an event that happens in the current period that also causes a change in future expected cash flows for the existing portfolio of insurance contracts (often referred to as in-force business). For example, the expected present value of net future cash flows would be impacted by a large number of policyholder lapses as cash inflows and outflows (presumably due to future coverage) would no longer be received and incurred respectively. We believe the Board intended to state that the effect of events in the current period (e.g., fewer lapses than expected) on future cash flows from the in-force contracts be recorded in profit or loss in the current period and should modify the guidance to make this clearer. For example, how does unlocking of the CSM for estimates of future cash flows interact with the derecognition of contracts (e.g., once the coverage period has ended or other termination of the contract).

- Can there be multiple services in one insurance contract?
    - In the ED, the Board requires that an insurer release the CSM over the coverage period in a way that best reflects the pattern of transfer of services (other than bearing risk) to policyholders under the contract. This guidance seems to assume that the insurance contract only has one service and does not address how the CSM should be allocated if there are multiple services. We recommend that the guidance be modified to specifically address insurance contracts that contain multiple services that are not distinct.

- How to treat asset management fees within the CSM?
    - Paragraphs B68(d) and B68(e) seem to contradict each other on whether changes to insurance contract liabilities from movements in underlying items which relate to future asset management services should be adjusted against the CSM. Also,

the ED does not address how participating features designed to compensate for asset management services should be treated.

Risk Adjustment

The Board proposes that all changes in the risk adjustment should be recorded in profit or loss and paragraph BC 37 provides the Board's reasoning for that decision. We believe that the measurement of the risk adjustment will, to some extent, be based on the potential variability in the future cash flows. Whilst determining the risk adjustment comes with challenges, it seems inconsistent to require changes in expected cash flows relating to future coverage be offset against the CSM whilst changes in the risk adjustment relating to risks for future coverage flow though profit or loss. For example, if the future expected cash flows increase and the overall uncertainty in those cash flows decreases, the proposal would reduce the CSM for the increase in future cash flows (no profit or loss impact for higher expected future cost) whilst the risk adjustment would decrease and thereby create income in profit or loss. We question whether the financial statement impact of this example (showing earnings whilst, at the same time, increasing the insurance liabilities) is a fair representation of the economics.

The IASB explains in the Basis for Conclusions that the decision to record the change in risk adjustment through profit or loss is partly based on a belief that most of the change in the value of the risk adjustment would relate to expiry of coverage. This contention may not always be true. Consider an example where the population of potential outcomes narrows, causing the risk adjustment to be reduced significantly at the end of a reporting period. Here, a large proportion of the change in the risk adjustment would relate to re-assessment of the uncertainty in the remaining future cash flows rather than to the expiration of coverage.

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?

Comments:

The building block approach applies the fundamental principle that the measurement of the insurance contract portfolio is independent of the assets held, unless the fulfilment cash flows of the insurance contracts depend wholly or partly on those assets. When there is such dependence, the measurement of the insurance liability should reflect the extent of that dependence. We agree that the Board follows the concept that when an arrangement transfers the specific investment risk of assets held to another party (e.g., the policyholder), the financial statements provide relevant information if the measurement of the portion of the values of the assets held agrees with the measurement of the obligations created by the arrangement.

We therefore understand the Board's rationale for proposing an exception (i.e., measurement and presentation exception based on 'mirroring' the measurement and presentation of underlying items) to the basic model. We believe the mirroring approach is, conceptually, a way to achieve the Board's goal to eliminate accounting mismatches where an economic mismatch cannot exist for (a portion of) the contract's cash flows. However, if the Board wishes to pursue the mirroring approach, we believe the Board would have to revisit and, where necessary, modify the mirroring proposals on the areas discussed below.

Insurance contracts have many aspects to them and the Board's proposed solution within its mirroring exception guidance requires decomposition of the cash flows of the insurance contract into separate categories: those that vary directly with underlying items, those that vary indirectly with underlying items and those that do not vary with underlying items (some of which are dependent on each other). This approach results in an insurance contract having to be decomposed for measurement and presentation purposes, similar to the

separation that is required for embedded derivative or distinct investment and service components[1]. In the Basis for Conclusions, the Board explains the rationale for prohibiting the separation of insurance components for non-distinct investment and service components by noting that such separation would be arbitrary and, thus, reduce transparency and comparability. We think that this rationale can be applied equally to the requirement to split cash flows relating to participating contracts to apply the mirroring approach. We note that the IASB provides some guidance in paragraphs B 85 and B 86, but this guidance is difficult to understand and we think companies would struggle in applying this guidance in a meaningful way to even fairly straightforward contracts. If the Board were to proceed with the mirroring approach, we believe further guidance will be necessary on how a company should allocate the cash flows between categories.

Further, the scope of contracts to which this exception applies could be considerably smaller than the Board had expected. For example, certain common unit-linked arrangements may not meet the scope requirements in some jurisdictions. We understand that the Board developed the scope for the purpose of eliminating accounting mismatches only in situations where an economic mismatch cannot exist. We believe criteria to widen the scope to capture a larger population of participating contracts will be challenging within this context. As a result, we believe that contracts that the Board had expected would be able to apply the mirroring approach are excluded by this bright line requirement. If the final standard retains this measurement and presentation exception, the mirroring guidance should include more examples on types of contracts to which the mirroring approach applies.

In addition, we believe that the guidance on how to apply the mirroring approach would require further clarification and/or expansion on the following areas:

- How will any future changes to IFRS 9, for example, new impairment and macro hedging models, interact with the insurance contracts standard?
- How should mirroring be applied if the underlying item is not a basket of underlying items but the profits of the company as a whole?
- What is the impact of local accounting standards when those standards are the basis for determining the contractual profit sharing amounts (e.g., XYZ Country GAAP is the basis for determining the benefit payments, not IFRS)?
- Are cash flows that are subject to discretion included in mirroring accounting? The wording of paragraph B84(a) needs to be clarified to express the Board's intention.
- How does the model work if the policyholder pays periodic premiums and the balance of the underlying items that are to be 'mirrored' build up over time?
- How are asset management fees allocated under the proposal – are they allocated across categories of cash flows or are they included in only one of the categories?

We are not confident at this stage whether the Board will be able to revise the mirroring approach so that it can be applied in a way that is transparent and comparable and not

[1] Separate one or more components from a 'host' insurance contract and account for those components in accordance with those components according to applicable IFRSs, as if they were stand-alone contracts.

subject to a significant degree of arbitrariness. As such, the Board may need to consider dealing with participating contracts in other ways.

One way could be for the Board to revisit the scope of what constitutes a distinct investment component with the potential objective of expanding the list of components deemed distinct and separated from the host insurance contract. However, considering the Board's struggle with the topic of separation in the past, we are not convinced that re-visiting the separation guidance would be productive at this stage of the project. We therefore believe the Board should retain its current proposal in the ED on separation.

The Board could also pursue an approach based on applying the building block model to all participating contracts without requiring further decomposition of cash flows into categories. As explained in our cover letter, we believe that, within the context of such an approach, the Board should consider providing companies with the choice to reduce accounting mismatches based on their particular circumstances. We would not support having too many choices or permitting insurers to switch the method they select between periods. We believe that the main features of such an approach should be:

- Application of the building block model to a bundle of cash flows from insurance contracts at the portfolio level, without further decomposition of cash flows. Applying the model to an undivided bundle of cash flows means a company would have to use one liability discount rate curve for all future cash flows from a portfolio of contracts. Under the Board's principle that the discount rate should reflect the characteristics of the insurance liability, a company may therefore have to use a practical expedient (e.g., a blended discount rate) as an approximation for applying liability discount rate curves for each type of cash flows based on the particular characteristics of those cash flows (e.g., participating or non-participating).
- An irrevocable choice to recognise the effects of changes in discount rates in profit or loss instead of OCI, elected at inception on a portfolio-by-portfolio basis. This option would allow insurers to reduce or eliminate accounting mismatches if their assets are not at FVOCI.

We acknowledge that applying the building block model to all contracts, including participating contracts, with a practical expedient for discount rates and an option to recognise the effect of changes in discount rates in profit or loss reflects, to some extent, a practical compromise that still does not solve all possible accounting mismatches. However, this would, in our view, be a justifiable simplification with the possibility to prevent most accounting mismatches without the need to resort to the complexities inherent in the mirroring approach. Moreover, as we consider the measurement model, we are continuously reminded that insurance contracts can be a complex amalgam of financial, pure risk and service-type components. Finding the perfect sole solution for such contracts is unlikely. Therefore, a compromise based upon a common measurement and presentation basis will be necessary to progress this project to completion.

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?

Comments:

We acknowledge that the notion of insurance contract revenue ('earned premiums') brings consistency with the revenue recognition model for all types of insurance contracts, both in how it reports premiums as revenue over time and what elements of premiums are reported as revenue. At the same time, application of the approach would be a dramatic change from recognising revenue on the basis of premiums due, as applied under most existing life or long-term insurance contract standards.

We agree with the Board that application of 'earned premiums' would only be consistent with the general revenue recognition proposals if non-distinct investment components are disaggregated for presentation purposes. We understand the Board may have intended this disaggregation to be applied in a simple, practical manner (by simply deducting from the 'gross' earned premium the surrender value for all policies lapsed in the period). Nevertheless, preparers and users may question why the contract is not separated for measurement purposes, but then the cash flows of investment components are disentangled for the purpose of income statement presentation. This dilemma highlights that the earned premium model, as an allocated customer consideration approach, may not produce useful information for contracts with a significant investment component that are measured on a current value basis.

We believe that the Board's ultimate decision on how to report revenue in comprehensive income should be based on what the users of financial statements value when analysing companies' financial performance. Therefore, the main rationale should be whether the users think 'earned premiums' is a useful depiction of performance from insurance contracts within the financial statements, and whether the additional benefits from presenting insurance contract revenue on a basis consistent with other entities outweighs the cost of preparing this amount.

If producing the earned premium would be too difficult or the users would not support the approach for contracts accounted for under the building block model, we believe the summarised margin presentation for the building block approach in the Statement of Comprehensive Income may be the only option available. Whilst this would result in companies not recognising revenue for contracts under the building block approach, it would

at least present a simple and understandable approach that avoids revenue amounts that are inconsistent with the general revenue recognition model. If the Board were to select a summarised margin presentation for contracts under the building block approach, it would need to consider whether a specific disclosure requirement for volume information is necessary.
We would not support using any other insurance contract revenue approach explored by the Board thus far, because other alternatives considered are not consistent with the principles of revenue recognition and would therefore not bring comparability.

We continue to support the use of earned premiums as insurance contracts revenue for those contracts accounted for under the simplified measurement approach. While we understand this would create some incomparability and inconvenience for composite insurers, other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. The Board could consider resolving this presentation difference through disclosures.

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 the amount of those cash flows; and
(b) recognising, in other comprehensive income, the difference between:
the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
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?

Comments:

The use of OCI is consistent with the fulfilment value measurement objective for insurance contracts. It is also consistent with the Board's proposal to introduce a FVOCI category in IFRS 9. The use of OCI for presenting the effect of changes in discount rates will avoid accounting mismatches for debt instruments accounted for at FVOCI. The use of OCI does not resolve accounting mismatches when a company holds investments that are not at FVOCI (i.e., real estate, derivatives, private equity funds, etc.) to provide funds to fulfil the

obligations created by insurance contacts. Rather, the mandatory application of OCI to insurance liabilities may introduce accounting mismatches for such instruments.

A possible solution for this accounting mismatch would be to give companies the choice to record the effect of changes in discount rates on their insurance liabilities in profit or loss, rather than to require the use of OCI for insurance liabilities. The disadvantage would be increased optionality and less comparability, although we believe this would be outweighed by the benefits of avoiding accounting mismatches and the possibility to simplify other areas of the proposal (we refer to our response to question 2). We recognise that optionality of the use of OCI on the liability side may not completely resolve the accounting mismatch issue as some assets cannot be measured at fair value through profit or loss under applicable IFRSs.

Insurance contracts that offer a link to investment results, but the mirroring approach does not apply

For participating contracts that do not qualify for the mirroring approach, the Board proposes to use the building block measurement with an update of the discount rate for interest accretion in profit or loss for those cash flows that vary directly with the underlying items. Whilst we agree with the Board's rationale to update the discount rate when the expected future cash flows to policyholders changes on the basis of changes in the underlying items, we have questions related to the application of this concept.

A consequence of updating the discount rate for interest accretion in profit or loss would be the need to distinguish cash flows that vary directly with the underlying items from other cash flows. This requires a decomposition of cash flows similar to the decomposition that needs to be applied for contracts that qualify for the mirroring approach (see BC 130 and BC 131). This would, in our view, result in similar complexity as observed for contracts that are subject to 'mirroring'. We therefore believe our suggested approach set out in our response to question 2 should be applied to all participating contracts, i.e., both for those that do and those that do not qualify for the mirroring approach.

For cash flows of a contract that are expected to vary directly with returns on underlying items, paragraph 60(h) requires companies to update the discount rate for determining the interest expense in profit or loss when the expected future cash flows change as a result of a change in the expected returns from the underlying items. In our view, the guidance in paragraph 60(h) is not sufficiently clear on how to apply this update. Based on this wording, the trigger point seems to be a change in returns on underlying assets changing expectations for future payments to the policyholders. Further, the wording seems to suggest any update is referenced to the market interest rate in effect at the time of the update.

The intention of the Board may have been to indicate that when the fulfilment value cash flows are changed to reflect returns expected to be passed on to the policyholder, the rate for interest accretion needs to be adjusted. If this were the Board's intention, we believe it should clarify the wording of paragraph 60(h) to say the rate for interest accretion is updated to reflect the changes in expected future crediting rates. This would result in the

insurance contract liability measurement being similar to a variable debt instrument. The crediting rate for determining the expected future payments to policyholders may depend on the returns (yield) on underlying assets currently held by the insurer and the expected returns on future reinvestments. The ED should provide guidance on how this should be reflected in the rate for interest accretion.

The requirement to present changes in expected future cash flows as a result of changes in the underlying items in profit or loss according to paragraph B68(d) could result in accounting mismatches when the underlying assets are held at FVOCI.

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?

Comments:

We agree with the Board's proposals to include a CSM on transition. However, we have some concerns regarding the Board's decision to select a retrospective approach with simplifications if applying IAS 8 is impracticable. Many preparers may conclude it is not practicable to apply the general retrospective approach to some portion of their existing policies in-force. We therefore agree that the introduction of simplifications is necessary. Two areas where we believe the modified retrospective methods need clarification are:

i. Unit of account: upon transition, the company may apply the retrospective approach fully to some portfolios and use the practical expedient for other portfolios. Further, companies may have portfolios that contain some individual contracts where a full retrospective approach is applied and others where the practical expedient is applied. The Board should therefore consider only permitting the option to select the use of the simplified transition approach to individual portfolios and require disclosure on such an election.

ii. Lack of historical data: the transition guidance allows companies to use the actual cash flows that occurred in the years before transition in estimating the margin at inception. However, in some cases, companies will not have all historical cash flows. Using incomplete historical cash flows means the estimate of the CSM would be based on an incomplete picture of cash inflows and cash outflows. Comparing an incomplete set of cash flows could result in a figure that has limited value. Since situations where a company is unable to retrieve a part of the historical actual data may not be uncommon, the Board should provide guidance on how a lack of historical data should be considered when estimating the CSM.

The transition guidance could create additional complications for auditors given the subjective nature of this guidance. Further, the IASB acknowledges in the ED that some aspects of the guidance may not be verifiable, including the discount rate and CSM applied at transition. For example, auditors would be charged with validating management's view on unearned profit at a date in the past, based on information that may have been obtained from sources that were not previously captured in the audit process and may have been maintained outside the data subject to the company's internal control procedures.
We agree with the Board that insurers will need a reasonable amount of time to implement the necessary changes to their processes and systems to be able to produce timely financial information. We believe that a minimum of a three-year period after the issuance of the revised IFRS 4 standard will be necessary.

We agree with the transition guidance that provides companies with the ability to redesignate their assets accounted for under IFRS 9 if the implementation of the new insurance standard would create an accounting mismatch. We would prefer to have the effective dates for the insurance contracts standard and the revised IFRS 9 aligned in order to avoid companies having to go through two rounds of change. However, we do not think the Board should delay the effective date of IFRS 9 solely to be in alignment with the effective date of the insurance contracts standard.

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.

Comments:

As currently formulated, the standard would significantly reduce the inconsistencies in insurance accounting globally as many countries rely on local standards. The proposed

standard would affect all companies from an earnings emergence perspective. The greatest impact for the industry will be on life insurers given the duration of their contracts. However, general insurers will have their own challenges as they will need to discount their liabilities for incurred claims, including the application of OCI for the effect of changes in discount rates.

As we have noted throughout our comment letter, the revised proposal includes several areas that would cause complexity. Companies would have to expend significant resources to initially adopt the proposals and to continue to apply them on an ongoing basis. Normally, when an accounting standard is updated, all companies have costs that are somewhat comparable. However, the current IFRS 4 is not a comprehensive model and the cost for companies to implement any update to IFRS 4 will be impacted by the information that they maintain today to prepare their financial statements. Some companies' costs may differ significantly from other companies' costs, and mid-size to smaller insurers may be more likely to have costs that will exceed the benefits.

We have not performed an analysis to assess the costs of implementing the proposed ED against the increased benefits of more decision-useful information. However, the cost to implement the proposal without any modifications may exceed the benefits due to the complexity in some areas of the ED. We believe if the Board considers the changes we suggest to simplify the proposal, the costs to implement should be at a level that is reasonable within the context of a new insurance contracts accounting standard that brings a consistent solution for the longer term.

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 any proposal that is not clear. How would you clarify it?

Comments:

We support the IASB's objective to prepare a principles-based standard. However, this poses the challenge to establish a balanced set of overarching principles with relevant application guidance. We do not think the ED achieves this balance in all cases; for some areas, the guidance is fairly high-level and for other areas, it is fairly detailed and prescriptive.

One specific area where we have considerable difficulty in understanding the intended application of the ED is the guidance on participating contracts, for both the measurement and presentation exception under the mirroring approach (paragraphs 33, 34 and 66) and the update of the discount rate for determining the expense in profit or loss in case the

mirroring approach does not apply (paragraph 60h). We believe the guidance requires significant improvement, particularly if the Board intends to retain the mirroring approach.

Related to the previous point, the Board needs to clarify the application of the ED to options and guarantees measured under the insurance model:

- The ED is clear on how to measure such options and guarantees: a current value, considering a range of scenarios (i.e., stochastic).
- The wording in the ED is, in our view, also clear on how to present changes in options and guarantees embedded in contracts to which the mirroring approach is applied: all changes in the value of the guarantee would be presented in profit or loss, including both changes in expected future cash flows and the effect of discounting. However, the wording in the ED is not clear on whether this would relate to both the intrinsic value and the time value of the guarantees.
- The ED is not explicit on how to present changes in embedded derivatives in contracts where the mirroring approach is not used. We believe the Board's intention is that for those contracts the change in the value of the derivative would have to be disaggregated according to the general model, notably with some elements presented in OCI, some elements presented in profit or loss, and some elements adjusted against the CSM.

The Basis for Conclusion (BC127(b)) appears to suggest the Board intended a different application depending on whether such a derivative is included within a contract that is treated under the mirroring approach. We are concerned about the complexity associated with isolating the changes in the value of options and guarantees from other measurement changes under the mirroring approach. We are also concerned about the potential diversity as a result of having different treatments for options and guarantees that are very similar.

Other topics

Comments:

In addition to our responses to the specific questions in the ED, we have the following comments.

Directly attributable acquisition cost

We prefer an approach that includes only directly attributable acquisition costs related to the entity's selling efforts that result in obtaining the contracts in the portfolio (that is, those costs for successful contracts). All other acquisition costs should be recognised as expenses when incurred.

We agree that a practical expedient to allow entities to expense all acquisition costs when incurred (accrued or paid in cash) for contracts measured using the simplified measurement

approach should be included, and we recommend that the Board considers expanding the practical expedient to a somewhat broader range of contracts measured under the simplified approach (e.g., with a coverage period of two years). Another alternative that would reduce the cost to implement this aspect of the proposal for the simplified model is to allow entities to only include incremental costs, similar to revenue recognition, in their determination of directly attributable acquisition costs. The costs to implement systems and processes to capture non-incremental costs such as underwriters' salaries and benefits and policy issuance costs for successful efforts do not outweigh the benefits gained from reporting such information.

Discount rates

Many insurance contracts have expected durations that extend beyond the period of observable market yields. Discounting cash flows expected in periods for which there are no observable data points may significantly affect the current period value of the insurance contracts and may have similarly significant effects on an insurer's financial statements. As a result, the guidance on how to determine the discount rate for that portion of the cash flows is a critical aspect of the proposal. The guidance included in paragraph B71 is unclear with respect to how insurers should estimate the discount rates for those periods. That guidance first states that an estimation technique could be used, but then also indicates those rates could be determined using the current, observable market yield curve for shorter durations. To clarify what we believe was the Board's intent, the Board should consider incorporating into paragraph B71 language similar to the observation in paragraph BCA81. That observation states that forecasts of unobservable inputs tend to put more weight on longer-term estimates than on short-term fluctuations.

We expect that most companies that would need to apply the simplified model will have insurance liabilities whose characteristics generally will not include any risk associated with assets, so starting with a risk-free rate and adding a liquidity adjustment may be preferable. Weighing the costs of determining a liquidity adjustment versus the benefits, the Board should consider allowing companies, especially those applying the simplified model, the option to use the risk-free rate for discounting its liabilities. We believe this option should be irrevocable and be used for all portfolios of contracts accounted for using the respective approaches; that is, for all contracts measured using the simplified model or for all contracts measured using the building block approach.

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Appendix B

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
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P.O. Box 5166
Norwalk, CT 06856-5116

28 October 2013

Proposed Accounting Standards Update, *Insurance Contracts* (File Reference No. 2013-290)

Dear Ms. Cosper,

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Insurance Contracts,* (the proposed Update) from the Financial Accounting Standards Board (FASB or Board).

We continue to believe that creating a single set of high-quality global accounting and financial reporting standards is important and we strongly support the convergence of US GAAP and IFRS. However, on the proposed guidance for insurance contracts, the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) have not been able to fully converge their proposals. We believe the Boards have made significant progress addressing the concerns raised by constituents about the FASB's 2010 Discussion Paper and the IASB's 2010 Exposure Draft. We encourage the Boards to continue to work together to minimize differences in their insurance contracts proposals and make them more comparable.

However, we recognize the Boards are in two different situations. US GAAP has comprehensive accounting standards for insurance entities and, therefore, the FASB should focus on improving existing US GAAP. In contrast, IFRS 4 does not comprehensively address accounting for insurance contracts and permits a wide range of practices. Therefore, the IASB should focus on issuing a revised IFRS 4 standard as soon as it can. Because of this, it may be necessary for the Boards to re-deliberate aspects of their proposals separately. However, we believe the Board should consider re-deliberating as many areas as possible with the IASB. We recognize that the Boards will not re-deliberate jointly in all areas which will result in some conceptual differences between the FASB's guidance for insurance contracts and that of the IASB. In some instances, we believe both approaches are conceptually sound, and while we prefer a converged standard, we do not object to some of those differences.

We also recommend that the Board form a working group to address implementation issues during the redeliberation process. We believe this will help ensure consistent interpretations and application of the guidance and will minimize implementation issues that could result in the Board needing to revisit certain aspects of the final guidance.

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We summarize our most significant concerns with the proposed Update below. Appendix A to this letter contains our detailed responses to selected questions in the proposed Update. Appendix B contains our letter to the IASB.

Scope

We agree with the principle that contracts that meet the definition of an insurance contract should be included in the scope of the proposed guidance. However, we are concerned that without modifications to the proposed definition of insurance, the population of arrangements that would be required to use the guidance would be too broad.

We believe the Board needs to more clearly articulate the difference between a financial risk and an insurance risk and clarify when compensation paid to another party fulfills an entity's own performance obligation. Clarifying the proposed guidance would also reduce the need for many of the proposed scope exclusions. We find those exclusions confusing, detract from the definition of insurance and note that they would need to be updated as new products are developed and issues arise. While we recognize that there still will be a need for some explicit scope exclusions, we believe the Board should focus on characteristics of contracts rather than specific examples, where possible.

We also believe the Board has not adequately explored the various arrangements that are currently accounted for under other accounting guidance but would fall within the scope of the proposed guidance. We are particularly concerned about arrangements currently in the scope of ASC 460 on guarantees. The accounting for these arrangements should be addressed on a comprehensive basis if it is to be changed. Without a detailed analyses and a broader awareness by preparers that issue these types of arrangements, the resultant accounting may not adequately address these arrangements.

The proposal indicates that insurance must cover a pre-existing risk, but the Board needs to clarify this fundamental concept because it is not well understood outside of the insurance industry. By clarifying when there is a pre-existing risk, the Board could alleviate any confusion among noninsurers about whether arrangements they routinely enter into with their customers would be in the scope of the proposed standard. In addition, we believe that entities should look at the substance of the transaction in its entirety. An example is an arrangement in which the settlement of a claim triggers a simultaneous, unavoidable transaction with the party that benefits from the loss event (i.e., a stand-by letter of credit). Another example is an arrangement where the issuer of the guarantee (insurance) only compensates the contract holder if the contract holder enters into a secondary transaction (i.e., a trade-in right). We do not believe the substance of these arrangements is insurance and therefore should not be in the scope of the proposed guidance. We also believe the Board needs to clarify its implementation guidance on when an arrangement is an insurance contract.

One or two models

We have a conceptual preference for one model, but we agree with the Board's decision to include two models due to the differences in insurance contracts and how those contracts are viewed by users of financial statements. However, we believe the principles in the two models should be consistent. For the most part, the premium allocation approach, once the coverage period ends, and building block approach are converged. The recognition of the profit is not converged and we believe it should be

treated the same under both models. We do not believe the accounting differences between the two models constitute different principles, except for the recognition of the profit.

If the general principles are modified to be consistent between the premium allocation approach and the building block approach, we do not believe that the premium allocation approach should be required for all contracts that meet the criteria to apply that approach. In addition, we have concerns about the criteria that would be used to determine the required model and whether diversity in practice might result.

Discount rates

Determining the discount rates

The selection of discount rates would have a significant impact on the accounting for insurance contracts. The discount rates need to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the contract holder and, at the same time, produces a liability that reflects the current expected value to fulfill the insurer's obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

We understand and agree with the Board's desire to use discount rates that are based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, using the characteristics of the liability as the basis could result in diversity in practice because views differ on what those characteristics are and/or how they should be reflected in the discount rates.

We believe that using a yield curve that reflects current market rates of returns either for a reference portfolio of assets or the entity's actual portfolio of assets is an appropriate starting point. We also believe that the yield curve should be adjusted to exclude factors that are not relevant to the liability. However, the lack of clarity in the proposed Update regarding this approach could lead to a lack of comparability.

We also are concerned that the proposal does not contain clear conceptual guidance for determining the liquidity adjustment to the risk-free rate. Where required for regulatory purposes, the calculation of the liquidity adjustment is prescriptive. Without additional guidance there would likely be diversity in practice and lack of comparability. We are also concerned that requiring the complex determination of the liquidity adjustment each period may outweigh the benefits of discounting at a higher rate.

Therefore, the Board should allow entities to discount their non-linked contracts (i.e., non-participating contracts) using either a risk-free rate or a high-quality corporate bond rate as a practical expedient. This would minimize the complexity and the costs of compliance. Although the discount rates will be different, we believe the proposed requirement to disclose the yield curves and the related expected cash flows would improve transparency and provide useful information to users of the financial statements.

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend it carefully consider the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

Recognizing the effect of changes in the discount rates

We agree with the Board's decision to recognize the effects of changes in discount rates in other comprehensive income (OCI), even though doing so increases the complexity of the accounting. We understand that the Board's intent is to isolate the changes in underwriting from the changes in discount rates and to minimize accounting mismatches while recognizing economic mismatches. However, we are concerned that requiring the effects of changes in discount rates to be recognized in OCI for all non-contractually linked contracts may exacerbate accounting mismatches.

A significant portion of an insurer's investment portfolio includes fixed income assets and asset-backed investments, much of which are accounted for at fair value through OCI under existing GAAP. However, many of these investments may be required to be accounted for at fair value through net income under the Board's proposed guidance on financial instruments. Insurers also invest in equities, derivatives and limited partnerships that are accounted for at fair value through net income and real estate and mortgage loans that are accounted for at amortized cost, among other investments. The investment portfolio typically reflects the characteristics of the liabilities within a portfolio, most importantly the duration of those liabilities and how interest rate movements affect them. While the accounting for insurance liabilities should not be based on the types of assets that a particular insurer holds, we believe consistent measurement and presentation of changes in value of the insurance liabilities and invested assets backing those liabilities is necessary to minimize accounting mismatches. We concur with the Board that standards generally should not give entities the option to choose their accounting. However, when there is a clear rationale such as minimizing accounting mismatches, we believe policy choices can be acceptable as long as the choice is disclosed.

We believe, where possible, entities should be provided accounting options to avoid accounting mismatches. Therefore, we believe entities should have an irrevocable choice at the portfolio level to determine whether to recognize changes in discount rates in either OCI or net income. Requiring the choice to be made at the portfolio level will not eliminate all accounting mismatches but will mitigate some of the mismatches in earnings. Providing such an option would not promote comparability. But requiring the disclosure of how discount rate changes in insurance liabilities are reported would provide users with sufficient information. We believe this approach would provide users with better information than they currently receive and would align, to the extent possible, the financial reporting of companies with their asset/liabilities strategies. This alignment also would increase transparency by allowing users to understand how the business is managed.

Interest accretion rates

We agree that interest expense should be based on a locked-in accretion rate, even though doing so would make the accounting more complex. We believe this approach is necessary because of the Board's decision to recognize the effect of current-period changes in the discount rates used to value the insurance portfolios in OCI. However, the definition of portfolio is not specific as it relates to the accretion rate. We are uncertain whether the Board intended that entities would need to have closed portfolios to apply the interest accretion guidance. Although this is not stated in the proposal, accreting interest at the initial recognition discount rates, as proposed, would appear to require entities to create a new portfolio each time there is a change in discount rate. We understand that the Board did not intend to force entities to create new portfolios for the same product within a given reporting period just because they adjust their pricing in response to market conditions. Requiring multiple portfolios for the same reporting period would mean entities would need to capture an enormous amount of data to calculate the difference between the current rates and the multiple locked-in rates for each portfolio. Therefore, we propose that when a closed portfolio is used the Board consider allowing entities to use an average interest accretion rate. This practical solution would minimize the complexity and the cost of compliance.

Margin and changes in expected cash flows

We agree that, at initial recognition of an insurance contract or reinsurance contract, a gain should not be recognized because an entity has not yet performed under the contract and there is uncertainty about whether the gain will occur. We would not object to using the one-margin approach included in the proposed guidance with modification to the period over which it is recognized in income. However, we also would not object to a two-margin model under which an entity would recognize a provision for uncertainty and a residual margin.

We recognize that the proposed margin represents the amount of expected consideration (premium) in excess of the expected cash outflows and is intended to compensate the entity for several items, including accepting risk that actual benefits are greater than expected, general operating costs to run a business and an economic return to the entity's shareholders. Decomposing the excess amount into separate measurement amounts may provide relevant information if the underlying principles for those separate measurements is sufficiently clear and would result in comparability across entities. However, the costs to prepare and update may not justify a model that has more than one margin.

We do not believe there is a conceptual reason for there to be a difference in the timing of profit recognition between the building block approach and the premium allocation approach. Therefore, either the margin should be recognized over the coverage and settlement period, as proposed for the building block approach, or the margin should be decomposed into two components, a residual margin that would be recognized over the coverage period and a provision for uncertainty that would be recognized over the coverage and settlement period as the uncertainty in the cash flows decreases. For the premium allocation approach, either the liability for remaining coverage should be earned over the coverage and settlement periods or a provision for uncertainty should be recognized when a claim is incurred.

We believe that, similar to the day one measurement, the margin should reflect the "remaining unearned profit" expected from the future cash flows and services between the insurer and contract holder/beneficiary at each reporting date. In other words, the margin should reflect the remaining unearned profits that flow from the expected consideration and the outflows to fulfill the obligations under the portfolio of contracts. Consequently, we do not agree that changes in estimated cash flows (other than the effect from changes in the discount rates) should be recognized in net income. Instead, both favorable and unfavorable changes in expected cash flows (other than the effect of changes in the discount rates) should be recognized as adjustments to the margin, up to the amount of consideration expected to be received. The margin should not be below zero and therefore any excess adjustments would be recognized as a loss.

If the Board decides to adjust the margin for changes in expected cash flows, it would need to decide how the adjusted margin should be calculated. While a retrospective catch-up approach may be most theoretically sound, the complexities may outweigh the benefits and a prospective approach may be a practical solution. The Board also would need to determine whether the margin would be based on a closed or open portfolio. Our preference is a closed portfolio. In addition, the Board would have to specify what is considered a current-period experience adjustment rather than a change in expected cash flows. Without sufficient guidance about these items, we believe that diversity in the application of unlocking the margin for changes in expected cash flows could emerge, resulting in a lack of comparability of reported profit emergence among insurers.

Notwithstanding our comments above, if the Board decides that the margin determined at initial recognition should be retained for the estimation risks in the portfolio or that adjusting the margin for changes in expected cash flows adds unnecessary complexity and detracts from transparency, we would not object to recognizing changes in expected cash flows in net income. However, we believe that entities should not recognize changes in the expected cash inflows in net income as proposed. Instead, we believe that the profit included in changes in expected cash inflows that relates to extending or obtaining increased coverage should adjust the margin. The reasons for deferring expected gains on the initial expected cash flows equally applies to any additional expected cash inflows; that is, an entity has not yet performed under the contract and there is uncertainty in the insurance contract about whether the gain will occur. Also, we do not believe an entity should recognize the remaining margin when the expected cash outflows are in excess of the expected cash inflows and the qualifying acquisition costs.

As previously noted, we also would not object to a two-margin approach under which an entity would decompose the amount of expected consideration (premium) in excess of the expected cash outflows into a provision for uncertainty (if it provided useful information) and a residual margin. However, we are concerned that a provision for uncertainty could become a standardized add-on to the mean, or a way for management to inject bias into the measurement process. Further, we continue to be concerned about the reliability of estimating a provision for uncertainty. Therefore, if a two-margin approach is adopted, we believe the objective of the provision for uncertainty needs to be clearly defined, the provision for uncertainty and diversification benefits for claims yet to be incurred should be calculated at a portfolio level and specific disclosures should be required about the techniques used and assumptions to calculate the provision for uncertainty.

Revenue recognition and presentation

Consistent with current reporting, we believe that users would obtain relevant information if insurance contract revenue and expense amounts were presented in an entity's financial statements. We do not believe there is a conceptual reason for a difference in the presentation of the consideration received (revenue) for an insurance contract and other types of services or the costs to provide the contract or service (costs of goods sold). However, due to the complexities of the proposed revenue recognition approach, we believe either an earned premium or summarized margin presentation could be used to present information in the statement of comprehensive income for contracts accounted for using the building block approach. While a summarized margin presentation would result in companies not recognizing revenue for contracts under the building block approach, it would at least present a simple and understandable presentation. Traditional volume measures like premiums due, claims and benefits could be shown through note disclosures to the financial statements. In making its determination, the Board should focus on which presentation provides the most useful information to all users of financial statements.

We agree with the Board that the current practice of recognizing revenue based solely on when the contract says payment is due is not appropriate because it does not consider when services are performed by the entity and it is inconsistent with the definition of revenue and how all other industries recognize revenue.

We agree with the proposal to recognize revenue over time for contracts measured using the building block approach. It is consistent with the premium allocation approach and the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time and the elements of premiums that are reported as revenue. However, we believe the Board should clarify what it means by "value of services", how it views the service that is being provided and its intent for how revenue should be recognized. This will help avoid non-comparable results for identical products/services due to diversity in interpretations.

We recognize that both the earned premium and summarized margin presentation will not convey the same volume (premium and claim) information that users receive today. Our understanding is that users do not view these amounts as revenue but rather as growth indicators that we believe should be contained in disclosures, as proposed.

Insurance contracts acquired in a business combination

We do not agree that an entity should recognize a loss on insurance contracts acquired in a business combination when the fair value of the insurance contracts' assets and liabilities is less than the measurement of those assets and liabilities in accordance with the proposed Update. We also do not believe that goodwill should be adjusted in such situations, as proposed in the IASB's revised Exposure Draft.

ASC 805 requires entities to measure the assets acquired and liabilities assumed at their acquisition-date fair value. We do not believe an exception to ASC 805 is warranted for the measurement of insurance contracts acquired in a business combination. Regardless of whether the insurance contract's assets or liabilities are recognized as one balance or separated into two components, we believe the total amount recorded upon acquisition should equal the fair value of the insurance contracts acquired.

Transition

The transition provisions would have a significant long-term effect on some insurance companies' results because existing contracts may stay in force for 20 or 30 years. Therefore, we believe the transition provisions need to result in the measurement of insurance contracts written before the transition date in a manner that will result in revenue, expense and profit recognition patterns consistent with insurance contracts issued after the transition date. We believe the Board's decision to apply the proposed Update retrospectively best achieves those objectives and that the practical expedients to determine the margin and the interest accretion rates adequately meet those objectives.

However, the proposal implies that companies could rely on information that may exist within the entity, but that information may not have been or cannot be subjected to auditing procedures. We believe that the practical expedient should be refined to limit the situations in which an entity would not be able to recognize a margin and would not have to use information that may be costly to accumulate and to audit.

Therefore, if full retrospective application is impractical, we believe the Board should consider simplifying the practical expedient to allow companies to use expectations as of the transition date. The total margin can be determined as the difference between the total premiums (charged or to be charged) for a portfolio of contracts and total estimates of expected cash outflows (paid or to be paid) and qualifying acquisition costs using historical data and assumptions at the transition date. That total margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet margin. Although this mimics adjusting the margin for changes in expected cash flows, this approach should be considered, regardless of the Board's decision on adjusting the margin, as an approximate transitional method where full retrospective application is impractical. This approach uses consistent measurement principles for the opening balance sheet and, with disclosure, is preferable to the elimination of margins when objective historical evidence is not readily available.

Costs versus benefits

The proposed Update represents a comprehensive reconsideration of the accounting for insurance contracts that has evolved over many years as a result of emerging insurance products and features. This reconsideration would replace existing industry practices with principles that are consistent with other accounting standards. These principles would be applied consistently by both insurance and noninsurance entities. This reconsideration would be a significant change that would have a pervasive impact on the entities' core system applications, data needs, processes and controls. In addition, it would increase the amount of judgment in several areas of recognition and measurement. Entities would expend considerable energy educating internal and external users of their financial statements, given that much of the financial information reported would change along with most key performance indicators.

In its redeliberations, the Board should consider whether the benefits of changing the insurance accounting models sufficiently outweigh the costs that will be borne by entities. Areas that can be simplified such that more cost effective solutions can be applied should be considered.

* * * * *

We would be pleased to discuss our comments with the Board or the FASB staff at your convenience. Please contact Richard Lynch at +1 212 773 5601 or Jennifer Weiner at +1 212 773 9094.

Very truly yours,

Ernst + Young LLP

- Appendix A: Responses to specific questions raised in the Proposed Accounting Standards Update, *Insurance Contracts*
- Appendix B: EY's letter to the IASB's Exposure Draft, *Insurance Contracts*

Responses to specific questions raised in the Proposed Accounting Standards Update, *Insurance Contracts*

Scope

Question 1 **Do you agree with the scope and the scope exclusions included in 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?**

Response:
We agree with the principle that contracts that meet the definition of an insurance contract should be included in the scope of the proposed guidance rather than industry-specific guidance. This is consistent with other areas of accounting such as derivatives and leases for which the accounting guidance applies to all entities purchasing or issuing these instruments. However, we are concerned that without modifications to the proposed definition of insurance, the population of arrangements that would be required to use the guidance would be too broad.

We believe the Board needs to more clearly articulate the difference between a financial risk and insurance risk and clarify when compensation paid to another party fulfills an entity's own performance obligation. The Board decided to reduce the number of arrangements that would be required to follow the guidance through several scope exclusions. Those exclusions detract from the definition of insurance, are confusing, and would need to be updated as new products are developed and issues arise. The exclusions suggest the proposed definition is too broad. We believe that, if the Board narrows and clarifies the guidance on the types of contracts that would be in scope, the number of scope exceptions can be reduced.

While we agree with the objective that contracts with similar economic attributes, cash flows and risk transfer should be accounted for the same way, we do not believe the Board has adequately explored the various arrangements that would fall within the scope of the proposed guidance. We are particularly concerned about arrangements currently in the scope of ASC 460 on guarantees. The accounting for these arrangements should be addressed on a comprehensive basis if it is to be changed. Without a detailed analysis and a broader awareness by preparers that issue these types of arrangements, the resultant accounting may not adequately address these arrangements. In addition, the Board should consider whether the proposed guidance addresses the perceived issues that gave rise to the predecessor of ASC 460.

We would support a separate project that examines these types of arrangements, including the subsequent accounting that is not addressed in ASC 460. Notwithstanding our concerns, we do believe that some arrangements and components of arrangements issued by noninsurance entities are in substance providing insurance. Such a project would help clarify which arrangements would be considered insurance contracts and which would remain in ASC 460 or other accounting guidance.

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While the proposal indicates insurance must cover a pre-existing risk, this concept is not well understood outside the insurance industry. Accordingly, we believe further clarification is needed to avoid confusion. We recommend the Board specifically clarify when there is and isn't a pre-existing risk that would qualify for insurance contract accounting. For example, risk between two parties that is created by a transaction between those two parties would not be deemed insurance risk. Clarification of this fundamental aspect of insurance is necessary to distinguish insurance from routine transactions with customers. Such a clarification would prevent many common arrangements that noninsurers routinely enter into with their customers from being within the scope of the proposed Update.

In addition, we believe that entities should look at the substance of the transaction in its entirety which may result in some arrangements being accounted for based on the subsequent transaction. For example, an arrangement in which the settlement of a claim triggers a simultaneous, unavoidable transaction with the party that benefits from the loss event may not be insurance. We believe that a standby letter of credit in which a loan is created upon the settlement of the claim is more analogous to a loan commitment, which would be evaluated for impairment under the financial instruments guidance. Another example is an arrangement where the issuer of the guarantee (insurance) only compensates the contract holder if the contract holder enters into a secondary transaction. This type of transaction often requires the contract holder to exchange a current property it holds (trade-in) to purchase a new product to get a pre-determined value for the existing property. We do not believe the substance of these arrangements is insurance and therefore should not be in the scope of the proposed guidance.

Notwithstanding these comments, we recognize that there still will be a need for some explicit scope exclusions. Where possible, we believe the Board should focus on the characteristics of contracts rather than specific examples because many arrangements may share fundamental characteristics but only the ones that have been specifically scoped out would be excluded.

While the comments above address the broader aspects of the scope of the proposed Update, the following comments address the guidance as proposed.

We agree with the proposed guidance that the definition of an insurance contract should include the chance that the issuing entity will incur a significant loss. This is an improvement over existing guidance, which is vague for direct insurance contracts and requires a reasonable possibility of a significant loss for reinsurance ceded. We believe this will simplify the determination of whether the insurance contract guidance should apply.

We agree that contracts entered into with a single counterparty (or related counterparties) for the same risk or that are otherwise interdependent should be considered a single contract for purposes of the risk transfer analysis. However, we believe the Board should consider expanding this requirement to contracts for which the party that is ultimately responsible for the risk has direct involvement in determining the risk assumed by the intermediary. An example is a reverse mortgage written by banks with the collateral backstop provided by the US government. Another example is an insurer using an unrelated insurance company to obtain business in a state that the insurer is not licensed in (typically referred to as fronting arrangements). Under these arrangements, while the direct writer is legally the primary obligor to the contract holder, the essence of the arrangements is that the direct writer is acting as an agent for the entity that is ultimately assuming the risk.

We agree with carrying forward the criteria for when a financial guarantee is insurance and when it is not from ASC 815, *Derivatives*, which would now apply to all entities and not just insurance entities.

We also agree with specifying the characteristics for when a fixed-fee service contract would be excluded from the proposed guidance. We generally believe that the first two characteristics (i.e., pricing and compensation) are appropriate. However, the third characteristic relating to the risk arising primarily from utilization or frequency of the event is vague and may lead to the proposed guidance not being applied consistently across all entities. For example, third-party product warranty contracts are typically written as short-term contracts that can be renewed (extended). These contracts may start out providing only frequency risk (asset is relatively new) and turn in to severity risk as the probability of the underlying property failing (approaching the end of its useful life) increases. Therefore, the age of the underlying property could drive the determination of whether contracts are classified as insurance. Because the coverage is the same in each period, we do not believe the accounting should be different.

Notwithstanding these comments, we agree with explicitly excluding arrangements that are specifically addressed elsewhere in Codification. Similar to the exclusions of employee benefit plans (ASC 715) and retirement benefit obligations (ASC 960), we recommend that the Board also exclude health and welfare benefit plans as defined within ASC 965.

We also agree that the benefits an employer provides to its employees that otherwise meet the definition of an insurance contract should not be within the scope of the proposed standard.

While the examples of arrangements in the implementation guidance that would be within the scope of the proposed Update are helpful, they provide evidence that the proposed definition of insurance requires additional precision. Consequently, we believe the Board's interpretation of the arrangements that create an insurance contract needs to be clarified. For example, the descriptions section should clearly identify the event that causes the payment and the party that incurs the loss that the payment relates to.

We agree with the Board's decision to exclude from the scope of the proposal participating investment contracts issued by insurance entities that do not meet the definition of insurance. Scoping such contracts into the proposed Update would have run counter to the objective to create an insurance contract standard instead of a standard for the insurance industry. These contracts should be included in the scope of the proposal on accounting for financial instruments. We disagree with the IASB's decision in its revised Exposure Draft to scope these contracts into the proposed guidance.

Recognition

Question 2

Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?

Response:

We agree with the requirements in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives and distinct investment components, should be separately accounted for under other applicable Topics.

We also generally agree with the proposed guidance for when noninsurance components of an insurance contract relating to distinct performance obligations to provide goods and services should be separately accounted for under other applicable Topics.

However, there appears to be some confusion regarding when certain service obligations would need to be separated and accounted for under other Topics. Some believe that because the entity provides the administration services separately for some contracts, or other entities in the marketplace provide those services, these services would need to be separated and accounted for under other Topics for all contracts. We understand that that was not the Board's intent. We believe it would be helpful for the Board to clarify that the determination of whether a performance obligation is distinct should be made on a contract basis and the determination of whether a service is sold separately should also be made on a contract basis, taking into consideration how these particular contracts are sold in the marketplace, not how they compare with other contracts that provide similar services. This would clarify that the determination to separately account for a performance obligation for some contracts does not require the entity to separately account for that same performance obligation for all contracts issued. For example, an entity may perform third-party administration services that include policy maintenance and claims processing services and not provide any insurance. These services would be accounted for separately. Those same services are provided as part of an entity's activities that it must undertake to fulfill its obligation under insurance contracts where the entity has taken on the risks. In this case, these services would not be accounted for separately.

The Board should also clarify that fees for services related to a non-distinct investment component of a contract that is not separately accounted for should not be excluded from the proposed guidance and accounted for using other Topics. For example, revenue and expenses to manage the investments that are directly part of the insurer's obligation under the insurance contract should not be separated.

Other comments related to recognition

We agree with the proposed guidance that an insurance contract and a reinsurance asset or liability that covers aggregate losses of the portfolio of underlying insurance contracts should be recognized at the beginning of the coverage period. However, we believe the proposed guidance for direct proportional reinsurance by a ceding entity that requires a reinsurance asset or liability to be recognized when the ceding entity recognizes the underlying contracts should be expanded to assuming entities' initial recognition of insurance contracts they assume.

Measurement approaches

Question 5

Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?

Response:

Conceptually, insurance contracts should be recognized and measured using a single measurement model. However, we agree that simplifying the measurement model for some types of contracts would benefit issuing entities, and we recognize that this would result in two separate models. We believe the general principles underlying the two models should be consistent and that both models should have similar principles to other Topics.

We believe that the accounting differences between the premium allocation measurement model and the building block approach are warranted to portray the information of most importance to the users of the financial statements. For the most part, the premium allocation approach, once the coverage period ends, and the building block approach are converged. The recognition of the profit is not converged and we believe it should be treated the same under both models. See our response to Question 25.

We do not believe the accounting differences between the two models constitute different principles, except for the recognition of the profit. For example, not updating assumptions in the liability for remaining coverage under the premium allocation approach but recognizing an onerous contract if applicable, results in similar results to the building block approach if the margin is adjusted for changes in expected cash flows. In addition, we do not believe that the practical expedients (for example, not discounting the liability for remaining coverage if there is not significant financing, expensing qualifying acquisition costs if the coverage period is less than one year and not discounting the liability for incurred claims if the claim is expected to be paid within one year of the insured event) deviate from the general principle as these appear to be allowed due to the expected immateriality of the amounts.

If the general principles are modified to be consistent between the premium allocation approach and the building block approach, we do not believe that the premium allocation approach should be required for all contracts that meet the criteria to apply that approach. However, contracts that do not meet the criteria to apply the premium allocation approach should be required to use the building block approach. In our responses to the various questions, we have made suggestions to make these principles as consistent as possible. If the Board makes additional changes to the premium allocation approach, such that the principles between the two approaches vary significantly, we believe the application of the premium allocation approach should be a requirement when the specified criteria are met.

Question 6

Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less? If not, what would you recommend and why?

Response:

As noted in our response to Question 5, we do not believe that the premium allocation approach should be required and thus we do not believe that all contracts that are one year or less should be required to be accounted for using this approach. We do, however, believe the guidance should include a specific coverage period as a practical expedient for when the premium allocation approach can be applied.

Although "one-year" has generally been the cut-off for using practical expedients in other guidance, we believe the Board should consider extending the period to two years for use of the premium allocation approach without providing additional support to meet other criteria. We understand that entities sometimes write a contract that is identical to a one-year contract for a longer period of 15 months, for example. This sometimes occurs when contracts are written in an off-period such that the renewal date will be the same as other similar contracts and the contract holder doesn't want to have to re-underwrite and re-price the contract for a short period of time. In addition, claims made contracts that cover events reported during the coverage period typically include extended reporting periods, which essentially extends the coverage period beyond one year. We do not believe that entities should incur additional costs and complexities associated with the building block approach for a contract that is 15 months and a one-year contract when these are written simply for conventional business purposes. Extending the practical expedient to two years would capture these situations and we do not believe it would significantly increase the number of contracts that can use this criterion. However, we believe there are different considerations for contracts that provide coverage for greater than two years and therefore the other criteria should be applied.

In addition, if an entity writes predominantly longer term contracts and begins issuing one-year contracts, it would be required to apply the premium allocation approach for those contracts in addition to the building block approach for its longer term contracts. Also, because the proposed guidance would require entities to present insurance contracts liabilities/assets and the revenue and expenses from such contracts separately for contracts that are measured using the building block approach and the premium allocation approach, the financial statements could result in similar contracts being presented differently because of their duration. There would be minimal benefit to the entity and to the users of the financial statements, so permitting the use of the building block approach seems reasonable. We acknowledge that this could cause a lack of comparability between entities.

Question 7

Do you agree that entities should be required to apply the premium allocation approach if at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?

Response:

We believe that the characteristics of a contract should be the driving factor in determining which model should be applied. We agree with the proposed criteria, indicators and examples, but we believe the words are difficult to understand. Therefore, we believe the Board should clarify its intent. We believe the Board should clarify that the criteria should be considered on a contract basis. While there may be evidence that the expected losses on a portfolio level may vary over time, there typically isn't similar evidence for an individual contract (unit of measurement for this analysis). In addition, we believe the Board should clarify what is meant by significant variability in the expected value of the net cash flows. We believe the Board intended this to capture contracts where the expectation of an event occurring is the same throughout the coverage period and the assumptions at the contract level are not expected to vary before the event occurs. This is in contrast to contracts where there is an increasing likelihood of the event occurring or assumptions changing.

Portfolio and contract boundary

Question 8

Do you agree with definition of a portfolio of insurance contracts as included in this proposed guidance? If not, what do you recommend and why?

Response:

We do not agree with the proposed definition of a portfolio of insurance contracts. As described below, the proposed criteria could result in more portfolios than would be needed to meet the objective of the proposed Update. We understand there should be some level of consistency between reporting entities on how contracts are grouped for measurement to improve comparability. The proposed guidance should have a definition of portfolio that is sufficiently clear to achieve this objective of consistency.

We believe there should be one definition of portfolio that is used for all aspects of the proposed guidance; that is, entities should not change their groupings of contracts for different aspects of measurement of the liability or asset or for revenue and expense recognition. However, the proposed guidance references portfolio in a number of areas and implies that some of the measurement requirements would need to be performed at a more granular grouping of contracts than the criteria provided for determining a portfolio. For example, the Board's decision to require the interest accretion rates to be based on the discount rates when the portfolios of contracts are initially recognized could result in a new portfolio of contracts being established whenever there are changes in the discount rates. The Board should consider the interaction between the definition of a portfolio and other areas of the proposed guidance.

We agree with the principle that contracts with different risks should not be combined. However, it would be helpful if the Board would clarify that different risks within a single contract would not need to be separated. For example, different reserving methodologies are typically used when measuring the different risks within a contract, such as physical damage and bodily injury risks within an auto insurance policy or reserves for brain and spinal cord injuries within a worker's compensation contract. Because these risks are part of a single contract, we do not believe they should be in separate portfolios. In addition, the Board should consider whether risks can be combined when companies manage those risks together. This would be consistent with the accounting for an entire contract that contains different risks.

While we agree that portfolios should not contain products that are priced differently such that losses on a product would be delayed because profits on other products would offset those losses, we do not believe this principle should be applied to the pricing of risks within a product. For example, the price relative to the risk for life insurance that an entity can obtain for a 70 year old may differ from the price relative to the risk for a 40 year old, even though the type of risk may be the same. We do not believe the Board intended for portfolios to be created for each age group. In another example, pricing of a product may change over time (even within a year) based on market conditions. We do not believe the Board intended for portfolios to be created every time there is a change in pricing for a product.

We believe the second proposed criteria (contracts that have similar duration and similar expected patterns of release from risk) is too prescriptive. For example, a whole life contract sold to a 65 year old may be expected to have a duration of 25 years; the same contract sold to a 40 year old would be expected to have a 50-year duration. Under the proposed guidance, these contracts would need to be accounted for in separate portfolios. Therefore, requiring a contract's duration to be a primary factor in the portfolio determination could result in an entity having a burdensome number of portfolios. It also ignores the fact that insurance is written by combining risks. We agree with the principle that a different pattern of revenue recognition should not result from combining two or more contracts. This is consistent with the Board's proposed revenue recognition guidance on a series of two or more distinct goods or services satisfied over time. However, we believe the proposal to recognize the margin as the entity is released from risk takes into consideration the varying durations of contracts in a portfolio. Therefore, to meet the Board's principle, these contracts do not need to be separated into different portfolios. For clarity, the Board could consider stating that principle.

In defining a portfolio, we believe there should be clear evidence that links a group of contracts. A strong indicator that contracts are similar and should be part of a portfolio is that they are managed together. If the Board considers this criterion to define a portfolio of contracts, as is proposed in the IASB's revised Exposure Draft, the Board should specify the level at which this criterion should be applied. The criteria included in the guidance for segment reporting may be a good starting point, given the other criterion would apply within the segment. However, the segment reporting criteria is for reporting purposes. The criterion for portfolios is used for measurement purposes and, therefore, may need to be at a lower level.

If the determination of portfolios is changed to consider the way contracts are managed, other complexities must also be considered. Some entities may change the way the business is managed and thus may change their portfolios to reflect that change. The Board should consider adding guidance for determining the amount of margin that would transfer with contracts that change portfolios as a result of changes in the way these contracts are managed, consistent with the guidance for re-allocating goodwill. And, if interest accretion rates remain locked in, as required in the proposed Update, (see our response on Question 16) making changes to groupings of portfolios could be even more complicated.

Question 9

Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?

Response:

We agree with the proposed guidance for the contract boundary for an individual contract. We also agree that for some types of contracts, the contract boundary should be considered at the portfolio level rather than the individual contract level. We agree that when the entity has the right or practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price or level of benefits that reflects the risk of that portfolio, the contract boundary should end. We believe the second criteria regarding the pricing of contracts taking into account risks relating to future periods is already in the first criteria and therefore is not needed.

Reinsurance contracts for long-duration contracts are sometimes written based on a "yearly renewable term" in which the reinsurance arrangement covers contracts written during a given year but can be canceled or re-priced (typically up to some cap) each year for the continuation of the coverage for those contracts. Ceding companies will account for these arrangements using the same model applied to the underlying contracts included in the arrangement, which most likely would be the building block approach. From an assuming company point of view these contracts could be viewed as contracts with a one year contract boundary, because of the re-pricing feature and how the cap is considered. However, the contract provides coverage on a long-term basis, the expected cash flows in the underlying contracts include multiple years and there could be significant variability in the cash flows prior to the claim being incurred. Therefore, including expected cash flows beyond one year may make more sense. We recommend the Board include guidance based on the implementation guidance for determining significant insurance risk that permits unlikely scenarios to be considered in the determination of whether the assuming company has the ability to re-price for the risks in the reinsurance contract.

Fulfillment cash flows

Question 10

Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees related to the insurance coverage under the existing insurance contract that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?

Response:

We agree that the cash flows that should be included in the measurement of the contract should include amounts specifically chargeable to the contract holder and all costs directly attributable to fulfillment of contracts or contract activity as part of fulfilling a portfolio of contracts that can be allocated to those portfolios. Taking into account these expected cash flows of an insurance contract will best reflect the direct economic relationship between the insurer and contract holder.

We also recognize that all entities have to incur some level of expenses to operate and that the pricing of products or services includes an amount to cover those costs. However, we do not believe that such costs should be included in the measurement of the insurance contract's liability or asset. Therefore, we agree that cash flows that result from the insurance contract being written but that are not part of the contract between the insurer and the contract holder (e.g., insurance-related assessments, transaction-based taxes) should be excluded. The accounting for such costs by insurers should be the same as the accounting applied by other entities for similar expenses.

We believe that the list of types of cash flows that should be included in and excluded from the measurement of the liability in paragraphs 834-10-55-79 through 55-80 in the implementation guidance is helpful. We note that the IASB, in its 2013 re-exposure draft, explicitly included transaction-based taxes (e.g., premium taxes, value added taxes, goods and services taxes) and levies (e.g., fire service levies, guarantee fund assessments). The Board, in our view appropriately excluded these costs in its list in the aforementioned paragraphs. However, the IASB also included fixed and variable overhead costs such as for accounting, human resources, building depreciation, rent and utilities in the cash flows. We do not believe it was the Board's intent to include such costs, nor do we believe such costs should be included. For clarity, we recommend that the Board explicitly state that these costs should not be included in the measurement of the cash flows of the insurance contract liability.

We also recommend the Board consider whether certain information technology costs should be included in the cash flows, specifically, automated functions that, if performed by a person, would be included.

The proposal does not address whether funds withheld balances should be included in the expected cash flows. It is common in reinsurance transactions for the ceding entity to maintain an account for the reinsurance activity, such as premiums due to the reinsurer and recoverables from the reinsurer on losses paid, rather than exchanging cash. This is generally referred to as a funds withheld arrangement. The account typically is credited with interest, is sometimes settled throughout the term of the arrangement, and at the end of the term of the reinsurance arrangement any remaining balance is

transferred to the reinsurer. We do not believe the Board intended to include funds withheld balances in the expected cash flows given that this is an alternative form of cash settlement, but the proposed guidance is not clear. If the Board intended for funds withheld balances to be included in the expected cash flows, the guidance should clarify that this amount would be considered a component that is contractually linked to the account balance and therefore should be measured at the account balance. Because it would be included in the insurance contract liability, entities should disclose these balances.

The proposed Update does not address situations in which the expected amount of premium is dependent on contract holder behavior and cannot be estimated reliably. For example, some contracts allow contract holders to pay an additional amount (dump in premiums) to purchase expanded coverage. These amounts are non-contractual and typically uncertain (i.e., they cannot be reliably estimated based on historical experience). In these cases, we do not believe an entity should include these future premiums in the expected cash flows. Instead, when these additional premiums are received, an entity should adjust its expected cash flows and the margin (see our response to Question 13). This is consistent with paragraph BC209 where the Board clarified that an entity should not consider expected changes in coverage in the measurement of the liability for remaining coverage. This is also analogous to the Board's proposal on revenue recognition. In that proposal, if a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only because of entering into a previous contract. In those cases, the entity has merely made a marketing offer that it should account for only when the customer exercises the option to purchase the additional goods or services.

Question 11

Do you agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period? If not, what do you recommend and why?

Response:

We agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period.

Question 12

Do you agree that the fulfillment cash flows for contracts measured using the building block approach and the liability for incurred claims for contracts measured using the premium allocation approach should be based on explicit, unbiased, and probability-weighted estimates (that is, the mean) of the future cash flows, as of the reporting date, expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets? If not, what do you recommend and why?

Response:

We agree with the Board that one component of an insurance liability should be the probability-weighted mean estimate of future cash flows. However, we recognize that in any calculation the views of management will influence the selection of expected cash flows and the related probability of those

cash flows. We believe that the use of the term "unbiased" is intended to prevent unduly optimistic or pessimistic assumptions (i.e., the assumptions should be neutral). We recommend that the Board remove the notion of "unbiased" from the proposed guidance and provide robust guidance on the objective of the calculation of the present value of probability-weighted cash flows.

We also agree that the expected cash flows should be a probability-weighted mean. However, to meet the Board's objective, we do not believe that all assumptions included in the modeling need to be probability-weighted; rather the outcomes used need to be probability-weighted. Therefore, we believe the Board's objective would be met when the estimates used produce a mean of expected cash flows. Without this clarification some entities might interpret the guidance as requiring a significant amount of additional work.

We agree that the measurement of the insurance contract liability (or asset) should reflect the insurer's obligation to the contract holder and therefore the measurement of the insurance contract liability (or asset) should consider in the cash flows any contractual linkage to an underlying item. See our response to Question 35.

In March 2013, the Board released a Frequently Asked Questions document on the proposed Accounting Standards Update, *Financial Instruments – Credit Losses (Subtopic 825-15)*. In Question 10 of that document, the Board stated: "The estimate of expected credit losses should consider current conditions and reasonable and supportable forecasts about the future. As a starting point, however, the Board expects that an entity's estimate of expected credit losses largely will be informed by historical loss information for financial assets of a similar type and credit risk. Once an entity has developed or obtained that historical loss information, the entity will need to evaluate whether and how the historical loss patterns differ from what is currently expected (which would be based on current conditions and reasonable and supportable forecasts). To do so, the Board expects that an entity would consider (a) the economic conditions that existed for the period over which historical statistics were developed and (b) how those conditions differ from what management currently expects will be the economic conditions facing the entity." Similar factors exist in the estimation of the expected cash flows for insurance contracts. This is most significant for mortgage and financial guarantee insurers where the assumptions that have the most significant effect on the expected losses is related to macro-economic conditions such as financial market and home appreciation rates and unemployment. We recommend the Board include similar guidance regarding the use of historical loss patterns updated for current conditions and reasonable and supportable forecasts in determining the expected value for the measurement of the fulfillment cash flows. This would provide consistency in measurement between the proposed Update and the financial instruments guidance.

Other comments related to measurement of the fulfillment cash flows

We agree that for contracts measured using the premium allocation approach an onerous contract test should be performed when facts and circumstances indicate that a portfolio of contracts may be in a loss position. We also agree that there should not be an exception for certain types of contracts such as contracts that cover losses from hurricanes. However, we believe that a liability that is based on an expectation of future events (e.g., an onerous liability) should not be measured solely using information that is available on the financial statement date. We believe it is appropriate to use information after the balance sheet date when the liability is measured based on expectations of

future events. Accordingly we do not support the Board's proposal to limit the information used to measure an onerous contract to expected loss information that would be known as of the balance sheet date. For example, if at 30 September a hurricane is expected to make landfall on 2 October and the entity determines at 30 September that a portfolio of contracts is expected to be onerous, the measurement of the estimate of the onerous contracts should be updated with current information. We do not believe ASC 855 on subsequent events is relevant for measurement of events yet to occur. In addition, we do not believe the costs to estimate the expected cash flows based on preliminary information that may no longer be relevant versus current information that may be more relevant outweighs the benefits to financial statement users. We are also concerned that, under the proposed guidance, an entity would need to perform procedures to determine its estimate for expected losses using data as of the reporting period date for recognition in its face financial statements and its estimate based on the actual occurrence, for disclosure purposes (Type II subsequent event) and on an ongoing basis to determine its losses. This would be complex and costly.

Question 13

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 rate) in net income in the period? If not, what do you recommend and why?

Response:

We agree that differences between expected cash flows and actual experience should be recognized in net income in the current period.

However, we believe that, similar to the day one measurement, the margin should reflect the "remaining unearned profit" expected from the future cash flows and services between the insurer and contract holder/beneficiary at each reporting date. In other words, the margin should reflect the remaining unearned profits that flow from the expected consideration and the outflows to fulfil the obligations under the portfolio of contracts. Consequently, we do not agree that changes in estimated cash flows should be recognized in net income.

Instead, both favorable and unfavorable changes in expected cash flows (other than the effect of changes in the discount rates) such as, mortality, longevity and general insurance claims should be recognized as adjustments to the margin, up to the amount of consideration expected to be received. The margin should not be below zero and therefore any excess adjustments would be recognized as a loss. However, the margin should not reflect profits the insurer expects to earn through sources that are not part of the measurement of the insurance contracts (e.g., an interest rate spread between earnings on investments and accretion of interest on the insurance contract portfolios).

Because changes in future cash flows can be caused by several items, some of which may be related to current actual experience and others will be related to future events, if the Board decides to adjust the margin the Update would need to provide guidance to distinguish current-period and future-period cash flows. The following are a few examples of cash flow changes that will need to be evaluated.

- A contract lapses and future expected premiums anticipated from the contract will not occur.

- A contract that was expected to lapse in the current period is now expected to lapse in five years, so there will be an additional five years of premiums paid.
- There are fewer deaths in the current period, which results in an expectation that the number of deaths in the future will increase.

We believe that changes in expected future cash flows caused by current-period events should be recognized in net income as current-period experience rather than adjustments to the margin. However, if the current-period event results in a change in benefits, the margin should be adjusted.

Without sufficient guidance for these items, we believe that diversity in practice on the application of unlocking the margin for changes in expected cash flows could emerge, resulting in a lack of comparability of reported profit emergence among insurers.

If the Board decides to adjust the margin for changes in expected cash flows, the guidance will need to address how to recognize favorable changes in future cash flows when the entity previously recognized losses in net income because the adjustment to the margin was limited (i.e, margin cannot be negative). We think that insurers should first reverse any previously recognized losses in net income before re-instating the margin. This would prevent the total margin that is earned from exceeding the actual margin.

Because the acquisition costs are essentially recouped by the margin, the Board would need to consider whether the amount of expected or incurred acquisition costs not yet recognized in net income should be the floor for the margin, at which point losses would be recognized for any additional unfavorable changes in expected cash flows. The Board also would need to consider the implications on the recognition of expense for acquisition costs. We do not believe that previously expensed acquisition costs should be reversed. Therefore, the Board may need to rethink whether recognizing acquisition costs in the same pattern as the margin will continue to be operable.

If the Board decides to adjust the margin for changes in expected cash flows, it would also need to decide how the adjusted margin should be calculated. A retrospective catch-up approach may be most theoretically sound. This would partially mitigate the Board's concern that the margin would "act as a "buffer" for potentially smoothing either favorable results or unfavorable results." It would also alleviate the complexities of differentiating between actual experience adjustments and changes in future expectations if the margin is adjusted on a prospective basis and would not skew future results based on when the adjustment was made. While a retrospective catch-up approach may be most theoretically correct, the complexities of adjusting the margin retrospectively may outweigh the benefits and a prospective approach may be a practical solution.

The proposed Update implies a portfolio should be closed versus open. An open portfolio combines previous-period contracts with current-period contracts. This allows expected profits from current-period contracts to offset losses that might arise from prior-year contracts. This becomes more important when adjusting the margin; our preference would be for the margin to be determined on a closed portfolio. However, if the Board believes an open portfolio is acceptable, the guidance should be clarified and additional guidance will be needed to explain how an open portfolio should be applied in relation to the Board's definition of a portfolio.

Notwithstanding our comments above, if the Board decides that the margin determined at initial recognition should be retained for the estimation risks in the portfolio or that adjusting the margin for changes in expected cash flows adds unnecessary complexity and detracts from transparency, we would not object to recognizing changes in expected cash flows in net income. However, we believe entities shouldn't recognize changes in the expected cash inflows in net income as proposed. Instead, we believe that the expected profit related to changes in expected cash inflows that relates to extending or obtaining increased coverage, should adjust the margin because every dollar of premium has a profit associated with it. The reasons for deferring expected gains on the initial expected cash flows equally applies to any additional expected cash inflows; that is, an entity has not yet performed under the contract and there is uncertainty in the insurance contract about whether the gain will occur. Therefore, if the expected premium increases, or decreases, the margin should be adjusted. This would be consistent with the proposed guidance for non-substantial modifications in the proposed Update. Absent such an adjustment, entities could recognize revenue merely by adjusting their assumptions.

Discount rates and discounting

Question 14

Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

Response:

The selection of discount rates would have a significant impact on the accounting for insurance contracts. The discount rates need to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the contract holder and at the same time produces a liability that reflects the current expected value to fulfill the insurer's obligations. The discount rates utilized and the interest accretion rates also must provide meaningful performance measures and be consistent with the economics of the business.

We understand and agree with the Board's desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, we are concerned that using the characteristics of the liability as the basis could result in diversity in practice. Not everyone has the same view of how to determine the characteristics of the liability, and the pricing of the contracts may reflect economics that could not align to the characteristics. Specifically, a contract could not transfer any market risks (i.e., risk free) to the contract holder, but it may have been priced with implied interest rates that are above the risk free rate. We would point out that in its projects on leases and revenue recognition the Board considered the pricing of the arrangements that includes an explicit or implicit interest (or financing) component in determining the discount rates. We believe, to be consistent, the Board should consider whether the pricing of an insurance contract should be a factor in determining the discount rates for the insurer's obligation.

We also have concerns with the two approaches proposed in the implementation guidance.

- We agree with using a yield curve that reflects current market rates of returns either for a reference portfolio of assets or the actual portfolio of assets the entity holds adjusted to exclude factors that are not relevant to the insurance contract liability. But the lack of clarity in the approach could lead to diversity in practice and lead to lack of comparability. Specifically, we believe that when using an actual portfolio of assets as the starting point in determining the discount rates, the Board should consider allowing all assets held that are designated as backing the portfolio of insurance contracts, to be considered. Insurers, and more frequently life insurers, invest in various types of investments, some of which are non-fixed income investments, to implicitly hedge their risks to market movements. This reflects asset-liability management such that the overall yield on the asset portfolio can be considered to reflect the characteristics of the liability and for which these insurers should not be penalized by not including yields on these investments in the determination of the discount rates.

- We also are concerned that there will be diversity in practice in determining the liquidity adjustment when added to the risk-free rate. We do not believe the proposed Update adequately articulates the underlying rationale and objective of a liquidity adjustment. This lack of clear rationale and objective, likely will result in inconsistent application by insurers and difficulty in auditing such an adjustment. Where a liquidity adjustment is required, such as in Solvency II, prescriptive calculations are provided that may be appropriate for regulatory purposes, but we do not believe is appropriate for general purpose financial statements. Therefore, we believe the Board should establish a clear principle explaining how a liquidity adjustment should be calculated. However, even if a principle is developed, we have concerns that the complexities to determine this adjustment each period may outweigh the benefits of discounting at a rate that may more closely reflect the characteristics of the liabilities.

We expect that most entities that would need to apply the premium allocation approach will have insurance liabilities whose characteristics generally will not include any risk associated with assets, so starting with a risk-free rate and adding a liquidity adjustment may be preferred. Therefore, if the Board decides to not permit a risk-free rate plus a liquidity adjustment due to uncertainties in determining the liquidity adjustment, we believe it will be necessary to have an alternative method to an approach that starts with the yield on a reference or actual portfolio of assets. We believe the risk-free rate would be an appropriate alternative.

While we understand the conceptual basis of developing a discount rate that attempts to reflect a rate that is consistent with the characteristics of the contract, the proposed approaches in the implementation guidance are complicated, require significant judgments about components of a yield curve (some of which may not have observable market information) and will not reflect how the pricing of the arrangement was determined. Similar to existing GAAP, neither approach included in the implementation guidance would lead to the same discount rates being applied by different entities. However, we believe the proposed requirement to disclose the yield curves and the related expected cash flows would improve transparency and provide useful information to users of the financial statements. Because of this transparency and the complexity and lack of consistency in the two approaches proposed, we believe the Board should consider allowing practical expedients.

If the Board decides a risk-free rate plus a liquidity adjustment is appropriate, the Board should consider allowing entities, especially those applying the premium allocation approach, the option to use the risk-free rate for discounting its non-linked liabilities. We believe this option should be irrevocable and should be used for all portfolios of contracts accounted for using either the premium allocation approach or the building block approach. This would minimize the complexity and the costs to comply.

The Board should also consider allowing entities to discount non-linked liabilities using a high-quality corporate bond rate similar to ASC 715, *Compensation — Retirement Benefits* or a risk-free rate similar to the guidance in ASC 820, *Fair Value Measurement*. This would minimize the complexity and the costs to comply. Consistent with the option to use the risk-free rates, we believe this option should be irrevocable and should be used for all portfolios of contracts accounted for using either the premium allocation approach or the building block approach.

We believe the Board needs to address the discount rates that should be applied to fee provisions that are based on asset values. The fees (premiums) for some insurance contracts are based on a percentage of a contract holders account balance. Because these cash flows are included in the fulfillment cash flows of the contract, discounting them at the appropriate rate is critical to avoid non-economic volatility. The Board should consider requiring entities to discount the fees at the same rates as the expected asset accretion rates.

Many insurance contracts have expected durations that extend beyond the period of observable market yields. Discounting cash flows expected in periods for which there are no observable data points may significantly affect the current period value of the insurance contracts and may have similarly significant effects on an insurer's financial statements. As a result, the guidance on how to determine the discount rate for that portion of the cash flows is a critical aspect of the proposal. The guidance included in paragraph 834-10-55-96 is unclear with respect to how insurers should estimate the discount rates for those periods. That guidance first states that an estimation technique could be used, but then also indicates those rates could be determined using the current, observable market yield curve for shorter durations. To clarify what we believe was the Board's intent, the Board should consider incorporating into paragraph 834-10-55-96 the language in paragraph BC151 that states "because forecasts of unobservable inputs tend to put more weight on longer term estimates than on short-term fluctuations that [estimation techniques] would counteract concerns that current period fluctuations in discount rates exaggerate the volatility of the very long-term liabilities."

As we have previously noted, potential financial statement volatility that is created by the application of the proposed standard is a significant concern for insurers. Very recent field testing by several North American insurers has highlighted these issues and that a significant contributing factor to that volatility is the use of observable points along a market yield curve that may be viewed as not being represented by a deep and liquid market when determining the discount rate. Before the Board proceeds to a final standard, we recommend it carefully consider the results of this useful field testing, as well as the results of any other field testing that is or has been performed by insurers in other geographic areas. That consideration should include evaluating the results with industry representatives and with users of insurers' financial statements to determine whether the application of the proposed standard produces financial results that are consistent with the Board's overall objective and produces decision-useful information for users of such financial statements.

Question 15

For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that entities should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would recommend and why?

Response:

We agree that the insurance liability should reflect the time value of money. Therefore, we agree that an entity applying the premium allocation approach should discount the liability for incurred claims. Also, we agree with the practical expedient to not apply discounting when the claims are expected to be paid within one year of the insured event because the costs to apply discounting would not outweigh the beneficial information provided to users of the financial statements.

However, the guidance implies that the practical expedient must be applied to a portfolio in its entirety. We believe the practical expedient should be applied to individual claims. The Board should consider modifying the practical expedient to allow insurers to not discount any claims that are paid within one year of the insured event.

Question 16

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.

Response:

A key concern that was raised in the 2010 Discussion Paper (DP) and continues to exist in this proposal is volatility in both the income statement and the equity as a result of changes in interest rates. We agree with the Board's decision to recognize the effect of changes in the discount rates in other comprehensive income (OCI) to mitigate the volatility in the income statement resulting from updating the assumptions of the discount rates each reporting period, even though this approach increases the complexity of the guidance. We understand that the Board's intent is to isolate the changes in underwriting from the changes in the discount rates and to minimize accounting mismatches while recognizing economic mismatches. However, we are concerned that requiring the effects of changes in discount rates to be recognized in OCI for all non-contractually linked contracts may exacerbate the accounting mismatches.

Although we agree that the effect of changes in the present value of the fulfillment cash flows due to changes in the discount rates should be recognized in OCI, we do not agree that it should be required for all non-contractually linked liabilities. A significant portion of an insurer's investment portfolio includes fixed income assets and asset-backed investments, much of which are accounted for at fair value through OCI under existing GAAP. However, many of these assets may be required to be accounted for at fair value through net income under the Board's proposed guidance on financial

instruments. Insurers also invest in equities, derivatives and limited partnerships that are accounted for at fair value through net income and real estate and mortgage loans that are accounted for at amortized cost, among other investments. The investment decisions typically depend on the characteristics of the liabilities within a portfolio, most importantly the duration of the liabilities and how interest rate movements affect them. While we believe that the accounting for insurance liabilities should not be based on the types of assets that a particular insurer holds, we also emphasize consistent measurement and presentation of changes in value for certain aspects of both the insurance liabilities and all invested assets is necessary to minimize accounting mismatches. We concur with the Board that standards generally should not give entities the option to choose their accounting. However, when there is a clear rationale such as minimizing accounting mismatches, we believe policy choices can be acceptable as long as the choice is disclosed.

We believe, where possible, entities should be provided accounting options to avoid accounting mismatches. Therefore, we believe entities should have an irrevocable choice at the portfolio level to determine whether to recognize changes in discount rates in either OCI or net income. Requiring the choice to be made at the portfolio level will not eliminate all accounting mismatches but will mitigate some of the volatility in earnings resulting from those mismatches. Providing such an option would not promote comparability between insurers. But requiring the disclosure of how discount rate changes in insurance liabilities are reported would provide users with sufficient information to understand the lack of full comparability. We believe this approach would provide users with better information than they currently receive and will align, to the extent possible, the financial reporting of companies with their asset/liabilities management strategies. This alignment also would increase transparency by allowing users to understand how the business is managed.

Question 17

Because this proposed guidance includes the approach that changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?

Response:

We believe that the proposed guidance should include a loss recognition test. Specifically, entities should reverse interest rate changes that reduced the insurance liabilities from other comprehensive income into net income when the entity determines that it is highly probable the premiums charged and the expected investment income on the assets purchased or likely to be purchased with the premiums will be insufficient to cover the claims.

Using other comprehensive income for the effect of changes in the discount rates is intended to address the belief that short-term fluctuations in the discount rates are less relevant to understanding the long-term performance of the insurer, the changes will reverse over time, and including the changes in current net income could distort the insurer's current performance. However, once the interest rates fall to a level that all market indicators project that the interest rates are expected to be substantially below the discount rates determined at inception, the financial statements should reflect that the entity will be unable to fulfill its obligations without utilizing the equity of the entity. Those

fluctuations will not likely reverse, which is one of the reasons used to permit the use of OCI. Reversing the amounts recorded in OCI when the entity determines that it is highly probable the premiums charged and the expected investment income on the assets purchased or likely to be purchased with the premiums will be insufficient to cover the claims is consistent with impairment charges recognized on financial instruments and other assets.

Also, without such a test, the transparency of the quality of an entity's earnings will be compromised. That is because losses on a specified portfolio of insurance contracts could be obscured by the returns of the entity's profits emerging from other portfolios of insurance contracts (e.g., assets backing profitable portfolios will be used to pay liabilities on loss portfolios).

Question 18

Do you agree that the method for calculating the discount rates should not be prescribed? Is the proposed guidance on determining the discount rates understandable and operable? If not, what do you recommend?

Response:

We agree that the calculation of the discount rates should be based on a principle and not on prescribed guidance.

The proposed guidance is understandable, but we have concerns that guidance limits the types of assets that can be used when starting with an entity's actual investment portfolio. See our response to Question 14.

Question 19

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?

Response:

We agree that interest expense should be based on a locked-in accretion rate, even though doing so would make the accounting more complex. We believe this approach is necessary because of the Board's decision to recognize the effect of current period changes in the discount rates used to value the insurance portfolios in OCI. However, the definition of portfolio is not specific as it relates to the accretion rate. We are uncertain whether the Board intended that entities would need to have closed portfolios to apply the interest accretion guidance. Although this is not stated in the proposal, accreting interest at the initial recognition discount rates as proposed in the guidance appears to require entities to create a set of portfolios each time their discount rates change. We do not believe the Board intended to force entities to have multiple portfolios for the same product within a given reporting period. Requiring multiple portfolios for the same product would mean entities would need to capture an enormous amount of data to calculate the difference between the current rates and the multiple locked-in rates for each portfolio each reporting period.

Therefore, we propose that when a closed portfolio is used, the Board consider allowing entities to use an average interest accretion rate. This practical solution would minimize the complexity and the cost of compliance.

If the Board rejects the notion of an average locked-in interest accretion rate, then we believe interest expense should be based on the discount rates determined at the date the portfolio of contracts was initially recognized. The discount rates at initial recognition are most consistent with the rates considered when pricing the insurance contracts and are consistent with other areas of accounting, such as leases and financial instruments.

However, for contracts accounted for under the premium allocation approach the Board should consider whether the locked-in interest accretion rate at the beginning of the accident period used to project the losses could be a policy election. Under this approach, entities would not be required to change their reserving process from an accident-basis (for example, quarterly or yearly), which is most common in the US, to an underwriting-basis. This would minimize the complexity and the cost of compliance.

If the Board does not allow the locked-in interest accretion rates to be based on an accident-basis, the Board should consider a practical expedient for outstanding claims at the date of transition for which underwriting year data was not previously captured. Determining the discount rates at initial recognition for the contracts in force at transition would be extremely cumbersome.

Question 20

Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contracts liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts? If not, what do you recommend?

Response:

We agree that upon any change in expectations of the crediting rates used to measure the insurance contracts liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset. However, the proposed guidance should clarify that all changes in future expected crediting rates should be considered in determining the entity's' expected cash flows. Instead of using an approach that solves to a level-yield for the remaining life of the portfolio of contracts, the initial yield curves should be updated such that it reflects the timing of the expected crediting and the timing of cash flows.

Margin for contracts measured using the building block approach

Question 21

Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows) but, rather, should defer this amount as profit to be recognized in the future? Why or why not?

Response:

We agree that, at initial recognition of an insurance contract or reinsurance contract, a gain should not be recognized as an entity has not yet performed under the contract and there is uncertainty about whether the gain will occur. However, if the Board decides in either the revenue recognition or the financial instruments projects that gains at inception are allowed for unobservable rights, the Board should reconsider whether gains should also be permitted for insurance and reinsurance contracts.

Question 22

Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.

Response:

We would not object to using the one-margin approach included in the proposed guidance with modification on the period amortized. However, we also would not object to a two-margin model under which an entity would recognize a provision for uncertainty and a residual margin.

We recognize that the proposed margin represents the amount of expected consideration (premium) in excess of the expected cash outflows and is intended to compensate the entity for several items including accepting risk that actual benefits are greater than expected, general operating costs to run a business, and an economic return to the entity's shareholders. The entire excess amount or expected profit is at risk due to the uncertainty in the cash flows. Decomposing the excess amount into separate measurement amounts may provide relevant information if the underlying principles that require the separate measurement is sufficiently clear and will result in comparability across entities. However, the costs to prepare and update these amounts may not justify a model that has more than one margin.

We do not believe there is a conceptual reason for there to be a difference in regards to when expected profit is recognized in net income between the building block approach and the premium allocation approach. Therefore, either the margin should be recognized over the coverage and settlement period as proposed for the building block approach or the margin should be decomposed into two components, a residual margin that would be recognized over the coverage period and a provision for uncertainty that would be recognized over the coverage and settlement period as the uncertainty in the cash flows decreases. For the premium allocation approach, either the liability for remaining coverage should be earned over the coverage and settlement periods or a provision for uncertainty should be recognized when a claim is incurred.

As previously noted, we also would not object to the guidance having an explicit provision for uncertainty and a residual margin if the provision for uncertainty provided useful information. But, we are concerned that the provision for uncertainty could become a standardized add-on to the mean or a way for management to inject bias into the measurement process. Further, we continue to be concerned, as noted in our 2010 letter, about the reliability of estimating a provision for uncertainty. Therefore, we believe the objective of the provision for uncertainty needs to be clearly defined, the provision for uncertainty and diversification benefits for claims yet to be incurred should be required to be calculated at a portfolio level and specific disclosures should be required around the techniques used and assumptions made when calculating the provision for uncertainty.

Question 23

If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determining the risk adjustment? Why or why not?

Response:

See our responses to Questions 13 and 22.

Question 24

Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the future cash outflows exceeds the expected present value of future cash inflows)? Why or why not?

Response:

We do not believe the margin should be less than zero. Therefore, we agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income. Should the Board decide to adjust the margin for changes in expected cash flows, any adjustments beyond the remaining margin should also be recognized immediately in net income. See our response to Question 13.

Question 25

Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?

Response:

We believe that releasing the margin as the entity is released from risk under the insurance contract, as evidenced by a reduction in the variability of cash outflows, is an appropriate principle because this would be consistent with the notion that the profit is more certain at that point in time. However, we also acknowledge that entities have to complete many tasks over the life of an insurance contract and

have to expend resources (costs) before they are certain that there is a reduction in variability in cash flows. Entities may fund those costs through inclusion in the premium, specific charges or income they earn on the asset/liability interest spread. Although we believe that the recognition of income should be independent of when an entity incurs costs, a question arises if some of the margin relates to services that are included in the expected cash flows. If the Board believes this, there may be a basis for the recognition of revenue when those services, including being released from risk, are provided. However, the complexities to attribute the margin to services may outweigh the benefits gained.

The proposed Update requires that an entity's methodology used to determine the release from risk for each portfolio should be applied consistently throughout the lifecycle of the portfolio. We believe that entities should be allowed to change their estimation methodology in certain situations. ASC 820, *Fair Value Measurement,* permits changes in a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value in the circumstances. Examples include: new markets develop, new information becomes available, information previously used is no longer available, valuation techniques improve and market conditions change. We believe that similar guidance should be included related to the method used to recognize the margin and that such changes should be classified as changes in accounting estimates.

Question 26

Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

Response:

We agree with accreting interest on the margin as it is a net present value amount. In addition, it represents the expected cash inflows in excess of the expected cash outflows and given the model accretes interest on the other expected cash flows, it would be inconsistent to not recognize interest on this component.

Question 27

Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

Response:

If the Board decides not to adjust the margin for changes in expected cash flows (see our response to Question 13), we do not believe the margin should be released when the portfolio of contracts is considered to be in a loss position. Recognizing the remaining margin when it is determined that the expected cash outflows of a portfolio of insurance contracts exceeds the expected cash inflows would result in the statement of financial position being equal to a situation where there is a day one loss that is recognized. However, the recognition of the remaining margin only when it is determined that the total expected cash outflows (including the qualifying acquisition costs) will exceed the total expected cash inflows could create a "cliff revenue" that follows a period of incurred expense charges. This seems to create an inconsistency in the financial statements. Just because expected cash outflows exceed the expected cash inflows does not mean the entity is relieved of the risk that is in the

portfolio of contracts. Therefore, the remaining margin should be adjusted (amortized) only for the amount of reduction in the uncertainty of cash flows. Should the remaining margin be fully recognized and reduced to zero, if the expectations reverse, revenue would not be recognized over the period in which the insurer is providing the coverage.

If the Board decides (1) not to adjust the margin for changes in expected cash flows and, (2) that the remaining margin should be recognized when it is expected that the portfolio of contracts will be in a loss position, the guidance should clarify that the determination should be based on total expected cash flows of the contract, plus the remaining expected qualifying acquisition costs not yet incurred.

Acquisition costs

Question 28

Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?

Response:

We agree that the direct acquisition costs should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio (that is, those costs for successful contracts) and that all other acquisition costs should be recognized as expenses when incurred. We recognize that this is inconsistent with the proposed guidance on revenue recognition (which is incremental costs at the contract level), but because of the nature of insurance contracts, we agree that the qualifying acquisition costs should be determined at the portfolio level. Limiting the costs to those that are directly related to the entity's selling efforts and to those that are successful is, in principle, similar to those that would be included under the Board's proposal on revenue recognition.

We also agree with the costs specified in the implementation guidance that could be considered directly attributable to obtaining the portfolio of contracts. We do not believe costs associated with unsuccessful efforts or costs for normal operating expenses not directly attributable to the portfolio of insurance contracts should be included.

We also agree that a practical expedient should be included to allow entities to expense all acquisition costs when incurred (accrued or paid in cash). We agree that the practical expedient should apply to contracts with a coverage period of less than one year but do not think it should be limited to contracts accounted for using the premium allocation approach. As noted in our response to Question 6, we do not believe that all contracts with a coverage period of one year or less should apply the premium allocation approach. Therefore, we recommend the practical expedient should be expanded to all contracts, including those accounted for using the building block approach. We also recommend the Board consider expanding the practical expedient to all contracts measured under the premium allocation approach or, as an alternative, allowing entities to only include incremental costs, similar to revenue recognition, in their determination of qualifying acquisition costs. The costs to implement systems and processes to capture non-incremental costs such as underwriters' salaries and benefits and policy issuance costs for successful efforts do not outweigh the benefits gained for many contracts that would be accounted for under the premium allocation approach.

Question 29

Do you agree that the measurement of the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using the premium allocation approach should be reduced for direct acquisition costs incurred? If not, what do you recommend?

Response:

We do not object to presenting acquisition costs accrued or paid with the margin under the building block approach or with the liability for remaining coverage under the premium allocation approach, given that these costs are an offset to the profit earned by the entity and are not stipulated in the contract with the contract holder. However, we also would not object to presenting the acquisition costs as an asset, given that the Board decided in the proposed guidance on revenue recognition to recognize these costs as an asset.

Question 30

Do you agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach or in the same pattern that it reduces the liability for remaining coverage under the premium allocation approach? If not, why not?

Response:

Because the acquisition costs are a reduction of an entity's profit, we believe the expense should be recognized in the same pattern that the margin and the liability for remaining coverage are recognized. However, the Board should clarify that the qualifying acquisition costs expected to be paid should be updated each reporting period, thus these changes should not be immediately recorded in net income. This would result in all qualifying acquisition costs being accounted for similarly, regardless of when they were initially recognized; that is they should be recognized as expense in proportion to the profit being recognized.

Insurance contract revenue

Question 31

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 information about changes in margin (that is, the net profit)? If not, why not?

Response:

We believe that users would obtain relevant information if insurance contract revenue and expenses are presented in an entity's financial statements. We do not believe there is a conceptual reason for the presentation of the consideration received for a good or service (revenue) for an insurance

contract and other types of services or the costs to provide the contract or services (costs of goods sold) to differ. For example, for some insurance contracts earned premiums are a measure of the consideration paid by the contract holder to the company for insurance coverage. The earning of that consideration over the coverage period represents the revenue of the entity and the costs for the payments of the claims and related expenses (costs of goods sold) should be presented in the statement of comprehensive income.

However, due to the complexities of the proposed revenue recognition approach, we believe a summarized margin presentation could be used to present information in the statement of comprehensive income for contracts accounted for under the building block approach. Under the summarized margin presentation, all cash inflows associated with an insurance contract (premiums) would be treated as deposits and all cash outflows (claims, benefits and related expenses) would be treated as repayments. Therefore, net income would only be affected by recognition of the profit or loss on the insurer's performance as it is released from risk, adjustments for actual experience that differs from previously estimated expected outcomes, and interest expense on insurance liabilities.

While a summarized margin presentation would result in companies not recognizing revenue for contracts under the building block approach, it would at least present a simple and understandable approach. Traditional volume measures like premiums due, claims and benefits could be shown through note disclosures to the financial statements.

We acknowledge the fact that using a summarized margin presentation would result in the use of two different presentation models under the standard, notably the summarized margin presentation for contracts accounted for under the building block approach and an earned premium presentation for contracts accounted for under the premium allocation approach. This would create some incomparability and inconvenience for composite insurers, but the other insurance contract revenue alternatives explored by the Boards thus far would not resolve this issue either. To the extent that this creates different presentation in the Statement of Comprehensive Income, the Board could investigate dealing with those different presentations through disclosures.

In making its decision regarding the presentation in the statement of comprehensive income, the Board should focus on which approach provides the most useful information to all users of financial statements.

Question 32

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? Please specific whether your view depends on the type of contract.

Response:

We agree that amounts that are returnable to the contract holder regardless of an insured event occurring, should be excluded from the revenue and expenses recognized in the statement of comprehensive income. Insurance is somewhat of a hybrid arrangement whereby one party pays cash

to potentially receive cash in return. Excluding the cash paid by the contract holder that will be returned to the contract holder regardless of an insured event from revenues and expenses is consistent with the accounting for deposits by other institutions. We believe this represents the economic substance of the contracts rather than the form. We believe there should be consistent accounting treatment of returnable amounts for all types of insurance contracts which should be aligned to other accounting topics.

We believe the guidance should be clarified that this determination is made at the contract level. If amounts could be returned to contract holders based on the overall performance (some contracts will have claims and other contracts will not) of a portfolio of contracts or based on the performance of the entity itself, those amounts should be considered as part of the measurement of the expected cash outflows. Including these amounts as estimated returnable amounts would be inconsistent with the notion of excluding amounts that are akin to deposits. We believe amounts "returned" based on the overall performance of a portfolio of business are analogous to a participation right (not guaranteed returnable amounts), dividends paid to shareholders or amounts credited to contract holders of mutual insurers. This clarification would be significant for health insurers because the Affordable Care Act requires them to return amounts in excess of a specified loss ratio based on a portfolio of contracts to contract holders that comprise that portfolio, regardless of whether those contract holders had a claim or not. If this determination is performed at the portfolio level, health insurers would not recognize a significant portion of the premiums. We do not believe this is what the Board intended.

Question 33

For contracts measured using the premium allocation approach, do you agree that if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue? Do you agree with the practical expedient that an entity should not be required to reflect the time value of money in measuring the liability for remaining coverage (that is, if the entity expects, at contract inception, that the time period between the payment by the policyholder of all or substantially all of the premium and the entity providing the corresponding part of the coverage is one year of less)? If not, what would you recommend and why?

Response:

We believe that adjusting the promised amount of consideration in a contract to reflect the time value of money is appropriate when a contract contains a significant financing component. Therefore, we agree that when using the premium allocation approach, if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue. We also support providing a practical expedient if the time period between the payment by the contract holder of all or substantially all of the premium and the entity providing the corresponding part of the coverage is one year of less.

This is consistent with the Board's decision in its project on revenue recognition. If the Board changes its decision in its final guidance on revenue recognition, we believe the Board should consider whether a similar change should be made to the proposed guidance on insurance contracts.

Question 34

For contracts measured using the building block approach, does this proposed Update contain sufficient guidance on how to determine insurance contract revenue in accordance with the principle that it should be allocated between reporting periods as performance obligations are satisfied over time (that is, to allocate consideration between periods by reference to the relative value of the services provided in each period)? If not, explain what additional guidance is necessary.

Response:

We agree with the proposal to recognize revenue over time for contracts measured using the building block approach. It is consistent with the premium allocation approach and the proposed revenue recognition model for other industries, both in how it reports premiums as revenue over time, and the elements of premiums reported as revenue.

However, we believe the Board should clarify what it means by "value of services", how it views the service that is being provided and its intent for how revenue should be recognized. This will help avoid non-comparable results for identical products/services due to diversity in interpretations.

Value of service could be interpreted such that revenue should be recognized when the claim is incurred, similar to a performance obligation satisfied at a point in time in the Board's proposal on revenue recognition. Recognizing revenue when the claim is incurred, which is when an event creating an obligation to pay occurs, is the least complex of the alternatives. However, some could view this approach as not fully reflecting the value of the service that insurers provide when they stand ready for the event to occur. For example, the premium attributed to the expected cash flows for a life insurance policy acquired at age 40 would not be recognized until the person died, which may occur 50 years later. Under this view, only the expected profit on the contract, which may be less than 10% of the total premiums, would be recognized over those 50 years.

Value of service also could be interpreted such that revenue should be recognized based on the likelihood of the event occurring (when the entity is standing ready) similar to a performance obligation satisfied over time in the Board's proposal on revenue recognition. For example, if the likelihood of a 40 year old dying is 1%, then 1% of the total expected premium should be earned. However, recognizing revenue based on the likelihood of the event occurring would require accumulating all expected consideration for a portfolio of contracts, then allocating a portion of that total consideration to each period, regardless of the actual losses. Consider a situation where losses are expected in year four of a portfolio, but they actually occur in year eight. Because the revenue is based on expectations, revenue is recognized in year four, but the actual expenses did not occur, so an adjustment would need to be recorded as an expense to the income statement as a change in future assumptions. This adjustment would need to be tracked such that when the losses are incurred in year eight, the amount of loss recognized in the income statement in year eight does not double count expenses already recognized. In addition, some could view this approach as recognizing an expense when the expense has not yet been incurred.

Also, some could interpret the term value of service from the perspective of the value received by the contract holder which could be higher in the earlier years of the coverage period. For example, contract holders typically view a 30-year term contract as having more value to them before they pay the full amount of premiums and when they most need the contract.

We agree with the Board that the current practice of recognizing revenue based solely on when the contract says a payment is due rather than considering when the insurer performs a service under the contract is not appropriate. We believe this recognition approach (premiums due) is inconsistent with the definition of revenue and how all other industries recognize revenue.

We recognize that both the earned premium and summarized margin presentations will not convey the same volume (premium and claim) information that users receive today. Our understanding is that users do not view these amounts as revenue but rather as growth indicators that we believe should be contained in disclosures, as proposed.

The proposed Update requires that an entity's methodology used to determine the value of coverage for each portfolio when recognizing premiums attributable to the fulfillment cash flows shall be applied consistently throughout the life cycle of the portfolio. We believe that entities should be allowed to change their estimation methodology. ASC 820, *Fair Value Measurement*, permits changes in a valuation technique or its application if the change results in a measurement that is equally or more representative of fair value in the circumstances. Examples include: new markets develop, new information becomes available, information previously used is no longer available, valuation techniques improve and market conditions change. We believe that similar guidance should be included related to the method used to recognize the premiums attributable to the fulfillment cash flows.

Participating contracts

Question 35

Do you agree that participation features contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion regarding the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

Response:

We agree that the measurement of the insurance contract liability (or asset) should reflect the insurer's obligation to the contract holder. If the insurer's obligation is contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself the measurement of the insurance contract liability (or asset) should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements.

However, we believe the Board should clarify that the measurement of the component of the insurance contract liability (or asset) that is contractually linked to an underlying item should be the measurement of the underlying item based on the insurer's obligation (that is, the measurement in the GAAP financial statements, fair value, or some other value) if that is what the Board intended. The words "should reflect" could be interpreted as needing to consider the measurement of the underlying in applying the building block approach (that is, the present value of the probability-weighted expected cash flows). Another interpretation could be that you do not use the building block approach and instead set the liability measurement to the measurement of the underlying items. We believe the Board intended the latter with which we agree. However, depending on how this is interpreted this could result in a different measurement of the insurance liability, especially if the discount rates applied to the components that are not contractually linked to an underlying item were to be applied.

We also agree that the insurance contract liability (or asset) should be adjusted when there is a difference in measurement of the underlying item in the US GAAP financial statements and the insurer's contractual obligation and that difference is a timing difference that is expected to reverse and enter into future calculations of participating benefits. This is consistent with existing US GAAP and with the treatment of temporary differences from deferred tax assets or liabilities. We believe that not making such adjustment would result in shareholder's equity being misrepresented.

We also agree that if the insurer's obligation is based on the fair value of an underlying item, the insurance contract liability (or asset) should be measured based on that fair value with changes being recognized in net income.

We also agree that features of a contract that are not contractually linked (or allow for management's discretion) to an underlying, should not be measured based on the measurement of the underlying item and instead should be measured using the general guidance on expected cash flows.

The guidance for contractually linked obligations will result in insurer's measuring the portion of its obligation that is contractually linked to underlying items separately from the portion of its obligation that is not contractually linked to underlying items which we believe is appropriate. See Question 14 with regard to fees that are based on underlying items.

Reinsurance

Question 36

Do you agree that a cedant should record a margin if the expected present value of the cedant's future cash inflows exceed the expected present value of the cedant's future cash outflows (thus prohibiting the recognition of a gain at inception upon entering into a reinsurance arrangement) for (a) retrospective reinsurance contracts accounted for using either the building block approach or the premium allocation approach and (b) prospective reinsurance contracts accounted for using the building block approach? If not, what do you recommend and why?

Response:

We agree that a cedant should not recognize a gain when entering into a reinsurance contract when there is still risk that the gain will not emerge. We believe that the general principles within the proposed guidance should apply equally to ceded reinsurance contracts as to directly written contracts. See our response to Question 21. Therefore, we agree that when applying the building block approach, a margin should be recognized when the contract (prospective or retroactive) is expected to result in an expected gain. We also agree that a margin should be recognized when applying the premium allocation approach when the reinsurance contract is retroactive as there is no liability for remaining coverage on retroactive contracts.

We also agree that expected losses on prospective ceded reinsurance contracts should not be immediately recognized and that the excess of the amount paid for future insurance protection should be expensed over the reinsurance coverage period. The Board should clarify that the cost of reinsurance is the consideration paid (ceded premium) to the reinsurer and should cross-reference the paragraphs that discuss the loss on prospective reinsurance contracts (834-10-30-31) to the guidance on recognition of the consideration paid for reinsurance (834-10-35-45).

The Board should consider adding guidance on the determination of the approach (building block or premium allocation) to be used when a contract contains both retroactive and prospective contracts/provisions.

Question 37

Do you agree that a cedant should estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding fulfillment cash flows for the underlying insurance contract or contracts, without reference to the margin on the underlying contracts? If not, what would you recommend and why?

Response:

We agree that the reinsurance contract should be evaluated separate from the underlying contracts that are being ceded under the contract. Therefore, the deferred gain on a ceded reinsurance contract should be determined based on the amount of expected cash inflows, which is based on the pricing of the reinsurance contract, in excess of the expected cash outflows, consistent with the proposed guidance on measuring the underlying insurance contracts.

Insurance contracts acquired in a business combination

Question 38

Do you agree that entities should record a loss at the acquisition date in the amount by which any excess of the asset and liability balances related to insurance contracts measured in accordance with the guidance in this proposed Update exceeds the fair value of those assets and liabilities? Do you agree that entities should record a margin (not an immediate gain) for the amount that the fair value of the asset and liability balances exceeds those assets and liabilities measured in accordance with the guidance in this proposed Update? If not, do you think an entity should instead increase or decrease goodwill for the differences between the fair value and the measurement in accordance with the guidance in this proposed Update on those assets and liabilities? Why or why not?

Response:

We do not agree that an entity should recognize a loss on insurance contracts acquired in a business combination when the fair value of the insurance contracts assets and liabilities is less than the measurement of those assets and liabilities in accordance with the proposed Update. We also do not believe that goodwill should be adjusted in such situations, as proposed in the IASB's revised Exposure Draft.

ASC 805 requires entities to measure the assets acquired and liabilities assumed at their acquisition-date fair value. We do not believe an exception to ASC 805 is warranted for the measurement of insurance contracts acquired in a business combination. Regardless of whether the insurance contracts assets or liabilities are recognized as one balance or separated into two components, we believe the total amount recorded upon acquisition should equal the fair value of the insurance contract.

We do not believe an entity acquires an entity or a business expecting to realize an immediate loss related to the assets acquired and liabilities assumed. Paragraph B382 in the Basis for Conclusions in Statement 141R, Business Combinations, states, "...the Boards believe that in practice any overpayment is unlikely to be detectable or known at the acquisition date. That is, the Boards are not aware of instances in which a buyer knowingly overpays or is compelled to overpay a seller to acquire a business. Even if an acquirer thinks it might have overpaid in some sense, the amount of overpayment would be difficult, if not impossible, to quantify. Thus, the Boards concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date."

For the proposed Update, the appearance of an expected loss is most likely due to differences in the fair value measurement of insurance contracts under the proposed guidance and in the guidance on business combinations. In a business combination the acquirer may be willing to accept assets that are less than the measurement of the insurance contracts. One reason could be that the fair value measurement uses a discount rate higher than the rate determined based on the characteristic of the insurance contracts.

As previously stated, we do not believe this measurement difference should create a loss on acquisition. Over time the acquirer recognizes income from the insurance contracts and amortizes this amount into income. Conceptually, the actual effect resulting from performing under the insurance contract after acquisition should result in a net (or aggregate) effect on results of operations in future periods during which the contract is completed. If a business combination is accounted for based on the proposed Update, we believe that the subsequent results of operation generally will not be reflective of the fair value of the business acquired. This could lead to a lack of comparability amongst entities. For example, if the fair value of the insurance contract was a net liability, the proposed guidance would result in the recognition of a loss as of the date of acquisition and have no subsequent effect on the results of operation. However, if the fair value of the insurance contract was a net asset, a liability assumed would be recognized as part of the business combination and would affect the subsequent results of operation as it is recognized over the remaining insurance contract.

We also do not believe the difference between the fair value of the insurance contracts assets and liabilities and the measurement of those assets and liabilities in accordance with the proposed Update should be included in goodwill as it does not meet the definition. Goodwill is defined in Codification as an asset representing the future economic benefits arising from other assets acquired in a business combination. However, for insurance contracts, the future economic benefit arises from the liabilities assumed in a business combination and potentially the financial instruments acquired that back those liabilities.

Because the measurement of the insurance contracts assets and liabilities under the proposed Update is not fair value, we believe the fair value of an acquired insurance contract in a business combination should be recognized in the following two components: (1) the measurement of the insurance contracts' assets and liabilities based on the guidance in the proposed Update and (2) a separate asset or liability, representing the difference between the fair value and the measurement of the insurance contracts assets and liabilities under the proposed Update. This is consistent with the guidance in the proposed Update for recognizing a margin when the fair value of the portfolio of insurance contracts acquired is in excess of the measurement of the insurance contracts liability measured in accordance with the proposed Update; this should apply regardless of whether the second component results in a liability or an asset. We believe the second component should be recognized in the same manner that the margin is recognized under the proposed guidance (that is, based on the entities release from risk).

Also, it is important to note that the proposed Update would create the only acquisition-date recognition event that would deviate from the business combination principle of fair value. The recognition principle included in the proposed Update is significantly different from a bargain purchase, which is the only other acquisition-date recognition event. However, a bargain purchase is a gain attributed to the acquirer that is faithful to the principle of recognizing the assets acquired and liabilities assumed at fair value.

Lastly, the guidance in paragraphs 834-10-30-36 through 30-37 appears to be focused on contracts measured using the building block approach. The Board should clarify that for contracts measured using the premium allocation approach, the excess of the fair value of the insurance contracts assets and liabilities and the measurement of those assets and liabilities in accordance with the proposed Update can be included in the liability for remaining coverage for contracts with outstanding coverage periods.

Contract modifications

Question 39

Do you agree that for a substantial modification (a) an entity should recognize a gain or loss as the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the carrying amount of the existing contract and (b) that the carrying amount of the existing contract should be derecognized? If not, what do you recommend?

Response:

We agree with the guidance on contract modifications. However we believe that this guidance should not only be used when there is a separate agreement between the two parties to make a change. We believe it should also be used when changes are allowed within the initial contract. See our response to question 13.

Presentation

Question 40

Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?

Response:

We agree with the proposed presentation of the balance sheet. However, regarding the statement of comprehensive income, we are concerned that requiring specific line items to be presented could result in a lengthy statement that could overshadow an entity's overall performance. While activity that represents expenses conceptually should not be netted against activity that generates revenue, the Board should consider whether there are situations in which it would be appropriate to present items together when the measurement is based on the same underlying cash flows with disclosures of any items that have been netted.

Disclosures

Question 41

Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and why? Do you think that any of the disclosure requirements included in this proposed Update would not provide decision-useful information and should not be required? If so, which ones and why?

Response:

We generally agree with the direction of the proposed disclosures, but we are concerned that the amount of disclosures could be voluminous. Although the proposal provides a principle for the level of aggregation of portfolios and disaggregation of information, for a multi-line, multi-location writer of insurance contracts, the disclosures could be overwhelming. Specifically, the disclosures of insurance, market and credit risks at a disaggregated level could be significant. Those disclosures could become a series of account balance roll-forward amounts or tables with generic commentary as to causes of changes in estimates.

In addition, the Board should consider limiting the disclosures that are required by entities whose primary business is not insurance.

Because the discount rates will differ by entity and is a significant assumption in the measurement of the insurance contract liability (or asset), we believe the proposal for entities to disclose the expected fulfillment cash flows and the weighted average discount rates in time bands used to measure the insurance contract liability (or assets) in the statement of financial position would provide useful information.

Effective date and transition

Question 42

The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?

Response:

We believe that the key drivers affecting the timing of implementation are system changes that will affect each company differently. Changes to processes and the implementation of controls will also be time consuming. In addition, because the reported amounts may differ significantly from those reported under existing US GAAP and this may change many key performance indicators, educating internal and external users of the financial statements prior to the implementation of the proposed Update will take time.

Based on these factors, we believe that, at a minimum, three years from the final issuance of a standard will be needed.

We believe that the effective date for the proposed Update on insurance contracts should align with the effective date of the proposed Update on financial instruments. However, if the effective dates do not align, the practical expedient provided to re-designate assets upon adoption of the proposed Update on insurance contracts is appropriate.

Question 43

Do you think the effective date should be the same for both public and nonpublic entities? Do you think the effective date should be the same for regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance? Why or why not?

Response:

We agree with the proposed Update to allow nonpublic entities an additional year to adopt the proposed guidance. As noted in Question 42, the key drivers in implementing the proposed guidance are system and process changes that could be more significant for nonpublic entities that may not have as many resources. In addition, many of the nonpublic insurers have historically learned from the adoption of accounting standards by public companies.

Notwithstanding our comment in Question 1 on scope, the system requirements and potential additional resources that may be required by noninsurance entities could be significant and thus an additional year should be afforded to these entities.

Question 44

Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for restrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

Response:

The transition provisions would have a significant long term effect on some insurance companies' results as existing contracts may stay in force for over 30 years. Therefore, we believe the transition provisions need to result in the measurement of insurance contracts written before the transition date and subsequent to the transition date being equivalent and that the revenue and expenses recognized after the transition date will be as comparable, as possible, for those contracts.

We believe the Board's decision to apply the proposed Update retrospectively best achieves those objectives and that the practical expedients to determine the margin and the interest accretion rates also adequately meet those objectives. Although insurers may have certain data available for contracts originated many years ago, it may be difficult for many insurance companies to obtain objective evidence for contracts entered into 20 or 30 years ago. However, the proposal implies that companies could rely on information that may exist within the entity but may not have been or cannot be subjected to auditing procedures. We believe that the practical expedient should be refined to limit situations in which an entity would not be able to recognize a margin and would have to use information that may be costly to accumulate and to audit.

Therefore, if full retrospective application is impractical, we believe the Board should consider simplifying the practical expedient to allow companies to use expectations as of the transition date. The total margin can be determined as the difference between the total premiums (charged or to be charged) for a portfolio of contracts and total estimates of expected cash outflows (paid or to be paid) and qualifying acquisition costs using historical data and assumptions at the transition date. That total

margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet margin. Although this mimics adjusting the margin for changes in expected cash flows, this approach should be considered, regardless of the Board's decision on adjusting the margin, as an approximate transitional method where full retrospective application is impractical. This approach uses consistent measurement principles for the opening balance sheet and, with disclosure, is preferable to the elimination of margins when objective evidence is not readily available.

Although we believe that it is appropriate to allow companies to determine the interest accretion rates retrospectively using the practical expedient, we are concerned that the amounts recorded to other comprehensive income upon transition will be significant, given that current discount rates are significantly different from discount rates that would have been applied before the 1990s. We believe that upon transition, a loss recognition test should be required that would potentially require entities to re-set their interest accretion rates to current discount rates, regardless of the Board's decision on loss recognition on an ongoing basis. See our response to Question 17.

As noted in our response to question 19, if the interest accretion rate is based on the discount rates determined at the date the portfolio of contracts was initially recognized, the Board should consider a practical expedient for outstanding claims at the date of transition for which underwriting year data was not previously captured.

The Board should also allow a practical expedient for insurance contracts that have been disposed of through a sale (that qualifies as a sale in accordance with ASC 805) subsequent to the transition date but prior to the effective date of the proposed Update to not be re-measured. The benefits of restating a business that has been sold do not outweigh the costs that would be incurred to do so. However, if not restated, the balances in the statement of financial position and the activity in the statement of comprehensive income should be separately presented, perhaps in a summarized manner similar to the requirements for discontinued operations with appropriate disclosures.

We agree with the Board's decision to allow entities to use their portfolios as designated immediately prior to transition rather than reclassifying contracts written prior to the transition date between portfolios.

As noted in our response to Question 42, if the effective dates of this proposed Update and the proposed Update on financial instruments do not align, the practical expedient provided to re-designate assets upon adoption of the proposed Update on insurance contracts is appropriate. We do not believe the re-designation should only be limited to re-designating assets between fair value through net income and fair value through other comprehensive income.

Question 45

For business combinations that occurred before the transition date, is the requirement included in this proposed Update on reallocating the fair value of the asset and liability balances related to insurance contracts between the expected fulfillment cash flows and the margin operable? Why or why not? If not, what would you recommend and why?

Response:

For business combinations that occurred before the transition date, we believe reallocating the fair value of the asset and liability balances related to insurance contracts as of the acquisition date between the expected fulfillment cash flows and the margin is appropriate, given the decision to apply the proposed Update retrospectively. See our response to Question 38.

Consistent with our response to Question 44, we have concerns regarding information that would be used in performing the reallocation of the acquisition-date fair value between the insurance contracts assets and liabilities and the separate asset or liability. Therefore, we believe the Board should consider the practical expedient proposed in our response to Question 44, modified to reflect acquisition accounting. That is, the separate liability or asset as of the acquisition-date should be determined as the difference between the fair value of the insurance contracts assets and liabilities as initially determined at the acquisition date and the total estimates of expected cash outflows (paid or to be paid). That amount margin could then be attributed across the life of the contract to determine the amounts that should have been earned and those yet to be earned which establishes the opening balance sheet separate asset or liability.

Question 46

Do you agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability? Why or why not?

Response:

We generally agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability. However, financial statements amongst entities will not promote comparability as each entity will have limitations to obtaining the required information necessary to develop a margin retrospectively. Therefore, as noted in our response to Question 44, we believe the Board should consider other practical expedients.

Costs and complexities

Question 48

Describe the nature of the incremental costs of auditing the financial reporting requirements included in this proposed Update, distinguishing between one-time and ongoing costs. Explain which aspects of the model in this proposed Update are driving those costs.

Response:

We believe the one-time costs of auditing the implementation of the proposed Update would be significant. Auditors would need to gain an understanding of decisions made by preparers in implementing the proposed Update and the changes in processes and controls implemented by preparers for the contracts affected by the guidance. They would also need to test the applications and underlying data supporting the accounting and related transition adjustments. Costs to audit the accounting for insurance contracts accounted for using the building block approach would be more significant, both during implementation and on an ongoing basis, due to the updating of assumptions that were previously locked-in and the inclusion of all expected cash flows each reporting period. The more complex areas of the models would be the more costly areas to audit and would probably include the updating of assumptions, including the updating of discount rates each reporting period, the use of OCI for the effect on the measurement of the insurance contract liability or asset from changes in discount rates, the updating of interest accretion rates when applicable and the recognition of the revenue from premiums attributable to the fulfillment cash flows. In addition, if the Board were to decide to adjust the margin for changes in expected cash flows, the complexity of the audit would increase.

Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

7 November 2013

Dear Kevin

Re: AASB ED 244 *Insurance Contracts* and ED 255 *Agriculture: Bearer Plants*

I am enclosing a copy of PricewaterhouseCooopers' responses to the International Accounting Standards Board's exposure drafts

- ED/2013/7 *Insurance Contracts* and
- ED/2013/8 *Agriculture: Bearer Plants*.

The letters reflect the views of the PricewaterhouseCoopers (PwC) network of firms and as such include our own comments on the matters raised in the requests for comment. PwC refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

AASB specific matters for comment

We are not aware of any regulatory or other issues that could affect the implementation of the proposals in either exposure draft by not-for-profit and public sector entities.

Subject to our concerns about specific matters as expressed in our submissions to the IASB, we believe the proposals would result in financial statements that would be useful to users. Should the proposed amendments be approved by the IASB, we are not aware of anything that would indicate that the proposals are not in the best interests of the Australian economy.

Reduced disclosure requirements for insurance contracts

As explained in our previous submission on ED 201, we generally agree with the AASB's approach of not specifying Tier 2 disclosures for insurance contracts, based on the assumption that entities with material insurance activities would generally be publicly accountable. However, this does not have to be the case. For example, a captive insurer who is a wholly-owned subsidiaries without external stakeholders would not normally be publicly accountable.

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Under the current differential reporting regime, these entities can reduce their disclosure burden by preparing special purpose financial reports. However, should the Board decide in the future to change the application focus of Australian Accounting Standards from 'reporting entity' to 'general purpose financial statements', all entities with insurance contracts would be required to apply the proposed insurance contracts disclosures regardless of whether they are publicly accountable or not, and whether users of the financial statements would require this kind of information. This would be an additional burden for entities such as captive insurers.

We therefore recommend that the Board reviews the application of the proposed disclosures to non-publicly accountable insurers using the Tier 2 Disclosure Principles should the reporting entity concept be revised at a future point in time.

I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 4664 if you would like to discuss our comments further.

Yours sincerely,

Paul Brunner
Partner, PricewaterhouseCoopers

pwc

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

25 October 2013

Dear Sir/Madam,

Revised Exposure Draft – Insurance Contracts

We are pleased to respond to the invitation by the IASB (the 'Board') to comment on behalf of PricewaterhouseCoopers on the revised Exposure Draft, Insurance Contracts. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of those member firms who commented on the revised Exposure Draft. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We commend the Board on its progress on the project towards issuing a comprehensive standard on insurance accounting. We re-emphasise that the development of a comprehensive standard for insurance contracts is essential because the transitional arrangements established in IFRS 4 do not provide the level of transparency and comparability necessary for the users of financial statements.

We recognise the efforts the Board has made in jointly re-deliberating its decisions with the Financial Accounting Standards Board ('FASB'). While there are differences in views between the Boards, we continue to support the development of a global converged standard for insurance contracts and urge the Board to keep working with the FASB to achieve this goal. However, given the lack of consistent accounting for insurance contracts outside of the United States of America, if timely convergence cannot be achieved with the FASB we urge the Board to finalise its insurance contracts standard once it has finished its re-deliberations and further testing has been completed.

Overall, we continue to support the proposed use of a measurement model for all insurance contracts that portrays a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate. We appreciate the efforts of the Board in addressing the concerns expressed in the comment letters to the 2010 Exposure Draft. Nevertheless, there are a number of areas where we believe the proposed standard could be further improved. In particular, we believe the accounting for contracts with discretionary participation in underlying items requires an alternative solution to that described in the revised Exposure Draft.

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

We appreciate the difficulty in developing a measurement approach that works for all contracts that have a link to underlying items. The revised Exposure Draft introduces an alternative approach for contracts that require the entity to hold underlying items and which specify a link between the payments to the policyholder and the returns on the underlying items. However, there are some types of contracts where these requirements may not be met as there is not a legal requirement to hold

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specific assets. We agree that the proposal in the revised Exposure Draft for the accounting for contracts that require an entity to hold underlying items and specify a link to the returns on those underlying items is appropriate for unit-linked contracts (also referred to as 'variable contracts'). However, we believe an alternative approach that does not require the decomposition of cash flows should be developed for discretionary participating contracts. We believe that such an alternative approach should be based upon the building block model to maintain a consistent measurement for all other insurance contracts using a current fulfilment value.

If the accounting for these discretionary participating contracts does not decompose the cash flows, the challenge is to determine the discount rate to be applied. This choice will affect how the options and guarantees prevalent within these contracts are valued. Where these options and guarantees are linked to market variables, they should be measured using these market variables and by considering a full range of scenarios. The final standard should be clear whether these options and guarantees are valued on a 'risk neutral' or 'real world' basis, as discussed further in our response to question 2. We also believe that changes in the value of options and guarantees should be recognised against the contractual service margin (unless the contract is onerous) for all contracts, regardless of whether the contracts include terms that result in payments that are contractually linked to returns on underlying items.

Interest expense in profit or loss

IFRS 9 has a mixed measurement model for the recognition of debt instruments, either at fair value through profit or loss, at fair value through other comprehensive income ('OCI') or at amortised cost. These latter two categories would recognise interest in profit or loss on a historic amortised cost basis. This is in contrast with IAS 37 'Provisions, contingent liabilities and contingent assets' where changes in discount rates are recognised in profit or loss using a current rate.

Given the mixed measurement model in IFRS 9 and the treatment in IAS 37, we do not believe that recognising changes in discount rates in OCI would provide relevant information in all circumstances. Many insurers hold assets supporting insurance contracts that will not be measured at fair value through OCI or amortised cost. For example, when assets supporting insurance contracts are recognised in profit or loss, we believe it would then be more appropriate to recognise changes in discount rates related to those insurance contracts in profit or loss. We therefore suggest that entities should be able to make an irrevocable choice at transition or on inception of a portfolio whether changes in discount rates in measuring insurance contract liabilities are recognised within the interest margin in profit of loss or in OCI.

Adjusting the contractual service margin

We agree that financial statements will provide relevant information if the differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services (excluding those that are due to changes in discount rates) are recognised against the contractual service margin. This will include changes in options and other cash flows that are expected to vary with returns on the underlying items (hereafter referred to as 'guarantees'), with the exception of mirrored cash flows of unit-linked contracts. This is subject to the condition that the contractual service margin should not be negative.

We believe that changes in the risk adjustment related to future coverage and other future services should also be recognised against the contractual service margin. We believe that recognising the changes in the risk adjustment for future coverage and other future services against the contractual service margin is conceptually consistent with adjusting the contractual service margin for changes in estimates of future cash flows, so that the contractual service margin is a measure of unearned profit.

We support the amortisation of the contractual service margin in profit or loss over the coverage period in a systematic way that best reflects the provision of services under the contract. However, while we support a principles-based standard, we are concerned that without further guidance there will be significant diversity in the patterns used to amortise the contractual service margin, even for similar contracts, because there is subjectivity in determining the underlying services that drive the amortisation. We suggest introducing a rebuttable presumption to amortise the contractual service margin using a straight line pattern after reflecting contract terminations, subject to guidance being provided as to when rebutting the straight-line pattern would be appropriate.

Presentation of insurance contracts revenue and expenses

We support the notion of revenue and expenses being recognised for insurance contracts, which is broadly consistent with the accounting for revenue in other industries. However, we recognise that there are significant concerns around the revenue measure in the revised Exposure Draft. In particular, there are concerns with both the difficulty in explaining to users movements in revenue as a result of multiple drivers and the operational complexities in disaggregating non-distinct investment components in many insurance contracts.

While on balance we support the definition of insurance contract revenue in a period as set out in the revised Exposure Draft, we recommend the Board continues to work with preparers and users during its re-deliberations to determine whether the inclusion of revenue and expenses in the statement of comprehensive income will provide useful information.

Effective date and transition

We agree with the simplifications for transition in the proposed standard as we believe these provide a pragmatic approach to transition for the different building blocks within the measurement model.

As stated in our response letter to the limited amendments to IFRS 9: classification and measurement, reflecting the economic linkage between assets and liabilities is fundamental to how the insurers' business is managed as well as how it is analysed by users. For insurers, the difference in timing between the new insurance contracts standard and IFRS 9 will inevitably cause challenges, as it appears that there may be a lag between the effective date of IFRS 9 and the completion date of the insurance contracts standard. While insurance entities could adopt IFRS 9 based on the existing standard for insurance liabilities (or based on their expectation of the direction the insurance proposals will take), in reality that linkage between the assets and liabilities is so intertwined that the accounting for financial assets will need to be revised once the new accounting model for insurance contracts is introduced. Accordingly, we suggest a practical solution to allow entities that issue insurance contracts a second opportunity to revisit the decisions in adoption of IFRS 9 when the final insurance standard becomes effective.

Although not part of the five key areas for re-exposure, as noted in our response to the previous ED, we believe the standard should allow for optional separation of interdependent account balances in insurance contracts that are not distinct. This will enable, for example, loans that are waived on death to be separated into the underlying loan and the insurance element.

We commend the Board for its efforts to carry out an extensive outreach programme in the comment period. However, given the complexity of the proposed standard, we believe preparers will need more time to fully test the proposals on a range of products. We urge the Board to continue working closely with the industry after the comment period in its re-deliberations to understand the implications of any amendments to the proposals. We also recommend that once the Board has finalised its re-deliberations, a review draft of the final standard be made available to provide sufficient time to allow preparers to perform detailed field tests of the proposals and resolve any material issues identified during the Board's re-deliberation process.

We have elaborated on the issues stated above in the Appendix together with a number of other areas where we believe the proposed standard can be improved. We believe that if the concerns noted above are addressed, the proposed model will provide a reliable source of data and useful information for users of the financial statements and be a significant improvement to the current accounting for insurance contracts.

If you have any questions, please contact John Hitchins, PwC Global Chief Accountant (+44 207 804 2497) or Gail Tucker, PwC Global Financial Instruments Leader (+44 117 923 4230).

Yours sincerely

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Appendix

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?

We agree that financial statements will provide relevant information if the differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are recognised against the contractual service margin ('CSM'), subject to the condition that the CSM should not be negative.

However, we are not clear which changes in cash flows have to be recognised against the contractual service margin, which are recognised in profit or loss and which are recognised in OCI. As currently written, the revised Exposure Draft is unclear with regard to the recognition of asset management charges for unit-linked contracts. Paragraph B68(d) notes that changes in estimates of cash flows that depend on investment returns, if those changes arise as a result of changes in the value of the underlying items, should not be recognised against the CSM. In contrast, according to paragraph B68(e) changes in cash flows relating to asset management services are an example of future services that would be adjusted against the CSM. In addition, paragraph 66(b) states that all changes in indirectly linked cash flows should be recognised in profit or loss. We believe that the Board should clarify that changes in asset management charges that are not unbundled and are based on changes in the underlying assets should be recognised against the CSM (except for changes attributable to changes in discount rates) as the asset management activity is a future service. Changes attributable to changes in discount rates should be recognised in OCI or in profit or loss based on the alternative that is chosen, as discussed in our response to question 4 below.

Another example would be changes in a guaranteed minimum death benefit, where changes in the liability may arise from changes in demographic assumptions, investment returns or discount rates. It is not clear which changes relate to future and past services and so which would be recognised against the contractual service margin. We believe all changes in fixed cash flows and options and guarantees should be treated according to the building block model that recognises them in OCI, profit or loss or against the CSM, depending on their characteristics. We believe more guidance and illustrative examples should be provided in the final standard to clarify past and future services.

In addition, we believe that changes in the risk adjustment related to future coverage periods and other future services should be recognised against the CSM. Recognising the changes in the risk adjustment related to future coverage periods and other services against the CSM is conceptually consistent with adjusting the CSM for changes in cash flows, so that it is a better measure of unearned profit in a contract. We understand that preparers of financial statements in some territories are able to allocate changes in the risk adjustment between changes related to incurred claims, other changes related to expiry of risk and changes related to future coverage and other future services. However, we recommend the Board works closely with preparers to assess whether this approach is fully operational.

We believe that the CSM should be reinstated if assumptions change for contracts that are onerous at inception or contracts that become onerous during the life of the contract and subsequently become profitable. We note that the requirement to reinstate the CSM is not clearly described within the proposed standard, although BCA 143 implies that this is the Board's intention, at least for contracts that subsequently become onerous. The proposed standard should also specify whether losses recognised in profit or loss relating to unfavourable changes in the present value of future cash flows for future coverage and other services are subsequently reversed through profit or loss to the extent that there are subsequent favourable changes in those cash flows or whether the subsequent favourable changes are all recognised as a change to the CSM. We believe favourable changes in fulfilment cash flows after a contract becomes onerous should be recognised in profit and loss as those favourable developments occur until previously recognised losses in excess of the CSM have been recouped and then used to re-establish a CSM. When the contract becomes profitable again, the CSM should reflect the remaining unearned profit expected on the contract as if it had been profitable during the entire life of the contract (that is including the amortisation of the margin to date).

We support the amortisation of the CSM in profit or loss over the coverage period in a systematic way that best reflects the provision of services under the contract. However, while we support a principles-based standard, we are concerned that without further guidance there will be significant diversity in the patterns used to amortise the contractual service margin, even for similar contracts This can be seen in some territories where a principle similar to that included in the revised Exposure Draft has been implemented and the resulting diversity in accounting for the amortisation of the CSM is evident. For some long-term insurance contracts the amortisation of the CSM will be a primary determinant of profit recognition and so such diversity is a significant concern. This diversity may arise as a result of the lack of clarity as to what 'services' the CSM covers. BC32 implies that the CSM is viewed as the profit that is recognised as the entity provides coverage and other services. We suggest clarifying which services are covered by the CSM to assist preparers in determining the proper release pattern. For example, some may say the transfer of service could be the reduction in the net amount at risk under a life insurance contract which would result in an earlier recognition of profits. Others see the service as a stand ready obligation which could result in a relatively level pattern of profits, whereas assigning the service as expected benefits could result in profits being recognised later in the coverage period.

We suggest introducing a rebuttable presumption to amortise the contractual service margin using a straight line pattern after reflecting contract terminations, subject to guidance being provided on when rebutting the straight-line pattern would be appropriate. A straight line pattern would represent the stand ready obligation to incur claims throughout the coverage period. Rebutting the straight-line pattern could, for example, be allowed for products where the amount of maximum coverage varies throughout the product life. This, for example, could apply to decreasing term insurance where the death benefit decreases at a predetermined rate over the life of the policy. We believe that such a

rebuttable presumption of a straight-line pattern would achieve more consistency in profit recognition among entities and be easier for users to understand.

In its discussions on participating contracts the Board concluded that the realisation of investment gains or losses and the payment or declaration of policyholder bonuses are not reflective of the services transferred under a participating insurance contract. As a minimum, the standard should include this guidance in clarifying the services that are provided under such contracts.

We also believe the final standard should be clear that newly written loss making contracts cannot be amalgamated with previously written profitable business. Therefore, we believe that the final standard should explicitly require that the CSM be calculated for contracts within a portfolio by similar date of inception. We also note that, if the OCI solution is retained, paragraph BCA 113 already indicates that in practice, entities may have to account for the CSM at a lower level of aggregation than the portfolio, for example by contracts that have similar inception dates and coverage periods. We believe a lower level than the portfolio will be necessary, given that interest accretes on the CSM using the rate from inception of the contract; as a result the standard should make this clear to avoid confusion. We believe that as a consequence, the requirements for the onerous contract test under the building block model (paragraph 15), as well as under the simplified approach (paragraph 36), should be amended to also be at the level of contracts within a portfolio by similar date of inception.

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 (i.e. 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;

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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?

We appreciate the difficulty in developing a measurement approach that works for all contracts that have a link to underlying items. The revised Exposure Draft introduces an alternative approach for contracts that require the entity to hold underlying items and which specify a link between the payments to the policyholder and the returns on the underlying items. There are some contracts where these requirements may not be met as there is not a legal requirement to hold assets. While the alternative approach, with an amended scope, may work for unit-linked contracts, we believe the proposal in the revised Exposure Draft is not appropriate for contracts where the cash outflows to policyholders have a significant linkage to the returns on underlying items, but there is discretion over the sharing of these returns (hereafter referred to as 'discretionary participating contracts') as set out below.

Unit Linked contracts

We agree that the proposal in the revised Exposure Draft for the accounting for contracts that require an entity to hold underlying items and specify a link to the returns on those underlying items is appropriate for unit-linked contracts, subject to our comments below on accounting for options and guarantees. Therefore, we suggest amending the scope of this approach to contracts for which some or all of the benefits are determined by the price of units in an internal or external investment fund (that is a specified pool of assets held by the insurer or a third party and operated in a manner similar to a mutual fund) as laid out in the previous Exposure Draft. In addition we believe it should be clarified that such contracts should stipulate that the returns on assets, other than specified fees, should be passed directly on to the policyholder in their entirety. In some jurisdictions these contracts are referred to as variable contracts but we refer to these hereafter as 'unit-linked contracts'.

Unit-linked contracts have a separate account balance and do not have discretionary participation, which significantly decreases the complexity of decomposing the cash flows into components that are expected to vary directly with returns of underlying items and those that are not expected to vary directly with returns of underlying items (fixed cash flows and embedded options and guarantees). However, we note that the current treatment of asset management charges for unit linked contracts is unclear in the revised Exposure Draft as discussed in our response to question 1.

Discretionary participating contracts

In discretionary participating contracts (such as Continental European participating contracts, UK With Profit contracts and Universal Life contracts), management has some discretion over when and

how much it allocates to policyholders in each year of the contract and often these contracts do not have separate account balances. As a result, when compared to unit-linked contracts, these contracts have an inconsistent degree of asset dependency over the life of the contract, which complicates the decomposing of cash flows.

In many discretionary participating contracts policyholders receive returns based upon income from sources in addition to investment returns, such as mortality gains. While in some contracts losses from one source can be offset with surpluses from another source, in other contracts such netting is prohibited. For discretionary participating contracts, the proposed model in paragraphs 33 and 34 of the revised Exposure Draft does not adequately reflect these different product characteristics. For example, in a single premium whole life contract which solely participates in the returns from underlying bonds, the return on these bonds will cover future benefits and expense outflows. Conceptually, we do not believe that the variable cash flows can be measured by mirroring the carrying value of the underlying bonds when the returns on these bonds also support cash flows that relate to, for example, fixed components that are decomposed and separately accounted for under paragraphs 33 and 34. This would not apply to unit-linked contracts, as the invested assets relating to the units are separated from the explicit charges that are deducted from the account balance.

Furthermore, paragraph B86 of the revised Exposure Draft prescribes the decomposition of the cash flows in a way that maximises the extent to which the cash flows vary with returns on underlying items in order to eliminate accounting mismatches. In our view such a split is arbitrary for discretionary participating contracts. For these contracts, the prescribed decomposition does not reflect the economics of the contract and results in the recognition of an option or guarantee that is not consistent with that included in the pricing of the option or guarantee component and how the contract is managed. Many preparers economically view the options and guarantees in discretionary participating contracts as described in paragraph B86(a). However, this decomposition does not give any directly varying cash flows, which can be measured by reference to the carrying amount of the underlying items. Therefore, such an approach would not reduce accounting volatility. In contrast, for typical unit-linked contracts, current regulatory and accounting practice requires the decomposing of cash flows in the way that paragraph B86(b) describes. Because unit-linked contracts have a 100% participation in the increase in the fair value of underlying assets, in our view, applying the simplified example in paragraph B86 results in the same outcome for both B86(b) and B86(c). Therefore, the prescribed decomposition effectively aligns with how the options and guarantees are economically viewed in unit-linked contracts.

We believe an alternative approach should be developed for discretionary participating contracts, where there is a significant link to the returns on underlying items. We believe that the alternative approach should be based upon the building block model to maintain a consistent measurement approach for all insurance contracts using a current fulfilment value. Discretionary participating contracts often include a number of interrelated guarantees and management actions that can be taken to reduce the effect of these guarantees in certain scenarios. We therefore believe that the alternative model should not require the decomposing of cash flows.

Options and guarantees

We believe that options and guarantees should be recognised and measured on a current basis, regardless of whether contracts have terms that lead payments to be contractually linked to returns on underlying items. As the proposed building block model requires a probability weighting of all cash

flows, both fixed and guaranteed, including those linked to market variables we believe all such cash flows should be measured using market variables, where relevant, and by considering a full range of scenarios. Because of the non-symmetric distribution of outcomes, the measurement of options and guarantees will in many cases involve stochastic modelling or using a deterministic model, run multiple times, to reflect a range of scenarios. A single deterministic approach omits valuing the scenarios where the investment return is less than the guarantee. We believe the final standard should give examples illustrating when modelling a single deterministic outcome is not appropriate. We note that for certain simple options and guarantees a formula (such as Black Scholes) may exist which could be equivalent to stochastic modelling.

We believe changes in the value of options and guarantees in all insurance contracts should be recognised against the contractual service margin (unless the contract is onerous), as these options and guarantees largely represent future services and coverage to be provided under the contract, except for changes attributable to discount rates. Conceptually, we believe changes related to discount rates should be recognised in OCI or in profit or loss based on the alternative that is chosen, as discussed in our response to question 4. We urge the Board to work with preparers to ensure that the use of a locked-in discount rate provides useful information where the valuation of options and guarantees is based on stochastic or similar techniques. We believe that all changes in options and guarantees should be recognised against the CSM if the changes due to interest rates cannot be separately identified or do not provide meaningful information for users.

We recognise that to the extent entities economically hedge their options and guarantees, an accounting mismatch will arise, as changes in the value of the hedging instruments will be recognised in profit or loss. Therefore, we urge the Board to develop a solution that will avoid introducing an accounting mismatch for entities that economically hedge options and guarantees.

If different valuation techniques are adopted for between fixed cash flows and guarantees, then we believe the distinction between fixed cash flows and guarantees is unclear in the revised Exposure Draft for discretionary participating contracts. For example, some view a guaranteed minimum death benefit (that is, the greater of a fixed amount and the account balance) as a fixed cash flow, whereas others view it as a guarantee as discussed in our response to question 1.

One of the key challenges for discretionary participating contracts is how options and guarantees should be measured. The basis for conclusions in BC61(b) seems to imply that a market-consistent approach should be applied. We view there to be a risk of significant diversity in the market related inputs that might be used as a consequence of the revised Exposure Draft. Some entities believe this implies that options and guarantees should be valued on a 'real world' basis, while others believe that a 'risk neutral' approach should be adopted. Both approaches begin with current market values at the balance sheet date and apply these to a range of scenarios, but the main difference is the inputs that are included in the models. This is relevant for inputs such as the discount rate and the investment return cash flows, which have a significant impact on the measurement of options and guarantees.

A real world basis considers multiple possible economic scenarios based upon the historic performance of an asset class. However, in order to do so, significant subjectivity can be involved (particularly for equity instruments and real estate), which may reduce the comparability between entities due to differences in the application of this experience. Using a real world valuation approach to derive the time value of options and guarantees generally assumes that certain asset classes will outperform fixed income asset classes. Further, some argue that this approach is inappropriate, as it is

likely in most cases, to result in a lower value of the option or guarantee than the cost of hedging the obligation at the balance sheet date.

In a risk-neutral market-consistent model[1], the asset related cash flows in the liability are measured by using observable information at the balance sheet date, which is consistent with the concept of a replicating portfolio and derivative pricing techniques. Some argue that the measurement of the options and guarantees in this way does not reflect the nature of the contract, which stipulates a linkage between assets and liabilities and introduces short-term volatility. In addition, some argue that the risk-neutral approach may not reflect the effect of policyholder behaviour assumptions based on historical patterns in various economic scenarios. Nevertheless, its advantage is valuations are more comparable between entities, as they would be based on market observable data at the balance sheet date and in this model, the option or guarantee is measured consistently with the cost of hedging the obligation at the balance sheet date.

Discount rate

As noted above we believe that the model for discretionary participating contracts should be based upon the building block model without requiring the decomposition of cash flows. This implies that the discount rate will be applied to the contract as a whole. For the directly varying cash flows in the contracts, projecting investment returns and discounting them at the same rates would result in the same outcome as under the proposed model in the revised Exposure Draft.

If asset-based discount rates are applied to the cash flows in discretionary participating contracts as a whole, this will result in the fixed cash flows being discounted at an asset-based rate. In addition, options and guarantees will be valued on a 'real world' basis, with the implications described above.

An alternative would be to apply the liability based discount rate that is used in the building block model for all cash flows, which has the advantage that the fixed cash flows will be discounted at a rate that reflects the characteristics of the liability. Under this alternative, options and guarantees would be valued on a risk neutral basis, with the implications described above. The use of a liability based discount rate would result in interest expense being recognised at the liability-based rate, while the effective interest on assets held at fair value through OCI would be at the higher asset-based rate, which creates an accounting mismatch in the income statement. As a result, where OCI is used, the use of the liability-based discount rate will not reflect the fact that cash outflows depend on the return on the underlying items.

Contractual Service Margin

We believe changes in cash flows attributable to the shareholders ('shareholders' component') in discretionary participating contracts should be recognised against the CSM. Recognising the shareholders' component against the CSM is consistent with how the CSM is recognised at inception of the contract. We appreciate that there are arguments for and against recognising the shareholders' component against the CSM. However, we believe this is one of the compromises that will be necessary to obtain support for the standard in certain key territories.

[1] By the term 'risk-neutral market-consistent' model and 'risk neutral basis', we include other actuarial techniques that provide an equivalent market consistent assessment, for example, a 'real world / deflator' method. We note that a 'real world / deflator' method is not the same as the real world basis discussed above.

We refer to our response to question 1 for our concerns regarding the release of the CSM in profit or loss according to realisation of investment gains or losses and payment or declaration of policyholder bonuses, as we do not believe these are reflective of the services provided.

Summary

We agree that the proposal in the revised Exposure Draft for the accounting for contracts that require an entity to hold underlying items and specify a link to the returns on those underlying items is appropriate for 'unit-linked contracts', subject to our comments above on recognising changes in options and guarantees. However, we believe the proposal in the revised Exposure Draft is not appropriate for contracts where the cash outflows to policyholders have a significant linkage to the returns on underlying items, but there is discretion over the sharing of these returns. We have assessed a number of approaches for these discretionary participating contracts in our deliberations. We believe an alternative should be developed based on the building block model without decomposing of cash flows. The final standard should make it clear whether indirectly varying cash flows are modelled on a real world or risk neutral basis, as this could have a significant effect on the measurement of some contracts. If both alternatives are permitted then disclosures should be included to explain the valuation methods used. We urge the Board to work with preparers and users to develop an approach for accounting for discretionary participating contracts that is operational and provides meaningful information to the users of financial statements.

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?

We support the notion of revenue and expenses being recognised for insurance contracts that is broadly consistent with the accounting in other industries. However, we recognise that there are significant concerns around the revenue measure in the proposed standard. In particular, the operational complexities in disaggregating non-distinct investment components and the difficulty in explaining to users movements in revenue as a result of multiple drivers (estimated claims and expenses, the change in the risk adjustment, and the amortisation of the contractual service margin).

While on balance we support the definition of insurance contract revenue in a period as set out in the revised Exposure Draft, we recommend that the Board continues to work with preparers and users during its re-deliberations to determine whether the inclusion of revenue and expenses in the statement of comprehensive income will provide useful information.

Additionally, we are unclear how revenue and expenses will be recognised for insurance contracts and assumed reinsurance contracts that provide coverage for past events. It is unclear what the definition of an 'incurred' claim is for these contracts, given that they cover the uncertainty around the ultimate settlement amount and not the occurrence of claims. We believe the proposed presentation of insurance contracts revenue and expenses should be clarified for these contracts. We also refer to

similar issues for contracts with liabilities in the settlement period that are acquired through portfolio transfers as explained in our response to question 6.

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:

- **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 the amount of those cash flows; and**
- **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?

IFRS 9 has a mixed measurement model for the recognition of debt instruments, either at fair value through profit or loss, at fair value through OCI or at amortised cost. The latter two categories recognise interest in profit or loss on a historic amortised cost basis. This is in contrast with IAS 37 'Provisions, contingent liabilities and contingent assets' where changes in discount rates are recognised in profit or loss using a current rate.

Some see insurance contracts as more akin to financial instruments and so would recognise changes in discount rates in OCI, while others see more of an analogy to a non-financial provision and so would recognise changes in profit or loss.

Given the mixed measurement model in IFRS 9 and the treatment in IAS 37, we do not believe that recognising changes in discount rates in OCI would provide relevant information in all circumstances. Many insurers hold assets supporting insurance contracts that cannot be measured at fair value through OCI or amortised cost. For example, for assets supporting insurance contracts whose changes in fair value are recognised in profit or loss, we believe it is more appropriate to recognise changes in discount rates related to those insurance contracts in profit or loss. We therefore suggest that entities should be able to make an irrevocable choice at transition or on inception of a portfolio whether

changes in discount rates in measuring insurance contract liabilities are recognised within the interest margin in profit of loss or in OCI.

We believe that if an entity elects to recognise changes in discount rates in profit or loss, the accretion of interest on the CSM should be based on the current discount rate.

For discretionary participating contracts, we believe that the characteristics of the contracts should be reflected in the interest expense recognised in profit or loss. For example, some contracts have a variable rate nature with similar economic features to borrowings with floating rate interest payments. Because those payments vary with changes in interest rates, portraying the interest expense as if it resulted from fixed rate financing would be inconsistent with the objective of recognizing in other comprehensive income changes that reverse when the contract is settled. We note that some entities would prefer to split discretionary participating contracts into a matched and unmatched period to reflect the duration mismatches in profit or loss. Although we understand the merits of this approach, we believe that such a split may be difficult to apply in practice for all discretionary participating contracts at the portfolio level, particularly when underlying assets are not debt instruments.

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?

We agree that the proposed approach to transition appropriately balances comparability with verifiability. We acknowledge that the simplifications for the building blocks may not provide a conceptually pure answer and that the simplification for estimating the risk adjustment will, for many contracts, result in an overstatement of the CSM on transition. However, we agree with the simplifications in the proposed standard as we believe they provide a pragmatic approach to transition for the different building blocks.

The CSM on transition is required to be calculated at the portfolio level. We believe that the CSM on transition should be allocated on a systematic and reasonable basis to contracts in a portfolio by similar date of inception for the purpose of subsequent amortisation to be consistent with our response to question 1 above.

As stated in our response letter to the limited amendments to IFRS 9: classification and measurement, reflecting the economic linkage between assets and liabilities is fundamental to how the business of insurers is managed, as well as how it is analysed by users. For insurers, the difference in timing between the new insurance contracts standard and IFRS 9 will inevitably cause challenges as it appears that there may be a lag between the effective date of IFRS 9 and the completion date of the insurance standard. While insurance entities could adopt IFRS 9 based on the existing standard for insurance liabilities (or based on their expectation of the direction the insurance proposals will take), in reality that linkage between the assets and liabilities is so intertwined that the accounting for financial assets will need to be revised once the new accounting model for insurance contracts is introduced. Accordingly, we suggest a practical solution to allow entities that issue insurance contracts a second opportunity to revisit the decisions in adoption of IFRS 9 when the final insurance standard

becomes effective. This will allow for a more holistic view of how the entity issuing insurance contracts manages its business and will provide enhanced information to users of the financial statements.

We commend the Board for its efforts to carry out an extensive outreach programme. However, given the complexity of the proposed standard, we believe preparers will need more time to fully test the proposals on a range of products. We urge the Board to continue working closely with preparers after the comment period in its re-deliberations to understand the implications of any amendments to the proposals. We also recommend that once the Board has finalised its re-deliberations, a review draft of the final standard is made available for sufficient time to allow preparers to further field test the proposals.

Many territories are planning to or already transitioning to IFRS. Entities in these territories and other entities that will have to apply the proposed insurance contracts standard for the first-time may find it useful to apply the implementation guidance that is currently available in IFRS 4. Therefore, we believe the applicable implementation guidance in current IFRS 4 should be carried forward to the final standard.

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.

Overall, we believe that the costs of complying with the proposed requirements are justified by the benefits that the information will provide. Entities transitioning to the final standard may incur significant costs to comply with the new requirements. However, we believe the need for a comprehensive standard for the accounting for insurance contracts outweighs these costs.

We believe that the proposals in the revised Exposure Draft, including an alternative proposal for discretionary participating contracts based on the principles set out in our response to question 2, will provide significantly more transparency and comparability for users of financial statements of entities issuing insurance contracts. We re-emphasise that the development of a comprehensive standard for insurance contracts is essential because the transitional arrangements established in IFRS 4 do not provide the level of transparency and comparability necessary for the users of financial statements. We also believe that our proposal to provide entities an irrevocable choice at transition or on inception of a portfolio to recognise changes in discount rates within the interest margin in profit of loss or directly

in OCI will be less costly and complex to apply than the current proposals in the revised Exposure Draft.

In response to the comments received on the 2010 Exposure Draft, the Board has made a number of significant changes to the requirements. We believe that many of these changes are justified to address concerns about perceived 'artificial' volatility. However, we have listed below some of our concerns with topics in addition to the five key areas for re-exposure, where we believe the standard should be improved.

Definition, scope and combining contracts

Paragraph 8 of the revised Exposure Draft indicates that two or more insurance contracts that are entered into at or near the same time with the same policyholder (or related policyholders) have to be accounted for as a single insurance contract when one of three criteria is met. As stated in our response to the 2010 Exposure Draft, there is currently diversity in practice when accounting for fronting arrangements. We believe the requirements in the revised Exposure Draft regarding combining of insurance contracts are insufficient to address the accounting for such fronting arrangements. These arrangements come in many forms, but diversity particularly arises where an operating entity within a consolidated group transfers risk through insurance to an independent insurer and this insurer passes the risk back to a captive insurer in the same consolidated group as the operating entity. The ED states that an entity shall combine two or more insurance contracts that are entered into with the 'same policyholder (or related policyholders)'. However, in this case, the operating entity is acting as policyholder and the captive insurer is acting as insurer, and thus the reference to 'same or related policyholders' will not encompass these contracts. Therefore, we suggest replacing 'policyholder' with 'counterparty' as this would address the accounting for these arrangements.

The proposed standard on Revenue from Contracts with Customers explicitly scopes out insurance contracts. However this standard has principal/agent guidance that would be useful to consider in the context of fronting arrangements. For example, some arrangements pass on 100% of the insurance risk from an entity to an insurer. Subsequently, the insurer passes 100% of the risk on to a reinsurer. The agreement stipulates that the insurer does not have to pay claims from the entity unless recoveries are received from the reinsurer (known as a 'pay-as-paid' clause). We believe that these contracts should be recognised on a net basis if the conclusion is reached that the insurer is an agent. We believe that an assessment based on principal/agent guidance tailored for insurance contracts could be useful to determine the accounting treatment for these agreements.

Separating components from an insurance contract

As stated in our cover letter, we support the optional separation of interdependent account balances in insurance contracts that are not distinct. This will enable, for example, loans that are waived on death to be separated into the underlying loan and the insurance element.

Risk adjustment

As stated in our previous comment letter, we do not support disclosure of confidence level information as a 'comparable benchmark', as this could be misleading when the pattern of claims is a skewed distribution. We are not convinced that the benefit of producing this information exceeds the cost of producing it. If any other method is used for measuring the liability, a significant amount of work will

be required (that is, a total rerun of the valuation model) to convert the risk adjustment as determined by these other methods to a corresponding confidence level. We do agree that disclosures about the risk adjustment technique used should be given, including a roll-forward, the objective and inputs and parameters used in the technique. Insurers should disclose information about the risk adjustment that will help users of financial statements understand and make their own judgements about the maximum amount the insurer would be willing to pay to be relieved of the risk and why the amount of the entity's risk adjustment is consistent with the objective for a risk adjustment.

Premium allocation approach/Simplified approach

Paragraph 38 states how entities that apply the simplified approach should measure the liability for remaining coverage. The initial recognition may take into account acquisition costs and any pre-coverage cash flows. However, it is not clear how any acquisition costs and pre-coverage cash flows get removed from the pre-coverage liability given that revenue is stated to be 'the amount of the expected premium receipts allocated in the period'. We recommend that the Board include a similar approach to that included for the building block model in paragraph B90(d).

Reinsurance

As stated in our response letter to the 2010 Exposure Draft, in risks attaching ceded reinsurance, where risks are assumed for contracts written in the next year, the reinsurance contract may not be eligible for the simplified approach. In contrast, each of the direct insurance contracts being reinsured might be eligible for the simplified approach. We believe it would be appropriate to apply the simplified approach to the reinsurance contract held for the cedant if all of the insurance contracts that are reinsured qualify for the simplified approach.

Business combinations and portfolio transfers

IFRS 3 states that an insurance contract should be classified on the basis of contractual terms existing at inception of the contract. We believe the Board should clarify whether this classification only includes the assessment of the transfer of significant insurance risk or also the classification as a contract under the premium allocation approach ('PAA') or the building block model. Illustrative example 10A explains that a CSM has to be recognised if the consideration received for an assumed portfolio of insurance contracts exceeds the fulfilment cash flows for that portfolio. It is unclear how a CSM would be set-up in a contract acquired in a business combination when the contract qualifies as PAA after the business combination as this approach does not identify this building block separately.

We believe the requirements are unclear as to whether an insurance contract in its settlement period that is acquired through a portfolio transfer should be treated as the remainder of a pre-existing contract that is in its post coverage period or as a new insurance contract which is at the beginning of its coverage period. In the latter case, the insured event would be the discovery of the ultimate cost of those claims and a CSM would be set-up in accordance with paragraph 18(b) and 28. However, if the contract is treated as a pre-existing contract, a CSM cannot be recognised as the contract is in its settlement period. We believe contracts acquired in a portfolio transfer are akin to acquiring new insurance contracts and therefore should be re-assessed at the acquisition date to determine whether they transfer significant insurance risk and qualify for the PAA or building block model. We note that some insurance contracts that qualified as PAA before the portfolio transfer may not qualify for PAA after the acquisition. We believe that contracts acquired in a portfolio transfer should be treated as

new insurance contracts when they are acquired in the settlement period. For these contracts the insured event is the discovery of the ultimate cost of those claims noted in paragraph B5. We believe that this implies that these contracts have a coverage period that ends upon the discovery of the ultimate cost of those claims. We believe the final standard should be clear on the coverage period for insurance contracts that cover events that have already occurred but whose financial effect is still uncertain.

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 any proposal that is not clear. How would you clarify it?

We have some concerns with the clarity of drafting in the proposed standard. We have listed below these concerns organised by topic:

Cash flows

Paragraph B66(k) notes that payments arising from existing contracts that provide policyholders with a share in the returns on underlying items are included in the fulfilment cash flows, regardless of whether those payments are made to current or future policyholders. A literal reading of this paragraph may imply that if these 'existing contracts' terminate or lapse, any amounts arising from those contracts but expected to be paid out to future policyholders would be recognised in equity. Subsequently these amounts would have to be recognised in the insurance contract liability when new contracts are initiated. We do not believe this was the Board's intention. We suggest amending paragraph B66(k) by including a reference to 'existing and prior contracts' to clarify that these expected cash flows should be included in insurance contract measurement regardless of whether they arise from current or past contracts.

Paragraph B66(c) explains which acquisition costs should be included in the fulfilment cash flows. In addition, B66(l) explains the types of overhead costs that are to be included in the fulfilment cash flows, which would seem to apply to all fulfilment cash flows (for example, claim adjustment and maintenance expenses as well as acquisition costs). We suggest clarifying to what extent overhead costs relating to acquisition are included in the fulfilment cash flows, for example, rent for a building occupied by in-house sales force, or application software relating to commission payment processing.

Contract boundary

We are unclear whether the wording on the contract boundary in paragraph 23(b)(ii) is intended to be restricted to the 'portfolio', as defined in the proposed standard. In many cases, the right to re-price exists at a different level than the portfolio and is often subject to external regulatory constraints. We believe the proposed requirements are too restrictive and we suggest removing the reference to the 'portfolio of insurance contracts' and instead refer to a group of contracts.

Discount rate

We support the Board's decision to allow a top-down as well as a bottom-up approach in determining the discount rate to reflect the time value of money of the cash flows of the insurance contract. The requirements for the top-down approach in paragraph B70(a)(iii) indicate that while there may be remaining differences between the liquidity characteristics of the insurance contract and the liquidity characteristics of the assets in the portfolio, an entity applying the top-down approach need not make adjustments to eliminate these differences. However, the example in paragraph B74(a) states that a 'market premium for liquidity' has to be eliminated from the total bond yield. These paragraphs seem contradictory and therefore we suggest deleting the reference to market premium for liquidity.

Paragraph B72 implies that the discount rate curves for cash flows that are not expected to vary with returns on underlying items should be the same for all liabilities in a given currency. This discount rate would be represented by an illiquid risk-free curve. In particular, we are unclear whether different illiquidity adjustments have to be applied to different contracts and also whether all cash flows within one contract should have the same illiquidity adjustment. We suggest clarifying this in the final standard.

Contractual service margin

Paragraph 30 in the proposed standard refers to the 'the remaining amount of the contractual service margin', which could be interpreted as requiring that the CSM cannot exceed the CSM initially booked, which we believe is not the Board's intention. We suggest removing the reference to 'the remaining amount'.

The same paragraph refers to a 'difference between the current and previous estimates of the present values of future cash flows'. We believe the final standard should be clear that this difference has to be calculated at the locked in discount rate, rather than the current discount rate, unless our alternative to recognise changes in discount rates in profit or loss is applied. Also, BC33 states that there is no change in the measurement of the liability as a whole. However, if the liability is re-measured at the current rate but the CSM is re-measured at the locked in rate, then we would expect a change to the liability as a whole.

Reinsurance

We believe that the Board should define the term 'aggregate losses' because it is unclear, for example, if a proportional reinsurance contract with a cap qualifies as a reinsurance contract that covers aggregate losses or as a proportional reinsurance contract.

Paragraph 73 refers to reconciliations 'separately for insurance contracts and reinsurance contracts'. We suggest clarifying that the reconciliations have to be provided for 'insurance contracts issued' and 'reinsurance contracts held' to make clear that separate reconciliations do not have to be provided for insurance and reinsurance contracts issued.

BCA 134 states that 'for reinsurance contracts held in the pre-coverage period, a cedant should recognise a reinsurance asset at the expected present value of any expected recoveries related to underlying contracts for which it has recognised an onerous contract liability'. We believe this requirement should also be reflected in the main body of the final standard.

Investment contracts with discretionary participating features

Paragraph 47(c) refers to 'asset management or other services under the contract'. The second sentence in this paragraph only refers to 'asset management services'. We recommend that these references be made consistent.

We are unclear whether contracts without insurance risk that permit switching between funds with and without discretionary participating features are in scope of the proposed standard. We recommend the Board clarify whether these contracts are in scope or not if at initial recognition there is no or limited investment in a participating fund. In addition, paragraph B25 states that a contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (i.e. discharged, cancelled or expired), unless the contract is derecognised in accordance with paragraph 49(a). It would be helpful to clarify that this paragraph applies to contracts that allow switching between funds with and without discretionary participating features.

Business combinations and portfolio transfers

Paragraph 61 states that 'for contracts that were acquired in a business combination or a portfolio transfer, the discount rates at initial recognition that are used to measure the interest expense recognised in profit or loss are the discount rates that applied at the acquisition date.' We believe that this is already covered by paragraph 43 and therefore we suggest removing paragraph 61.

Modification and derecognition of an insurance contracts

We are unclear as to why paragraph 52 contains separate requirements for an issuer of reinsurance contracts, whereas this does not apply elsewhere in the proposed standard. We suggest aligning the requirements for issuers of insurance and reinsurance contracts.

Disclosure

Paragraph 80 requires that if the entity discloses the fair value of underlying items that are measured on a basis other than fair value, it shall disclose the extent to which the difference between the fair value and the carrying amount of the underlying items would be passed on to policyholders. We believe that this disclosure requirement does not provide relevant information, as the mirroring approach, if retained, only applies to those cash flows where there is no scenario of economic mismatches for the entity. Therefore, the entire difference will always be passed on to the policyholder.

Paragraph 82 states that an entity shall disclose the interest on insurance contracts in a way that highlights the relationship between the interest on the insurance contracts and the investment return on the related assets that an entity holds. We believe this paragraph should be clarified to state that the disclosure requirement only applies for contracts where the mirroring approach does not apply, if this approach is retained.

As stated in our response to question 6, we do not support the confidence level disclosure. However, if it is retained, we suggest clarifying in paragraph 84 that the confidence level disclosure is also required when a confidence level technique is used for calculating the risk adjustment.

If retained, we also suggest clarifying whether the disclosure of the confidence level is required gross or net of reinsurance or both. This also applies to the disclosure requirement in paragraph 90 related to the claims development tables. We believe the Board should clarify that these disclosures should be provided gross of reinsurance.

Transition

Paragraph C6(c) and (d) refer to a period of three years before the date of transition for estimating the discount rate. We had understood that the Board's intention was for this to be a period of three years before the effective date, rather than the date of transition.

We believe that the words 'historical observable data from the date of initial recognition' in paragraph BC170(b)(iii) should be replaced with 'historical observable data from at least three years before the date of transition' in order to be consistent with the requirement set out in paragraph C6(c) and (d) as currently drafted. However, if our proposed changes to C6(c) and (d) are made as stated above; these words should instead be replaced with 'historical observable data from at least three years before the effective date'.

Consequential amendments to IFRS 1

We note that the amendments to IFRS 1 in Appendix D do not include a requirement for derecognition of deferred acquisition costs which is prescribed in the transition requirements in Appendix C. We believe the Board should clarify that deferred acquisition costs are derecognised upon first-time adoption of IFRS.