25 October 2013

Dear Mr Hoogervorst and Technical Director

Comment letter on:

- ED/2013/7 Insurance Contracts; and
- Proposed Accounting Standards Update Insurance Contracts (Topic 834)

We appreciate the opportunity to comment on the International Accounting Standards Board’s (IASB) Exposure Draft ED/2013/7 Insurance Contracts (the ED or the IASB’s proposals) and the Financial Accounting Standards Board’s (FASB) Proposed Accounting Standards Update, Insurance Contracts (Topic 834) (the PASU or the FASB’s proposals) and collectively referred to as the proposals. We have consulted within the KPMG network in respect of this letter, which represents the views of the international network of KPMG member firms, including KPMG LLP (U.S.). This letter is being submitted to both the IASB and the FASB (jointly the Boards).

Measurement Model

We believe that the proposals in the ED and the PASU represent an improvement from the proposals in the IASB Exposure Draft ED/2010/8 Insurance Contracts (the 2010 ED) and FASB Discussion Paper Preliminary Views on Insurance Contracts (the 2010 DP).

We also believe that arriving at common approaches under both IFRSs and U.S. GAAP would mean a significant improvement in transparency and consistency in the financial reporting of insurers with benefits for both investors and the insurance industry.
We welcome the proposals and believe, that although they will be complex to implement they do respond to many aspects of constituent feedback with respect to the volatility introduced in profit or loss resulting from short-term market fluctuations.

We broadly agree with principles in the revised proposals, however there are specific areas of concern including:

- **Participating features**: We acknowledge the Boards’ efforts to reduce accounting mismatches in situations where there is no economic mismatch and support the general principle to reflect the interaction between assets (and certain other items) and liabilities for contracts with participating features. Additionally, we acknowledge the need for updating of discount rates for features which have a linkage to underlying items but no contractual or regulatory requirement to hold the underlying items (e.g. changes in crediting rates for universal life insurance and certain deferred annuities).

However, we believe the proposals relating to contracts with participating features are complex and difficult both to understand and to apply consistently. We believe the Boards need to clearly define an overall principle in accounting for contracts with participating features and to reconsider various aspects of the proposals for contracts that have a linkage to, or vary with, underlying items.

In addition, we have concerns on how the IASB’s proposals would apply to contracts issued by mutual entities under which some entities might report nil equity and nil net income.

- **Adjusting (‘Unlocking’) of the contractual service margin and single margin and inclusion of a risk adjustment**: We believe that consistency with the revenue recognition proposals to not recognise revenue when no service under the contract has been performed is important for the Boards to retain. As a result, the contractual service margin and the FASB’s margin (referred to as the ‘single margin’ in this document for the sake of clarity) should be recorded at initial recognition of the insurance contract. We agree that the contractual service margin should be adjusted for changes in estimates of cash flows related to future coverage and other future services because we believe that this is consistent with the rationale for including the contractual service margin and single margin at initial recognition. However, we believe that the contractual service margin should also be adjusted for changes in the risk adjustment related to future coverage and other future services.

Under the PASU, the single margin would be locked-in at inception and would not be adjusted in future periods. We believe the single margin should be adjusted for changes in estimates of cash flows related to future coverage and other future services. Additionally, we support the inclusion in the FASB’s model of a risk adjustment or other mechanism to reflect explicitly and on a current basis the uncertainty about the amount and timing of cash flows. We believe these changes would simplify the release of the single margin and result in significant convergence between the IASB and FASB models.
• **Use of other comprehensive income (OCI) to present changes in insurance liabilities due to changes in discount rates:** The proposals which require an entity to present in OCI the changes in their insurance liabilities arising from changes in discount rates together with the proposed revisions to accounting for financial instruments – including a fair value through OCI (FVOCI) category for measuring financial assets – would reduce volatility in profit or loss arising from changes in interest rates for some entities. However, in some cases these proposals may create other accounting mismatches because the OCI presentation would be mandatory. Consequently, we believe that an entity should have an option to present changes in their insurance liabilities due to changes in discount rates in profit or loss if doing so would eliminate or significantly reduce an accounting mismatch. This would be consistent with the fair value option that exists for financial assets and liabilities under financial instrument accounting.

• **Unit-linked contracts/segregated fund arrangements:** The 2010 ED proposed a single line presentation for unit-linked assets and liabilities, and related income and expenses. Many constituents agreed with these presentation proposals in the 2010 ED but they have not been carried forward to the ED. We agree with the FASB’s proposals with respect to the presentation and measurement of segregated fund arrangements, which include unit-linked contracts, except for the presentation in the statement of profit or loss and OCI as discussed in Question 40 in Appendix 2 of this letter. In addition, the PASU also includes certain consolidation exemptions for such contracts. In many cases under IFRS 10, separate funds that back unit-linked insurance contracts may need to be consolidated. We encourage the IASB to consider the same consolidation exemptions in order to avoid divergence.

• **Presentation of the statement of profit or loss and OCI:** One of the key areas for further consideration by the Boards is whether presenting insurance contract revenues and expenses in profit or loss based on the proposed approach will provide the information that users consider most relevant. Although this new presentation approach may be aligned conceptually with the gross presentation in profit or loss in the revenue recognition proposals and adds consistency in presentation to the building-block and premium-allocation approaches, we encourage the Boards to undertake outreach and consultation with users of financial statements to determine whether they believe that it provides them with the most relevant and decision-useful information and whether the costs of applying such an approach would outweigh the benefits.

• **Alignment with financial instruments:** We support an alignment of the effective dates of the insurance contracts and financial instruments standards. We encourage the Boards to consider the effects of changes in accounting principles on users’ ability to compare financial results over time. We recommend that the Board progress expeditiously on both projects with a view to having aligned effective dates. If there is no alignment of effective dates, the IASB should – at a minimum – include the redesignation provisions for financial assets as proposed by the FASB.
Timing of a final IFRS and convergence are key concerns

We support the development of one comprehensive global insurance contracts standard; however, we believe this should not be at the expense of a significant delay in the finalisation and implementation of the proposals. Given the current diversity in accounting practices for insurers under IFRSs, an insurance IFRS is urgently needed to address the current lack of consistency in reporting.

Insurance is a ‘global’ business and we believe that the benefits of convergence are significant for users in international capital markets and for both international insurers with foreign operations in the U.S. and U.S. insurers with foreign operations. At present, there are a number of key differences between the IASB’s and the FASB’s proposals. We believe the Boards should make efforts to resolve these differences in order to settle on a unified measurement model. We believe that a high extent of convergence could be reached quickly if the Boards consider our responses to the IASB’s Questions 1 and 2 and to the FASB questions detailed in the Appendices. However, considering the extended period since the project commenced and the length of the debate, we would not support an overly-long extension in the timetable for the purpose of enabling further redeliberations about convergence.

User and preparer feedback should be considered

Given the overall complexity of the revised proposals, we believe that it is important that the Boards ensure that the final standard reflects adequate consultation with users and preparers. The proposals in the ED and PASU, particularly those addressing the treatment of contracts that vary with underlying items as well as the mandatory use of OCI, add a significant amount of complexity as compared to the 2010 ED and 2010 DP. We believe implementing the proposals in their current form will require significant effort for most financial statement preparers, including some entities that are not insurers but that issue insurance contracts as defined in the proposals. It will take preparers and users time to become familiar with applying the new reporting requirements and how to interpret them. We agree with the Boards that it is important that the standards are high quality, stable, clear and based on sound principles that can be applied consistently from when they are first issued and without over-reliance on prescriptive rules.

Insurance contracts exhibit highly diverse characteristics across business segments and jurisdictions. Some of the proposals would pose substantial operational and administrative challenges for many preparers. We believe that the final standards will benefit from the Boards’ consideration of feedback from users and preparers in the round table discussions and field testing on the balance between costs and benefits of the proposals, in particular with respect to the following areas:

- participation features;
- mandatory use of OCI for presenting changes in the discount rate;
• presentation of the statement of profit or loss and OCI; and

• inclusion within the scope of the proposals of certain contracts not previously perceived as insurance.

Some recently published field testing results raise concerns about some aspects of the proposals, including the effectiveness of the proposals in addressing measurement volatility, the application of guidance in setting discount rates, particularly at very long durations where there is little or no observable market data, and operational complexity of the proposals.

Despite the consultation and field testing currently undertaken by the Boards and by market participants, it is possible that there will be unforeseen consequences from applying the revised proposals. We believe that the Boards should consider conducting further outreach activities after the re-deliberations on the ED and PASU have been completed. Such an outreach may consist of posting a near final draft prior to finalization so that areas requiring additional clarity or unintended consequences can be identified and addressed.

Attached to this letter, we have provided answers to the questions posed in the ED and PASU and other matters we believe the Boards should consider (Appendices).

If you have any questions about our comments or wish to discuss any of these matters further, please contact Mark Vaessen or Joachim Kölschbach with KPMG’s International Standards Group in London at +44 (0)20 7694 8871, or Darryl Briley with KPMG LLP in New York at +1 (212) 909 5680.

Yours sincerely

KPMG IFRG Limited

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Appendix 1

KPMG’s Responses to Specific Questions posed by the IASB

Question 1: Adjusting the contractual service margin (paragraphs 30–31, B68, BC26–BC41 and IE9–IE11)

Do you agree that financial statements would provide relevant information that faithfully represents the entity’s financial position and performance 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?

Adjusting the contractual service margin for changes in estimates of cash flows relating to future coverage and services

We agree that the proposal in the ED to adjust the contractual service margin for differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services. These would provide relevant information. However, we believe that the contractual service margin should also be adjusted for changes in the risk adjustment that relate to future coverage and other future services.

We believe that adjusting the contractual service margin for both the changes in estimates of cash flows and the risk adjustment related to future coverage and other future services would result in a more faithful representation of the unearned profit of the insurance contract. Consistency with the revenue recognition proposals to not recognise revenue when a service under the contract has not been performed is important for the Boards to retain. As a result, the contractual service margin and single margin should be recorded at initial recognition of the insurance contract. We agree that the contractual service margin should be adjusted for changes in estimates of cash flows related to future coverage and other future services because we believe that this is consistent with the rationale for including the contractual service margin and single margin at initial recognition.

We agree that an entity should not recognise any gain at the inception of an insurance contract due to the inherent uncertainty in the estimates used to measure the present value of the future
cash flows. It would be counterintuitive that an entity (i) could recognise a loss in subsequent periods for an adverse change in estimates when the contract is expected to be profitable as a whole and the embedded profits in the contractual service margin will be released over the remaining coverage period; or (ii) could recognise a gain shortly after inception from favourable changes in estimates whereas that gain would have been precluded from recognition at inception.

We believe that the contractual service margin should reflect the risk-adjusted unearned profit of the contract and as a result it should also be adjusted for changes in the risk adjustment related to future coverage and other future services. Adjusting the contractual service margin for such changes would add consistency to the treatment of the risk adjustment at inception and in subsequent measurement with the treatment of other changes in the estimates of the present value of future cash flows related to future coverage and other future services.

For the reasons mentioned above, we also believe that the single margin should also be adjusted for differences between current and previous estimates of the present value of future cash flows related to future coverage and other future services. Such a change would result in further convergence between the IASB and FASB measurement models.

The FASB’s proposals do not include a separate risk adjustment, but rather a combined single margin. Consistent with our previous response letter on the IASB’s 2010 ED and the FASB’s 2010 DP, we would support the introduction in the FASB model of a separate risk adjustment or other mechanism to reflect on a current basis the uncertainty about the amount and timing of cash flows as we believe it would be consistent with a fulfilment-based measurement and with an insurer’s business model. The IASB has included a risk adjustment in the fulfilment cash flows to reflect the compensation that the entity would require for bearing the uncertainty about the amount and timing of the cash flows when fulfilling the obligation to the policyholder. We believe that the inclusion of a risk adjustment or other mechanism to reflect the uncertainty about the amount and timing of cash flows, particularly in the case of the liability for incurred claims under the premium-allocation approach, represents better financial reporting by reflecting the risks associated with an uncertain stream of cash flows in the measurement of those cash flows. The risk-adjusted fulfilment measurement recognises that users of financial statements are not indifferent to the extent of variability in the present value of cash flows. Additionally, disclosures provide transparency about the changes in risk associated with the insurance liabilities. If a risk adjustment were to be incorporated in the FASB’s measurement model, consistent with our views on the IASB’s model we also believe that changes in the risk adjustment related to future coverage and services should also adjust the margin in subsequent measurement.

Clarification on changes in estimates of cash flows that do not relate to future coverage and other future services

We agree that differences between current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services (excluding the effects
of changes in discount rates; see our response to Question 4) should be recognised immediately in profit or loss. We also agree conceptually that the differences between current and previous estimates of cash flows that relate to future coverage and other future services should be treated according to B68(a) to (c) and (e). However, we believe the guidance in B68(d) requires clarification.

According to B68(d), under the building-block approach, the contractual service margin would not be adjusted for 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 because such changes do not relate to services provided under the contract. It is not clear if the proposals in B68(d) apply only to cash flows that vary directly with the returns on the underlying items or as well to cash flows varying indirectly, i.e. minimum guarantees that are not separated from the insurance component.

In many cases an underlying option or guarantee in an insurance contract depends on mortality and similar insurance risks as well as the values of underlying items. Also, many participating contracts provide policyholders with a share in the profits of other insurance contracts which depend on insurance rather than financial risks.

We believe further clarification is needed as to whether B68(d) applies to cash flows arising from options and guarantees that are not considered distinct and separated from the insurance contract and also could depend on investment returns. The ED should clarify whether the provision of an option or guarantee (that is not considered distinct and not separated from the insurance contract) would be considered to be a service and if so whether changes in estimated future cash flows arising from those options and guarantees should be adjusted against the contractual service margin on the basis that they relate to future coverage or services provided under the guarantee or option. See also our response to Question 2 on the consistency of treatment of options and guarantees between contracts which vary directly with underlying items and those that do not.

Mechanics of adjusting the contractual service margin for favourable and unfavourable changes in future cash flows

We do not agree with how the ED appears to treat favourable changes in estimates of cash flows in periods subsequent to the contractual service margin being exhausted. It appears that if the contractual service margin has been previously exhausted, any subsequent favourable changes in estimates are treated as an adjustment to the contractual service margin.

For example (accrual of interest is ignored for purposes of this example):

- At the end of the second year, the contractual service margin of a portfolio equals 30.
- In the third year, there is an unfavourable change in estimates of cash flows related to future coverage of (40). Under the proposals, the contractual service margin would equal zero and the entity would recognise a loss of 10 in profit or loss.
• In the fourth year, there is a favourable change in estimates of cash flows related to future coverage of 15.

Under the ED, the favourable adjustment of 15 would entirely go to create a positive contractual service margin that would be released to income in future periods. We believe the concept of unlocking the contractual service margin is more appropriately applied if the favourable change in estimates of future cash flows were applied to reverse the charge in profit or loss of 10 (incurred in year 3) and the contractual service margin was set to equal 5 (i.e. 15-10).

We believe favourable changes in future cash flows should be recognised in profit or loss to the extent of the previously recognised loss with only the excess amount being recognised as a positive contractual service margin. This may increase complexity due to the need to track information, but would avoid differences that could result from an entity’s frequency of reporting (e.g. quarterly vs. annual reporting) or differences in the pattern by which the earlier estimates were adjusted to get the current estimate. To reduce complexity, the Boards may consider not adjusting the contractual service margin retrospectively for the additional amounts that would have been amortised had the current assumptions been known earlier.

Question 2: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs 33–34, 66, B83–B87, BC42–BC71 and IE23–IE25):

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;
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;

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 understand the Boards’ objective to reduce accounting mismatches in situations where there is no economic mismatch and acknowledge the Board’s efforts to address the interaction between assets (and certain other items) and liabilities for contracts with participating features.

However, we believe the proposals related to contracts with participating features are complex and difficult to understand and apply consistently. The current proposals appear to take a piecemeal approach to the accounting and presentation of participating features in insurance contracts and include different treatments for (i) features that are defined as having a direct linkage to underlying items (e.g. variable annuities and unit-linked contracts) when the entity is required by contract or regulation to hold the underlying items, (ii) features which have a linkage to underlying items without a contractual or regulatory requirement to hold the underlying items (e.g. changes in crediting rates for universal life insurance and some deferred annuities) and (iii) those discretionary features that are not covered under (i) or (ii).

We believe the Boards need to clearly define an overall principle in accounting for contracts with participating features. Specific areas of concern with respect to the measurement and presentation exceptions ('mirroring') contained in paragraphs 33, 34, and 66 for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items include the following topics:

- Scope of the measurement and presentation exception;
- Decomposition of cash flows; and
- Presentation of changes in cash flows of options and guarantees.

In addition to the measurement exception in paragraph 34 that may avoid accounting mismatches for certain products (e.g. variable annuities), we also would support a measurement and presentation approach for participating contracts that is more aligned with the principles of the building-block model and with the revenue recognition proposals.

In respect to some of the concerns that are being raised about the approach to such contracts in the proposals, we are aware of alternative approaches for the accounting for participating
contracts that will be presented to the Boards aspects of which address concerns we are raising within our response.

In addition, we believe the guidance for participating contracts may be clearer to understand and consistently apply if all relevant guidance was in one section of the standard with a clear delineation of the scope of the guidance.

Scope of the measurement and presentation exception

Based on discussions with constituents, we notice that, based on the current drafting, many are finding it difficult to determine if a contract where there is a defined sharing of overall results qualifies for the measurement and presentation exception (i.e. the contract requires the entity to hold underlying items and specifies a link to the returns on those underlying items). We are concerned that the proposals in the ED may create an artificial bright line between (i) contracts to which the measurement and presentation exception in paragraphs 34 and 66 would apply and (ii) contracts that would not qualify for the measurement and presentation exception but contain cash flows which depend on underlying items and would apply paragraph 60(h) along with paragraph 26(a) on the discount rate.

We believe that the Boards should reconsider and explain what types of contracts with participating features, e.g. those with a linkage to underlying items, would qualify for measurement under the building-block approach or another measurement approach aligned with the building-block approach for participating features rather than the current proposals which take a piecemeal approach to addressing specific participating features and may not be consistently applied considering the variety of participating features found in different jurisdictions.

Decomposition of cash flows

Paragraph 34 indicates that cash flows, after excluding any embedded derivatives that would be unbundled, would need to be decomposed into three separate sets of cash flows accounted for in different manners. B85 and B86 include application guidance on how to do this. Overall, we believe that the decomposition of cash flows as proposed in the ED is operationally complex, difficult to understand and to some extent arbitrary (as acknowledged in BC 130).

B85 would require the decomposition of cash flows in a way that maximises the extent to which the cash flows are expected to vary with returns on the underlying items and the minimum fixed payment the policyholder will receive. We have concerns that this approach may not be operational as in many cases the valuation of an option or guarantee is considered interrelated with the cash flows that are directly linked to the underlying items (e.g. in cases where the value of options and guarantees directly impact payments to policyholders, such as surrender options).

In addition, the example in B86 illustrates how the cash flows could be decomposed. However, it is not clear whether the decomposition would need to be done in a specific way or whether the
example in the application guidance is only included to reflect the objective/principle. For example, B85 would require maximisation of both the extent to which the cash flows are expected to vary with returns on the underlying items and the minimum fixed payment the policyholder will receive. However, it appears to be unclear how the two objectives relate to each other and whether one objective would need prioritisation over the other objective. Some might interpret the wording in B86 as implying that there is only one way of decomposing as described in paragraph B86(c) while others might interpret these paragraphs as indicating that other approaches – which are not presented – may be acceptable.

We also believe that it is not clear whether a similar decomposition of cash flows would be required under the proposals if the contract does not qualify for the measurement and presentation exception but contains cash flows which vary with underlying items, as described in paragraphs 60(h), 66(b) and B68(d) (e.g. changes in crediting rates for universal life insurance and deferred annuities).

Presentation of changes in cash flows of options and guarantees

According to paragraph 66(b), changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised and presented in profit or loss. We understand that this paragraph would apply to options and guarantees (not separated from the insurance component in accordance with paragraph 10(a)) that are embedded in an insurance contract that qualifies for the measurement and presentation exception in paragraphs 33, 34 and 66. However, the treatment specified in paragraph 66(b) may be inconsistent with other contracts that do not meet the measurement and presentation exception, in which changes in cash flows for options and guarantees would be recognised consistent with the building-block approach (e.g. in profit or loss, in OCI, or as an adjustment the contractual service margin if related to future coverage or other future services).

As well as being inconsistent with the general treatment of closely related options and guarantees under the building-block approach, we believe that the Boards’ proposal for a different treatment for cash flows from options and guarantees embedded in insurance contracts that vary with underlying items the entity is required to hold would increase complexity. We understand the Boards’ concerns about the transparency of changes in the current value of options and guarantees but it is unclear why application of the building-block approach would not provide adequate transparency since it requires measurement based on a risk-adjusted present value that reflects future cash flows on a probability-weighted basis.

We also understand that, according to B68(d), under the building-block approach, the contractual service margin would not be adjusted for 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 because such changes do not relate to services provided under the contract. It is not clear if the proposals in B68(d) apply only to cash flows that vary directly with the returns on the underlying items or as well to cash flows varying indirectly, i.e. options and guarantees that are not separated from the insurance component.
In many cases an underlying option or guarantee in an insurance contract depends on mortality and similar insurance risks as well as the values of underlying items. Also, many participating contracts provide policyholders with a share in the profits of other insurance contracts which depend on insurance rather than financial risks.

We believe it would be inconsistent to present changes in the value of options and guarantees that depend on insurance risk under paragraph 66(b) for contracts where the provisions of paragraphs 33 and 34 apply (measurement and presentation exception) while changes in the value of similar options and guarantees in participating contracts that do not fall under paragraphs 33 and 34 and changes in the value of underlying insurance contracts that depend on insurance risk may be considered related to future coverage or other future services and, as a result, would be adjusted against the contractual service margin.

On this basis, changes in future cash flows related to options and guarantees that are not separated from the insurance contract could relate to future services provided under the contract and, if so, those changes should adjust the contractual service margin. This would be consistent with the general building-block approach.

**Adjusting the contractual service margin**

As explained in our response to Question 1, we believe that the contractual service margin should be adjusted for differences between current and previous estimates of the present value of future cash flows relating to future coverage and other future services. Overall, the current proposals do not clearly articulate the “services” provided under participating contracts.

**Options and guarantees**

In addressing the concerns over the different treatments of options and guarantees described above, to the extent the Boards do not consider the provision of some options and guarantees to be related to coverage or a service, they should articulate a clear rationale for this view and set out plainly why and how they require changes in different types of options and guarantees to be presented.

**Services in participating contracts**

An insurance contract contains a package of services and benefits to the contract holder. In a participating contract, these may – depending on the type of the participating contract – include:

- Insurance coverage;
- Asset management and other services, including;
  - participation in asset performance;
  - guaranteed amounts and returns; and
We believe that the profit recognised from participating contracts should reflect all the services provided under the contract.

There can be varying interpretations on what are considered to be services in participating contracts. For example, an entity that provides services will typically require remuneration of more than the present value of the expected cost of providing services. Under one interpretation some participating contracts where the policyholder participates in a defined sharing of overall results of a group of contracts or of the entity as a whole, the insurer's share in net positive returns on underlying items represents the remuneration for the package of services provided over the life of the contract and is therefore a component of the unearned profits in the contract. Changes in this component represent changes in the profitability of the contract and would therefore be recognised over the coverage period by adjusting the contractual service margin. The Boards should provide clarification on what is considered to be a service in participating contracts so that an appropriate method can be determined for recognising the profit from participating contracts that reflects the services provided.

We believe the Boards should consider in the context of the services provided under a participating contract, to what extent the insurer's share in the returns on underlying items is regarded as "earning" the right to keep a share in the returns over the life of the contract. This means, the Boards should consider whether and to what extent this share effectively represents remuneration for asset management and other services over the contract life and thus it would be appropriate to apply the general building-block model and B68(e) to adjust the contractual service margin to the extent changes in cash flows relate to future services under the contract.

**Discount rate proposals**

We observe that the ED and PASU include different proposals on updating the discount rate for cash flows that are expected to vary with the returns on underlying items when the measurement and presentation exception does not apply (paragraphs 60(h) and 834-10-35-25). We believe that the ED and PASU are addressing the same concern for updating the discount rate for these cash flows (e.g. changes in crediting rates for universal life insurance and certain deferred annuities). However, the ED and PASU use different approaches. The ED effectively puts the effect of changing the discount rate and the changes in estimated cash flows due to the change in crediting rates through profit and loss, while the PASU adjusts the discount rate in a manner that spreads the impact of the changes in crediting rates over the life of the contract on a level yield basis. The approach in the ED may be simpler to apply; however, we are not aware if sufficient modelling has been performed to identify the extent of breakage that may be reflected in profit and loss. The PASU approach eliminates the breakage in profit and loss initially but adds complexity to the model. We recommend an evaluation of the results of modelling being performed in the current fieldwork for these concerns and any other unintended consequences; and, whether additional modelling is needed to evaluate the proposed methods of addressing changes in crediting rates. Additionally, we recommend a consistent drafting of the final IASB
and FASB standards in addressing this issue. See also our comments on Question 7 (Contracts with participating features).

**Question 3: Presentation of insurance contract revenue and expenses (paragraphs 56–59, B88–B91, BC73–BC116 and IE12–IE18)**

*Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?*

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

**Presentation in the statement of profit or loss and OCI**

The 2010 ED proposed a 'summarised margin presentation' in the statement of profit or loss and OCI for contracts accounted for under the building-block approach. Many respondents expressed concerns about this presentation approach – in particular:

- the loss of volume information for key metrics – i.e. premiums and benefits; and
- inconsistencies between the presentation of life and non-life contracts.

The new presentation approach in the proposals would:

- provide a measure for income and expenses on a gross basis; and
- be broadly consistent with the gross presentation in profit or loss in the revenue recognition proposals.

Under the proposed presentation requirements, insurance contract revenue would be based on the initial expected pattern of claims and benefits, revised to reflect revisions in estimates. This approach would be drastically different from current approaches to premium presentation, especially for long-duration contracts using a premium due presentation. For contracts using the premium-allocation approach, premiums would be allocated in a consistent manner over the coverage period in a way that best represents the transfer of services. We understand that the proposed approach for presenting insurance contract revenues is conceptually aligned with the revenue recognition model and adds consistency in presenting contracts under both the building-block and premium-allocation approaches and with other industries. In addition, it provides valuable information on claims incurred and operating expenses. However, it would also require significant education for both users and preparers.

We believe that consultation is needed with users and preparers of financial statements through the comment and redeliberation periods to determine whether they believe that the proposals provide users with the most relevant and decision-useful information and whether the costs of
applying the new presentation approach would outweigh the benefits.

We also encourage the Boards to consider feedback from users and preparers on whether another alternative presentation would be preferred such as:

- a ‘summarised margin presentation’ proposed in the 2010 ED supplemented with disclosure on certain additional information, e.g. new business written or premiums due on segment level; or

- a premiums due approach more aligned with current practice.

We would like to point out the following considerations:

- The proposed approach may result in increased costs in deriving gross amounts for the statement of profit or loss and OCI which does not impact profit or loss. Users and preparers will likely need additional time to understand and accept the new presentation. In addition, although insurance contract revenue amounts would be derived based on changes in the insurance liability, these amounts would be less straightforward to derive as compared to current premium measures.

- Non-distinct investment components which are not separated from insurance contracts would be excluded for the purpose of determining insurance contract revenues and claims incurred presented in accordance with paragraph 57 if they represent an amount that the entity is required to repay to the policyholders or their beneficiaries regardless of whether an insured event occurs. Although we agree with the intention to exclude deposit elements from insurance contract revenue, we also recognise that the nature of certain products, particularly life products, presents significant difficulty in splitting premiums between ‘risk’ business and ‘investment’ business.

- We would encourage the Boards to consider feedback from preparers on the complexities and balance between costs and benefits in applying these proposals and whether there are certain products that may require further guidance or clarification. For investment components, we would consider an approach consistent with the separation of deposit elements under current U.S. GAAP for life and annuity contracts to be a reasonable and practicable approach in excluding clear deposits without the complexities associated with the proposals.

- Some users and analysts have expressed concerns when commenting on the 2010 ED that there would be a loss of volume (premiums and claims) information on the face of the financial statements under the ‘summarised margin approach’. We suggest that the Boards consider user and analyst feedback on whether the proposed presentation would meet the need for such information.
• The 2010 ED proposed single-line presentation for unit-linked assets and liabilities, and related income and expenses. Many constituents agreed with these presentation proposals in the 2010 ED. We believe that the IASB should retain the presentation proposals for unit-linked contracts from the 2010 ED. At a minimum, we would suggest considering the FASB’s proposals for presenting segregated fund arrangements, except for the presentation in the statement of profit or loss and OCI as discussed in Question 40 in Appendix 2 of this letter.

• It is unclear how the guidance on presentation would apply to insurance contracts which in whole or in part are measured under the replicating asset approach. For example, it is not clear for insurance contracts that utilise the replicating asset approach, how the presentation requirements related to the discount rate and changes in risk adjustments and related disclosures would be quantified and applied. In drafting the final standard, the Boards should incorporate further guidance in this area.

Question 4: Interest expense in profit or loss (paragraphs 60–68 and BC117–BC159)

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?

Utilisation of OCI

Many respondents to the 2010 ED were concerned about the potential volatility in profit or loss arising from short-term movements in interest rates whose effect may reverse over time and accounting mismatches that would result when assets are measured at amortised cost. In addition, those entities issuing long-duration insurance products thought the effects of volatility
May be exacerbated because the discount rates used to measure such liabilities might be extrapolated beyond observable yield curves.

We acknowledge the Boards' efforts to address these concerns and to reduce accounting mismatches by proposing the presentation in OCI of the effects of changes in discount rates together with the proposed revisions to financial instruments accounting related to a FVOCI category for measuring financial instruments.

We agree that the changes in discount rates that are expected to unwind over time should be segregated from other gains and losses and that this segregation provides greater transparency for users of the financial statements.

However, in applying the proposals accounting mismatches may still arise, e.g. if financial assets held to fund insurance contract liabilities are not classified as FVOCI under revised financial instruments standards – e.g. if the assets do not satisfy the solely principal and interest test or business model test, if entities have concluded that financial assets are managed on a fair value basis, or if entities have assets that would otherwise require fair value through profit or loss (FVTPL) classification under those proposals (e.g. equities and derivatives which do not meet hedge accounting requirements).

We believe that accounting mismatches may be further reduced if the insurance proposals provide an option for recognising changes in discount rates in profit or loss. As a result, we propose that an entity would be required to recognise in OCI 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 relevant for recognition in profit or loss, i.e. the rate that applied at the date that the contract was initially recognised (or was subsequently updated under paragraph 60(h)),

unless presenting effects arising from discount rate changes in profit or loss would eliminate or significantly reduce an accounting mismatch. This would be consistent with the alternative discussed in BC 144 of the ED. We believe that an option for recognising changes in discount rates in profit or loss (if doing so eliminates or significantly reduces accounting mismatches) should be applied at the portfolio level and be irrevocable for that portfolio.

We recognise that such a restricted option at a portfolio level may not fully eliminate accounting mismatches. However, the restricted option would significantly reduce accounting mismatches for many entities resulting from applying the proposed mixed measurement model for financial instruments. In addition, it would be consistent with the fair value option that exists for financial assets and financial liabilities.

In our response to Question 3, we noted that it is unclear how the guidance on presentation would apply to insurance contracts which, in whole or in part, apply the replicating asset
technique. For example, it is not clear for insurance contracts that utilise the replicating asset technique, how the presentation requirements related to discount rate changes, the risk adjustment and changes in margins and related disclosures would be quantified and applied. We believe that this problem also supports a flexible approach to presenting the effects of changes in discount rates.

We understand that providing an option to recognise the effects of discount rate changes in profit or loss is potentially more complex initially for preparers because it would require them to assess whether presenting a change in profit or loss would eliminate or significantly reduce an accounting mismatch.

However, we believe that the increase in initial complexity would be outweighed by the benefit of more transparent and relevant information for users which would result when accounting mismatches are reduced in subsequent periods.

Updating discount rates

We agree that for cash flows that are expected to vary with returns on underlying items, but for which the measurement and presentation exception does not apply (e.g. changes in crediting rates for universal life insurance and deferred annuities), the entity should update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and the entity should update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows. However, we have raised some concerns with respect to the scope and application of this concept as detailed in Question 2.

**Question 5: Effective date and transition (paragraphs CI–C13, BC160–BC191 and IE26–IE29)**

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?

Retrospective application

We agree that the new insurance contracts standard should be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and FASB ASC Topic 250 Accounting Changes and Error Corrections. We also agree with the modified retrospective approach using practical expedients for determining the contractual service margin or single margin at transition and determining the discount rate at initial recognition if a fully retrospective application would be impracticable.

We acknowledge that determining the remaining amount of the contractual service margin at transition may represent a challenge. Therefore, we support the practical expedients the Boards
have developed, but also have some feedback on consistency of the practical expedients to
determine the contractual service margin or single margin to the maximum extent practicable.

We understand that a fully retrospective application of the proposals would often be
impracticable in accordance with IAS 8/ASC Topic 250. We believe that the modified
retrospective approach (considering the practical expedients) for determining the contractual
service margin or single margin at transition and determining the discount rate at initial
recognition as proposed appropriately balances comparability with verifiability. In addition, we
think that the disclosure of significant judgements applied in determining the contractual
service margin or single margin and discount rate as required by paragraph C8 of the ED contributes to
comparability.

However, we believe that the IASB should consider adding a practical expedient for the entity’s
determination of portfolios when determining the contractual service margin at transition,
similar to the practical expedient in the PASU. Under the PASU (paragraph 834-10-65-1(d)),
when determining the single margin at contract inception, an entity would be able to measure
the insurance contract liability and the single margin using the entity’s determination of the
portfolio immediately before transition; contracts written or substantially modified after the date
of transition would be grouped into portfolios in accordance with the proposed guidance – this
may require separate portfolios. Some concerns have been raised with respect to the complexity
of application, particularly with respect to accumulating historical information and determining
the discount rate and OCI adjustments as well as margins, and adding such an expedient may
help reduce the costs and complexities of transition related to sorting historical data into
groupings not envisioned when the data was originally accumulated.

Also, we believe that the following additional practical expedient may make the retrospective
application at transition easier: When 100% of the risks of direct business have been ceded
through reinsurance, allow the ceding entity to establish the transition margin on both the direct
block of business and the cession at zero. Please also refer to our comments on Other issues
(Reinsurance).

Redesignation of financial assets

Although the IASB tentatively decided in July 2013 to defer and leave open the effective date of
IFRS 9 pending the finalisation of its impairment and classification and measurement
requirements, IFRS 9 might still come into effect before the insurance proposals – potentially
requiring two major programmes of change. Please see also our response to the question on the
effective date of the final insurance contracts standard below.

If the final insurance contracts standard does not include specific transition relief for the
redesignation of financial assets, then an entity would be able to reclassify financial assets only
in accordance with the requirements in IAS 39 or IFRS 9 – i.e. under IFRS 9, only in response
to significant changes in its business model for managing financial assets.
We generally support the current redesignation options for financial assets as proposed by IASB. However, there should be a greater ability to reduce potential accounting mismatches when transitioning to the insurance contracts standard. We believe the FASB’s proposals include more flexible redesignation provisions because an entity would be allowed to reclassify its financial assets without having to demonstrate that the reclassification criteria (which may be more restrictive than the classification criteria) of the applicable financial instruments guidance are met; instead, an entity would be permitted to use the classification criteria in the financial instruments standards to reclassify financial assets that are related to the entity’s insurance contracts. Consequently, we propose that the IASB should, consistent with the redesignation provisions proposed by the FASB (paragraph 834-10-65-11), consider more flexible redesignation options in order to provide additional transitional relief if insurers are required to adopt IFRS 9 prior to the insurance contracts standard. We view this as an area where the Boards could easily achieve further convergence.

Restatement of comparatives

We agreed with the proposals to require a restatement of comparative financial information on first applying the standard – to apply the standard retrospectively from the beginning of the earliest period presented.

Effective date

Due to the complexities of the proposals and fundamental change to current practices, the implementation of the proposals is expected to be an extensive task for most affected entities, including some entities that are not insurance entities but that issue insurance contracts as defined in the proposals. Entities would need sufficient time to develop the systems, test those systems and capture data by the beginning of the comparative year presented at transition. It will take preparers and users time to become familiar with applying the new reporting requirements and how to interpret them. As a result, we would support providing a period of at least three years between the publication of the final insurance contracts standard and the mandatory effective date.

As noted above, the IASB tentatively decided in July 2013 to defer and leave open the effective date of IFRS 9 pending the finalisation of its impairment and classification and measurement requirements; however, IFRS 9 might still come into effect before the insurance proposals and this would require two major programmes of change and might result in significant implementation difficulties.

As a result, for both the IASB and the FASB, we support an alignment of the effective dates of the insurance and financial instruments standards. We encourage the Boards to consider the effects of changes in accounting principles on the ability of users to perform comparisons of financial results over time, especially in long-term businesses. We recommend that the Boards expeditiously progress both projects with a view to having aligned effective dates. If there is not alignment of
effective dates, the IASB should – at a minimum – add the redesignation option for financial assets as proposed by the FASB to its proposals, as discussed above.

**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 proposals in the ED and the PASU represent an improvement from the proposals in the 2010 ED and the 2010 DP and respond to many aspects of constituent feedback. However, as recognised by the Boards these changes also introduce significant complexities.

Given the overall complexity of the revised proposals, we believe that it is important that the Boards ensure that the final standard reflects adequate consultation with users and preparers. Despite the consultation and field testing currently being undertaken by the Boards, it is possible that there will be unforeseen consequences from applying the revised proposals. Insurance contracts exhibit highly diverse characteristics across business segments and jurisdictions. Some of the proposals would pose significant operational and administrative challenges for organisations. We believe that the final standard would benefit from the Boards considering feedback from users and preparers on the balance between costs and benefits of the proposals, in particular with respect to the following areas:

- treatment of contracts with participating features;
- use of OCI for presenting changes in the discount rate;
- presentation of the statement of profit or loss and OCI; and
- inclusion within the scope of the proposals of certain contracts not previously perceived as insurance.

We also believe that the Boards should consider conducting further outreach activities after the re-deliberations on the ED and PASU have been completed. Such outreach may consist of
posting a near final draft prior to finalisation so that areas requiring additional clarity or unintended consequences can be identified and addressed.

In addition to the topics above, we believe that any further convergence that can be achieved by the Boards may reduce some of the additional complexity in implementation for both international insurers with operation in the U.S. and U.S. insurers with foreign operations who will be reporting under both models.

Disclosures

The proposals have extensive disclosure requirements that we believe may make the notes to the financial statements unwieldy and reduce the effectiveness of communicating financial results. The volume of disclosures will also impact preparers’ ability to produce timely financial reporting. While each disclosure may have appeared necessary when the Boards discussed the various topics in redeliberation, the combined volume appears excessive. We suggest additional outreach to users and preparers to identify disclosures for elimination.

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?

Yes, we generally agree that the proposals are drafted clearly and reflect the decisions made by the IASB. However, in addition to the comments made in response to Questions 1 to 6 above, we recommend clarifications of the following areas.

Level of measurement of the contractual service margin (B37(c)-(d) and BCA113)

B37(c), B37(d) and BCA113 include guidance on the level of measurement of the contractual service margin. We believe that this guidance in the ED indicates that there may be a difference in the level of measurement of the contractual service margin at initial recognition (portfolio level) and subsequent measurement (at a level of aggregation such that once the coverage period has ended, the related contractual service margin has been fully recognised in profit or loss).

We recommend that the IASB should clarify if a different level of measurement of the contractual service margin at initial recognition and subsequent measurement is intended. In addition, we propose that clarification should be added on the level of measurement for adjusting the contractual service margin – i.e. how the adjustments for differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services should be allocated or aggregated to the contractual service margin.
Adjusting the contractual service margin (paragraphs 30–31, B68, BC26–BC41 and IE9–IE11)

Under the ED, the contractual service margin would be adjusted for differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services. The terminology “future coverage and other future services” might imply that the differences between these current and previous estimates would have to relate to both future coverage and other future services. We do not believe the IASB intended to limit the unlocking of the contractual service margin to situations where the differences relate to both future coverage and other future services. As a result, we suggest that the terminology “future coverage and other future services” be amended to clarify that the contractual service would be adjusted for differences between the current and previous estimates of the present value of future cash flows related to “future coverage or other future services”.

Acquisition costs and overhead costs within the contract boundary (B66(c) and B66(l))

According to B66(c) and B66(l), cash flows within the boundary of an insurance contract include:

- directly attributable acquisition costs that can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts. Acquisition costs include costs that cannot be attributed directly to individual insurance contracts in the portfolio; and

- fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent and maintenance and utilities) that are directly attributable to fulfilling the portfolio that contains the insurance contract and that are allocated to each portfolio of insurance contracts using methods that:
  - are systematic and rational, and are consistently applied to all costs that have similar characteristics; and
  - ensure that the costs included in the cash flows that are used to measure insurance contracts do not exceed the costs incurred.

We believe that paragraph B66(c) lacks clarity about the type of costs that would be included in directly attributable acquisition costs. In particular, we understand that although fixed and variable overheads that are directly attributable to fulfilling a portfolio of contracts would be included in its fulfilment cash flows, similar fixed and variable overheads that are attributable to the acquisition of the portfolio of contracts could not be included in directly attributable acquisition costs.

The PASU includes implementation guidance on the determination of qualifying acquisition costs (paragraphs 834-10-55-104 to 834-10-55-111). We recommend that the IASB includes similar guidance. We understand that, other than for the treatment of costs relating to unsuccessful sales, the IASB’s and the FASB’s proposals for the determination of attributable acquisition costs are intended to be consistent.
Contracts with participating features

We acknowledge the Boards’ efforts to reduce accounting mismatches in situations where there is no economic mismatch and support the general principle to reflect the interaction between assets (and other items) and insurance liabilities for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items.

However, we believe that the proposals are complex and difficult to understand and apply. We believe that the current drafting may result in different interpretations of the proposals.

We believe the guidance for participating contracts may be clearer to understand and consistently apply if all relevant guidance was in one section of the standard with a clear delineation of the scope of the guidance. For example, currently the guidance for features which have a linkage to underlying items but do not qualify for the measurement and presentation exception in paragraphs 33, 34 and 66 (e.g. changes in crediting rates for universal life insurance and deferred annuities) needs to be pulled from paragraphs 60(h), 66(b) and B68(d) and considered together to specify an approach to these features. Discretionary features are considered part of the probability weighted cash flows, but this should be explicitly mentioned in a section of the guidance devoted to participating features.

The ED refers to the features in paragraph 60(h) as “expected to vary directly with returns for underlying items” and the PASU refers in paragraph 834-10-35-25 to “changes in expected asset returns ... affects the present value of expected cash flows.” We refer in this letter to these features having a linkage to underlying items as we believe the “vary directly” wording in the ED creates confusion with the features subject to the measurement and presentation exception in paragraphs 33, 34 and 66.

We also refer to our response to Question 2.

Measurement of unit-linked contracts (BC49, Appendix D IFRS 9.3.3.4A and IAS 32.33A)

The IASB confirmed its proposal in the 2010 ED that an entity would be permitted to recognise and measure its own shares and owner-occupied property at fair value with the changes recognised in profit or loss (BC49). The IASB also extended this proposal to an entity’s own debt and to unit-linked contracts that are not insurance contracts.

We note that the expressed intention of BC49 and the proposed additional paragraph IAS 32.33A in the consequential amendments to IAS 32 Financial Instruments: Presentation are potentially inconsistent because IAS 32.33A refers to recognising an entity’s own shares as assets at fair value whereas BC 49 specifically refers to classifying them at FVTPL. We propose that IAS should address the inconsistent drafting of paragraphs IAS 32.33A and BC49.

In addition, paragraphs IFRS 9.3.3.4A and IAS 32.33A refer to “notional units in linked contracts”.

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We believe that the term “notional units in linked contracts” is unclear as regards whether (i) “notional” has any substantive meaning (e.g. whether “actual” units are excluded) and (ii) the reference to “linked contracts” means there has to be a contract in addition to the contract that constitutes the units. The terminology in the ED may restrict the scope of contracts subject to the consequential amendments to IFRS 9 and IAS 32, but we do not see a reason why the principles therein should not apply equally to the case of actual units issued by a consolidated fund. As a result, we suggest that the term “notional units in linked contracts” be amended or clarified so that there is no inconsistency in the assessment of the scope of these amendments.

**Investment components – policyholder loans**

The ED defines an investment component as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. The ED does not state whether the amount of an investment component should include or is reduced by any loans advanced to the policyholder. At the April 2012 meeting, the Boards decided that, in applying the general decisions on separating and disaggregation, policy loans should be considered in determining the amount of the investment component to which they relate. In order to avoid diversity in practice and to reflect the Boards’ April 2012 decision, we recommend that the Boards clarify that the amount of an investment component also should include related advances and repayments of any policyholder loan.

**Surrender options**

We do not support removing the exception in IFRS 4.8 that precludes separation as an embedded derivative of an option to surrender an insurance contract for a fixed amount. This is likely to cause confusion. An entity would apply the requirements in IAS 39 or IFRS 9 to decide whether it needs to bifurcate a surrender option. Applying the guidance in paragraph AG33(h) of IAS 39 or paragraph B4.3.8(h) of IFRS 9, an entity would need to determine whether the surrender option is closely related to the host contract. This guidance clarifies that an embedded derivative in an insurance contract is closely related to the host contract if the embedded derivative and host contract are so interdependent that an entity cannot measure the embedded derivative separately, i.e. without considering the host contract.

However, this analysis does not consider the tension with the guidance in IFRS 9 B4.3.5(e)/IAS 39.AG30(g) that a call or put option is not closely related unless the exercise price is approximately equal on each date to the carrying amount of the host insurance contract. A surrender option is a type of put option and IFRS 4.8 serves to resolve this contradiction by overriding B4.3.5(e)/AG30(g) when the surrender option’s price is fixed. Removing IFRS 4.8 merely makes the matter less clear.

**Eligibility for the simplified premium-allocation approach (paragraph 37)**

According to paragraph 37, applying the simplified premium-allocation approach would not produce a ‘reasonable approximation’ to the building-block approach if, at contract inception,
the entity expects significant variability in the fulfilment cash flows that are required to fulfil the contract during the period before a claim is incurred. This criterion has been the subject of much discussion among constituents. We believe additional clarity is needed on how to interpret this criterion. Some constituents have interpreted it to be met only if in the coverage period, pending events could cause a change in expected net cash flows prior to claims being incurred (e.g. a hurricane may be offshore and expected to impact policyholders causing a change in expected cash flows; however, there has not yet been an incurred claim). This interpretation could result in many contracts with a coverage period of more than one year failing the eligibility criterion of reasonable approximation and being accounted for under the building-block approach. Other constituents believe that the analysis at an individual contract level would consider that policies may be cancelled early and thus preclude compliance with the reasonable approximation criterion. As a result, some believe that very few contracts would qualify for the simplified premium-allocation approach other than those with a coverage period of one year or less.

We do not believe the Boards intended to effectively limit the use of the simplified premium-allocation approach to contracts with coverage periods of one year or less. See also our discussion in Appendix 2 on FASB Question 7. Additional clarification of the principles to be applied in determining which contracts qualify for the simplified premium-allocation approach along with examples of application would enhance consistency in applying the final standard. Clarifications might include that the evaluation of the significance of variability in net cash flows is focused on variability in the cash flows exclusive of payments of claims under the policy. This would result in a focus on the revenue to be recognised under the contract being reliably determinable.

Implementation Guidance from IFRS 4 on embedded derivatives

We do not believe that the Implementation Guidance and Examples from IFRS 4 that deal with the application of the embedded derivative requirements from IFRS 9 (previously IAS 39) should be deleted. This guidance has been and continues to be helpful in the practical application of the principles and we believe that it should be updated and carried forward. Removing the implementation guidance is likely to detract from consistency in application, as well as potentially cause confusion. The application of the requirements from IFRS 9 is technically challenging. Removing the implementation guidance needlessly increases the costs associated with application as insurers would have to perform analyses of typical features from scratch as opposed to consulting the implementation guidance.

Illustrative examples

Both the IASB’s and the FASB’s proposals include illustrative examples. We noted that in some areas the FASB’s proposals provide more examples that the IASB’s proposals. We believe that in areas where the Boards have a converged approach, the IASB could include the additional examples from the FASB’s proposals.
Other issues

Scope of fixed-fee service contracts (paragraph 7(e) and BCA181–BCA183)

Under the ED, certain fixed-fee service contracts would be excluded from the scope of the proposals. According to paragraph 7(e), fixed-fee service contracts that meet the following conditions would not be in the scope of the ED, but accounted for under the forthcoming revenue recognition standard:

- the primary purpose is the provision of services;
- the contract price set by the entity does not reflect an assessment of the risk associated with an individual customer;
- the contact compensates customers by providing a service rather than by making cash payments; and
- the insurance risk that is transferred by the contract arises primarily from the customer’s use of services.

We understand that a key argument for excluding certain fixed-fee service contracts from the scope of the ED is that accounting for these contracts under the insurance contracts standard may impose costs and disruptions for non-insurance entities (BCA 182) – e.g. road side assistance programmes provided with the sale of an automobile.

However, some insurance arrangements include fixed-fee services that might be excluded from the scope of the ED as well. We believe that entities should not be prevented from applying the insurance contracts standard to fixed-fee service contracts that meet the definition of an insurance contract. As a result, we propose that the proposals should – instead of providing a mandatory scope exclusion for certain fixed-fee service contracts – include an option not to apply the insurance contracts standard for those fixed-fee service contracts.

Some contracts issued by non-financial services entities may remain in the scope of the insurance contract proposals (e.g. certain maintenance and other service arrangements provided to commercial customers priced based on the risk associated with individual customers might be accounted for as insurance contracts). These contracts may result in the service provider accepting significant risk from uncertainties as to the amount of required maintenance or service on their customers’ assets.

Non-financial services entities issuing these contracts that are scoped into the insurance contracts proposals have generally been following the revenue recognition proposals; however, frequently they have not been actively following the insurance contracts project and, in many cases, are not aware that the project will impact their accounting. We do not believe there is sufficient widespread understanding and analysis by these non-insurance entities to provide the IASB with the constituent feedback needed to include these entities in the scope of the insurance contracts standard. The insurance contracts proposals bring complex models for
measurement, presentation and disclosure that may not provide sufficient benefits in the form of improved accounting compared to the costs of applying the proposals for entities that do not have insurance as their primary business. Some of these entities, if included in the scope of the insurance contracts standard, would have the additional complexities of applying the presentation and disclosure proposals of both the building-block and premium-allocation approaches.

We believe that the IASB should consider allowing a scope exclusion for these types of entities.

Scope of financial guarantee contracts (paragraph 7(f), B30 and BCA184–BCA188)

Paragraph 7(f) proposes to retain the existing IFRS approach of permitting an issuer of a financial guarantee contract to account for the contract as an insurance contract if it had previously asserted that it regards such contracts as insurance contracts and had accounted for them on that basis.

Therefore, under the ED, the option to account for financial guarantees under the insurance contracts standard would only be available if the entity had previously made an accounting policy election to that effect. However, we believe that the option to account for financial guarantees under the insurance contracts standard should not be restricted to entities that had a particular previous accounting practice.

We believe that the current scope requirements of IFRS 4 and IAS 39 in this regard reflect the fact that IFRS 4 Phase 1 requires an entity to apply its previous insurance accounting policies and does not provide a comprehensive model for insurance accounting. They also were designed to cater to existing entities that transition from a previous GAAP to IFRS. As the new insurance contracts standard will provide a comprehensive model for insurance accounting, we believe that the restrictions from applying IFRS 4 to financial guarantee contracts should be removed. Essentially, entities should have a choice to apply either IFRS 4 or IFRS 9 to issued financial guarantee contracts as both of these are intended to provide robust guidance for accounting for these contracts.

As discussed in our comment letter on the 2010 ED, we believe that the proposals should allow entities an irrevocable accounting policy choice whether to account for different types of financial guarantee contracts as insurance contracts or as financial instruments depending on the nature of the contract and the entity’s business model for managing such contracts. This would enable entities to elect the accounting approach most appropriate to their particular facts and circumstances, thus reflecting their risk management practices and minimising potential accounting mismatches. Furthermore, we believe that this choice should also be made available to both newly-formed entities and to entities that begin writing financial guarantee contracts for the first time and that these entities should not be prejudiced relative to incumbent credit insurers.
In addition, please see our comments to the FASB on the scope of other guarantees in Question 1 of Appendix 2.

Discount rates to be used

We believe that there are a number of operational difficulties when determining the discount rate curve using a bottom-up or top-down approach. We suggest that the Boards consider an additional approach to developing a discount rate, consistent with basing the discount rate curve on the characteristics of the liability, which would be to reflect in the discount rate assumptions that an insurer uses to price the insurance premium for the initial measurement of the liability, with subsequent measurement reflecting updates of these assumptions for identical or similar products. This approach would address the difficulties of estimating illiquidity, adjustments and curves particularly for very long-duration contracts for which observable data does not exist, by using a rate curve that is implicit in pricing actual arms-length transactions for the insurance contracts being measured. The pricing discount rate is more closely aligned with the characteristics of the insurance contract liabilities than the starting points for either the top-down or bottom-up approaches in the proposals. This does not imply a principle of using a “locked in” discount rate curve based on pricing assumptions at inception, but rather considering the mechanics and assumptions used in the pricing process in determining the discount rate curve for subsequent measurement of the contract.

In order to apply this approach and retain consistency with the objective of the measurement model to determine a discount rate curve which is a current reflection of the characteristics of the liability, we suggest that an insurer use the most relevant pricing that an insurer has available. For example, to the extent an insurance product with similar characteristics is currently being marketed and priced by the insurer we believe that this benchmark may be the most relevant for updating the discount rate. To the extent that there is not a current pricing benchmark based on similar products, we suggest being able to use the last pricing point that would be relevant to the product based on its characteristics and updated to reflect current market data such as changes in risk-free rates. When products are no longer being sold, an approach similar to the practical expedient for transition may be appropriate where the most recent three years where pricing data was available are matched to a benchmark and that benchmark, or a rate curve determined by adjusting that benchmark, is used for subsequent discount rate determination.

Measuring insurance contracts using a discount rate curve that is significantly lower than the rate implicit in setting premiums could result in recognition of losses at the inception of contracts on contracts expected to be profitable. We find recognising losses at inception to be counter-intuitive for products that are expected to be profitable in active markets, where pricing assumptions are reflective of transactions in the marketplace.
Non-recourse loans

In our comment letter on the 2010 ED, we noted that the 2010 ED did not include guidance on whether non-recourse loans are, or contain, insurance contracts and recommended that it should. As the ED does not provide guidance on this question, we believe this issue remains.

We understand that some constituents believe that, under IFRS 4, some debt instruments for which recourse in the event of default is limited to specific non-financial assets of the debtor (e.g. a non-recourse mortgage loan secured against a particular residential or commercial property) are, or contain, insurance contracts. This belief is based on the notion that the debtor, as owner of the collateral, is exposed to adverse changes in the value of the collateral (a non-financial variable) but that the non-recourse feature in the loan serves to transfer some or all of that risk from the debtor (supposedly as holder of an insurance contract) to the creditor (supposedly as issuer of an insurance contract).

The proposals do not include guidance that addresses this question. We believe that most entities that hold non-recourse assets have presented these assets as financial instruments and accounted for them in accordance with the requirements of IAS 39/IFRS 9. Historically, given the absence of prescriptive guidance in IFRS 4 as to the accounting for insurance contracts, we believe this question has not given rise to any significant diversity in practice as to measurement of non-recourse assets. However, given the more detailed, prescriptive guidance on the measurement of insurance policies in the ED together with the specific references to non-recourse financial assets in IFRS 9 and other potential impacts of the IAS 39 replacement project, we believe that the Board should provide an explicit answer to this question so as to forestall any significant diversity arising in the future.

Mutual entities (BCA62 and BC Appendix D7)

According to BCA62, if a contract issued by a mutual entity provides policyholders with the right to participate in the whole of any surplus of the issuing entity, then there would be no equity remaining and no profit reported in any accounting period.

Under the PASU (FASB BC246-BC250), a mutual entity would treat as equity any amount of surplus that the entity does not have the obligation or intention to pay out in fulfilling the insurance contract obligations. We understand that the FASB believes that this approach is consistent with its treatment of the cash flows resulting from any other entity’s discretionary participation features – i.e. to include only cash outflows that an entity will incur to directly fulfil its obligation to the policyholders.

In addition, the FASB believes that if a mutual entity presents as equity the ‘notional’ surplus that it is not obligated, and does not intend, to pay to policyholders, then this would:

- provide more useful information to users of its financial statements; and
- be more comparable to other entities that issue similar insurance contracts.
We believe that the outcome of FASB’s proposal in this respect provides a better reflection of the financial position of mutual entities under the going concern principle. Special consideration would need to be given to the nature of the participation of contracts issued by mutual entities and the going concern principle needs to be considered in these circumstances. We believe that the amounts that the entity is not obligated and does not intend to pay to policyholders from a going concern perspective should be treated as equity. This would be similar to the FASB’s proposals.

Unit-linked contracts and segregated fund arrangements (paragraphs 834-10-30-9, 834-10-45-7, 834-10-50-16, 834-10-55-91 to 834-10-55-92, FASB BC186 to FASB BC190)

The 2010 ED proposed a single line presentation for unit-linked assets and liabilities, and related income and expenses. Many constituents agreed with these presentation proposals in the 2010 ED. We believe that the IASB should retain the presentation proposals for unit-linked contracts from the 2010 ED (paragraphs 71 and 78 in the 2010 ED). At minimum, we would suggest considering the FASB’s proposals for presenting segregated fund arrangements.

We agree with the FASB’s proposals which:

- revise the eligibility criteria for segregated fund arrangements from current U.S. GAAP;
- require an entity to measure the portion of segregated fund assets (including the entity’s proportionate share of the segregated funds) representing contract holder funds at FVTPL; and
- retain the separate asset presentation in the statement of financial position.

In addition, the FASB retained the guidance in FASB ASC Subtopic 944-80 on an entity’s consideration of qualifying fund arrangements when performing analyses for consolidation under FASB ASC Subtopic 810-10 Consolidation–Overall, which include specific consolidation exemptions for segregated fund or separate account arrangements. Although outside the scope of the insurance proposals, we urge the IASB consider these exemptions to achieve further consistency and comparability of separate account arrangements under IFRS and U.S. GAAP and consistency within IFRS. Because under IFRS 10 separate funds that back unit-linked insurance contracts may need to be consolidated in many cases, diverging practices may arise if no consolidation exemption is provided.

Reinsurance (paragraphs 41(c) and BCA139–BCA143)

We generally agree with the Boards’ approach to reinsurance. However, we have identified situations where we question whether the general approach to reinsurance is appropriately addressing the circumstances. If the direct business is being written in a portfolio in an onerous position and ceded through proportionate reinsurance (e.g. in a fronting arrangement where 100% of the direct business is being reinsured or in a 50% quota share arrangement), the ceding entity will reflect a loss on the direct business and any gain on the reinsurance will be deferred through a margin. We believe in this situation that an exception to the prohibition on
recognising a gain would be appropriate up to the appropriate proportion of the loss recognised on the direct business (100% in the fronting example or 50% in the quota share example). Similar circumstances exist when a portfolio of direct contracts becomes onerous after subsequent recognition, whereby the loss is recognised directly in profit or loss and the gain on the reinsurance contract would be added to the contractual service margin and deferred.

We believe the Boards need to consider these situations and any similar circumstances to evaluate whether the current accounting model for reinsurance (especially with respect to reinsurance contracts based on individual losses that have a proportionate relationship with the underlying direct insurance contracts) adequately reflects the proportionate relationship between the direct contracts and related reinsurance.

Portfolio transfers and business combinations (paragraphs 43–46 and BCA145–BCA150)

It is unclear how contracts measured under the premium-allocation approach, or under the building-block approach when there is no remaining coverage period, would be measured when acquired in a portfolio transfer or business combination if the fair value of the consideration received is greater than the fulfilment cash flows. If the insurance contract liabilities assumed are all post-claims liabilities we believe that the difference would be recognised immediately in profit or loss in a portfolio transfer and as an adjustment to goodwill in a business combination since there would be no remaining coverage period. If the acquired insurance contract liabilities include both pre-claims and post-claims liabilities any difference would presumably be added to the pre-claims liabilities and recognised over the remaining coverage period.

However, other approaches might be possible. It would be helpful if the intended approach could be clarified.

Disclosure of confidence level (paragraph 84 and BCA100–BCA102)

The ED does not prescribe a specific method for determining the risk adjustment. However, if the entity uses a technique other than the confidence level technique for determining the risk adjustment, then paragraph 84 requires the entity to disclose a translation of the result of that technique into a confidence level.

We agree with the proposal in the ED not to restrict available techniques for determining the risk adjustment to the extent that the technique used meets the objective. There may be cases in which the use of a confidence level technique does not provide the most meaningful information for users. In addition, the confidence level disclosure may be costly and in some cases the benefits of the disclosure may not justify the costs of preparing the disclosure.

As a result, we believe that the ED should allow the disclosure of approximate quantitative information about how the recognised risk adjustment compares with a confidence level technique (e.g. a certain range in which the confidence level would fall or how much the risk
adjustment would have changed if it had been calculated using a confidence level technique and a certain confidence level).

In addition, we believe that the ED should clarify that the level of aggregation for determining the confidence level disclosure does not have to be at a total-entity level, but could reflect the level of aggregation actually used in measurement of the risk adjustment to bring it more in line with management's approach to managing and quantifying risk and uncertainty.
Appendix 2

KPMG’s Responses to Specific Questions posed by the FASB

Scope

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

We generally agree with the scope and scope exceptions of the proposed guidance. However, we do not agree with the scope exceptions as it relates to guarantees, indemnifications and fixed fee service contracts. Also, we believe the scope provisions require additional clarity for consistent application. The proposals appropriately address a number of scope exceptions for contracts where, even though they meet the definition of an insurance contract, other guidance is more appropriate financial reporting for these contracts (e.g. product warranties issued directly by a manufacturer, dealer or retailer; employers’ assets and liabilities under employee benefit plans; and derivatives in the scope of ASC Topic 815, Derivatives and Hedging).

Guarantees

While we understand the FASB’s desire to have consistent accounting for similar contracts, we are concerned that including guarantees currently accounted for under ASC Topic 460, Guarantees, will bring many contracts issued by entities outside the insurance industry into the insurance contract guidance. The insurance contracts proposals bring complex models for measurement, presentation and disclosure that may not provide sufficient benefits in the form of improved accounting compared to the costs of applying the proposals for entities that do not have insurance as their primary business. Some of these entities if included in the scope of the insurance contracts standard would have the additional complexities, presentation and disclosure of both the building-block and premium-allocation approaches. We question whether the benefits of including these contracts in the insurance contracts proposals are greater than the costs and complexities being introduced.

Additionally, entities issuing these guarantees, particularly outside of financial services entities, have not been actively following the insurance contracts project and, in many cases, are not aware that the project will impact their accounting. While the FASB staff has reached out to non-insurance entities and publications, including those from KPMG, have highlighted the expanded scope of the insurance contracts proposals, we do not believe there is sufficient, widespread understanding and analysis by these other entities to provide the FASB with the constituent feedback needed to include these entities in the scope of the insurance contracts standard.

The types of guarantees that may be subject to the proposals include auction rate security guarantees, financial guarantees, indemnities, minimum revenue guarantees, standby letters of
credit, lease guarantees by a franchisee for a franchisor, guarantees of the debt of franchisees and many others. We believe that the FASB should only address in the insurance contracts standards guarantees issued by insurance entities that have historically been accounted for as insurance under ASC Topic 944, Financial Services – Insurance, (e.g. financial guarantee insurance, mortgage insurance and credit insurance). Whether there are changes needed to other guarantees accounted for in accordance with ASC Topic 460, including possible subsequent inclusion in the scope of the insurance contracts standard, should be addressed as part of a separate project. After the effective date of the insurance contracts standard and prior to any other action taken by the FASB, entities that commence issuing these guarantees should be allowed to make an accounting policy election to apply either the insurance contracts or ASC Topic 460 guidance.

Should the FASB not accept our recommendation on the scope of guarantees subject to the insurance contracts standard, we support the inclusion of guidance such as that contained in implementation Example 4 (paragraph 834-10-55-40); however, we have observations on that guidance. The extent of our comments causes us to question whether the proposals could be consistently applied by the non-insurance entities that will be brought into the scope of these proposals. Expanded explanations of the rationale for the potential ‘insurance’ vs. ‘not insurance’ classification would be helpful in getting consistent application of the final standard. Additionally, some of the guidance appears to be combining features that may lead to different classifications into one fact pattern:

- Auction rate security guarantees – the description should be separated with each sentence being treated as an issue. The first sentence addressing marketability and liquidity should result in a classification of ‘insurance’ and the second sentence that describes a financial risk being ‘not insurance.’

- Guarantees on securitized assets – many of these representations are a guarantee of the entity’s own performance, similar to a manufacturer’s representation that the product fits its specifications. A guarantee of an entity’s own performance would be excluded from the scope of these proposals.

- The section on ‘indemnities’ covers a lot of ground since a large percentage of contracts (e.g. business acquisition, major construction contracts, and real estate sales commonly include significant indemnification provisions) have some level of indemnification. This section could be enhanced to include additional examples, including the exclusion from application of the insurance contracts standards of standard representations and warranties not otherwise included in an insurance contract that are more of a guarantee of the entity’s own performance. For example, we believe indemnifications by the seller of real estate for potential environmental contamination existing at the sale date would be excluded from the scope of the insurance contracts proposals by paragraph 834-10-15-5(1)(3) but do not think the guidance is clear. Additional guidance would aid in the consistent application of the final standards.

- Liquidity facilities – “payments if losses occur” seem to be a financial risk as opposed to “defaults” that seem to be a guarantee that would be included in the scope of the PASU.
Rights to tender a financial interest at a specified price appear to be a put option; it is unclear why this would result in insurance contract classification. This example brings many elements into the example without differentiating which element is causing the insurance contract classification.

- Merger and acquisition guarantees – it is unclear how this differs from a standby letter of credit which is addressed in a separate section.
- Residual value guarantees – this example should clarify that ‘insurance’ classification is appropriate if the condition of the asset is a factor and ‘not insurance’ classification would be the proper classification if the value was based on an index.
- Standby letters of credit – the payout trigger has two conditions (i) repay as scheduled and (ii) repay on default. The combination with one classification answer ‘insurance’ is confusing since condition (i) doesn’t seem to be insurance and condition (ii) does appear to be insurance.
- Trust preferred securities and whole loan sale guarantees – it is unclear whether these are a guarantee of the entity’s own performance or the guarantee of another entity’s performance. The distinction would drive different answers as to the classification of these contracts as ‘insurance’ or ‘not insurance.’

Other scope matters

The PASU includes a number of scope exceptions, including certain fixed fee service contracts. Specifically, fixed fee service contracts that have as their primary purpose the provision of services and meet all of the following criteria are not within the scope of the insurance contracts proposals:

- The price of the contract is not based on an assessment of the risk associated with an individual customer, unless the assessment is limited to a credit check.
- The contract compensates the customer by providing a service rather than by making a cash payment to the customer or a third party provider.
- The insurance risk transferred by the contract arises primarily from uncertainty about the utilization of the policyholder’s use of services (that is, frequency risk) relative to the overall risk transferred in the contract (i.e., the contract has frequency risk, not severity risk).

Some contracts issued by non-financial services entities may remain in the scope of the insurance contract proposals, (e.g. certain maintenance and other service arrangements provided to commercial customers priced based on the risk associated with individual customers might be accounted for as insurance contracts). These contracts may result in the service provider accepting significant risk from uncertainties as to the amount of required maintenance or service on their customers’ assets. It is not clear why the pricing of risk at an individual contract level would cause contracts currently accounted for under revenue recognition standards to be accounted for as insurance contracts.
The insurance contracts proposals bring complex models for measurement, presentation and disclosure that may not provide sufficient benefits in the form of improved accounting compared to the costs of applying the proposals for entities that do not have insurance as their primary business. Some of these entities, if included in the scope of the insurance contracts standard, would have the additional complexities of applying the presentation and disclosure proposals of both the building-block and premium-allocation approaches.

Additionally, non-financial services entities issuing these contracts that are scoped into the insurance contracts proposals have generally been following the revenue recognition proposals; however, frequently they have not been actively following the insurance contracts project and, in many cases, are not aware that the project will impact their accounting. We do not believe there is sufficient widespread understanding and analysis by these non-insurance entities to provide the FASB with the constituent feedback needed to include these entities in the scope of the insurance contracts standard.

We believe that the FASB should consider allowing a scope exclusion for these types of entities.

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?*

We believe the proposed ASU provides a reasonable approach to unbundling components where appropriate. There is one area in the application guidance in implementation Example 5 (paragraph 834-10-55-45) where additional explanation of the differentiating factors between the answers in fact pattern 2(b), where the claims processing services for a self-insured entity are unbundled from the stop-loss coverage, and fact pattern 3, high-deductible health insurance where there is no unbundling, would help in consistent application of this guidance. We do not believe unbundling deductibles from insurance contracts would be appropriate as this would create significant complexities, particularly in applying the premium-allocation approach, without any benefit. The distinction between these items appears to be the sale of claims processing services as a separate product for fact pattern 2(b) and not for fact pattern 3. We think that point needs to be clarified.

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?*
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?

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?

In response to Questions 5 to 7, we agree that both of the building-block and premium-allocation approaches should be part of the final standard.

The premium-allocation approach, as proposed, is mandatory under the FASB’s proposals when contracts meet the eligibility criteria. The IASB permits the use of the premium-allocation approach when the eligibility criteria are met. We believe the use of the premium-allocation approach should be permitted when the eligibility criteria are met rather than be mandatory. Applying the building-block approach to contracts that meet the eligibility criteria for using the premium-allocation approach would not be expected to have a significantly different accounting result for many of the contracts where we believe an option would be applied (e.g. one year term life insurance when all of the other contracts issued by the entity would be required to use the building-block approach). This change for the FASB would (i) achieve convergence and (ii) allow entities that will be required to use the building-block approach for the majority of their contracts to use one method for all contracts, reducing the complexity of maintaining two models and simplifying the financial statement presentation and disclosure.

We agree with allowing entities to apply the premium-allocation approach when the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less (the first criterion for eligibility), as this criterion is a reasonable expedient for identifying many of the contracts where the premium-allocation approach is appropriate to measure and present the contracts.

The second eligibility criterion, that entities should 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, has been the subject to much discussion among constituents. We believe additional clarity is needed on how to interpret this criterion. Some constituents have interpreted this to be met only if there is not a significant change in variability including consideration of changes that might occur at some point in the coverage period if pending events could cause a change in expected net cash flows prior to claims being incurred (e.g. a hurricane may be offshore and expected to impact policyholders causing a change in expected cash flows; however, there has not yet been an incurred claim). This interpretation could result in many portfolios where the contracts do not meet the first eligibility criterion above failing the second eligibility criterion and being classified as under the building-block approach. Other constituents believe that the analysis at an individual contract level would consider that policies may be cancelled early and thus
preclude compliance with the second criterion for eligibility. As a result, some believe that very few contracts would qualify for the premium-allocation approach other than those meeting the first criterion of eligibility (i.e. those contracts with a coverage period of one year or less).

We do not believe the FASB intended to effectively limit the use of the premium-allocation approach to contracts with coverage periods of one year or less. This view is supported by the three-year surety bond and 18 month workers compensation contracts contained in Example 6 of the implementation guidance (paragraph 834-10-55-53). Additional clarification of the principles being applied in determining which contracts qualify for the premium-allocation approach will enhance consistency in applying the final standard. Clarifications might include the following:

- The determination of significance in net cash flows is focused on variability in the cash flows exclusive of payments of claims under the policy. This would result in a focus on the revenue to be recognized under the contract being reliably determinable.

- Expanding the discussion in Example 6 of the implementation guidance to describe the key drivers in the determination of whether the building-block or premium-allocation approach was the appropriate decision in the circumstances for each fact pattern (i.e. adding context to the guidance). Additionally, it would be helpful to know if the staff would have answered the surety contract differently if the contractor’s financial position was not stable (likely this would change the response) or they had past problems in completing projects on time (this appears to be an incurred claim that would not impact the decision).

- Addressing some of the contracts that might fall into a gray area (e.g. claims-made coverages vs. claims made with a death, disability and retirement rider; and additional multi-year contracts, such as the three-year surety contract used in the examples, where some are premium-allocation approach and some are building-block).

We discuss our proposed changes to the building-block and premium-allocation approaches in the following sections.

**Portfolio and contract boundary**

**Question 8: Do you agree with the definition of a portfolio of insurance contracts as included in this proposed Update? If not, what do you recommend and why?**

We agree with the overall approach to portfolios providing for the exercise of judgment and acknowledge that the difference in definitions of portfolios between the FASB and IASB is, in part, driven by the differences in amortization of the margins (we address concerns over the amortization of the margin below). While we believe the FASB meant to allow reasonable flexibility for preparers in grouping policies, there are several aspects of the guidance that are being interpreted differently by constituents and warrant additional clarification:
The meaning of "subject to similar risks and priced similarly relative to the risk assumed." We are hearing from constituents that there is wide diversity in interpretation as to whether this requires a large number of small portfolios.

The requirement in paragraph 834-10-55-48 that "all" of the factors listed be considered raises a similar question as to whether this requires a large number of small portfolios. For example, does the requirement to consider geographies that discusses levels down to counties require that level of disaggregation of portfolios? We do not think the FASB intended such fine disaggregation of portfolios. Additionally, the guidance in this paragraph on type of coverage may be interpreted to require separating risks within a contract (e.g., the various coverages included in a personal automobile contract such as property damage, collision, bodily injury, liability, etc.). The final standard should clarify if this separation is acceptable or required. We believe this separation is acceptable but should not be required as it may add additional complexity with little benefit in some situations.

The premium-allocation approach treats the liability for remaining coverage and the liability for incurred claims as two components. The portfolios are accumulation of contracts, yet paragraph BC 123 discusses entities generally grouping contracts by accident year for non-life contracts and suggests the definition of portfolio should not add significant additional costs or complexity to implement. Accident year refers to the period in which losses were incurred even though the contract may provide coverage across multiple accident years. This raises a question as to whether the portfolios for these two components of the premium-allocation approach need to be consistent.

Some of the interpretations being made by constituents imply a very large number of small portfolios. The level of granularity will impact the cost and complexity of applying the building-block and premium-allocation approaches, including the determination of onerous portfolios. We do not believe that the FASB intended to require a large number of small portfolios. Clarifying the general principles involved and that there is room for judgment would allow preparers to group contracts in a meaningful manner to apply the building-block and premium-allocation approaches consistent with the limitations in paragraph 834-10-55-47.

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?

We agree with the boundary proposals.

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 existing insurance contracts 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?
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?

In response to Questions 10 and 11, we generally agree with the determination of fulfillment cash flows and the provisions for updating assumptions as proposed. We do question the difference between the FASB and IASB related to costs typically associated with acquisition costs (commissions and premium taxes) which we address below in our response to Questions 28 to 30.

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 an explicit, unbiased, and probability-weighted estimate (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?

We agree fulfillment cash flows should be based on explicit, unbiased, and probability-weighted estimates (that is, the mean or an approximation of 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.

We do not agree that the fulfillment cash flows should exclude a risk adjustment or other provision for the uncertainty in the cash flows. The FASB has determined the fulfillment cash flows are based solely on discounted estimates of cash flows. The IASB has included a risk adjustment in the fulfillment cash flows to reflect the compensation that the entity would require for bearing the uncertainty about the amount and timing of the cash flows when fulfilling the obligation to the policyholder. We believe that the inclusion of a risk adjustment or other mechanism to reflect the uncertainty about the amount and timing of cash flows, particularly in the case of the incurred claims liability under the premium-allocation approach, represents better financial reporting by measuring fulfillment cash flows in a manner that reflect the risks associated with an uncertain stream of cash flows. We have additional observations on the IASB's proposed risk adjustment in our responses to the IASB's Questions 1 and Other issues (Disclosure of confidence level) in Appendix 1 of this letter.

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

Please see our response to the IASB’s Question 1 in Appendix 1 to this letter and FASB Questions 21 to 25 below, where we support inclusion of a risk adjustment and unlocking of the margin for changes in estimates related to future coverage and other future services along with the related changes in the risk adjustment.
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?

**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 an entity 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 you recommend and why?

**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.

**Question 17:** Because the proposed guidance includes the approach under which 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?

**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?

**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?

**Question 20:** Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contract 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?

Please see our response to the IASB’s Questions 2, 4, 7 (Contracts with participating features) and Other issues (Discount rates to be used) in Appendix 1 to this letter where we request clarity on the proposals on updating the discount rate for cash flows that are expected to vary with the returns on underlying items (e.g. changes in crediting rates for universal life insurance and deferred annuities), address the discount rates being used, consideration of not using OCI in...
some circumstances for changes in discount rates, consideration of using rates based on the
pricing of the contracts and address contracts with participating features.

We do not believe 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) as such a test would increase the complexity of the
accounting for little, if any, benefit.

Additionally, there is some confusion in the determination of the liquidity adjustment when
using the bottom up approach to determining discount rates. Paragraph 834-10-55-95 implies
the illiquidity is from the perspective of the entity as insurance contacts cannot be traded and
there may be no provisions in the contract for cancellation prior to maturity (similar wording
exists in IASB paragraph B70(b). In contrast, paragraph BC147 addresses the illiquidity from
the perspective of the policyholder being unable to liquidate their investment in some contracts
without incurring significant costs. We believe the wording in BC147 is inconsistent with the
wording in both the FASB and IASB standards and should be modified.

Practical expedient for premium-allocation approach

Since the FASB considers the premium-allocation and the building-block approaches to be two
different models, we would support as a practical expedient allowing the use of a risk free rate
without adjustment for illiquidity for purposes of discounting in the premium-allocation
approach. Such an expedient, particularly when coupled with our suggestion to allow changes in
discount rates to be included in profit and loss when this allocation would eliminate or
significantly reduce an accounting mismatch, would reduce the complexity in discounting and
tracking the discount rate at inception over the long settlement periods of some types of non-life
contracts. This expedient would also simplify transition for many non-life portfolios.

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 that amount as profit to be recognized in the future? Why or why not?

*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.

*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 determine the risk adjustment? Why or why not?
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 cash outflows exceeds the expected present value of cash inflows)? Why or why not?

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?

In response to Questions 21 to 25, we agree that there should not be a gain at inception, that the gain should be deferred through the use of a margin and that a loss at inception should be recognized in profit and loss. The inclusion of a margin to eliminate any day one gain is largely consistent with the principle under the revenue recognition proposals that revenue should not be recognized when no service has been performed. We do not agree with the use of a single margin, that the margin is not adjusted for changes in certain assumptions related to future coverage or services, nor the amortization of the margin over the coverage and settlement periods.

We prefer the IASB’s approach to using a risk adjustment to measure the uncertainty in cash flows and a contractual service margin to represent the unrecognized profit in the contract (initially established to remove any gain at inception). Separating the risk adjustment from the unearned profits element of the margin allows for a simpler approach to releasing the margin over the coverage period, inclusion of an element in the liability for incurred claims under the premium-allocation approach that addresses the uncertainty in the cash flows, more consistency in reporting for non-life contracts that are required to use the building-block approach and those that use the premium-allocation approach. Additionally, this change to the FASB’s model would promote convergence between the FASB and IASB models, which as discussed earlier in this letter, would be a goal we support.

Under the FASB’s proposals, the single margin would be released as an entity satisfies its performance obligation – i.e. as the entity is released from its exposure to risk. The release from risk would be evidenced by a reduction in the variability of cash outflows. This would result in the single margin being recognized over both the coverage and settlement periods. The FASB’s approach to releasing the margin based on reductions in variability of cash flows may be subject to significant variation in application for similar fact patterns.

While we agree with the change from the formulistic approach in the 2010 discussion paper and not having one approach that would need to address a broad range of contracts with different economics and risks, the language in the proposals is confusing as to whether a simple approach to release of the margin as described in implementation Examples 14 and 15 (paragraphs 834-10-55-143 to 55-148) would meet the criteria in the preceding paragraphs 834-10-55-137 to 55-142 of the implementation guidance in situations other than very simple products.
The implementation guidance in paragraphs 55-138 and 55-139 include the requirement to consider "all" of the factors in these paragraphs. This implies that the simple approaches will not work in a broad range of the contracts being issued and that the more complex approach in Example 17 (paragraphs 834-10-55-149 to 55-152) based on changes in standard deviations of expected cash flows or a similarly complex method of determining the release of the margin will be required. We believe simpler approaches than Example 17 may be appropriate for many products. We also find it unusual that Examples 14 and 15 are addressing the same fact pattern, yet Example 14 releases 10% of the margin in the first 10 years and Example 15 releases 40% of the margin in that time period.

We believe separating the risk element from the margin allows the risk adjustment to capture the release from risk and the margin to be released over the coverage period in a manner consistent with the approach of the IASB to releasing the contractual service margin (i.e. the margin would be recognized consistently with the pattern of transfer of service provided under the contract). The pattern of transfer of the services provided could include insurance coverage and auxiliary services – e.g. asset management services. A profit driver might be selected at inception, based on the type of service provided. Example services may be expected claims; expected premiums for annually renewable insurance in which premiums increase each year with age; expected annuity payments; or assets under management.

The premium-allocation approach under the FASB's model includes only discounted unbiased cash flows in the liability for incurred claims. The IASB's risk margin relates to both the coverage period and the settlement period. We believe that the FASB should include a provision in the liability for incurred claims that addresses the uncertainty in the cash flows. Without this provision two portfolios may have the same probability weighted unbiased cash flows and thus the same liability even though one portfolio has a very narrow range of possible outcomes and the other portfolio has a very wide range of possible outcomes. We believe users of financial statements would not be indifferent between portfolios with disparities in the ranges of possible outcomes. Inclusion of the IASB's risk adjustment would differentiate these portfolios by including a larger risk adjustment in the liability for the portfolio with the wide range of potential outcomes.

If three-year non-life contracts with a very long tail (e.g. the 30+ years common for workers compensation contracts\(^1\) on the settlement period are accounted for under the building-block approach, the FASB's proposals would recognize the margin over the 30+ year settlement period. A similar three-year workers compensation contract with only limited differences in features allowing the contract to be eligible for the premium-allocation approach would recognize the profits in the contract over the three-year coverage period and only discounted unbiased cash flows after that time. After the three year period a significant difference in the liability for the incurred claims may be evident even though in both cases the coverage period and, potentially, the period where there was a difference between the contracts may have passed. Using one margin to address both the unearned profits in a contract and the uncertainty

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\(^1\) This is used as an example not as a position whether multi-year workers compensation policies would be in the building-block or premium-allocation approach.
in cash flows results in a significant difference in recognizing the profits in our long-tailed three-year contracts, even though the economics of the two contracts may be very similar, particularly during the settlement period.

We support the IASB in not defining a single approach to the risk adjustment. The broad range of products with very divergent economics and risks warrant the flexibility to select a risk adjustment that is appropriate to the products. The disclosures associated with the risk adjustment will provide transparency into the methods used, key assumptions and sensitivity of those assumptions.

The IASB’s contractual service margin would be adjusted for:

- experience differences that relate to future coverage – e.g. premiums for future coverage and any resulting changes in future outflows; and
- changes in estimates of cash flows that are expected to vary directly with returns on underlying items if they relate to future services – e.g. changes in cash flows relating to future asset management services.

The contractual service margin would not be adjusted for:

- changes in estimates of incurred claims or differences between expected and actual cash flows – e.g. experience adjustments – if those differences relate to coverage already provided;
- a delay or acceleration of investment components if the change in timing does not affect cash flows relating to future services; and
- changes in estimates of cash flows that depend on investment returns that arise as a result of changes in the value of underlying items.

For the same reason that a gain at inception is not recognized, we believe that in subsequent periods the effects of changes in assumptions related to future coverage or services should adjust the margin (i.e. unlocking the margin). Positive adjustments would increase the margin and adverse adjustments would reduce the margin, subject to the limitation that the margin would not be allowed to become negative. Except as addressed in earlier sections of this letter, we believe the adjustment of the margin should generally follow the guidance of the IASB as summarized in the previous paragraphs; we would also support adjusting the margin, subject to the same limitation, for changes in the risk adjustment related to future coverage or services. Unlocking the margin would avoid taking a loss in the current period for adverse changes in cash flows even though the contract will continue to be profitable and avoid situations where gains are recognized in subsequent periods for favourable changes in assumptions, even though this gain is prohibited at inception based on the assumptions at that date.

See also our response to the IASB’s Question 1 in Appendix 1 of this letter.
**Question 26:** Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

We agree that interest should be accreted on the margin.

**Question 27:** Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

We believe that in an onerous portfolio the single margin should be recognized immediately in profit or loss to the extent of the lesser of the loss on the onerous portfolio or the amount of the single margin. Paragraph 834-10-35-22 implies the full margin is released which we believe would only be appropriate if the loss in the onerous portfolio exceeded the remaining single margin.

**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?

**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?

**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?

We agree that the acquisition costs to be included should be consistent with the recently applied definition from ASU 2010-26, *Financial Services – Insurance (Topic 944) Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, including the change to expense direct response advertising costs consistent with the modifications being made in revenue recognition. Further we agree with amortizing the acquisition costs consistently with the pattern of recognition of the margin in the building-block approach and the reduction of the liability for remaining coverage under the premium-allocation approach.

We agree with the practical expedient of expensing all acquisition costs as incurred under the premium-allocation method. We would also support an expedient under the simplified premium-allocation approach and building-block approach to apply the revenue recognition
proposals of defining acquisition costs as incremental costs (e.g. commissions and premium taxes). This modification would eliminate the complexity of capturing the other acquisition costs that in some cases represent a very small portion of the total acquisition costs. We believe these practical expedients bring a consistency in the principles being applied to revenue recognition and reduce complexity.

The FASB excludes acquisition costs such as commissions and premium taxes from fulfillment cash flows, rather these costs are treated as a reduction of the margin. The IASB model would include such costs in fulfillment cash flows. The difference in classification appears to be driven by the FASB’s presentation of the margin separately from the rest of the insurance contract asset or liability on the statement of financial position. We believe these acquisition costs should be included in fulfillment cash flows the same as other expenditures that are included in those cash flows. The exclusion of premium taxes and commissions from cash flows in paragraph 834-10-55-80 may create confusion for readers who are not aware that these costs are included as acquisition costs as part of the margin determination. At a minimum the final standard should clarify that some of the costs excluded from fulfillment cash flows may qualify as acquisition costs which are presented as a reduction of the margin. If the FASB continues with the more disaggregated presentation on the statement of financial position, we would prefer that the unamortized acquisition costs be presented as an asset consistent with the proposals in leasing and revenue recognition.

It is unclear from the PASU how changes in estimates of acquisition costs to be paid in the future should be addressed in subsequent measurement (e.g. adjust the acquisition costs which are offsetting the single margin or reflect the change in profit and loss). We believe that subsequent changes in the estimates of acquisition costs should be recorded as an adjustment to the amount of acquisition costs offsetting the margin, which is consistent with our belief that the margin should be unlocked for changes in estimates related to future services.

Additionally, some constituents have questioned whether level commissions over the life of the contract, which are expensed as incurred in current U.S. GAAP accounting, would qualify as acquisition costs under the proposals. Additional questions have been raised about premium taxes. We believe level commissions and premium taxes would qualify as acquisition costs and request that the proposals clarify this position.

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

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? If not, what do you recommend? Please specify whether your view depends on the type of contract.

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 when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less)? If not, what do you recommend and why?

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.

Please see our response to the IASB’s Question 3 in Appendix 1 to this letter.

Participating Contracts

Question 35: Do you agree that participation features that are 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 about the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

Our concerns on participating features are addressed in our response to the IASB’s Question 2 in Appendix 1 of this letter.

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?

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?

We generally agree with the FASB’s approach to reinsurance. The FASB has linked the use of the building-block or premium-allocation approach for the reinsurance ceded to the approach used for the direct business (paragraph 834-10-30-28). Since the reinsurance agreement is a separate agreement and could in some circumstances differ from the direct business in meeting, or not meeting, the eligibility criteria for use of the premium-allocation approach, we believe the terms of the reinsurance agreement should be used to determine whether the building-block or premium-allocation approach should be utilized (we discuss the optionality of using the premium-allocation approach elsewhere in this letter).

The FASB and IASB differ on whether changes in the risk of non-performance by the reinsurer should be considered in the fulfillment cash flows (IASB) or evaluated under the financial instruments impairment guidance (FASB). We believe that the insurance measurement model using fulfillment cash flows (based on discounted, unbiased, probability-weighted cash flows) is the appropriate model as this is the model that will be used to address disputes with reinsurers. Using separate models for disputes and credit quality adds complexity while not yielding a significantly different result.

We have identified situations where we question whether the general approach to reinsurance is appropriately addressing the circumstances. If the direct business is being written in a portfolio in an onerous position and ceded through proportionate reinsurance (e.g. in a fronting arrangement where 100% of the direct business is being reinsured or in a 50% quota share arrangement), the ceding entity will reflect a loss on the direct business and any gain on the reinsurance will be deferred through a margin. We believe in this situation that an exception to the prohibition on recognizing a gain would be appropriate up to the appropriate proportion of the loss recognized on the direct business (100% in the fronting example or 50% in the quota share example). Similar circumstances exist when a portfolio of direct contracts becomes onerous after subsequent recognition, whereby the loss is recognized directly in profit or loss and the gain on the reinsurance contract would be added to the single margin (assuming the single margin is unlocked) and deferred.

We believe the FASB needs to consider these situations and any similar circumstances to evaluate whether the current accounting model for reinsurance (especially with respect to reinsurance contracts based on individual losses that have a proportionate relationship with the
underlying direct insurance contracts) adequately reflects the proportionate relationship between the direct contracts and related reinsurance.

**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?

We agree with the use of fair value as consideration in establishing a margin at the acquisition date. We do not agree with the recognition of a loss on the acquisition date when the difference between fair value and measurement under either the building-block or premium-allocation approach results in a debit balance. We believe the current accounting to establish an intangible asset representing this difference and amortize the intangible asset over the life of the insurance contracts is better financial reporting. The intangible asset is driven by differences in the determination of fair value and fulfillment cash flows, most notably differences in the discount rate used in the two measures. The recognition of the intangible asset maintains the underlying principle of recording acquired assets and liabilities at their fair value, while also allowing the application of the insurance accounting model for day two accounting. If the FASB does not wish to retain the current accounting, we would prefer to adjust goodwill consistent with the approach of the IASB rather than record a loss at acquisition. We would also support the establishment of an intangible asset in the case of a portfolio transfer for both the FASB and IASB as it does not appear appropriate to record a loss on a transfer where two parties negotiated an arms-length price for the transfer.

Also, please see our response in Appendix 1 to Other issues (Portfolio transfers and business combinations) which raises an additional issue related to the application of this guidance.

**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?

We agree with the proposals for contract modifications.
Presentation

Question 40: Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?

Please see our comments on presentation in response to the IASB’s Question 3 in Appendix 1 of this letter.

Additionally, we do not agree with the FASB’s proposed presentation where the investment performance of the segregated fund assets and the corresponding amounts credited to the contract holder would be reflected as investment income and interest expense in profit and loss. We do not believe that these amounts representing a pass through to policyholders of investment performance in segregated accounts, which in many cases will be significant, should be shown as investment income and interest expense on the face of the income statement. The current U.S. GAAP presentation netting these amounts on the same line of the income statement (effectively not showing these amounts) is better presentation than grossing up the income statement for policyholder directed investments where the performance flows through to the policyholders.

Disclosure

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?

Please see our comments on disclosure in response to the IASB’s Question 6 in Appendix 1 of this letter.

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?

Question 43: Do you think the effective date should be the same for both public and non-public 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?

We believe that the effective date should be no earlier than three years after the issuance of the final standard. Allowing a longer period than normally would apply to new accounting standards is appropriate because the proposed insurance contracts standard would be a
fundamental change to current practices and implementing the new requirements, including retrospective application, would be an extensive task. We agree with the FASB’s proposal to include an additional year for non-public entities. Should the FASB not accept out proposal above to limit the scope of financial guarantees included in the final standard, we believe that the non-insurance entities that will become subject to the insurance contracts standard should receive the additional year of transition regardless of whether they are public or private entities.

Please see our comments in response to the IASB’s Question 5 in Appendix 1 of this letter, where we support an alignment of the effective dates of the insurance contracts and financial instruments standards.

**Question 44:** Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for retrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

**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?

**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?

We agree that practical expedients are necessary in order to retrospectively apply the proposals to insurance contracts that frequently are in force for periods in excess of 40 years.

We believe that additional practical expedients may make the retrospective application at transition easier:

- When 100% of the risks of direct business have been ceded through reinsurance, allow the ceding entity to establish the transition margin on both the direct block of business and the cession at zero.
- The IASB allows the use of hindsight in establishing the cash flows prior to the transition date. This expedient should be included in the FASB transition guidance as well to reduce the complexity in establishing margins at the transition date. We support this expedient whether or not the FASB accepts our recommendation to unlock the margin.

**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.
Please see our response to IASB Question 6 in Appendix 1 to this letter.

Other comments

Onerous contracts. In evaluating whether an onerous portfolio condition exists in the premium-allocation approach (paragraphs 834-10-55-132 to 55-135), we do not believe that there should be consideration of changes that might occur if pending catastrophic events (e.g. a hurricane is offshore and expected to impact policyholders however, there has not yet been an incurred claim) could cause a change in expected net cash flows prior to claims being incurred. By including these events in the onerous contract considerations an entity may effectively record catastrophe reserves for events that have not yet happened and be precluded from removing those additional liabilities if after the date of the statement of financial condition the event did not impact or did not as severely impact the ultimate cash flows (e.g. when the pending hurricane at the statement of financial condition date did not ultimately make landfall or came ashore in a less populated area than was being forecast).

Additionally, in paragraph 834-10-30-17, at recognition the additional onerous contract liability should be added to the premiums that are within the boundary not deducted from those premiums.

Mirroring. Paragraph 834-10-35-14 implies the determination of estimated returnable amounts does not use present value concepts, yet Exhibit 18 of the implementation guidance (paragraph 834-10-55-155) uses present value concepts.

Non-recourse loans. See our comment in the Other Issues (Non-recourse loans) section of Appendix 1.