

Accounting Standards Advisory Forum

Insurance Contracts

March 2015

Insurance Contracts: Use of OCI for Presentation of Unearned Profits

Summary

1. This paper is prepared by the ASBJ as a contribution to the global discussions regarding the accounting requirements of insurance contracts. The IASB has continued its deliberation regarding the accounting requirements of insurance contracts, having regard to the recent proposal from the European CFO Forum.
2. In this paper, the ASBJ proposes that **the CSM be presented as AOCI** as opposed to being presented in the liability section of the statement of financial position, having considered the definition of a liability under the *Conceptual Framework*. This proposal is also consistent with the ASBJ's view that OCI is the 'linkage factor' used to accommodate two different measurement bases. In this proposal, the CSM presented as AOCI should be reclassified to profit or loss over the coverage period in a rationale way.
3. Considering the fact that the nature of the CSM (that is, generally the representation of unearned profits) would not significantly differ between participating contracts and non-participating contracts, the ASBJ thinks that **this AOCI presentation should be applied irrespective of whether insurance contracts contain non-participating or participating features.**
4. The ASBJ hopes that this proposal would promote consistency between the presentation requirement of the CSM and the definition of a liability under the *Conceptual Framework*; thereby contributing to the development of the improved insurance contract standards.

I. Preface

1. This paper is prepared by the ASBJ as a contribution to the global discussions regarding the accounting requirements of insurance contracts, having consulted with the Japanese constituents (including preparers, auditors and users). This paper explains the ASBJ's proposal to present the unearned profits of insurance contracts as accumulated other comprehensive income (AOCI) as opposed to being presented in the liability section of the statement of financial position.
2. The ASBJ very much appreciates the IASB's long-term efforts in the development of accounting standards on insurance contracts. Having observed the diversity of accounting practice of insurance contracts internationally, the ASBJ agrees with the need for a robust accounting standard dealing with insurance contracts, and supports the IASB's efforts to date.
3. Nevertheless, the ASBJ acknowledges that there still remain controversies in the area, reflecting the challenges in technical aspects as well as the significant impact on insurers' financial reporting. Very recently, the European CFO Forum put forward its proposal of the alternative model for the IASB's additional consideration. Although the ASBJ generally agrees with many aspects of the proposal (including the concept of 'fully' unlocking the contractual service margin (CSM)), the ASBJ has come to believe that the presentation of the CSM warrants further consideration. Accordingly, the ASBJ decided to prepare this paper to explain the ASBJ's proposal in this respect, hoping to stimulate meaningful debate among key constituents. The ASBJ hopes that this paper will help promote further discussion towards the development of insurance contract accounting standards that will be accepted globally.

II. Background

The IASB's Redeliberation

4. In June 2013, the IASB published the Revised Exposure Draft *Insurance Contracts* (hereinafter referred to as the “2013 ED”) with the comment period ended October 2013. Since January 2014, the IASB has continued its deliberation on various issues, having regard to the comments received on the 2013 ED.
5. The IASB first progressed with its deliberation on issues regarding non-participating contracts¹, and the major focus of the current deliberation is on the accounting requirements regarding insurance contracts with participating features². The IASB has had several rounds of discussion about issues regarding insurance contracts with participating features, but no significant decision has been made to date.

The CFO Forum's Proposal

6. In November 2014 IASB Board meeting, the European CFO Forum (hereinafter referred to as the “CFO Forum”) presented a paper which outlined their alternative proposals for the accounting for insurance contracts with participating features³. The paper explained that its primary objective is to ensure that the insurance contract standard:
 - (a) Provides an accounting basis that reflects the long-term nature and other features of insurance contracts;

¹ For the IASB's tentative decisions to date, please refer to the following link:
<http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2014/Insurance-Updated-summary-ED-effect-Oct-2014.pdf>

² The existing IFRS 4 *Insurance Contracts* does not define the term “participating feature”, and the 2013 ED did not propose to define the term either. However, IFRS 4 defines the term “discretionary participation feature” as a contractual right to receive, as a supplement to guarantee benefits, additional benefits:

- (a) That are likely to be a significant portion of the total contractual benefits;
- (b) Whose amount or timing is contractually at the discretion of the issuer; and
- (c) That are contractually based on:
 - (i) The performance of a specified pool of contract or a specified type of contract;
 - (ii) Realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
 - (iii) The profit or loss of the company, fund or other entity that issues the contract.

³ For the CFO Forum's proposal, please refer to the following link:
<http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/November/AP02-Insurance-Contracts.pdf>

- (b) Addresses the inherent link between underlying assets and insurance contract liabilities; and
 - (c) Provides an appropriate basis for the reporting of *performance*.
7. The ASBJ generally supports the primary objective of the alternative proposals, where it stated that the newly developed standard should provide an appropriate basis for the reporting of 'performance'. In the ASBJ's view, information about financial performance is the most important for users, because such information would be most useful for users to assess the prospects for future net cash inflows to an entity (OB3 of the *Conceptual Framework*). Having regards to the use of financial information, the ASBJ also understands that 'profit or loss' is commonly understood as the primary source of information about an entity's performance.
8. The paper also highlighted the following as key features of the alternative proposals:
- (a) The approach is applicable to all types of participating contracts.
 - (b) A single measurement basis is used for all insurance contracts. In addition, options and guarantees that are embedded in the insurance contract are treated consistently with other elements of the insurance contract liabilities.
 - (c) The CSM is 'fully' unlocked, such that the CSM represents unearned profit at initial recognition and throughout the life of insurance contracts.
 - (d) Income from insurance contracts is recognised in accordance with fulfilment of the contract as services are provided.
 - (e) The discount rate used to present interest expense is determined consistently with the investment return recognised for the assets that back the insurance contracts liabilities.
 - (f) The effect of changes in the discount rate when measuring insurance contract liability can be presented either through OCI or profit or loss as an accounting policy choice.
9. With regard to the key features of the alternative proposal in the previous paragraph, the ASBJ has been informed by the Japanese constituents (particularly, life-insurers) of their

high-level support for the CFO Forum’s proposal, especially with regard to the aspect of the proposal to ‘fully’ unlock the CSM (that corresponds to (c) in paragraph 8 of this paper). They were of the view that underwriting activities and investment activities are inseparable in insurance contracts; thus, the requirements to ‘partially’ unlock CSM would result in a significant accounting mismatch in profit or loss, which would also result in inappropriate presentation in the statement of financial position. In addition, they think that by ‘fully’ unlocking the CSM, unrealized gains and losses of insurance contract liabilities and their corresponding assets would be presented consistently on the statement of financial position; whereas the effects of remeasurement would be presented separately for financial and non-financial assumptions if the CSM is ‘partially’ unlocked.

10. The ASBJ agrees that when cash flows from insurance contracts and underlying assets are so interrelated, that a significant accounting mismatch would arise unless their measurement bases were considered concurrently. In line with the analyses in the Staff Paper for the June 2014 IASB Board meeting⁴, the ASBJ thinks that significant dependency of cash flows would require that measurement bases of different items (including underlying assets and liabilities) should be determined altogether.
11. In the case of insurance contracts (especially, those with participating features), the effect on cash flows from changes in financial assumptions and non-financial assumptions are so interrelated that arbitrarily separating the effects would give rise to an accounting mismatch. An insurance industry expert informed us that this interrelationship is evidenced by the source of dividends to policyholders of insurance contracts, where cash flows relevant to financial and non-financial components are not separately identified. Accordingly, as a general principle, as far as cash flows from components of insurance contracts and underlying assets are significantly interrelated (that is, especially the case of insurance contracts with participating features), the ASBJ generally supports ‘fully’ unlocking the CSM. By doing so, the CSM would represent unearned profits both at initial recognition and throughout the life of insurance contracts.

⁴ Please refer to the relevant IASB Staff paper from the following link:
<http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/June/AP10E-Conceptual%20Framework.pdf>

Is Presenting the CSM in Liabilities Appropriate?

12. Yet this posed a question to the ASBJ as to whether it is appropriate to present the CSM (which would represent unearned profit) in the liability section, when considered in the context of the discussion under *The Conceptual Framework for Financial Reporting* (the *Conceptual Framework*). The existing *Conceptual Framework* defines a liability as ‘**a present obligation** of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.’ In addition, as part of the project to review the *Conceptual Framework*, the IASB tentatively decided that a definition of a liability should be largely unchanged⁵, where it tentatively decided that a liability should be defined as ‘a present obligation of the entity to transfer an economic resource as a result of past events.’
13. When the nature of the CSM is considered in the context of the definition of a liability, the ASBJ’s understanding is that an entity **does not** have an obligation to transfer unearned profits to third parties. Instead, in the ASBJ’s view, the CSM can be viewed as the difference between the measurements that are relevant from the perspective of reporting the entity’s *financial position* and the measurements that are relevant from the perspective of reporting the entity’s *financial performance*. If this is the case, the ASBJ thinks that the CSM should be accounted for as OCI and presented as AOCI in the statement of financial position.
14. For the said reasons therefore, the ASBJ raised a question about whether the CSM would be better presented as AOCI as opposed to in the liability section during the Accounting Standards Advisory Forum (ASAF) meeting in December 2014. During the meeting, the ASBJ received insightful questions and helpful comments from the IASB members and Staff and the ASAF members.
15. Having regards to the questions and comments, the ASBJ will provide its views and analysis on this matter in order of the following:
 - (a) The ASBJ’s thought about when to use OCI;

⁵ During May 2014 Board meeting, the IASB tentatively decided that a liability should be defined as a present obligation of the entity to transfer an economic resource as a result of past events.

- (b) The ASBJ's proposal regarding the presentation of the CSM (that is the unearned profit of insurance contracts); and
 - (c) Analysis of the ASBJ's proposal (including the ASBJ's preliminary views on the aspects where questions and comments were received during the ASAF meeting).
16. In addition, the ASBJ shares its preliminary views on other aspects of the CFO Forum's proposal in the Appendix of this paper.

III. Use of OCI

17. The existing *Conceptual Framework* is silent on the use of OCI, but the use of OCI is often controversial. Therefore, as part of the project to review the *Conceptual Framework*, the IASB has been exploring how the use of OCI can be articulated in the *Conceptual Framework*. For example, the IASB stated its preliminary views in the Discussion Paper (DP) *A Review of the Conceptual Framework for Financial Reporting*, that OCI can be explained using the following three categories (i.e., bridging items, mismatched remeasurement and transitory remeasurement).
18. The ASBJ agrees that the use of OCI is critical and that it should be properly explained in the *Conceptual Framework*. However, the ASBJ did not agree with the preliminary views in the IASB's DP, primarily due to the proposed categorization and the related explanation. In order to propose an alternative suggestion, the ASBJ prepared a paper titled "Profit or Loss / OCI and Measurement" (hereinafter referred to as the "ASBJ's ASAF Paper") for discussion at the December 2013 Accounting Standards Advisory Forum (ASAF) meeting⁶. In summary, the ASBJ's ASAF Paper proposed the following:
- (a) Comprehensive income, profit or loss and OCI should be defined as separate elements of financial statements in the following manner:
 - (i) **Comprehensive income** is the change in net assets during a period except those

⁶ For the ASBJ's ASAF paper, please refer to the following link:
https://www.asb.or.jp/asb/asb_e/asbj/pressrelease/pressrelease_20131227_e.pdf

changes resulting from transactions with owners in their capacity as owners, whereby the recognised assets and liabilities comprising the net assets are measured using measurement bases that are relevant from the perspective of reporting the entity's *financial position*.

(ii) **Profit or loss** is the change in net assets during a period except those changes resulting from transactions with owners in their capacity as owners, whereby the recognised assets and liabilities comprising the net assets are measured using measurement bases that are relevant from the perspective of reporting the entity's *financial performance*.

(iii) **OCI** is the “linkage factor” that is used when the measurements that are relevant from the perspective of reporting the entity's *financial position* differ from the measurements that are relevant from the perspective of reporting the entity's *financial performance*.

(b) **Profit or loss** represents an all-inclusive measure of irreversible outcomes of an entity's business activities in a certain period.

(c) Two different measurement bases could be used for the same item and thus OCI should be used as the linkage factor, when:

(i) it is relevant from the perspective of reporting the entity's *financial position* to remeasure assets and liabilities that are exposed to certain risks by using the information updated at the reporting date; but

(ii) such remeasurements are not relevant from the perspective of reporting the entity's *financial performance*.

IV. The ASBJ's Proposal regarding Presentation of the CSM

19. If the IASB decides to follow the CFO Forum's proposal to 'fully' unlock the CSM, the CSM would represent unearned profit at initial recognition and throughout the life of insurance contracts. Under the 2013 ED, the CSM is initially calculated as the amount

equal and opposite to the amount of fulfilment cash flows for the insurance contract, unless any pre-coverage cash flows or insurance contracts are onerous at initial recognition⁷ and presented in the liability section, as adjusted in subsequent periods. In other words, the CSM is recognised on the statement of financial position so as not to recognise income at the inception of the insurance contract, because the IASB felt that recognising a day-one gain is not appropriate from the perspective of reporting the entity's financial performance primarily due to the fact that services under the insurance contract are not provided to policyholders at or before the initial recognition⁸.

20. Thus, at least at initial recognition, the ASBJ thinks that the CSM can be viewed as the difference between the measurements that are relevant from the perspective of reporting the entity's *financial position* and the measurements that are relevant from the perspective of reporting the entity's *financial performance*. This is because the current measurement basis is considered to be relevant from the perspective of reporting the entity's *financial position*, but is not relevant from the perspective of reporting the entity's *financial performance*.
21. To put it a different way, reflecting the demands from users, the measurement basis considered to be relevant from the perspective of reporting the entity's *financial position* is determined using current assumptions (including the most recent estimates of cash inflows and outflows from insurance contracts) as at the period end, which is generally consistent with the measures of fulfilment cash flows in the 2013 ED. On the other hand, the measurement basis considered to be relevant from the perspective of reporting the entity's *financial performance* is determined by carrying over the balance from previous periods (starting with nil at initial recognition), as appropriately adjusted

⁷ See paragraph 28 of the 2013 ED.

⁸ Paragraph 12 of the 2013 ED proposed to require that an entity shall recognise an insurance contract that it issues from the earliest of the following:

- (a) The beginning of the coverage period;
- (b) The date on which the first payment from the policyholder becomes due; ad
- (c) If applicable, the date on which the portfolio of insurance contracts to which the contract will belong is onerous.

through additions and subtractions in subsequent periods⁹ rather than applying a particular measurement basis (such as, fair value). In the ASBJ's view, the application of the principle that purports to represent the 'irreversible outcome' of an entity's business activities in a certain period would be relevant for the purpose of reporting an entity's *financial performance*.

22. This paper does not describe in detail how to calculate the measurement basis that is relevant for the purpose of reporting an entity's *financial performance* (that is, to determine the appropriate adjustments that should be made to the measurement of fulfilment cash flows), because consideration of this would require addressing every aspect relating to accounting requirements of insurance contract standards. Instead, this paper's primary focus is the issue of 'presentation of the CSM'. However, if the CSM continues to represent future profits at initial recognition and throughout the insurance contract periods, the ASBJ thinks that logic explained in paragraph 20 of this paper would be applicable throughout the contractual periods of insurance contracts, because future profits by their very nature, would not be relevant for reporting the entity's financial performance during the period.
23. Therefore, when the CSM is considered in light of the proposal regarding the use of OCI stated in the ASBJ's ASAF Paper, **the ASBJ believes that the CSM should be presented as AOCI as opposed to in the liability section.** In doing so, the CSM presented as AOCI should be reclassified to profit or loss over the coverage period in a rational way that best reflects the remaining transfer of services that are provided under the contract. The ASBJ thinks that the driver of the reclassification would be determined in a manner such that profit or loss represents an 'all-inclusive' measure of the irreversible outcome of an entity's business activities in a certain period (which is consistent with the way an insurer is released from risks associated with insurance contracts). Thus, AOCI should be clearly differentiated from retained earnings, such that reclassification from AOCI to retained earnings or vice versa should be prohibited.

⁹ This way of determining the measurement basis is similar to that of PPEs, where the measurement is determined by subtracting depreciation during the subsequent periods from the amount recognised at initial recognition.

Save for some concerns (see Appendix of this paper), the ASBJ thinks that the application of this concept is considered to be generally consistent with the CFO Forum's proposal to require amortising the CSM in a manner that reflects the nature and timing of services provided by the insurer.

24. Considering the fact that the nature of the CSM (that is, generally the representation of unearned profits) would not significantly differ between participating contracts and non-participating contracts, the ASBJ thinks that **this AOCI presentation should be applied irrespective of whether insurance contracts contain non-participating or participating features.**
25. The ASBJ recognises that there are cases where the IASB decided to depart from the *Conceptual Framework* in the development of Standards and the requirements of the Standards prevail over the *Conceptual Framework*¹⁰. Nevertheless, by considering the consistency with the *Conceptual Framework*, the ASBJ thinks that Standards of IFRSs will become more internally consistent; thereby resulting in more useful financial information being available to the user.

V. Analysis of the ASBJ's Proposal

26. In the following paragraphs, the ASBJ will provide its analysis on possible counterarguments of its proposal to present the CSM as AOCI, having regard to the counterarguments received during December 2014 ASAF meeting and the meeting with its domestic constituents. The list of these counterarguments to be discussed is as follows:
 - (a) The use of OCI for the CSM may give rise to inconsistency with the IASB's tentative decision as part of the project to review the *Conceptual Framework* that the OCI only arises from remeasurement.
 - (b) It would not be prudent to present the CSM as AOCI, because the amount of equity would be inflated. It may give rise to inconsistency with the prudential regulations.

¹⁰ See Purpose and status of the *Conceptual Framework*.

- (c) Even if the CSM itself does not satisfy the definition of a liability, the CSM is an inseparable component of the insurance contract liability as it is essentially a “shock absorber” for the contract.
- (d) Other Standards (for example, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*) already require that deferred income be presented in the liability section. In addition, even where deferred income should be presented in AOCI, the CSM is different from deferred income in that it represents ‘unearned profits.’
- (e) Presentation of the CSM as part of insurance contract liability is consistent with the requirements of IFRS 15 *Revenue from Contracts with Customers*.
- (f) It is unclear as to the implications to the premium allocation approach if the CSM were presented as AOCI.

OCI Should Arise Only From Remeasurement (Day-1 OCI)

- 27. Some may argue that it is inappropriate to recognise OCI at initial recognition, citing the IASB’s tentative decision in its meeting of July 2014 that the Exposure Draft regarding a review of the *Conceptual Framework* will propose that items of income and expense should be included in profit or loss but can however be rebutted for ‘changes’ in current measures of assets and liabilities.
- 28. The ASBJ understands that the use of OCI is not prevalent under the existing accounting requirements. However, the ASBJ thinks that the proposed insurance contract standard is markedly different in nature from other standards in that measuring cash inflows and outflows from the entity’s viewpoint is considered appropriate from the perspective of reporting an entity’s *financial position* but many believe that applying the same approach to the measurement from the perspective of reporting the entity’s *financial performance* would be considered inappropriate. This is because it would result in recognising day-one gains as soon as an insurer enters into an insurance contract. This measurement difference (corresponding to the amount of day-one gains) is due to the fact that both

future cash inflows and outflows of insurance contracts are measured from the insurer's perspective (rather than a policy holder) at initial recognition, thus the current value of the estimates of future cash outflows would eventually differ from that of premium income. In addition, the ASBJ suspects that the fact that OCI has not been used at initial recognition is simply because measurement bases other than the transaction price have not been used extensively in the existing Standards, and that therefore there has not been much robust discussion regarding whether to use OCI at initial recognition.

29. Furthermore, in its July 2014 Board meeting, the IASB tentatively decided that one example of when the rebuttable presumption can be rebutted is when the IASB concludes that one measurement basis is appropriate for an asset or a liability in the statement of financial position and another measurement basis is appropriate for profit or loss. The exceptional situation envisaged in the tentative decision is consistent with the ASBJ's proposal stated in paragraph 18 (c) of this paper. If this tentative decision is applied in the context of insurance contracts, the ASBJ thinks that such a situation exists regardless of timing, and that this applies to measurement at the initial recognition of insurance contract liabilities.

Presentation of the CSM as AOCI Being Imprudent

30. Some may argue that the use of OCI for the presentation of the CSM would be considered imprudent, because the equity balance would be increased as soon as insurance contracts are entered into. Proponents of the view think that the 'debt equity ratio' would be calculated in a wrong way, if users of financial statements refer to equity as including the CSM.
31. However, the ASBJ does not agree with this argument, because the equity is in the first place defined merely as a 'residual' of the difference between the assets and liabilities (see paragraph 4.4 of the *Conceptual Framework*). Thus, although the equity balance can be used as a starting point for valuation of an entity, it is acknowledged that the equity balance per se does not purport to represent the value of an entity. This is because the value of internally generated goodwill is not reflected in equity and that

general purpose financial reports are not designed to show the value of a reporting entity (see paragraph OB 7 of the *Conceptual Framework*)¹¹.

32. In addition, although the objectives of financial reporting and prudential regulation obviously differ, the ASBJ understands that the presentation of the CSM as AOCI would increase affinity with the prudential regulation (especially, provisions set out in the so-called ‘Solvency-II’). For example, the Solvency-II requires that the future margin be excluded from the calculation of the value of technical provisions (which correspond to the amount to be recognized for insurance undertakings) as it requires that the value of technical provisions shall be equal to the sum of a best estimate of future cash flows from insurance contracts and a risk margin¹². Some constituents also pointed out the affinity with the calculation of embedded value.
33. Furthermore, the ASBJ acknowledges that the IASB has initiated a research project on the distinction between liabilities and equity. Having regard to the various conflicting objectives to be achieved by the appropriate classification of claims against an entity (which may includes, an entity’s liquidity, solvency and financial performance as well as returns to the holders of a particular class of instruments¹³), the ASBJ shares the IASB’s view that accounting requirements regarding the classification of the credit side of the statement of financial position should be investigated further. In this respect, the ASBJ has advocated that the usefulness of financial information would be enhanced either through classifying the credit side of the statement of financial position into three categories or to establish a sub-category within the equity section.

¹¹ As part of deliberation of the project to review the *Conceptual Framework*, the IASB tentatively decided that although ‘prudence’ is an important concept, the term should mean ‘the exercise of caution when making judgments under conditions of uncertainty’ and that the exercise of prudence should be consistent with ‘neutrality’ and should not allow the overstatement or understatement of assets, liabilities, income or expenses. This means that ‘prudence’ of itself should not be a qualitative characteristic of useful financial information, and whether a particular presentation is prudent or not should not affect the decision as to its presentation.

¹² See Article 77 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

¹³ See paragraph 22 of the European Financial Reporting Advisory Group (EFRAG)’s Discussion Paper *Classification of Claims*.

34. Under such a presentation model, the most residual category would include only the amounts that are attributable to the owners of the entity (in the case of the consolidated financial statements, this would be the controlling interest holders of the group.) Thus, although AOCI is a component of equity, AOCI would be classified outside of the category (or in a sub-category) which represents the amounts that are attributable to the owners of the entity. The ASBJ also thinks that using this category (or the sub-category) would be consistent with the intended notion of the debt-equity ratio, which purports to represent the percentage of company financing that comes from creditors and investors (or owners), so that users can assess the extent to which the owners' equity can fulfil an entity's obligations to creditors in the event of a liquidation¹⁴.

The CSM Being an Inseparable Component of Insurance Contract Liabilities

35. Some may argue that the CSM is an inseparable component of insurance contract liabilities and that it is inappropriate to present the amount of the fulfilment cash flows for the insurance contracts and the CSM in different sections.

36. However, the ASBJ does not think that this argument is sufficiently convincing. It is true that estimation uncertainty is high for the measurement of the insurance contract liabilities primarily due to the nature of risk bearings as well as their long-term nature, but the fact that very different requirements are already stipulated for the fulfilment cash flows and the CSM respectively for subsequent accounting means that the difference between the fulfilment cash flows and the CSM is not merely a presentation issue.

37. In addition, the 2013 ED requires, among others, that the estimate of fulfilment cash flows incorporates in an unbiased way all of the available information about the amount, timing and uncertainty of all of the cash inflows and outflows that are expected to arise, separately from other elements. In this connection, the *Conceptual Framework* states that if the level of estimation uncertainty is considered too high, the relevance of the item

¹⁴ Some may also think that 'return on equity' may be calculated in a wrong way if the CSM is presented as AOCI because the denominator may be overstated. However, the ASBJ thinks that the ratio of 'return on equity' would be properly reflected in the calculation, if the amount recognised in the said category (or the sub-category) representing the amount attributable to the owners of the entity is used as a denominator.

being faithfully represented is questionable and that estimation would not be particularly useful (see paragraph QC 16 of the *Conceptual Framework*). This means that the level of estimation uncertainty would affect the decision as to which is the most *appropriate* measurement basis considering the relevant factors (relevance, faithful representation and costs benefit balance) but would not affect where to present the item on the face of the financial statements.

Interaction with Other Standards

38. Some may argue that the presentation of the CSM in the liability section is consistent with other Standards in IFRSs. For example, paragraph 24 of IAS 20¹⁵ permits that government grants are presented as deferred income within the liability section.
39. However, the ASBJ does not think that consistency with the requirements of IAS 20 can sufficiently justify the presentation of the CSM in the liability section, because IAS 20 itself has often been criticised for its inconsistency with the *Conceptual Framework* and many stakeholders believe that it should be amended as time permits. For example, the IASB's Request for Views *Agenda Consultation 2011* stated the following:

Government grants

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* provides guidance on recognising, measuring and disclosing government grants and disclosing other forms of government assistance. IAS 20 is inconsistent with the conceptual framework, in particular in its recognition of a deferred credit when the entity has no liability. The standard also permits accounting policy choices that can reduce the comparability of financial statements and understate the assets controlled by an entity. The IASB added this project to its agenda but has deferred work pending progress on the revenue recognition and emission trading schemes projects. No due process documents have been published.

40. Having said that, the need of changing the requirement would not be that significant, because, except for limited situations, deferred income recognised by a government grant is normally not too significant in an entity's financial statements. The ASBJ thinks that, except for certain situations (especially the situations envisaged for the application of the premium allocation approach) the impact of the CSM presented in the liability section is

¹⁵ Paragraph 24 of IAS 20 requires that government grants related to assets, including non-monetary grants at fair value shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

far greater than the similar presentation requirement under IAS 20 and other Standards, due to the supposed sizes and durations of the insurance contracts within the scope of the proposed standard.

41. Some may also argue that deferred income and unearned profits are different, and that it is conceptually appropriate to present unearned profits in the liability section. However, the ASBJ does not agree with this view, because the ASBJ thinks that both items arise due to the difference between the measurement bases that are relevant from the perspective of reporting the entity's *financial position* and those of reporting the entity's *financial performance*. Accordingly, although the length of the future periods that they relate to (hence, the degree of uncertainty) may differ between the two items, the ASBJ thinks that the substance of these items are not that different.

Presentation of the CSM as Part of Insurance Contract Liability Being Consistent with IFRS 15

42. Some may argue that presentation of the CSM as part of insurance contract liability is consistent with the requirements of IFRS 15. The Basis for Conclusions in the 2013 ED explained that the CSM as defined in the ED purports to reflect part of the price that the entity charged to provide the remaining services, and this measurement requirement is generally consistent with the measurement requirements for contract positions in the 2011 Exposure Draft *Revenue from Contracts with Customers*, being that it also reflects the price that the entity charged to provide services.
43. However, the ASBJ does not think that consistency will be an issue, because the cited consistency between the requirements of IFRS 15 and the 2013 ED relates only to the effect that both insurance contract liabilities and performance obligations should not be 'remeasured' for the purpose of reporting 'profit or loss' at the current measurement basis every period. In fact, unlike the proposed accounting requirements on insurance contracts, IFRS 15 does not in the first place, require the use of current measure for the purpose of reporting an entity's *financial position*, and unearned profits are not recognised in the statement of financial position.

44. Said differently, measurement bases of insurance contracts are determined differently from the perspective of reporting an entity's *financial performance* and from its *financial position*, where the former is determined in light of the policy holder's point of view (reflecting cash outflows from an entity) and the latter is determined in light of insurer's point of view (reflecting cash inflows to an entity). Thus, the portion of unearned profits is presented on the statement of financial position for insurance contracts. On the other hand, under IFRS 15, measurement bases of contracts from customers are determined solely in light of customer's point of view (reflecting cash inflows to an entity); thus the portion of unearned profits would not be presented on the statement of financial position.

Interaction with the Premium Allocation Approach

45. Some may argue that the use of OCI for presentation of the CSM may give rise to a change in the IASB's tentative decision regarding the presentation requirements using the premium-allocation approach.

46. The 2013 ED proposed the following requirement.

35 An entity may simplify the measurement of the liability for the remaining coverage using the premium-allocation approach set out in paragraphs 38–40 if:

(a) doing so would produce a measurement that is a reasonable approximation to those that would be produced when applying the requirements in paragraphs 18–32; or

(b) the coverage period of the insurance contract at initial recognition (including coverage arising from all premiums within the contract boundary determined in accordance with paragraphs 23–24) is one year or less.

47. The ASBJ supports the premium allocation approach because this approach is cost-effective, while ensuring that useful information (especially those relating to an entity's financial performance) is provided to users of financial reports. This is especially because the scope of the premium allocation approach is mostly for contracts of which duration is less than one-year, and the impact of not separately presenting the portion of unearned profits in AOCI is not expected to be too significant. Yet this significant benefit of the premium allocation approach would be lost if the premiums

received were required to be bifurcated into the components corresponding to liabilities and those corresponding to AOCI.

48. Although it has not been made explicit, the ASBJ understands that the premium allocation approach is the simplified method primarily used to arrive at the ‘profit or loss’ figures that are reasonably proximate to the amount using the general requirements of the insurance contracts accounting model (so-called the “building block approach”). The ASBJ thinks that it would be worthwhile clarifying this spirit before finalising the standard. As far as the said spirit of the use of the premium-allocation approach is to be clarified, the ASBJ thinks that the ASBJ’s proposal does not give rise to significant inconsistency with the IASB’s tentative decision regarding the premium allocation approach. Accordingly, the ASBJ thinks that they can coexist in the insurance contracts standard.

VI. Other Matters

49. During the course of discussions with Japanese constituents in preparing this proposal, the ASBJ has received helpful suggestions on peripheral areas. For the purpose of future discussion by the IASB, the ASBJ shares its thoughts on selected issues below.

Overhead costs

50. Some questioned if the CSM can ever represent ‘unearned profits’ regardless of the CFO Forum’s proposal, because overhead costs are not factored into the calculation of fulfilment cash flows, except for in limited situations (that is, when they are directly attributable to fulfilling the portfolio that contain the insurance contract and are allocated to each portfolio using the specified methods¹⁶). Some pointed out that the magnitude of exploring a different presentation of the CSM is considerably large due to the limited attribution of overhead costs to fulfilment cash flows, which posed some to hesitate presenting the CSM as AOCI owing to the concern over prudence.

¹⁶ See paragraphs 22 and B66 (l) of the 2013 ED.

51. Provided that requirements of attribution of overhead costs are unchanged, the ASBJ thinks that it would be more precise to describe the CSM as the representation of ‘unearned profits arising from cash inflows and outflows that relate directly to the fulfilment of the portfolio of insurance contracts’. If the ASBJ’s proposal were to be adopted, this nature of the CSM should be clearly explained in the notes to the financial statements.
52. At the same time, the ASBJ explored if overhead costs that are excluded from the calculation of fulfilment cash flows under the 2013 ED could be meaningfully incorporated into the calculation, while maintaining the ‘verifiability’ of the resulting financial information. For example, the ASBJ thinks that it may be appropriate to attribute part of overhead costs to insurance contracts, to the extent that they are factored in the pricing of the insurance contracts, while updating the relevant assumptions and taking into account the actual figures.

Additional Consideration to the CFO Forum’s Proposal

53. In preparing this paper, the ASBJ discussed with its constituents their views on the CFO Forum’s proposal. As stated in paragraph 7 of this paper, the ASBJ generally supports the objectives of the CFO Forum’s proposal, especially where it states that the newly developed standard should provide an appropriate basis for the reporting of *performance*. In addition, as stated in paragraph 11 of this paper, the ASBJ generally supports the concept of ‘fully’ unlocking the CSM, **except that the CSM should not be presented in the liability section irrespective of whether insurance contracts contain participating features or non-participating features.**
54. However, the ASBJ thinks that there are areas where modifications or clarifications are warranted. Accordingly, the ASBJ shares its preliminary views on the following aspects of the proposal:
- (a) Use of book yield;
 - (b) Application of the mirroring approach;
 - (c) Presentation of the effect of changes in discount rate;
 - (d) Roll-forward disclosure of the CSM; and
 - (e) Others.

Use of Book Yield

55. The CFO Forum’s paper proposed that interest expense recognised in the profit or loss be determined consistently with investment returns (that is, the use of “book yield”) for all insurance contracts with participating features, irrespective of the type of contract. Conceptually, the ASBJ thinks that the use of book yield is an effective tool to address accounting mismatches; thus, the use of book-yield would be appropriate where the degree of accounting mismatch is significant. However, some pointed out significant

implementation challenges for the application of the application of the book yield. Consequently, some even questioned if the application of book-yield is really necessary, especially when the concept of ‘fully’ unlocking the CSM was adopted.

56. In addition, although the ASBJ agrees that it is essential that an entity apply an appropriate discount rate to calculate interest expense on insurance contracts due to their size and long-term duration, the ASBJ wonders if it is possible to prescribe the scope of application of book-yield in the Standards. Due to the differing nature of insurance contracts, the ASBJ suspects that keeping a principle-based requirement would be appropriate.
57. Accordingly, the ASBJ thinks that further consideration would be necessary as to the appropriate scope of the application of the book-yield when considering the CFO Forum’s proposals.

Application of the Mirroring Approach

58. Paragraph 114 of the CFO Forum’s paper explained that a single measurement basis be applied for all insurance contracts. Thus, although the need for the “mirroring approach” was not made explicit in the CFO Forum’s paper, the paper seemed to suggest that the mirroring approach should not be used.
59. In its comment letter to the IASB, the ASBJ expressed its general agreement with the application of the mirroring approach to the extent that the scope of application is limited. This is because the cash flow dependency of assets and liabilities was significant in the situations to which the mirroring proposal would apply, such that it would deem inappropriate to establish accounting requirements for assets and related liabilities separately. Such a situation exists, for example, in the case of variable life contracts that are common products globally. In light of the cash flows dependency, the ASBJ believed that the mirroring approach would be a useful vehicle to present the meaningful information about *financial performance*.

60. Accordingly, consistent with the view stated in paragraph 7 of this paper that reporting of financial performance is of paramount importance, the ASBJ continues to support the limited use of the mirroring approach, even when the IASB were to follow the CFO Forum's proposal to 'fully' unlock the CSM.

Presentation of the Effect of Changes in Discount Rate

61. The CFO Forum's proposal permits an insurer to present the effect of changes in the discount rate in OCI or in profit or loss as an accounting policy choice. As stated in paragraph 18 of this paper, the ASBJ thinks that OCI is the 'linkage factor' that is used when the measurements that are relevant from the perspective of reporting the entity's *financial position* differ from the measurements that are relevant from the perspective of reporting the entity's *financial performance*. Accordingly, the ASBJ disagrees with the use of OCI as an accounting policy choice.
62. Conversely, in principle, the ASBJ thinks that the effect of changes in the discount rate should be presented as OCI when cash flows from insurance contracts are not expected to vary largely, because the effect of changes in the discount rate are expected to unwind over the period over which the cash flows occur (in other words, the OCI would be reclassified to profit or loss with the passage of time). Yet the use of OCI for the effect of changes in the discount rate may give rise to an accounting mismatch due to the application of different measurement bases for the corresponding items (for example, when interest rate risks associated with insurance contracts is fully hedged by interest rate swaps measured at FV-PL). In such situations, the effect of changes in the discount rate could be presented in profit or loss when certain conditions are met.

Roll-forward Disclosures of the CSM

63. During discussions with the Japanese constituents, financial statement users commented that the CFO Forum's proposal regarding a roll-forward disclosure of the CSM is particularly helpful to better understand the nature of its balance at the period end. They also emphasised that the importance will be unchanged when the CSM is

presented as AOCI in line with the ASBJ's proposal, because the period-end AOCI balance would consist of different components and cannot be explained simply with a single measurement basis. Thus, the ASBJ recommends that this disclosure requirement (as modified appropriately) be incorporated into the final standard, if the IASB decides to follow the ASBJ's proposal in this paper.

Others

64. Lastly, the ASBJ believes that it is important to ensure that the requirements of this standard are sufficiently operational before finalizing the standards, because the nature of insurance contracts vary significantly due to the different prudential regulations that are influenced, for example, by legal systems as well as the cultural value of respective jurisdictions. The larger the volume of insurance contracts, the larger the size of the technology investments would be to implement the requirements.
65. The ASBJ found that November 2014 IASB Board meeting was a valuable opportunity for the IASB members and Staff and the industry to exchange questions and comments so as to improve the level of understanding about areas of practical challenges. The ASBJ would welcome if the IASB seeks further dialogue with important constituents, for example, through further outreach activities, publication of additional documents or by holding working group meetings.