Accounting Standards Board
AcSB
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Conseil des normes comptables

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Submitted electronically via www.ifrs.org

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

Dear Sirs,

Re: Insurance Contracts (ED/2013/7)

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the International Accounting Standards Board's (IASB) Exposure Draft, "Insurance Contracts", issued in June 2013.

The AcSB is Canada's national accounting standard setting body, which has adopted a strategy of importing IFRSs into Canada for publicly accountable enterprises. The AcSB consists of members from a variety of backgrounds, including financial statement users, preparers, auditors, and academics. Additional information about the AcSB can be found at www.frascanada.ca.

The views expressed in this letter take into account comments from the AcSB's Insurance Accounting Task Force, our outreach to Canadian stakeholders, individual members of the AcSB and its staff. Our consultations with the Insurance Accounting Task Force involved discussing the full proposals and seeking the advice of a diverse group of preparers, actuaries, auditors, and users with in-depth knowledge of insurance issues. Our outreach activities included holding, in conjunction with the IASB, discussion forums to hear the views of over 50 stakeholders, various meetings to consult over 30 users of financial statements, and additional meetings with various stakeholders. However, the views expressed in this letter do not necessarily represent a common view of the AcSB, its committees, or staff. Formal positions of the AcSB are developed only through due process.

We recognize and support strongly the continued efforts by the IASB and its staff to develop the proposed insurance contracts standard further through its joint deliberations with the U.S. Financial Accounting Standards Board (FASB), its consultations in Canada and the rest of the world, its additional field tests and its re-exposure of the proposals.

We agree with the fundamental principles in the proposed insurance standard. Based on our consultations, we think that the IASB and its staff should continue their efforts and amend some aspects of the guidance as identified in this response. The resulting revised standard would result in high-quality financial reporting on a globally comparable basis.

Benefits and costs of financial information

General purpose financial statements are intended to portray the economic benefits and costs of a business. For insurers, financial statements report on the income earned from providing insurance and investment services, the expenditures incurred to provide those services and the results of financing those activities through its investments. These statements are prepared so investors, lenders, other creditors and customers can make informed decisions about whether to buy, sell or hold equity and debt instruments in and purchase insurance products from an entity.

Significant changes to how insurers recognize, measure and disclose their business activities in financial statements need to be done in a high-quality and consistent manner across jurisdictions. In particular, users of the financial statements and others need to consider the information and the possible effects of the information. For example, entities may revise how they price long-dated insurance and investment products. Such decisions could affect users' expectations about the entity's future profitability and could result in policyholders paying more or no longer being offered those products. Entities may also buy fewer long-term investments in other entities, governments and infrastructure projects and as a result, the markets for those investments could become less liquid and more costly. Such changes should result from business activities based on relevant financial information rather than as a result of misapplication or misinterpretation of new accounting guidance.

Therefore, our response sets out recommendations to amend some aspects of the proposed standard to result in financial reporting that would represent the economics of insurance contracts faithfully. In addition, we make several recommendations for making the standards operational and enhancing the quality of their implementation on a global basis.

One global standard

Given the global nature of the insurance industry, we urge the IASB and FASB to develop standards that will result in earnings from insurance contracts being reported in substantially the same manner. With that objective in mind, we encourage both Boards to renew their efforts and give priority to deliberating jointly the comments received on both proposals and the results of the field testing, and resolving the differences between their approaches.

While we recognize that the proposed standards would result in more similar accounting by U.S. and other insurers than there is today, we think that users of financial statements within North America and around the world should be able to compare the financial performance of different insurers without having to consider differences in accounting. If necessary, we recommend that the IASB take some additional time to develop a common standard with the FASB for accounting for insurance contracts.

Supporting a global implementation

For many jurisdictions, including Canada, the proposed new standard will require significant implementation effort and changes to current practices. There are a number of different requirements in the standard that, when applied together, will make it challenging to account for insurance contracts. Some of the field test results demonstrate these challenges.

Joint implementation committee

We recommend that the IASB, the FASB and other parties work together to support the finalization and implementation of a global standard on insurance contracts. We think that the Boards should establish a joint implementation committee similar to that being formed to support the transition to the new converged standard on revenue recognition. The joint implementation committee should be structured broadly to include preparers, actuaries, financial statement users and regulators from a variety of jurisdictions to promote the collection and sharing of information across jurisdictions.

We think that the committee's work should begin sooner rather than later to oversee additional field tests and the development of educational and other non-authoritative guidance.

Continue field testing

We recommend that the revised proposals should continue to be reviewed and tested throughout the remaining period to completion of the project. The IASB should make an updated draft of the standard available publicly, either when the redeliberations of a section are completed or when the standard is completed, to enable a broad group of stakeholders to continue to assess the proposed standard. Additional testing would also enable stakeholders to understand the amendments the IASB makes to the proposed standard and enable the IASB to fine tune the amendments, if necessary. The joint implementation committee could help to support such work and assess the results, subject to overcoming confidentiality concerns.

Continuing to subject the proposed new standard to on-going scrutiny will help to identify additional issues and unintended consequences and enable the IASB to respond to those concerns in an orderly manner. Such efforts would facilitate and enhance the quality of initial application of the standard.

Communicate more information about field testing

In addition, we recommend that the IASB make information about the type, extent and findings of the field testing that has already been done more widely available, without releasing confidential information about the results of the testing. Providing additional information about field testing completed and how the IASB has considered that input would respond to criticisms we have heard from some stakeholders.

Develop non-authoritative guidance

We think that the joint implementation committee should develop non-authoritative guidance, such as examples of different estimation techniques that could be used to determine discount rates, and consider application issues as they arise. It is through such efforts that the proposed new standards can be implemented globally and result in more comparable financial information across and within jurisdictions.

Effective date

We recommend that the IASB set the same effective date for IFRS 9 and the new insurance contract standard and allow for early application of each standard, if the two standards will be issued in close succession. Requiring the standards to be adopted at the same time will minimize the costs for some insurers from redesignating financial assets twice in quick succession and avoid requiring users to understand multiple changes. By allowing early application, entities in other industries and entities that issue insurance contracts and expect not to redesignate a significant amount of financial assets upon adoption of the new insurance standard would still be able to apply IFRS 9 and benefit from applying it when it is available.

Current measurement model and 2013 proposals

We continue to agree with determining a current measurement of insurance contracts by using the building block approach and its simplified version (the premium allocation approach). We and users of financial statements who we consulted agree with using a current measurement because of the high degree of uncertainty in estimating the amount and timing of the cash flows to fulfill insurance obligations. Requiring an insurer to update its cash flow estimates and adjustments for risk at each reporting date will provide a faithful representation of its liabilities and timely recognition of changes in its expectations.

Canadian insurers have been accounting for insurance contracts for almost 20 years using a measurement model that is similar to the proposed building block approach. Based on that experience, we know that the model can be applied practically and can provide decision-useful information to financial statement users.

That said, we recognize that the proposed model would still result in significant changes for Canadian insurers, in particular those entities with long-duration liabilities. Canadian practices would change, in part, as the current estimate of expected cash flows to fulfill insurance obligations and the adjustments for risk would be measured independently of the assets expected to fund those obligations. Therefore, we are pleased to see that the IASB has proposed to reduce accounting mismatches between the insurance liability and the assets backing the liability, through the following requirements:

- Measure financial assets held to collect contractual cash flows and for sale at fair value through other comprehensive income (OCI), by changes to be introduced through the financial instrument project.
- Measure the insurance liability by reference to the carrying amount of the underlying assets when there is no possibility of economic mismatch between the insurance contract and the assets backing that contract (see a recommendation below to expand the scope of the 'mirroring approach').
- Present in OCI the difference in interest expense on the insurance liability between using the discount rate applied at the date the contract was initially recognized and the rate applied at the current reporting date (see a recommendation below to make the use of OCI optional and further reduce accounting mismatches).

We are pleased that these proposals and other revisions to the proposed standard were developed after considering the comments we and others made on the 2010 Exposure Draft. However, we think that some aspects of the proposed new standard need amendment.

Further amendments proposed

Discount rate

We support the principle-based approach in the proposed standard of requiring an entity to exercise its judgement in determining a discount rate that reflects the characteristics of the insurance cash flows. Given the judgement that management of an entity would exercise, we agree with requiring an entity to disclose the methods used, judgements made and the yield curve used to enable users to evaluate how an entity has discounted its insurance contract liabilities.

We think that more clarity is needed with respect to the use of management judgment when determining rates to discount long-term obligations over periods of time in which there are few or no observable market interest rates. From outreach activities, we have been told that Canadian, American and Japanese life insurers, among others, issue many long-term contracts that extend well beyond the periods for which there are observable market inputs. Not only does this create significant complications, as determining the rate in the period when market information is not available can be extremely difficult, but slight changes in the rate on long-term contracts can result in dramatic changes in the reported amount of insurance liabilities. In this circumstance, we think that the IASB should amend and expand its guidance so that it is more comparable to the guidance provided for determining future cash flows and the risk adjustment.

Expand the scope of the mirroring approach

We recognize that the mirroring approach would reduce accounting mismatches by measuring fulfillment cash flows that are expected to vary directly with returns on underlying items at the carrying amount of the underlying items when there is a specified contractual or regulatory requirement. We are concerned that few insurance contracts issued in Canada would qualify.

Stakeholders we consulted expressed concern about challenges and costs of segregating contract cash flows between those that vary directly and those that vary indirectly with the returns from the underlying item. From a practical perspective, we think that amending the guidance on how to determine discount rates and providing an option to use OCI may reduce the need for the mirroring approach. It may be the case that the hedging proposals, once released, may alleviate much of the issue of 'matching' by permitting hedging in circumstances that would not work currently. On balance, we recommend that the IASB reconsider whether the mirroring approach is necessary after considering these and other proposals.

If the IASB decides to retain the mirroring approach, we recommend that the requirements for the mirroring approach be expanded to include arrangements that create a constructive obligation that links the payments to the policyholder and the returns on the underlying items. In such situations, we think that there would be no expectation of economic mismatch as a constructive obligation binds the entity to pay the policyholder amounts related to underlying items.

Use of OCI

We agree with the proposal to present in OCI the difference between interest expense determined using a current rate and using the rate at inception of the contract, from a practical perspective. A majority of users of financial statements we consulted expressed the view that the interest expense from insurance obligations is a cost of providing insurance coverage and should be reported in profit or loss. While we concur with that view from a conceptual perspective, we think that the use of OCI provides a practical approach that would facilitate the change to discounting insurance liabilities using a current rate.

However, we recommend that the use of OCI should not be mandatory when reporting interest expense through profit or loss would reduce an accounting mismatch. Canadian insurers invest in some assets that are measured at fair value through profit or loss and in other assets that are measured at fair value through OCI. Some insurers invest in only one type of asset while others invest in different types of assets. Therefore, an option to report interest expense in profit or loss by making an irrevocable designation by portfolio of insurance contracts and/or report interest expense through other comprehensive income would reflect how insurers manage their portfolios of contracts.

Transition

We agree with requiring the new insurance standard to be applied on a retrospective basis in order to estimate the unearned profit on outstanding insurance contracts at transition and reflect that profit in earnings as coverage and services are provided in the future. We recommend that the IASB consider simplifying the transition requirements further to enable comparative information to be prepared in a more cost-effective manner.

Implementing the new standard will require significant effort and costs. Accountants, actuaries and auditors will need time to:

- understand and interpret how the standard is to be applied;
- develop or revise methodologies for measuring components of insurance obligations, including discount rates and the risk adjustment; and
- revise insurance contract management and financial reporting systems to track new data and account for insurance contracts.

We think that providing three years to implement the new insurance standard will provide sufficient time for a quality implementation and would balance the need to implement IFRS 9 shortly after it is finalized with the need for some entities with insurance contracts to implement IFRS 9 and the new insurance standard at the same.

We are willing to provide the IASB and FASB with any additional assistance we can to help further amend aspects of the proposed new standard on insurance contracts and support its global implementation.

An explanation of the discount rate concerns and our responses to the Exposure Draft questions are included in the Appendix.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards at +1 416 204-3276 (email pmartin@cpacanada.ca), or Rebecca Villmann, Principal, Accounting Standards at +1 416 204-3464 (email rvillmann@cpacanada.ca).

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Appendix

Discount Rate

1. As was the case with the 2010 Exposure Draft, we support the discount rate requirements in the 2013 Exposure Draft that allow an entity to exercise its judgement and determine the best way to estimate a discount rate that reflects the characteristics of the insurance cash flows. In particular, we support the use of a top-down or bottom-up approach. While amendments are needed to provide more guidance, we think that the IASB must keep the guidance principle-based and should not provide guidance that is prescriptive.

2. Determining the discount rate for long-duration contracts is a concern in Canada because many insurers provide a significant amount of long-term life insurance coverage that extends well beyond the period for which market rates are observable. Not only can the lack of observable market rates make determining discount rates extremely difficult, but slight changes in the rate on long-term contracts can result in dramatic changes in the reported amount of insurance liabilities.

Interpreting the guidance

3. We think that more guidance is needed regarding the use of estimation techniques when observable market rates are not available, given the concerns expressed by many stakeholders and how the guidance was applied in some field tests. In particular, we think that the example in paragraph B71 should be removed in light of the concerns of some Canadian and US stakeholders about how it could be interpreted. The example could be read to require that the last observable market rate be extended over the unobservable period. As a result, changes in market rates over the shorter-term observable period are reflected to the same extent in the long-term rates within the unobservable period.

4. For example, the volatility of one-year interest rates is typically greater than the volatility of 20-year interest rates, where 20-year interest rates are the last observable rate in the market. Therefore, it would appear reasonable to assume that this trend of declining volatility would continue beyond the end of the range of observable rates, such that 40 or 50-year interest rates would show far less volatility than 20-year interest rates. However, if the interpretation of paragraph B71 described above is applied, the extension of the last observable rate at year 20 for the remainder of the term of long-dated contracts would appear to result in including excess volatility in the longer-term unobservable rates.

5. While such an extrapolation of the interest rate curve may be appropriate in some circumstances, we are concerned that it may not be a fair representation of long-term rates in all circumstances, based on past experiences.

6. We recognize that changes in observable market inputs need to be taken into consideration when determining the discount rate for the unobservable end of the range. We think that changes in market rates over the shorter-term observable period need not be reflected to the same extent in the long-term rates within the unobservable period.

Historical interest rate data

7. In reviewing historical interest rate data from the Canadian Institute of Actuaries, Insurance Accounting Task Force members observed how current rates have been negatively correlated to longer-term rates earned over the last 20 years (i.e., if the current rates are low, 20 years later they would be high). They expect that other jurisdictions have had similar experiences. We think that historical market data could also be considered when determining long-term rates within the unobservable period.

Results of consultations

8. In consultations with Canadian stakeholders and during the IASB and AcSB discussion forums in Toronto, the following three time periods were identified and assessed:

   (a) *Short term when there are observable-market rates* – Stakeholders agreed with using observable-market rates and adjusting the rate as necessary to reflect the characteristics of the insurance liability. For Canada, stakeholders expressed the view that this short-term period would include terms up to 15 or 20 years as government and corporate bonds are issued for those periods.

   (b) *Medium term when there may be some observable market rates* – There was agreement at the discussion forums that this was the most troublesome time period because there may be a few observable rates, yet those rates may not result from an active or liquid market. For Canada, stakeholders expressed the view that this medium-term period would include terms from 15 or 20 years to 30 years.

   (c) *Long term when there are no observable market rates* – There was agreement again at the discussion forums that the fluctuations in observable market rates in the short-term period should not result in corresponding changes in long-duration rates. Short-term fluctuations in rates should instead be assessed to identify whether those changes are "structural" or indicate a revised long-term expectation by market participants. Overall, the discount rates selected for long-term periods should reflect the characteristics of long-dated liabilities. For Canada, stakeholders expressed the view that this long-term period would include terms greater than 30 years.

9. Throughout our discussions with stakeholders, we have also observed that there is uncertainty when reviewing the guidance in the 2013 Exposure Draft as to whether:

   (a) observable market data used in measuring insurance contracts should only reflect deep and liquid markets;

   (b) historical interest rate data or non-market variables could (or should) be used when determining rates beyond the range of observable market rates (i.e., in the long-term period);

   (c) the relevance of observable market inputs compared to historical rate data could be considered when there are few or no observable market inputs (i.e., in the medium and long-term periods); and

(d) estimation techniques, such as using a moving average, grading or mean reversion, could be used.

Recommendations

10. In this case, we think that the IASB must amend and expand the guidance on how to determine discount rates for the time periods in the interest rate curve in which there are few or no observable market inputs. The additional guidance should not be prescriptive and could leverage the concepts and the statements used in other parts of the proposed standard and other IFRSs, as outlined below.

11. We recommend that the IASB consider providing that additional guidance in the proposed standard in a manner similar to that provided for determining estimates of future cash flows and the risk adjustment by:

(a) making statements corresponding to "the Standard does not specify the technique that is used" (paragraph B81) and that "an entity shall apply judgement when determining an appropriate discount rate ~~risk adjustment~~ technique to use" (paragraph B82 on risk adjustment), to make clear the entity uses its judgement to decide the technique it would use to determine the discount rate.

(b) identifying characteristics that the discount rate must have to meet the objective of the time value of money requirement (paragraph B81 on risk adjustment) to reinforce that the discount rate reflects the characteristics of the liability and maximizes the use of observable market inputs.

(c) referring to the use of market variables (current and past observable market interest rates) and non-market variables (such as the entity's own data in paragraph B44 on estimating future cash flows) to identify other inputs an entity could consider and adjust to reflect the characteristics of the insurance liability. Such an approach is suggested by the reference to using estimates that are categorized within Level 3 of the fair value hierarchy in the Basis for Conclusions (paragraph BCA81 and paragraph 89 of IFRS 13).

(d) clarifying whether "maximizing the use of observable market inputs" and the references to using level 3 estimates in the fair value hierarchy creates a requirement that the discount rate is to be determined from a market participant perspective.

(e) emphasizing "the need to reflect all available evidence, both external and internal" concerning non-market variables (paragraph B49) as well as observable market data.

(f) identifying when observable market rates in the short-term period may have more or less relevance in estimating rates in the medium and long-term time periods, in a manner similar to the guidance provided regarding the use of non-market data that may have more or less relevance than internal data for estimating future cash flows (paragraph B50).

(g) stating that the use of "non-market variables shall not contradict observable market variables" (paragraph B51).

12. Including such guidance in the proposed standard should result in moving the following non-authoritative statement from the Basis for Conclusions into the standard and making it authoritative:

> …"forecasts of unobservable inputs tend to put more weight on long-term estimates than on short-term fluctuations, this counteracts concerns that current-period fluctuations in discount rates exaggerate the volatility of very long-dated liabilities." (paragraph BCA81)

13. Consideration should be given to importing the guidance provided in Appendix A of IAS 36 *Impairment of Assets* on how to apply present value techniques and determine discount rates.

14. In addition, we think that the following guidance from paragraph B71 should be deleted, given the possible interpretations some stakeholders have raised (see paragraph 3):

> "For example, the entity may need to determine the discount rates applied to cash flows that are expected beyond the period for which observable market data is available using the current, observable market yield curve for shorter durations. Another example would be the estimate of the credit risk premium that is included in the spread of a debt instrument using a credit derivative as a reference point. An entity assesses the extent to which the market prices for credit derivatives includes factors that are not relevant to determining the credit risk component of the market rate of return so that the credit risk component of the overall asset spread can be determined."

Question 1—Adjusting the contractual service margin

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

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

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

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

15. Yes; we agree that, for purposes of profit or loss determination, an appropriately constructed and periodically adjusted contractual service margin would provide more relevant information that faithfully represents the services provided under the contract compared to recognizing the margin estimated when the contract was entered.

Constructing the contractual service margin

16. We think that an appropriately constructed contractual service margin should be adjusted periodically for differences between the current and previous estimates of the present value of:

    (a) the future cash flows related to future coverage and other future services; and

    (b) the future compensation for fulfilling the insurance liability or the changes in risk adjustment relating to future estimates (the risk adjustment).

17. We think that it is not consistent to unlock the contractual service margin for the expected assumptions and not for the risk adjustment, because it is the sum of those two items that defines the fulfillment cash flow used in determining the insurance contract liability.

18. We also do not agree with the IASB rationale that most changes in the risk adjustment would relate to the expiry of coverage (in paragraph BC37) as the changes can also relate to future periods. Experience has shown that, for long-term insurance contracts, changes to the cash flow assumptions regarding future payments can have a corresponding material effect on the risk adjustment.

19. We are concerned that, if the contractual service margin is not adjusted for changes in the risk adjustment related to future compensation the entity requires to fulfill a liability that has uncertain future cash flows, entities would use non-GAAP measures to provide an alternate margin that would better reflect the services being provided under the contract.

Unlocking the contractual service margin

20. We agree that the contractual service margin should be unlocked to report an updated estimate of earnings from providing insurance services over the life of the contract. We also support this approach as it would result in:

    (a) reporting earnings from providing insurance services being reported in a manner similar to how other industries report earnings from providing services; and

    (b) reducing the volatility reported in earnings from changes in future estimates.

21. Most users of financial statements that we consulted preferred this approach as the earnings reported would be more sustainable. A few users expressed concern with unlocking the contractual service margin because the changes in estimates of future cash flows and the risk adjustment would be less transparent than recognizing those changes in profit or loss. Instead, users would need to review the notes to the financial statements to identify and understand the off-setting changes in the different components of the insurance liability reported on the statement of financial position.

Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items ('mirroring approach')
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; (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and (ii) 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?

22. Yes; we agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance when an entity applies the proposed mirroring approach because the insurance liability would be measured at the amount the entity is obligated to pay, being the underlying investment and the income earned from the investment. We also agree that this approach would eliminate accounting mismatches when the terms of the contract mean that the entity will not suffer any economic mismatches.

23. Stakeholders we consulted are concerned that applying the approach would be complex. It would be difficult to assess the contractual and regulatory requirements, and the degree to which management has discretion to determine whether the conditions for applying the mirroring approach are met. It would also be challenging to decompose and track contract

cash flows between those expected to vary directly, vary indirectly, and not expected to vary with returns on underlying items and to apply the different accounting treatments to each. However, on balance, we think that it would be worth the effort.

Expand the scope of the mirroring approach

24. We are concerned that few contracts issued in Canada would qualify. From a practical perspective, we think that amending the guidance on how to determine discount rates and providing an option to use OCI (and perhaps, the hedging proposals, once finalized) may reduce the need for this proposal. On balance, we recommend that the IASB reconsider whether the mirroring approach is useful given the changes that are proposed to other areas of the standard.

25. If the IASB decides to retain the mirroring approach, we recommend that its scope be expanded to include when there is a constructive obligation that binds the entity to pay the policyholder amounts related to underlying items. In such situations, we think that the entity would not expect to suffer any economic mismatches. Constructive obligations bind the entity in a similar manner as contractual and regulatory requirements for the entity would have "no realistic alternative to settling that obligation" to the policyholder for the amounts related to underlying items. Constructive obligations would arise from past actions of the entity that demonstrates that it accepts this responsibility, and as a result, has created a valid expectation on the part of the policyholder that it will discharge that responsibility. Applying the mirroring approach to such arrangements would represent the economic nature of the contract more faithfully.

26. The use of constructive obligations would be consistent with other IFRSs, such as IAS 19 *Employee Benefits* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The use of this concept would be consistent with the intent expressed in the Basis for Conclusions regarding the mirroring approach that:

    > "measurement of an insurance contract should include an unbiased estimate of the cash outflows from the contract that are expected to vary with returns on underlying items. This would be regardless of whether such cash outflows are paid to satisfy a legal *or constructive obligation* arising from the contract that exists at the reporting date, or whether they are paid to current or future policyholders." (paragraph BCA59, emphasis added)

27. An entity would be able to demonstrate the existence of constructive obligations by reference to its published policies, established history of past practice and materials provided to policyholders to market the insurance contract that create a valid expectation that amounts paid would be related to the performance of those underlying items. We think that an entity should be required to disclose the nature and amount of its insurance obligations that are constructive.

28. We would be willing to further develop this proposal, including applying the proposals to Canadian arrangements, to identify and work through possible application concerns.

29. Expanding the scope of the mirroring approach to include arrangements when there is a constructive obligation that links the payments to the policyholder and the returns on those underlying items could result in some participating contracts in Canada qualifying.

Question 3—Presentation of insurance contract revenue and expenses
Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts? Why or why not? If not, what would you recommend and why?

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

31. For reporting revenue earned from property and casualty contracts, we agree that the use of earned premiums as a volume measure in profit or loss is a better measurement than the previously proposed summarized margin approach.

32. For life insurance contracts, we think that the proposal to report the change in the insurance liability as insurance revenue, based on changes in expected cash flows, the risk adjustment and the contractual service margin, is a practical approach to depicting the transfer of services provided by insurance contracts. However, based on feedback we have received from preparers representing life insurance entities, a significant effort is required to make these requirements operational. As such, we think that the IASB should consider simplifying the requirements while maintaining the usefulness of the information to users (see suggested clarification below).

33. The advantage is that it would provide a comparable top line number to report revenue earned on property and casualty contracts and life insurance contracts, especially when an entity sells both types of contracts. In addition, that top line number would be comparable to revenue reported by entities in different industries and enable users of the financial statements to compare more easily the revenue capability of entities across industries. As well, revenue would exclude investment components that are refundable and do not represent funds earned. Many financial statement users we consulted supported this proposal for those reasons.

34. The disadvantage is that the one revenue number will not provide insight into the volume of life insurance business on the face of the statement of profit or loss. For this reason, some analysts that specialize in the insurance industry expressed a preference for the 2010 Exposure Draft proposal to present a summarized margin approach. On the other hand, these users also requested additional volume measures, similar to those provided

by Canadian insurers in supplemental information on Source of Earnings as required by Canada's Office of the Superintendent of Financial Institutions.

35. After discussing the types of disclosures that would be required, many financial statement users we consulted agreed that the financial statement notes would provide informative volume measures, such as premiums and deposits received during the period. These users agreed that the requirements to disclose reconciliations of the opening and closing balances of the insurance liability, contractual service margin and premiums received would provide them with the information to assess the extent of new contracts written and whether they are profitable or not. They also recommended that insurers be required to disclose a maturity analysis for the contractual service margin to assist them in predicting when the unearned services will be provided over the remaining life of the contract. Therefore, we think that it is important that these disclosure requirements be retained and that providing a maturity analysis for the contractual service margin be added.

Clarifying the proposal

36. Through our discussions with the Insurance Accounting Task Force and consultations with other stakeholders, we have learned that there is confusion regarding how insurance contract revenue should be calculated under the building block approach. They are concerned that the cost and effort to calculate insurance contract revenue would be high because identifying and supporting the change in the components that comprise revenue would be judgmental and a time-consuming process. In discussions with and presentations by the IASB, revenue is to be derived from the change between opening and closing balances of the insurance contract liabilities, plus cash premiums received and the interest accretion on the opening liability, and less repayments.

37. While calculating revenue in the manner described would seem to provide a practical way to determine the amount of insurance coverage and service an entity provided in the period, we think that the IASB should consider simplifying the requirements.

38. At a minimum, we recommend that paragraph B90 be revised to explain the mechanics of how insurance contract revenue is to be derived, rather than expressing it as a sum of the resulting components. In addition, we recommend that the "repayments of investment components" be clarified. The expected amount of repayments on outstanding contracts can vary period to period. In discussions with the IASB staff, it was clarified that repayments refer to the investment component of policies terminated in the period. Repayments include cash surrender values paid and any other repayments that a policyholder was entitled to and obtained regardless of whether the insured event occurs or not. Paragraph B90(a) should describe the meaning of repayments, as described above.

Question 4—Interest expense in profit or loss

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

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

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

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

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

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

39. Yes; we agree with the proposal to segregate the effects of underwriting performance from the effects of the changes in the discount rates and present those interest rate changes in OCI from a practical perspective. A majority of users of financial statements we consulted expressed the view that the interest expense from insurance obligations is a cost of providing insurance coverage and should be reported in profit or loss. While we concur with that view from a conceptual perspective, we think that the use of OCI provides a practical approach that would facilitate the change to discounting insurance liabilities using a current rate.

40. We think that the proposal for recognizing interest expense in profit or loss and other comprehensive income would help to reduce accounting mismatches that arise from how insurance liabilities and the assets backing those liabilities are presented. In particular, this proposal would be effective when accounting for property and casualty contracts in Canada as these contracts are often matched with investments in bonds that are measured at fair value through other comprehensive income. The use of other comprehensive income to report changes in and discounting using a current market rate is similar to the additional information many Canadian property and casualty insurers provide in their Management, Discussion and Analysis (management commentary). These insurers quantify the effect of the change between the rate used at the end of the prior year and the current year rate.

41. However, we have concerns with how this proposal would affect the accounting for entities with long-duration life insurance contracts and other contracts that are backed by assets that an entity cannot elect to remeasure through other comprehensive income. The

mandatory use of other comprehensive income for a portion of the interest cost on insurance liabilities would mean mandatory accounting mismatches.

Irrevocable option to use OCI

42. Many Canadian entities have portfolios of long-duration contracts and invest in a variety of asset types for which the change in fair value is reported in profit or loss. Thus, the ability to elect the optional treatment and report the effect of changes in the discount rate on liabilities between the current and the locked-in rate either in OCI or in profit or loss would help to reduce additional accounting mismatches. Therefore, we recommend that the use of OCI should be permitted, not mandatory, when accounting for the difference between the current and the locked in discount rate through profit or loss would reduce an accounting mismatch.

43. The proposed new standard should include an irrevocable option to designate by portfolio of insurance contracts whether to classify the interest expense on that portfolio through profit or loss, when doing so eliminates or significantly reduces a measurement inconsistency that arises when measuring financial and non-financial assets at fair value through profit or loss and those assets back the insurance liabilities.

44. We recommend that such an option should be irrevocable to preserve the integrity of the reported results and to provide a straight-forward approach to using the option. Permitting an option to be applied by portfolio of insurance contracts would be subject to internal controls over financial reporting requirements in Canada.

45. On balance, we think that it is better to reduce the occurrence of accounting mismatches and operational complexity. It would also better reflect how companies manage their portfolios of contracts. We recognize that it may make it more difficult to assess the investing performance of the entity as the interest expense on insurance liabilities would report the interest expense measured using both cost-based and current market discount rates. To assist users of financial statements in making that assessment, an entity could be required to disclose the extent of interest expense reported at a current rate in profit or loss when significant.

46. Providing such an option would make it more difficult to compare different entities' financial statements, as they may account for their interest expense on insurance contracts differently depending on how they invest. The additional disclosure proposed in the paragraph above would identify the effect of the differences in approaches used and allow for better comparison between insurers by users. This option would also be consistent with other options provided in IFRS 9 and IAS 39, both in approach and effect. That is, other options are provided in IFRS to reduce accounting mismatches even though they may reduce comparability among entities.

Consider an opposite approach

47. In standing back and assessing the overall approach of using OCI and providing an irrevocable option to not use it, we think that the IASB should consider the opposite

approach. Instead, entities should be required to report interest expense on insurance liabilities in profit or loss and have an option to report the effect of changes in the discount rate on liabilities between the current and the locked-in rate in OCI. We think that such an option should be permitted when doing so eliminates or significantly reduces a measurement inconsistency that would arise when measuring financial and non-financial assets at fair value through OCI and those assets back the insurance liabilities. The option should be irrevocable and designated by portfolio of insurance contracts for the reasons explained previously.

48. Such an approach would be simpler and less costly to implement. From a conceptual perspective, it identifies that the interest expense on insurance liabilities is a key business cost that should be reported in profit or loss as noted by the users we consulted. Thus, the option becomes the practical concession. We think that it would achieve the same overall result as requiring the use of OCI and providing an irrevocable option.

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

Transition

49. Yes; we agree that the proposed approach to transition appropriately balances comparability with verifiability. We think that the change from the 2010 Exposure Draft to allow for retrospective application will result in a more faithful representation of insurance liabilities.

50. During our consultations, several stakeholders expressed concerns about the complexities and cost of applying the new standard retrospectively as proposed. Preparers and auditors, who are in a better position to judge those complexities, may propose alternative ways to implement the new standard. While we support the IASB in considering options proposed to reduce the cost of implementing the standard for the first time, we think that the proposed new standard must be implemented on a retrospective basis and result in providing restated comparative information.

Effective date

51. We are concerned that this standard will be effective at a different date than IFRS 9 *Financial Instruments*. Many entities might have to designate and redesignate a significant amount of their financial assets in quick succession that would lead to increased costs for entities that issue life insurance contracts and would also confuse the users of their financial statements.

52. Insurance Accounting Task Force members have explained that adopting IFRS 9 at an earlier date than the proposed new standard would have a minimal impact on income in

Canada as any changes to the measurement of financial assets would be offset by corresponding changes to the insurance liability given the Canadian practice of measuring the insurance cash flows based on the measurement of the assets backing those liabilities. Yet, the cost and effort to redesignate financial assets would be significant. We think that the effort and resources should be directed to adopting the new standard on insurance contracts.

53. We recommend that the IASB minimize these costs and concerns by setting the same effective date for IFRS 9 and the new insurance standard and also allow for early application, if the two standards will be issued in close succession. By allowing early application, entities in other industries or entities that issue insurance contracts and expect not to redesignate a significant amount of financial assets upon adoption of the new insurance standard would still be able to apply IFRS 9 and benefit from it as soon as it is available. Early adoption of IFRS 9 would allow entities to implement the revised hedging requirements. It would also allow entities with property and casualty contracts to report market changes on financial assets held to collect principal and interest and for sale at fair value through OCI.

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.

Standard as a whole

54. When considering the proposed standard as a whole, we have mixed views on whether the costs of complying with the proposed requirements justify the benefits that the information would provide.

55. Based on discussions with Canadian preparers and auditors, we think that the benefits the information would provide would exceed the costs of applying the proposals to property and casualty contracts. The proposed standard, including the proposal to report the effects of changes in the discount rate in OCI, would result in reporting property and casualty contracts in an improved manner in financial statements yet consistent with how many explain these changes in Canada today.

56. The proposed standard would significantly change how life insurance contracts are accounted for in Canada compared to existing practices. While the Canadian asset and liability method shares some attributes with the measurement model in the proposed standard, life insurance liabilities would be required to be measured without reference to the expected performance of the assets that back those liabilities. We think that the proposed standard would result in a more transparent reporting of an entity's investment and underwriting activities but we recognize the extent of the costs that preparers, auditors, regulators and users would incur.

57. On the other hand, we note that current Canadian accounting practices for insurance contracts have resulted in Canadian stakeholders developing, and having experience in applying, complex measurement models to determine a current measure of their insurance liabilities. Therefore, we think that it would be less costly and not as difficult for entities in Canada to apply the new standard compared to entities in other jurisdictions that have been using cost-based methods to measure their insurance liabilities.

58. We think that implementing accounting requirements that would result in earnings from insurance contracts being reported in a similar manner globally would result in benefits that outweigh the costs.

59. While the proposals were developed to report economic results, there are a number of different requirements that, when applied together, may make it difficult to account for insurance contracts. We are concerned that until the requirements are applied, implementation challenges may not be identified. Therefore, we recommend that the proposals should continue to be reviewed and tested throughout the completion of the project by preparers, actuaries, auditors and regulators.

60. The IASB should make available publicly an updated draft of the standard upon completing the redeliberations of a section and a complete review draft to enable a broad group of stakeholders to continue to assess the proposals. Continuing to subject the proposed new standard to on-going scrutiny would help to identify additional issues and unintended consequences and enable the IASB to respond to those concerns in an orderly manner. Such efforts would facilitate and enhance the quality of how the standard is applied for the first time.

61. Entities would need to prepare for the implementation early given the changes stakeholders have identified, such as expected changes required to contract management systems, measurement methodologies and corresponding internal controls processes over financial reporting.

Supporting a global implementation

62. While we agree that the adoption and application of the new standard around the world would improve global financial reporting by providing a consistent basis to account for insurance contracts, we think that the IASB and FASB should establish a joint implementation committee to support achieving that objective. Such a committee would

help by working with the actuarial community and others to develop supporting guidance and educational material, and by considering implementation issues that arise.

63. Similar committees were effective in supporting and helping the implementation of IAS 19 *Employee Benefits* and the Canadian standard on insurance when the model was first introduced and represented a significant change from prior practices. The committee could be developed based on the joint transition resource group the IASB and FASB are forming to support the transition to the new converged standard on revenue recognition. It would be through such efforts and IASB responses to interpretation concerns that the range of practices can be narrowed and a higher degree of comparability across and within jurisdictions achieved.

2013 proposals

64. Compared to the 2010 Exposure Draft, we support the 2013 proposals and think that:

(a) unlocking the contractual service margin would be beneficial (see response to question 1).

(b) providing a mirroring approach may provide benefits that exceed the costs for the contracts that qualify. However, we think that the IASB should assess the need for the mirroring approach given the other amendments being proposed to the standard. If the IASB decides to retain the mirroring approach, the overall benefit could be increased if the scope of the requirement is expanded to include arrangements when the entity is bound to pay the policyholder amounts related to underlying items and would not suffer any economic mismatches (see response to question 2).

(c) reporting revenue on an earned premium basis is a practical approach for preparers to implement that with further simplifications would provide a consistent basis for a wide range of users to compare the earnings from different types of insurance contracts and from different industries. Users would need to review the notes to financial statements for information about risk and uncertainties of those contracts, and to assess the volume of new business written, such as premiums and deposits received during the period. Therefore, we think that reporting revenue on an earned premium basis would be beneficial (see response to question 3).

(d) reporting the effects of changes in the discount rate in OCI would provide a practical approach that would facilitate the change to discounting insurance liabilities using a current rate. However, we recommend that reporting the effects of changes in the discount rate in OCI should not be mandatory when reporting interest expense through profit or loss would reduce an accounting mismatch (see response to question 4).

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?

65. While we agree that the proposals are generally drafted clearly and reflect the decisions made by the IASB in many areas, we think that the following areas warrant additional clarification.

One global standard

66. There are many differences between the words used in the IASB's and FASB's proposals when the concepts are similar. When the words are different, preparers, auditors and regulators tend to think that the words are meant to imply a different meaning, increasing the chances of these standards being interpreted differently. We recommend that the Boards should explain in their bases for conclusions when they intended the concepts to be the same and not result in application differences.

Determining portfolios of insurance contracts

67. We agree with requiring an entity to apply its judgement when determining "a group of insurance contracts that provide coverage for similar risks and that are priced similarly relative to the risk taken on" (part (a) of the definition of a portfolio of insurance contracts in Appendix A). We are concerned with the interaction of that requirement with the second requirement that the group of insurance contracts "are managed together as a single pool" (part (b) of the definition).

68. Stakeholders we consulted described their current practice of managing a group of contracts at a higher level than the IASB might have intended. The difference was highlighted when discussing the interaction of the definition of the portfolio and identifying when a contract is onerous. For example, if a portfolio of contracts is in an onerous position, some Canadian stakeholders would add new contracts that provide similar insurance coverage and have been priced in a similar manner as they would be managed together, which would have the effect of potentially avoiding recognition of a loss on that portfolio.

69. The determination of a portfolio is critical to the implementation of the standard. It determines the unit of account for measuring insurance liabilities and could result in different entities and entities within different jurisdictions applying the guidance differently.

70. We think that further consultations are needed to understand how entities manage portfolios of contracts and how those practices would affect the determination of portfolios. The IASB, possibly in consultation with a joint implementation committee, should consider these operational implications and assess whether additional guidance on how to apply the portfolio definition is needed.

Determining discount rates

71. Refer to the recommendation to amend and provide more guidance on how to determine rates to discount long-term obligations in which there are periods of time when there are few or no observable market rates (see paragraphs 1 to 14 in the Appendix).

Determining revenue

72. Refer to the recommendation to clarify how revenue from insurance contracts when applying the building block approach should be calculated in the response to question 3.

Reinsurance

73. Some reinsurance contracts issued in Canada only have lapse risk; however lapse risk is not within the proposed definition of insurance. We think that the IASB did not intend to exclude these contracts from the standard. Therefore, we think that lapse risk should be added to the list of risks within the definition of insurance to avoid any unintended consequences.

Mutual entities

74. We recommend that the Basis for Conclusions clarify the effect on equity of when insurance contracts provide policyholders with the right to participate in a portion of the surplus, not the whole surplus, to avoid any unintended consequences. For example, the Basis for Conclusions could be revised as follows;

BCA62 Some insurance contracts that specify payments to policyholders based on underlying items are issued by mutual entities, while others are issued by investor-owned entities. The IASB has identified no reason to adopt different treatments for these contracts on the basis of the legal form of the issuer. This means that, if the contract provides policyholders with the right to participate in the whole of any surplus of the issuing entity, there would be no equity remaining and no profit reported in any accounting period. <u>In other cases, the contract may provide the policyholder with a distribution fixed in the contract, or set at the discretion of the entity, so that only a portion of the entity's surplus is required or expected to be distributed to policyholders.</u> In the FASB's approach, a mutual entity treats as equity an amount of surplus that the entity does not have the obligation or intention to pay out in fulfilling the insurance contract obligations. The FASB believes that this approach is consistent with its treatment of the cash flows resulting from any other entity's discretionary participation features (that is, to include only cash outflows that an entity will incur to directly fulfil its obligation to the policyholders). In addition, the FASB believes that presenting the amounts the entity is obligated and intends to pay its policyholders as a liability, and this 'notional' surplus that it is not obligated and does not intend to pay to policyholders as equity, would provide more useful information to users of the financial statements of mutual entities and would be more comparable to other entities that issue similar insurance contracts.