Project **Insurance Contracts**

Topic **Transition**

Purpose of this paper

1. This paper addresses the proposed transition requirements for a forthcoming Exposure Draft (ED) on Insurance Contracts.

2. This paper does not address effective date, nor does it consider whether early adoption should be permitted. For the standards to be completed by 30 June 2011, the boards plan to consider collectively effective dates and whether to permit early adoption. In developing the requirements published on November 2009 in IFRS 9 *Financial Instruments*, the IASB noted that it would consider delaying the effective date of IFRS 9 if the new IFRS on insurance contracts has a mandatory effective date later than 2013, so that an insurer would not have to face two rounds of changes in a short period.

Summary of staff recommendations

3. The staff recommend the following:

   (a) An insurer should apply the standard at the start of the earliest period presented. At that date, the insurer should, for the contracts already existing at that date, determine the expected [probability weighted] present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment]. The insurer should compare that amount with the amount recognised at that date using the insurer's previous accounting policies:

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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(i) If the second of those amounts (ie the amount recognised under the previous accounting policies) exceeds the first amount (ie expected cash flows plus, if applicable, a risk adjustment), the insurer should treat the difference as the [residual margin] [composite margin] at that date.

(ii) If the first of those amounts (ie expected cash flows plus, if applicable, a risk adjustment) exceeds the second amount (ie the amount recognised under the previous accounting policies), the insurer should recognise that difference by reducing opening retained earnings at that date.

(b) In determining the amount recognised at the beginning of the earliest period presented, the insurer should deduct any intangible assets that were recognised in business combinations and relate solely to existing insurance contracts, rather than possible future contracts, and any deferred acquisition costs.

(c) Insurers should be exempted from disclosing previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed standard.

(d) When an entity issuing insurance contracts adopts the standard on insurance contracts, this standard should permit the entity to redesignate a financial asset as measured at fair value through profit or loss at the start of the earliest period presented if doing so would eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

(e) The proposed transition summarised above would apply equally to insurers already applying IFRSs or US GAAP, and to insurers adopting IFRSs for the first time.

Structure of the paper

4. The paper is organised as follows:

(a) Application of transitional models to insurance accounting (paragraphs 5-7).

(b) Measurement-related transition issues for insurance contracts (paragraphs 8-26):

(i) Determination of Residual and Composite margins on transition (paragraphs 11-18).

(ii) Treatment on transition date of intangibles arising from a business combination (paragraphs 19-20).

(iii)Treatment on transition date of deferred acquisition costs (paragraphs 21-26).

(c) Transition disclosures (paragraphs 27-29):

(i) Disclosures about the effect of the change in accounting policy (paragraph 27).

(ii) Transitional disclosure reliefs (paragraphs 28-29).

(d) Reclassification of financial assets(paragraphs 30- 34).

(e) First time adopters (IASB only) (paragraphs 35-36).

Application of transitional models to insurance accounting

5. The two basic transitional models are usually referred to as 'full retrospective application' and 'pure prospective application'. Under the former, all prior periods are restated as if the new accounting policy has always been applied; it presents the major advantage of providing, after transition, comparable financial information across time, but it may be impracticable to apply because, for example, it may imply an excessive use of hindsight and may imply undue costs and efforts. The latter model applies the new accounting policy only to contracts issued on or after the effective date ('new transactions'); its main advantage is that it can be easily implemented, but it does not provide comparable information and does not apply the new accounting policy to contracts issued before the effective date and still open after that date ('open contracts').

6. Staff believe that practicability concerns may arise if a full retrospective model is applied to the proposed accounting for insurance contracts, especially with respect to the residual and composite margins. On the other hand, because a pure prospective model would apply the new accounting policy only to new contracts (occurring on or after the effective date), that would exclude a significant piece of comparative information for a possibly extended period (eg level payment life insurance contracts).

7. Because it would be a practical approach that still would provide relevant (comparative) information, staff recommend a retrospective model, with some modifications that we will discuss below (see paragraphs 8-26).

Measurement-related transition issues for insurance contracts

8. Both in the dual margin (risk adjustment and residual margin) and in the composite margin versions, the proposed measurement model for insurance contracts combines:

   (a) a current measurement (the expected present value of future cash flows and, if any, the risk adjustment); and

   (b) an allocation component (for the residual or composite margin).

9. The current measurement component under (a) does not pose any major challenges on the date of transition. All components of that measure reflect circumstances at that date and do not incorporate historic inputs.

10. On the other hand, transition issues could arise from the allocation component under paragraph 8(b). The determination of the residual or the composite margins aims to eliminate, at the date of inception (and based on the circumstances existing at that time), any gains arising from an insurance contract. To perform this *calibration exercise* at a later time (after the inception date) would necessarily generate a practical issue: *how does an entity determine the residual or composite margins on transition?*

Determination of Residual and Composite margins on transition

11. We identified three alternative approaches for determining the residual and composite margins on transition:

    (a) Set the [residual margin] or [composite margin] to nil.

    (b) Determine the [residual margin] or [composite margin] by (i) determining the [residual margin] or [composite margin] as if it were calculated at inception of the contract; and (ii) decreasing it by the cumulative amortisation at transition date.

    (c) Use the existing measurement of items related to insurance contracts under the insurer's previous accounting policies as the calibration point for the [residual margin] or [composite margin] on transition.

12. In practice, the alternative under (a) would not provide trend (comparative) information about residual / composite margins; while the approach under (b) would sometimes be impracticable or cause excessive cost (some insurance contracts are decades old).

13. Instead, the approach under (c) seems to be a more practical alternative that could be seen as being consistent with eliminating any gains at issue of the contract using a proxy for the

residual or composite margins as if they were calculated at inception of the contract. This proxy is determined as the difference between:

(a) the carrying amount of items related to insurance contracts under the insurer's previous accounting policies (including insurance liabilities and, as discussed in paragraphs 19-25, acquisition costs and intangible assets relating to existing insurance contracts); and

(b) the current measurement derived from the application of the first two (IASB: three) building blocks (ie expected cash flows, time value of money and, if applicable, a risk adjustment).

14. The following highly simplified example illustrates approach (c) (showing the results both under a risk adjustment plus residual margin approach and under a single composite margin approach).

15. <u>Example 1</u>– The fact pattern on transition date is the following:

(a) Amount resulting from the measurement of the insurance liability under the insurer's previous accounting policies: CU500.

(b) Estimate of the expected present value of future cash flows: CU350.

(c) Estimate of the risk adjustment: CU100 [for a model with a separate risk adjustment only].

(d) No deferred acquisition costs or intangible assets (we discuss this separately in paragraphs 19-26).

The **residual margin** on transition date would result as the difference between (a) and the sum of (b) and (c): [500-(350+100)] = CU50.

The **composite margin** on transition date would result as the difference between (a) and (b): (500-350) = CU150.

16. The example above shows a 'positive' difference. However, the calibration performed on transition could also result in a negative amount. Because under the boards' tentative decisions the residual and the composite margin cannot be negative, this effect of the change in accounting policy should be recognised in opening retained earnings.

17. This exercise may result in negative differences for some portfolios and positive differences for other portfolios. It would be unreasonable – and not generate useful information – to require an insurer to recognise all the negative differences immediately (as

a reduction in retained earnings) if the insurer must defer the positive differences as a residual or composite margin. A reasonable approach would be to reduce retained earnings immediately only if the aggregate difference for the whole entity is negative. If the aggregate difference is positive, it should be allocated across all those portfolios for which the difference is positive. Table 1 below presents a simple example where on transition date an entity has three portfolios, of which one presents a negative difference while the others show positive differences:

Table 1

Portfolio	Difference arising on transition date	**Cross-portfolio allocation (pro rata) of the transition difference**
A	+40	**48*(40/[40+20])=32**
B	+20	**48*(20/[40+20])=16**
C	-12	**0**
Total	48	**48**

Under the proposed approach, the negative difference on portfolio 'C' is allocated pro rata and 'absorbed' by the positive differences on portfolios 'A' and 'B'.

18. On the basis of the considerations in paragraph 11-17, staff recommend applying the following treatment at the beginning of the earliest period presented. The insurer should determine the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment]. The insurer should compare that amount with the amount recognised at that date using the insurer's previous accounting policies:

    (a) If the second of those amounts (ie the amount recognised under the previous accounting policies) exceeds the first amount (ie expected cash flows plus, if applicable, a risk adjustment), the insurer should treat the difference as the [residual margin] [composite margin] at that date.

    (b) If the first of those amounts (ie expected cash flows plus, if applicable, a risk adjustment) exceeds the second amount (ie the amount recognised under the previous accounting policies), the insurer should recognise that difference by reducing opening retained earnings at that date.

Question 1
Do the boards agree with the staff's recommendation?

Treatment on transition date of intangibles arising from a business combination

19. IFRS 4 requires an expanded presentation for insurance contracts assumed in a business combination[1]. That presentation reports an intangible asset that is, in substance, part of the measurement of the insurance liability. Insurers often describe this intangible asset by names such as the present value of in force business (PVIF), present value of future profits (PVFP or PVP) or value of business acquired (VOBA). (That intangible asset does not include other intangible assets such as customer relationships and customer lists because that intangible asset relates to future contracts. Those other intangible assets are therefore not affected by transition.) For example, suppose the amount resulting from the measurement of the insurance liability under the insurer's previous accounting policies was CU520 and the measurement of the intangible assets was CU20 at that date, then the measurement of the insurance liabilities would be treated as CU500 (CU520 – CU20).

20. Staff recommend merging this intangible asset with the insurance liability, before applying the treatment described in paragraph 13.

Question 2
Do the boards agree with the staff's recommendation?

Treatment on transition date of deferred acquisition costs

21. A related issue is the treatment of the existing balance of deferred acquisition costs (DAC) that insurers may have recorded under previous accounting policies. The proposed measurement for insurance contracts does not include any similar deferral of acquisition costs, which would instead be expensed as incurred. Under many existing accounting models, the recoverability of DAC balances is linked to the assessment of future cash flows arising from insurance liabilities. Therefore, an intuitive approach to deal with DAC on transition is to incorporate it in the determination of the residual or composite margins. The following example illustrates this approach, using the same fact pattern as in Example 1, except that the measurement of the insurance liability is CU520 (not CU500) and there is a DAC balance of CU20.

22. Example 2 – The fact pattern on transition date is the following:

    (a) Amount resulting from the measurement of the insurance liability under the insurer's previous accounting policies: CU520.

[1] IFRS 4, paragraph 31.

(b) **DAC balance amount: CU20.**

(c) Expected present value of cash flows: CU350.

(d) Risk adjustment: CU100 [for a model with a separate risk adjustment only].

As shown in table 2, the **residual margin** on transition date would result as the difference between: (i) the difference between the amounts under (a) and (b); and (ii) the sum of the amounts under (c) and (d). The **composite margin** on transition date would result as the difference between: (i) the difference between the amounts under (a) and (b); and (ii) the amount under (c).

Table 2

Inputs Description	**Residual Margin**	**Composite Margin**
Insurance liability	**+520**	**+520**
DAC balance	**- 20**	**- 20**
Cash flows:	**-350**	**-350**
Risk adjustment	**-100**	**-**
Residual margin/ Composite margin	**CU50**	**CU150**

23. This approach would be consistent with the IASB's tentative decision to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. [Though the IASB's decision focuses on incremental acquisition costs, it does not seem practical to make the distinction between incremental acquisition costs and other acquisition costs for transition purposes]. This approach is also consistent with the recommended treatment of intangibles recognised in a business combination as a result of the expanded presentation (see paragraph 19).

24. Another approach would be to write off any DAC balance against opening retained earnings on transition date. This would be consistent with the FASB's tentative decision to expense all acquisition costs and not recognize any revenue (or income) to offset those costs incurred.

25. We could ask the boards to select between an approach that excludes from the residual or composite margin on transition an amount equal to the DAC (consistent with the IASB's view on treatment of acquisition costs) and an approach that writes off any DAC balance

against opening retained earnings on transition date (consistent with the FASB's view on treatment of acquisition costs).

26. However, a third way of looking at the issue is, for the purpose of transition, to consider the nature of the DAC balances under existing accounting models, separately from the boards' views on how they would treat of acquisition costs under the insurance contracts model after transition. Under many existing accounting models, DAC was capitalised to the extent it was recoverable from future premiums resulting from the insurance contract (see, for example, ASC Topic 944-30-30-2 *Financial Services—Insurance - Acquisition Costs - Long-Duration Contracts* under US GAAP). Therefore, DAC arguably is an item that, under previous accounting models, did not exist in isolation from the insurance contracts. It seems to be inconsistent to consider some previous balances relating to insurance contracts in determining the transition effects, but not others . Staff concludes that such an inconsistent treatment of previous balances would lead to overstated transition effects and therefore recommends to incorporate the amount of any DAC balance on transition in the determination of the residual or composite margins.

Question 3
Do the boards agree with the staff's recommendation?

Transition Disclosures

Disclosures about the effect of the change in accounting policy

27. Existing disclosure requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and FASB ASC Subtopic 250-10-50 *Accounting Changes and Error Corrections - Disclosure* already provide a comprehensive set of disclosure requirements that describe the effect of the application of a new accounting policy, therefore staff do not recommend any additional disclosure requirements on the date of transition.

Transitional disclosure reliefs

28. However, a transitional relief may be appropriate for one specific disclosure required by paragraph 40 of IFRS 4 and which is also included in the proposed disclosures for the forthcoming ED on Insurance Contracts. This requirement refers to the presentation of a claim development table that "shall go back to the period when the earliest material claim

arose for which there is still uncertainty about the amount and timing of the claims payments, but need not got back more than ten years".

29. Staff believe that it could be impracticable for some entities to comply with this requirement and therefore recommend an exemption similar to the exemption in paragraph 44 of IFRS 4. This would exempt an insurer from disclosing previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed standard.

Question 4
Do the boards agree with the staff's recommendations?

Application of IFRS 9 and reclassification of financial assets

30. One additional aspect that deserves specific consideration relates to the classification of financial assets when an insurer applies the requirement under IFRS 9 before applying the requirements under the future insurance standard ('Phase II' of IFRS 4). In October 2009 the IASB discussed possible transitional insurance issues in relation to IFRS 9 and tentatively decided to consider, in developing the transitional requirements for a future insurance contracts standard, whether to create a transitional option for an insurer to revisit the classification of financial assets when the insurer adopts the future insurance contracts standard (IFRS 4 already includes a similar option for almost the same reasons). This paper now provides a basis for the boards to consider that issue at this meeting.

31. Because the current version of IFRS 4 permits a wide range of accounting practices to continue and, although some insurers measure insurance liabilities on a current value basis, many other insurers use approaches that are closer to a cost basis. In order to avoid accounting mismatches in profit or loss, many insurers applying IAS 39 classify many of their financial assets as available for sale.

32. Similarly, if insurers choose to adopt IFRS 9 before they adopt the new IFRS 4, some of them may wish to classify some of their financial assets, where allowed, at amortised cost rather than at fair value through profit or loss. However, the proposed model for the future IFRS on insurance contracts is a current value with all remeasurements recognised in profit or loss. Thus, when those insurers later adopt the new IFRS 4, they may wish to use the fair value option for those assets. This may help them to avoid accounting mismatches.

33. Similar considerations would apply if an insurer adopts the FASB's proposed standard on financial instruments and classifies some of its financial assets as at fair value through other comprehensive income, and subsequently wishes to reclassify them to fair value through profit or loss when it adopts the standard on insurance contracts.

34. Therefore staff recommend that an entity issuing insurance contracts should be permitted, but not required, when it adopts the future insurance contracts standard, to redesignate a financial asset as measured at fair value through profit or loss at the start of the earliest period presented, if doing so would eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. The entity should recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.

Question 5
Do the boards agree with the staff's recommendation?

First time adopters (IASB Only)

35. Staff believe that no specific reasons exist that justify a different treatment on transition for first time adopters of IFRSs, compared to the arrangements provided for entities that are already IFRSs or US GAAP compliant; the existing IFRS 4 already contains a similar provision.

36. Therefore staff recommend that the proposed transition summarised above would apply equally to insurers already applying IFRSs or US GAAP, and to insurers adopting IFRSs for the first time.

Question 6
Does the IASB agree with the staff's recommendation?