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| Project | **Insurance Contracts** |
| Topic | **Transition** |

## Purpose of this paper

1. In this session, the staff would like to discuss the transitional requirements in the Exposure Draft (ED) *Insurance Contracts*.

2. We would also like to ask working group participants how long they expect it would take to implement a new standard on insurance contracts.

3. This paper does not discuss:

   (a) transitional requirements for assets backing insurance contracts.

   (b) disclosures about transition.

## The proposals in the Exposure Draft

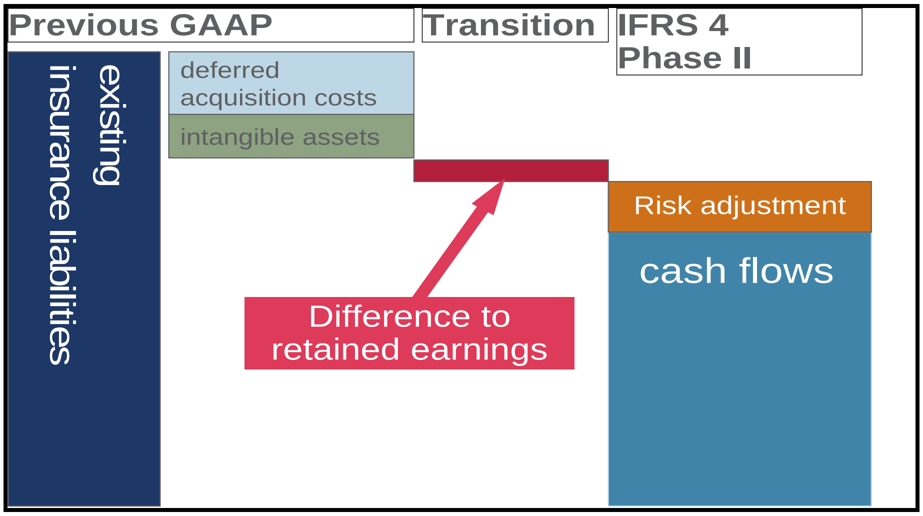
4. The ED requires that (extracts from paragraph 100):

At the beginning of the earliest period presented, an insurer shall, with a corresponding adjustment to retained earnings:

(a) measure each portfolio of insurance contracts at the present value of the fulfilment cash flows. It follows that for insurance contracts to which these transitional provisions are applied, the measurement, both at transition and subsequently, does not include a residual margin.

This requirement is illustrated in Figure 1.

**Figure 1**




5. We do not envisage any specific transitional problems for entities in determining the present value of the fulfilment cash flows, provided that the Board allow for sufficient lead time for entities to set up their information systems and other resources. That measurement is current and reflects circumstances at the measurement date. Therefore performing that direct measurement on transition to the new model will be no more difficult than performing that measurement for a later date. However, the Board were concerned that it would be difficult to determine the residual margin on transition date for the following reasons (extracts from paragraphs BC247 and BC248 of the Basis for Conclusions):

   (a) In principle, the insurer would need to estimate the future cash flows as it would have estimated them at initial recognition of the contracts. That exercise may be burdensome and costly and is subject to bias through the use of hindsight.

   (b) IAS 8 *Accounting Policies, Changes in Estimates and Errors* prohibits the retrospective application of an accounting policy to the extent that this would be impracticable, as defined in IAS 8. The Board concluded that retrospective determination of the residual margin would sometimes be impracticable in that sense and, if not impracticable, it would often cause costs disproportionate to the resulting benefit for users.

6. Accordingly, the exposure draft proposes that an insurer should, on first applying the new IFRS, measure its existing contracts at that date by setting the residual margin equal to zero.

## The alternative models

7. In developing the exposure draft, the Board considered whether to set the residual margin at the date of transition as equal to the difference between (a) the carrying amount of the insurance liability as determined at transition using the existing measurement approach; and (b) the present value of fulfilment cash flows at that date, if that difference was greater than zero. If the difference was less than zero, there would be no residual margin, because the residual margin cannot be negative.

8. For example, if the carrying amount at transition is CU100[1] using the existing measurement approach and the present value of fulfilment cash flows at that date is CU95, the residual margin would be set at CU5.

9. However the Board rejected this approach because the residual margin derived on transition date would not be comparable with the residual margins that would be determined at future dates and would have depended significantly on the pattern of income recognition under previous accounting models, which are not uniform.

10. The staff also intend to consider over the coming months the following alternatives that we identified during outreach activities:

    (a) Permitting or requiring a full retrospective application provided that it is practicable.

[1] CU = currency units

(b) Permitting or requiring a full retrospective application in selected cases where, although practicable, a retrospective application does not pass the cost-benefit test.

| **Question 1** |
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| Do you agree that a fully retrospective determination of the residual margin would sometimes be impracticable and, if not impracticable, would cause costs disproportionate to the resulting benefits for users? Why or why not?<br><br>If not, for which insurance contracts would a fully retrospective approach be appropriate? Why?<br><br>Should the fully retrospective approach be permitted or required? |

| **Question 2** |
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| Do you suggest any other transitional approaches? What are the advantages and disadvantages of these approaches? |

## Time needed to implement a new standard

11. On 19 October the IASB and the FASB each published documents seeking views on when new financial reporting standards resulting primarily from their work to improve and achieve convergence of International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) should become effective. Comments are requested by 31 January 2011.

12. When finalising an IFRS, the IASB will identify a date from which entities will be required to start applying the new requirements (known as the effective date). This date is normally at least 12-18 months after the date the IFRS is published, allowing time for entities to prepare for the change and for jurisdictions to implement the IFRS into their legal or regulatory regime. However, for complex projects such as insurance contracts, the IASB would consider allowing more time.

| **Question 3** |
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| How long do you think the Board should allow for entities to implement a new standard on insurance contracts? Please explain the considerations the Board should consider in setting the effective date. |