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Insurance working group

Project	**Insurance contracts**		
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Introduction

1. When an insurer adopts the proposed IFRS, it would need to measure the insurance contract liabilty at the date of transition. In principle, a new IFRS should be applied retrospectively, ie as if that IFRS had always been applied, except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change. IAS 8 *Accounting Policies, Changes in Estimates and Errors* states that it is impracticable to apply a change in accounting policy retrospectively if:

   (a) The effects of the retrospective application or retrospective restatement are not determinable;

   (b) The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

   (c) The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

      (i) Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosud; and

(ii) Would have been available when the financial statements for that prior period were authorized for issue

from other information.

2. IAS 8 further requires that:

(a) When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilties as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.

(b) When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

Implications for transition to the proposed IFRS for insurance contracts

3. As explained in the Basis for Conclusions to the ED (reproduced in the appendix), we do not expect that there would be difficulties in retrospective determination of the present value of fulfilment cash flows at the date of transition. All components of the present value of fulfilment cash flows reflect circumstances at that date and do not incorporate historic inputs.

4. In contrast, the determination of the residual margin could be more burdensome and subject to bias and unacceptable use of hindsight. In principle, the insurer would need to estimate the future cash flows as it would have estimated them at initial recognition of the contracts and update the residual margin so-determined for the changes in estimates of future cash flows that occurred before the date of transition.

5. As a result, the question of how to measure the insurance contract liabilty at transition is mainly a question of how to estimate the residual margin on transition.[1]

6. We note that other questions about transition remain, notably:

   (a) How to determine the amount accumulated in other comprehensive income on transition.

   (b) What discount rate should be applied to existing contracts after the date of transition for determining the interest expense in profit and loss after the date of transition.

   (c) Whether to permit an insurer, at the date of transition, to reclassify financial asssets or investment property that it holds to back insurance contracts (eg to reclassify those assets from one measurement catgory – such as fair value through profit or loss, fair value through OCI or amortised cost – into another measurement catgeory).

   (d) Transitional disclosures, for example whether there is a need to require separate disclosure for pre-transition contracts of the residual margin and its release. Such disclsoures depend on the extent of simpliciation and the differences between the approaches before or after transition.

   (e) How to co-ordinate the transition with transition for other new and forthcoming IFRSs, particular IFRS 9 *Financial Instruments.*

7. However, answering these questions requires that the amount of the residual margin on transition is determined as a first step and so this paper focuses on that question.

8. In addition, the Board will need to consider whether to require comparative information when the new IFRS is first applied. That assessment requires the Board to strike a balance between the conceptually preferable method of requiring full comparative information for all years presented and the practicabilty of adopting a new standard within a limited time frame. Therefore the Board will consider that question when it sets the effective date of the new IFRS.

[1] The same issue also arises in estimating the residual margin in a business combination.

The proposals in the ED

9. The ED proposed that, 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.

   (b) derecognise any existing balances of deferred acquisition costs.

   (c) derecognise any intangible assets arising from insurance contracts assumed in previously recognised business combinations. That adjustment does not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts."

10. The vast majority of respondents did not agree with ED proposal to measure each portfolio of insurance contracts at the present value of the fulfillment cash flows, with no residual margin. They argued that the proposed measurement:

    (a) is not consistent with principle in the ED that prohibits the recognition of profit on inception, as for contracts in force at transition it recognises all remaining expected future profits in the retained earnings at that date;

    (b) will misstate an insurer's financial position and will make it less possible to predict the profitability, especially for long-duration contracts, as no trend information would be observed for contracts in force at transition;

    (c) will result in lack of comparability between:

       (i) short-duration and long-duration insurance contracts. Such differences would be present for many decades.

       (ii) insurers with growing and mature in-force business.

       (iii) contracts written before and after transition.

       (iv) entities that will make a transition to IFRS on different dates.

(d) will make insurance business appear to be less profitable than it actually is for some years after transition, which imposes a competitive disadvantage within the capital markets compared to other sectors;

(e) will force the insurers in jurisdictions that are currently accounting for insurance contracts on a similar basis to the proposals in the ED to derecognise residual margin which could be reliably calculated;

11. Respondents generally supported any other solution which would allow them to recognise residual margin at transition. We describe below some of the suggested alternative approaches.

Retrospective application when practicable

12. Some suggest that the board should be consistent with the general approach in IFRSs by requiring retrospective application when practicable, and specifying another method only when retrospective application is impracticable. They note that retrospective application may be practicable when:

(a) an insurer has only short duration contracts.

(b) the accounting model used prior to adopting the new IFRS was similar to the proposed standard. For example, an insurer that has prepared market-consistent embedded value information in previous periods might have publicly disclosed information that would allow it to determine the residual margin at the date of transition without the unacceptable use of hindsight.

(c) the date of inception of a portfolio of contracts is relatively recent.

13. Where retrospective application is practicable, they state that it:

(a) is the most appropriate conceptual approach and consistent with general requirements in IFRSs.

(b) provides faithful representation of financial position and performance for comparable periods before the new IFRS is applied.

(c) enhances comparability and allows prediction of profitability arising from the release of the residual margin for users of financial statements.

A proxy for the residual margin when retrospective application is not practicable

14. When retrospective application is not practicable, some suggest that the residual margin at the date of transition should be estimated. The boards could consider the following approaches for estimating the residual margin at the date of transition:

    (a) Requiring that the residual margin at the date of transition is the difference (but not less than zero) between the present value of the fulfillment cash flows at that date and one of the following:

        (i) the carrying amount of the insurance liability immediately before transition. This approach was considered and rejected by the Board in developing the ED, but was supported by a significant number of constituents. In particular, respondents noted that this approach would maintain some continuity with previously reported profit or loss, without imposing significant additional costs. It would also result in some level of comparability within jurisdictions.

        (ii) the fair value estimation of the remaining liability. In principle, this would be the same as the approach that would need to be applied in acquisition accounting in a business combination. The acquirer would need to estimate the residual margin at the date of the business combination.

        (iii) the current entity specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to remaining part of the newly recognised insurance contract. This is the measurement the board decided to use to determine the amount of gain or loss recognized when an insurer substantially modifies the contract. It is similar to the fair value estimation of the remaining liability, but uses an entity-specific perspective rather than a market participant perspective.

    (b) Measuring the residual margin directly on the date of transition as the present value of future profits using current assumptions. This approach would treat those assumptions as if they had been in place at inception. However, rather than offsetting in the residual margin some changes in

estimates of future cash flows (relating to future estimates) and recognising in profit and loss other changes in estimates of future cash flows (experience adjustments), the insurer would assume that all changes in estimates of future cash flows were experience adjustments and hence recognised in profit and loss.

15. In each case, the residual margin would not be fully comparable with the residual margins for contracts that are recognised for the first time after the date of transition. However, any concerns about the comparability of the residual margin estimated on transition and the residual margin for contracts that are recognised after the date of transition could be addressed through the separate disclosure after transition of the residual margin and its release.

Question for working group members
1. Should the Board: • leave an insurer to judge whether it is practicable to apply the new IFRS retrospectively? • specify the circumstances in which retrospective application is impracticable? If so, what would those circumstances be? • assume that retrospective application is always impracticable? 2. If retrospective application is impracticable, which possible proxy should the Board specify for the residual margin at the date of transition? 3. Do you have any comments about the operationality of any of the possible proxies for the residual margin at the date of transition? 4. Do you have a preference between (a) requiring full comparative information for all years presented, and (b) an earlier application date?

Appendix: Extract from Basis for conclusions

BC245 [The] proposed measurement model comprises two elements:

(a) a direct measurement, based on estimates of future cash flows; and

(b) a residual margin, determined at initial recognition of the insurance contract and then released over the coverage period.

BC246 The Board has identified no specific transitional problems for the introduction of the direct measurement component of the measurement. That measurement is current and reflects circumstances at the measurement date. Therefore, provided an insurer has sufficient lead time to set up the necessary systems, performing that direct measurement on transition to the new model will be no more difficult than performing that measurement for a later date.

BC247 Determining the remaining amount of the residual margin on transition may be more problematic. 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.

BC248 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 benefits for users. 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. In consequence, for contracts in force when the new IFRS comes into effect, an insurer would not recognize residual margins as income for any subsequent period. However, the insurer will recognize income arising from the release of residual margins for contracts recognized initially after adopting the IFRS.