STAFF PAPER

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IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Transition—Ancillary issues		
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Introduction

1. This paper discusses the following topics related to transition:
   - (a) the treatment of changes in estimates of cash flows before the date of transition (paragraphs 5-17);
   - (b) first-time adopters of IFRS (paragraphs 18-23); and
   - (c) redesignation of assets in the scope of IAS 16 or IAS 40 (paragraphs 24-35).
2. This paper does not discuss the following topics related to transition:
   - (a) redesignation and reclassification of financial assets (which is discussed in agenda paper 10C for this meeting);
   - (b) effective date, comparative financial statements and early application (which is discussed in agenda paper 10E for this meeting); or
   - (c) any transition requirements that may be needed relating to the presentation of premiums, claims and expenses in the statement of comprehensive income. This topic will be discussed at a future meeting subject to the IASB's decision on the presentation of premiums, claims and expenses in the statement of comprehensive income.
3. Proposed drafting for the recommendations in this paper are set out in agenda paper 10B *Transition—Overview and proposed drafting*.

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Staff recommendations

4. The staff recommend that:

   (a) an insurer shall determine the residual margin on transition assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition;

   (b) the proposed transition requirements for insurers that already apply IFRS should also apply to first-time adopters of IFRS; and

   (c) the IASB should not include specific guidance on redesignation of property, plant and equipment and investment property on transition.

Treatment of changes in estimates before the date of transition

5. At their June 2011 meeting the IASB tentatively decided[1] that an insurer should:

   (a) adjust (unlock) the residual margin for favourable and unfavourable changes in the estimates of future cash flows used to measure the insurance liability. Experience adjustments would be recognised in profit or loss;

   (b) not limit increases in the residual margin;

   (c) recognise changes in the risk adjustment in profit or loss in the period of the change; and

   (d) make any adjustments to the residual margin prospectively.

6. At their September 2012 meeting, the IASB and FASB decided to use a modified form of retrospective application[2] to calculate the margin on transition. In particular, the IASB modified the general requirements in IAS 8 for retrospective application regarding when retrospective application would be impracticable. Because of the long-term nature of the insurance business and because the

[1] The FASB decided that any changes in future estimates would be reported in the statement of comprehensive income in the year when the insurer finds out about those changes.

[2] According to IAS 8 'retrospective application is applying a new accounting policy to transactions, other events and conditions as if the policy had been always applied'.

measurement of insurance contracts requires significant estimates, the limitations on retrospective application in IAS 8 would likely apply for establishing the margin for a significant portion of the business. Therefore, if retrospective application would normally be considered impracticable because it would require significant estimates that are not solely based on objective information, the IASB decided the insurer would be allowed to estimate, using any objective information reasonably available, what the residual margin at initial recognition would have been had the insurer been able to apply the new standard retrospectively.

7. Accordingly, the insurer would not need to establish the margin at inception as a difference between the expected present value of the future cash outflows plus the risk adjustment and expected present value of the future cash inflows but could use instead other relationships between the margin at inception and objective available information. For example, as noted in the agenda paper 2B/89B for the September 2012 meeting, the insurer would be allowed to use the expected return on equity ratio or the estimated average margin per contract determined from those contracts where retrospective application was possible. Consequently, the staff did not explore further simplifications in respect of the margin measurement at inception, such as for the risk adjustment.[3]

8. As described in agenda paper 10B *Transition—Overview and proposed drafting* for this meeting, in order to calculate the margin on transition, the insurer would need to establish the changes of the margin from initial recognition to the transition date, as follows:

   (a) determine the release pattern for the margin for the period between initial recognition and transition date;

   (b) determine the amount and timing of all changes in estimates of cash flows at the end of each reporting period after initial recognition. Furthermore, the insurer would need to separate those changes into:

      (i) changes related to the future cash flows which adjust the margin prospectively from the date of the change in estimate; and

[3] The staff notes that there is a greater need to specify the determination for the locked-in discount rate to establish the cumulative amount to be accounted for in OCI and for the interest expense to be charged in the statement of the comprehensive income after transition.

(ii) differences between actual cash flows and previous estimates of those cash flows (experience adjustments) which are recorded in the statement of comprehensive income in the year of the change in estimate.

9. The staff believe that fully retrospective application in relation to the changes in cash flows as described in paragraph 8(b) would be a difficult exercise involving high risk of using hindsight in the calculation. It would require insurers to know whether changes from original estimates made at inception had been changes in estimates of then-future cash flows or experience adjustments, and in which period those changes in estimates occurred. Depending on what the insurer estimated, the effect of those changes in estimates would be either recognised as an adjustment to retained earnings or recognised as part of the remaining residual margin to be allocated to profit and loss. Consequently, the staff propose that the IASB should require an insurer to treat all changes in estimates of cash flows in the same way, namely as if the insurer knew about them at initial recognition. The staff believe that this would mean the following:

   (a) an insurer would adjust the margin for all changes in cash flows retrospectively rather than prospectively; and

   (b) an insurer would have no need to distinguish whether the change was related to the future cash flows or whether it was an experience adjustment in the year when the insurer knew about the change.

10. The effect of this proposal and the difference from retrospective application is illustrated in the example below.

11. Example assumptions:

    (a) coverage period 5 years.

    (b) premium equals CU41,000.

    (c) expected claims equal CU100 for each year of the coverage period.

    (d) the margin is released equally over time (CU500/5 years = CU100 per annum).

    (e) for simplicity, there is no risk adjustment and no time value of money.

    (f) in year 2, the insurer changes its estimate of the expected cash flows in years 4 and 5, which now equal CU200 per annum. The insurer treats the change as a change in estimates and consequently offsets the effect of the changes in the margin.

12. The residual margin calculation[5], if full retrospective application were to be applied, is presented below:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	400	150	100	50	
Change in estimates		-200				
Release of margin	-100	-50	-50	-50	-50	-300
Closing balance	400	150	100	50	0	

13. The residual margin calculation applying the staff's proposal is presented below:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	240	180	120	60	
Change in estimates	-200					
Release of margin	-60	-60	-60	-60	-60	-300
Closing balance	240	180	120	60	0	

14. As presented in the example above, the amount of the opening and closing balance for the residual margin is different in each year. Thus, if the date of

[4] In this paper, currency amounts are denominated in 'currency units' (CU).

[5] According to the summarised margin presentation in the statement of comprehensive income, the release of the residual margin would be presented as a separate line item. According to the assumptions in this example, the release of residual margin would be equal to the result for the period.

transition were at the end of year 3, there would be a difference in the residual margin at the date of transition of CU20 between retrospective adjustment and the staff's proposal.

15. The arguments against this proposal are as follows:

    (a) it may be viewed as inconsistent with IAS 8 because it *requires* the use of hindsight, as all changes would be treated as if the insurer knew about them at inception. However the staff note that the board already provided some simplifications to the retrospective application of the standard in order to permit the inclusion of a residual margin on transition for more contracts.

    (b) it would lead to different financial results (and consequently impaired comparability) for those contracts which use the retrospective application of the forthcoming Standard (or contracts written after transition) and those that use the simplification.

16. The arguments in favour of this proposal are as follows:

    (a) as noted in paragraph 9, the unlocking of the margin would be a challenging exercise and hindsight might be very difficult to avoid. The proposed solution would be therefore introducing a significant simplification to the transition requirements, as described in paragraph 9(b). That simplification would introduce some rigour and lead to more consistent application for accounting for changes in estimates.

    (b) The staff believe that the proposal to treat all changes in estimates as if they had been known at inception would be consistent with the principle underlying the unlocking of the margin. Some might argue that, to be consistent with the view that that residual margin reflects the expected profit in the contract, it would have been conceptually preferable that the margin should absorb changes in estimated future cash flows retrospectively, ie that wrong estimations at inception should be adjusted retrospectively. Those with this view would believe that because of the operational difficulties of retrospective adjustment in normal circumstances, the IASB selected prospective unlocking instead. However, on transition retrospective

application would be not only conceptually preferable, but also more practical.

17. The staff recommend that in determining the residual margin on transition, the IASB should require the insurer to treat all changes in assumptions of cash flows between initial recognition and the beginning of the earliest period presented as if they were already known at initial recognition. The staff believe that the proposed simplification should be required rather than permitted because it is arguably the conceptually preferable answer and is also the least costly on transition.

Question 1—Treatment of changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented
Does the IASB agree that an insurer shall determine the residual margin on transition assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition?

First-time adopters of IFRS

18. The ED proposed that the transition requirements would apply both to insurers that have already adopted IFRS when they first apply the final standard and to insurers that adopt IFRS for the first time. The Basis for Conclusions (paragraph BC252) noted that the IASB saw no reason to treat first-time adopters differently from insurers that already apply IFRSs. There was no comment from respondents specifically about the transition requirements for those entities that are adopting IFRS for the first time.

19. In evaluating the requirements for first-time adopters, the staff considered the approach described in paragraphs BC7-BC15 of the Basis for Conclusions for IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Those paragraphs refer to the qualitative characteristics (in particular comparability) which make the information in financial statements useful and discuss how those characteristics should be considered in the context of first time adopters. These paragraphs are reproduced in Appendix A.

20. Paragraph BC9 of IFRS 1 notes the emphasis that the IASB has placed on comparability:
    (i) within an entity over time; and
    (ii) between first-time adopters and entities that have already adopted IFRS.
21. Paragraph BC14 of IFRS 1 indicates that the IASB considers retrospective application of new IFRSs to achieve the objective of comparability over time within a first-time adopter's first IFRS financial statements. In September 2012, the IASB decided that entities that already apply IFRSs should apply the proposed insurance contracts standard retrospectively as far as possible, with specified modifications to retrospective application if retrospective application is impracticable. Thus, applying the same approach for first-time adopters and insurers that already apply IFRSs would result in first-time adopters applying the same modified retrospective approach as proposed for insurers that already apply IFRSs.
22. The staff believe that using a consistent approach for first-time adopters and entities already applying IFRSs would accomplish improved comparability between first-time adopters and entities that have already adopted IFRSs and would enable users to understand the financial position and performance of insurers that have already adopted IFRS and insurers that are adopting IFRS for the first time. The staff also note that because IFRS 4 permits the continuation of existing practices, the task of applying the standard for the first time would be similar for both insurers that have already adopted IFRS and insurers that are adopting IFRS for the first time.
23. As the staff cannot identify any conceptual or practical reasons for providing different transition requirements for first-time adopters of IFRS, the staff recommend requiring first-time adopters to follow the proposed transition requirements.

Question 2—Transition for first-time adopters
Does the IASB agree that the proposed transition requirements for insurers that already apply IFRS should also apply to first-time adopters of IFRS?

Redesignation of assets in the scope of IAS 16 or IAS 40

24. The ED proposed to permit an insurer to redesignate a financial asset if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition. Redesignation of financial assets, including of equities measured at fair value through other comprehensive income, is discussed in AP10C *Redesignation and reclassification of financial assets*.

25. The ED did not address redesignation of other types of assets which insurers may hold, specifically:

    (a) property, plant and equipment in the scope of IAS 16 *Property, Plant and Equipment*; and

    (b) investment property in the scope of IAS 40 *Investment Property*.

26. Respondents to the ED did not address redesignation of property, plant and equipment within the scope of IAS 16. However a small number of respondents stated that accounting mismatches could result if insurers were not permitted to redesignate their investment property within the scope of IAS 40.

27. IAS 16 and IAS 40 both require an entity to choose between a cost model and a revaluation/fair value model as its accounting policy:

    (a) For IAS 16, an entity is required to measure each class of property, plant and equipment subsequent to initial recognition using the chosen model.

    (b) For IAS 40, an entity is required to measure all of its investment property subsequent to initial recognition using the chosen model, subject to the following exception:

        (i) an entity is required to use one model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property.

        (ii) an entity is required to use one model for all other investment property.

28. Accordingly, if the IASB did not specify a different approach, the requirements of IAS 8 relating to changes in accounting policy would apply to changes between the cost and revaluation/fair value models.

29. Paragraph 17 of IAS 8 permits an entity to switch from the cost model to the revaluation model to measure property, plant and equipment and to account for the change in accounting policy as a revaluation under IAS 16. An insurer may wish to do so on transition to the new standard considering the interaction between the following:

    (a) the revaluation model measures property, plant and equipment at a current value with some changes in the carrying amount of the property, plant and equipment presented in other comprehensive income; and

    (b) the insurance liability will be measured at a current value with changes presented in other comprehensive income.

30. Similarly paragraph 31 of IAS 40 permits an entity to change the accounting policy used to measure investment property. However, IAS 40 requires that, in the revaluation model, changes in fair value are recognised in profit and loss. On transition to the new insurance contracts standard, an entity may wish to consider the following:

    (a) the cost model does not measure investment property at a current value. Fluctuations in fair value are therefore not presented in profit or loss.

    (b) the fair value model measures investment property at a current value, and changes are presented in profit or loss.

    (c) the insurance liability will be measured at a current value with changes presented in other comprehensive income.

31. An entity would account for a change in the accounting model applied to measure investment property using IAS 8. This means that an entity would need to meet the criteria in IAS 8 to change an accounting policy, namely that the change must increase the reliability and relevance of the information in the financial statements.

32. The staff believe that redesignation of property, plant and equipment and investment property could enhance the relevance and reliability of the information in an insurer's financial statements. Asset-liability matching is an integral aspect of an insurer's business. Accordingly, an insurer may wish to make different decisions about which model to use on transition to the insurance contracts standard from those it has made applying its previous accounting policies.
33. On the one hand the IASB could consider providing explicit guidance to permit insurers to redesignate property, plant and equipment and investment property on transition. Such guidance would serve to inform insurers that redesignation on transition may result in a clearer depiction of their asset-liability matching and is therefore permitted.
34. On the other hand such guidance may not be needed. An insurer is already permitted to switch from the cost model to the revaluation model to account for property, plant and equipment according to IAS 16 and IAS 8. Likewise an insurer is already permitted to switch between the cost model and the fair value to account for investment property according to IAS 40 and IAS 8 provided that the change enhances the reliability and relevance of the financial statements.
35. The staff therefore recommend not to include explicit guidance permitting an insurer to redesignate property, plant and equipment and investment property on transition.

Question 3—Redesignation of assets in the scope of IAS 16 or IAS 40 on transition
Does the IASB agree not to include explicit guidance on redesignation of property, plant and equipment and investment property on transition?

Appendix A—Excerpt from Basis for Conclusions for IFRS 1 *First-time Adoption of International Financial Reporting Standards*

A1. This appendix contains paragraphs BC7 through BC15 of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Basic concepts

Useful information for users

BC7 In developing recognition and measurement requirements for an entity's opening IFRS balance sheet, the Board referred to the objective of financial statements, as set out in the *Framework for the Preparation and Presentation of Financial Statements*. The *Framework*[2] states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

BC8 The *Framework* identifies four qualitative characteristics that make information in financial statements useful to users. In summary, the information should be:

(a) readily understandable by users.

(b) relevant to the decision-making needs of users.

(c) reliable, in other words financial statements should:

(i) represent faithfully the transactions and other events they either purport to represent or could reasonably be expected to represent;

(ii) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;

(iii) be neutral, that is to say, free from bias;

(iv) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and

(v) be complete within the bounds of materiality and cost.

(d) comparable with information provided by the entity in its financial statements through time and with information provided in the financial statements of other entities.

Comparability

BC9 The previous paragraph notes the need for comparability. Ideally, a regime for first-time adoption of IFRSs would achieve comparability:

(a) within an entity over time;

(b) between different first-time adopters; and

(c) between first-time adopters and entities that already apply IFRSs.

BC10 SIC-8 gave priority to ensuring comparability between a first-time adopter and entities that already applied IASs. It was based on the principle that a first-time adopter should comply with the same standards as an entity that already applied IASs. However, the Board decided that it is more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective.

Current version of IFRSs

BC11 Paragraphs 7–9 of the IFRS require a first-time adopter to apply the current version of IFRSs, without considering superseded or amended versions. This:

(a) enhances comparability, because the information in a first-time adopter's first IFRS financial statements is prepared on a consistent basis over time;

(b) gives users comparative information prepared using later versions of IFRSs that the Board regards as superior to superseded versions; and

(c) avoids unnecessary costs.

BC12 In general, the transitional provisions in other IFRSs do not apply to a first-time adopter (paragraph 9 of the IFRS). Some of these transitional provisions require or permit an entity already reporting in accordance with IFRSs to apply a

new requirement prospectively. These provisions generally reflect a conclusion that one or both of the following factors are present in a particular case:

(a) Retrospective application may be difficult or involve costs exceeding the likely benefits. The IFRS permits prospective application in specific cases where this could occur (paragraphs BC30–BC73).

(b) There is a danger of abuse if retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known. The IFRS prohibits retrospective application in some areas where this could occur (paragraphs BC74–BC84).

BC13 Some have suggested three further reasons for permitting or requiring prospective application in some cases:

(a) to alleviate unforeseen consequences of a new IFRS if another party uses financial statements to monitor compliance with a contract or agreement. However, in the Board's view, it is up to the parties to an agreement to determine whether to insulate the agreement from the effects of a future IFRS and, if not, how they might renegotiate it so that it reflects changes in the underlying financial condition rather than changes in reporting (paragraph 21of the *Preface to International Financial Reporting Standards*).

(b) to give a first-time adopter the same accounting options as an entity that already applies IFRSs. However, permitting prospective application by a first-time adopter would conflict with the Board's primary objective of comparability within an entity's first IFRS financial statements (paragraph BC10). Therefore, the Board did not adopt a general policy of giving first-time adopters the same accounting options of prospective application that existing IFRSs give to entities that already apply IFRSs. Paragraphs BC20–BC23 discuss one specific case, namely derecognition of financial assets and financial liabilities.

(c) to avoid difficult distinctions between changes in estimates and changes in the basis for making estimates. However, a first-time adopter need not make this distinction in preparing its opening IFRS balance sheet, so the IFRS does not include exemptions on these grounds. If an entity becomes aware of errors made

under previous GAAP, the IFRS requires it to disclose the correction of the errors (paragraph 26 of the IFRS).

BC14 The Board will consider case by case when it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. However, if the Board concludes in a particular case that prospective application by a first-time adopter is justified, it will amend the IFRS on first-time adoption of IFRSs. As a result, IFRS 1 will contain all material on first-time adoption of IFRSs and other IFRSs will not refer to first-time adopters (except, when needed, in the Basis for Conclusions and consequential amendments).

BC15 Under the proposals in ED 1, a first-time adopter could have elected to apply IFRSs as if it had always applied IFRSs. This alternative approach was intended mainly to help an entity that did not wish to use any of the exemptions proposed in ED 1 because it had already been accumulating information in accordance with IFRSs without presenting IFRS financial statements. To enable an entity using this approach to use the information it had already accumulated, ED 1 would have required it to consider superseded versions of IFRSs if more recent versions required prospective application. However, as explained in paragraphs BC28 and BC29, the Board abandoned ED 1's all-or-nothing approach to exemptions. Because this eliminated the reason for the alternative approach, the Board deleted it in finalising the IFRS.

Appendix B—Excerpts from IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and the accompanying Basis for Conclusions

B1. This appendix contains paragraphs 14, 15 and 17 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and paragraph BC7 of the accompanying Basis for Conclusions.

IAS 8

Changes in accounting policies

14 An entity shall change an accounting policy only if the change:

(a) is required by an IFRS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

15 Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the criteria in paragraph 14.

17 The initial application of a policy to revalue assets in accordance with IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* is a change in an accounting policy to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard.

Basis for Conclusions on IAS 8

BC7 The Board concluded that retrospective application made by amending the comparative information presented for prior periods is preferable to the previously allowed alternative treatments because, under the now required method of retrospective application:

(a) profit or loss for the period of the change does not include the effects of changes in accounting policies or errors relating to prior periods.

(b) information presented about prior periods is prepared on the same basis as information about the current period, and is therefore comparable. This information possesses a qualitative characteristic identified in the *Framework for the Preparation and Presentation of Financial Statements*, and provides the most useful information for trend analysis of income and expenses.

(c) prior period errors are not repeated in comparative information presented for prior periods.