IASB discusses transition for non-participating contracts

Overview
During its October 2014 meeting, the International Accounting Standards Board (IASB, or Board) continued redeliberations on its 2013 Exposure Draft Insurance Contracts (ED). The Board has essentially completed the development of the model for non-participating contracts at previous meetings. During the October meeting, the Board discussed the measurement approaches that should be applied to non-participating contracts on transition to the new insurance contract accounting standard.

The staff will ask the Board to decide on the transition model for participating contracts at a future meeting.

Transition
The staff reminded the Board that the elements of the insurance contracts model that are measured on a current basis, notably the current fulfilment cash flows (i.e., the expected present value of the future cash flows plus the risk adjustment), should not present any transition issues. However, the staff did note that the insurance contract measurement also includes an estimate of the remaining unearned profitability through the contractual service margin (CSM). Under the proposed insurance model, this CSM is first established on initial recognition of an insurance contract as the difference between the expected present value of the cash inflows and the expected present value of the cash outflows plus the risk adjustment. Therefore, estimating the CSM on transition would require retrospective application using historical information up to initial recognition. Other elements of the transition measurement that require retrospective application based on historical information are:

► Determination of the discount rate at initial recognition for calculating any accumulated effect of changes in discount rates in other comprehensive income (OCI) on transition and accreting interest on the CSM
► Identification of the amount to be reported as insurance contract revenue over the remaining coverage period after transition
Whilst the ED proposes retrospective application, it also acknowledges that retrospective application according to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors will be impracticable in many cases. Therefore, the transition approach in the ED incorporates a number of simplifications. However, several comment letters noted concerns on the practicability of the simplifications and mentioned additional simplifications to deal with transition challenges.

During the meeting, the Board discussed whether modifications to the transition requirements in the ED should be made based on comments they received. The staff proposed the following three transition approaches, to be applied at the portfolio level based on the particular circumstances:

1. The starting point would be a full retrospective application in accordance with IAS 8 unless impracticable
2. If a full retrospective application is impracticable, a retrospective approach with several simplifications should be applied unless this simplified approach is also impracticable
3. If simplified retrospective application is impracticable, for example due to a lack of historical data, a transition approach based on fair value should be applied

**Full retrospective application**

The staff asked the Board whether it agrees with the staff recommendation to confirm the transition method in the 2013 ED that required the standard to be applied retrospectively on a portfolio by portfolio level, in accordance with IAS 8, unless retrospective application would be impracticable. The staff recommended that the Board confirm this approach as both preparers and users broadly agreed with the proposal in their comment letters. Also, the staff believes this approach would give best comparability between contracts written before and after transition.

Some Board members noted that transition is expected to be a major issue in some areas if a retrospective approach is required. Also, there are many types of contracts and many specific circumstances and these Board members believe that mandating a retrospective approach could cause significant differences in the transition burden from one situation to another. The Board members gave the example of certain Asian countries where significant declines in interest rates have occurred after contracts were written which, for insurance contracts, could cause significant debit balances in accumulated OCI on transition. They believe that this would create an artificial separation of investing and underwriting and should be resolved by allowing insurance companies to apply a fresh start (i.e., fully prospective approach) on transition for all components of the model. As a result, the effect of past changes in interest rates would be recorded in retained earnings upon transition instead of in OCI.

However, several other Board members commented that the debit balances in accumulated OCI that are caused by a decline in interest rates are economic circumstances that should be reflected in an insurer’s financial statements. One Board member noted retrospective application will also be applied to financial instruments upon adoption of IFRS 9 Financial Instruments. Staff commented that, if there is concern about diversity, comparability can best be sought through retrospective application of the new insurance standard. Also, if an entity wishes to avoid debit balances in OCI, it could choose to recognise the effect of changes in discount rates in profit or loss.

Board members had differing views on the impact of costs associated with retrospective application. One Board member emphasised that retrospective application will require significant cost that will ultimately be borne by investors.

However, another Board member commented entities should not be denied retrospective application if they are willing to make the investment.

When asked to vote, nine Board members agreed with the staff recommendation to confirm a retrospective transition approach in accordance with IAS 8 unless impracticable, and five disagreed.

**Application of the simplified transition approach**

In the ED, the Board acknowledges full retrospective application could be impracticable in many cases, for example, because it would not be practicable to make all the estimations necessary under the model in a retrospective manner. Therefore, the transition method proposed in the ED included several simplifications in case retrospective full application is impracticable:

- Using the actual cash flows known at the beginning of the earliest period presented
- Using the risk adjustment determined at the beginning of the earliest period presented
- An approximation of discount rates based on the observable market information for the three years before the earliest period presented

Respondents to the ED generally agreed the proposal represents a significant improvement over the proposals in the 2010 ED, but noted that, in many cases, entities would not have all necessary information, such as full historic cash flow information, even to apply the simplified retrospective approach. Accordingly, the staff proposed to adopt a third transition approach (discussed in the following section).
Additionally, the comment letters raised concerns on the simplifications proposed in the ED. One such concern is the perceived understatement of the risk adjustment at inception and the corresponding overstatement of the CSM at inception, as a result of setting this risk adjustment directly to the risk adjustment determined at the beginning of the earliest period presented.

The staff recommended that the Board confirms the use of the simplified retrospective transition approach, but with one modification: entities should estimate the risk adjustment at the date of initial recognition by starting with the risk adjustment determined at the beginning of the earliest period presented and then adjust it for the assumed release pattern since initial recognition. This assumed release pattern since inception should be determined by reference to the release pattern for similar insurance contracts that the entity issues at transition.

On the discount rate, staff remained convinced that sufficient information will be available to estimate the rates at initial recognition and therefore saw no need to make any changes to the treatment proposed in the ED. All fourteen Board members agreed with the staff recommendation to confirm the use of a simplified transition approach if full retrospective application were to be impractical, but with the modification on how to estimate the risk adjustment at inception.

**Approach based on fair value if the simplified transition approach is impracticable**

The staff noted that it expects that for many long-duration contracts, retrospective application, both full and simplified, will be impracticable due to a lack of historic cash flow data. If any form of retrospective application is impracticable under IAS 8, the staff proposes that the CSM should be estimated at the beginning of the earliest period presented as the (positive) difference between:

a) The fair value of the insurance contracts

And

b) The current fulfilment cash flows of the insurance contracts

If the fair value is less than the current fulfilment cash flows, the (negative) difference would be recognised in retained earnings at the beginning of the earliest period presented.

Staff commented that this third approach, in contrast to the other two approaches, is not based on a calibration of the CSM to the contract premiums at inception and will diminish comparability. Therefore, the staff believes the transition approach based on fair value should only be available as the third – and final – approach, once an entity has determined it cannot apply either of the other two approaches.

As noted previously, the staff is convinced that entities will have sufficient information available to estimate the discount rates at initial recognition. Therefore, it proposed that entities should determine the accumulated effect of changes in discount rates after initial recognition in OCI (to the extent it elected to present discount rate changes in OCI) irrespective of the transition approach it applies.

To enable users to understand the impact where an entity did not apply a full retrospective approach, the staff proposes that the entity should provide the specific transition disclosures proposed in the ED separately for contracts measured using the fair value-based transition approach (these disclosures should also be separately provided for contracts measured using the simplified retrospective transition approach).

One Board member commented that a fair value-based transition approach would effectively mix up a prospective measurement (for the current fulfilment cash flows and the CSM) and retrospective measurement (for the discount rate changes) and believed such a combined approach has no real meaning; if a transition approach based on fair value were to be introduced, then it should be done so on a fully prospective basis according to this Board member.

Another Board member made the observation three different transition approaches could be applied to different portfolios by an entity, causing incomparability due to the various approaches that could be applied within one entity.

After some discussion, eleven Board members supported the staff recommendation, and three members disagreed.
How we see it

The Board concluded that a retrospective approach to transition would require full information on all the historic cash flows; if some of this information is lacking, it would be inherently difficult to determine the CSM at initial recognition. The Board responded to its conclusion by introducing a third transition approach, based on fair value, that applies when an entity is lacking some or all of the historic cash flow data.

As a result, entities that lack historic cash flow data will not be able to utilise the data they have for the purpose of estimating the CSM. Instead, entities will be required to use the transition approach based on fair value. Entities should be aware that this requirement may have important implications for their approach to transition including their documentation on whether a (simplified) retrospective approach is practicable or not.

What’s next?

The Board’s next meeting on the insurance contracts project is in November 2014. The topics have not yet been announced, but the Board is expected to continue its discussions on the model for participating contracts. The IASB expects to publish a final standard in 2015.