STAFF PAPER

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Purpose of the paper

1. This paper considers an entity's initial application of the forthcoming Insurance Contracts Standard (the proposed Standard) for contracts with no participating features.

2. This paper does not address:

   (a) other issues relating to the initial application of the proposed Standard, including the effective date and the interaction between the accounting for insurance contracts with the accounting for assets that an entity holds. The staff plan to consider those issues closer to the issuance of the proposed Standard.

   (b) initial application of the proposed Standard for contracts with participating features, which the staff will consider when the IASB finalises its proposed accounting for contracts with participating features.

3. The appendix includes relevant paragraphs from the 2013 Exposure Draft *Insurance Contracts* (2013 ED) and its Basis for Conclusions.

Staff recommendation

4. The staff recommend that the IASB should confirm the proposal in 2013 ED that at the beginning of the earliest period presented, an entity should:

   (a) apply the Standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* unless impracticable; and

   (b) if retrospective application of the Standard is impracticable, an entity should use the simplified approach proposed in paragraphs C5 and C6 of the 2013 ED[1] with the following modification: instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of the risk before the beginning of the earliest period presented. The expected release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the beginning of the earliest period presented.

   (c) if the simplified approach described in paragraph (b) is impracticable, an entity should apply a 'fair value approach' in which the entity should:

      (i) determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date; and

      (ii) determine interest expense in profit or loss, and the related amount of other comprehensive income accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 ED.

[1] Please refer to the appendix for the relevant paragraphs from the 2013 ED.

5. The staff also recommends that, for each period presented for which there are contracts that were measured in accordance with the simplified approach in paragraph 4(b) or the fair value approach in paragraph 4(c), an entity should disclose the information proposed in paragraph C8 of the 2013 ED[2] separately for:
   (a) contracts measured using the simplified approach; and
   (b) contracts measured using the fair value approach.

Introduction

6. This paper provides the following background information:
   (a) A reminder of the 2013 ED proposals - paragraphs 8-11;
   (b) Feedback on the 2013 ED proposals:
      (i) Widespread agreement with the retrospective application - paragraphs 12-13;
      (ii) Modifications proposed to the simplified approach - paragraphs 14-24.
      (iii) Alternative proposals – paragraph 25.
7. In the light of the feedback received, this paper considers:
   (a) Whether the IASB should confirm the proposal that an entity should, unless impracticable, apply the proposed Standard retrospectively (paragraphs 26-30);
   (b) Whether the IASB should modify the simplified approach proposed in the 2013 ED that would be applied when retrospective application of the proposed Standard is impracticable (paragraphs 31-45); and
   (c) Whether the IASB needs to specify an alternative approach that would be applied when it would be impracticable for the entity to apply the simplified approach (paragraphs 46-56).

[2] Please refer to the appendix for the relevant paragraphs from the 2013 ED.

Background

2013 ED proposals

8. The general principle in IFRS is that a new accounting policy, including new accounting policies caused by the adoption of a proposed Standard, should be applied retrospectively. Retrospective application of the measurement requirements of the new Insurance Contracts Standard would require the entity to measure an insurance contract at the beginning of the earliest period presented as follows:

   (a) the fulfilment cash flows, which would be based on current information, and would not be difficult to obtain.

   (b) an estimate of the contractual service margin at the beginning of the earliest period presented. Because the contractual service margin is an allocated amount, this estimate would rely on historical information and would mean that an entity would need to determine:

      (i) the contractual service margin at the date of initial recognition by determining the fulfilment cash flows at the date of initial recognition;

      (ii) the amount of the contractual service margin that would have been recognised in profit or loss between the date of initial recognition and the beginning of the earliest period presented; and

      (iii) the amount and timing of the changes in fulfilment cash flows that would have been offset in the contractual service margin (ie that unlock the contractual service margin) between the date of initial recognition and the beginning of the earliest period presented.

9. In addition, the 2013 ED proposed presentation that would require an entity to use historical information, specifically:

   (a) The 2013 ED proposed that an entity present insurance contracts revenue in a way that is consistent with revenue presented for other types of contracts. Insurance contacts revenue would be measured as the release from the liability for remaining coverage excluding any losses previously recognised in profit or loss, adjusted to add an allocation of the acquisition costs based on the pattern of services. [3] Accordingly, retrospective application of the proposed Standard would mean that an entity would need to determine any losses that would have been recognised before the beginning of the earliest period presented, if the standard had always been applied. It would also mean that the entity would need to determine the acquisition costs that would have been included in the measurement of the insurance contract at the date of initial recognition, and the subsequent allocation of those acquisition costs.

(b) The 2013 ED proposed that an entity should present the effect of changes in discount rate in other comprehensive income (OCI)[4]. Retrospective application of the proposed Standard would mean that an entity would need to determine the discount rate at the date of initial recognition so that the entity could determine:

(i) The interest expense recognised in profit or loss, which would be measured using the discount rate as applied at the date of initial recognition; and

(ii) the related amount of OCI accumulated in equity, which would be measured as the difference between the fulfilment cash flows discounted using the current rates and rates at the date of initial recognition.

10. The 2013 ED proposed that an entity should apply the proposed Standard retrospectively unless impracticable. However, in developing the 2013 ED, the IASB acknowledged that it might be impracticable to determine historical information for insurance contracts written many years before the date the proposed Standard is applied. Consequently, the IASB proposed a simplified

[3] If the losses previously recognised in P&L were not excluded, this could result in an entity recognising more revenue than the consideration received. For example, if the premium was CU100, and the entity had incurred losses so that the insurance contract liability at the beginning of the year is CU120, then if the liability at the end of the year is zero, the entity would recognise revenue of CU120, unless the CU20 of losses were excluded from the calculation of revenue.

[4] At its March 2014 meeting, the IASB tentatively decided that an entity could choose as an accounting policy whether to present the effect of the discount rate changes on the insurance contract liability in OCI.

approach that would enable entities to approximate retrospective application when retrospective application is impracticable, as follows:

(a) Instead of estimating expected cash flows at the date of initial recognition of the contract and determining the subsequent changes in those cash flows that unlock the contractual service margin, an entity should determine the expected cash flows at the date of initial recognition by estimating the expected cash flows at the beginning of the earliest period presented and adjusting that estimate by the cash flows known to have occurred between the date of initial recognition and the beginning of the earliest period presented. This would have the same effect as if the entity had unlocked the contractual service margin on a retrospective basis (rather than the prospective basis proposed in the 2013 ED).

(b) Instead of estimating the yield curve at the date of initial recognition, an entity should use an observable yield curve that, for the three years before the beginning of the earliest period presented, best approximates the yield curve for insurance contracts in-force at that date. If there is no such observable yield curve, the entity should adjust an observable yield curve using an average spread between that observable yield curve and the yield curve for insurance contracts in-force at that date. The spread should be determined as an average over at least three years before the beginning of the earliest period presented.

(c) Instead of estimating the risk adjustment at the date of initial recognition, an entity should use the risk adjustment at the beginning of the earliest period presented.

11. In the Basis for Conclusions to the 2013 ED, the IASB acknowledged that measuring the in-force insurance contracts the beginning of the earliest period presented using the simplified approach would inevitably lead to differences in measurement between contracts written before and after the date the proposed Standard is applied. Consequently, the IASB proposed disclosures that would explain the extent to which amounts in the financial statements have been

measured using the simplified approach at the beginning of the earliest period presented and at any subsequent period.

Feedback received on retrospective application

12. Most preparers, standard-setters and auditors welcomed the IASB's decision that entities should estimate the contractual service margin at the beginning of the earliest period presented. The proposals were also supported by all the users of financial statements who commented and by the Accounting Standards Advisory Forum (ASAF). All saw the proposals as a significant improvement over the proposals in the 2010 ED, because the 2013 ED proposals:

    (a) are consistent with the requirements in IAS 8 for changes in accounting policies;

    (b) will provide the most useful information to users of financial statements by allowing comparisons between contracts written before and after the date the proposed Standard is applied, and will enable comparisons using trend information;

    (c) will provide a pragmatic approach when retrospective application is impracticable.

13. Many noted that although there would be increased costs in applying the revised proposals, the benefits would outweigh the costs. However, some respondents expressed concerns about:

    (a) operational complexity and the possible lack of data needed to apply the proposed approach (see more details in paragraphs 14-16);

    (b) the subjective nature of the estimates and the extent to which such estimates are auditable; and

    (c) the possible outcome that, at the beginning of the earliest period presented, some entities will recognise accumulated losses in equity (specifically in OCI accumulated in equity) because interest rates have fallen since the date of initial recognition of the insurance contracts. The objection is that this causes a reduction in the entity's equity, even though these losses would be partially offset in the future when the entity recognises the release of the contractual service margin in profit or loss. This was a critical issue for some Asian preparers, who view the contractual service margin as unrealised profits at the reporting date (rather than as a component of the measure of the insurance contract liability).

Feedback received on the simplified approach

14. Many noted that the proposed simplified approach would be less costly than retrospective application of the proposed Standard. However, many preparers were concerned that they might not have all the information necessary even to apply the simplified approach. Others asked for further simplifications to reduce implementation costs.

Cash flow information

15. Some preparers from Asia, Africa and North America were concerned about the availability of information for cash flows that had occurred before the beginning of the earliest period presented (especially information relating to acquisition costs). Some noted that information about those cash flows might be available only for a limited period, for example:

    (a) around five years before the date the proposed Standard is applied for jurisdictions that require current value measurement for insurance contracts (because historical information is not generally relevant in those jurisdictions); or

    (b) around 15-20 years before the date the proposed Standard is applied if an entity uses cost accounting.

    Some commented that the amount of information retained depends on when the entity last changed its systems.

16. A further concern, which is linked to the concern about availability of cash flow information, is the level of aggregation applied. Some, including some global accounting firms and some Asian and North American preparers, suggested that the IASB should introduce an expedient similar to the unit of account simplification proposed by the FASB in their 2013 ED. Such an expedient would

allow entities to use the portfolios determined under the entity's accounting policy immediately before the beginning of the earliest period presented, instead of determining the portfolios in accordance with the proposed Standard. Some preparers believed that this expedient would reduce the cost of implementation because entities would not be required to determine cash flows at a different level of aggregation than they had previously used.

17. A few constituents were concerned that the proposals would require them to use information for contracts that are no longer in-force when the proposed Standard is applied, and for which they no longer held any information.

18. The need for an approach that addressed the lack of cash flow information was also supported by ASAF.

Discount rates at the date of initial recognition of the contract

19. Some constituents were concerned about the availability of the historical, observable discount rates for use as a basis for estimating the liability discount rates at the date of initial recognition. They believed that it might be often impracticable to estimate the liability discount rate even if they applied the simplification proposed in the 2013 ED. This was the case especially in some developing markets where historical market-observed discount rates for long durations are less available, although this issue was also raised in most other jurisdictions.

20. As a consequence, some comment letters suggested that the accumulated balance of OCI at the beginning of the earliest period presented should be determined as equal to zero or equal to the accumulated balance of OCI for the assets backing insurance contracts. However, those comment letters did not specify how the entity would estimate the rates at the date of initial recognition for the purpose of determining the interest expense reported in profit or loss after the beginning of the earliest period presented.

21. Finally, some commented that the drafting of the simplified approach proposed in the 2013 ED was not easy to understand.

Overstatement of the risk adjustment

22. Some were concerned that there would be an understatement of the risk adjustment at the date of initial recognition if it were to be estimated as equal to the risk adjustment at the beginning of the earliest period presented as proposed in the 2013 ED. This would cause an overstatement of the contractual service margin (and hence an overstatement of the insurance contract liability and understatement of retained earnings). In particular, some constituents in Asia were concerned that an understatement of the risk adjustment at the date of initial recognition would exacerbate the issue of reduced or negative equity when the proposed Standard is applied (as described in paragraph 13(c)).

Restrictions on use of simplifications

23. Some suggested that the IASB should be less restrictive about the use of simplifications. In particular:

   (a) some suggested that an entity should be able to choose the particular simplification it needs to measure any particular component of the insurance contract, instead of being required to use a simplified approach which incorporates simplifications for all the components as a package.

   (b) at the September 2014 ASAF meeting, one member suggested the IASB should allow simplifications other than those proposed in the 2013 ED, either by stating the objective of the simplified approach or by adding guidance on what estimates are acceptable. That member suggested that this approach could extend the use of the simplified approach.

Disclosure

24. Regardless of views and concerns about the simplified approach proposed in the 2013 ED, many supported the proposals to disclose the amounts in the financial statements that were determined using the simplified approach and explain the assumptions used in determining those amounts (paragraph C8 of the 2013 ED). They commented that it is useful for users of financial statements to understand amounts that might not be fully comparable with amounts determined if the entity had applied the Standard retrospectively.

Alternative proposals

25. Due to the concerns about the practicability of the 2013 ED proposals, some proposed that there should be an alternative approach that would apply :

    (a) when it would be impracticable for an entity to apply the proposed simplified approach; or

    (b) as an alternative to retrospective application of the proposed Standard, if the entity concludes that the cost of retrospective application would outweigh the benefits; or

    (c) as an alternative to the proposed simplified approach, because they thought that the simplified approach would not provide comparability with the contracts written after the date the proposed Standard is applied.

Staff analysis and recommendation

Confirmation of proposals for retrospective application

26. Given the widespread support (see paragraph 12), there is little need for the IASB to reconsider the proposal that entities should apply the proposed Standard retrospectively, unless this is impracticable. The staff observes that this proposal:

    (a) provides comparability between contracts written before and after the date the proposed Standard is applied;

    (b) provides information necessary for trend analysis; and

    (c) addresses the concerns expressed in the feedback received on the 2010 ED (as evidenced in the response to the 2013 ED proposals), including feedback from users of financial statements.

27. The staff notes the concerns about operational complexity and the possible lack of data needed to apply the Standard retrospectively. However, this paper proposes to address these concerns through revising the simplified approach, and by introducing new requirements when it would be impracticable to apply the simplified approach. The staff also notes that the proposals for transition are no

more or less subjective than many of the proposals in the 2013 ED as a whole, and that the proposed simplified approach seeks to remove some of that subjectivity.

28. Some are of the view that the transition proposals will not portray an accurate depiction of the entity's position. This is because of the possible outcome that, at transition, some entities will recognise accumulated losses in OCI because interest rates have fallen since the date of initial recognition of the insurance contracts., even though those losses would be partially offset in the future by the profits recognised when the entity recognises the release of the contractual service margin in profit or loss. In some cases, the contractual service margin would be greater at the beginning of the earliest period presented that was originally expected at the date of initial recognition because the entity has experienced favourable changes in mortality and expense assumptions. In fact, in the staff's view, this outcome accurately depicts the situation in which investing losses caused by interest rates lower than originally expected are recognised in the period in which they arose (ie in the period of the change in interest rates), and underwriting profits greater than originally expected (eg from favourable changes in mortality and expense assumptions) are recognised in profit or loss in future periods. This outcome is consistent with the IASB's model which recognises investing gains and losses in a way consistent with similar gains and losses for financial instruments, and underwriting gains and losses in a way consistent with a service contract. The separation of underwriting and investing results is an important feature of the IASB's model.

29. Accordingly, the staff recommend that the IASB should confirm the 2013 ED proposals that an entity should apply the proposed Standard retrospectively, unless impracticable.

Question 1: Confirmation that proposed Standard should be applied retrospectively

Does the IASB confirm the 2013 ED proposals that, at the beginning of the earliest period presented, an entity should apply the Standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* unless impracticable?

Amendments to the simplified approach

30. Although some suggested that the simplified approach should be replaced by a different measure of the insurance contract, the staff notes that the simplified approach was widely supported in the comment letters, and would allow entities to achieve an approximation to retrospective application. Furthermore, although some comment letters suggested that a measure with a different objective should be used in place of the simplified approach, those letters did not provide new justifications for doing so. In particular, those letters did not address the IASB's main reason for not using a measure with a different objective, which was that doing so would result in little comparability between contracts issued before and after the date the proposed Standard is applied. While the simplified approach does not provide results that are fully comparable to retrospective application, it would provide a closer approximation to retrospective application than measures with a different objective. Accordingly, although the staff considered the use of a measure with a different objective, this was only within the context of application to a more restricted group of contracts for which the use of the simplified approach is impracticable. In the paragraphs that follow, the staff assumes that the IASB will confirm the use of a simplified approach and consider modifications to it.

Cash flows

31. The staff believes that it would not be possible to develop a simplification that addresses the lack of cash flow information while providing comparable information. In particular, the staff believe that using current (rather than historical) information about cash flows would assume that contracts written before the date the proposed Standard is applied were written in similar market circumstances as the contracts issued at the date the proposed Standard is applied. Thus, such information would not be comparable. In addition, the total profit of a contract could be different from the one actually earned by the entity because the cash flows for the contracts that are written at the date the proposed Standard is applied could not appropriately reflect the cash inflows that entity received and cash outflows that an entity paid.

32. Furthermore, the staff also believes that it would not be possible to develop a simplification that addressed the situations in which cash flows data is available, but not at the required level of detail. This is because when an entity allocates the cash flows to in-force contracts at the beginning of the earliest period presented it needs to take into account the effect of contracts that were no longer in-force at the beginning of the earliest period presented. This is illustrated in the Example below.

> Example 1
>
> Consider an entity that has 100 in-force contracts at the beginning of the earliest period presented. Those 100 contracts might have originally been written in a portfolio of 500 contracts, but 400 of those contracts have lapsed before the beginning of the earliest period presented.
>
> The entity might have recorded that it paid CU500 of acquisition costs to acquire this portfolio of contracts. If the entity had applied the proposed Standard retrospectively, the entity would have included CU1 per contract at the date of initial recognition (CU500 for 500 in-force contracts).
>
> However, if the IASB were to allow the entity to include CU500 of acquisition costs in the measurement of the 100 in-force contracts at the beginning of the earliest period presented, then there would be CU5 of acquisition costs included each in-force contract (CU500 for 100 in-force contracts), and the contractual service margin on each contract would be artificially suppressed.

33. Based on the Example above the staff does not believe it would be appropriate to allow an entity to use cash flow information relating to a portfolio determined immediately before the beginning of the earliest period presented and apply it only to the contracts in-force at the date of transition.

34. Consequently, the staff believes that it is not possible to further simplify the estimate of cash flows that occurred before the earliest period presented, and because the staff agrees that there are situations in which cash flows information would not be available, the staff believes the IASB needs to specify an approach that can be applied if it would be impracticable for an entity to apply the simplified approach. The alternative approach to situations when simplified approach is not practicable discussed in paragraphs 47-52.

Discount rate at the date of initial recognition of contract

35. The simplified approach would require an entity to determine the discount rates at the date of initial recognition either:

    (a) by reference to an observable yield curve that approximated the yield curve of the insurance contract during the three years before the beginning of the earliest period presented; or

    (b) if there is no such observable yield curve, by applying an average spread between an observable yield curve and the yield curve of the insurance contract. The spread should be determined as an average over at least three years before the beginning of the earliest period presented.

36. As noted in paragraph 19, some constituents were concerned that observable yield curves with sufficiently long durations would not have been observable at the date of initial recognition of the insurance contract. However, the staff notes that:

    (a) an entity could use an observable yield curve for a reference portfolio of assets in a different currency, provided that appropriate foreign currency risk were adjusted for.

    (b) an entity would need to extrapolate the observable yield curve using techniques similar to those used to adjust a yield curve that reflects the current market rates of returns for a reference portfolio of assets to determine a yield curve appropriate for the insurance contract. Although there may be a greater degree of adjustments in the estimation techniques used, it should always, in principle, be possible to apply estimation techniques to extend the observable yield curve.

37. Accordingly, the staff believes that there is no need to modify the estimation of the discount rate at the date of initial recognition in the simplified approach.

Risk adjustment

38. Paragraph 16 describes the concern that the risk adjustment at the date of initial recognition would often be understated when the simplified approach is applied. As a consequence, the contractual service margin would often be overstated.

39. The proposal to estimate the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented arose because the IASB believed that:

    (a) it would often be impracticable to estimate the risk adjustment at the date of initial recognition without using hindsight. This is because the risk adjustment is an unobservable, entity-specific measure that takes into account the entity's aversion to risk at the time the measure is made and relies on circumstances that existed on the date of the transaction.[5]

    (b) the possible misstatement of the risk adjustment would not affect the total profit of an entity over the contract term. The only difference would be the split between the profit recognised from the release of risk and the profit recognised from the release of the contractual service margin, both at initial, recognition and in subsequent periods.

40. The staff also notes that estimating the risk adjustment at the date of initial recognition as the risk adjustment measured at the beginning of the earliest period presented assumes that there has been no risk released before the beginning of the earliest period presented. This conclusion is consistent with the proposal that the expected cash flows at the date of initial recognition should be estimated as the expected cash flows at the beginning of the earliest period presented, adjusted by cash flows that occurred before the beginning of the earliest period presented. As there is no uncertainty associated with the cash flows that occurred before the beginning of the earliest period presented, there would be no release of risk. Consequently, the staff believe that understatement of the risk adjustment and overstatement of the contractual service margin at the date of initial recognition is a natural consequence of the simplified approach proposed.

41. Nonetheless, the staff believes that the understatement of the risk adjustment at the date of initial recognition could be avoided by estimating the risk adjustment at the date of initial recognition as the risk at the beginning of the earliest period

[5] A similar situation arises in IFRS 9 *Financial Instruments*, which does not permit an entity to designate financial instruments retrospectively because those designations would be based on the intent at the time of designation. Similarly, IFRS 15 *Revenue from Contracts with Customers* provides practical expedient from retrospectively estimating the variable consideration in the comparative reporting periods. That expedient allows using hindsight to minimise cost of initial application of the new Standard.

presented, adjusted for the expected release of the risk adjustment determined by reference to similar insurance contracts that the entity issues at the beginning of the earliest period presented. Estimating the risk adjustment in this way would be more complex and could be inconsistent with the method used to estimate cash flows in the simplified approach, but would provide a more accurate estimate of the risk adjustment in the limited circumstances when the release from risk over the contract term has had the same pattern as that expected for contracts issued at the beginning of the earliest period presented, and there have been no unexpected changes in risk. This approach to estimating the release adjustment would potentially understate or overstate the risk adjustment when the expected release pattern of the contracts written at the beginning of the earliest period presented is not the same as the release pattern for in-force contracts at transition date. In contrast, the estimate of the risk adjustment proposed in the 2013 ED would understate the risk adjustment at the date of initial recognition in almost all cases.

42. The staff believes that the arguments for and against each approach are finely balanced, but recommends that entities should estimate the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, adjusted for the expected release of the risk determined by reference to similar insurance contracts that the entity issues at the beginning of the earliest period presented. The recommended approach would avoid a systematic understatement of the risk adjustment.

Restrictions on use of simplifications

43. As noted in paragraph 23, some believed that the proposed simplified approach was too restrictive and proposed that an entity should be able to choose particular simplifications for measuring insurance contracts or that an entity should be allowed to use other simplifications that meets the principle for measuring insurance contracts at the beginning of the earliest period presented.

44. However the staff believe that permitting an entity to apply some of the simplifications specified in the simplified approach and not others, or permitting entities to develop their own simplifications would significantly reduce the comparability of insurance contracts and would reduce the understandability of the amounts reported. The staff notes that, if the recommendations in this paper

are accepted, there would already be three different transition approaches available to entities, and that allowing variations on those approaches or allowing additional approaches would add complexity for users of financial statements in understanding the transition adjustments.

45. Consequently, the staff recommends that when an entity applies the simplified approach, all of the proposed simplifications must be used together.

Question 2: Simplified approach proposed in the 2013 ED
Does the IASB agree to confirm the 2013 ED proposal that if retrospective application of the Standard is impracticable, an entity should use the simplified approach proposed in paragraphs C5 and C6 of the 2013 ED (reproduced in the Appendix) with the following modification: instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of the risk. The expected release of risk should be determined by reference to similar insurance contracts that the entity issues at the beginning of the earliest period presented.

Alternative proposals when using the simplified approach is impracticable

46. Paragraphs 32-34 concluded that it may be impracticable to use the simplified approach to estimate the contractual service margin at the beginning of the earliest period presented because of the lack of cash flow information. Accordingly, the staff propose that the IASB should specify how an entity should make the transition to the proposed Standard if it is impracticable to apply the simplified approach.

Estimating the contractual service margin at the beginning of the earliest period presented

47. When there is no information about expected cash flows that occurred before the beginning of the earliest period presented, there is little alternative but to use another measure of the insurance contract. Any such approach would suffer the disadvantages of:

(a) reduced comparability between contracts before and after the proposed Standard is applied.

(b) any measure that does not rely on cash flow information at the date of initial recognition has the potential risk of overstatement of revenue.[6]

48. For these reasons, as explained in paragraph 30, staff considered an alternative approach only when the simplified approach is impracticable. Accordingly, the staff do not propose that entities be permitted a choice between applying an alternative approach or the simplified approach when retrospective application is impracticable.

49. With the limitations noted in paragraph 47 in mind, the staff considered approaches the IASB previously rejected when developing 2013 ED as the primary means for determining the contractual service margin at the beginning of the earliest period presented. This was because the main objection against these previously-rejected approaches compared to the simplified approach was that they would reduce comparability, and any alternative approach used when the simplified approach is impracticable would suffer this lack of comparability. In particular, the staff considered determining the contractual service margin at the beginning of the earliest period presented as:

(a) set to zero as proposed in the 2010 ED; or

(b) the difference between the fulfilment cash flows measured at the beginning of the earliest period presented and fair value.

50. In the staff's view, the main advantage of setting the contractual service margin to zero is that it is simple, objective and introduces no operational complexity. However, when the IASB proposed this approach as the primary means of determining the contractual service margin at the beginning of the earliest period presented in the 2010 ED, respondents noted that this approach would have significant disadvantages. In particular, it would significantly increase equity at the date the proposed Standard is applied and decrease subsequent profits for the

[6] As described in paragraph 9, under the IASB's proposals, revenue is recognised by reference to the change in the insurance contract liability, adjusted to exclude the effects of losses previously recognised in P&L and the allocation of the acquisition costs based on the pattern of services. If the losses previously recognised in P&L were not excluded, this could result in an entity recognising more revenue than the consideration received.

in-force business. In the staff's view, that disadvantage remains significant. That view was also supported by the ASAF at its September 2014 meeting.

51. The staff believes that a better alternative is to use the difference between the fulfilment cash flows and fair value to determine the contractual service margin at the beginning of the earliest period presented. The staff notes that fair value is a commonly understood measure, that is already used in the proposed Standard to determine the contractual service margin in a business combination or a portfolio transfer. Although some constituents were concerned that entities might not be able to calculate fair value, the staff notes that a fair value could always be determined to measure contracts at the date of the business combination. Furthermore, while the staff acknowledges that there would be costs associated with determining fair value, these would be a one-off cost only for contracts for which both retrospective application and the simplified approach are impracticable. At the September ASAF meeting, some members supported the use of fair value for determining the contractual service margin at the beginning of the earliest period presented.

52. Accordingly, the staff recommends that when the simplified approach is impracticable, an entity should measure the contractual service margin at the beginning of the earliest period presented as the difference between the fulfilment cash flows and the fair value of the insurance contract at that date. The staff also recommends for each period presented for which there are contracts measured in this way, an entity should disclose the information proposed in paragraph C8 of the 2013 ED (reproduced in the Appendix). This is because the estimate of the contractual service margin would not be fully comparable with the contractual service margin estimated using either retrospective application or the simplified approach,

Estimating interest at the date of initial recognition to present the effect of changes in the discount rates in OCI

53. The fair value approach would provide a measure of the contractual service margin at the beginning of the earliest period presented. However, it would not provide an estimate of the discount rate at the date of initial recognition of the contract. Such an estimate is necessary for the entity to determine the interest

expense in profit or loss and the related amount of other comprehensive income accumulated in equity when the entity choses as its accounting policy to recognise the effect of changes in discount rate in profit or loss.

54. In paragraph 38, the staff concluded that entities should always be able to determine the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 ED. This would mean that the entity estimates the discount rate at the date of initial recognition either:

    (a) by reference to an observable yield curve that approximated the yield curve of the insurance contract during the three years before the beginning of the earliest period presented; or

    (b) if there is no such observable yield curve, by applying an average spread between an observable yield curve and the yield curve of the insurance contract. The spread should be determined as an average over at least three years before the beginning of the earliest period presented.

55. Accordingly the staff proposes that, when an entity applies the fair value approach, and the entity chooses as its accounting policy to present the effect of changes in discount rates in other comprehensive income, the entity should estimate the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 ED.

56. The staff also notes that an entity applying the fair value approach could choose to avoid the complexity of determining the discount rate at the date of initial recognition of the contract if it chooses as its accounting policy to recognise the effect of changes in discount rate in profit or loss.

Question 3: Alternative proposal when use of the simplified approach is impracticable

Does the IASB agree that:

a) if the simplified approach is impracticable, an entity should apply a 'fair value approach' in which the entity would:

   i. determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract and the fulfilment cash flows measured at that date; and

   ii. determine the discount rate used for determining interest expense in profit or loss, and the related amount of Other Comprehensive Income accumulated in equity, by estimating the discount rate at the date of initial recognition of the insurance contract using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 ED.

b) for each period presented for which there are contracts that were measured in accordance with the simplified approach or the fair value approach, an entity should disclose the information proposed in paragraph C8 of the 2013 ED (ie the disclosures for contracts for which retrospective application is impracticable) separately for:

   i. contracts measured using the simplified approach; and

   ii. contracts measured using the fair value approach?

Appendix A: Relevant paragraphs from the 2013 ED and Basis for Conclusions

2013 Exposure Draft Insurance Contracts

Transition

C2 The transition requirements in paragraphs C3–C12 apply when an entity first applies this [draft] Standard. The application of this [draft] Standard is a change in accounting policy, to which IAS 8 *Accounting Policies, Changes in Accounting Estimates and Changes in Accounting Policies* applies. Unless otherwise specified, an entity shall recognise the cumulative effect of such changes in the accounting policy as, at the beginning of the earliest period presented, an adjustment to the opening retained earnings and, if applicable, to the opening balance of the accumulated other comprehensive income.

C3 At the beginning of the earliest period presented, an entity shall, with a corresponding adjustment to retained earnings, derecognise:

(a) any existing balances of deferred acquisition costs relating to insurance contracts.

(b) derecognise any intangible assets that arose from insurance contracts that were assumed in previously recognised business combinations and that do not meet the definition of an intangible asset.

(c) recognise, in accordance with IFRS 3 *Business Combinations*, any assets or liabilities acquired in a business combination that were not previously recognised because they had been subsumed in amounts recognised in accordance with IFRS 4 *Insurance Contracts* and that are derecognised in accordance with (a) or (b). The entity shall measure such assets or liabilities on the basis that relevant Standards would have required for such assets or liabilities at the date of the business combination.

(d) measure each portfolio of insurance contracts at the sum of:

(i) the fulfilment cash flows; and

(ii) a contractual service margin, determined in accordance with paragraphs C4–C6.

(e) recognise, in a separate component of equity, the cumulative effect of the difference between the expected present values of the cash flows at the beginning of the earliest period presented, discounted using:

(i) current discount rates, as determined in accordance with paragraph 25; and

(ii) the discount rates that were applied when the portfolios were initially recognised, determined in accordance with paragraph C6.

C4 Except when paragraph C5 applies, an entity shall apply this [draft] Standard retrospectively in accordance with IAS 8 to measure an insurance contract in existence at the beginning of the earliest period presented.

C5 IAS 8 specifies when it would be impracticable to apply this [draft] Standard to measure an insurance contract retrospectively. In those situations, an entity shall, at the beginning of the earliest period presented:

(a) measure the insurance contract at the sum of:

(i) the fulfilment cash flows in accordance with this [draft] Standard; and

(ii) an estimate of the remaining contractual service margin, using the information about the entity's expectations at initial recognition of the contract that were determined in accordance with paragraph C6.

(b) estimate, for the purpose of measuring insurance contract revenue after the beginning of the earliest period presented, in accordance with paragraph C6, the carrying amount of the liability for the remaining coverage, excluding:

(i) any losses on the date of initial recognition; and

(ii) any subsequent changes in the estimates between the date of initial recognition and the beginning of the earliest period presented that were immediately recognised in profit or loss.

(c) determine, for the purpose of measuring the interest expense to be recognised in profit or loss, the discount rates that applied when the contracts in a portfolio were initially recognised in accordance with paragraph C6.

C6 In applying paragraph C5, an entity need not undertake exhaustive efforts to obtain objective information but shall take into account all objective information that is reasonably available and:

(a) estimate the expected cash flows at the date of initial recognition at the amount of the expected cash flows at the beginning of the earliest period presented, adjusted by the cash flows that are known to have occurred between the date of initial recognition and the beginning of the earliest period presented;

(b) estimate the risk adjustment at the date of initial recognition at the same amount of the risk adjustment that is measured at the beginning of the earliest period presented. The entity shall not adjust that risk adjustment to reflect any changes in risk between the date of initial recognition and the beginning of the earliest period presented;

(c) estimate the discount rates that applied at the date of initial recognition using an observable yield curve that, for at least three years before the date of transition, approximates the yield curve estimated in accordance with paragraphs 25–26 and B69–B75, if such an observable yield curve exists; and

(d) if the observable yield curve in (c) does not exist, estimate the discount rates that applied at the date of initial recognition by determining an average spread between an observable yield curve and the yield curve estimated in accordance with paragraphs 25–26 and B69–B75, and applying that spread to that observable yield curve. That spread shall be an average over at least three years before the date of transition.

Disclosure

C7 An entity applying this [draft] Standard for periods beginning before [date specified in paragraph C1] shall disclose that fact.

C8 For each period presented for which there are contracts that were measured in accordance with paragraphs C3–C6, an entity shall disclose, in addition to the disclosures required by IAS 8:

(a) the earliest date of initial recognition of the portfolios for which the entity applied this [draft] Standard retrospectively; and

(b) the disclosures required by paragraphs 83–85 separately for portfolios to which paragraphs C3–C6 apply. At a minimum, an entity shall provide those disclosures for:

(i) the contractual service margin as determined in accordance with paragraphs C5–C6, including a description of the extent to which the entity used information that is not objective in determining that margin; and

(ii) the discount rates as determined in accordance with paragraph C6.

C9 In applying paragraph 90, an entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies this [draft] Standard. However, if an entity does not disclose that information, it shall disclose that fact.

C10 An entity is not required to disclose, for the current period and for each prior period presented, the amount of the adjustment for each financial statement line item that is affected, as paragraph 28(f) of IAS 8 would otherwise require.

Basis for Conclusions to the 2013 Exposure Draft Insurance Contracts

Applying the proposals for the first time (paragraphs C1–C13)

Modified retrospective approach (paragraphs C2–C6)

BC160 The proposed measurement model comprises two elements:

(a) a direct measurement, which is based on estimates of the present value of future cash flows and an explicit risk adjustment; and

(b) a contractual service margin, which is measured at initial recognition of the insurance contract, adjusted for subsequent changes in estimates relating to future services and recognised in profit or loss over the coverage period.

BC161 In addition, the proposed presentation approach would include in profit or loss:

(a) insurance contract revenue, which is measured as the change in the liability for the remaining coverage excluding losses on initial recognition and changes in estimates that are not offset in the contractual service margin;

(b) an allocation of the acquisition costs and the related insurance contract revenue that is based on the pattern of transfer of services under the contract;

(c) claims and expenses on an incurred basis; and

(d) interest expense, measured using the discount rate at the date of initial recognition of the contract, updated if the entity expects any changes in the returns on underlying items to affect the amount of cash outflows.

BC162 In general, when an entity applies accounting policies that result from a new Standard for the first time, the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply, unless another Standard contains more specific requirements. IAS 8 requires retrospective application of a new accounting policy except when it would be impracticable. When it is impracticable, IAS 8 requires an entity, at the beginning of the current period, to measure the cumulative effect of applying a new accounting policy to prior periods, and to adjust the comparative information so that the new accounting policy is applied prospectively from the earliest date practicable. The entity therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity that arise before the date at which it would be practicable to apply the Standard retrospectively.

BC163 The IASB has identified no specific transition problems for the introduction of the direct measurement component of the insurance contract. That measurement reflects only circumstances at the measurement date. Consequently, provided an entity 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 on a later date.

BC164 Measuring the remaining amount of the contractual service margin at the date of transition, and the information needed for presentation in the statement of profit or loss and other comprehensive income in subsequent periods, is more challenging. In principle:

(a) an entity would measure the remaining contractual service margin by:

  (i) estimating the fulfilment cash flows at initial recognition of the contracts;

  (ii) estimating the amount by which the contractual service margin at initial recognition would have been adjusted to reflect changes in estimates of expected future cash flows before the date of transition; and

  (iii) estimating the amount of contractual service margin that would have been recognised in profit or loss in the periods before the date of transition.

(b) an entity would determine insurance contract revenue to be recognised in periods after the date of transition as the carrying amount of the liability for the remaining coverage at the date of transition less the portion of that carrying amount that arose from expected losses that were recognised:

  (i) as an immediate expense at contract inception; and

  (ii) as a result of changes in estimates of claims, benefits and expenses after contract inception.

(c) an entity would measure the interest expense recognised in profit or loss by estimating the discount rate when the contract initially was recognised, or updated as a result of changes in expectations of cash flows that the entity expected to credit to the policyholder, and applying that discount rate to the fulfilment cash flows.

BC165 The IASB believes that measuring the following amounts would often be subject to bias through the use of hindsight:

(a) the expected cash flows at the date of initial recognition;

(b) the risk adjustment at the date of initial recognition;

(c) the discount rate at the date of initial recognition; and

(d) for each accounting period, the changes in estimates that would have been recognised in profit or loss because they did not relate to future coverage, and the extent to which such changes in estimates would have been reversed as claims were incurred.

BC166 As a result, the IASB concluded that, for many contracts, retrospective application of this Exposure Draft would often be impracticable, as defined in IAS 8.

BC167 In the 2010 Exposure Draft, the IASB proposed that an entity should, when first applying the new Standard, measure its existing contracts at that date by setting the contractual service margin equal to zero.

BC168 However, most comment letters to the 2010 Exposure Draft criticised this approach because it would result in a significant lack of comparability between contracts that were in force at the date of transition and those that were recognised initially after the date of transition. The effects of this lack of comparability would be present for many years to come because of the long duration of insurance contracts.

BC169 The IASB was persuaded by the arguments that there would be a lack of comparability in the measurement, both at transition and subsequently, of contracts that were written before and after the date of transition. In particular, the IASB was persuaded that when an entity first applies a new Standard, subject to cost-benefit considerations, the primary focus should be on consistency between:

(a) the measurement of the insurance contracts' liability and the contractual service margin on the insurance contracts in force at the date of transition and those for new contracts issued after transition; and

(b) the presentation of the insurance contract revenue and profit for the insurance contracts in force at transition and on new contracts issued after transition.

BC170 As a result, this Exposure Draft proposes that:

(a) where practicable, an entity should apply this Exposure Draft retrospectively in accordance with IAS 8.

(b) when retrospective application of this Exposure Draft is not practicable, an entity should apply a modified retrospective application of this Exposure Draft. This modified retrospective application would require entities to estimate the information needed to apply this Exposure Draft listed in paragraph BC165, maximising the use of objective data, and with the following simplifications:

(i) the entity should assume that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were known already at initial recognition. This simplification is equivalent to offsetting all changes in estimates of cash flows against the contractual service margin on a retrospective basis. This avoids the need for entities to measure the changes in estimates that would have been recognised in profit or loss because they did not relate to future coverage, or to assess the extent to which such changes in estimates had been reversed as claims were incurred. The IASB believes that entities could approximate the expected cash flows at the date of initial recognition without undue effort by adjusting the expected cash flows at the date of transition by the cash flows that occurred before the date of the earliest period presented.

(ii) the risk adjustment at the date of initial recognition should be assumed to be the same as the risk adjustment at the date of the earliest period presented. This simplification would most likely understate the risk adjustment at the date of initial recognition. However, the risk adjustment at the date of transition could be more objectively determined than by any other approach for estimating what the risk adjustment would have been at the date of initial recognition.

(iii) the discount rate at the date of initial recognition should be estimated to be consistent with historical observable data from the date of initial recognition, averaged over a minimum of three years. The IASB observed that many entities that issue insurance contracts will have objective, contemporaneous data about insurance contracts issued before the date of transition. Such data would include actuarial reports and regulatory filings. Using such information would increase comparability between the accounting for contracts that are in force at the beginning of the earliest period presented and the accounting for contracts that are recognised initially after the beginning of the earliest period presented.

Other approaches considered but rejected

BC171 The IASB considered whether entities could measure the contractual service margin at the date of transition as the difference between the fulfilment cash flows and another measure of the insurance contract at the date of transition. Possible alternative measurements that were considered included fair value, the premium that the entity would have charged the policyholder if it had entered into a contract with equivalent terms, or the carrying amount under previous GAAP at the date of transition. Such other measurements would be determined at the date of transition and would not exclude the use of hindsight. Additionally, those other measurements:

(a) would not aim to provide comparability between contracts that are in force at the date of transition and contracts that are recognised initially after the date of transition;

(b) would not provide the information that is needed to measure insurance contract revenue; and

(c) would still require the IASB to specify simplifications.

BC172 Consequently, the IASB concluded that there would be minimal benefit in applying a different measurement of the insurance contract at the date of transition.

BC173 The IASB concluded that there is no need to constrain the amount of contractual service margin because the requirements, proposed in this Exposure Draft, to use all of the available information to approximate retrospective application would be sufficient to ensure that the contractual service margin is not overstated.

Other transition issues

BC174 The IASB does not propose any specific application guidance on the level of aggregation for contracts that exist at the beginning of the earliest period presented. Thus, the level of aggregation would be the same as for contracts that are written after the beginning of the earliest period presented. In contrast, the FASB proposes that an entity may, as a practical expedient, measure the insurance contract liability and its margin using its determination of the portfolio immediately prior to transition.

Elimination of deferred acquisition costs and some other intangible assets (paragraph C3(a) and (b))

BC175 As proposed in the 2010 Exposure Draft, when an entity applies the new measurement model it would not only need to adjust the measurement of its insurance contracts but would also need to eliminate some related items such as deferred acquisition costs and some intangible assets that relate solely to existing contracts. The IASB decided that elimination of these items, if any exist, is appropriate because those items could be viewed as corrections for a previous overstatement of the insurance liability, and so their elimination is likely to coincide with a reduction in the measurement of the insurance liability.