STAFF PAPER

November 2016

IASB Meeting

Project	**Insurance contracts**
Paper topic	Transition issues

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Purpose of this paper

1. This paper considers how the International Accounting Standards Board (the Board) should respond to the issues relating to transition that have been identified in external testing of a draft of IFRS 17 *Insurance Contracts* (draft IFRS 17), other than those relating to the use of derivatives used to mitigate financial risk, which are addressed in Agenda Paper 2F, and those relating to contracts previously acquired under a business combination and comparative information, which are addressed in Agenda Paper 2G.

Staff recommendations

2. The staff recommend that when an entity applies IFRS 17 for the first time:
   (a) the entity shall apply the requirements of IFRS 17 retrospectively in accordance with IAS 8*Accounting Policies, Changes in Accounting Estimates and Errors* to groups of insurance contracts[1], unless doing so is impracticable;
   (b) for insurance contracts for which the entity cannot identify a group retrospectively, and for groups of insurance contracts for which retrospective application is impracticable, the entity is permitted to

[1] Grouping of contracts is discussed in Agenda Paper 2C.

choose between a modified retrospective approach or the fair value approach, unless a modified retrospective approach is impracticable, in which case the entity must use the fair value approach;

(c) the objective of a modified retrospective approach is to achieve the closest outcome to retrospective application that is possible using reasonable and supportable information. The entity is permitted to use specified modifications (listed in Appendix B) but shall use the minimum modifications necessary to meet the objective of the modified retrospective approach;

(d) in applying a modified retrospective approach, the entity shall maximise the use of information that would have been used to apply a fully retrospective approach but need only use such information that is available without undue cost or effort;

(e) the entity should determine the contractual service margin using the permitted modifications for the variable fee approach at the beginning of the earliest period presented, rather than the date of initial application of IFRS 17;

(f) in applying the fair value approach, the entity should be allowed to make the following assessments:[2]

    (i) whether a contract is eligible for the variable fee approach;

    (ii) how to group contracts; and

    (iii) how to determine the effect of discretion on estimated cash flows for contracts subject to the general model

    either:

    (iv) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

    (v) at the beginning of the earliest period presented;

[2] These choices are also allowed under a modified retrospective approach and are included in the list of permitted modifications in Appendix B.

(g) as part of a modified retrospective approach or the fair value approach, the entity is permitted;

(i) not to divide contracts into groups that were written in the same year;

(ii) for groups applying the general model, to accrete and adjust the resulting contractual service margin after transition using the discount rate at the beginning of the earliest period presented;

(iii) if the entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, for non-participating contracts the entity is permitted to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented;

(h) if the entity chooses to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented (paragraph (g) (iii)), it should:

(i) make separate disclosures for amounts relating to insurance finance income and expenses for:

1. insurance contracts that were in force at the beginning of the earliest period presented; and
2. insurance contracts issued after the beginning of the earliest period presented.

(ii) disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income for related financial assets measured at fair value through other comprehensive income (FVOCI).

3. The staff also recommend that an entity should:

(a) provide all the disclosures required by IFRS 17 relating to:

(i) the contractual service margin;

(ii) insurance contract revenue; and

(iii) insurance finance income or expenses separately for:

(iv) insurance contracts that existed at the beginning of the earliest period presented, for each transition method:

1. restrospective application applying IAS 8;
2. modified retrospective application;
3. the fair value approach; and

(v) insurance contracts written after the beginning of the earliest period presented.

(b) for all periods in which disclosures arise under (a) (iv), explain how the entity determined the measurement of insurance contracts at transition to enable users to understand the nature and significance of the methods used and judgements applied.

Overview of the proposals for transition and the issues identified

4. Draft IFRS 17 requires retrospective application in accordance with IAS 8 if it is practicable[3]. If it is impracticable to retrospectively measure the contractual service margin at the beginning of the earliest period presented, draft IFRS 17 provides simplified transition approaches for estimating the opening contractual service margin. If both retrospective application and the simplified transition approaches are impracticable, entities would be required to estimate the contractual service margin at the beginning of the earliest period presented as the excess, if any, of the fair value of contracts over the fulfilment cash flows measured at that date.

5. The feedback from the test participants is provided in Agenda paper 2B. In summary:

(a) Test participants generally expected to apply IFRS 17 retrospectively for a small proportion of their existing contracts;

(b) Some test participants were concerned about how to interpret “impracticability”. For example test participants questioned whether

[3] There is an exception to retrospective application for the use of risk mitigation techniques under the variable fee approach which must be applied prospectively. This is discussed in agenda paper 2F

they need actual cash flow information or if they could estimate the amount and timing of cash flows based on actuarial valuation data. Some also thought that the need to demonstrate impracticability of retrospective application before being permitted to use the simplified approach, and impracticability of the simplified approach before being permitted to use to use the fair value approach would result in entities spending significant time, resources and cost for little or no benefit (Issue 1).

(c) Some test participants questioned whether the simplified transition approaches would be practical to apply, and some suggested further simplification to the simplified transition approaches. In addition, some test participants thought that the simplified approaches needed to be modified to provide further guidance, further simplification, or to permit entities to use information they thought was a better approximation to retrospective application if available (Issue 2).

(d) The simplified transition approach for contracts with direct participation features (to which an entity applies the variable fee approach) requires the contractual service margin at the beginning of the earliest period presented to be determined by reference to the contractual service margin at the date of initial application. Some respondents were concerned that this means that they would not be able to prepare their opening comparative information until they start reporting in real time. Those respondents suggested that entities should apply the simplified transition approach by reference to the contractual service margin at the beginning of the earliest period presented, as in the general model (Issue 3).

(e) Draft IFRS 17 requires that, when the entity applies the simplified approaches or the fair value approach, contracts written before the beginning of the earliest period presented in financial statements that apply IFRS 17 are grouped separately from contracts written after initial application of IFRS 17. Some entities questioned whether this would result in useful information when contracts are mutualised. This issue is superseded by the staff proposal in Agenda Paper 2C to restrict groups to contracts that are issued within one year. The effect of that proposal on mutualised contracts is discussed in paragraphs 36-39 of that paper.

(f) Some respondents expressed concerns about how to measure fair value of insurance contracts for the fair value approach, and that the outcome of that approach would be too small a contractual service margin (Issue 4). This paper also discusses:general transition issues arising from the staff proposal in Agenda Paper 2C to restrict groups to contracts that are issued within one year (Issue 5); and

(b) disclosure requirements related to transition arising from the issues discussed (Issue 6).

Issue 1: The need to demonstrate impracticability before using the simplified approach and fair value approach

7. Paragraph 51 of IAS 8 specifically allows for the use of estimates in retrospective application, albeit noting that making such estimates is potentially more difficult because of the longer period of time that might have passed since the transaction or event being measured. Hence, the staff do not think it necessary to add anything to draft IFRS 17 stating that estimates based on actuarial data are permitted.

8. The staff think that it is important to require retrospective application when practicable, and only allow alternatives when retrospective application is impracticable. This is consistent with the general principles to transition set out in IAS 8. The question of whether retrospective application is impracticable arises for many new Standards. The staff do not think that it will be more difficult to demonstrate if retrospective application is impracticable for IFRS 17 than for other Standards.

9. In relation to whether the fair value approach should be allowed only if the simplified approaches are impracticable, the staff note that a key reason for doing this in the 2013 Exposure Draft *Insurance Contracts* was to achieve as consistent an approach on transition as possible. However, if the Board agrees with the staff recommendation to move from a mandatory simplified approach to a range of

permitted modifications from a retrospective approach (see discussion of issue 2); consistency has inevitably become less of an objective.

10. In addition, the extent to which a modified retrospective approach will be close to full retrospective application depends on the extent of reasonable and supportable information available to an entity. If an entity has relatively little reasonable and supportable information and therefore would need to use many of the permitted modifications, it may decide that benefits of a modified retrospective approach compared to the fair value approach are not worth the costs.

11. The staff therefore propose that there should be a choice between a modified retrospective approach (developed from the simplified approaches in draft IFRS 17) and the fair value approach, unless a modified retrospective approach is impracticable, in which case an entity must use the fair value approach.

Question for Board members: Issue 1

Question 1: Does the Board agree that:

(a) an entity should apply the requirements of IFRS 17 retrospectively in accordance with IAS 8 to groups of insurance contracts, unless it is impracticable?

(b) for insurance contracts for which an entity cannot identify a group retrospectively, and for groups of insurance contracts for which retrospective application is impracticable, an entity is permitted to choose between a modified retrospective approach or the fair value approach, unless a modified retrospective approach is impracticable, in which case an entity must use the fair value approach?

Issue 2: Concerns with the simplified transition approaches

12. Draft IFRS 17 includes two simplified approaches, one for the general model and one for the variable fee approach. Concerns raised about the simplified transition approaches mainly relate to:

(a) should IFRS 17 allow a combination of transition approaches?

(b) a lack of completeness in the simplifications needed. These concerns are set out in more detail in Appendix A.

13. The staff are sympathetic to the concerns of those who had information that would allow them to get closer to the retrospective approach than the simplified approaches, even though they were not able to apply a full retrospective approach. In fact, if an entity has reasonable and supportable information available without undue cost and effort such that it could choose to apply a full retrospective approach, the staff do not think that the entity should be able to disregard that information.

14. The staff therefore propose that rather than have simplified approaches with mandatory requirements, entities should be allowed to use modifications from retrospective application, but only to the extent necessary because they do not have reasonable and supportable information to apply the retrospective approach.

15. The modifications that would be allowed are based on the previously proposed simplified approaches, with additional modifications permitted to fill the specific gaps identified by the external test participants (discussed in Appendix A). The proposed modifications are listed in Appendix B.

Questions for Board members: Issue 2

Question 2: Does the Board agree that the objective of a modified retrospective approach should be to achieve the closest outcome to retrospective application that is possible using reasonable and supportable information?

Question 3: Does the Board agree that an entity should be permitted to use specified modifications (listed in Appendix B) but shall use the minimum modifications necessary to meet the objective of the modified retrospective approach?

Question 4: Does the Board agree that, in applying a modified retrospective approach, an entity shall maximise the use of information that would have been used to apply a fully retrospective approach but need only use such information that is available without undue cost or effort?

Question 5: Does the Board agree with the list of permitted modifications in Appendix B?

Issue 3: The date for determining the contractual service margin for contracts with direct participation features

16. The simplified transition approach for contracts with direct participation features (to which an entity applies the variable fee approach) would have required the contractual service margin at the beginning of the earliest period presented to be determined by reference to the contractual service margin at the date of initial application. This is because the contractual service margin under the variable fee approach depends on the fair value of the underlying items and estimating fair values at past dates may require the use of hindsight. This is consistent with IFRS 9 *Financial Instruments*, which does not allow restatement of comparative amounts at transition to that Standard, including the fair value of financial instruments, if that required the use of hindsight.

17. Some respondents were concerned that determining the contractual service margin at the beginning of the earliest period presented by reference to the contractual service margin at the date of initial application means that they would not be able to prepare their opening comparative information until they start reporting in real time. Those respondents suggested that entities should apply the simplified transition approach by reference to the contractual service margin at the beginning of the earliest period presented, as in the general model.

18. The staff recommend that, under the modified retrospective approach, the contractual service margin for contracts under the variable fee approach is based on the fair value of underlying items at the beginning of the earliest period presented for the following reasons:

    (a) IFRS 17 will be published at least three years before the date of initial application, consequently entities will have time to gather information about fair value contemporaneously. The staff expects most entities will adopt IFRS 17 at the effective date, not earlier, because of time needed to amend their reporting systems and processes. Further, because of the importance of restating comparative amounts, the staff do not think we should adjust the transition requirements to help early adopters if doing so causes difficulty in restating comparatives. This is different from the situation in which the IFRS 9 transition requirements were set, when the Board wanted to minimise obstacles to early adoption. Another difference from IFRS 9 is that IFRS 9 is not applied to items that have been derecognised at the date of initial application, whereas IFRS 17 does not include such an exclusion.

(b) Determining the fair value of underlying items as at the beginning of the earliest period presented is not qualitatively different from making other estimates necessary to determine fulfilment cash flows at that date, especially for contracts under the variable fee approach. The modified retrospective approach (and the previous simplified approaches) requires fulfilment cash flows to be determined at the beginning of the earliest period presented.

(c) The fair value approach in draft IFRS 17 already requires an entity to determine the fair value of insurance contracts at the beginning of the earliest period presented.

19. The staff recommendation is consistent with the Board's tentative decision that entities should restate their comparatives when first applying IFRS 17, even though they are not required to restate their comparative figures for financial assets when they adopt IFRS 9. [4]

Question for Board members: Issue 3
Question 6: Does the Board agree that an entity should determine the contractual service margin using the permitted modifications for the variable fee approach (listed in paragraph B8) determined at the beginning of the earliest period presented?

Issue 4 – fair value approach

20. Some respondents expressed concerns about how to measure fair value of groups of insurance contracts for the fair value approach, and that the outcome of that approach would be too small a contractual service margin (Issue 4).

21. The staff note that IFRS 13 *Fair Value Measurement* provides guidance on fair value measurement. The staff acknowledge that the contractual service margin

[4] See Agenda Paper 2B of the October 2015 Board meeting.

resulting from the fair value approach will be different from that resulting from retrospective application or a modified retrospective application. However, the Board accepted the need for an approach that could be applied when no form of retrospective application is available based on reasonable and supportable information available without undue cost or effort. Using fair value as the basis for such an approach provides a clear objective and useful information about insurance contracts at transition. The staff recommend no changes to the fair value approach relating to how to measure fair value or the outcome of using the fair value approach.

22. However, the staff note that some of the modifications permitted for retrospective application are also relevant to the fair value approach. They relate to the following assessments that under a retrospective approach would be made at inception of a contract but that are relevant for the measurement of the insurance contract after transition;

 (a) whether a contract is eligible for the variable fee approach;

 (b) how to group contracts; and

 (c) how to determine the effect of discretion on estimated cash flows for contracts subject to the general model.

23. For these assessments, the staff recommend that an entity should have the same choice as permitted when applying a modified retrospective approach, ie the entity should be allowed to make the assessments:

 (a) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

 (b) at the beginning of the earliest period presented.

24. Paragraphs A3-A12 discuss the reasons why the staff recommend these choices.

Question for Board members: Issue 4
Question 7: Does the Board agree that under the fair value approach, and entity should be allowed to make the following assessments: (a) whether a contract is eligible for the variable fee approach;

(b) how to group contracts; and

(c) how to determine the effect of discretion on estimated cash flows for contracts subject to the general model

either:

(d) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

(e) at the beginning of the earliest period presented?

Issue 5: Grouping of contracts written within the same year

25. In Agenda Paper 2C, the staff recommend that entities should be permitted to group only contracts written within the same year.

26. The staff think it may not always be practicable for entities to group contracts in force at the beginning of the earliest period presented into groups according to the accounting period in which they were written. The staff therefore recommend that as part of a modified retrospective approach and the fair value approach, an entity is permitted;

   (a) not to divide contracts into groups that were initially recognised in the same reporting period;

   (b) for groups applying the general model, to accrete and adjust the resulting contractual service margin after transition using the discount rate at the beginning of the earliest period presented;

   (c) if the entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, for non-participating contracts the entity is permitted to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented.[5]

[5] This modification is already permitted for participating contracts under the general model.

27. Applying the discount rate at the beginning of the earliest period presented for determining insurance finance income or expenses presented in the statement of profit or loss is the same as assuming that accumulated other comprehensive income is nil in respect of the relevant contracts. If a full retrospective approach had been applied, then the accumulated balance of other comprehensive income (OCI) is likely to be a debit balance at the beginning of the earliest period presented.[6]

28. The staff note that this is likely to result in a larger positive investment margin in reporting periods after transition compared to the result if the requirements were applied retrospectively. The larger positive margin results from:

    (a) presenting an insurance investment expense in profit or loss based on interest rates at transition. Those rates are likely to be significantly lower than the interest rates present when the contract was written; and

    (b) if the related assets are held, and are measured using a cost basis in profit or loss, the investment income of the assets will reflect the interest rates at the time at which those assets were purchased /originated. Those rates are likely to be higher than the current interest rates.

29. The staff think that users of financial statements in these circumstances need to be alerted to the causes for any apparent positive investment margin. The staff therefore recommend that an entity should:

    (a) make separate disclosures for amounts relating to insurance finance income and expenses for:

        (i) insurance contracts that were in force at the beginning of the earliest period presented; and

        (ii) insurance contracts issued after the beginning of the earliest period presented.

    (b) disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income for

[6] Accumulated OCI is likely to have been a debit balance because interest rates are likely to be lower now than at inception of the contracts.

related financial assets measured at fair value through other comprehensive income (FVOCI).[7]

Questions for Board members: Issue 5

Question 8: Does the Board agree that as part of a modified retrospective approach and the fair value approach, an entity is permitted;

(a) not to divide contracts into groups that were written within the same year;

(b) for groups applying the general model, to accrete and adjust the resulting contractual service margin after transition using the discount rate at the beginning of the earliest period presented;

(c) if the entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, for non-participating contracts the entity is permitted to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented?

Question 9: Does the Board agree that if an entity chooses to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented, it should:

(a) make separate disclosures for amounts relating to insurance finance income and expenses for:

(i) insurance contracts that were in force at the beginning of the earliest period presented; and

(ii) insurance contracts issued after the beginning of the earliest period presented.

(b) disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income for related financial assets measured at fair value through other comprehensive income (FVOCI)?

[7] This recommended disclosure is consistent with that previously decided by the Board for participating contracts under the general model.

Issue 6 – Disclosure of transition amounts and methods

30. Draft IFRS 17 requires disclosure of the following amounts in the financial statements determined at transition using the simplified approaches, both at the date of transition and in subsequent periods:

    (a) the contractual service margin;

    (b) insurance contract revenue; and

    (c) insurance finance income or expenses.

31. The staff think that the recommendations in this paper will help preparers to apply a modified retrospective approach but may increase the likelihood of different methods being adopted by different insurers, and to different products by the same insurer. The staff think this is necessary in the light of the feedback we have received from testing participants. However, to provide compensating information to users of financial statements, the staff think that an entity should:

    (a) provide all the disclosures required by IFRS 17 relating to:

        (i) the contractual service margin;

        (ii) insurance contract revenue; and

        (iii) insurance finance income or expenses

        separately for:

        (iv) insurance contracts that existed at the beginning of the earliest period presented; and

        (v) insurance contracts written after the beginning of the earliest period presented.

    (b) for all periods in which disclosures arise under (a) (iv), explain how they determined the measurement of insurance contracts at transition in order for users to understand the nature and significance of the methods used and judgements applied.

Questions for Board Members: Issue 6

Question 10: Does the Board agree that an entity should provide all the disclosures required by IFRS 17 relating to:

(a) the contractual service margin;

(b) insurance contract revenue; and

(c) insurance finance income or expenses

separately for:

(d) insurance contracts that existed at the beginning of the earliest period presented; and

(e) insurance contracts written after the beginning of the earliest period presented?

Question 11: Does the Board agree that for all periods in which disclosures arise under paragraph 31 (a) (iv) (Question 10 (d)), an entity should explain how they determined the measurement of insurance contracts at transition in order for users to understand the nature and significance of the methods used and judgements applied.

Appendix A: gaps in the requirements of the simplified transition approaches

A1. Draft IFRS 17 included two simplified transition approaches, one for the general model and one for the variable fee approach. Test respondents noted a number of aspects of transition for which they thought additional or amended simplifications were needed covering:

(a) assessments that under a retrospective approach would be made at inception of a contract;

(i) whether a contract is eligible for the variable fee approach;

(ii) how to group contracts; and

(iii) how to determine the effect of discretion on estimated cash flows for contracts subject to the general model.

(b) the effect of contracts derecognised before transition on the contractual service margin at transition.

A2. The issues are discussed below. To address the issues in the context of the proposed modified retrospective approach (see paragraphs 12-15), the staff recommend that the permitted modifications include:

(a) that entities should be allowed to make the assessments described in A1(a) either:

(i) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

(ii) at the beginning of the earliest period presented.

(b) no modification relating to the need to incorporate the effect of contracts derecognised prior to transition into the calculation of the contractual service margin at transition.

Making an assessment of whether contracts fall under the scope of the variable fee approach

A3. Draft IFRS 17 defines insurance contracts with direct participation features that fall under the scope of the variable fee approach as contracts for which:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and

(c) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

A4. Draft IFRS 17 requires an entity to assess the conditions noted in paragraph A3 based on its expectations at the inception of a contract and not to reassess the conditions subsequently.

A5. It may be difficult to make a retrospective assessment of these conditions at transition without the use of hindsight (ie making an assumption of what an entity would have expected in the past). Considering each condition:

(a) The staff think it should be possible to determine the contractual terms of a contract and the relevant laws and regulations that applied at the date of inception. However, this might not be the case if there has been a change in regulatory practice since inception of the contracts.

(b) The staff think it may not always be feasible to assess whether an entity expected at the inception of a contract to pay policyholders an amount equal to a substantial share of the returns from underlying items. For example, such an expectation might have depended on the exercise of an expected level of discretion that was not documented at the time of the inception of a contract.

(c) The staff think it may not always be feasible to assess whether an entity expected, at inception of an insurance contract, that a substantial proportion of the amounts it expected to pay to the policyholder would vary with the cash flows from the underlying items. For example, such an expectation might have depended on the entity's expectations for returns from underlying items or how it would exercise discretion, or both, that were not documented at the time of the inception of a contract.

A6. The Board could avoid a need for hindsight if it required the assessment for eligibility of the variable fee approach to be performed at the date of transition instead of at the date of inception of the contract. However, the staff think that contracts issued in the past that would have been eligible for the variable fee approach if the assessment were made as at the date of inception of the contract might not be eligible if the conditions were assessed at transition to IFRS 17, for example because of the effect of guarantees that would have been 'out of the money' at inception but are 'in the money' at the beginning of the earliest period presented. Hence the staff recommend allowing the entity to make the assessment at:

(a) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

(b) at the beginning of the earliest period presented.

Grouping of contracts

A7. The simplified transition approaches in draft IFRS 17 require grouping of contracts at transition with similar expected responsiveness of the nature and timing of future cash flows to changes in key assumption. The assessment would be made at the beginning of the earliest period presented for contracts without direct participation features and the date of initial application of IFRS 17 for contracts with direct participation features.

A8. Agenda Paper 2C makes recommendations about the level of aggregation of contracts within the scope of IFRS 17 for the purposes of identifying contracts that are onerous and for measurement of the contractual service margin. The staff recommendation in Agenda Paper 2C requires identifying a group of contracts that have no significant risk of becoming onerous and a group of other profitable contracts. An entity should assess if there is a significant risk of the contracts in the group becoming onerous based on the sensitivity of the contracts' cash flows to changes in estimates needed before the contracts would become onerous.

A9. The staff recommend that entities are given the same choice of date for making the assessment of the sensitivity of the contracts' cash flows to changes in estimates as is recommended for assessing eligibility for the variable fee approach.

Distinguishing between changes in discretion and changes in financial assumptions

A10. Paragraph B94 of draft IFRS 17 requires:

> B94. The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify discretionary cash flows, an entity shall specify at the inception of the contract:
>
> a. what basis it regards as its commitment under the contract for the payments that it expects to continue with regardless if changes in assumptions that give rise to financial risk and
>
> b. what it regards as discretionary.

A11. Some testing participants stated that it could be difficult for entities to define the mechanism used to determine the amounts paid to the policyholders (eg using a formula) and the amounts that are subject to discretion to contracts, as this information would not have been available.

A12. The staff recommend that entities are given the same choice of date for distinguishing between changes in discretion and changes in financial assumptions as is recommended for assessing eligibility for the variable fee approach.

The effect of contracts derecognised before transition on the contractual service margin at transition

A13. Draft IFRS 17 requires that an entity aggregates contracts in force at the date of the beginning of the earliest period presented into groups to determine whether to recognise a loss for a group of onerous contracts and to measure the contractual service margin after initial recognition.

A14. However, the contractual service margin of a group of contracts at transition will reflect not only the past and expected future cash flows of contracts in force at that time but also the cash flows of contracts that were in the same group but which have been derecognised before the beginning of the earliest period presented.

For example,

Consider a group of annuity contracts issued 20 years prior to transition to men age 65 at that time. Assume that the entity that issued the contracts expected that the annuitants would live, on average, to age 80 and priced the contracts accordingly.

At the date of transition the surviving annuitants would be age 85. Considered in isolation, the contracts in force at transition could be considered to be onerous, (ie the entity expects to pay the surviving annuitants more than the premium they paid plus investment return). However, the group as a whole may still be expected to be profitable, and consequently have a positive contractual service margin at transition, because of the effect of net cash inflows from annuitants who died before they reached age 80.

Hence, it is necessary to consider the effect of cash flows of contracts that have been derecognised but which would have been in the same groups as contracts in force at transition.

A15. The staff propose to include in the modified retrospective approach an explicit requirement to incorporate the effect of contracts derecognised prior to transition into the calculation of the contractual service margin for groups of contracts in force at transition.

A16. An entity may have difficulty obtaining details of cash flows for all contracts that have been derecognised. However, the staff note that under retrospective application applying IAS 8 (and under a modified retrospective approach) the entity may make estimates and extrapolations using reasonable and supportable information, such as actuarial valuation files, movement analyses (reconciliations between year-end valuation files), experience analyses (comparing actual and expected experience), and analyses of surplus prepared in the past and mortality tables used in the past, etc..

Appendix B: list of proposed permitted modifications

For both the general model and variable fee approach

Not in the simplified approaches, but proposed by staff in the light of feedback received

B1. An entity is allowed to group together contracts in force at the beginning of the earliest period presented that were written in different reporting periods.

B2. An entity may assess to which group a contract belongs, and whether the contract is eligible for the variable fee approach:

(c) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

(d) at the beginning of the earliest period presented.

B3. An entity must incorporate the effect of contracts derecognised prior to transition into the calculation of the contractual service margin at transition, but the entity is allowed to assume that the effect on the contractual service margin at transition of contracts derecognised before the earliest date of inception of contracts in force in each group at transition is nil.

For the general model

Included in the simplified approach in the external testing draft

B4. To determine the contractual service margin at the beginning of the earliest period presented, an entity may:

(a) estimate the future cash flows at the date of initial recognition at the amount of the future 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 by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of 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) estimate the discount rates that applied at the date of initial recognition taking into account all objective information that is reasonably available:

(i) using an observable yield curve that, for at least three years before the date of transition, approximates the yield curve estimated applying paragraphs 32 and B70-B80 of draft IFRS 17, if such an observable yield curve exists; and

(ii) if the observable yield curve in (i) 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 applying paragraphs 32 and B70-B80 of draft IFRS 17, 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.

(d) adjust the contractual service margin at the date of initial recognition determined using (a)-(c) for the allocation of the contractual service margin before the beginning of the earliest period presented. The entity shall estimate the amount of the adjustment by comparing the remaining coverage units with the total coverage units of the group of contracts.

Proposed by staff in response to feedback received

B5. An entity may assess how to determine the effect of discretion on estimated cash flows for contracts subject to the general model:

(a) as at inception of a contract - based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at that time; or

(b) at the beginning of the earliest period presented.

B6. An entity may subsequently accrete and adjust the contractual service margin determined at the beginning of the earliest period using the discount rate at the beginning of the earliest period presented.

B7. If the entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, for non-participating contracts the entity is permitted to base finance income or expenses included in profit or loss using the discount rate at the beginning of the earliest period presented.

For the variable fee approach

Included in the simplified approach in the external testing draft

B8. An entity may determine the contractual service margin at the date of the beginning of the earliest period present8 of IFRS 17 as:

(a) the total fair value of the underlying items at the date of the beginning of the earliest period presented; less

(b) the fulfilment cash flows at the date of the beginning of the earliest period presented, adjusted to reflect relevant cash flows that have already occurred between the inception of the contracts and the date of beginning of the earliest period presented; and

(c) the amount of contractual service that relates to service provided before the date of the beginning of the earliest period presented. The entity shall estimate this amount by comparing the remaining coverage units with the total coverage units of the group of contracts.

[8] Draft IFRS 17 required this assessment to be made at the date of initial application. Paragraphs 16-19 explain why the staff recommend that this assessment is made at the beginning of the earliest period presented.