INSURANCE

Insurance accounting under IFRS

FINANCIAL SERVICES

AUDIT ▪ TAX ▪ ADVISORY

Step one towards an international accounting standard on insurance

The IASB issued IFRS 4 in March 2004 to provide interim guidance on accounting for insurance contracts. The Standard is the result of the first phase (phase I) of the IASB's project to develop an accounting standard to address the many complex and conceptual problems in insurance accounting. Before introduction of the Standard, IFRSs did not address specific insurance issues, while certain IFRSs specifically excluded insurance business. This resulted in diversity in the accounting practices of insurers.

Given the need to create a stable platform of accounting standards by March 2004, due to mandatory application of IFRSs in many jurisdictions by 2005, the IASB developed IFRS 4 as an interim measure. It is expected that the Standard will not add significant costs to financial reporting that might become unnecessary once the more comprehensive project (phase II) is completed. The IASB has just begun phase II of the insurance contracts project and has established a new industry advisory group to assist them in this project.

The main impact that IFRS 4 is expected to have is on classification of insurance contracts and disclosure in financial statements of entities issuing insurance contracts. The Standard has also brought about a number of changes in other IFRSs which will need to be addressed.

Both existing IFRS reporters and first-time adopters should closely evaluate their current insurance contract accounting in relation to the requirements of IFRS 4.

This publication provides an overview of IFRS 4 and selected sections of other IFRSs applicable to insurers. We hope this publication will be useful to you and your organisation while preparing to implement the requirements of IFRS 4.

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About this publication

Content

Information in this publication is current at 31 March 2004. It considers standards and interpretative guidance that were effective at 31 March 2004 and provides commentary on the likely impact of IFRS 4 and practical issues. Further interpretations of the Standard are likely to develop during the course of 2004 as companies work with their advisors to understand the requirements and implement them.

IFRS 4 is applicable for annual periods beginning on or after 1 January 2005. Earlier application is however encouraged and where an entity applies the Standard to an earlier period it should disclose that fact[1].

This publication is mainly aimed at insurers and limited reference is made to insurance contracts issued by non-insurers.

Organisation of the text

Throughout this publication we have made reference to IFRS 4, the Implementation Guidance and Basis for Conclusions accompanying the Standard, as well as other current statements of IFRS. Direct quotations from IFRSs are included in dark blue within the text.

A column noted as Reference is included in the left margin of Sections 1 through 15 to enable users to identify the relevant paragraphs of IFRS 4, the Interpretation Guidance and Basis for Conclusions as well as references to other applicable Standards.

Reference to IFRSs made throughout the text are identified in an appendix to the publication.

Examples are included throughout the text to elaborate or clarify the more complex principles of IFRS 4. These appear in shaded light blue boxes within the text.

Footnotes have been included to further clarify issues, as appropriate.

[1] It should be noted that the European Commission has at this stage not fully endorsed the application of IFRS 4 or IAS 39 and IAS 32, on financial instruments, for companies in the European Union.

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Keep in contact and stay up–to–date

IFRS 4 is intended to cover all entities that issue insurance contracts, not only insurance companies in the legal or regulatory sense. Further interpretation of the Implementation Guidance, Basis for Conclusions and IFRS 4 are required for an entity to apply the standard to its own facts, circumstances and individual transactions. Also, some of the information in this publication is based on interpretations of current literature, which may change as practice and implementation guidance continue to develop. Users are cautioned to read this publication in conjunction with the actual text of the Standard, Implementation Guidance and Basis for Conclusions and to consult their professional advisors before concluding on accounting treatments for their own transactions.

This publication has been produced by KPMG’s Global Insurance Industry Group in association with KPMG’s IFR Group. For further information, please visit www.kpmg.co.uk/ifrs, where you will find up–to–date technical information and a briefing on KPMG's IFRS conversion resources.

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1. Purpose of the Standard

Key topics covered in this Section:

- Objective of the Standard
- Scope of the Standard

Reference

1.1 Objective of the Standard

IFRS 4.BC2–BC4

IFRS 4 *Insurance Contracts* was issued by the International Accounting Standards Board (IASB) on 31 March 2004 as the first step in the IASB's project to achieve convergence of widely varying accounting practices in insurance industries around the world.

IFRS 4.1

The objective of IFRS 4 is to:

- achieve limited improvements in accounting for insurance contracts by insurers[1]; and
- introduce appropriate disclosure to identify and explain amounts in insurers' financial statements arising from insurance contracts and to help users understand the amount, timing and uncertainty of future cash flows from insurance contracts.

1.2 Scope of the Standard

IFRS 4.2–3

IFRS 4 applies to contracts in which an entity takes on insurance risk either as an insurer or a reinsurer. It also applies to contracts in which an entity cedes insurance risk to a reinsurer. The Standard does not address accounting and disclosure of direct insurance contracts in which the entity is the policyholder. (This will be addressed in Phase II of the IASB's project.)

IFRS 4 also addresses the treatment of certain financial instruments issued by an entity which allow the policyholder to participate in profits of the entity or investment returns on a specified pool of assets held by the entity through discretionary participation features.

IFRS 4 specifically mentions that other aspects of accounting by insurers are not addressed by the standard, except for some transitional provisions relating to the redesignation of financial assets as at 'fair value through profit or loss'. (Refer to chapter 11 for further discussion of accounting for non–insurance assets) This means that all other standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* are as applicable to insurers as they are to entities active in other industries.

[1] An insurer is the party which accepts insurance risk under a contract, whether or not the entity is regarded as an insurer for legal or supervisory purposes.

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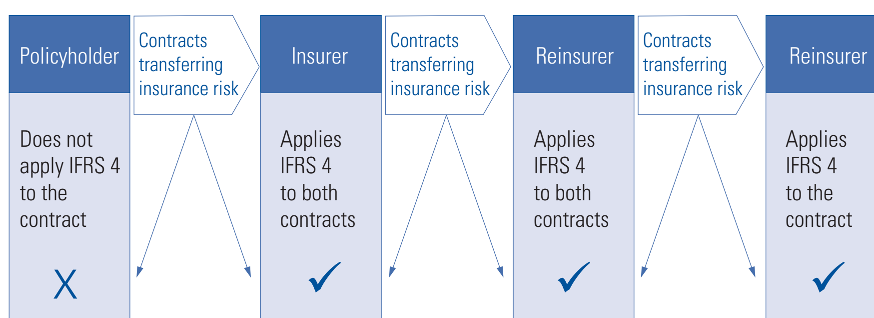
IFRS 4.4

In addition, IFRS 4 scopes out the following transactions that may meet the definition of an insurance contract, but are already covered by other standards:

- employers' assets and liabilities under employee benefit plans (covered by IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit plans (covered by IAS 26 *Accounting and Reporting by Retirement Benefit Plans*);
- financial guarantees that an entity enters into or retains on transferring financial assets or financial liabilities, within the scope of IAS 39, to another party – regardless of whether the financial guarantees are described as financial guarantees, letters of credit or insurance contracts[2];
- product warranties issued directly by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*);
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets)*; and
- contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

The applicability of IFRS 4 to the parties to insurance contracts



Source: KPMG International, 2004

[2] The IASB published an Exposure Draft in July 2004 which proposes that all financial guarantees be accounted for as prescribed in IAS 39 even if they meet the definition of an insurance contract. The Exposure Draft is open for comment until 8 October 2004.

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2. How do you identify an insurance contract?

Key topics covered in this Section:

- Definition of an insurance contract
- Definition of insurance risk
- Further guidance regarding insurance risk
- Special issues

Reference

2.1 Definition of an insurance contract

IFRS 4 provides a new definition of insurance contracts. This replaces definitions used in other IFRSs which exclude insurance business from their scope.

Appendix A to IFRS 4

An **insurance contract** is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

2.2 Definition of insurance risk

Appendix A to IFRS 4

IFRS 4.C6

The conceptual basis of an insurance contract is the presence of significant insurance risk. Insurance risk is defined as a *transferred* risk *other than financial risk*. Financial risk is defined in terms of changes in the same variables used in the definition of a derivative in IAS 39[1]. With the introduction of IFRS 4, the definition of financial risk was amended in IFRSs to include non–financial variables which are not specific to one of the parties of the contract.

IFRS 4.IG2, Examples 1.15 and 1.19

IAS 39.AG12A

Examples of non–financial variables *not specific* to a party to the contract and therefore *included* in the definition of *financial risk*

- Weather or catastrophe indices such as an index of temperatures in a particular city or an index of earthquake losses in a particular region;
- Mortality rates of a population;
- Claims indices of an insurance market;
- Changes in the fair value of a non–financial asset reflecting the change in market prices for such assets.

[1] Financial risks include the risk of a possible change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index.

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IFRS 4.IG2, Examples 1.15

Examples of non–financial variables *specific* to a party to the contract and therefore *excluded* from the definition of *financial risk*

- The claims index, cost or lapse rate of that party;
- The state of health of the party; or
- A change in the condition of an asset that the party owns.

IFRS 4. B12–B16 and B24(a)–(b)

The requirement that insurance risk is always transferred risk, means that only risks accepted by the insurer, which were pre–existing for the policyholder at the inception of the contract, meet the definition of insurance risk.

Lapse, persistency or expense risks, resulting from contracts written, do not constitute insurance risk as they are not transferred risks – even if these risks are triggered by the same events that trigger insurance risk. It therefore follows that the loss of future earnings for the insurer, when the contract is terminated by the insured event, is not insurance risk as the economic loss for the insurer is not a transferred risk. Also, the waiver on death of charges that would be made on cancellation or surrender does not compensate the policyholder for a pre–exisiting risk and is therefore not an insurance risk. However, the transfer of these risks to another party through a second contract, gives rise to insurance risk for that party.

IFRS 4.BC33

IFRS 4 does not provide quantitative guidance for assessing the significance of insurance risk, because the IASB felt that creating an arbitrary dividing line would result in different accounting treatments for similar transactions that fall marginally on different sides of the line.

IFRS 4.B23

When assessing the significance of insurance risk two factors should be considered. The insured event should have a sufficient *probability* of occurrence and a sufficient *magnitude* of effect. The probability and the magnitude are measured independently to determine the significance of the insurance risk.

The occurrence of an event is viewed as sufficiently probable if the occurrence thereof has commercial substance. Any event, which policyholders see as a threat to their economic position and for which they are willing to pay for cover, has commercial substance. Therefore even if its occurrence is considered unlikely this is considered to be sufficient.

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Following the same logic, the magnitude of the effect of an event is considered sufficient if the effect on the policyholder is significant when compared to the minimum benefits payable in a scenario of commercial substance.

IFRS 4.B13

Payments made which do not compensate the policyholder for the effect of the insured event, e.g. payments made for competitive reasons, are not taken into consideration in the assessment of insurance risk.

However, IFRS 4 does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. The definition therefore does not exclude 'new–for–old' cover that pays the policyholder an amount sufficient to replace the old asset and does not limit payment under term life cover to the financial loss suffered by the deceased's dependants.

IFRS 4.B25

The significance of insurance risk is measured at contract[2] level without considering the risk exposure of the entire portfolio. Therefore, the effect of risk equalisation in the portfolio is ignored. However, IFRS 4 provides that where a portfolio of homogenous contracts are known to generally contain significant insurance risk, each contract can be treated as an insurance contract, without applying the requirement to assess the significance of insurance risk to each individual contract.

IFRS 4.IG2, Example 1.5

Example of a portfolio of homogenous contracts – treated as insurance but which may include a few contracts which do not transfer significant insurance risk

The significance of insurance risk in endowment contracts typically depends on the age of the policyholder at the outset of the contract or on the contract duration. Where insurance risk is known to generally be significant based on these factors, the few contracts with an unusually low entry age or unusually short duration, forming part of a portfolio of endowment contracts, need not be considered separately.

2.3 Further guidance regarding insurance risk

IFRS 4 provides further guidance on the term 'insurance risk' as used in the definition of an insurance contract.

The transfer of risk, in the form of a specified uncertain future event that could have an adverse affect on the policyholder if it occurs, takes place by agreeing the compensation to be paid on realisation of that risk.

[2] For this purpose, contracts entered into simultaneously with a single counterparty form a single contract.

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IFRS 4.B13-14 and BC28-29

IFRS 4 requires, however, that the insurable interest is embodied in the contract as a precondition for providing benefits. The insurer is not obliged, however, to assess the presence of an insurable interest when providing benefits.

This requirement could be interpreted as excluding many life insurance contracts, which usually do not require the provable presence of an insured interest, from the scope of IFRS 4. The IASB decided to retain this requirement as it provides a principle-based distinction between insurance contracts and other contracts that happen to be used for hedging. The concept of an insurable interest was not refined for life insurance contracts as these contracts usually provide for a predetermined amount to quantify the adverse effect.

IFRS 4.B18(d)

IFRS 4 also clarifies that survival risk, which reflects uncertainty about the required overall cost of living, qualifies as insurance risk.

IFRS 4.B2

The uncertainty of the insured event can result from uncertainty over:

- the *occurrence* of the event;
- the *timing* of the occurrence of the event; or
- the *magnitude* of the effect, if the event occurs.

IFRS 4.B3

IFRS 4.B4

Areas of uncertainty to consider in determining insurance risk

Uncertainty over the occurrence of the event

Uncertainty over the occurrence of the event may take various forms. Under some insurance contracts the insured event occurs during the period of cover specified in the contract, even if the resulting loss is discovered after the end of this period of cover. For others the insured event is the discovery of a loss during the period of cover of the contract, even if the loss arises from an event that occurred before the inception of the contract.

Uncertainty over the timing of the event

In whole life insurance contracts the occurrence of the insured event, within the duration of the contract, is certain but the timing is uncertain.

Uncertainty over the magnitude of the effect

Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the cedant against the adverse development of claims already reported.

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The insured event must be specified, i.e. the event cannot be a general protection against adverse deviations from targets, but must be explicitly or implicitly described in the contract. Where the contract provides an option to extend cover, this will only qualify as insurance risk at the start of the contract if the contract specifies the terms of the extended cover. The probability that the option will be exercised is taken into consideration when assessing the significance of the future insurance risk.

IFRS 4.B6

Some fixed–fee service contracts, where the extent of the services provided depends on an uncertain event, may also qualify as insurance contracts. Prior to the issuance of IFRS 4, such contracts were not regarded as insurance contracts and may have been issued by companies which are not insurers in legal or regulatory terms.

Examples of fixed–fee service contracts qualifying as insurance contracts

A typical example is a maintenance contract in which the service provider agrees to repair an appliance after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the appliance adversely affects its owner and the contract compensates the owner in kind, rather than cash.

Another example is a contract for car breakdown services in which the service provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage.

2.4 Special issues

IFRS 4.B11

If the applicability of IFRS 4 is assessed for a component of a contract, significance is assessed in relation to the component. In assessing whether the component contains significant insurance risk, IFRS 4 disregards whether or not the component contains other risks such as financial risks, even if these other risks would scope the component into the definition of a derivative in the absence of significant insurance risk. This might occur particularly if the benefit payable is subject to a variable creating financial risk which is also triggered by the insured event. (Refer to chapter 3 for further discussion of embedded derivatives.)

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IFRS 4.IG4, Example 2.19

Example of a dual trigger contract qualifying as an insurance contract

A contract requiring payment that is contingent on both a breakdown in power supply that adversely affects the policyholder and a specified level of electricity prices qualifies as an insurance contract unless the breakdown in power supply lacks commercial substance.

IFRS 4.B19(g)

Weather or catastrophe bonds are usually not considered insurance contracts and therefore fall under the ambit of IAS 39. This is because they do not require an insurable interest as a pre–condition for payment. For this type of coverage, the beneficiary does not have to have incurred a loss to benefit from the contract.

IFRS 4.B30

Insurance risk should be assessed at the inception of the contract. Where cashflows after inception differ from those expected and if the contract subsequently meets the requirement of transferring significant insurance risk, when assessed on the new information, it should be re-classified as an insurance contract at that date. Once a contract is classified as an insurance contract, it remains an insurance contract until the ultimate settlement of all rights and obligations under that contract.

The level of insurance risk may vary during the period of the insurance contract. For example, in a pure endowment policy the insurance risk reduces as the value of the investment increases. Also, in a deferred annuity contract there may be no insurance risk during the savings phase but there is significant insurance risk during the annuity phase.

In assessing the significance of insurance risk at the inception of the contract the effect of discounting on the expected cash flows may be significant. The low present value of expected cash flows should not by itself be a reason to conclude that the insurance risk is not significant at inception. For example, the savings phase in a deferred annuity contract may last a number of decades and therefore the present value of future potential adverse deviations arising during the annuity payment phase might, once discounted, be small at the outset of the contract.

If a contract contains an option which if executed would introduce insurance risk into the contract, the specific terms of the option need to be considered in determining the classification of the contract at inception. If the insurer is able to determine the terms of the option at execution, the execution of the option is in substance a new two–sided agreement. This may mean that the existence of the option is irrelevant in the assessment of insurance risk at the inception of the contract.

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Changes made to a contract, as the consequence of a two–sided agreement of the parties involved, result in the formation of a new contract, while the execution of a unilateral option changes the shape of the existing contract.

IFRS 4.B29

Assessing how an option affects the classification of a contract

Take for example an investment contract with an annuitisation option where the annuity factor is the same as new annuities offered by the insurer at the time the option is executed. Since the insurer is free to determine the annuity factor, the annuitisation is in substance the formation of a new contract, the terms of which are agreed at the date the option is exercised. The contract cannot therefore be classified as an insurance contract at inception.

However, if the terms of the annuity are agreed at the start of the contract or severe constraints are imposed on the insurer in determining the annuity factor at the date the option is exercised, so that the insurer is not able to influence the policyholders' decision to exercise the option, the option may be taken into consideration in determining whether significant insurance risk exists at the inception of the contract.

IAS 32.13

Considering the complex structure of some contracts, especially in group and reinsurance business, it is often difficult to determine the boundaries of a contract. A substance over form approach must be adopted to determine what qualifies as a 'contract'.

IFRS 4.B25

As insurance risk has to be assessed at contract level, judgement is often needed to determine whether a group contract is in fact a group of insurance contracts or just one insurance contract. Considering that group business often includes risk mitigating features at a group level, the level of risk at a group level will often not equal the sum of the individual risks in the group.

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3. How do you identify and account for embedded derivatives?

Key topics covered in this Section:

- Overview and IAS 39 requirements
- Identification and separation of embedded derivatives
- Recognition and measurement
- Disclosure

Reference

3.1 Overview and IAS 39 requirements

IAS 39.9

A derivative is a financial instrument or other contract *within the scope of IAS 39*[1] with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non–financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

IAS 39.AG12A

A non–financial variable not specific to a party to the contract includes, for example, an index of earthquake losses in a particular region and an index of temperatures in a particular city. A non–financial variable specific to a party would be, for example, the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract.

IAS 39.10

An embedded derivative is described in IAS 39 as a component of a hybrid (combined) instrument that also includes a non–derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand alone derivative.

Since the embedded derivative usually modifies some or all of the already identifiable contractual cash–flows, it is possible to identify and separate the effect of the embedded derivative. The host contract could be a financial instrument or a contract which is not within the scope of IAS 39, such as an insurance contract.

[1] Note that insurance contracts are not within the scope of IAS 39, hence, anything qualifying as an insurance contract cannot be a derivative.

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IAS 39.2(e)

The provisions for embedded derivatives in IAS 39 apply to derivatives embedded in insurance contracts or financial instruments with discretionary participation features, within the scope of IFRS 4. However, if the embedded derivative is itself an insurance contract or a financial instrument with a discretionary participation feature within the scope of IFRS 4, it need not be separated and measured in terms of IAS 39.

The reason for creating special accounting rules for embedded derivatives is to prevent entities from circumventing the requirement to account for all derivatives at fair value with changes in fair value through profit or loss. Requiring certain embedded derivatives to be separated from their host contracts ensures that the appropriate measurement is applied to all the components of the host contract. The requirements also ensure that contractual rights and obligations that create similar risk exposures are treated in the same way regardless of whether or not they are embedded in a non–derivative contract.

3.2 Identification and separation of embedded derivatives

IAS 39.11

An embedded derivative shall be separated from the host contract and accounted for as a derivative under IAS 39 if, and only if:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Provided that the first two requirements are met, embedded derivatives should be separated from the host contract where the host contract is measured at amortised cost or at fair value with changes in fair value recognised in equity, as may be the case with some financial instruments including some financial instruments with discretionary participation features, accounted for under IFRS 4.

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IFRS 4.7 and B28

As noted above, IFRS 4 does not require separation if the component itself meets the definition of an insurance contract. In considering whether this exemption applies, insurance risk is assessed in relation to the component. It may happen that the contract as a whole does not fall within the scope of IFRS 4 because it does not contain significant insurance risk, but that the component itself contains significant insurance risk and, had it been a separate contract, would have fallen within the definition of an insurance contract. IFRS 4 does not provide any further limitations – any significant insurance risk disqualifies a component from recognition as a derivative and therefore the need to be separated.

If the component is not an insurance contract and would qualify as a stand alone derivative and is embedded in a contract that is measured at amortised cost or fair value through equity the next thing to consider is whether the economic characteristics and risks of the embedded derivative are closely related to the host contract.

IAS 39.AG30–AG33

IFRS 4.IG4, Example 2

Neither IAS 39 nor IFRS 4 explain or define what the phrase 'closely related economic characteristics and risks' means. Both Standards, however, set out examples where economic characteristics and risks are closely related and where they are not.

Examples of embedded derivatives which are not required to be separated

A derivative embedded in an insurance contract is considered to be closely related to the host insurance contract if the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately. In this situation, an entity would not separate the embedded derivative.

IAS 39 also regards a unit–linking feature embedded in either an insurance contract or financial instrument as being closely related to the host contract if the unit–denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. This allows unit–linked liabilities to be measured in accordance with the unit value of the related assets, clarifying that an insurer does not need to separate the unit–linking feature even if it is an embedded derivative as defined.

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IFRS 4.8–9; IG4, Examples 2.12–13 and 2.15

Certain surrender options are exempt from the application of IAS 39 and therefore are not required to be separated. These include surrender options where the surrender value is:

- specified in a schedule, not indexed and not accumulating interest;
- based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest bearing securities), possibly less a surrender charge.

However, if the surrender value varies in response to the changes in a financial variable or a non–financial variable that is not specific to a party to the contract, this exemption would not apply.

If the surrender value is already carried at fair value, for example, when it is based on the fair value of a pool of equity investments, then it is not required to be separated. However, to the extent that the fair value of the host contract differs from its surrender value, if the policyholder's option to surrender qualifies as a derivative, this exemption would not apply and it may be required to be measured at fair value.

IFRS 4.IG4, Examples 2.1–3

Examples of embedded derivatives which contain insurance risk and are therefore not required to be (but not prohibited from being) separated and measured at fair value:

- option to take a life–contingent annuity at a guaranteed rate (unless life contingent payments are insignificant);
- death benefit that is greater of the unit value of investment fund or the guaranteed minimum (unless life–contingent payments are insignificant); or
- death benefit linked to equity prices or equity index payable only on death or annuitisation. The equity–linked feature is an insurance contract because the policyholder only benefits from it when the insured event occurs.

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IFRS 4.IG4, Examples 2.5, 2.7–8 and 2.17

Examples of key terms and conditions in an insurance contract that may be embedded derivatives requiring separation:

- embedded guarantee of minimum interest rates used to determine surrender or maturity values at the inception of the contract;
- leveraged terms in the contract relating to benefits not contingent on an insured event, for example maturity and surrender values leveraged on interest or inflation rates;
- equity or commodity indexed benefit payments not contingent on an insured event; and
- additional contractual terms that do not fall under the definition of an insurance contract. For example a persistency bonus paid only at maturity in cash unless the persistency bonus is life-contingent to a significant extent.

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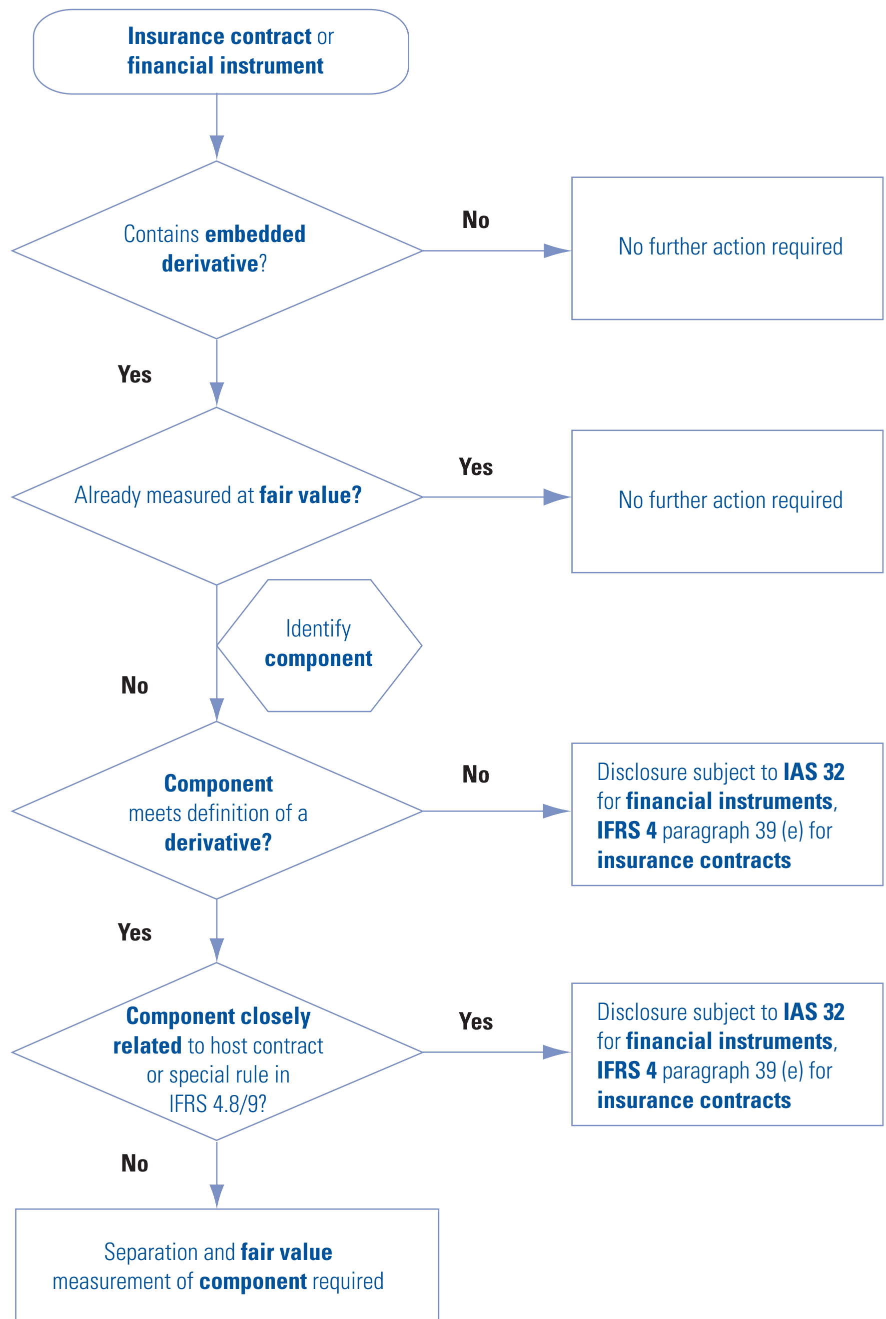
Decision tree for the separation of an embedded derivative



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3.3 Recognition and measurement

IAS 39.11

Embedded derivatives are simply derivatives embedded in a host contract. Therefore, the measurement rules for embedded derivatives which are required to be separated are the same as those applicable to stand alone derivatives in IAS 39.

IAS 39.9(a)(iii) and 46–47

If the embedded derivative is separated from the host contract then the embedded derivative shall be valued at fair value and the changes in the fair value recognised in profit or loss.

IAS 39.12
IFRS 4.7-8

In terms of IAS 39, if an entity is unable to separately measure the fair value of an embedded derivative requiring separation from the host contract, the whole contract shall be measured at fair value with the changes in fair value recognised in profit or loss. The combined contract is therefore treated as 'at fair value through profit or loss'.

IAS 39.72

IAS 39 does not prohibit embedded derivatives that are separated from the host contract from being designated as hedging instruments. If the embedded derivative is part of a hedging relationship, the normal hedge accounting rules apply.

IAS 39.10

If the embedded derivative is not required to be separated, it is accounted for as part of the host contract.

A derivative that is attached to a contract, but in terms of the contract:

- is transferable independently of that contract; or
- has a different counterparty from that contract.

is not an embedded derivative but a separate financial instrument. The normal accounting rules for derivatives would then apply. The terms of a contract therefore need to be examined closely to determine whether the relationship of the components is such that they form one contract or separate contracts.

3.4 Disclosure

IAS 39.11

IAS 39 does not contain any specific disclosure or presentation requirements regarding embedded derivatives.

IFRS 4.39(d)

IAS 32 contains the requirements for disclosure of all financial assets and financial liabilities, including embedded derivatives.

IFRS 4.39(e) and IG66–70

If the issuer of a contract within the scope of IFRS 4 is not required to and does not measure a derivative embedded in that contract at fair value, it shall disclose information about exposure to interest rate risk or market risk under that embedded derivative.

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4. When do you unbundle a deposit component?

Key topics covered in this Section:

- Overview
- When to unbundle the deposit component of an insurance contract
- Accounting treatment
- Disclosure

Reference

4.1 Overview

Appendix A to IFRS 4

The definition of an insurance contract distinguishes insurance contracts that are subject to IFRS 4 from those contracts that are subject to IAS 39. Some contracts, however, contain both an insurance component and a deposit component. The deposit component of an insurance contract is defined as a contractual component that is not accounted for as a financial instrument under IAS 39, but that would be within the scope of IAS 39 if it were a separate instrument.

The failure to separately account for the deposit component inherent in an insurance contract may result in material liabilities and assets not being fully recognised on the balance sheet of an entity, under the existing accounting policies which continue to apply in terms of IFRS 4.

Logically, therefore, there will be circumstances where the deposit component should be unbundled and accounted for separately under IAS 39.

4.2 When to unbundle the deposit component of an insurance contract

IFRS 4.10

Depending on the circumstances, an insurer may be required, permitted or prohibited from unbundling the deposit component.

IFRS 4.10(a)

4.2.1 Unbundling is *required* if both of the following conditions are met:

- the insurer can measure the deposit component (including any embedded surrender options) separately without considering the insurance component; and
- the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.

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IFRS 4.10(b)

4.2.2 Unbundling is *permitted* (but not required) if:

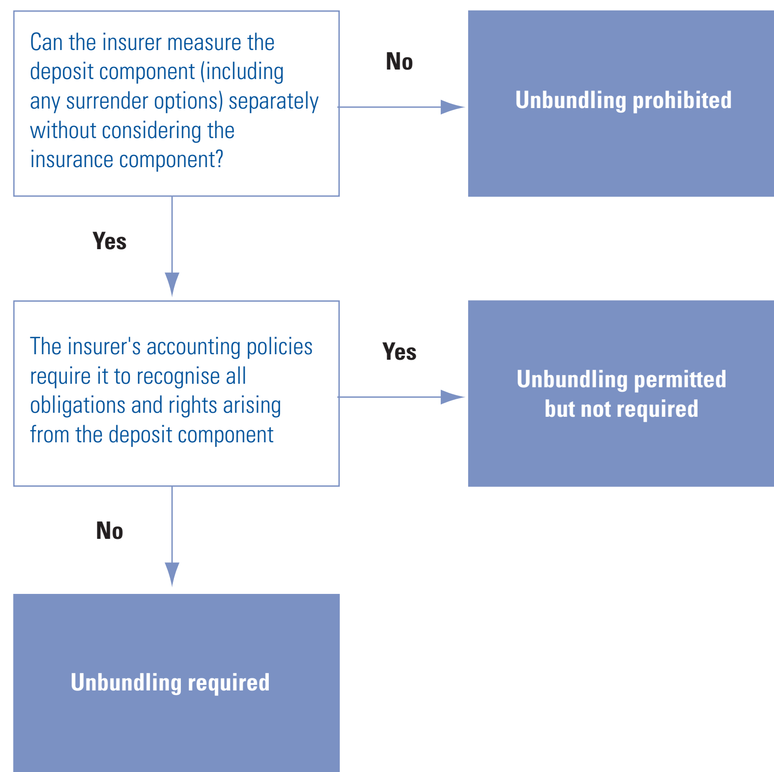
- the insurer can measure the deposit component separately from the insurance component, but its accounting policies already require it to recognise all rights and obligations arising from the deposit component, regardless of the basis used to measure those rights and obligations.

IFRS 4.10(c)

4.2.3 Unbundling is *prohibited* if:

- the insurer cannot measure the deposit component separately.

Decision tree for the unbundling of the deposit component of an insurance contract



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4.3 Accounting treatment

Unbundling the deposit component of an insurance contract leads to the separate recognition and measurement of the financial asset or financial liability arising under the deposit component, and the insurance component of the contract.

If the deposit unbundling rules did not apply and the accounting policies of the insurer or reinsurer did not require all assets and liabilities under the contract to be recognised, liabilities might be incorrectly recognised as income and assets as expenses.

IFRS 4.12(a)

If the deposit component is unbundled, the insurance component of the unbundled contract is accounted for, in terms of IFRS 4, using the entity's accounting policies for insurance contracts. The treatment of assets and liabilities associated with the insurance component of the contract is therefore consistent with the treatment of assets and liabilities arising from other insurance contracts.

IAS 39.2

IFRS 4.12(b)

The financial assets or financial liabilities arising from the deposit component are accounted for under IAS 39. The classification of the deposit component depends on the intention of the insurer or reinsurer, the definitions of the various IAS 39 categories and the underlying contractual requirements of the insurance contract. (Refer to chapter 14 for further discussion of the accounting treatment in terms of IAS 39.)

Receipts and payments relating to the deposit component, except those subject to the requirements of IAS 18, are not recognised in the income statement but as assets and liabilities, while receipts and payments relating to the insurance element are generally recognised in the income statement. (Refer to chapter 14 for further discussion of the application of IAS 18 to investment contracts.)

The related portion of the transaction costs incurred at inception are allocated to the deposit component if material. The deferral and amortisation rules of IAS 39 and IAS 18 apply to these costs.

In practice unbundling a contract may be difficult, as an entity's systems may not cater for the separate recognition of different elements of a contract that has traditionally been measured as one contract.

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4.4 Disclosure

IFRS 4.36

As the unbundled deposit component and the insurance component are treated as two independent contracts, IFRS 4 disclosure requirements do not apply to the deposit component.

IFRS 4.38

The financial assets or financial liabilities arising from the deposit component are subject to the disclosure requirements of IAS 32.

Why unbundle?

When the deposit component and the insurance element of contracts are separately maintained on an entity's systems, unbundling facilitates the reporting of financial information, externally, in the same manner as is used for internal purposes.

Banks that issue insurance contracts may have similar deposit features in their banking products. Unbundling the deposit components of insurance contracts will ensure that these features are consistently accounted for.

Unbundling the deposit components of insurance contracts and reporting these separately facilitates the more accurate assessment of the pure insurance risk that an entity is exposed to.

A contract containing a deposit component may not meet the definition of an insurance contract, as the insurance risk may not be significant in relation to the entire contract. Unbundling allows the insurer to classify the insurance component as an insurance contract and therefore to apply existing accounting policies to the insurance element.

Unbundling the deposit component and accounting for it as a financial instrument may better reflect the nature of the deposit component.

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5. What does the exemption from IAS 8 mean?

Key topics covered in this Section:

- Understanding the exemption from IAS 8

Reference

5.1 Understanding the exemption from IAS 8

IAS 8.10–12

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides for a situation where no specific IFRS governs the accounting treatment of a particular transaction. It states that in this situation management shall apply its judgment to develop an accounting policy which will result in reporting financial information that is relevant to meet the economic decision making needs of the users of the financial statements.

In making this judgement, management shall first refer to the requirements and guidance in IFRSs and IASB issued Interpretations that deal with similar or related issues.

If no such guidance is available, management shall refer to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the IASB *Framework for the Preparation and Presentation of Financial Statements*.

Management may also consider recent pronouncements of other standard–setting bodies that use similar frameworks to develop accounting standards, other accounting literature and accepted industry practice, to the extent that these do not conflict with the above mentioned sources. In our view, this would include many of the requirements in US GAAP.

IFRS 4.13

IFRS 4 exempts an insurer from applying the section of IAS 8 which specifies the criteria, outlined above, that an entity shall apply in developing an accounting policy in the absence of a specific IFRS for insurance contracts that it issues and reinsurance contracts that it holds.

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The exemption from these rules is important because it allows IFRS 4 to limit the requirement for insurers to change their existing accounting policies for insurance contracts. These changes were limited so as to avoid the unnecessary disruption of both the preparers and the users of financial statements during phase I, which might complicate the transition to phase II. As a result, IFRS 4 does not specify recognition and measurement requirements with respect to assets, liabilities, income and expenses arising from insurance contracts. In practice existing accounting practices will continue in phase I with the following changes necessary to bring them in line with the requirements of IFRS 4.

IFRS 4.14

Specifically, an insurer:

- shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions);
- shall carry out the liability adequacy test described in the Standard;
- shall remove an insurance liability (or part of an insurance liability) from its balance sheet when, and only when, it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled or expires;
- shall not offset:
  - reinsurance assets against the related insurance liabilities; or
  - income or expense from reinsurance contracts against the expense or income from the related insurance contracts; and
- shall consider whether its reinsurance assets are impaired.

(Refer to chapters 7 and 9 for discussion of the liability adequacy test and reinsurance impairment test, respectively.)

These requirements were maintained because the IASB considered that abandoning them might adversely affect the relevance and reliability of an insurer's financial statements to an unacceptable degree. These requirements are not expected to be reversed in phase II.

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6. Can you subsequently change an accounting policy?

Key topics covered in this Section:

- Overview
- Specific issues

Reference

6.1 Overview

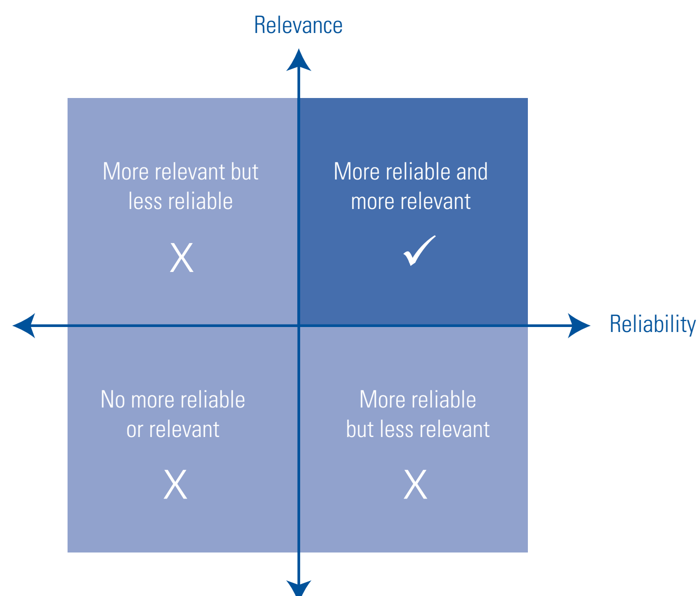
IFRS 4.21

IFRS 4 allows both insurers adopting IFRSs for the first time and insurers already using IFRSs to change their accounting policies relating to insurance contracts. However, these changes are subject to certain limitations.

IFRS 4.22

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision making needs of users and no less reliable, or more reliable and no less relevant to those needs.

Is a proposed change in accounting policy allowed?



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IFRS 4.22

Framework. 26

IAS 8.10

Relevance and reliability are judged based on the criteria in IAS 8. Relevance is assessed in relation to the economic decision making needs of the user. Information is more relevant when it helps the user better evaluate past, present or future events. Information is reliable if the financial statements: represent faithfully the financial position, financial performance and cash flows of the entity; reflect the economic substance of transactions not merely the legal form; are neutral and free from bias; are prudent; and are complete in all material respects.

IFRS 4.23

A change in accounting policy must bring the financial statements closer to meeting the criteria in IAS 8, however the change need not be in full compliance with those criteria. IFRS 4 provides guidance on certain specific issues.

6.2 Specific issues

IFRS 4.23

IFRS 4 provides guidance on specific issues to meet the requirement of improving the relevance and/or reliability of reporting in the financial statements.

6.2.1 An insurer is permitted to continue to apply the following accounting policies, but not to introduce them:

IFRS 4.25(a)

- Measuring insurance liabilities on an undiscounted basis.

IFRS 4.25(b)

- Measuring contractual rights to future investment management fees at an amount that exceeds their fair value, as determined by comparison to market related fees for similar services. The fair value at inception of the contractual rights is expected to equal the origination costs paid, unless future investment management fees and related costs are not consistent with the market.

IFRS 4.25(c)

- Using non–uniform accounting policies for insurance contracts of subsidiaries. If the accounting policies are not uniform, these may be changed, provided the change does not make them more diverse and is not limited by another section of IFRS 4.

IFRS 4.26

- Measuring its insurance contracts with excessive prudence. An insurer need not change its accounting policy to eliminate excessive prudence, but cannot introduce additional prudence, if the insurance contracts are already measured with sufficient prudence.

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IFRS 4.27 and BC134–144

6.2.2 An insurer is permitted to continue to apply the following accounting policies and may be permitted to introduce them:

- Reflecting future investment margins in the measurement of insurance contracts. There is a rebuttable presumption in IFRS 4 that an insurer's financial statements will be less relevant and reliable if it introduces an accounting policy to this effect, unless those margins affect the contractual payments.

  Two examples of accounting policies that reflect future investment margins are:

  - using a discount rate that reflects the estimated return on the insurer's assets to discount future contractual cash flows in determining the insurance liability; and
  - projecting the returns on those assets at an estimated rate of return as part of the projected contractual cash flows and discounting the projected cash flows at a different rate in measuring the liability.

Example of a situation where the presumption may be rebutted

The presumption may be rebutted by replacing the existing accounting policy with a widely used comprehensive basis of accounting for insurance contracts that is, in aggregate, more relevant and reliable despite using an asset–based discount rate. In our view this may be met by applying the principles in US GAAP.

It must be emphasised that, in order to overcome the rebuttable presumption, the accounting basis must be widely used (in this case world–wide), based on formulated principles similar to the Framework and on detailed and consistent guidance.

IFRS 4.29

However it is highly unlikely that an insurer will overcome the rebuttable presumption where a discount rate reflecting the estimated return on the insurer's assets has a significant or direct effect on the initial measurement of insurance liabilities. The introduction of traditional forms of embedded value for determining the insurance liability is therefore not permitted, unless a similar consideration of the returns on assets is already part of an insurer's existing accounting policy.

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IFRS 4.30

- Using shadow accounting. This approach is based on the fact that realised gains or losses on an insurer's assets may have a direct impact on the measurement of some or all of the insurance liabilities and related deferred acquisition costs and intangible assets.

Shadow accounting means that unrealised gains or losses on the assets, which are recognised in equity without affecting profit or loss, are reflected in the measurement of the insurance liabilities (or deferred acquisition costs or intangible assets) in the same way as realised gains or losses. The related adjustment will be recorded as an unrealised gain or loss in equity, if the unrealised gains and losses on the assets are recognised in equity.

Example of shadow accounting

Policyholders share in participating business at 90 percent of net earnings recognised in profit or loss. Assume that a change in the fair value of assets classified as 'available for sale' causes the recognition of CU[1] 100 in unrealised gains and losses in equity.

The liability for policyholders' rights under the participating contracts does not properly reflect the ownership of that unrealised gain. If the gain had been realised, the insurance liability would have been increased by CU90. If shadow accounting is applied, the insurance liability is increased by CU90, as though the gain were realised. However, the change would not be reflected in profit or loss, but by reducing the unrealised gain in equity to CU10. The CU10 reflects the shareholders' share of the unrealised gain.

IFRS 4.24

- Remeasuring designated insurance liabilities to reflect current market interest rates or other current estimates and assumptions and recognising changes in those liabilities in profit or loss.

IFRS 4 allows an insurer to apply or introduce this accounting policy for certain designated liabilities, overriding the requirement of IAS 8 to apply accounting policies consistently to all similar liabilities. However, the accounting policy must be applied to the designated liabilities until they are extinguished.

[1] CU = Currency Unit, for the purposes of this example

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7. How do you determine the sufficiency of insurance liabilities and assets?

Key topics covered in this Section:

- The liability adequacy test
- Using an existing liability adequacy test
- IAS 37 test
- Impairment tests

Reference

7.1 The liability adequacy test

IFRS 4 requires an insurer to assess whether its recognised insurance liabilities are adequate at each reporting date. The test should confirm that insurance liabilities are not understated, taking into consideration related assets[1].

Although, in general, an insurer is able to continue using its existing accounting policies in the measurement of insurance liabilities and assets under IFRS 4, the accounting policies must incorporate a liability adequacy test. If a test meeting the minimum requirements set out in IFRS 4 is already included in the existing accounting policy for insurance contracts that test may be used.

IFRS 4.16

The minimum requirements are the following:

- The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs as well as cash flows resulting from embedded options and guarantees.
- If the test shows that the liability is inadequate, the entire deficiency must be recognised in profit or loss.

IFRS 4.17

If the accounting policies do not incorporate a liability adequacy test meeting the above minimum requirements, IFRS 4 prescribes the test which must be applied at each reporting date. If the existing test only covers part of the portfolio the test prescribed in the Standard will apply to the remaining part of the portfolio.

[1] Related assets include deferred acquisition costs (DAC) and intangible assets arising from the aquisition of insurance contracts through business combinations or portfolio transfers.

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IFRS 4.17

The liability adequacy test prescribed by IFRS 4 is as follows:

- determine the carrying amount of the insurance liabilities less the carrying amount of:
  - any related deferred acquisition costs; and
  - any related intangible assets, such as those acquired in a business combination or portfolio transfer.
- determine whether the carrying amount is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*
- if the carrying amount is less, recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

The related reinsurance assets are not considered in applying the prescribed test as these are accounted for separately. IFRS 4 includes special requirements for reinsurance assets, including an impairment test which considers credit risk in assessing the recoverability of reinsurance assets. (Refer to chapter 8 for further discussion of reinsurance assets.)

IFRS 4 requires a liability adequacy assessment to be made, at a minimum, on each reporting date.

7.2 Using an existing liability adequacy test

The minimum requirements for the use of an existing test are simply that the adequacy of the insurance liability, net of related assets, should be assessed against current estimates of contractual cash flows, including embedded options and guarantees as well as related cash flows such as those arising from claims handling costs and any adjustment should be recognised in profit or loss. As no mention is made of a requirement to discount the cash flows this implies that an undiscounted cash flow approach may be used. The Standard is also silent on the discount rate to be used if the insurer uses a discounted cash flow approach.

It follows therefore that various approaches are acceptable when using existing accounting policies, and there is flexibility as regards the interest rates used and the use of realistic or conservative cash flow projections.

Where an existing test is used, this will continue to be applied at the level of aggregation specified in that test.

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Example of an existing liability adequacy test which would comply with the minimum requirements outlined in IFRS 4

In our view, the requirements of US GAAP regarding the recognition of a premium deficiency, would be in compliance with the minimum requirements outlined in IFRS 4. The test is broadly outlined below.

For short–term contracts compare:

- the sum of expected claims costs and claim adjustment expenses; expected dividends to policyholders; unamortised acquisition costs; and maintenance costs; to
- unearned premiums.

A premium deficiency is recognised firstly by expensing any unamortised acquisition costs and then, if necessary, by creating a liability for the excess deficiency.

For long–term contracts compare:

- the present value of benefits and related settlement and maintenance costs less the present value of future gross premiums (determined using assumptions updated for actual and anticipated experience with respect to investment yields, mortality, morbidity, terminations, or expenses); to
- the existing liability for future policy benefits reduced by unamortised acquisition costs.

A premium deficiency is recognised by a charge to the income statement and either a reduction of unamortised acquisition costs or an increase in the liability for future policy benefits.

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7.3 IAS 37 test

IFRS 4.17

If the existing accounting policy does not meet the minimum requirements outlined in IFRS 4, the prescribed test must be used. This test compares the level of insurance liabilities, net of related assets, against an amount that would have been determined under IAS 37.

IAS 37.37 and 42–43

As market–related margins for risk and uncertainty are used to determine provisions under IAS 37, the 'best estimate' determined under IAS 37 differs from the typical insurance 'best estimate' which is the estimate of expected cash flows without applying market–related margins. Therefore the amount determined under the test prescribed by IFRS 4 may be significantly more prudent than existing tests adopted by the insurer. As a result the shortfall of insurance liabilities may have to be adjusted.

The insurer may decide to account for the treatment of any resulting shortfall, either by increasing the insurance liability or decreasing the related deferred acquisition costs or related intangible assets.

In applying the prescribed test, contracts subject to similar risks and managed together as a single portfolio should be aggregated.

If the prescribed liability adequacy test is introduced for the first time, this constitutes a change in accounting policy and is subject to the requirements of IFRS 4 regarding changes in accounting policies. (Refer to chapter 6 for discussion of these requirements.) In particular the requirements over the use of future investment margins are relevant. IAS 37 requires market assessments of the time value of money to be used in calculating provisions, however, IFRS 4 only allows the use of future investment margins if those margins are also reflected in the carrying amount of the relevant insurance liabilities.

7.4 Impairment tests

The requirements of IAS 36 should be applied in accounting for the impairment of all assets of an insurance company other than financial assets, DAC, intangible assets arising from the acquisition of insurance contracts in a business combination or portfolio transfer and insurance contracts within the scope of IFRS 4. (Refer to chapter 9 for further discussion on the acquisition of insurance contracts.) Impairment of financial assets is accounted for under the requirements of IAS 39.

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Areas to consider in applying IAS 36

If an insurer's accounting policies incorporate a prospective present value approach, e.g. Embedded Value or full Zillmer, where negative values are recognised as assets, it may be able to classify an insurance contract as an insurance asset at its inception, and for some time thereafter (in rare cases for the full duration of the contract).

The insurance asset is dependant on the liability of the policyholder to pay premiums. Consider a five year non–life insurance contract with monthly premium payments, which is non–cancellable by the policyholder. The value of that contract, if it is priced profitably, is always negative and thus represents an asset. As the asset is not DAC and does not represent an intangible asset resulting from a business combination or portfolio acquisition, it is not excluded from IAS 36.

Under some existing approaches, the contract is reported as a liability while the DAC is recorded as an asset. In addition, DAC is explicitly excluded from the application of IAS 36.

The result of applying IAS 36 to insurance assets arising from a prospective present value approach is that, assuming there are indicators of impairment, they will be limited to the initial cost or the value in use. *Initial cost* may be seen as equivalent to net selling price unless there is observable data to prove the contrary. *Value in use* requires the use of a market–related discount rate. An insurer can prove that an asset is not impaired if the contracts are so profitable that their initial net present value is positive even when discounted using market–related discount rates (rather than entity specific discount rates).

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8. How do you account for reinsurance?

Key topics covered in this Section:

- Offsetting
- Impairment test
- Gains and losses on buying reinsurance

Reference

8.1 Offsetting

In general, IFRSs prohibit the offsetting of assets and liabilities and income and expenses, unless specifically required or permitted. In addition, IFRS 4 specifically prohibits offsetting reinsurance assets against related insurance liabilities; and income or expenses from reinsurance contracts against expenses or income from related insurance contracts.

Insurers are required to change existing accounting policies which allow for offsetting to comply with IFRS 4.

8.2 Impairment test

An insurer is required to consider, at each reporting date, whether its reinsurance assets are impaired. The impairment test to be applied is prescribed by IFRS 4.

IFRS 4.20

A reinsurance asset is impaired if, and only if:

- there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due under the terms of the contract; and
- that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Impairment could arise from the credit risk which the cedant is exposed to or from reinsurance disputes. The loss events described under IAS 39 for the impairment of financial assets can be used as guidance for assessing the impairment of reinsurance contracts. This includes referring to observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of assets since the initial recognition of those assets.

If a cedant's reinsurance assets are impaired, the cedant is required to reduce the carrying amount of those reinsurance assets to their recoverable amount.

[1] Reinsurance assets are defined as the cedant's net contractual rights under a reinsurance contract.

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8.3 Gains and losses on buying reinsurance

Under some reinsurance contracts, an insurer recognises gains on the purchase of reinsurance in profit or loss based on its existing accounting policies. IFRS 4 does not prohibit such practices but requires an insurer to disclose information in this respect. A cedant under a reinsurance contract, is required to disclose the following either on the face of the financial statements or in the notes:

- gains and losses relating to the purchase of reinsurance contracts recognised in the profit or loss; and
- where gains or losses arising from the purchase of reinsurance contracts have been deferred and amortised, the amortisation for the period and the unamortised amount at the beginning and end of the period.

The objective of this requirement is to disclose the impact on reported profit as a result of contracts with the legal form of a reinsurance contract, which not only transfer insurance risk but contain an element of financing for the cedant. These contracts are often referred to as 'financial reinsurance'.

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9. How do you account for acquired insurance portfolios?

Key topic covered in this Section:

- IFRS requirements

Reference

9.1 IFRS requirements

IFRS 3.36–37

According to IFRS 3 *Business Combinations*, an acquirer shall allocate the cost of a business combination by recognising the acquired asset (including intangible assets), liabilities and contingent liabilities at fair value. The difference between the cost of the business combination and the acquirer's interest in the fair value of assets, liabilities and contingent liabilities is goodwill.

IFRS 4.31

To comply with IFRS 3, an insurer shall measure the fair value of insurance liabilities assumed and insurance assets acquired in a business combination, at the date of acquisition. However, an insurer is permitted, but not required, by IFRS 4 to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- a liability measured in accordance with its own accounting policies for insurance contracts that it issues; and
- an intangible asset, representing the difference between the:
  - fair value of the contractual insurance rights acquired and insurance obligations assumed; and
  - the liability determined in accordance with its own accounting policies.

The intangible asset is subsequently measured in a manner consistent with the measurement of the related insurance liabilities. It will therefore be taken into account in applying the liability adequacy test.

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Examples of the intangible assets described in IFRS 4

In *life insurance* business, the intangible asset arising from the acquisition of insurance assets and liabilities represents the Present Value of Future Profits (PVFP), sometimes referred to as the Value of Business Acquired (VOBA). PVFP reflects the excess of the carrying value of the insurance contract over its fair value. (I.e. it reflects the present value of margins in the carrying value in excess of those used to determine the fair value). Since the carrying value of the intangible asset is limited under IFRS 4 to the fair value of *contractual* rights and obligations, it does not include the value of future business (including an intangible asset reflecting the value of a customer list.)

In *non–life insurance* business, an intangible asset could arise if the insurer's accounting policies do not prescribe the discounting of claims provisions, as would be required in measuring fair value.

IFRS 4.32

The expanded presentation may be adopted for the acquisition of a portfolio of insurance contracts through a portfolio transfer.

IFRS 4.33

The intangible asset resulting from this approach is excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. However, the consideration paid for intangible assets that are related to future insurance business but go beyond existing contractual rights and obligations (for example the consideration paid in respect of customer lists and customer relationships), is subject to the impairment test under IAS 36 and the related recognition criteria under IAS 38. Example 4 in the illustrative examples accompanying IFRS 3 defines intangible assets resulting from insurance contracts in a broad manner, encompassing estimates of renewals as well as cross–selling. (Refer to chapter 7 for further discussion of treatment of insurance assets and liabilities.)

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10. How do you account for discretionary participation features?

Key topics covered in this Section:

- Overview
- Definition of a discretionary participation feature
- Financial instruments with discretionary participation features
- Recognition, measurement and disclosure

Reference

10.1 Overview

Why do we have discretionary participation features (DPFs)?

Many long–term insurance contracts transfer the effect of long–term deviations in assumptions back to the policyholders, in the form of retroactive premium adjustments or performance–linkage clauses. Typical assumptions subject to deviation include financial risk, mortality risk and expense risk. Due to the long term nature of the contracts, premiums relating to the guaranteed benefits are often determined on a very conservative basis, both for economic and regulatory purposes. Insurers may therefore want to refund a share of the excess premium to policyholders, either for economic reasons, based on market pressure or competition for new business, or due to regulatory or contractual requirements.

Since participation features reflect, in part, the performance of the insurer they are subject to the discretion of the insurer. The right to participate, as well as the discretion of the insurer over the amount and timing of benefits in respect of those rights, is usually implicitly or explicitly granted by the contracts.

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In addition to contractual requirements the additional non–guaranteed benefits arising from the participation features may be affected by the following factors:

- the rules and judgement of regulators;
- management judgement due to the influence management has on the performance of the business;
- competitive constraints which may result in management paying additional benefits, which are more than required under participation clauses or by regulations; and
- constructive obligations arising from the long–term application of business policies in respect of participation or other factors which imply the insurer's responsibility or create a valid expectation amongst the policyholders that they will receive benefits in excess of those legally or contractually provided for.

Recognition and measurement of these obligations and determining which benefits are discretionary, may therefore be very difficult as the obligations are not simply based on the contractual rights of the policyholders. Therefore, most aspects of accounting for these features have been deferred to phase II.

However, the IASB recognised the need to provide limited guidance for the presentation of financial information relating to contracts with discretionary participation features as defined in IFRS 4. The main aims of the requirements of phase I are to prohibit these amounts from being reported in an intermediate balance sheet category, as neither liability nor equity[1] and to ensure that the policyholders' rights recognised as equity are appropriately disclosed. In the case of a financial instrument with DPF, where the amount relating to the DPF is reported as equity, IFRS 4 requires that the liability recognised for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element. In the case of an insurance contract with DPF, the liability is subject to the liability adequacy test.

10.2 Definition of a discretionary participation feature

IFRS 4 distinguishes between the guaranteed elements of contracts and DPFs.

Appendix A to IFRS 4

The 'guaranteed element' refers to a contractual obligation to pay guaranteed benefits.

Guaranteed benefits are payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

[1] A typical example of a line item in the intermediate category is the Fund for Future Appropriation in the UK.

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Guaranteed benefits are therefore not unilaterally determined by the insurer but by a contractual formula based on conditions outside the control or influence of the insurer. These benefits may include performance–linked benefits[2] which are not subject to the discretion of the insurer.

Appendix A to IFRS 4

A discretionary participation feature is a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

- that are likely to be a significant portion of the total contractual benefits;
- whose amount or timing is contractually at the discretion of the issuer; and
- that are contractually based on:
  - the performance of a specified pool of contracts or a specified type of contract;
  - realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - the profit or loss of the company, fund or other entity that issues the contract.

A DPF is therefore a contractual right to receive significant benefits in addition to the guaranteed benefits. These additional benefits are, in terms of the contract, subject to the performance of the entity or a specified pool of assets whilst the amount or the timing of such additional benefits are at the discretion of the insurer.

Both elements defined in IFRS 4 are distinguishable from other voluntary payments[3], as they have a contractual basis. It is clear in terms of the Framework that voluntary benefits which have no legal or constructive basis, because they are not provided for in the contract with the policyholder, cannot be recognised as a liability until a decision about their allocation is made and communicated.

The discretion inherent in a DPF must be embodied in the terms of the contract. In some contracts, the insurers only have discretion to influence the timing of the payments. In other contracts, insurers may have the discretion to determine the ultimate share that policyholders have in the performance of the entity.

To qualify as a DPF, under IFRS 4, the additional benefits paid in terms of the contractual rights of the policyholder must be subject to the insurer's discretion over either (or both) the timing or the amount of the benefits, but must also be linked to the performance of a contract; a pool of assets; or the entity, as specified in the contract.

[2] Performance linked benefits include unit-linked benefits.

[3] Other voluntary payments would include additional payments made for competitive reasons, such as, voluntary interest payments on universal–life contracts and those paid voluntarily in excess of the contractual right to receive performance–linked benefits.

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While the additional benefits paid under the DPF are required to be significant, there is not a similar requirement regarding the extent of discretion needed. Where the policyholder's participation is subject to regulation in certain countries, consideration should be given as to whether the insurer is in fact able to exercise discretion in making these payments.

The insurer need not have the discretion to determine the actual amount of the benefit. It is sufficient that the insurer can influence the timing of the benefits e.g. by deciding the timing of the realisation of hidden reserves – if the timing of allocations depends on realised earnings. Where the policyholders' participation in the unrealised gains is subject to the DPF, the IASB has not specified whether this share is a liability or equity, other than the allowance for shadow accounting. (Refer to chapter 6 for further discussion of shadow accounting.)

10.3 Financial instruments with discretionary participation features

Along with participating life insurance contracts, many insurance companies offer long–term investment or savings contracts. These financial instruments often contain characteristics which are very similar to the traditional insurance contracts. Therefore the contracts may include DPFs similar to those in insurance contracts.

IFRS 4.35

DPFs are not commonly used for financial instruments outside of the insurance industry, since they were developed specifically to meet the needs of insurers and their policyholders[4]. The IASB recognised that financial instruments with DPFs may be subject to the same recognition and measurement difficulties as insurance contracts and therefore have included them within the scope of IFRS 4.

[4] A specific example of this is the need for fixed terms on long-term insurance cover to protect against the reduced insurability of the policyholders in later years

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10.4 Recognition, measurement and disclosure

All rules governing insurance contracts under IFRS 4 are also applicable to insurance contracts and financial instruments with discretionary participation features. Consequently, insurers may continue to apply their existing accounting policies for the recognition, measurement and presentation of these contracts, with a few exceptions. (Refer to chapter 5 for further discussion of these exceptions.) IFRS 4 allows insurers to continue to recognise all premiums as revenue, even if the DPF forms part of a financial instrument and/or is reported as equity.

Specific rules in IFRS 4 for contracts with DPFs are as follows:

IFRS 4.34(a)

- The guaranteed element, regardless of whether it is recognised separately or together with the DPF, must be classified as a liability not equity.
- If the DPF is not recognised separately from the guaranteed element, the whole contract must be classified as a liability.

IFRS 4.34(b)

- If the DPF is recognised separately from the guaranteed element it may be classified as either equity or a liability. Intermediary items on the balance sheet, which are neither liability nor equity, are prohibited. IFRS 4, intentionally, does not provide any guidance on how the allocation should be made. The accounting policy adopted should be applied consistently.

IFRS 4.34(c)

- If any portion of the DPF is reported as equity, it should be shown as a separate component. Any profit or loss attributable to the DPF reflected in equity should be recognised as an allocation of profit or loss, and not as an income or expense item.

IFRS 4.35

- In addition, for DPFs in financial instruments:
  - if the DPF is classified as a liability the liability adequacy test should be applied to the whole contract. (Refer to chapter 7 for further discussion of the liability adequacy test.)
  - if any part of the DPF is reported as equity, the liability recognised for the entire contract should not be less than the amount that would have been reported for the guaranteed element by applying IAS 39. The amount determined under IAS 39 need not be disclosed. If the carrying amount of the total liability is clearly higher, there is no requirement to determine the minimum amount.

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A careful analysis of the terms of the contract relating to the DPF is necessary to identify all relevant cash flows.

Amounts which belong to the insurer i.e. shareholder's funds to which the policyholder has no contractual right are not affected by the conditions of the contract regarding the DPF.

The Implementation Guidance to IFRS 4 indicates that it may be appropriate to apply shadow accounting to contracts containing DPFs. (Refer chapter 6 for further discussion on shadow accounting.) The judgements made by an insurer in applying accounting policies relating to DPFs should be disclosed if these have a significant effect on the financial statements. Insurance contracts with DPFs are subject to the same disclosure requirements under IFRS 4 as all insurance contracts. Financial instruments with DPFs are subject to the disclosure requirements in IAS 32.

IFRS 4 also requires the disclosure of those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's cash flows, including information on DPFs. Disclosure relating to risks which are mitigated by DPFs, should include information about the effect of the DPFs. (Refer to chapter 13 for further discussion of disclosure requirements.)

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11. How do you account for non–insurance assets?

Key topics covered in this Section:

- Overview
- Categories of financial assets and their measurement
- How to determine fair value
- Impairment
- Embedded derivatives
- Investment properties

Reference

11.1 Overview

The majority of investments held by an insurer will be accounted for under IAS 39. These will include an insurer's portfolios of equity shares, bonds, and any derivatives or other trading instruments held. Investment property will be accounted for under IAS 40 *Investment Property*.

IAS 39.9

IAS 39 establishes specific categories into which financial instruments should be classified. The classification determines how the financial assets will be measured and recognised in the financial statements. There are four categories of financial instruments:

- financial assets at fair value through profit or loss;
- loans and receivables;
- held–to–maturity investments; and
- available–for–sale financial assets.

Based on the requirements in IAS 39, most of an insurer's investment portfolios will be measured at fair value. Fair value changes are recognised either in income or as a separate component of equity, depending on the category into which an instrument falls. Financial assets may also contain embedded derivatives that may require separation from the host debt or equity instrument and measurement at fair value.

IAS 39.58–70

Financial assets are tested for impairment using various methods depending on their classification.

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Other assets of an insurer, such as owner-occupied property, equipment, intangible assets and prepayments are covered by other IFRSs and are not dealt with in this guide. Investment properties are, however, covered briefly.

Requirements of IFRSs regarding financial instruments are complex and can be difficult to apply in practice. This section discusses the requirements of IAS 39 in the context of an insurer's investments and the requirements of IFRS 4. (Refer to chapter 14 for discussion of accounting for financial instruments.)

11.2 Categories of financial assets and their measurement

Financial assets held by an insurer may include listed and unlisted equity shares, bonds, loans (both originated and purchased), deposits (including unbundled deposits) and derivative instruments. On initial recognition of a financial asset, it is classified into one of the four categories depending on the nature of the asset and the purpose for which it is acquired, as follows:

IAS 39.9

11.2.1 Financial assets at fair value through profit or loss

This category is used for two purposes. Firstly, any financial asset purchased with the intention of trading must be included within this category. A trading asset is one that is acquired or incurred principally for the purpose of generating profits from short–term fluctuations in price. Any asset that is subsequently transferred into a trading portfolio also becomes a trading asset. All derivatives are classified as trading assets unless they qualify as hedging instruments.

IAS 39.9 and 50

Secondly, an insurer may, at the date of initial recognition only, designate irrevocably any financial asset as 'at fair value through profit or loss', except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. The IASB is presently proposing to limit the use of this designation option to a few specific situations. (Refer to chapter 14 for details of these limitations.)

IFRS 4.45

IAS 39.105

When IAS 39 is first applied, an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or available for sale despite the general requirement to make such designation upon initial recognition.

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An example of why an insurer may wish to designate assets 'at fair value through profit or loss'

For an insurer, this category might be used, for example, to avoid the complexities of separating embedded derivatives from complex savings product liabilities by measuring the entire product at fair value.

By also designating the assets held to back the liabilities as 'at fair value through profit or loss', the insurer is able to measure the assets and liabilities on the same basis.

As implied by the title, this category of financial assets is measured at fair value with changes in fair value being recognised in profit or loss as they arise.

IAS 39.9

11.2.2 Loans and receivables

The loans and receivables category is used for loans both originated and purchased by the entity, not quoted in an active market[1] that:

- are not included in the fair value through profit or loss category;
- the entity does not intend to sell immediately or in the near term, which shall be classified as held for trading;
- are not classified as available–for–sale because the holder may not recover substantially all of its initial investment, other than because of credit deterioration; or
- the entity does not, upon initial recognition, designate as available–for–sale.

IAS 39.9 and 46

Loans and receivables are measured at amortised cost using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. Under this method, any initial discounts, premiums and direct incremental transaction costs are included in the cash flows to be discounted.

[1] This category is not appropriate for listed debt securities such as bonds.

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IAS 39.9

11.2.3 Held–to–maturity financial assets

The held–to–maturity classification is available in practice only for listed debt securities such as bonds. In order to include a financial asset in this category, an insurer must be able to demonstrate that it has both a positive intent and ability to retain the asset until its maturity.

IAS 39.46

The advantage of using the held–to–maturity category is that this category is measured at amortised cost. To the extent that an insurer is able to demonstrate its positive intent and ability to retain debt securities until maturity, measurement at amortised cost will avoid the volatility, in income or in equity, that may otherwise result from fair value measurement.

IAS 39. IGB.19–21

However, significant safeguards are built into the standard to ensure that an entity's positive intent and ability are appropriately assessed. With some minor exceptions, if an insurer sells (or transfers to another category) more than an insignificant amount of its held–to–maturity portfolio, it is prevented from using the held–to–maturity category for two full financial years following the sale. These requirements are often described as the 'tainting rules'.

In practical terms, an insurer will need to consider the maturities of its bond portfolios and the extent to which, in the absence of disaster–type scenarios that could not have been foreseen, it is able to demonstrate its positive intent and ability to hold them to maturity. To the extent that an insurer may be required to sell debt securities in order to fund lapses and surrenders by its policyholders, it will need to exclude these from the held–to–maturity category in order to avoid the tainting penalty.

An insurer may also consider investing a portion of its funds in unlisted loans and deposits that could be measured at amortised cost under the loans and receivables category and to which no tainting rules would apply.

IAS 39.9

11.2.4 Available–for–sale financial assets

The available–for–sale category is largely a residual category. It includes any financial asset that does not fall into the other three categories. An insurer's non–trading investments in equity shares will fall into this category, as well as debt securities that are quoted in an active market and therefore do not meet the requirements for held–to–maturity investments.

In addition, an insurer may at the date of initial recognition only, irrevocably, designate any non–trading financial asset as available–for–sale. For example, an entity may wish to designate a loan, which would otherwise be measured at amortised cost, as available–for–sale.

IAS 39.46

IAS 39.55(b)

Available–for–sale financial assets are measured at fair value with fair value changes deferred in a separate reserve within equity. Those deferred unrealised gains and losses are recycled to income when the asset is sold or when it becomes impaired.

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IAS 39.48 and AG69–82

11.3 How to determine fair value

When an asset is quoted in an active market, the published price is the best evidence of fair value. The appropriate price to be used is the current bid price. No adjustments or reserves for liquidity or large holdings, for example, are permitted.

If there is no active market for an asset, IAS 39 requires the use of other valuation techniques. Such techniques include reference to quoted prices or recent transactions in instruments that are substantially the same, as well as valuation models. If a model is used, it should make maximum use of market inputs, incorporate all factors that market participants would consider in setting a price, and be consistent with accepted economic methodologies for pricing financial instruments.

An extremely limited exception is provided in IAS 39 for investments in unlisted equity instruments. The standard recognises that it will often be possible to derive a reliable fair value for such instruments. However, if the range of fair value estimates is significant and the probabilities of each estimate cannot be reasonably assessed, an insurer is precluded from measuring unlisted equities at fair value.

11.4 Impairment

IAS 39.58

An insurer is required to assess, at each reporting date, whether a financial asset, or a group of assets, is impaired. Impairment exists only if there is objective evidence that an event has taken place that has an impact on the estimated future cash flows.

IAS 39.59 and 63–66

Objective evidence of impairment for debt instruments such as loans and bonds would include significant financial difficulties of the issuer. For equity instruments, a significant decline in market value below cost is objective evidence of impairment.

Once it is established that there is objective evidence of impairment, the amount of the loss is generally calculated by comparing the cost, or amortised cost, of the asset with its fair value. For loans and held–to–maturity assets, the loss is calculated by comparing the amortised cost of the asset with the present value of the estimated future cash flows, discounted at the original effective rate.

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IAS 39.10–13

11.5 Embedded derivatives

Some financial assets include one or more embedded derivatives. Examples include a convertible or exchangeable bond, which includes an equity call option, and loans with prepayment options. When the economics of the embedded derivative are not closely related to the economics of the host investment contract and the host contract is not already measured at fair value, the derivative must be separated and accounted for as a trading asset or liability.

IFRS 4.C12

11.6 Investment properties

Besides financial assets, an insurer may own investment properties. Generally, an insurer is required to make an accounting policy choice, on a group–wide basis, as to whether properties are measured at depreciated cost or at fair value. However, in some cases, insurers may link benefits directly to the fair value or income of a fund, which may include investment properties. In such cases, an insurer is permitted to adopt separate accounting policies for the investment properties linked to liabilities and other investment properties held.

Why an insurer may wish to choose separate measurement categories for investment properties

An insurer is required, under IAS 39, to measure a liability linked to the performance of investment property at its fair value. It could choose to measure the investment property backing the unit–linked liabilities at fair value, whilst continuing to measure other investment properties, for which liabilities are not linked to the fair value, consistently at depreciated cost. The amortised cost method may be regarded as a simpler accounting method and this option may, therefore, be attractive to the insurer.

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12. How do you deal with an 'asset–liability mismatch'?

Key topics covered in this Section:

- Overview
- Requirements of the Standard

Reference

12.1 Overview

Many insurers make a significant effort to match their earnings and cash inflows from investments, and their expenses and cash outflows for obligations, where these are of a short to medium term. This is possible because assets may be available to match short to medium term obligations, however, for long–term contracts this is not really achievable. The key objective in the past has been to match the insurer's assets, which under many local reporting practices are measured on a consistent amortised cost approach, with the insurer's liabilities. Due to the varying duration of insurance contracts, some of which are of a very long duration, and the uncertainty surrounding cash flows arising from these contracts, full cash flow matching is often impossible as investments are not available which match these cash flows or the duration of these contracts. In addition, a perfect match of assets and liabilities may not be desirable as an investment policy free from these constraints has the potential to be more profitable.

Changing from local accounting practices to reporting under IFRS may cause even further inconsistencies. While substantially all insurance contract assets and liabilities continue to be measured in a consistent manner under IFRS 4, financial assets are measured under a variety of different approaches under IAS 39. (Refer to chapter 11 for further discussion of the measurement of different categories of assets.)

IFRS 4.IG13

In considering the effect that the differing measurement bases have on the assets and liabilities reported in the financial statements, the general principle in IAS 1 should also be considered. IAS 1 requires an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. The effect of the mismatch may therefore need to be disclosed. (Refer to Chapter 13 for further discussion of the disclosure.)

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An example of an asset–liability mismatch

Take, for example, a large portfolio of single premium pure endowment policies of a 5–year duration, without a surrender option but with a guaranteed maturity value. In this case, it is possible to match the cash flows under the portfolio with 5–year fixed–interest bonds. The total amount of the bonds required, reflects the expected maturity value payable to the surviving policyholders after 5 years.

Generally, the existing accounting policies for the insurance liabilities will use a fixed discount rate, reflecting the inherent guarantee, which results in the recognition of a consistent annual expense increasing the liability to maturity value.

If the bonds are classified as held–to–maturity, and therefore measured at amortised cost, the change in carrrying amount determined using the effective interest rate will match the change in liability each year. However, under IAS 39 it might be necessary to classify the bonds as at fair value through profit or loss or available–for–sale. As a result the carrying value of the bonds will be measured at fair value and will be subject to market volatility, causing an 'artificial' mismatch between the valuation of the assets at fair value and liabilities at fixed discount rates.

IFRS 4.24

12.2 Requirements of the Standard

Due to factors outlined above, the IASB intended to provide some measures to reduce or even eliminate the ‘artificial’ volatility caused by inconsistent measurement approaches for assets and liabilities. IFRS 4 provides for limited measures to reduce the effect of the conceptual mismatch.

12.2.1 Current market interest rates

IFRS 4 has relaxed the requirement of IAS 8 to use uniform accounting policies for all insurance contracts by allowing insurers to apply market interest rates in the discounting of designated insurance contracts.

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IFRS 4.45

12.2.2 Redesignation of financial assets

IFRS 4 permits an insurer to reclassify some or all of its existing financial assets, subject to IAS 39, to 'at fair value through profit or loss', when it changes its accounting policy for insurance liabilities. This reclassification is treated as a change in accounting policy. Any financial assets subsequently acquired can be classified directly as 'at fair value through profit or loss'.

These limited measures allow insurers to use a consistent approach, based on current market assumptions, for the assets and liabilities of the designated contracts, where they believe that this choice improves the relevance of the reported figures. This is especially applicable to insurance contracts where the cash flows are matched to a great extent with those of assets held.

However, for a majority of insurance contracts this does not solve the mismatch problem. In non–life business, the timing and amount of claim liabilities are often uncertain and volatile even during settlement, making matching with assets impossible.

Life insurance obligations are often of a much longer duration than assets available in the market. In these contracts, financial risk is often mitigated by the inclusion of participating features. Due to the uncertainty inherent in these features it may be difficult to match benefit payments to assets.

IAS 39.49

In addition, the use of a fair value measure for both assets and liabilities in order to achieve matching is constrained because the fair value of a financial liability with a demand feature, such as an option to surrender, cannot be less than the amount payable on demand (the surrender value).

12.2.3 Shadow accounting

Insurers are permitted to introduce or continue using shadow accounting. (Refer to chapter 6 for further discussion of shadow accounting).

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13. What do you disclose?

Key topics covered in this Section:

- Overview
- Explanation of recognised amounts
- Amount, timing and uncertainty of cash flows

Reference

13.1 Overview

The disclosure requirements in IFRS 4 are based on two main principles:

IFRS 4.36

- explanation of recognised amounts; and

IFRS 4.38

- amount, timing and uncertainty of cash flows.

The Implementation Guidance to IFRS 4 provides further information on specific disclosures to satisfy these requirements.

The principles and most of the supporting requirements are either applications of the existing IFRSs or analogies based on requirements in other existing standards, particularly IAS 32.

IAS 30
ED7

The IASB recently issued an Exposure Draft proposing new financial instrument disclosures relating to the entity's exposure to risks and how those risks are managed.

This Exposure Draft proposes amendments to IAS 32 and once implemented will supersede IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and will result in amendments to the disclosures required for insurance contracts. It is open for comment until 22 October 2004.

The IASB expects that the broad disclosure principles will remain unchanged for phase II, although the suggested disclosure in the Implementation Guidance may be amended once the practical difficulties surrounding the availability of information and development of systems to meet the disclosure principles in phase I have been identified.

It is important to note that the disclosure requirements in the Standard relate to insurance contracts as defined. (Refer to chapter 2 for further discussion of the definition of insurance contracts.) Contracts that do not meet the definition are, therefore, not subject to the disclosure requirements of IFRS 4 but may be subject to the disclosure requirements of other IFRSs such as IAS 18 or IAS 32. Financial instruments with DPF are subject to the disclosure requirements of IAS 32.

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Separate disclosures are to be made for insurance contracts and any other contract, including financial instruments with DPF where the contracts are subject to the same or similar recognition and measurement rules as insurance contracts. (Financial instruments with DPF are subject to the scope of IAS 32.)

IFRS 4.36–37

13.2 Explanation of recognised amounts

According to the first disclosure principle, an insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts. To comply with this requirement, an insurer should disclose the following:

IFRS 4.37(a)

13.2.1 Accounting policies

Accounting policies shall be disclosed for assets, liabilities, income and expenses relating to insurance contracts. This requirement is of special relevance considering the diverse nature of existing accounting policies continued under IFRS 4.

The Implementation Guidance provides an extensive list of suggested disclosures to meet this requirement, including methods of dealing with risk and uncertainty, embedded options and guarantees, discretionary participation features and, as required by IAS 1, the judgments made by management in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements.

IFRS 4.37(b)

13.2.2 Identification of recognised assets, liabilities, income and expenses

Amounts resulting from insurance contracts reported in the balance sheet or income statement are identified as such, either directly on the face or in the notes. Where an insurer prepares a cash flow statement under the direct method, the cash flows arising from insurance contracts should also be identified and disclosed.

If the insurer is a cedant, it should also disclose gains and losses recognised in profit or loss on the purchase of reinsurance contracts and provide a schedule showing the movement of any deferred and amortised gains and losses arising from these transactions.

IFRS 4.BC109–114

The requirement to disclose gains and losses from buying reinsurance results from the various discussions on the acceptability of recognising immediate gains on the purchase of reinsurance. As measurement principles have not been incorporated in IFRS 4, the IASB has decided to allow insurers to recognise these gains and losses, provided they disclose the impact on the financial statements.

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IFRS 4.37(c)–(d)

13.2.3 Assumptions

An insurer shall disclose the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts. In addition it should disclose the effect of changes in these assumptions. Changes that have a material effect on the financial statements should be shown separately.

Where practical, an insurer should also quantify the effect of the assumptions. The Implementation Guidance provides a summary of items that could be presented to meet this requirement, including:

- the objective of the assumptions, e.g. to reflect market expectations or regulatory requirements;
- the source of the data used as inputs, e.g. the insurer's own statistics, industry statistics or randomly generated data in stochastic models;
- a comparison with observable market data or other published information;
- a description of past experience and trends, e.g. whether and for which periods: past experience is seen as relevant; observed trends are expected to continue or change; and past experience and trends are considered in determining assumptions;
- a description of how the assumptions about future trends, such as changes in mortality, were developed;
- correlations between assumptions and uncertainties relating to certain assumptions, e.g. the dependence of lapse rates on market interest rates; or a deviation from current assumptions as a result of a reasonably possible change of circumstances which could potentially cause a material change in liabilities in the future; and
- the policy and assumptions made in the allocation or distribution of contracts with discretionary participation features.

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IFRS 4.37(e)

13.2.4 Reconciliations of changes in insurance liabilities, reinsurance assets and related deferred acquisition costs

Reconciliations would normally take the form of a movement schedule similar to those required under IAS 37.

This would include information about the nature of the changes of insurance liabilities such as:

- increases caused by premium payments; amortisation of deferred acquisition costs; the accumulation of interest or the occurrence of insured events; and
- decreases due to the lapse or settlement of liabilities.

The reconciliation may be provided on a portfolio basis and need not be provided per line of business, provided the assets and liabilities have a broadly similar measurement basis. For example, separate reconciliations might be provided for discounted life insurance liabilities, fair valued unit–linked life insurance liabilities, non–discounted non–life claims liabilities or non–life unearned premiums.

IFRS 4.IG15–16

In practice, insurers need to ensure that they provide informative disclosures without providing excessive detail that might not be beneficial to the users of the financial statements. For this reason, the IASB discusses the concept of materiality in the Implementation Guidance, as used in IAS 1 and the Framework. Based on the concept of materiality, an insurer should decide the level of detail appropriate to satisfy the disclosure requirements, including which areas require greater emphasis and how to aggregate information so as to provide a good overview of the business without combining information that has materially different characteristics. The specific characteristics of the insurer and the circumstances surrounding its business have to be taken into consideration.

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IFRS 4.38

13.3 Amount, timing and uncertainty of cash flows

The second high–level disclosure principle in IFRS 4 requires an insurer to disclose information to help users of the financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts. This requirement focuses on disclosure about cash flows, not disclosure of cash flows.

The disclosure is based on two foundations:

- there should be a balance of quantitative and qualitative information. Sometimes information is more useful if provided in narrative form, rather than a summary of figures without sufficient explanation. Therefore, it is not necessary to provide figures for each individual disclosure.
- the information provided should be consistent with how management perceives its activities and risks, and the methods that management uses to manage those risks.

Disclosure may differ greatly depending on the type of company, e.g. a large international, diversified insurance group compared to a smaller, specialised company.

The implementation guidance explains the type of disclosure which would meet this principle, built largely on the requirements of other IFRSs, such as the disclosure for financial instruments in IAS 32.

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IFRS 4 requires an insurer to disclose the following:

IFRS 4.39(a)

13.3.1 Risk management objectives and policies

An insurer should disclose its objectives in managing risks arising from insurance contracts and its policies for mitigating those risks. The Implementation Guidance discusses the following examples: risk acceptance policies, risk assessment methods, reinsurance programmes and asset and liability management techniques.

Further relevant information would include the effectiveness of risk mitigation at a portfolio level, indicating whether the size and composition of the portfolio is sufficient to mitigate the current insurance risks covered.

IFRS 4.39(b)

13.3.2 Terms and conditions of insurance contracts

The terms and conditions of insurance contracts which have a material effect on the amount, timing and uncertainty of the insurer's cash flows should be disclosed. It is particularly important to strike a balance between aggregated information and excessive detail. This may be solved by grouping insurance contracts into broad classes appropriate to the nature of the information to be disclosed, like the characteristics of the contracts. Additional guidance may be found in IAS 14 Segment Reporting, which requires the identification of reportable segments which reflect differences in the risk and returns of an entity's products and services based on functional or geographic reporting segments.

Various options are available to insurers, e.g. splitting the products into life, non–life and health and perhaps further splitting non–life business into short–tail and long–tail business and life business into individual life and group life. Or perhaps disclosure could be grouped by line of business or product type. Whichever split is chosen, the focus should be on identifying classes of products which are generally subject to similar risks.

In some cases, e.g. in large multinational insurance groups, the terms and conditions of individual insurance products may be too numerous or diversified to refer to individually. It may be more useful to include information on how the group manages product development and the control of terms and conditions of products offered. Further information could include terms and conditions which have a general impact on the risk exposure of the insurer, e.g. participation clauses used throughout the life portfolio or premium adjustment clauses.

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IFRS 4.39(c)

13.3.3 Insurance risk

Information about insurance risk should be disclosed, both before and after the effect of reinsurance, including information about:

- the sensitivity of profit or loss and equity to changes in variables that have a material effect on them;
- concentrations of insurance risk; and
- claims development. Actual claims should be compared to previous estimates going as far back as the period when the earliest material claim arose for which there is still uncertainty surrounding the amount and timing of benefit payments, up to a maximum of ten years. This disclosure is not required when the uncertainty is typically resolved within one year. As a result, it is unlikely that many life insurers will have to provide this disclosure.

The general approach to this disclosure in IFRS 4 was to model the requirements, as far as possible, on those included in IAS 32, while taking insurance specific issues into account. Since IFRS 4, in general, allows insurers to continue to apply local accounting practices as the accounting basis for such liabilities, the disclosure is aimed at increased transparency until the measurement of insurance liabilities is harmonised in phase II.

The requirement to disclose the concentrations of insurance risk is intended to include risks related to low–frequency, high–severity risks like natural disasters. It is practice, in certain jurisdictions, to set up catastrophe provisions relating to these risks, but these provisions can no longer be reported as liabilities in terms of IFRS 4. Instead they will be included as part of equity. (Refer to chapter 6 for further discussion of changes in accounting policies.) By disclosing the exposure to risks of this kind and the estimated frequency of losses, users still obtain the information necessary to assess the financial position and risk profile of the insurer.

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IFRS 4.39(d)

13.3.4 Interest rate and credit risk

An insurer should disclose the same information about interest rate risk and credit risk that IAS 32 would require if the insurance contracts were financial instruments within the scope of IAS 32.

The Implementation Guidance provides examples such as disclosure of:

- lapse behavior where the behavior is sensitive to interest rates;
- policyholder participation features linked to interest rates; and
- credit risk of reinsurance contracts and receivables from intermediaries as well as credit risk assumed under credit insurance contracts and financial guarantees.

IFRS 4.39(e)

13.3.5 Embedded derivatives

Where an insurer does not measure embedded derivatives at fair value in terms of IAS 39, it should disclose information about its exposure to interest rate risk and market risk.

This requirement is intended to compensate for the fact that, in terms of IFRS 4, an embedded derivative which contains significant insurance risk need not be separated from its host contract and be measured at fair value. (Refer to chapter 3 for further discussion of embedded derivatives.) Since the fair value measurement requirements do not apply, additional disclosure is necessary to identify and explain material interest rate and market risk exposures resulting from these derivatives.

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14. Accounting for investment contracts

Key topics covered in this Section:

- Overview
- Categorisation of contracts
- Initial measurement
- Transaction costs
- Investment management fees
- Front end fees
- Subsequent measurement – amortised cost
- Subsequent measurement – fair value
- Consideration of renewal premiums
- Unit–linked contracts
- Actuarial funding
- Disclosure

Reference

14.1 Overview

Contracts issued that do not meet the definition of an insurance contract contained in IFRS 4 (referred to as 'investment contracts' in this chapter) will be accounted for as financial instruments under IAS 39.

An exception is for financial instruments containing a DPF, which fall within the scope of IFRS 4, and will continue to be recognised and measured under existing accounting policies in phase I, subject to certain restrictions and provisions. (Refer to chapter 10 for further discussion of accounting for DPFs.)

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IAS 39.9

14.2 Categorisation of contracts

Under the current version of IAS 39 a financial liability may be categorised in either of the following two categories:

- 'Fair value through profit or loss' which includes:
  - financial liabilities acquired or incurred principally for the purposes of selling or repurchasing in the near term; or that are part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent actual pattern of short–term profit taking;
  - derivatives (except those that are designated as effective hedging instruments); and
  - any financial liability designated as at fair value through profit or loss upon initial recognition.
- 'Other liabilities', which is a default category into which all financial liabilities other than those at 'fair value through profit or loss' will fall.

Different measurement rules apply to the two categories. Financial liabilities categorised as 'fair value through profit or loss' are measured at fair value while 'other liabilities' are measured at amortised cost.

IAS 39.43–49

Insurers will therefore have the option to measure their financial instruments either at fair value or amortised cost. However, an Exposure Draft to IAS 39 released in April 2004 will limit the ability to designate any financial instrument as at fair value through profit or loss upon initial recognition[1]. In respect of financial liabilities the designation 'at fair value through profit or loss' will be limited to liabilities meeting one of the following conditions:

- The item contains one or more embedded derivatives. It is irrelevant whether the embedded derivative(s) are required to be separated.
- The item is a financial liability with cash flows contractually linked to the performance of assets that are measured at fair value. This condition is met only if the contract specifies the linked assets.
- The exposure to changes in the fair value of the financial liability (or portfolio thereof) is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability (or portfolio thereof), including a derivative (or portfolio thereof).

[1] The European Commission has issued a draft proposal to adopt IAS 39 but excluding the provisions in IAS 39 relating to the fair value option, which are distinct and separable from the Standard. This is due to the uncertainty surrounding the final version of those provisions associated with the release of this exposure draft.

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In the case of the second and third points above, the designation of a financial instrument as at fair value through profit or loss requires the identification of the offsetting exposure. In both cases, if the financial liability is to be designated as at fair value through profit or loss, the identified related financial asset shall also be measured at fair value through profit or loss, either by designation or, when the necessary requirements are met, by classification as held–for–trading.

Unit–linked contracts and contracts with DPFs qualify for the designation at fair value through profit or loss where the cash flows of these contracts are contractually linked to the performance of assets that are measured at fair value.

Unless an insurer is able to replicate the economic influences that a financial liability is exposed to in the assets that back the liability, it may be difficult to designate an investment contract as at fair value through profit or loss using the argument that the exposure to changes in the fair value of a financial liability is substantially offset by the exposure to changes in the fair value of a financial asset. Nonetheless, given that most investment contracts will contain an embedded derivative it may still be possible for entities to designate the majority of their contracts as at fair value through profit or loss.

14.3 Initial measurement

IAS 39.43

When a financial liability is recognised initially, an entity shall measure it at its fair value less, in the case of a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial liability.

IAS 39.AG64

The fair value of a financial instrument on initial recognition is normally the transaction price which is the fair value of the consideration given or received.

It follows that the issuer of a financial liability would not normally recognise a gain at the inception of a contract by valuing the fair value of the contract at an amount that is different from the consideration received.

For contracts measured on an amortised cost basis, transaction costs that are directly attributable to the issue of the financial liability are deducted from the fair value of the consideration received on initial measurement. Transaction costs in respect of financial liabilities measured at fair value are not included in the initial measurement amount.

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14.4 Transaction costs

IAS 39.9

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

IAS 39.AG13

Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties.

Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Incremental costs will include any costs that may be determined at contract level without requiring an allocation of costs to be made including, for example, commissions, medical fees and stamp duty.

It may also be possible to include bonuses paid to agents as incremental costs, even though these would require an allocation of costs to be made if costs were to be maintained at a contract level.

Semi–variable costs such as new business processing costs, except where these are outsourced and therefore charged on an incremental basis, are not considered to meet the IAS 39 definition of transaction costs.

Appendix to IAS 18.14(a)(iii)

An insurer may receive origination fees, on issuing a financial liability, that are an integral part of generating an involvement with the financial liability. If the financial liability is carried at amortised cost the origination fees are included in the initial carrying amount of the financial liability and recognised as an adjustment to the effective yield.

If the financial liability is measured at fair value these origination fees will be recognised in profit or loss as they are earned in accordance with the principles of IAS 18, outlined below.

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14.5 Investment management fees

IFRS 4 resulted in the following addition to the appendix to IAS 18:

Appendix to IAS 18.14(b)(iii)

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered.

As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

This amendment allows an insurer to defer some of the transaction costs incurred on financial liabilities carried at fair value that would otherwise have been expensed under IAS 39. It is important to note that only those transaction costs incurred to secure the investment management fees can be deferred. These costs may also only be deferred to the extent that they will be recovered through future fees charged to policyholders. The deferral of these costs does not impact on the financial liability recognised in the balance sheet.

The application of IAS 18 is not optional. It must be applied to all investment contracts that contain an investment management services contract.

As IAS 18 does not specify that acquisition costs may be calculated on a portfolio basis it might be assumed that the asset representing the right to future investment management fees should be determined at contract level. In practice, costs are likely to be captured at a contract level since the costs are incremental to contracts. However, it is accepted that assets, as well as deferred income liabilities in respect of front–end fees, do not have to be maintained at a contract level but could be maintained at product level or at portfolio level for relatively homogeneous contracts.

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IAS 18.20 and 24

14.6 Front end fees

IAS 18 requires front end fees received in respect of investment management service contracts to be deferred and recognised by reference to the stage of completion of the contract. The stage of completion may be determined by a variety of methods and an entity should use the method that most reliably measures the services performed. An entity would need to be able to justify that part of the investment management service was performed when it set up the contract, to be permitted to recognise part of the front end fee as earned at the inception of the contract. Otherwise, the whole of the front end fee will have to be deferred.

Front end fees and acquisition costs must be calculated and deferred separately, as the deferred acquisition cost asset and deferred income liability cannot be offset. In a similar manner, the expenses and fees should be separately disclosed in profit or loss.

It is important to note that all fees, not only front end fees, must be recognised on a basis that reflects the services provided. This should reflect the level of investment management activity undertaken under the contract over its life, on behalf of the policyholder.

IAS 39.9

14.7 Subsequent measurement – amortised cost

Under IAS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through its expected life to its carrying amount at initial recognition. Since net transaction costs are deducted from the fair value of the consideration received in order to establish the amount on initial recognition, the amortised cost approach implicitly defers net transaction costs.

IAS 39.AG8

If an entity revises its estimates of payments or receipts, it shall adjust the carrying amount of the financial instrument to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as an income or expense in profit or loss.

IAS 39.11

If the investment contract measured at amortised cost contains an embedded derivative, it may be necessary to separate the embedded derivative and measure it at fair value. (Refer chapter 3 for discussion on the treatment of embedded derivatives.)

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IAS 39.AG74

14.8 Subsequent measurement – fair value

IAS 39 requires that the fair value of a financial instrument that is not quoted in an active market be established using another valuation technique. This valuation technique might include using recent arm's length transactions between knowledgeable, willing parties; reference to the current fair value of another instrument that is substantially the same; or applying a discounted cash flow analysis or an option pricing model.

In practice, it is likely that the fair value of the financial instrument component of an investment contract issued by a insurer will be established either using a discounted cash flow technique, or by reference to the current fair value of another instrument that is substantially the same, or a combination of the two.

It is likely that a discounted cash flow calculation using realistic assumptions would indicate that the fair value of the financial instrument component of an investment contract, at issue, is less then the consideration received. However, since IAS 39 does not permit a gain to be recognised on the issue of a contract, except to the extent that front end fees have been earned, it follows that a discounted cash flow analysis must incorporate margins[1] so that the discounted cash flows equal the consideration received.

IAS 39.49

IAS 39 states that the fair value of a financial liability with a demand feature, such as an investment contract that the policyholder can cancel at any time, cannot be less than the amount payable on demand (discounted from the first date that the amount could be required to be paid).

It should be noted, however, that this does not mean that the fair value of a financial instrument is its surrender value. The fair value of a financial instrument is the higher of its surrender value and its fair value calculated using a discounted cash flow (or replicating portfolio) technique.

14.9 Consideration of renewal premiums

No guidance is currently included in IAS 39 (or IAS 18) on the treatment of renewal premiums. Therefore, there is neither clarity on whether to take account of contractual future premiums when assessing fair values under IAS 39, nor whether assets recognised under IAS 18 are recoverable.

However, when assessing if assets recognised under IAS 18 are recoverable, it could be assumed that a contract provides for the payment of future fixed regular premiums. In addition, if the policyholder has the option to terminate the contract, the expected surrender patterns should be taken into account.

[1] Margins could be in the form of either an adjustment to the risk free discount rate, or an adjustment of individual cash flows

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IAS 39. AG30(g)

14.10 Unit–linked contracts

Unit–denominated payments can be measured at the current unit values that reflect the fair values of the assets of the fund. This avoids the need to separate an embedded derivative representing the equity–linking component that is inherent in these contracts.

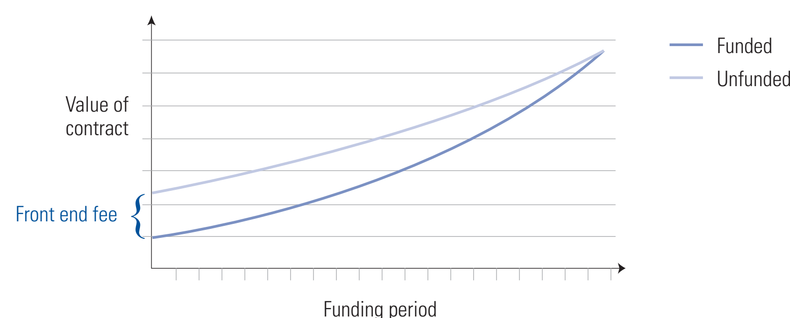
14.11 Actuarial funding

Some unit–linked contracts have 'capital' units. These capital units have a higher annual management charge (AMC) than the normal 'accumulation' units. They are used to fund the accumulation units and are therefore allocated in the early years of regular premium contracts, after which accumulation units are allocated. The policyholder is informed of the full (partially unfunded) amount of capital units allocated. Assets equal to a lower funded amount, are held to back the contract. Over the funding period (typically equal to the term of the contract) the funded value grows to equal the unfunded value as the AMC is capitalised. Allocating capital units for the early premiums of contract is similar to applying a front–end charge to the contract, where the front–end charge equals the difference between the funded and unfunded unit value.

Two alternative approaches are available when measuring investment contracts subject to actuarial funding:

- measure the financial liability at the gross value of the units allocated to the policyholder and create a separate asset representing the contractual right to benefit from providing investment services; or
- measure the financial liability at the funded value of the units and treat the difference between the gross value of the units and the funded value as a fee received in respect of the investment services contract by recognising a deferred income liability for the amount.

Although on initial recognition the difference between the two approaches is presentational only, the subsequent amortisation pattern will be different under the two different options.



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IAS 32.86

14.12 Disclosure

IAS 32 contains the requirements for disclosure of financial assets and financial liabilities. A significant disclosure requirement of IAS 32 is the requirement to disclose the fair values of all financial assets and liabilities with a few limited exceptions. Therefore, an insurer will have to determine the fair value of all investment contracts, even those carried at amortised cost, as it is required for disclosure purposes.

Summary of accounting treatment for investment contracts

	Amortised cost	**Fair value**
Embedded derivatives	Certain embedded derivatives must be separated and measured at fair value	Embedded derivatives do not need to be separated if the whole contract is measured at fair value
Front–end fees and transaction costs	Front end fees and transaction costs are implicitly deferred in the calculation of the contract liability	Deferral of front–end fees and transaction costs in accordance with IAS 18 principles
Effective yield	Required. Straight line is not a substitute	Not applicable
Surrender options	If the surrender option does not approximate amortised cost at each exercise date the investor’s option to surrender must be measured at fair value	The fair value of the contract liability cannot be less than the surrender value
Disclosure	Additional fair value disclosures are required in respect of liabilities measured on an amortised cost basis	No additional disclosure required

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15. Transition and implementation

Key topics covered in this Section:

- Overview
- Requirements of the Standard
- Amendment to IFRS 1 for first–time adopters

Reference

15.1 Overview

IFRS 4.41

IFRS 4 is applicable for years beginning on or after 1 January 2005. Earlier application is encouraged but if an entity applies the Standard for an earlier period, it must disclose that fact.

IFRS 4.40

The transitional provisions are the same for entities already applying IFRSs and for those applying IFRSs for the first time (first time adopters). However, IFRS1 provides that an insurer applying IFRS for the first time need not restate its comparative information in respect of IAS 32, IAS 39, IFRS 4.

15.2 Requirements of the Standard

15.2.1 Disclosure

IFRS 4.37(a)–(b) and 42

The transitional requirements within IFRS 4 provide some relief from applying the disclosure requirements of the Standard retrospectively.

Entities need not provide comparative disclosures for periods beginning before 1 January 2005, except for the following:

- accounting policies for insurance contracts and related assets, liabilities, income and expenses;
- recognised assets, liabilities, income and expenses; and
- cash flows relating to insurance contracts where a cash flow statement is presented using the direct method.

Cedants should also disclose comparative information in respect of the following:

- gains and losses arising from the acquisition of reinsurance which are recognised in profit or loss; and
- for gains and losses arising from the acquisition of reinsurance, which are deferred and amortised, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.

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The effect of the exemption is that entities will not need to provide the detailed note disclosure for comparatives. However, for an existing IFRS reporter, no exemption is provided from the general requirement to apply IFRS 4 restrospectively in terms of recognition, measurement and presentation requirements. (IFRS 1 provides further assumptions for a first time adopter as described below. It is therefore essential that entities gear themselves towards the appropriate level of disclosure for the first year of application and the first comparative period. (Refer to chapter 13 for further discussion of the disclosure requirements.)

IFRS 4.43

Where an insurer is not able to apply the requirements of the Standard relating to:

- unbundling of deposit components;
- recognition and measurement (including changes in accounting policies);
- acquired insurance portfolios; and
- discretionary participation features

to the comparatives for recognised assets, liabilities, income, expenses and, where appropriate, cash flows – it shall disclose that fact. However, this exemption is restricted in practice by the requirements set out below.

IAS 8.5

An insurer need not apply these requirements *only* if it is impracticable to do so.

Applying a requirement is **impracticable** when an entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- the effects of the retrospective application or retrospective restatement are not determinable;
- the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or
- the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  - provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
  - would have been available when the financial statements for that prior period were authorised for issue from other information.

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IFRS 4.43

The IASB expects that, as regards comparative information, only the application of the liability adequacy test may be impracticable. IFRS 4 states that it is ‘highly unlikely’ that the exemption would apply in any other respect.

IFRS 4.44

An insurer is required to disclose information relating to the development of claims going back to the period when the earliest material claim arose for which there is still uncertainty surrounding the settlement, up to a period of ten years.

However, this disclosure need only be given for five years when the Standard is first applied. In addition, if it is impracticable to disclose claims development for more than the current and first full comparative period in the first year that IFRS 4 is applied, the insurer should disclose this fact.

15.2.2 Redesignation of financial assets

If an insurer changes its accounting policies for insurance liabilities, either when first applying IFRS 4 or subsequently, it is permitted but not required to reclassify some or all of its financial assets as ‘at fair value through profit or loss’. (Refer to chapter 11 for further information on the treatment of non–insurance assets.)

If an insurer makes a subsequent change in accounting policies this has to comply with the requirements of IFRS 4. (Refer to chapter 6 for these requirements.) The reclassification of financial assets is a change in accounting policy and should be accounted for in terms of IAS 8.

IFRS 1.36A

15.3 Amendment to IFRS 1 for first–time adopters

In terms of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, entities adopting IFRSs for the first time, before 1 January 2006, shall present at least one year of comparative information. However, this comparative information need not comply with IAS 32, IAS 39 or IFRS 4.

An entity that chooses to apply this exemption in it’s first year of transition shall apply its previous accounting policies to the comparative information for financial instruments within the scope of IAS 32 and IAS 39 and insurance contracts within the scope of IFRS 4 and disclose this fact, together with the basis used to prepare this information.

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In addition, the entity shall disclose the nature of the main adjustments that would make the information comply with IAS 32, IAS 39 and IFRS 4. The entity need not quantify these adjustments. However, any adjustment between the comparative period's balance sheet and the balance sheet at the start of the first IFRS reporting period is treated as arising from a change in accounting policy and the following are certain of the disclosures required in terms of IAS 8:

- the Standard and a description of the cause of the change in the accounting policy;
- the nature of the accounting policy; and
- the amount of the adjustment for each line item affected.

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