IFRS 4 *Insurance Contracts*
Frequently asked questions
July 2004

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The IASB staff has prepared this document to answer questions that the staff frequently receives. The Board has not reviewed this document.

Background

Why do we need an IFRS on insurance contracts?

1. The Board decided to develop an International Financial Reporting Standard (IFRS) on insurance contracts because:

   (a) before IFRS 4, there was no IFRS on insurance contracts, and insurance contracts were excluded from the scope of existing IFRSs that would otherwise be relevant (IFRSs on provisions, financial instruments, intangible assets).

   (b) accounting practices for insurance contracts were very diverse, and also often differed from practices in other sectors.

Why did the Board split this project into two phases?

2. Few insurers report under IFRSs at present, but many more are expected to do so from 2005, particularly in the European Union and Australia. To enable insurers to implement some aspects of the project in 2005, the Board split the project into two phases. The Board completed phase I in March 2004 by issuing IFRS 4 *Insurance Contracts*. The Board's objectives for phase I were:

   (a) to make limited interim improvements to accounting for insurance contracts.

   (b) to require any entity issuing insurance contracts (an insurer) to disclose information about those contracts.

Phase I

How will phase I make the financial statements of insurers more useful to users?

3. IFRS 4 introduces the first specific requirements in international standards for disclosures about insurance contracts. The disclosures will shine some light into insurance accounting, which users of insurers' financial statements often describe as an impenetrable black box.

4. IFRS 4 also confirms explicitly that IFRSs:

   (a) prohibit provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions).

(b) require a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets.

(c) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.

Will phase I make life easier for insurers adopting IFRSs in 2005?

5. IFRS 4 includes measures that should ease the burden for insurers adopting IFRSs for the first time in 2005:

   (a) A new definition of an insurance contract. This removes some contracts from the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (see paragraphs 44-47 below).

   (b) An exemption from the requirement in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to refer to other IFRSs and the *Framework* in areas where no specific IFRS applies (paragraphs 48 and 49).

   (c) An exemption, if specified conditions are met, from the requirement to measure an embedded derivative at fair value (paragraphs 56-58).

   (d) An optional expanded presentation for insurance contracts acquired in a business combination or portfolio transfer (paragraphs 66-68).

   (e) A temporary exemption from some aspects of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 for discretionary participation features contained in insurance contracts or financial instruments (paragraphs 76 and 77).

How do IFRSs treat financial assets that insurers hold to back their insurance contracts?

6. IFRS 4 does not change the measurement of financial assets held by insurers to back insurance contracts. These assets are within the scope of IAS 39, which identifies four categories of financial asset. In summary:

   (a) financial assets classified as 'at fair value through profit or loss' (including all financial assets held for trading and all derivatives) are measured at fair value, and all changes in their fair value are included in profit or loss.

   (b) available-for-sale assets (ie those that do not fall into any of the other categories) are measured at fair value and changes in their fair value are reported in equity until the asset is derecognised or becomes impaired.

(c) assets with a fixed maturity ('held-to-maturity investments') may be measured at amortised cost if the entity intends to hold them to maturity and shows that it has the ability to do so.*

(d) most loans and receivables may be measured at amortised cost.*

What is accounting mismatch?

7. *Accounting mismatch* arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities.

8. It is important to distinguish accounting mismatch from *economic mismatch*. Economic mismatch arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions.

How could accounting mismatch arise in phase I?

9. Many existing accounting models measure insurance liabilities using the original interest rate ruling when the liabilities were originated, rather than current market interest rates, and IFRS 4 permits insurers to retain this aspect of existing models. Under IAS 39, many financial assets are likely to be measured at fair value. If the insurer classifies the assets as 'available for sale', this difference in measurement basis would not affect profit or loss but it could lead to some volatility in equity.

Did the Board try to eliminate the accounting mismatch?

10. An ideal accounting model would report all the economic mismatch that exists and would generate no accounting mismatch. No such model could be developed in the limited time available for phase I. Therefore, the Board considered the following alternatives, observing that all had advantages and disadvantages:

<u>asset-based alternatives</u>

(a) permit cost-based measurements for all financial assets held to back insurance contracts

(b) permit cost-based measurements for fixed-maturity financial assets that are held to back insurance contracts and meet other specified criteria

(c) permit cost-based measurements for fixed-maturity financial assets held to back insurance contracts, but require insurers to report economic mismatch between those assets and the related insurance liabilities

<u>liability-based alternatives</u>

(d) permit or require insurers to remeasure insurance liabilities to reflect current market interest rates

* Held-to-maturity investments and loans or receivables may also be designated as 'available for sale' or (at initial recognition only) as 'at fair value through profit or loss'.

(e) permit or require insurers to remeasure insurance liabilities, and report the resulting changes directly in equity

Alternative (a) – cost measurements for all financial assets held to back insurance contracts

11. Some suggested that the Board should permit insurers to use cost-based measurements for all assets held to back insurance contracts. However, this could have meant that an insurer's financial statements do not report economic mismatches. In effect, this alternative assumes that no economic mismatch exists, and never tests this assumption.

12. For example, some insurers include some equity securities in the portfolio of assets that back their insurance liabilities, because their asset liability management systems indicate that this gives the optimal trade-off between risks and returns. However, even if the portfolio that optimises this trade-off includes some equity securities, an economic mismatch still exists between the assets and liabilities. It would be misleading to conceal that economic mismatch by continuing to use a cost basis for both the equity securities and the liabilities.

13. If an entity sells assets that were measured on a cost basis, the gain and loss since inception is reported in profit or loss. Thus, a cost basis permits an accounting mismatch because selling the assets and reinvesting the proceeds in other assets has the same effect as a selective remeasurement to fair value. Some suggested adopting deferral mechanisms to counter selective sales, but such mechanisms would have been complex and reduced transparency.

Alternative (b) - cost measurements for fixed-maturity assets that meet specified criteria

14. Alternative (b) would permit broader use of cost measurements for assets backing insurance liabilities, but would set criteria that attempt to ensure that it eliminates mainly accounting mismatch, not economic mismatch.

15. The Board considered two versions of alternative (b). The first would have extended the use of the held-to-maturity category. The second would have created a new category.

16. Some suggested that insurers wish to follow a strategy that involves holding fixed maturity investments to maturity, with some flexibility to sell investments if insurance claims or lapses are unusually high. They recommended relaxing restrictions in IAS 39 so that insurers using such a strategy could use the held-to-maturity category more easily. However, relaxing those criteria would undermine the fundamental assertion that an entity has both the intent and ability to hold the assets until maturity.

17. Morevoer, in discussions with individual Board members and staff, insurers generally indicated that they also wished to keep the flexibility to make sales in the light of changing demographic and economic conditions so that they can seek the best trade-off between risk and return. That is a valid and understandable business objective, but it is difficult to argue that cost could be more relevant than fair value in such cases. Although IAS 32 requires disclosure of the fair value of financial assets carried at amortised cost, disclosure does not rectify inappropriate measurement. If an entity may need to sell assets in response to, for example, changes in market prices or a liquidity shortage, the only appropriate measurement is fair value.

18. In summary, the first version of alternative (b) would not relax the held-to-maturity criteria sufficiently for insurers to wish to use it. Conversely, if the criteria had been relaxed enough for insurers to use it, there would have been too great a risk of obscuring economic mismatch.

19. The second version of alternative (b) creates a new category of financial assets and attempts to create some discipline by placing restrictions on its use. The Board reviewed an implementation in Japan of this version. This implementation permits a cost approach if the durations (ie average maturities) of insurance liabilities match those of the related assets within a specified band of 80-125 per cent. If any economic mismatch arises within that band, this approach does not recognise it. In addition, gains and losses on selling assets held at amortised cost are generally recognised immediately in profit or loss (except that some gains are deferred and amortised if sales are not compatible with the duration matching strategy).

20. Creating such a category would lead to a need for arbitrary distinctions and complex attribution procedures. This would not make an insurer's financial statements more relevant and reliable, and could require insurers to develop costly systems. Indeed, for systems or other reasons not all insurers in Japan use the new category of assets.

Alternative (c) - cost measurements, but report economic mismatch

21. Alternative (c) would permit broader use of cost measurements for the assets, but would require an insurer to estimate the extent of economic mismatch on a simplified basis and account for it.

22. For example, suppose that the fair value of an insurer's bond portfolio changes by 70 (because of changing interest rates and changing credit spreads), and the insurer estimates that the changing interest rates caused its insurance liabilities to change by 80. Thus there is an economic mismatch of 10 (80 – 70). Using alternative (c), the bonds would remain at cost, the insurance liabilities would not be remeasured for changing interest rates and the insurer would recognise a loss of 10 to reflect the economic mismatch. The loss would be recognised as an additional liability.

23. Representatives of major European insurers presented a preliminary outline of proposals for developing alternative (c) at a meeting with some Board members and staff. This alternative would have avoided some of the practical and conceptual problems inherent in alternatives (a) and (b). However, many insurers may not be able or willing to invest in systems that could need amendment in phase II. Moreover, this untried approach had been developed at short notice and not all details had been worked through.

24. The systems needed for alternative (c) would also permit alternative (d) discussed below (adjusting all or designated liabilities for changes in interest rates). Using alternative (d), the insurer would measure the assets at fair value (an adjustment of 70 in the above example) and adjust the liabilities for changes in interest rates (80 in the above example), thus reporting a net loss of 10 (as in the above example).

Overall conclusion on asset-based alternatives

25. In summary, the asset-based alternatives (a) to (c) had the following disadvantages:

    (a) Fair value is a more relevant measurement than amortised cost for financial assets that an entity might sell in response to changing market and other conditions.

    (b) In its response to ED 5, the Association for Investment Management and Research (AIMR) strongly urged the Board not to extend the use of amortised cost in IAS 39. The AIMR is a non-profit professional association of more than 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries.

    (c) An accounting model that measured both assets and liabilities at amounts based on current interest rates would provide information about the degree of economic mismatch. A model that measured both at historical values, or ignored the time value of money in measuring some insurance liabilities, would not. Financial analysts often observe that information about economic mismatch is very important to them.

    (d) The accounting mismatch arises more from imperfections in existing measurement models for insurance liabilities than from deficiencies in the measurement of the assets.

    (e) No single proposal would have eliminated the accounting mismatch for a broad cross-section of insurers without also obscuring the economic mismatch.

    (f) No single proposal would have been acceptable to a broad cross-section of insurers.

    (g) No single proposal could have been implemented by a broad cross-section of insurers without major systems changes. In other words, no solution was available that built on common industry approaches and systems.

Alternative (d) - remeasure insurance liabilities to reflect current market interest rates

26. Switching from a historical discount rate for insurance liabilities to a current market-based discount rate would make an insurer's financial statements more relevant and reliable. Therefore, IFRS 4 permits such a change. If insurance liabilities and related fixed maturity interest-bearing assets respond in similar ways to changes in interest rates, such a change would eliminate much of the accounting mismatch.

27. For systems and other reasons, some insurers may not wish, or be able, in phase I to introduce a current market-based discount rate for all insurance liabilities. Therefore, although IFRS 4 permits such a change, it does not require it.

28. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires consistent accounting policies. Nevertheless, the Board concluded that the increase in relevance and reliability from introducing a current discount rate could outweigh the disadvantages of permitting accounting policies that are not applied consistently to all similar insurance liabilities. Accordingly, IFRS 4 permits, but does not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require.

29. Simplified models may sometimes give a reasonable estimate of the effect of interest rate changes. Thus, insurers may be able to update some or all insurance liabilities for changes in interest rates without making major changes to their underlying transaction processing systems.

30. Adjusting the discount rate for designated liabilities will not eliminate all the accounting mismatch described above and some, perhaps many, insurers, will choose not to make that adjustment. The reasons for this are as follows:

    (a) As noted above, many insurers may not have systems to adjust liabilities for changes in interest rates and may not wish to develop such systems, even for designated liabilities as opposed to all liabilities.

    (b) Changes in discount rates would not affect the measurement of insurance liabilities that are measured, at present, at an accumulated account value.

    (c) Changes in discount rates would not affect the measurement of financial liabilities with a demand feature, because IAS 39 states that their fair value is not less than the amount payable on demand (discounted, if applicable, from the first date when that amount could be required to be paid). Although this last point is not directly relevant for insurance contracts, many life insurers issue investment contracts for which it is relevant.

Alternative (e) - remeasure insurance liabilities, and report changes in equity

31. Some suggested that the Board should create a new category of 'available-for-settlement' liabilities, analogous to available-for-sale assets, that would be measured at fair value, with changes in fair value recognised in equity. However, the Board did pursue this alternative, which:

    (a) would have required some basis for distinguishing between that category and the existing residual category of non-trading financial liabilities (ie all financial liabilities that are not held for trading). The Board identified no basis for such a distinction, nor for deciding which of these two categories would be the new residual category.

    (b) could have required insurers to develop new systems with no certainty that those systems would be needed in phase II.

Is the IASB alone in not eliminating the accounting mismatch?

32. Extending the use of amortised cost would have created an inconsistency with US GAAP. The accounting mismatch described above has existed for some years in US GAAP, which requires insurers to account for their financial assets in broadly the same way as under IAS 39. Furthermore, the US Financial Accounting Standards Board (FASB) decided in January 2004 not to add to its agenda a project to reconsider US GAAP for investments held by life insurance companies.

Does the separate measurement of assets and liabilities ignore the importance of asset and liability management?

33. Asset and liability management is an important part of an insurer's risk management. IFRS 4 underlines this by requiring disclosures about it. However, the fact that an insurer invests premiums received in particular assets does not affect the fair value of the liability (unless the cash flows from the asset determine the amounts paid to policyholders).

34. A simple analogy may help to explain this. Three entities each issue one-year bonds for proceeds of 100. The bonds require a single payment of 105 in one year. The first entity invests the proceeds in one-year government securities bearing interest at 5%, payable annually. The second entity invests the proceeds in traded equity investments. The third entity invests the proceeds in a diversified portfolio of venture capital investments. The second and third entities believe (probably quite rationally) that the most likely outcome is that their assets will grow by more than 5% in 12 months. However, the fair value of the assets at inception is no more than 100. Similarly, the fair value of the liability is no less than 100 (assuming that the possibility of default is negligible).

35. Some insurers use asset-liability management programmes that involve investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities. Such programmes do not necessarily eliminate *economic* mismatch. For example, as discussed in paragraph 12, economic mismatch exists if an insurer acquires equity securities to back insurance liabilities providing benefits that are not contractually linked to those securities, even if those securities form part of a portfolio that provides an optimal trade-off between risk and return for those liabilities.

Can insurers find a way to explain the effect of the accounting mismatch?

36. IAS 1 and IAS 32 do not preclude a presentation identifying a separate component of equity to report a portion of the change (and cumulative change) in the carrying amount of fixed-maturity available-for-sale financial assets. An insurer could use such a presentation to highlight the effect on equity of changes in interest rates that (a) changed the carrying amount of assets but (b) did not change the carrying amount of liabilities that respond economically to changing interest rates.

37. Insurers may be particularly sensitive to equity reported in general purpose financial statements in some countries where this amount is used in assessing compliance with regulatory capital requirements. However, although insurance supervisors are important users of general purpose financial statements, those financial statements are not directed at specific needs of insurance supervisors that other users do not share. Furthermore, supervisors generally have the power to obtain additional information that meets their specific needs. In the Board's view, creating new exemptions from IAS 39 in this area would not have been the best way to meet the common needs of users (including insurance supervisors) of an insurer's general purpose financial statements.

When it finalised IFRS 4, did the Board do anything to reduce the accounting mismatch?

38. The following points summarise amendments the Board made in finalising IFRS 4 that might mitigate the accounting mismatch in some cases, as well as relevant observations made by the Board:

    (a) The Board decided to permit, but not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates (see paragraphs 26-30).

    (b) The Board clarified the applicability of the practice sometimes known as 'shadow accounting' (paragraphs 41 and 42).

    (c) The Board amended IAS 40 *Investment Property* to permit two separate elections when an entity selects the fair value model or the cost model for investment property. One election is for investment property backing contracts (which could be either insurance contracts or financial instruments) that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property. The other election is for all other investment property.

    (d) The Board observed that some entities appeared to have misread the application guidance in IAS 39 on sales of held-to-maturity investments following a significant deterioration in the issuer's creditworthiness. Specifically, some appeared to have read it as limited to changes in a credit rating by an external credit rating agency, although the guidance also refers to internal ratings that meet particular criteria.

Did the Board devote much time to the accounting mismatch?

39. The Board discussed this subject at its meeting in November 2002. It was also a major topic raised by insurance participants at two half-day sessions during the financial instruments round-tables in March 2003. Before finalising ED 5, the Board discussed the subject again in April 2003.

40. Many of the respondents to ED 5 urged the Board to explore ways of reducing the accounting mismatch described above. The Board discussed this subject at length at all three meetings at which it discussed the responses to ED 5 before finalising IFRS 4. In addition, the Board discussed it with the Standards Advisory Council. It was also raised at a meeting of the Board's Insurance Advisory Committee in September 2003, which six Board members attended together with the project staff. Individual Board members and staff also had many discussions with interested parties, including users, insurers, actuaries, auditors and regulators.

What is shadow accounting?

41. In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities. When many of those models were constructed, unrealised gains and most unrealised losses were not recognised in financial statements. Some of those models were extended later to require some financial assets to be measured at fair value, with changes in fair value recognised directly in equity (ie the same treatment as for available-for-sale financial assets under IAS 39).

When this happened, a practice sometimes known as 'shadow accounting' was developed with the following two features:

(a) A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.

(b) If unrealised gains or losses on an asset are recognised directly in equity, the resulting change in the carrying amount of the insurance liability is also recognised in equity.

42. Some respondents asked the Board to clarify whether the proposals in ED 5 permitted shadow accounting. The Board concluded the following:

(a) In principle, gains and losses on an asset should not influence the measurement of an insurance liability (unless the gains or losses on the asset alter the amounts payable to policyholders). Nevertheless, the Board decided that it was not feasible to eliminate this practice in phase I.

(b) Shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (i) the gains and losses are realised or unrealised and (ii) unrealised gains and losses are recognised in profit or loss or directly in equity. This is a logical application of a feature of some existing models.

(c) Because the Board does not expect that feature of existing models to survive in phase II, insurers should not be required to develop temporary systems to apply shadow accounting.

(d) If an unrealised gain or loss on an asset triggers a shadow accounting adjustment to a liability, that adjustment should be recognised in the same way as the unrealised gain or loss.

(e) In some cases and to some extent, shadow accounting might mitigate accounting mismatch caused by using different measurement bases for assets and insurance liabilities. However, that is a by-product of shadow accounting and not its primary purpose.

Do IFRSs treat insurers less favourably than banks?

43. Some argue that banks enjoy an 'advantage' that is not available to insurers. Under IAS 39, a bank may measure its core banking-book assets and liabilities (originated loans and receivables and non-trading financial liabilities) at amortised cost, whereas an insurer may not be able to use cost-based measurements for many fixed maturity financial assets held to back its core insurance activities. However, the Board's predecessor organisation (IASC) permitted amortised cost measurement for loans and receivables because it was persuaded that there are difficulties in estimating their fair value. This factor does not apply to many assets held by insurers to back insurance liabilities.

Why does IFRS 4 include a new definition of insurance contract?

44. Under the definition in IFRS 4, some contracts previously subject to IAS 39 qualify as insurance contracts. This change applies to contracts that principally involve the transfer of financial risk but also transfer significant insurance risk. The change reduces

uncertainty caused by the previous definition. It also reduces the possibility of changes that might need to be reversed in phase II.

Why doesn't IFRS 4 use existing local definitions of an insurance contract?

45. Local definitions may vary from country to country and may not be most relevant for deciding which IFRS ought to apply to a particular type of contract. If a contract has the legal form of an insurance contract but does not transfer significant insurance risk to the issuer, it should not be treated as an insurance contract for accounting purposes. As explained in the *Framework*, financial statements should reflect economic substance and not merely legal form. Furthermore, abuse could occur if adding an insignificant amount of insurance risk made a significant difference to the accounting.

46. There is no reason to delay the application of IAS 39 to contracts that do not transfer significant insurance risk. The Board noted that some insurers sell some contracts that are within the scope of IAS 39 but have features, such as long maturities, recurring premiums and high initial transaction costs, that are more common in insurance contracts than in other financial instruments. Nevertheless, applying a single set of accounting requirements to all financial instruments will make an insurer's financial statements more relevant and reliable.

47. The definition in IFRS 4 is solely for accounting purposes and is not intended to change or pre-empt definitions used for other purposes.

Why doesn't IFRS 4 make greater improvements to existing practice for insurance contracts?

48. Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. The criteria include relevance to the decision-making needs of users and reliability. Reliability encompasses faithful represention of transactions and other events in accordance with their substance and economic reality, neutrality (ie freedom from bias), prudence (ie a degree of caution in exercising judgements under conditions of uncertainty) and completeness within the bounds of materiality and cost.

49. Without changes made in IFRS 4, an insurer adopting IFRSs in 2005 would have needed to assess whether its accounting policies for insurance contracts comply with these requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some insurers might have made major changes in 2005 followed by further significant changes in phase II. This would have caused unnecessary disruption for both users and preparers in phase I, without easing the transition to phase II. To avoid this disruption, IFRS 4:

    (a) creates a temporary exemption from the hierarchy in IAS 8. This exemption from the criteria of relevance and reliability is a highly unusual step and the Board contemplated it only as part of an orderly and relatively fast transition to phase II.

(b) limits the impact of that exemption from the hierarchy by five specific requirements (relating to catastrophe provisions, liability adequacy, derecognition, offsetting and impairment of reinsurance assets).

(c) permits some existing practices to continue but prohibits their introduction.

Does IFRS 4 require an insurer to continue to use its national GAAP for insurance contracts?

50. An insurer may continue to follow those accounting policies that it was using when it first applies IFRS 4, with a small number of specified exceptions. If specified criteria are met, an insurer may improve those accounting policies to, for example:

    (a) reflect other accounting developments with no counterpart in national GAAP.

    (b) achieve greater consistency with accounting policies that it uses for contracts subject to IAS 39.

Why should insurers measure embedded options at fair value in phase I?

51. Fair value is the only relevant measurement basis for derivatives. The cost of most derivatives is nil or immaterial. Hence if derivatives were reported at cost, they would not be included in the balance sheet and their success (or otherwise) in reducing risk, or their role in increasing risk, would not be visible.

52. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to users the nature of the rights and obligations inherent in derivatives.

53. IAS 39 requires entities to account separately for derivatives embedded in non-derivative contracts of any kind. It would be a retrograde step to exclude insurance contracts from that requirement, which:

    (a) treats contractual rights and obligations in the same way if they create similar risk exposures, whether or not they are embedded in a non-derivative contract.

    (b) counters the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative contract.

54. If phase II requires an insurer to measure insurance contracts at fair value and recognise changes in their fair value in profit or loss, an insurer would not need to measure embedded derivatives separately. Therefore, some argued that the Board should create an exemption from the existing requirement to measure separately at fair value derivatives embedded in a host insurance contract.

55. However, much of the effort needed to measure embedded derivatives at fair value arises not from their separation but from the need to identify the derivatives and from other steps

that would still be needed even if the phase II requires a fair value measurement for the whole contract. Moreover, if phase II does not require measurement of the whole contract at fair value (or close to fair value), the Board would reconsider the treatment of some derivatives for which IFRS 4 does not require separate measurement at fair value. The incremental effort needed to measure the embedded derivatives separately in phase I is relatively small and is well justified by the increased transparency that fair value measurement will bring.

Why doesn't IFRS 4 require insurers to measure all embedded derivatives at fair value?

56. It would have been contradictory to require a fair value measurement in phase I of an insurance contract embedded in a larger contract, given that such measurement is not required for a stand-alone insurance contract. Similarly, it would have been contradictory to require fair value measurement for embedded derivatives whose value changes in response to the changes in value of an insurance contract.

57. Therefore, IFRS 4 confirms that an insurer need not measure an embedded derivative separately at fair value if the derivative:

    (a) meets the definition of an insurance contract in IFRS 4;

    (b) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate); or

    (c) is so interdependent with the host insurance contract in which it is embedded that an entity cannot measure the embedded derivative separately.

58. This approach means that insurers need not, during phase I, recognise some potentially large exposures to items such as guaranteed annuity options and guaranteed minimum death benefits. These items create risks that many regard as predominantly financial, but because the payout is contingent on an event that exposes the insurer to significant insurance risk, these embedded derivatives meet the definition of an insurance contract. IFRS 4 requires disclosures to inform users about these items. In addition, an insurer must consider these items when it assesses whether its recognised insurance liabilities are adequate (see paragraphs 63 and 64). However, IFRS 4 does not prescribe a particular method for doing so because that was beyond the reasonable scope of phase I.

What are catastrophe and equalisation provisions and why does IFRS 4 ban them?

59. Some insurance contracts expose the insurer to infrequent but severe catastrophic losses caused by events such as damage to nuclear installations or satellites or earthquake damage. Some jurisdictions permit or require catastrophe provisions for contracts of this type. The catastrophe provisions are generally built up gradually over the years out of the premiums received, usually following a prescribed formula, until a specified limit is reached. They are intended to be used on the occurrence of a future catastrophic loss that is covered by current or future contracts of this type. Similarly, some countries permit or require equalisation provisions to cover random fluctuations of claim expenses for some types of insurance contract (eg hail, credit, guarantee and fidelity insurance), using a formula based on experience over a number of years.

60. Such provisions are not liabilities as defined in the *Framework*, because the insurer has no present obligation for losses that will occur after the end of the current contract period.

Recognising deferred credits as if they were liabilities would make an insurer's financial statements less relevant and reliable.

61. IFRS 4 does not prevent an insurer from recognising these items as a component of equity. Changes in a component of equity are not recognised in profit or loss.

62. IFRS 4 requires disclosures about concentrations of insurance risk, and the Implementation Guidance accompanying IFRS 4 suggests possible ways to comply with that requirement. These disclosures could be particularly relevant for those exposures for which catastrophe and equalisation provisions have traditionally been created.

Liability adequacy test

63. IFRS 4 requires an insurer to test whether its recognised insurance liabilities are adequate. Because it is beyond the scope of IFRS 4 to create a detailed accounting regime for insurance contracts, it imposes only the following minimum requirements:

    (a) The test must consider 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.

    (b) If the test shows that the liability is inadequate, the entire deficiency must be recognised in profit or loss.

64. If the insurer does not apply a test that meets those requirements, it must apply a test that refers to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

What does IFRS 4 say about reinsurance?

65. To increase transparency about reinsurance held by insurers, IFRS 4:

    (a) does not permit an insurer to remove a liability from its balance sheet until the liability is extinguished.

    (b) does not permit an insurer to offset reinsurance assets against the related direct insurance liabilities.

    (c) requires an insurer to report the deposit components of insurance contracts separately in some cases. This practice, known as unbundling, may be particularly relevant for some financial reinsurance transactions.

    (d) requires specific disclosure of gains and losses that arose on buying reinsurance.

    (e) requires an insurer to reduce the carrying amount of its reinsurance assets if there is objective evidence that the insurer may not receive all amounts due to it under the reinsurance contract.

What is the expanded presentation for insurance contracts acquired in a business combination?

66. There has been a general principle for many years that liabilities assumed in a business combination should be measured at fair value. In practice, insurers have often measured insurance liabilities assumed in a business combination on the same basis as insurance

contracts they issue, and have recognised a separate intangible asset. IFRS 4 permits that practice to continue.

67. For example, suppose that (a) the fair value of the insurance liabilities assumed was 100, and (b) the insurer's accounting model for insurance contracts that it issues would measure the insurance liabilities at 120.

68. In this example, the insurer could either (a) measure the insurance liabilities assumed at 100 or (b) measure the insurance liabilities assumed at 120 and recognise an intangible asset measured at 20.

Does IFRS 4 permit insurers to report embedded values?

69. Life insurers in an increasing number of countries disclose embedded value information. Most disclose this information outside the financial statements or as supplementary information (usually unaudited), but a few use it as a measurement in their balance sheets.

70. Embedded value is an indirect method of measuring an insurance liability. Indirect methods measure the liability by discounting all cash flows arising from the insurance contracts and the related assets, to arrive at a net measurement for the contracts and supporting assets. The measurement of the assets is then deducted to arrive at a measurement of the contracts.

71. In contrast, direct methods measure the liability by discounting future cash flows arising from the book of insurance contracts only. If the same assumptions are made in both methods, direct and indirect methods can produce the same results, at least in theory.

72. If embedded values are recognised in the balance sheet, they are typically presented as two components: an insurance liability and a separate intangible asset. This is similar to the expanded presentation that IFRS 4 permits in a business combination.

73. IFRS 4 permits insurers to continue using embedded value measurements in their balance sheet. However, an insurer can introduce embedded value measurements in its balance sheet only if all the following conditions are met:

    (a) the new accounting policy will result in more relevant and reliable financial statements. This is not an automatic decision and will depend on a comparison of the insurer's existing accounting with the way in which it intends to apply embedded value.

    (b) the embedded value does not include future investment margins. Including them generally means that assets are implicitly measured at more than fair value (many existing applications of embedded value do include them). IFRS 4 states that it is highly unlikely that adopting embedded value could increase the relevance and reliability of an insurer's financial statements sufficiently to overcome IFRS 4's rebuttable presumption against including future investment margins.

    (c) the embedded values include contractual rights to future investment management fees at an amount that does not exceed their fair value as implied by a comparison with current fees charged by other market participants for similar services.

74. Two other features of embedded value are worth noting:

    (a) Embedded value approaches are largely unregulated at present and there is diversity in their application. For example, some view the methods used to reflect risk as fairly crude, diverse and not always fully consistent with capital market prices.

    (b) Embedded values do not always address embedded guarantees and options, such as embedded interest rate guarantees, rigorously.

75. IFRS 4 does not prohibit the disclosure of embedded value information, either in the notes to the financial statements or outside the financial statements.

What does IFRS 4 say about discretionary participation features?

76. Under some insurance contracts and some other financial instruments (issued mainly by entities that also issue insurance contracts), the amounts paid to policyholders are contractually linked to the performance of a pool of insurance contracts, a pool of assets or the results of a fund or entity, but the issuer has at least some discretion to vary the amounts that are linked in that way. These contracts are often known as with-profits contracts or participating contracts.

77. Phase I addresses very limited aspects of these features and the Board will address them in more depth in phase II. The main issue for phase II is whether the amounts that are ultimately likely to be paid to current or future policyholders should be classified as liabilities or as an unusual form of equity.

Does IFRS 4 address policyholder accounting?

78. IFRS 4 does not deal with accounting for insurance contracts by policyholders because the Board does not consider this a high priority. The Board expects to address polichholder accounting in phase II and discussed policyholder accounting briefly in February 2002 (see IASB *Update* February 2002).

Phase II

What approach is the Board considering for phase II?

79. The Board reached some tentative conclusions for phase II in January 2003, but phase II has been dormant since then. The Board expects to begin work again on phase II in the second half of 2004. The Board will regard the past work as a useful resource, but will not feel bound by it. The IASB web site www.iasb.org gives information about progress on phase II and other IASB projects.

Due Process

What process has the IASB followed for this project?

80. The IASB's predecessor organisation, the International Accounting Standards Committee (IASC), set up a Steering Committee in 1997 to carry out the initial work on this project. The Steering Committee published an Issues Paper in 1999. The first volume of the Issues Paper analysed the characteristics of different forms of insurance contract and considered the significant accounting issues. The second volume contained 82 illustrative

examples, summarised relevant national standards and requirements in 17 countries and summarised the main features of the principal contracts found in eight countries.

81. The Issues Paper attracted 138 responses. The Steering Committee held two meetings of three days each to discuss the comment letters and two further meetings, totalling seven days, to develop a *Draft Statement of Principles* (DSOP). The Steering Committee used the DSOP as an internal report to the newly constituted IASB. The role of the Steering Committee finished at that point.

82. The IASB began discussing the project in November 2001, using the DSOP as the initial basis for the discussions, and discussed the project at most meetings until February 2004, when it completed the deliberations that led to IFRS 4.

83. The Issues Paper indicated the former IASC Steering Committee's intention to publish the DSOP for formal comment. However, the Board decided not to invite formal comments at that stage on a document that the Board had not yet discussed, as it takes commentators a great deal of time and effort to develop a response to documents of this kind. Nevertheless, the Board took the unusual step of making the DSOP available on its Website and this helped to stimulate an active debate, within both the industry and the actuarial community.

84. The Board split this project into two phases in May 2002.

85. The Board published its proposals for phase I in July 2003 as ED 5 *Insurance Contracts*. The deadline for comments was 31 October 2003 and the Board received 135 responses. After reviewing the responses, the Board issued IFRS 4 in March 2004.

86. The Board consulted its Standards Advisory Council to seek feedback on this project at various times, principally in June 2002, November 2002 and November 2003.

87. The IASB established an Insurance Advisory Committee. The role of the Advisory Committee was to respond to requests from the IASB staff for advice. The Advisory Committee met in April 2002, September 2002 and September 2003 and the staff consulted it extensively by e-mail, though unavoidably at short notice given the tight timetable for phase I. Between October 2002 and April 2003, the staff sought advice on 17 papers. Members of the committee gave the staff valuable input, although inevitably different members had different views. In view of the quantity and quality of input available from the comment letters on ED 5, the staff consulted the Insurance Advisory Committee less extensively after the close of comments on ED 5.

88. Between October 2001 and June 2002, IASB staff and Board members conducted field visits to nineteen insurance companies from nine countries. The purpose of these visits was to assess the practical implications of implementing the model proposed in the DSOP. The staff and Board members gained a great deal of practical input during these visits.

89. The Board sees phase I as a stepping stone to phase II and is committed to completing phase II without delay once it has thoroughly investigated all relevant conceptual and practical questions and completed a full and extensive due process. As in all projects, the

Board will keep its tentative conclusions under review as the project proceeds and will not reach final decisions until its due process is complete.

Did the IASB make any changes to ED 5 when it finalised IFRS 4?

90. The following is a summary of the main changes from ED 5 to the IFRS. The Board:

(a) clarified aspects of the definition of an insurance contract.

(b) clarified the requirement to unbundle deposit components in some (limited) circumstances.

(c) deleted a proposal that the exemption from the hierarchy in IAS 8 should expire in 2007 (many described this proposal as a 'sunset clause').

(d) clarified the need to consider embedded options and guarantees in a liability adequacy test and clarified the level of aggregation for the liability adequacy test.

(e) replaced the impairment test for reinsurance assets. Instead of referring to IAS 36 (which contained no scope exclusion for reinsurance assets before the Board issued IFRS 4), the test refers to IAS 39.

(f) deleted the proposed ban on recognising a gain at inception of a reinsurance contract, and replaced this with a disclosure requirement.

(g) clarified the treatment of acquisition costs for contracts that involve the provision of investment management services.

(h) changed the prohibition on introducing asset-based discount rates into a rebuttable presumption.

(i) clarified aspects of the treatment of discretionary participation features and created an explicit new exemption from the requirement to separate, and measure at fair value, some options to surrender a contract with a discretionary participation feature.

(j) introduced an option for an insurer to change its accounting policies so that it remeasures designated insurance liabilities in each period for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require.

(k) amended IAS 40 to permit two separate elections for investment property when an entity selects the fair value model or the cost model. One election is for investment property backing contracts that pay a return linked directly to the fair value of, or returns from, that investment property. The other election is for all other investment property.

(l) clarified the applicability of shadow accounting.

(m) clarified that an embedded derivative is closely related to the host insurance contract if they are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

(n) clarified that the Implementation Guidance does not impose new disclosure requirements.

(o) deleted the proposed requirement to disclose the fair value of insurance contracts from 2006.

(p) provided an exemption from applying most disclosure requirements for insurance contracts to comparatives that relate to 2004.

(q) confirmed that unit-denominated payments can be measured at current unit values, for both insurance contracts and investment contracts, avoiding the apparent need to separate an 'embedded derivative'.