Basis for Conclusions on Exposure Draft

ED 5 INSURANCE CONTRACTS

Comments to be received by 31 October 2003

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 5 *Insurance Contracts* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **31 October 2003**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

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Basis for Conclusions on ED 5 Insurance Contracts

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

INTRODUCTION

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in ED 5 *Insurance Contracts*. Individual Board members gave greater weight to some factors than to others.

Background

BC2 There is a need for an International Financial Reporting Standard (IFRS) on insurance contracts because:

(a) there is currently no IFRS on insurance contracts, and insurance contracts are 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 are very diverse, and also often differ from practices in other sectors.

BC3 Few insurers report under IFRSs at present, although many more are expected to do so from 2005, particularly in the European Union. At present, many of the insurers that already report under IFRSs use US GAAP as a reference point in setting accounting policies for insurance contracts.

BC4 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. In December 1999, the Steering Committee published an *Issues Paper*, which attracted 138 comment letters. The Steering Committee reviewed the comment letters and concluded its work by developing a report to the IASB in the form of a *Draft Statement of Principles* (DSOP). The Board started discussing the DSOP in November 2001. The Board did not approve the DSOP or invite formal comments on it, but made it available to the public on the IASB's Website.

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BC5 Because it was not feasible to complete this project for implementation in 2005, the Board split the project into two phases so that insurers can implement some aspects in 2005. ED 5 contains the Board's proposals for phase I. The Board's objectives for phase I are:

(a) to make limited improvements to accounting practices for insurance contracts, without requiring major changes that may need to be reversed when the Board completes phase II.

(b) to require an insurer to disclose information about insurance contracts that gives users insights into the key risk drivers and sensitivities, without imposing costs that exceed the benefits and at a reasonable, but not excessive, level of aggregation.

Tentative conclusions for phase II

BC6 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. In January 2003, the Board reached the following tentative conclusions for phase II:

(a) The Board plans an asset-and-liability approach that would require an entity to identify and measure directly the contractual rights and obligations arising from insurance contracts, rather than create deferrals of inflows and outflows.

(b) Assets and liabilities arising from insurance contracts should be measured at their fair value, with the following two caveats:

(i) Recognising the lack of market transactions, an entity may use entity-specific assumptions and information when market-based information is not available without undue cost and effort.

(ii) In the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical contractual terms and remaining maturity from new policyholders. It follows that an insurer would not recognise a net gain at inception of an insurance contract, unless such market evidence is available.

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(c) As implied by the definition of fair value:

(i) an undiscounted measure is inconsistent with fair value.

(ii) expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).

(iii) the measurement of fair value should include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows.

(iv) fair value measurement of an insurance contract should reflect the credit characteristics of that contract, including the effect of policyholder protections and insurance provided by governmental bodies or other guarantors.

(d) The measurement of contractual rights and obligations associated with the closed book of insurance contracts should include future premiums specified in the contracts (and claims, benefits, expenses, and other additional cash flows resulting from those premiums) if, and only if:

(i) policyholders hold uncancellable continuation or renewal rights that significantly constrain the insurer's ability to reprice the contract to rates that would apply for new policyholders whose characteristics are similar to those of the existing policyholder; and

(ii) those rights will lapse if the policyholders stop paying premiums.

(e) Acquisition costs should be recognised as an expense when incurred.

(f) The Board will consider two more questions later in phase II:

(i) Should the measurement model unbundle the individual elements of an insurance contract and measure them individually?

(ii) How should an insurer measure its liability to holders of participating contracts?

BC7 Since January 2003, constraints on Board and staff resources have prevented the Board from continuing work to determine whether its tentative conclusions for phase II can be developed into a standard that is consistent with the IASB *Framework* and workable in practice. The

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Board intends to return to phase II of the project in the third quarter of 2003. At that time, it plans to focus on both conceptual and practical issues, as it would as part of its deliberations on any project. Only after completing those deliberations will the Board proceed with an Exposure Draft of a proposed IFRS. The Board's regular deliberations include a consideration of alternatives and whether those alternatives represent conceptually superior approaches to financial reporting issues.

BC8 The Board's tentative conclusions for phase II differ from the recommendations in the DSOP in two areas:

(a) the use of a fair value measurement objective rather than entity-specific value. However, that change is not as significant as it might seem because entity-specific value as described in the DSOP is almost indistinguishable from estimates of fair value determined using the measurement guidance that the Board has tentatively adopted in its project on business combinations. One difference is that fair value, unlike entity-specific value, reflects the credit characteristics of the contract, including the effect of policyholder protections and insurance.

(b) the criteria used to determine whether measurement should reflect future premiums and related cash flows (paragraph BC6(d)).

SCOPE

BC9 Some argue that the proposed IFRS should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They note that regulatory requirements, and some national accounting requirements, often cover all aspects of an insurer's business. However, for the following reasons, the draft IFRS deals with insurance contracts of all entities and does not address other aspects of accounting by insurers:

(a) It would be difficult, and perhaps impossible, to create a robust definition of an insurer that could be applied consistently from country to country. Among other things, an increasing number of entities have major activities in both insurance and other areas.

(b) It would be undesirable for an insurer to account for a transaction in one way and for a non-insurer to account in a different way for the same transaction.

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(c) The project should not reopen issues addressed by other IFRSs, unless specific features of insurance contracts justify a different treatment. Paragraphs BC109-BC114 discuss the treatment of assets backing insurance contracts.

Definition of insurance contract

BC10 The definition of an insurance contract determines which contracts fall within the scope of the draft IFRS and which contracts will come under other IFRSs. Some propose that phase I should use existing national definitions of insurance contracts, on the following grounds:

(a) Before the Board gives guidance, in phase II, on applying IAS 39 *Financial Instruments: Recognition and Measurement* to difficult areas such as discretionary participation features and cancellation and renewal rights, it would be premature to require insurers to apply IAS 39 to contracts that contain these features and rights.

(b) If a definition is adopted for phase I, it may need to be amended again for phase II. This could compel insurers to make extensive changes twice in a short time.

BC11 However, in the Board's view, it is unsatisfactory to base the definition used for accounting purposes on local definitions that 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.

BC12 Some express concerns that the adoption of a particular definition by the IASB could lead ultimately to inappropriate changes in definitions used for other purposes, such as insurance law, insurance supervision or tax. The Board emphasises that any definition used in IFRSs is solely for accounting purposes and is not intended to change or pre-empt definitions used for other purposes.

BC13 Various IFRSs use definitions or descriptions of insurance contracts to exclude insurance contracts from their scope. The scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 38 *Intangible Assets* excludes provisions, contingent liabilities, contingent assets and intangible assets that arise in insurance enterprises from contracts with policyholders. IASC used this wording when its insurance project had just started, to avoid prejudging whether the project would address insurance contracts or a broader class of contracts. Similarly, the scope of IAS 18 *Revenue* excludes revenue arising from insurance contracts of insurance enterprises.

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BC14 The following definition of insurance contracts is used to exclude insurance contracts from the scope of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39.

'An insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption.'

BC15 This definition is supplemented by a statement that IAS 32 and IAS 39 do, nevertheless, apply when a financial instrument 'takes the form of an insurance contract but principally involves the transfer of financial risks (see paragraph 43 [of IAS 32]), for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other enterprises.'

BC16 For the following reasons, the Board decided not to keep the existing definition in IAS 32 and IAS 39:

(a) The definition gives a list of examples, but does not define the characteristics of the risks that it is intended to cover.

(b) A clearer definition will reduce the uncertainty about the meaning of the phrase 'principally involves the transfer of financial risks'. This will help insurers planning to adopt IFRSs for the first-time ('first-time adopters') in 2005 and minimise the likelihood of further changes in classification for phase II. Furthermore, the existing test could lead to many contracts being classified as financial instruments even though they transfer significant insurance risk.

BC17 In developing a new definition, the Board also considered US GAAP. The main FASB statements for insurers deal with accounting by insurance entities and do not define insurance contracts explicitly. However, paragraph 1 of SFAS 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* states: 'Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered.'

BC18 Paragraph 6 of SFAS 113 applies to any transaction, regardless of its form, that indemnifies an insurer against loss or liability relating to insurance risk. The glossary appended to SFAS 113 defines insurance risk as: 'The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and

claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.'

BC19 Having reviewed these definitions from US GAAP, the Board developed a new definition of insurance contract for the draft IFRS and expects to use the same definition for phase II. The following aspects of the definition are discussed below:

(a) insurance risk (paragraphs BC20 and BC21);

(b) insurable interest (paragraphs BC22 and BC23);

(c) quantity of insurance risk (paragraphs BC24-BC29);

(d) unbundling (paragraphs BC30-BC37); and

(e) weather derivatives (paragraphs BC38 and BC39).

Insurance risk

BC20 The proposed definition of insurance contracts focuses on the feature that causes accounting problems unique to insurance contracts, namely insurance risk. The definition of insurance risk excludes financial risk, defined using a list of risks that also appears in IAS 39's definition of a derivative.

BC21 Some contracts have the legal form of insurance contracts but do not transfer significant insurance risk to the issuer. Some argue that all such contracts should be treated as insurance contracts, because they are traditionally described as insurance contracts and are generally subject to regulation by insurance supervisors. However, as explained in the *Framework*, financial statements should reflect economic substance and not merely legal form. Furthermore, accounting arbitrage could occur if the addition of a trivial (insignificant) amount of insurance risk made a significant difference to the accounting. Therefore, the Board decided that contracts described in the previous paragraph should not be treated as insurance contracts for accounting purposes.

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Insurable interest

BC22 In some countries, the legal definition of insurance requires that the policyholder (or the beneficiary under the contract) should have an insurable interest in the insured event. For the following reasons, the definition proposed in 1999 by the former IASC Steering Committee in the Issues Paper did not refer to insurable interest:

(a) Insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities.

(b) Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest.

BC23 Because the definition proposed in the Issues Paper did not include a notion of insurable interest, it would have encompassed gambling. Several commentators on the Issues Paper stressed the important social, moral, legal and regulatory differences between insurance and gambling. They noted that policyholders buy insurance to reduce risk, whereas gamblers take on risk. In the light of these suggestions, the definition of an insurance contract in the draft IFRS incorporates the notion of insurable interest, by referring to an uncertain event that adversely affects the policyholder (or other specified beneficiary). This reference to an adverse effect is open to the objections set out in the previous paragraph. However, without this reference, the definition of an insurance contract might capture any prepaid contract to provide services whose cost is uncertain. This would be beyond the reasonable scope of this project and would extend the meaning of the term 'insurance contract' too far beyond its traditional meaning.

Quantity of insurance risk

BC24 Paragraphs B21-B24 of Appendix B of the draft IFRS discuss how much insurance risk must be present before a contract qualifies as an insurance contract. In developing this material, the Board noted the conditions in US GAAP for a contract to be treated as an insurance contract.

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SFAS 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* requires two conditions for a contract to be eligible for reinsurance accounting, rather than deposit accounting:

(a) the contract transfers significant insurance risk from the cedant to the reinsurer (which does not occur if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote); and

(b) either:

(i) there is a reasonable possibility that the reinsurer will suffer a significant loss (based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes); or

(ii) the reinsurer has assumed substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (and the cedant has retained only insignificant insurance risk on the reinsured portions).

BC25 Under paragraph 8 of SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, an annuity contract is considered an insurance contract unless (a) the probability that life-contingent payments will be made is remote* or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.

BC26 The Board understands that some practitioners use the following guideline in applying US GAAP: a reasonable possibility of a significant loss is a 10 per cent probability of a 10 per cent loss. In this light, the Board considered whether it should define the amount of insurance risk in quantitative terms in relation to, for example:

(a) the probability that payments under the contract will exceed the expected (ie probability-weighted average) level of payments; or

(b) a measure of the range of outcomes, such as the range between the highest and lowest level of payments or the standard deviation of payments.

* Paragraph 8 of SFAS 97 notes that the term remote is defined in paragraph 3 of FASB Statement No. 5 *Accounting for Contingencies* as 'the chance of the future event or events occurring is slight.'

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BC27 The Board concluded that quantitative guidance creates an arbitrary dividing line that results in different accounting treatments for similar transactions that fall marginally on different sides of the line. It also creates opportunities for accounting arbitrage by encouraging transactions that fall marginally on one side or the other of the line. For these reasons, the draft IFRS does not propose quantitative guidance.

BC28 The Board also considered whether it should define the significance of insurance risk by referring to materiality, which the *Framework* describes as follows. 'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.' However, a single contract, or even a single book of similar contracts, could rarely generate a loss that is material in relation to the financial statements as a whole. Therefore, the draft IFRS defines the significance of insurance risk in relation to the individual contract (paragraph B22). The Board had two reasons for this proposal:

(a) Although insurers manage contracts on a portfolio basis, and often measure them on that basis, the contractual rights and obligations arise at the level of the individual contract.

(b) An assessment contract by contract is likely to increase the proportion of contracts that qualify as insurance contracts. If a large book of contracts consists mainly of insurance contracts, the Board does not intend insurers to examine each contract within that book to identify a few non-derivative contracts that do not transfer significant insurance risk. The Board's intention is to make it easier, not harder, for a contract to meet the definition.

BC29 The Board also rejected the notion of defining the significance of insurance risk by expressing the expected (ie probability-weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes. Instead, the guidance in Appendix B of the draft IFRS focuses on whether adverse outcomes would cause significant incremental losses, judged contract by contract.

Unbundling

BC30 The main function of the definition of an insurance contact is to distinguish insurance contracts subject to the draft IFRS from investments and deposits, which are subject to IAS 39. However, many insurance contracts contain a significant deposit component, ie a component that will be repaid together with an actual or imputed investment return. Indeed, virtually all insurance contracts have an implicit or explicit deposit

component, because the policyholder is generally required to pay premiums before the period of risk; therefore, the time value of money is likely to be one factor that insurers consider in pricing contracts.

BC31 To reduce the need for guidance on the definition of an insurance contract, some argue that an insurer should 'unbundle' the deposit component from the insurance component. This would have the following consequences:

(a) The insurance component would be measured as an insurance contract.

(b) The deposit component would be measured under IAS 39 at either amortised cost or fair value. This may not be consistent with the basis used for insurance contracts in phase I.

(c) Premium receipts for the deposit component would be recognised not as revenue, but rather as movements in the deposit liability. Premium receipts for the insurance element would typically be treated as revenue.

(d) Transaction costs incurred at inception would be allocated between the two components if the treatment of such costs for insurance contracts differs from their treatment under IAS 39.

BC32 Supporters of unbundling deposit components argue that:

(a) an entity should account in the same way for the deposit component of an insurance contract as for an otherwise identical financial instrument that does not transfer significant insurance risk.

(b) the tendency in some countries for banks to own insurers (and vice versa) and the similarity of products offered by the insurance and fund management sectors suggest that insurers, banks and fund managers should account for the deposit component in a similar manner.

(c) many groups sell products ranging from pure investments to pure insurance, with all variations in between. Unbundling would avoid sharp discontinuities in the accounting between a product that contains just enough insurance risk to be an insurance contract, and another product that falls marginally on the other side of the line.

(d) financial statements should make a clear distinction between premium revenue derived from products that transfer significant insurance risk and premium receipts that are, in substance, investment or deposit receipts.

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BC33 The Issues Paper published in 1999 proposed that the deposit component should be unbundled if it is either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. However, commentators on the Issues Paper generally opposed unbundling, giving the following reasons:

(a) The components are closely interrelated and the value of the bundled product is not necessarily equal to the sum of the individual values of the components.

(b) Unbundling would require significant and costly systems changes.

(c) Contracts of this kind are a single product, regulated as insurance business by insurance supervisors and should be treated in a similar way for accounting purposes.

(d) Some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they consider information about gross premium inflows to be important. A consistent use of a single measurement base would be more useful as an aid to economic decisions than a mixture of one measurement basis for the deposit component with another measurement basis for the insurance component.

BC34 In the light of these arguments, the DSOP proposed that an insurer or policyholder should not unbundle these components. However, that was against the background of an assumption that the treatments of the two components would be reasonably similar. This may not be the case in phase I, because phase I would permit a wide range of accounting treatments. Nevertheless, the Board does not wish to require costly changes in phase I that might be reversed in phase II. Therefore, the draft IFRS proposes unbundling only when it is easiest to perform and the effect is likely to be greatest (paragraphs 7 and 8 of the draft IFRS and IG Example 3 following paragraphs IG5 and IG6 of the draft Implementation Guidance).

BC35 The Board acknowledges that there is no clear conceptual line between the cases when unbundling is required and the cases when unbundling is not required. At one extreme, the Board regards unbundling as appropriate for large customised contracts, such as some financial reinsurance contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations. These contracts may be viewed as being made up of two separate and unconnected contracts that are stapled together. In the Board's view, it would not be representationally faithful to report their deposit components on a basis that differs materially from the way they

would be treated in the absence of the (unrelated) insurance contract. This is especially important because some of these contracts may be deliberately structured in a particular way to achieve a specific accounting result. Furthermore, practical problems cited by respondents to the Issues Paper are much less significant for these contracts.

BC36 At the other extreme, unbundling the surrender values in a large portfolio of traditional life insurance contracts would require significant systems changes, which would be beyond the intended scope of phase I; furthermore, the failure to unbundle these contracts would affect the measurement of these liabilities, but not lead to their complete omission from the insurer's balance sheet. In addition, a desire to achieve a particular accounting result is much less likely to influence the precise structure of these transactions.

BC37 The option for the policyholder to surrender a traditional life insurance contract at an amount that differs significantly from its carrying amount is an embedded derivative and IAS 39 would require the insurer to separate it and measure it at fair value. That treatment would have the same disadvantages, described in the previous paragraph, as unbundling the surrender value. Therefore, paragraph 6 of the draft IFRS would exempt an insurer from applying this requirement to some surrender options embedded in insurance contracts. However, the Board saw no conceptual or practical reason to create such an exemption for surrender options in non-insurance financial instruments issued by insurers or by others.

Weather derivatives

BC38 The scope of IAS 39 excludes contracts that require a payment based on climatic, geological, or other physical variables (if based on climatic variables, sometimes described as weather derivatives). It is convenient to divide these contracts into two categories:

(a) contracts that require a payment only if a particular level of the underlying climatic, geological, or other physical variables adversely affects the contract holder. These are insurance contracts as defined in the draft IFRS.

(b) contracts that require a payment based on a specified level of the underlying variable regardless of whether there is an adverse effect on the contract holder. These are derivatives and would, without the existing scope exclusion, be subject to IAS 39.

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BC39 The existing scope exclusion was created mainly because the holder might use such a derivative in a way that resembles the use of an insurance contract. However, the definition of an insurance contract proposed in the draft IFRS provides a principled basis for deciding which of these contracts are treated as insurance contracts and which are treated as derivatives. Therefore, the Board proposes to remove the scope exclusion from IAS 39 (see paragraph C3 of Appendix C of the draft IFRS). Such contracts would be subject to the IFRS on insurance contracts if payment is contingent on an uncertain future event that adversely affects the contract holder, and subject to IAS 39 in all other cases.

Scope exclusions

BC40 The scope of the draft IFRS excludes various items that may meet the definition of insurance contracts, but are, or will be, covered by existing or proposed future IFRSs (paragraph 4). The following paragraphs discuss:

(a) financial guarantees and insurance against credit risk (paragraphs BC41-BC46);

(b) product warranties (paragraphs BC47-BC50); and

(c) accounting by policyholders (paragraph BC51).

Financial guarantees and insurance against credit risk

BC41 Some contracts require a third party to make payments to a creditor if a specified debtor fails to make payment when due. These contracts meet the proposed definition of an insurance contract. Some of these contracts have the legal form of an insurance contract and others have the legal form of a financial guarantee or letter of credit. In the Board's view, although this difference in legal form may be associated in some cases with differences in substance, the same accounting requirements should, in principle, apply to all contracts with similar substance.

BC42 The following contracts are currently within the scope of IAS 39 and the Board concluded that they should remain so:

(a) a financial guarantee given or retained by a transferor when it derecognises financial assets or financial liabilities.

(b) a financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset

when due (see IAS 39 *Implementation Guidance* IGC 1-2, IGC 1-5-a and IGC 1-5-b). This contract does not meet the definition of an insurance contract.

(c) a financial guarantee contract that provides for payments to be made in response to changes in a specified interest rate, security price, commodity price, credit rating or credit index, foreign exchange rate, index of prices or rates, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. This contract is a derivative that does not meet the definition of an insurance contract.

BC43 Other financial guarantees are subject to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In June 2002, an Exposure Draft of improvements to IAS 39 proposed that IAS 39 should deal with all financial guarantees at initial recognition, but that the subsequent measurement of some financial guarantees should remain subject to IAS 37.

BC44 Some take the view that IAS 39 should cover all contracts that provide cover against credit risk, on the following grounds:

(a) Although credit insurers manage credit risk by pooling individual risk within a portfolio, banks also do this in managing the credit risk in a portfolio of financial guarantees. Although banks may rely more on collateral, this is no reason to require a different accounting treatment.

(b) Banks manage credit risk embedded in their financial assets, and there is no reason to require them to apply a different standard to credit risk embedded in financial guarantees.

(c) Credit risk is commonly traded in capital markets, even if the specific forms of credit risk embedded in some forms of credit insurance are not traded.

(d) As noted above, some financial guarantees are already within the scope of IAS 39, and the Board proposes that they should remain within its scope. To ensure consistent reporting, IAS 39 should cover all contracts that provide protection against similar exposures.

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BC45 Some argue that insurance against credit risk is different from a financial guarantee and should fall within the scope of the IFRS on Insurance Contracts, on the following grounds:

(a) Insurance against credit risk is often arranged by the seller of goods and protects the seller against default by the buyer. The fact that default is generally outside the control of the seller, and so is fortuitous, allows the use of stochastic methods to estimate future cash flows arising from the contract, because they are random and not subject to moral hazard. By contrast, some financial guarantees, such as some letters of credit, are arranged at the request of the party whose obligation is being guaranteed. Default on such guarantees is partly under the control of that party.

(b) Insurance against credit risk is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities.

(c) A credit insurer may refuse to pay a claim if the policyholder did not give full disclosure and may delay payment while a claim is investigated, whereas a guarantor is often required to pay on first notice of a default.

(d) A credit insurer faces risks similar to those arising in some other insurance contracts. For example, a contract may require payments (either to the debtor or to the creditor) if a debtor's income is reduced by specified adverse events such as unemployment or illness, regardless of whether the debtor continues to pay off the loan when due. The issuer of this contract may face risks similar to those faced by a guarantor of the loan.

(e) Including these contracts within the scope of IAS 39 would compel credit insurers to change their accounting immediately, unlike issuers of other types of insurance contract. Furthermore, some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the Board will not resolve until phase II.

BC46 After reviewing these arguments, the Board reached the following conclusions:

(a) Contracts that are within the scope of IAS 39 should remain so. In particular, any financial guarantee, regardless of its legal form (eg financial guarantee, letter of credit or insurance contract), that results from the transfer of financial or non-financial assets or

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liabilities, should be within the scope of IAS 39. In finalising the improvements to IAS 39, the Board will review the subsequent measurement of those financial guarantees.

(b) All other contracts that, as a precondition for payment, require the holder to be exposed to, and have incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due, meet the definition of an insurance contract. They should be treated in the same way as other insurance contracts. All contracts without that precondition should be within the scope of IAS 39.

(c) The issuer of any financial guarantee, whatever its legal form, should recognise a liability at the inception of the guarantee. IAS 39 achieves this for contracts within its scope. For those contracts that are within the scope of the draft IFRS, the loss recognition test would apply (paragraphs 11-13 of the draft IFRS).

Product warranties

BC47 A product warranty clearly meets the proposed definition of an insurance contract if an entity issues it on behalf of another party (such as a retailer or manufacturer). The scope of the draft IFRS includes such warranties.

BC48 A product warranty issued directly by a retailer or manufacturer also meets the proposed definition of an insurance contract. Although some might think of this as 'self insurance', the risk retained arises from existing contractual obligations towards the customer. Some may reason that the definition of insurance contracts should exclude such direct warranties because they do not involve a transfer of risk from buyer to seller, but rather a crystallisation of an existing responsibility. However, in the Board's view, excluding these warranties from the definition of insurance contracts would complicate the definition for only marginal benefit.

BC49 Although such direct warranties create economic exposures similar to warranties issued on behalf of the retailer or manufacturer by another party (the insurer), the scope of the draft IFRS excludes them because they are closely related to the underlying sale of goods and because IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* addresses product warranties (except in the financial statements of 'insurance enterprises' if the warranties are considered to be 'contracts with policyholders'). IAS 18 *Revenue* covers the revenue received for such warranties (unless the warranties are 'insurance contracts of insurance enterprises').

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BC50 In a separate project on revenue recognition, the Board is exploring an asset and liability approach to revenue recognition. If this approach is implemented, the accounting model for these direct product warranties may become more similar to the accounting model that the Board has tentatively decided to adopt for insurance contracts in phase II.

Accounting by policyholders

BC51 The draft IFRS does not address accounting and disclosure by policyholders for direct insurance contracts because the Board does not regard this as a high priority. The Board intends to address accounting by policyholders in phase II (see *Update* February 2002 for the Board's discussion of accounting by policyholders). IFRSs address some aspects of accounting by policyholders for insurance contracts. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* addresses accounting for reimbursements from insurers for expenditure required to settle a provision. SIC-14 *Property, Plant and Equipment - Compensation for the Impairment or Loss of Items* addresses some aspects of reimbursement by insurers for impairment or loss of items of property, plant and equipment.

TEMPORARY CONTINUATION OF SOME EXISTING ACCOUNTING POLICIES

BC52 Paragraphs 5 and 6 of the May 2002 Exposure Draft of improvements to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria that an entity should use in developing an accounting policy for an item if no IFRS applies specifically to that item. If an insurer adopts IFRSs in 2005 before phase II of this project is in place, it would need to assess whether its accounting policies for insurance contracts comply with these requirements.

BC53 In the absence of additional guidance in phase I, there might be some uncertainty about what is acceptable. Establishing what is acceptable may involve costs and some insurers might make major changes in 2005 followed by further significant changes when phase II is in place. To avoid unnecessary disruption in phase I that would not ease the transition to phase II, the Board proposes to limit the need for insurers to change their existing accounting policies for insurance contracts. Specifically, the

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proposals in paragraph 9 of the draft IFRS would exempt an insurer temporarily from applying the criteria in paragraphs 5 and 6 of IAS 8 to its existing accounting policies for:

(a) insurance contracts (including reinsurance contracts) that it issues; and

(b) reinsurance contracts that it holds.

BC54 Some suggest that the Board should specifically require an insurer to follow its national accounting requirements (national GAAP) in accounting for insurance contracts during phase I, to prevent selection of accounting policies that do not form a comprehensive basis of accounting to achieve a predetermined result ('cherry-picking'). However, this would require a definition of national GAAP, which may pose problems. Further definitional problems would arise if an insurer currently applies, for example, US GAAP instead of its own national GAAP. Moreover, it is unusual and, arguably, beyond the Board's mandate to impose requirements set by another body.

BC55 In addition, an insurer might wish to improve its accounting policies to reflect other accounting developments with no counterpart in national GAAP. For example, an insurer adopting IFRSs for the first time might wish to amend its accounting policies for insurance contracts for greater consistency with accounting policies that it uses for contracts subject to IAS 39.

BC56 Therefore, the Board decided that an insurer should continue to follow those accounting policies that it was using when the insurer first applies the phase I requirements, with some exceptions noted below. An insurer could also improve those accounting policies if specified criteria are met (see paragraphs 14-17 of the draft IFRS).

BC57 The criteria in paragraphs 5 and 6 of [draft] IAS 8 include relevance and reliability. The Board acknowledges that granting an exemption from those criteria, even temporarily, is a highly unusual step. The Board contemplates that step only as part of an orderly and relatively fast transition to phase II. In addition, because the proposed exemption is so exceptional, the Board decided to specify a limited life for the exemption. Therefore, the Board proposes that the exemption should apply only for accounting periods beginning before 1 January 2007.

BC58 Furthermore, the Board decided to maintain some requirements that follow from the criteria in [draft] IAS 8. The Board acknowledges that it is difficult to make piecemeal changes to recognition and measurement practices in phase I because many aspects of accounting for insurance contracts are interrelated with aspects that will not be completed until

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phase II. However, abandoning these particular requirements would detract from the relevance and reliability of an insurer's financial statements to an unacceptable degree. The following points are discussed below:

(a) catastrophe and equalisation provisions (paragraphs BC59-BC63);

(b) loss recognition (paragraphs BC64-BC67);

(c) derecognition (paragraph BC68); and

(d) offsetting (paragraph BC69).

Catastrophe and equalisation provisions

BC59 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. In some jurisdictions, insurers are permitted or required to recognise 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. Some countries also permit or require equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims for some types of insurance contract (eg hail, credit, guarantee and fidelity insurance) using a formula based on experience over a number of years.

BC60 Those who favour recognising catastrophe or equalisation provisions as liabilities base their view on one or more of the following arguments:

(a) Such provisions represent a deferral of unearned premiums that are designed to provide for events that are not expected, on average, to occur in any single contract period but are expected to occur over an entire cycle of several contract periods. Although contracts cover only one period in form, in substance contracts are commonly renewed, leading to pooling of risks over time rather than within a single period. Indeed, in some jurisdictions, regulations make it difficult for an insurer to stop offering insurance against some forms of risk, such as hurricanes.

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(b) In some jurisdictions, an insurer is required to segregate part of the premium (the catastrophe premium). The catastrophe premium is not available for distribution to shareholders (except on liquidation) and, if the insurer transfers the contract to another insurer, it must also transfer the catastrophe premium.

(c) In years when no catastrophe occurs (or when claims are abnormally low), such provisions portray an insurer's long-term profitability faithfully because they match the insurer's costs and revenue over the long term. Also, they show a pattern of profit similar to one obtained through reinsurance, but with less cost and administrative burden.

(d) Such provisions enhance solvency protection by restricting the amounts distributed to shareholders and by restricting a weak company's ability to expand or enter new markets.

(e) Such provisions encourage insurers to accept risks that they might otherwise decline. Some countries reinforce this encouragement with tax deductions.

BC61 For the following reasons, the proposals in the draft IFRS would prohibit the recognition of catastrophe and equalisation provisions relating to future claims under future contracts:

(a) 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. As the *Framework* states, the matching concept does not allow the recognition of items in the balance sheet that do not meet the definition of assets or liabilities. Recognising deferred credits as if they were liabilities would diminish the relevance and reliability of an insurer's financial statements.

(b) Even if the insurance law requires an insurer to segregate catastrophe premiums so that they are not available for distribution to shareholders in any circumstances, earnings on those segregated premiums will ultimately be available to shareholders. Therefore, those segregated amounts are appropriately classified as equity, not as a liability.

(c) Recognising such provisions obscures users' ability to examine the impact of past catastrophes and does not contribute to their analysis of an insurer's exposure to future catastrophes. Given adequate disclosure, knowledgeable users understand that some

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types of insurance expose an insurer to infrequent but severe losses. Moreover, the analogy with reinsurance contracts is irrelevant, because reinsurance changes the insurer's risk profile.

(d) The objective of general purpose financial statements is not to enhance solvency but to provide information that is useful to a wide range of users for economic decisions. Moreover, the recognition of provisions does not, by itself, enhance solvency. However, even if the objective of financial statements were to enhance solvency and such provisions were an appropriate means of enhancing solvency, the insurer would need to recognise the entire provision immediately, rather than accumulating it over time. Furthermore, if catastrophes (or unusual experience) in one period are independent of those in other periods, the insurer should not reduce the liability when a catastrophe (or unusually bad experience) occurs. Also, if diversification over time were a valid basis for accounting, above-average losses in early years should be recognised as assets, yet proponents of catastrophe and equalisation provisions do not advocate this.

(e) Recognising catastrophe or equalisation provisions is not the only way to limit distributions to shareholders. Other techniques, such as solvency margin requirements and risk-based capital requirements, could play an important role. Another possibility is for an insurer to segregate a portion of its equity for retention to meet possible losses in future years.

(f) The objective of general purpose financial statements is not to encourage or discourage particular transactions or activities, but to report neutral information about transactions and activities. Therefore, accounting requirements should not try to encourage insurers to accept or decline particular types of risks.

(g) If an insurer expects to continue writing catastrophe cover, presumably it believes that the future business will be profitable. It would not be representationally faithful to recognise a liability for future contracts that are expected to be profitable.

(h) There is no objective way to measure catastrophe and equalisation provisions, unless an arbitrary formula is used.

BC62 Some suggest that it is not appropriate to eliminate catastrophe and equalisation provisions in phase I as a piecemeal amendment to existing approaches. However, in the Board's view, these provisions can be deleted without undermining other components of existing approaches. There is no credible basis for arguing that catastrophe or equalisation

'provisions' are recognisable liabilities under IFRSs and there is no realistic prospect that the Board will permit them in phase II. Indeed, as noted above, paragraphs 5 and 6 of [draft] IAS 8 require an entity to consider various criteria in developing an accounting policy for an item if no IFRS applies specifically to that item. In the Board's view, that requirement (and its existing equivalent in paragraph 22 of IAS 1) is already clearly sufficient to prohibit the recognition of such items as a liability. Accordingly, the draft IFRS confirms this prohibition (see paragraph 10(a) of the draft IFRS).

BC63 Although the proposals in the draft IFRS would prohibit the recognition as a liability of catastrophe and equalisation provisions, they would not prohibit the segregation of a component of equity. Changes in a component of equity are not recognised in profit or loss.

Loss recognition

BC64 Many existing accounting models have loss recognition tests to ensure that insurance liabilities are not understated, and that related amounts recognised as assets, such as deferred acquisition costs, are not overstated. The precise form of the loss recognition test depends on the underlying measurement approach. However, there is no guarantee that these tests exist everywhere and the credibility of IFRSs could suffer if an insurer claims to comply with IFRSs but fails to recognise material and reasonably foreseeable losses. To avoid this, the draft IFRS proposes a loss recognition test (see paragraphs 11-13). The Board's intention is not to introduce piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses remain unrecognised during phase I.

BC65 To use a basis that already exists in IFRSs and minimise the need for exceptions to existing principles, the Board decided to draw on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to create the mechanism. The loss recognition test would also apply to deferred acquisition costs and to intangible assets representing the contractual rights acquired in a business combination or portfolio transfer. As a result, the Board proposes to exclude deferred acquisition costs and those intangible assets from the scope of IAS 36 (see paragraph C10 of Appendix C of the draft IFRS).

BC66 The Board considered whether it should retain the impairment model in IAS 36 *Impairment of Assets* for deferred acquisition costs, and perhaps also the related insurance liabilities. However, the IAS 36 model cannot be applied to deferred acquisition costs alone, without also considering the cash flows relating to the reported liability. Indeed, some insurers

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capitalise acquisition costs implicitly through deductions in the measurement of the liability. Moreover, it would be confusing and difficult to apply this model to liabilities without some re-engineering. In the Board's view, it is simpler to use a model that is designed for liabilities, namely the IAS 37 model. In practice, a re-engineered IAS 36 model and IAS 37 might not lead to very different results.

BC67 It is beyond the scope of phase I to create a detailed accounting regime for insurance contracts. Therefore, the draft IFRS does not specify whether:

(a) additional losses recognised because of the loss recognition test would be recognised by reducing the carrying amount of deferred acquisition costs or increasing the carrying amount of the related insurance liabilities.

(b) the loss recognition test would be carried out for a book of insurance contracts or contract by contract. Material impairment losses are likely to arise either from an individual contract that generates losses that are individually material (in which case separate measurement would be necessary) or from a book of contracts that share a common exposure and could, in practice, be measured together.

Derecognition

BC68 The Board has identified no reasons why derecognition requirements for insurance liabilities and insurance assets should differ from those for financial liabilities and financial assets. Therefore, the draft IFRS proposes the same derecognition requirements for insurance liabilities as for financial liabilities (see paragraph 10(c)). However, because derecognition of financial assets is a controversial topic and not yet resolved, the draft IFRS does not address derecognition of insurance assets.

Offsetting

BC69 A cedant (the insurer that is the policyholder under a reinsurance contract) does not normally have a right to offset amounts due from a reinsurer against amounts due to the underlying policyholder. Normal offsetting criteria prohibit offsetting when no such right exists. When these criteria are not met, a gross presentation gives a clearer picture of the cedant's rights and obligations, and related income and expense (see paragraph 10(d) of the draft IFRS).

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Other existing practices

BC70 The draft IFRS does not address:

(a) acquisition costs (paragraphs BC71 and BC72);

(b) salvage and subrogation (paragraphs BC73 and BC74); and

(c) policy loans (paragraph BC75).

Deferred acquisition costs

BC71 Acquisition costs are the costs that an insurer incurs to sell, underwrite and initiate a new insurance contract. The proposals in the draft IFRS would neither prohibit nor require the deferral of acquisition costs, nor would they prescribe what acquisition costs are deferrable, the period and method of their amortisation or whether an insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. The treatment of deferred acquisition costs is an integral part of existing models and cannot be amended easily without a more fundamental review of those models in phase II.

BC72 The treatment of acquisition costs for insurance contracts in phase I may differ from the treatment of transaction costs incurred for investment contracts.* IAS 39 requires (specified) transaction costs to be presented as an adjustment to the initial proceeds received and the Board did not wish to create exceptions to the definition of the transaction costs to which this treatment applies. Those costs may be defined more broadly or more narrowly than the acquisition costs that an insurer is required or permitted to defer under its existing accounting policies.

Salvage and subrogation

BC73 Some insurance contracts permit the insurer to sell (usually damaged) property acquired in settling the claim (salvage). The insurer may also have the right to pursue third parties for payment of some or all costs (subrogation). The Board will consider salvage and subrogation in phase II.

* 'Investment contract' is an informal term referring to contracts issued by insurers that do not expose the insurer to significant insurance risk and are, therefore, within the scope of IAS 39.

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BC74 In the following two related areas, the proposals in the draft IFRS would not amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*:

(a) Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the IFRS dealing with the assets concerned (paragraphs 51 and 52 of IAS 37).

(b) Paragraphs 53-56 of IAS 37 address reimbursements for some or all of the expenditure required to settle a provision. The Board is currently working on a project to amend various aspects of IAS 37.

Policy loans

BC75 Some insurance contracts permit the policyholder to obtain a loan from the insurer. The DSOP proposed that an insurer should treat these loans as a prepayment of the insurance liability, rather than as the creation of a separate financial asset. Because the Board does not regard this issue as a priority, phase I does not address it.

CHANGES IN ACCOUNTING POLICIES

BC76 Paragraph 9 of [draft] IAS 8 prohibits a change in accounting policies that is not required by an IFRS, unless the change will result in a more relevant and reliable presentation. Although the Board wishes to avoid imposing unnecessary changes in phase I, there is no need to exempt insurers from the requirement to justify changes in accounting policies. Therefore, paragraph 14 of the draft IFRS would permit an insurer to change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant and reliable, judged by the criteria in [draft] IAS 8. As the Board's conclusions for phase II develop (see paragraphs BC6-BC8), they will give insurers further context for judgments about whether a change in accounting policies will make their financial statements more relevant and reliable.

BC77 Paragraph 16 of the draft IFRS would specifically prohibit the adoption of the following practices that would diminish the relevance and reliability of an insurer's financial statements, although it would permit an insurer to continue using them if it already does so:

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(a) measuring insurance liabilities on an undiscounted basis (paragraph BC78).

(b) measuring insurance liabilities with excessive prudence (paragraph BC79).

(c) reflecting future investment margins in the measurement of insurance liabilities (paragraphs BC80-BC84).

(d) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraphs BC85 and BC86).

(e) using non-uniform accounting policies for the insurance liabilities (and related deferred acquisition costs, if any) of subsidiaries (paragraphs BC87 and BC88).

Discounting

BC78 In current practice, most general insurance claims liabilities are not discounted. In the Board's view, discounting of insurance liabilities results in financial statements that are more relevant and reliable. However, because the Board will not address discount rates and the basis for risk adjustments until phase II, the Board concluded that it could not require discounting in phase I. Nevertheless, the proposals in the draft IFRS would not permit an insurer to change from an accounting policy that involves discounting to one that does not involve discounting (paragraph 16(a)).

Excessive prudence

BC79 Insurers sometimes measure insurance liabilities on what is intended to be a highly prudent basis that lacks the neutrality required by the *Framework*. However, phase I does not define excessive prudence and cannot, therefore, eliminate it. Consequently, the proposals in the draft IFRS would permit an insurer to continue using measurements of insurance liabilities that lack neutrality because of excessive prudence. Nevertheless, they would not permit an insurer to adopt a new accounting policy that creates or increases excessive prudence (see paragraph 16(b) of the draft IFRS). The loss recognition test proposed by paragraphs 11-13 addresses the converse problem of understated insurance liabilities.

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Future investment margins

BC80 The Board has tentatively concluded for phase II that the cash flows from an asset should not influence the measurement of a liability (except to the extent that the cash flows from the asset affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability). Many existing measurement practices for insurance liabilities do not comply with this principle because they use a discount rate based on the estimated return from the assets that are deemed to back the insurance liabilities. The proposals in the draft IFRS would not eliminate this practice, because the Board concluded that this would not be feasible until phase II gives guidance on discount rates and the basis for risk adjustments.

Future investment margins and embedded value

BC81 In addition to considering asset-based discount rates in general, the Board also considered a specific measurement technique that, at least in current practice, typically reflects future investment margins, namely embedded value. Life insurers in an increasing number of countries disclose embedded value information. Most disclose this information outside the financial statements or as supplementary information, but a few use it as a measurement in their (consolidated) balance sheets.

BC82 Embedded value approaches are largely unregulated at present and there is diversity in their application. In addition, the Board's tentative conclusions for phase II would not permit measurements that include future investment margins. Therefore, some suggest that phase I should prohibit embedded value measurements in the balance sheet.

BC83 However, for the following reasons, the proposals in the draft IFRS would not preclude an insurer from continuing to use embedded value in its balance sheet:

(a) One objective of phase I is avoid disturbing existing practice for insurance contracts, except where a change creates a significant improvement and leads in a direction consistent with the likely direction of phase II. A prohibition on the continued use of embedded values would not meet that criterion.

(b) Embedded value methods are based on estimates of future cash flows, rather than on an accumulation of past transactions. The advantages of this may, in some cases, outweigh the disadvantage of including future investment margins. Therefore, the Board

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concluded that eliminating embedded value methods may not result in more relevant and reliable financial statements in every case.

(c) Given that the Board does not propose to prohibit asset-based discount rates for other measurements of insurance liabilities in phase I, there is no compelling reason to prohibit embedded value measurements that contain future investment margins in phase I.

(d) Although embedded value measurements today typically include future investment margins, that need not be a feature of such measurements. Indeed, some practitioners criticise existing embedded value measurements because they implicitly measure assets at more than their fair value. In effect, these existing measurements consider the expected return from the assets without considering the full risk premium that market participants require from those assets. Among other things, this implies that a shift in investment policy will change the reported measurement of the liability. These critics suggest that embedded values should be corrected by adjusting the asset cash flows fully for risk.

BC84 If an insurer wishes to start using embedded value measurements in its balance sheet, it could do so only if:

(a) the insurer shows that the new accounting policy will result in more relevant and reliable financial statements (paragraph 14 of the draft IFRS); and

(b) the embedded values neither include future investment margins (paragraph 16(c) of the draft IFRS) nor use measurements that implicitly measure contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraph 16(d) of the draft IFRS and paragraphs BC85 and BC86).

Investment management fees

BC85 Under some insurance contracts, the insurer is entitled to receive a periodic investment management fee. Some suggest that the insurer should, in determining the fair value of its contractual rights and obligations, discount the estimated future cash flows at a discount rate that reflects the risks associated with the cash flows. Some insurers use this approach in determining embedded values.

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BC86 However, in the Board's view, this approach can lead to results that are not consistent with a fair value measurement. If the insurer's contractual asset management fee is in line with the fee charged by other insurers and asset managers for comparable asset management services, the fair value of the insurer's contractual right to that fee would be expected to be approximately equal to what it would cost insurers and asset managers to acquire similar contractual rights. Therefore, paragraph 16(d) of the draft IFRS confirms that an insurer would not adopt a new accounting policy that involves measuring those contractual rights at more than their fair value as implied by fees charged by others for comparable services; however, if an insurer's existing accounting policies involves such measurements, it may continue to use them in phase I.

Uniform accounting policies on consolidation

BC87 Some insurers consolidate subsidiaries without conforming the measurement of insurance liabilities using the subsidiaries' own local GAAP to the accounting policies used by the rest of the group. Although IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* currently does not require entities to use uniform accounting policies if this would not be practicable, the Exposure Draft for the Improvements project, published in May 2002, proposed to remove this exemption.

BC88 The use of non-uniform accounting policies reduces the relevance and reliability of financial statements. However, prohibiting this would force some insurers to change their accounting policies for the insurance liabilities of some subsidiaries in phase I. This could require systems changes that might no longer be needed in phase II. Therefore, the Board proposes that an insurer already using non-uniform accounting policies for insurance contracts could continue to do so. However, if an insurer already uses uniform accounting policies for insurance contracts, it could not switch to a policy of using non-uniform accounting policies (paragraph 16(e) of the draft IFRS).

ACCOUNTING BY A CEDANT FOR REINSURANCE

BC89 The draft IFRS defines a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on one or more contracts issued by the

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cedant. One consequence is that the level of insurance risk required to meet the definition of an insurance contract is the same for a reinsurance contract as for a direct insurance contract.

BC90 National accounting requirements often define reinsurance contracts more strictly than direct insurance contracts to avoid distortion through contracts that have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). One of the main sources of such distortions is the fact that many non-life insurance claims liabilities are not discounted under current practice. If the insurer buys reinsurance, the premium paid to the reinsurer reflects the present value of the liability and is, therefore, less than the previous carrying amount of the liability. Reporting a gain on buying the reinsurance is not representationally faithful, because no economic gain occurred at that time. The accounting gain arises largely because of the failure to use discounting for the underlying liability. Similar problems arise if the underlying insurance liability is measured with excessive prudence.

BC91 The Board does not propose to address these problems through the definition of a reinsurance contract because the Board found no conceptual reason to define a reinsurance contract more or less strictly than a direct insurance contract. Instead, the Board proposes to address these problems through the following measures:

(a) prohibiting the offsetting of reinsurance assets against the related direct insurance liabilities (paragraph 10(d) of the draft IFRS and paragraph BC69).

(b) prohibiting a change in the measurement basis of the underlying liability when the cedant buys reinsurance (paragraph 18(a)).

(c) prohibiting the cedant from recognising a gain at inception, except to the extent that receipts from the reinsurer compensate the cedant for the reinsurer's portion of acquisition costs that the cedant recognised as an expense in the current or past periods (paragraph 18(b)-(e)).

(d) requiring unbundling in some cases (paragraphs 7 and 8 of the draft IFRS and IG Example 3 in the draft Implementation Guidance).

BC92 The Board acknowledges that the requirements in (b), (c) and (d) are conceptually imperfect. They are needed in phase I only because of imperfections in existing measurement models. They will not be needed for phase II.

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ACQUISITION OF INSURANCE CONTRACTS IN BUSINESS COMBINATIONS AND PORTFOLIO TRANSFERS

BC93 When an entity acquires another entity in a business combination, IAS 22 *Business Combinations* requires the acquirer to measure at fair value the identifiable assets and liabilities acquired. ED 3 *Business Combinations* proposes to maintain that requirement. Similar requirements exist under many national accounting frameworks. Nevertheless, in practice, insurers often use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it originated; and

(b) an intangible asset, representing the fair value of the contractual rights acquired and contractual obligations assumed, to the extent that the liability does not reflect that fair value. This intangible asset is often known by names such as the present value of in force business (PVIF), present value of future profits (PVFP or PVP) or value of business acquired (VOBA).

BC94 For the following reasons, the Board proposes to permit these existing practices during phase I (paragraph 20 of the draft IFRS):

(a) One objective of phase I is to avoid prejudging most phase II issues and to avoid requiring systems changes for phase I that might need to be reversed for phase II. In the meantime, disclosure about the nature of, and movements in, the related intangible asset would provide transparency for users.

(b) There may be some doubt about how an insurer should determine the fair value of insurance liabilities until the phase II guidance is finalised. Thus, fair values identified during phase I might need to be changed in phase II (unless the Board permits prospective application of the changes to be made in phase II).

(c) It may be difficult to integrate a fair value measurement at the date of a business combination into subsequent insurance contract accounting under national requirements without requiring systems changes that could become obsolete in phase II.

BC95 The draft IFRS does not give guidance on how to determine the fair value of the insurance liabilities, because that would be premature in phase I.

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BC96 The intangible asset described above is generally amortised over the estimated life of the contracts. Some insurers use an interest method of amortisation, which appears appropriate for an asset that essentially comprises the present value of a set of contractual cash flows. However, it is doubtful whether IAS 38 *Intangible Assets* permits its use. Therefore, the draft IFRS proposes that this asset should continue to be excluded from the scope of IAS 38 and its subsequent measurement should be consistent with the measurement of the related insurance liability (paragraph 22(b) of the draft IFRS).

BC97 Because this asset would be covered by the loss recognition test proposed in paragraphs 11-13, the draft IFRS proposes to exclude it from the scope of IAS 36 *Impairment of Assets* (paragraph 22(a) of the draft IFRS).

BC98 IAS 36 and IAS 38 would still apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination.

BC99 Measurements of the intangible asset discussed above sometimes include future investment margins. Those margins would be subject to the same requirements as future investment margins included in the measurement of the related insurance liability (see paragraphs BC80-BC84).

BC100 If an entity changes the measurements of its assets and liabilities on adopting IFRSs for the first time, it may need to make some consequential amendments to the measurement of the intangible asset described above. This would be the case if the entity's existing accounting policies involve measuring that asset on a basis derived from the carrying amounts of those other assets and liabilities.

BC101 An insurer may acquire a portfolio of insurance contracts in a transaction that is not a business combination as defined in IAS 22 (or ED 3). The draft IFRS would treat these contracts in the same way as insurance contracts acquired in a business combination (paragraphs 21 and 22).

DISCRETIONARY PARTICIPATION FEATURES

BC102 Some insurance contracts contain a discretionary participation feature as well as a fixed element that requires non-discretionary payments. The insurer has discretion over the amount and/or timing of distribution to policyholders, although that discretion may be subject to some contractual, legal, regulatory or competitive constraints. Distributions are

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typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit.

BC103 Although the issuer has contractual discretion over distributions, it is usually likely that current or future policyholders will ultimately receive some part of the accumulated surplus available, at the reporting date, for distribution to holders of contracts with discretionary participation features (distributable surplus). The main accounting question is whether that part of the distributable surplus is a liability or a component of equity. The Board will explore that question in phase II.

BC104 Features of this kind are found not only in insurance contracts but also in some investment contracts (non-insurance financial instruments). Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board may decide on a different treatment in phase II. Furthermore, in some cases, holders of insurance contracts and investment contracts have a contractual right to share in discretionary payments out of the same pool of assets. If the Board required a particular treatment for the discretionary participation features of the investment contracts in phase I, it might prejudge the treatment of these features in insurance contracts that are linked to the same pool of assets.

BC105 For these reasons, the Board decided not to address most aspects of the accounting treatment of such features in phase I, in either insurance contracts or investment contracts. However, the proposals in paragraphs 24 and 25 of the draft IFRS would prohibit the classification of distributable surplus as an intermediate category that is neither liability nor equity, because this would be inconsistent with the *Framework*. Under the *Framework*, if a balance sheet item does not meet the *Framework*'s definition of, and recognition criteria for, assets or liabilities, it is included in equity.

BC106 Furthermore, the proposals in paragraph 25 of the draft IFRS would require the issuer of an investment contract containing such a feature to recognise a liability measured at no less than the measurement that IAS 39 would require for the fixed element of the contract. Because issuers need not determine the IAS 39 measurement of the fixed element if the total recognised liability is clearly higher, the Board expects that issuers would not need to develop extensive systems to comply with this requirement.

BC107 There may be timing differences between accumulated profits under IFRSs and distributable surplus. For example, distributable surplus may exclude unrealised investment gains that are recognised under IFRSs.

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The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases. The draft IFRS does not address the classification of these timing differences because the Board will not determine until phase II whether the distributable surplus is all equity, all liability or part equity and part liability.

BC108 Discretion is the factor that makes it difficult to determine the appropriate accounting for these features. If participation features lack this element of discretion, they are embedded derivatives and subject to IAS 39.

ISSUES RELATED TO IAS 39

Assets held to back insurance contracts

BC109 The draft IFRS does not address financial or non-financial assets held by insurers to back insurance contracts. IAS 39 *Financial Instruments: Recognition and Measurement* identifies four categories of financial asset, with three different accounting treatments. In developing IAS 39, the Board's predecessor (IASC) acknowledged that most countries had a mixed measurement model, measuring some financial assets at amortised cost and others at fair value. IASC decided to retain, but regulate and structure, the different approaches as follows:

(a) assets held for trading are measured at fair value. Furthermore, all derivatives are deemed to be held for trading, and hence measured at fair value, because this is the only method that provides sufficient transparency in the financial statements.

(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.* Measurement at fair value is appropriate given that available-for-sale assets are defined as those that may be sold in response to, for example, changes in market prices or a liquidity shortage.

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* Under the current version of IAS 39, an entity may also elect to include changes in the fair value of available-for-sale assets in profit or loss. The proposals in the Exposure Draft of improvements to IAS 39, published in 2002, would eliminate that election because other proposals in the Exposure Draft would eliminate the need for the election.

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(c) assets with a fixed maturity 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. Many argued that if an asset is held to maturity, changes in market prices in the meantime are irrelevant to the entity because they will reverse by maturity (unless the asset becomes impaired).

(d) originated loans and receivables are measured at amortised cost. IASC was persuaded that there are difficulties in estimating the fair value of such loans, and that further progress was needed in valuation techniques before fair value should be required.

BC110 Some express concerns that mismatches may arise in phase I if financial assets (particularly interest-bearing investments) held to back insurance contracts are measured at fair value under IAS 39 whilst insurance liabilities are measured on a different basis. Although this difference in measurement basis would not affect profit or loss if the insurer classifies the assets as available-for-sale and recognises changes in their fair value directly in equity, it could lead to volatility in the insurer's reported equity. Some do not regard that volatility as a faithful representation of changes in the insurer's financial position. After discussing various suggestions for reducing that volatility, the Board decided:

(a) not to relax the criteria in IAS 39 for classifying financial assets as held-to-maturity. Relaxing those criteria would undermine the fundamental assertion that an entity has both the intent and ability to hold the assets until maturity. The Board noted that an insurer may be able to classify some of its financial assets as held-to-maturity if, in addition to meeting the other conditions set out in IAS 39, it concludes that an unexpected increase in lapses or claims would not compel it to sell those assets (except in the 'disaster scenario' discussed in IAS 39 paragraph 85). For example, after examining its circumstances carefully, an insurer might conclude that it would not be compelled to sell, say, specified assets representing 80 per cent of the fixed-maturity assets backing a book of insurance liabilities. If the other conditions in IAS 39 are met, the insurer could classify those specified assets as held-to-maturity.

(b) not to create a new category of assets carried at amortised cost: assets held to back insurance liabilities. The creation of such a category would lead to a need for arbitrary distinctions and complex attribution procedures that would not make an insurer's financial statements more relevant and reliable. The Board reviewed a precedent that exists in Japan for such a category, but

was not persuaded that the procedures adopted there can overcome these difficulties. Moreover, if an insurer may sell assets in response to, for example, changes in market prices or a liquidity shortage, the only appropriate measurement is fair value.

(c) not to create a new category of 'available-for-settlement' liabilities, analogous to available-for-sale assets, measured at fair value, with changes in fair value recognised in equity. The creation of such a category would make it necessary to find some basis for distinguishing between that category and the existing category of non-trading financial liabilities, or to permit a free choice of accounting treatments. The Board has identified no basis for such a distinction, nor for deciding which of these two categories would be the new residual category.

BC111 In the Board's view, the reasons given above outweigh the effects of any possible mismatch on an insurer's reported equity. Therefore, the Board decided not to exempt insurers from these existing requirements, even temporarily. The Board also noted that the mismatch described in paragraph BC110 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.

BC112 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. Because this is not the case for US insurers, their experience under US GAAP may not be a useful precedent in assessing this particular implication of IAS 39. 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. In the Board's view, creating new exemptions from IAS 39 in this area is not the best way to meet the common needs of users (including insurance supervisors) of an insurer's general purpose financial statements.

BC113 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 would have no such option for many of the assets held to back its core insurance activities. However, as noted in paragraph BC109(d), IASC permitted amortised cost measurement for originated loans and receivables

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because it had concerns about difficulties in establishing their fair value. This factor does not apply to many assets held by insurers to back insurance liabilities.

BC114 IAS 40 *Investment Property* permits an entity to use a fair value model for investment property, but IAS 16 *Property, Plant and Equipment* does not permit this model for owner-occupied property. An entity may measure its owner-occupied property at fair value under the allowed alternative treatment in IAS 16, but changes in its fair value must be recognised in revaluation surplus rather than in profit or loss. Some insurers regard their owner-occupied property as an investment and prefer to use a fair value model for it. However, the Board concluded that this was a broader question for IAS 40 generally and decided not to propose piecemeal changes to IAS 40 at this stage.

Investment contracts

BC115 Many insurers issue investment contracts (contracts that do not transfer enough insurance risk to qualify as insurance contracts). Under IAS 39, the issuer measures investment contracts at either amortised cost or, if the issuer designates them at inception under an option proposed in the Exposure Draft published in June 2002, at fair value. Some aspects of the measurements under IAS 39 differ from the measurements that are often used at present under national accounting requirements for these contracts:

(a) The definition and treatment of transaction costs under IAS 39 may differ from the definition and treatment of acquisition costs in some national requirements.

(b) The condition in IAS 39 for treating a modification of a financial liability (or the exchange of the new liability for an old liability) as an extinguishment of the original liability may differ from equivalent national requirements.

(c) Future cash flows from assets do not affect the amortised cost or fair value of investment contract liabilities (unless the cash flows from the liabilities are contractually linked to the cash flows from the assets).

(d) The amortised cost of a financial liability is not adjusted when market interest rates change, even if the return on available assets is below the effective interest rate on the liability (unless the change in rates causes the liability cash flows to change).

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(e) The fair value of a financial instrument reflects the credit characteristics of the instrument.

(f) Premiums received for an investment contract are not recognised as revenue under IAS 39, but as balance sheet movements, in the same way as a deposit received.

BC116 Some argue that the Board should not require insurers to change their accounting for investment contracts in phase I because the scope of phase I is intended to be limited and because the current treatment of such contracts is often very similar to the treatment of insurance contracts. However, the Board could see no reason to delay the application of IAS 39 to contracts that do not transfer significant insurance risk. The Board notes that some of these contracts have features, such as long maturities, recurring premiums and high initial transaction costs, that are less common 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.

BC117 Some contracts subject to IAS 39 grant cancellation or renewal rights to the holder. Under IAS 39, an issuer measures these contracts at amortised cost. The cancellation or renewal rights are embedded derivatives and IAS 39 requires the issuer to measure them separately if they are not closely related to their host contract. Under the amendments to IAS 39 proposed in the Exposure Draft of June 2002, the issuer could elect to measure these contracts at fair value. The Board intends to clarify the following when it finalises the amendments to IAS 39:

(a) The issuer of such a contract determines the amortised cost of its contractual liability on the basis of expected (ie probability-weighted) surrender patterns. This is consistent with the treatment of assets subject to prepayment risk under the Exposure Draft of June 2002.

(b) The issuer treats changes in estimated surrender patterns in the same way that a lender treats changes in estimated impairments of loans under paragraphs 111–114 of the Exposure Draft of June 2002. The Board will consider redrafting those paragraphs to focus on the underlying principle, which applies equally to assets and liabilities.

(c) If the amortised cost of the contractual liability differs from its surrender value, the issuer measures at fair value the investor's option to surrender, unless the surrender value is approximately the same as the carrying amount at each date. This complies with

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paragraph A4(g) of the Exposure Draft of June 2002. However, an insurer need not separate similar options to surrender an insurance contract (see paragraph 6 of draft IFRS X *Insurance Contracts*).

(d) The fair value of the liability is based on the expected (ie probability-weighted) surrender patterns and includes all associated cash flows, such as deposits, repayments, future front-end fees and surrender charges. However, the Board will not address criteria for distinguishing new contracts from continuation of an existing contract until phase II of the project on insurance contracts.

(e) The fair value of a financial liability with a demand feature (eg an investment contract that the investor can cancel at any time) is not less than the amount payable on demand. This precludes a liability measurement based on expected surrender patterns (the measurement described in paragraph BC117(d)) if the latter amount is less than the amount payable on demand. Furthermore, IAS 38 *Intangible Assets* applies to intangible assets, if any, associated with investment contracts. In practice, internally generated intangible assets associated with those contracts are unlikely to qualify for recognition as assets under IAS 38.

(f) If future investment management fees and related costs are in line with current fees charged, and costs incurred, by other market participants for similar services, it is likely, unless there is market evidence to the contrary, that the fair value at inception of the contractual right to those fees equals the origination costs paid.

(g) If the costs of servicing a financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that liability.

Embedded derivatives

BC118 Some suggest that the Board should exempt insurers from the requirement to separate embedded derivatives contained in a host insurance contract and measure them at fair value under IAS 39. They argue that:

(a) separating these derivatives would require extensive and costly systems changes that might not be needed for phase II if insurance contracts are measured at fair value.

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(b) some of these derivatives are intertwined with the host insurance contract in a way that would make separate measurement arbitrary and perhaps misleading, because the fair value of the whole contract might differ from the sum of the fair values of its components.

BC119 In the Board's view, fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. 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. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). 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.

BC120 IAS 39 requires entities to account separately for derivatives embedded in non-derivative contracts. This is necessary:

(a) to ensure that contractual rights and obligations that create similar risk exposures are treated in the same way whether or not they are 'embedded' in a non-derivative contract.

(b) to counter 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.

BC121 The requirement to separate embedded derivatives already applies to a host contract of any kind. Exempting insurance contracts from that existing requirement would be a retrograde step. Furthermore, much of the effort needed to measure embedded derivatives at fair value arises from the need to identify the derivatives and from other steps that would still be needed to develop a fair value measurement for phase II. In the Board's view, the incremental effort needed to identify the embedded derivatives separately in phase I is relatively small and is well justified by the increased transparency that fair value measurement will bring. IG Example 2 in the draft Implementation Guidance gives guidance on the treatment of various forms of embedded derivative.

BC122 Some embedded derivatives meet the definition of an insurance contract. It would be contradictory to require a fair value measurement in phase I of an insurance contract that is embedded in a larger contract when such

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measurement is not required for a stand-alone insurance contract. Therefore, the draft IFRS proposes to confirm that this is not required (paragraphs 5 and C2).

BC123 The Board acknowledges that 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 creates significant insurance risk, these embedded derivatives meet the definition of an insurance contract. The draft IFRS proposes specific disclosures about these items (paragraph 29(e)). In addition, the proposed requirement for fair value disclosure from 2006 will create further transparency about these items.

DISCLOSURE

BC124 The proposed disclosure requirements are designed as a set of three high level principles, supplemented by some specified disclosures to meet those objectives. Draft Implementation Guidance, published in a separate booklet, discusses how an insurer might satisfy the requirements. In the Board's view, this approach is superior to requiring a long list of detailed and descriptive disclosures, because concentrating on the underlying principles:

(a) makes it easier for insurers to understand the rationale for the requirements, which promotes compliance.

(b) avoids 'hard-wiring' into the IFRS disclosures that may become obsolete, and encourages experimentation that will lead to improvements as techniques develop.

(c) avoids requiring specific disclosures that may not be needed to meet the underlying objectives in the circumstances of every insurer and could lead to information overload that obscures important information in a mass of detail.

(d) gives insurers flexibility to decide on an appropriate level of aggregation that enables users to see the overall picture but without combining information that has different characteristics.

BC125 Some suggest that some of the proposed disclosures, particularly those that are qualitative rather than quantitative or that convey management's assertions about possible future developments, should be located outside the financial statements in a financial review by management.

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However, in the Board's view, the proposed disclosure requirements are all essential and should be part of the financial statements. The Board also notes that virtually all of the proposed disclosure requirements are analogous to existing requirements in IFRSs.

BC126 The first two principles, and most of the requirements supporting them, are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. The Board expects that both these principles will remain largely unchanged for phase II, although the guidance to support them may need refinement because different information will be available and because insurers will have experience of developing systems to meet the disclosure principles in phase I.

Explanation of reported amounts

Assumptions

BC127 The first principle requires disclosure of amounts in an insurer's balance sheet and income statement that arise from insurance contracts (paragraph 26 of the draft IFRS). In support of this principle, paragraph 27(c) and (d) would require disclosure about assumptions and changes in assumptions. The disclosure of assumptions both assists users in testing reported data for sensitivity to changes in those assumptions and enhances their confidence in the transparency and comparability of the reported information.

BC128 Some express concerns that information about assumptions and changes in assumptions may be costly to prepare and of limited usefulness. There are many possible assumptions that could be disclosed: excessive aggregation would result in meaningless information, while excessive disaggregation could be costly, lead to information overload, and reveal commercially sensitive information. In response to these concerns, the draft IFRS proposes that disclosure about the assumptions should focus on the process used to derive them.

BC129 Some argue that it is difficult to disclose meaningful information about changes in assumptions, because assumptions are often interdependent. As a result, an analysis by sources of change depends on the order in which the analysis is performed. To acknowledge this difficulty, the draft IFRS does not specify a rigid format or contents for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for their particular circumstances.

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Changes in insurance liabilities

BC130 Paragraph 27(e) of the draft IFRS proposes disclosures about material changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires broadly comparable disclosure of movements in provisions, but the scope of IAS 37 excludes insurance contracts. Disclosure about movements in deferred acquisition costs is important because some existing methods use adjustments to deferred acquisition costs as a means of recognising some effects of remeasuring the future cash flows from an insurance contract (for example, to reflect estimated premium deficiencies or to account for changes in the fair value of investments).

Amount, timing and uncertainty of cash flows

BC131 The second principle requires disclosure of information that helps users understand the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraph 28 of the draft IFRS). The supporting guidance for this principle builds largely on existing requirements in IFRSs, particularly the disclosures for financial instruments in IAS 32.

Insurance risk

BC132 For insurance risk (paragraph 29(c)), the proposed disclosures are intended to be consistent with the spirit of the disclosures required by IAS 32. The usefulness of particular disclosures about insurance risk depends on the circumstances of a particular insurer. Therefore, the proposed requirements are written in general terms to allow practice in this area to evolve.

Sensitivity analysis

BC133 Paragraph 29(c)(i) requires disclosure of a sensitivity analysis. The Board decided not to include specific requirements that may not be appropriate in every case and could impede the development of more useful forms of disclosure or become obsolete.

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Claims development

BC134 Paragraph 29(c)(iii) requires disclosure about claims development. The Board noted that the US Securities and Exchange Commission requires property and casualty insurers to provide a table showing the development of provisions for unpaid claims and claim adjustment expenses for the previous ten years, if the provisions exceed 50 per cent of equity. The Board noted that the period of ten years is arbitrary and decided instead to set the period covered by this disclosure by reference to the length of the claims settlement cycle. Therefore, the draft IFRS proposes that the disclosure should go back to the period in which the earliest material incurred claim still outstanding arose, but need not go back more than ten years.* Furthermore, the proposal applies to all insurers, not only to property and casualty insurers. However, because an insurer need not disclose this information for claims that are typically settled within one year, it is unlikely that most life insurers would need to give this disclosure.

BC135 In the US, disclosure of claims development is generally presented in management's discussion and analysis, rather than in the financial statements. However, this disclosure is important because it gives users insights into the uncertainty surrounding estimates about future claims, and also indicates whether a particular insurer has tended to overestimate or underestimate ultimate payments. Therefore, the draft IFRS proposes that it should be required in the financial statements.

Probable maximum loss

BC136 Some suggest that an insurer—particularly a general insurer—should disclose the probable maximum loss (PML) that it would expect to suffer if a reasonably extreme event occurred. For example, an insurer might disclose the loss that it would suffer from a severe earthquake of the kind that would be expected to recur every one hundred years, on average. However, given the lack of a widely agreed definition of PML, the Board concluded that it is not feasible to require disclosure of PML or similar measures.

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* An insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the IFRS (paragraph 34).

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Material exposures to interest risk or market risk

BC137 As discussed in paragraph BC123, the draft IFRS proposes that insurers need not account at fair value for embedded derivatives that meet the definition of an insurance contract, but also create material exposures to interest risk or market risk. For many insurers, these exposures can be very large. Therefore, paragraph 29(e) of the draft IFRS specifically requires disclosures about these exposures.

Fair value of insurance liabilities and insurance assets

BC138 The third principle requires an insurer to disclose the fair value of its insurance liabilities and insurance assets (paragraph 30 of the draft IFRS), although disclosure of fair values would not be required for dates before 31 December 2006 (paragraph 33). This proposal is intended not only to give useful information to users of an insurer's financial statements, but also to encourage insurers to begin work on fair value systems to avoid the need to provide a long transition period for phase II.

BC139 The Board's tentative decision to adopt a fair value model will not become definitive until the due process for phase II is complete. Therefore, some argue that the Board should not require disclosure of the fair value of insurance liabilities and insurance assets until it completes phase II. However, the Board's proposal to require disclosure of fair value is not conditional on the measurement model that it will eventually adopt for phase II. Disclosure of the fair value of insurance liabilities and insurance assets will provide relevant and reliable information for users, and this would still be the case even if phase II does not result in a fair value model. The Board also notes that IAS 32 introduced a requirement to disclose the fair value of financial instruments before IAS 39 introduced measurement requirements for financial instruments. Moreover, IAS 32 still requires that disclosure for financial instruments that are measured at amortised cost.

BC140 The Board must resolve several significant issues about fair value, both conceptual and practical, in phase II. Therefore, some argue that disclosing the fair value of insurance liabilities and insurance assets in phase I is premature. However, insurers can begin preparing for a fair value measurement before the Board answers all these questions. It is clear, for example, that any fair value measurement involves the need to estimate future cash flows and to identify the significant options and guarantees that are embedded in many insurance contracts. Moreover, the information needed for fair value disclosures is likely to be useful to

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many insurers for their risk management systems. The Board intends to address in phase II the remaining aspects of fair value that insurers will need so that they can implement fair value disclosures. Because it intends to complete phase II without delay, the Board expects to provide further guidance on determining fair values before the requirement to disclose fair values comes into effect. In finalising the IFRS for phase I, the Board intends to consider whether the guidance on fair value is sufficiently advanced to require this disclosure as early as 2006.

Disclosures to be addressed elsewhere

BC141 The draft IFRS does not address disclosures in the following areas, which the Board is considering in its project on financial risk and other amendments to financial instruments disclosures:

(a) capital and solvency requirements

(b) market risk

(c) liquidity risk

(d) operational risk.

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APPENDIX
Alternative views on ED 5 *Insurance Contracts*

AV1 Four Board members voted against the publication of ED 5 *Insurance Contracts*. Their alternative views are set out below.

Alternative view of two Board members

AV2 Two Board members voted against the publication of ED 5 because they would not exempt an entity from applying paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 when accounting for insurance and reinsurance contracts. In particular, paragraph 5 of [draft] IAS 8 requires an entity to develop and apply an accounting policy that results in information that is relevant to the decision-making needs of users and reliable. They believe that the requirements in IAS 8 have particular relevance and raison d'être when an IFRS lacks specificities, as is the case for insurance and reinsurance contracts, since the proposed IFRS allows a variety of measurement bases for these very material items. In their view, if an entity cannot meet those requirements, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.

Alternative view of the third Board member

AV3 The third Board member voted against the publication of ED 5 on the following grounds:

(a) phase I of this project should not require disclosure of the fair values of insurance liabilities and insurance assets;

(b) for the limited duration of phase I, a special category of 'assets held to back insurance contracts' should be allowed in order to match the accounting policies applied for insurance liabilities with those for assets backing those liabilities.

AV4 Paragraphs BC6-BC8 explain the Board's tentative conclusion for phase II of this project that insurance liabilities and insurance assets should be measured at fair value. That tentative conclusion is subject to revision until the due process for phase II is complete. The third Board member is not persuaded, at this stage, that the fair value of insurance liabilities and insurance assets is more relevant and reliable than an entity-specific measurement. For this reason, that Board member

disagrees with the requirement to disclose the fair value of insurance liabilities and insurance assets in phase I. In addition, that Board member regards it as premature to require such disclosure before the Board has resolved significant issues about fair value measurement and before it can give detailed guidance on how to perform such measurements.

AV5 The third Board member also believes that, for the limited time during which phase I will be effective, insurers should be allowed to use a special asset category measured at amortised cost for assets held specifically to back insurance liabilities. This option would avoid mismatches that will arise if financial assets have to be measured at fair value under IAS 39 whilst the insurance liabilities are measured on a different basis. The possibility of a special asset category at amortised cost would be a pragmatic and practical solution for preparer entities and would be tolerated only for a limited period.

Alternative view of the fourth Board member

AV6 The fourth Board member voted against the publication of ED 5 because that Board member believes that phase I should not require disclosure of the fair values of insurance liabilities and insurance assets. That Board member regards it as premature to require such disclosure before the Board has resolved significant issues about fair value measurement and before it can give detailed guidance on how to perform such measurements.

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