

July 2010

149. DSR-Sitzung am 05.10.2010

149\_08d\_100730\_ED\_insurance\_148\_08c

Exposure Draft ED/2010/8

# Insurance Contracts

Comments to be received by 30 November 2010

# **Exposure Draft Insurance Contracts**

*Comments to be received by 30 November 2010*

**ED/2010/8**

This exposure draft *Insurance Contracts* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as an International Financial Reporting Standard (IFRS). Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **30 November 2010**. Respondents are asked to send their comments electronically to the IFRS Foundation website ([www.ifrs.org](http://www.ifrs.org)), using the 'Open to Comment' page.

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ISBN for this part: 978-1-907026-91-1

ISBN for complete publication (set of two parts): 978-1-907026-90-4

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# INTRODUCTION AND INVITATION TO COMMENT

## Introduction

### Reasons for publishing the exposure draft

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- IN1 The International Accounting Standards Board (the Board or IASB) has published the exposure draft *Insurance Contracts* to propose significant improvements to the accounting for insurance contracts. Such improvements are needed urgently. Many users of financial statements describe insurance accounting today as a 'black box' that does not provide them with relevant information about an insurer's financial position and financial performance.
- IN2 The proposals in the exposure draft, if confirmed, would:
- (a) provide a comprehensive framework that will require insurers to provide information that is relevant to users of financial statements for economic decision-making.
  - (b) eliminate inconsistencies and weaknesses in existing practices, by replacing IFRS 4 *Insurance Contracts*. IFRS 4 is an interim standard that allows insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years.
  - (c) provide comparability across entities, jurisdictions and capital markets.

### Main features of the exposure draft

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- IN3 The exposure draft proposes a comprehensive measurement approach for all types of insurance contracts issued by entities (and reinsurance contracts held by entities), with a modified approach for some short-duration contracts. The approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and outflows (benefits and claims). An insurer would apply to that package of cash flows a measurement approach that uses the following building blocks:
- (a) a current estimate of the future cash flows
  - (b) a discount rate that adjusts those cash flows for the time value of money

- (c) an explicit risk adjustment
  - (d) a residual margin.
- IN4 For most short-duration contracts, a modified version of the measurement approach would apply:
- (a) During the coverage period, the insurer would measure the contract using an allocation of the premium received, on a basis largely similar to much existing practice.
  - (b) The insurer would use the building block approach to measure claims liabilities for insured events that have already occurred.

## Development of the proposals

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- IN5 The proposals in the exposure draft are the result of extensive deliberations following the publication of a discussion paper *Preliminary Views on Insurance Contracts* in May 2007, consultations with the IASB's Insurance Working Group (IWG) and input from participants in a targeted field test in late 2009.
- IN6 The Board developed the proposals jointly with the US Financial Accounting Standards Board (FASB). The boards reached the same conclusions in many areas, but reached different conclusions in areas summarised in the invitation to comment that follows and in the appendix to the Basis for Conclusions. The FASB plans to publish a discussion paper to seek additional input from constituents. That discussion paper would present the IASB's proposals, the FASB's tentative decisions, and a comparison of each of those models with existing US generally accepted accounting principles (GAAP).

## Invitation to comment

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- IN7 The Board invites comments on any aspect of the exposure draft of its proposed IFRS *Insurance Contracts*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:
- (a) respond to the questions as stated,
  - (b) indicate the specific paragraph or paragraphs to which the comments relate,
  - (c) contain a clear rationale, and

- (d) describe any other approaches the Board should consider, if applicable.
- IN8 Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.
- IN9 The Board will consider all comments received in writing by **30 November 2010**. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

## **Measurement (paragraphs 16–61, B34–B110 and BC45–BC155)**

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### **Measurement model (paragraphs 16–53 and BC45–BC144)**

- IN10 The exposure draft proposes a measurement model for all types of insurance (and reinsurance) contracts that, except for modification for short-duration contracts (see paragraph IN15), uses:
- (a) a direct measurement that incorporates current, discounted estimates of future cash flows revised at each reporting date, adjusted for the effects of uncertainty about the amount and timing of those future cash flows (ie a risk adjustment); and
  - (b) a margin that reports profitability of the contracts over their coverage period (ie a residual margin).
- IN11 The risk adjustment represents the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. It is remeasured at the end of each reporting period and declines over time as the insurer is released from risk.
- IN12 The residual margin is calibrated at inception to an amount that means the insurer recognises no gain on entering into an insurance contract. The residual margin is released over the coverage period in a systematic manner based on the passage of time, unless the pattern of claims and benefits makes another pattern more appropriate.

- IN13 For US GAAP, the FASB reached a different conclusion. The FASB concluded that the model should not include a separate risk adjustment and residual margin, but should instead combine these in a single composite margin. The composite margin is released over both the coverage period and the claims handling period on the basis of the insurer's exposure from the provision of insurance coverage, and the insurer's exposure from uncertainties associated with future cash flows.
- IN14 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract (ie acquisition costs). The exposure draft requires an insurer:
- (a) to include incremental acquisition costs for contracts actually issued in the initial measurement as part of the contract cash flows. As a result, those costs affect profit over the coverage period, rather than at inception.
  - (b) to recognise all other acquisition costs as an expense when incurred.

**Question 1 – Relevant information for users  
(paragraphs BC13–BC50)**

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

**Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25,  
B37–B66 and BC51)**

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?



**Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)**

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?
- (b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

**Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)**

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

**Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)**

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?
- (c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

- (d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?
- (e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

**Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)**

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

**Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)**

- (a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

**Short-duration contracts  
(paragraphs 54–60 and BC145–BC148)**

- IN15 A premium allocation model is proposed as a modified measurement for the pre-claims liabilities of some short-duration insurance contracts (unless the contract is onerous).

**Question 8 – Premium allocation approach**

- (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
- (b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

**Cash flows that arise from future premiums  
(paragraphs 26–29 and BC53–BC66)**

- IN16 To identify the future cash flows that are expected to arise as the insurer fulfils the obligation, it is necessary to determine whether future premiums (and resulting benefits and claims) arise from:
- (a) existing contracts (included in the liability measurement) or
- (b) future contracts (not included in the measurement).
- IN17 To achieve this distinction, paragraph 27 of the exposure draft proposes that the boundary of an insurance contract would be the point at which an insurer either:
- (a) is no longer required to provide coverage, or

- (b) has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

**Question 9 – Contract boundary principle**

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

**Participating features  
(paragraphs 23, 62–66, BC67–BC75 and BC198–BC203)**

IN18 Some insurance contracts provide policyholders with a right to participate in the favourable performance of a specified class of contracts, related assets or both (ie a participating feature). The exposure draft proposes that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash outflows (ie on an expected present value basis).

IN19 Some insurers issue financial instruments with discretionary participation features similar to those found in some participating insurance contracts. The Board proposes to include these contracts within the scope of the IFRS, if specified conditions are met. For US GAAP, the FASB has tentatively decided to include these contracts within the scope of its financial instruments standards.

**Question 10 – Participating features**

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
- (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

## **Definition and scope (paragraphs 2–7, B2–B33 and BC188–BC209)**

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IN20 The proposed definition of an insurance contract is based on the transfer of significant insurance risk to the insurer, used in IFRS 4. Appendix B provides guidance on the definition. The scope exclusions are listed in paragraph 4 of the exposure draft.

### **Question 11 – Definition and scope**

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

## **Unbundling (paragraphs 8–12 and BC210–BC225)**

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- IN21 The exposure draft proposes that an insurer should account for investment (ie financial) and service components separately from the insurance component (ie unbundling) when there is:
- (a) an investment component reflecting an account balance that meets specified criteria;
  - (b) an embedded derivative that is separated from its host in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*; and
  - (c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

### **Question 12 – Unbundling**

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

## **Presentation (paragraphs 69–78 and BC150–BC183)**

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- IN22 The exposure draft proposes a presentation of the statement of comprehensive income that will help users of an insurer's financial statements understand important performance factors; such information is lacking under many existing models, particularly for life contracts. The presentation also fits together naturally with the proposed measurement approach for insurance contracts. The proposed presentation would achieve this by presenting income and expense in a manner that highlights:
- (a) the underwriting margin (ie changes in the risk adjustment and release of the residual margin);
  - (b) experience adjustments (ie differences between actual cash flows and previous estimates) and changes in estimates (ie changes in current estimates of cash flows and discount rates); and

- (c) interest on insurance contract liabilities (presented or disclosed in a way that highlights its relationship with the investment return on assets backing those liabilities).

IN23 An insurer would be required to present all income and expense arising from insurance contracts in profit and loss.

**Question 13 – Presentation**

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

**Disclosures (paragraphs 79–97, BC242 and BC243)**

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IN24 The objective of the proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of cash flows arising from insurance contracts. Specifically, the proposed disclosure principle requires an insurer to explain:

- (a) the amounts recognised in the financial statements arising from insurance contracts and
- (b) the nature and extent of risks arising from those contracts.

**Question 14 – Disclosures**

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

## **Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C, and paragraphs BC153–BC155 and BC184–BC187)**

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IN25 For unit-linked contracts (sometimes known as variable contracts), the exposure draft proposes that, for assets for which existing requirements result in an accounting mismatch, an insurer should recognise the underlying assets and measure them at fair value through profit or loss. With respect to those assets, this proposal would require consequential amendments to:

- (a) IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*, to address shares issued by the insurer.
- (b) IAS 16 *Property, Plant and Equipment*, to address property occupied by the insurer.

IN26 In addition:

- (a) the proposals on unbundling (see paragraph IN21) are relevant for unit-linked contracts.
- (b) the exposure draft proposes presentation requirements for unit-linked contracts and related assets.

### **Question 15 – Unit-linked contracts**

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

## **Reinsurance (paragraphs 43–46 and BC230–BC241)**

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IN27 The proposals in the exposure draft would also apply to the reinsurance contracts that an insurer holds. The Board has identified no reason for different measurement approaches for direct insurance liabilities and reinsurance liabilities.

IN28 A cedant faces the risk that the reinsurer may default. The Board proposes an expected loss model for reinsurance assets. In other words, the measurement of the reinsurance asset would incorporate a reduction for the expected (ie probability-weighted) present value of losses from default or disputes.



**Question 16 – Reinsurance**

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

**Transition and effective date  
(paragraphs 98–102 and BC244–BC257)**

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IN29 The proposed transition requirements are in paragraphs 98–102. As noted in the Basis for Conclusions on IFRS 9, the Board will consider delaying the effective date of IFRS 9 if the IFRS on insurance contracts has a mandatory effective date later than 1 January 2013.

**Question 17 – Transition and effective date**

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

**Other comments**

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**Question 18 – Other comments**

Do you have any other comments on the proposals in the exposure draft?

## **Benefits and costs (paragraphs BC258–BC263)**

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IN30 When the Board develops an IFRS it assesses whether the overall benefits of improved financial information justify the costs of providing it.

### **Question 19 – Benefits and costs**

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

[Draft] International Financial Reporting Standard X *Insurance Contracts* ([draft] IFRS X) is set out in paragraphs 1–102 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

# [Draft] International Financial Reporting Standard X

## *Insurance Contracts*

### Objective

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- 1 The objective of this [draft] IFRS is to establish the principles that an entity should apply to report useful information to users of its financial statements about the amount, timing and uncertainty of cash flows from:
- (a) *insurance contracts* that it issues,
  - (b) *reinsurance contracts* that it holds, and
  - (c) financial instruments containing *discretionary participation features* that it issues.

### Scope

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- 2 An entity shall apply this [draft] IFRS to:
- (a) *insurance contracts* (including *reinsurance contracts*) that it issues and *reinsurance contracts* that it holds.
  - (b) financial instruments that it issues containing a *discretionary participation feature* (see paragraphs 62–66).
- 3 This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for their financial assets and financial liabilities, other than those mentioned in paragraph 2(b) (see IFRS 9 *Financial Instruments*, IFRS 7 *Financial Instruments: Disclosures*, IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transition requirements in paragraph 102.
- 4 An entity shall not apply this [draft] IFRS to:
- (a) *product warranties* issued by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
  - (b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

- (c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (eg some licence fees, royalties, contingent lease payments and similar items, see IAS 17 *Leases*, IAS 18 and IAS 38 *Intangible Assets*).
  - (d) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 and IAS 18).
  - (e) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction (see IAS 18). However, an insurer shall apply this [draft] IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.
  - (f) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).
  - (g) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply this [draft] IFRS to reinsurance contracts that it holds.
- 5 For ease of reference, this [draft] IFRS describes any entity that issues an insurance contract as an *insurer*, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.
- 6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.
- 7 Appendix B provides guidance on the definition of an insurance contract (see paragraphs B2–B33).

## Unbundling

- 8 Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a

contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (ie shall *unbundle* that component). The following are the most common examples of components that are not closely related to the insurance coverage:

- (a) an investment component reflecting an account balance that meets both of the following conditions:
  - (i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and
  - (ii) the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.
- (b) an embedded derivative that is separated from its host contract in accordance with IAS 39 (see paragraph 12 below).
- (c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

9 In unbundling an account balance specified in paragraph 8(a), an insurer shall regard all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, as belonging to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate used in determining that account balance reflects a crediting rate after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance.

10 An insurer shall not unbundle components of a contract that are closely related to the insurance coverage specified in the insurance contract.

- 11 Throughout this [draft] IFRS, the term *insurance contract* refers to the components of an insurance contract that remain after unbundling any components in accordance with paragraph 8.

### **Embedded derivatives**

- 12 IAS 39 applies to a derivative embedded in an insurance contract unless the embedded derivative is itself an insurance contract. IAS 39 requires an entity to separate an embedded derivative from its host contract, measure it at fair value and recognise changes in its fair value in profit or loss, if the embedded derivative meets both of the following criteria:
- (a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contract (see paragraphs AG30–AG33 of IAS 39). The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host insurance contract if, for example, the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract (see paragraph AG33(h) of IAS 39).
  - (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and be within the scope of IAS 39 (eg the derivative itself is not an insurance contract).

## **Recognition**

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- 13 **An insurer shall recognise an *insurance contract liability* or an *insurance contract asset* when the insurer becomes a party to the insurance contract.**
- 14 An insurer becomes a party to an insurance contract on the earlier of the following two dates:
- (a) when the insurer is bound by the terms of the insurance contract, and
  - (b) when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

- 15 An insurer shall not recognise as a liability or an asset any amounts relating to possible claims under future insurance contracts (such as the amounts described in some jurisdictions as catastrophe provisions or equalisation provisions). This [draft] IFRS does not prohibit an entity from presenting such amounts by appropriating retained earnings to reserves within equity. IAS 1 *Presentation of Financial Statements* requires an entity to describe the nature and purpose of each reserve within equity.

## Measurement

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- 16 Paragraphs 17–53 describe the measurement model that an insurer shall apply to all insurance contracts, except some short-duration contracts specified in paragraph 54, for which paragraphs 55–60 describe a modified version of that model.

### Initial measurement

- 17 **An insurer shall measure an insurance contract initially at the sum of:**
- (a) **the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, adjusted for the effects of uncertainty about the amount and timing of those future cash flows (*present value of the fulfilment cash flows*, see paragraph 22); and**
  - (b) **a residual margin that eliminates any gain at inception of the contract. A residual margin arises when the amount in (a) is less than zero (ie when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows).**
- 18 If the present value of the fulfilment cash flows specified in paragraph 17(a) is greater than zero (ie the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), the insurer shall immediately recognise that amount in profit or loss as an expense.
- 19 It follows from paragraphs 17 and 18 that the measurement of an insurance contract at initial recognition is:
- (a) zero, if the present value of the fulfilment cash flows is zero or less.
  - (b) the present value of the fulfilment cash flows, if that present value is greater than zero.



- 20 An insurer shall determine the residual margin in paragraph 17(b) at a level that aggregates insurance contracts into a *portfolio of insurance contracts* and, within a portfolio, by similar date of inception of the contract and by similar *coverage period*.
- 21 An insurer can become a party to an insurance contract before the coverage period starts. In many cases, the measurement of insurance contracts does not change materially after initial recognition before the start of the coverage period. During that time, the measurement of the insurance contract is updated only for cash received or paid, the accretion of interest, and changes in estimates of cash flows and discount rates. An insurer shall start recognising the residual margin in profit or loss only once the coverage period begins (see paragraph 50).

### **Present value of the fulfilment cash flows**

- 22 The following building blocks constitute the present value of the fulfilment cash flows:
- (a) an explicit, unbiased and probability-weighted estimate (ie expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract (paragraphs 23–25);
  - (b) a discount rate that adjusts those cash flows for the time value of money (paragraphs 30–34); and
  - (c) an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows (risk adjustment—paragraphs 35–37).

### **Future cash flows**

- 23 **Estimates of cash flows for a portfolio of insurance contracts shall include all incremental cash inflows and cash outflows arising from that portfolio, and shall:**
- (a) **be explicit (ie separate from estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows).**
  - (b) **reflect the perspective of the entity but, for market variables, be consistent with observable market prices.**

- (c) **incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfils the insurance contract.**
  - (d) **be current (ie the estimates shall reflect all available information at the measurement date).**
  - (e) **include only those cash flows that arise from existing contracts (ie cash inflows and cash outflows that arise within the boundary of those contracts—see paragraphs 26 and 27).**
- 24 At initial recognition, an insurer shall include in the measurement of the insurance contract an estimate of all cash flows that will arise as the insurer fulfils the insurance contract over the life of that contract. Some of those cash flows are received or paid on the day the insurance contract is initially recognised, for example initial premiums and some incremental acquisition costs (see paragraph 39(a)). Those cash flows result in a change in the carrying amount of the insurance contract liability on the day the insurance contract is initially recognised, but immediately after the moment of initial recognition.
- 25 Appendix B provides guidance for estimating future cash flows (see paragraphs B37–B66).

### **Contract boundary**

- 26 The measurement of an insurance contract shall include premiums and other cash flows (eg claims and expenses) resulting from those premiums if, and only if:
- (a) the insurer can compel the policyholder to pay the premiums, or
  - (b) the premiums are within the boundary of that contract.
- 27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which an insurer either:
- (a) is no longer required to provide coverage, or
  - (b) has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).

- 28 Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the benefits they will receive. Such features include surrender options, conversion options and options to cease paying premiums but still receive some benefits. The measurement of insurance contracts shall reflect the future behaviour of policyholders on an expected value basis, with an adjustment for the risk that the actual behaviour of the policyholder may differ from the expected behaviour. For example, the measurement of an insurance contract:
- (a) shall not assume that all policyholders surrender their contracts only because surrender would be unfavourable to the insurer.
  - (b) shall not assume that all policyholders continue their contracts only because continuation would be unfavourable to the insurer.
- 29 If options, forwards and guarantees do not relate to the insurance coverage under the existing insurance contract, they are not within the boundary of that contract. The insurer shall account for those features as new insurance contracts or other stand-alone instruments according to their nature.

### **Time value of money**

- 30 **An insurer shall adjust the future cash flows for the time value of money, using discount rates that:**
- (a) **are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity.**
  - (b) **exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed).**
- 31 As a result of the principle in paragraph 30, if the cash flows of an insurance contract do not depend on the performance of specific assets, the discount rate shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, with an adjustment for illiquidity (see paragraph 34).

- 32 If the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence. In some circumstances, the most appropriate way to reflect that linkage might be to use a replicating portfolio technique (see paragraphs B45–B47).
- 33 Estimates of cash flows and discount rates shall be internally consistent to avoid double-counting or omissions. For example, nominal cash flows (ie those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Real cash flows (ie those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.
- 34 Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all. Thus, in estimating discount rates for an insurance contract, an insurer shall take account of any differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract.

### **Risk adjustment**

- 35 **The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.**
- 36 An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts.
- 37 Appendix B provides guidance for estimating the risk adjustment (see paragraphs B67–B103).

## **Non-performance risk**

- 38 The present value of the fulfilment cash flows shall not reflect the risk of non-performance by the insurer, either at initial recognition or subsequently.

## **Acquisition costs**

- 39 **At initial recognition, an insurer shall:**

- (a) **include incremental acquisition costs in the present value of the fulfilment cash flows (see also paragraph B61(f)).**
- (b) **recognise all acquisition costs other than those identified in (a) as an expense when incurred.**

## **Insurance contracts acquired in a portfolio transfer or business combination**

- 40 **An insurer shall measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of the following:**

- (a) **the consideration received (after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships). The excess of that consideration over the present value of the fulfilment cash flows establishes the residual margin at initial recognition.**
- (b) **the present value of the fulfilment cash flows. If that amount exceeds the consideration received, the insurer shall recognise that excess immediately as an expense.**

- 41 In assessing whether a loss arises when acquiring a portfolio of insurance contracts (see paragraph 40(b)), the insurer shall determine whether it has recognised all of the intangible or other assets acquired in the portfolio transfer, and shall review its measurement of that portfolio at initial recognition.

- 42 **An insurer shall measure a portfolio of insurance contracts acquired in a business combination at the higher of the following:**

- (a) **the fair value of the portfolio. The excess of that fair value over the present value of the fulfilment cash flows establishes the residual margin at initial recognition.**
- (b) **the present value of the fulfilment cash flows. If that amount exceeds the fair value of the portfolio, that excess increases the**

**initial carrying amount of goodwill recognised in the business combination.**

**Reinsurance contracts**

- 43 Applying the same principles as those underlying paragraph 17, a cedant shall measure a reinsurance contract at initial recognition as the sum of:
- (a) the present value of the fulfilment cash flows (for this purpose the expected present value of the cedant's future cash inflows plus the risk adjustment less the expected present value of the cedant's future cash outflows); and
  - (b) a residual margin, as described in paragraph 45.
- 44 The cedant shall estimate the present value of the fulfilment cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contract(s) on initial recognition of the reinsurance contract. In addition, the cedant shall consider the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of the fulfilment cash flows.
- 45 In accordance with paragraph 17, the residual margin cannot be negative. Therefore, if the present value of the fulfilment cash flows for the reinsurance contract is:
- (a) less than zero (ie the expected present value of future cash inflows plus the risk adjustment is less than the expected present value of future cash outflows), the cedant shall establish that amount as the residual margin at initial measurement.
  - (b) greater than zero (ie the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows), the cedant shall recognise that amount as a gain at initial recognition of the reinsurance contract.
- 46 The cedant shall treat ceding commissions it receives as a reduction of the premium ceded to the reinsurer.

**Subsequent measurement**

- 47 **The carrying amount of an insurance contract at the end of each reporting period shall be the sum of:**
- (a) **the present value of the fulfilment cash flows at that date, and**

- (b) the remaining amount of the residual margin.**
- 48 The present value of the fulfilment cash flows shall reflect all available information at the end of the reporting period (ie it shall reflect current estimates of the amount, timing and uncertainty of the remaining future cash flows, current discount rates and a current risk adjustment). An insurer shall review its estimates at that date and update them if evidence indicates that previous estimates are no longer valid. In doing so, an insurer shall consider both of the following:
- (a) whether the updated estimates represent faithfully the conditions at the end of the reporting period, and
  - (b) whether changes in estimates represent faithfully changes in conditions during the period.
- 49 A cedant shall update the measurement of the present fulfilment cash flows of a reinsurance contract for changes in the risk of non-performance by the reinsurer.
- 50 An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:**
- (a) on the basis of the passage of time, but**
  - (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.**
- 51 An insurer shall accrete interest on the carrying amount of the residual margin, using the discount rate specified in paragraph 30 as determined at initial recognition.
- 52 The residual margin shall not be negative. Once the coverage period has ended, the residual margin is zero; hence, after that point the contract shall be measured as the present value of the fulfilment cash flows.
- 53 If fewer contracts are in force at the end of a period than was expected at the beginning of the period, the amount of the residual margin recognised in profit or loss during the period shall include an adjustment to eliminate from the residual margin at the end of the reporting period the portion relating to contracts that are no longer in force. If more contracts are in force at the end of a period than was expected at the beginning of the period, the insurer shall not increase the residual margin.

**Pre-claims liability for short-duration contracts**

- 54 Paragraphs 55–60 apply to insurance contracts that meet both of the following conditions:
- (a) The coverage period of the insurance contract is approximately one year or less.
  - (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12.
- 55 For those contracts, an insurer shall:
- (a) measure its *pre-claims liability* by allocating premiums over the coverage period as described in paragraphs 56–60.
  - (b) measure its *claims liability* at the present value of the fulfilment cash flows, in accordance with paragraphs 22–46.
- 56 The pre-claims liability is the pre-claims obligation (as described in paragraphs 57 and 58), less the expected present value of future premiums, if any, that are within the boundary of the existing contract.
- 57 **For insurance contracts specified in paragraph 54, an insurer shall measure its pre-claims obligation at initial recognition as**
- (a) **the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract; less**
  - (b) **the incremental acquisition costs.**
- 58 **Subsequently, the insurer shall reduce the measurement of the pre-claims obligation over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:**
- (a) **on the basis of the passage of time, but**
  - (b) **on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.**
- 59 An insurer shall accrete interest on the carrying amount of the pre-claims liability, using the discount rate specified in paragraph 30, updated in each reporting period.



- 60 An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfilment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation. If a contract is onerous, the insurer shall recognise an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfilment cash flows. To determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability, the insurer shall aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of inception. An insurer shall update the measurement of that additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous.

### **Foreign currency**

- 61 When applying IAS 21 *The Effects of Changes in Foreign Exchange Rates* to an insurance contract that results in cash flows in a foreign currency, the insurer shall treat the contract as a monetary item. This requirement applies not only to the present value of the fulfilment cash flows, but also to the residual margin. That requirement also applies to the pre-claims liability of short-duration contracts measured in accordance with paragraphs 56–60.

### **Financial instruments that contain discretionary participation features**

- 62 As specified in paragraph 2(b), this [draft] IFRS applies to financial instruments that contain a discretionary participation feature.
- 63 Such financial instruments do not transfer significant insurance risk. Therefore, some of the requirements in this [draft] IFRS are modified as described in paragraphs 64 and 65 when applied to those financial instruments.
- 64 Paragraph 27 defines the boundary of an insurance contract. Instead, the boundary of a financial instrument with a discretionary participation feature is the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract.

- 65 Paragraph 50 describes the basis for the release of the residual margin. Instead, the residual margin for an financial instrument with a discretionary participation feature shall be recognised as income in profit or loss over the life of the contract in a systematic way that best reflects the asset management services, as follows:
- (a) on the basis of the passage of time, but
  - (b) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.
- 66 Other requirements of this [draft] IFRS apply equally to a financial instrument with a discretionary participation feature, even though those contracts do not transfer significant insurance risk. For example, the cash flows arising from those financial instruments may be subject to uncertainty as a result of risks other than insurance risk (eg lapse risk and expense risk). If those risks are material, the present value of the fulfilment cash flows shall include a risk adjustment to reflect the risk that the ultimate cash flows may exceed those expected. But because financial instruments with discretionary participation features contracts do not transfer significant insurance risk, the application of some of the requirements in this [draft] IFRS may not be relevant or may not have a material effect.

## **Derecognition**

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- 67 **An insurer shall remove an insurance contract liability (or a part of an insurance contract liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the insurance contract is discharged or cancelled or expires. At that point, the insurer is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance obligation.**
- 68 When a cedant buys reinsurance, it shall derecognise the underlying contract or contracts only if that contract or those contracts are extinguished.

## **Presentation**

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### **Statement of financial position**

- 69 **An insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities.**

**70 An insurer shall not offset reinsurance assets against insurance contract liabilities.**

**71 An insurer shall present:**

- (a) the pool of assets underlying unit-linked contracts as a single line item, and not commingle it with the insurer's other assets.**
- (b) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (a) as a single line item and not commingle it with the insurer's other insurance contract liabilities.**

## **Statement of comprehensive income**

**72** At a minimum, an insurer shall include for insurance contract line items in its statement of comprehensive income that present the following amounts for the period:

- (a) underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:**
  - (i) the change in risk adjustment.**
  - (ii) the release of residual margin.**
- (b) gains and losses at initial recognition, disaggregated either in the statement of comprehensive income or in the notes into:**
  - (i) losses on insurance contracts acquired in a portfolio transfer (see paragraph 40(b)).**
  - (ii) gains on reinsurance contracts bought by a cedant (see paragraph 45(b)).**
  - (iii) losses at initial recognition of an insurance contract (see paragraph 18).**
- (c) acquisition costs that are not incremental at the level of an individual contract (see paragraph 39(b)).**
- (d) experience adjustments and changes in estimates, disaggregated either in the statement of comprehensive income or in the notes into:**
  - (i) differences between actual cash flows and previous estimates of those cash flows (ie experience adjustments).**
  - (ii) changes in estimates of cash flows and changes in discount rates.**

- (iii) impairment losses on reinsurance assets.
  - (e) interest on insurance contract liabilities.
- 73 The changes in estimates of discount rates and the interest on insurance liabilities shall be presented or disclosed in a way that highlights their relationship with the investment return on the assets backing those liabilities.
- 74 An insurer shall not present in the statement of comprehensive income, except as noted in paragraph 75(a):
- (a) premiums, which instead are treated in the same way as deposit receipts; and
  - (b) claims expenses, claims handling expenses, incremental acquisition costs and other expenses included in the measurement of the insurance contract, which instead are treated in the same way as repayments of deposits.
- 75 For some short-duration contracts, the pre-claims liability is measured in accordance with paragraphs 56–60. For those contracts, an insurer shall, in addition to the applicable line items in paragraph 72, include in its statement of comprehensive income line items that present the following amounts from insurance contracts for the period:
- (a) the underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:
    - (i) premium revenue, determined as the gross release of the pre-claims obligation (ie grossed-up for the amortisation of incremental acquisition costs, see paragraph 57(a)).
    - (ii) claims incurred.
    - (iii) expenses incurred.
    - (iv) amortisation of incremental acquisition costs included in the pre-claims obligation (see paragraph 57(b)).
  - (b) changes in additional liabilities for onerous contracts (see paragraph 60).
- 76 **An entity shall present all income and expense from insurance contracts in profit or loss.**
- 77 **An insurer shall not offset income or expense from reinsurance contracts against the expense or income from insurance contracts.**

- 78 **An insurer shall present income and expense from:**
- (a) **unit-linked contracts as a single line item, and not commingle them with income and expense from the insurer's other insurance contract liabilities.**
  - (b) **the pool of assets underlying unit-linked contracts as a single line item, and not commingle them with income or expense from the insurer's other assets.**

## **Disclosure**

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- 79 **To help users of financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts, an insurer shall disclose qualitative and quantitative information about:**
- (a) **the amounts recognised in its financial statements arising from insurance contracts (see paragraphs 85–90); and**
  - (b) **the nature and extent of risks arising from insurance contracts (see paragraphs 91–97).**
- 80 If the disclosures required by this [draft] IFRS and other IFRSs do not meet that objective in a particular situation, an insurer shall disclose whatever additional information is necessary to meet that objective.
- 81 An insurer shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements. An insurer shall aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.
- 82 An insurer shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.
- 83 The disclosures required in this [draft] IFRS shall not aggregate information relating to different reportable segments, as defined in IFRS 8 *Operating Segments*.
- 84 Examples of aggregation levels that might be appropriate are:
- (a) type of contract.
  - (b) geography (eg country or region).

## Explanation of recognised amounts

- 85 **An insurer shall disclose information about the amounts recognised in its financial statements in sufficient detail to help users of its financial statements evaluate the timing, amount and uncertainty of future cash flows arising from insurance contracts, including:**
- (a) **reconciliation from the opening to the closing aggregate contract balances (see paragraphs 86–89).**
  - (b) **the methods and inputs used to develop the measurements (see paragraph 90).**

### Reconciliation of contract balances

- 86 To comply with paragraph 85(a), an insurer shall disclose a reconciliation from the opening to the closing balance of each of the following, if applicable:
- (a) insurance contract liabilities and, separately, insurance contract assets.
  - (b) risk adjustments included in (a).
  - (c) residual margins included in (a).
  - (d) reinsurance assets arising from reinsurance contracts held by the insurer as cedant.
  - (e) risk adjustments included in (d).
  - (f) residual margins included in (d).
  - (g) impairment losses on reinsurance assets.
- 87 For each reconciliation required by paragraph 86, an insurer shall show, at a minimum, each of the following, if applicable:
- (a) the carrying amounts at the beginning and end of the period.
  - (b) new contracts recognised during the period.
  - (c) premiums received.
  - (d) payments, with separate disclosure of:
    - (i) claims and benefits.
    - (ii) expenses.
    - (iii) incremental acquisition costs.

- (e) other cash paid and, separately, other cash received.
  - (f) income and expense, reconciled to the amounts disclosed to comply with paragraphs 72 and 75.
  - (g) amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations.
  - (h) net exchange differences arising on the translation of foreign currency amounts into the presentation currency.
- 88 For short-duration contracts measured using the measurement described in paragraphs 54–60, an insurer shall disclose the reconciliation required by paragraph 86 separately for:
- (a) pre-claims liabilities.
  - (b) additional liabilities for onerous insurance contracts.
  - (c) claims liabilities.
- 89 For those contracts for which uncertainty about the amount and timing of claims payments is not typically resolved fully within one year, an insurer shall disclose the claims and expenses incurred during the period.

### **Methods and inputs used to develop the measurements**

- 90 To comply with paragraph 85(b), an insurer shall disclose:
- (a) for the measurements that have the most material effect on the recognised amounts arising from insurance contracts, the methods used and the processes for estimating the inputs to those methods. When practicable, the insurer shall also provide quantitative information about those inputs.
  - (b) to the extent not covered in (a), the methods and inputs used to estimate:
    - (i) the risk adjustment, including information about the confidence level to which the risk adjustment corresponds. If the insurer uses a conditional tail expectation technique or a cost of capital technique, it shall disclose the confidence level to which the risk adjustment estimated under those methods corresponds (eg that the risk adjustment was estimated at conditional tail expectation (Y) and corresponds to a confidence level of Z per cent).
    - (ii) discount rates.

- (iii) estimates of policyholder dividends.
- (c) the effect of changes in the inputs used to measure insurance contracts, showing separately the effect of each change that has a material effect on the financial statements.
- (d) a measurement uncertainty analysis of the inputs that have a material effect on the measurement. If changing one or more inputs used in the measurement to a different amount that could have reasonably been used in the circumstances would have resulted in a materially higher or lower measurement, the insurer shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, an insurer shall not take into account inputs that are associated with remote scenarios. An insurer shall take into account the effect of correlation between inputs if such correlation is relevant when estimating the effect on the measurement of using those different amounts. For that purpose, materiality shall be judged with respect to profit or loss, and total assets or total liabilities.

## **Nature and extent of risks arising from insurance contracts**

- 91 An insurer shall disclose information about the nature and extent of risks arising from insurance contracts in sufficient detail to help users of financial statements evaluate the amount, timing and uncertainty of future cash flows arising from insurance contracts.**
- 92 To comply with paragraph 91, an insurer shall disclose:
- (a) the exposures to risks and how they arise.
  - (b) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
  - (c) any changes in (a) or (b) from the previous period.
  - (d) information about the effect of the regulatory frameworks in which the insurer operates, for example minimum capital requirements or required interest rate guarantees.
  - (e) information about insurance risk on a gross and net basis, before and after risk mitigation (eg by reinsurance) including information about:



- (i) the sensitivity to insurance risk in relation to its effect on profit or loss and equity. This shall be disclosed by a sensitivity analysis that shows any material effect on profit or loss and equity that would have resulted from:
  - (A) changes in the relevant risk variable that were reasonably possible at the end of the reporting period;
  - (B) the methods and inputs used in preparing the sensitivity analysis; and
  - (C) any changes from the previous period in the methods and inputs used.

However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as embedded value or value at risk, it can meet this requirement by disclosing that alternative sensitivity analysis.

- (ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (eg type of insured event, geographical area or currency). Concentrations of insurance risk can arise if an insurer has, for example:
  - (A) underwritten risks concentrated in one geographical area or one industry.
  - (B) underwritten risks that are also present in its investment portfolio, for example if an insurer provides product liability protection to pharmaceutical companies and also holds investments in those companies.
- (iii) actual claims compared with previous estimates of the undiscounted amount of the claims (ie claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose information about the development of claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year. An insurer shall reconcile the disclosure about claims development with the carrying amount of the

insurance contract liabilities recognised in the statement of financial position.

- 93 For each type of risk, other than insurance risk, arising from insurance contracts, an insurer shall disclose:
- (a) summary quantitative information about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to the key management personnel of the insurer and shall provide information about the risk management techniques and methodologies applied by the insurer.
  - (b) concentrations of risk if not apparent from other disclosures. Such concentrations can arise from, for example, interest rate guarantees that come into effect at the same level for an entire book of business.
- 94 With regard to credit risk arising from reinsurance contracts and, if applicable, other insurance contracts, an insurer shall disclose:
- (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period.
  - (b) information about the credit quality of reinsurance assets.
- 95 With regard to liquidity risk, an insurer shall disclose:
- (a) either a maturity analysis that shows the remaining contractual maturities or information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities. This may take the form of an analysis, by estimated timing, of the amounts recognised in the statement of financial position.
  - (b) a description of how it manages the liquidity risk resulting from its insurance liabilities.
- 96 With regard to market risk (as defined in IFRS 7) an insurer shall disclose:
- (a) a sensitivity analysis for each type of market risk to which the insurer is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date; if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, or a sensitivity analysis, such as value at risk, that reflects interdependencies between risk variables and uses it to manage

*financial risks*, it may use that sensitivity analysis to meet this requirement.

- (b) an explanation of the methods and main inputs used in preparing the sensitivity analysis.
  - (c) an explanation of the objective of the methods used and of limitations that may result in the information not fully reflecting the carrying amount of the insurance contracts involved.
  - (d) changes from the previous period in the methods and inputs used and the reasons for such changes.
  - (e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract, including information about the levels at which these exposures begin to have a material effect on the insurer's cash flows.
- 97 If the quantitative information about the insurer's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, it shall disclose that fact, the reasons for those conclusions and shall provide further information that is representative of the exposure during the period.

## **Effective date and transition**

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- 98 The transition requirements in paragraphs 99–102 apply both to an insurer that applies IFRSs when it first applies this [draft] IFRS and to an insurer that applies IFRSs for the first time (a first-time adopter).
- 99 An insurer shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. If an insurer applies this [draft] IFRS for an earlier period, it shall disclose that fact.
- 100 At the beginning of the earliest period presented, an insurer shall, with a corresponding adjustment to retained earnings:
- (a) measure each portfolio of insurance contracts at the present value of the fulfilment cash flows. It follows that for insurance contracts to which these transitional provisions are applied, the measurement, both at transition and subsequently, does not include a residual margin.
  - (b) derecognise any existing balances of deferred acquisition costs.
  - (c) derecognise any intangible assets arising from insurance contracts assumed in previously recognised business combinations. That

adjustment does not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.

## **Disclosure**

- 101 In applying paragraph 92(e)(iii), an insurer need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies this [draft] IFRS. Furthermore, if it is impracticable when an insurer first applies this [draft] IFRS to prepare information about claims development that occurred before the beginning of the earliest period for which the insurer presents full comparative information that complies with this [draft] IFRS, it shall disclose that fact.

## **Redesignation of financial assets**

- 102 At the beginning of the earliest period presented, when an insurer first applies this [draft] IFRS, it is permitted, but not required, to redesignate a financial asset as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition. The reclassification is a change in accounting policy and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies. The insurer shall recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.

## Appendix A

### Defined terms

*This appendix is an integral part of the [draft] IFRS.*

<b>acquisition costs</b>	The direct and indirect costs of selling, underwriting and initiating an <b>insurance contract</b> .
<b>cedant</b>	The <b>policyholder</b> under a <b>reinsurance contract</b> .
<b>claims handling period</b>	The period during which the <b>insurer</b> investigates and pays claims.
<b>claims liability</b>	The liability to pay valid claims for <b>insured events</b> that have already occurred, including claims incurred but not reported (IBNR).
<b>coverage period</b>	The period during which the <b>insurer</b> provides coverage for insured events.
<b>direct insurance contract</b>	An <b>insurance contract</b> that is not a <b>reinsurance contract</b> .

<b>discretionary participation feature</b>	<p>A contractual right to receive, as a supplement to <b>guaranteed benefits</b>, additional benefits:</p> <ul style="list-style-type: none"> <li>(a) that are likely to be a significant portion of the total contractual benefits;</li> <li>(b) whose amount or timing is contractually at the discretion of the issuer; and</li> <li>(c) that are contractually based on: <ul style="list-style-type: none"> <li>(i) the performance of a specified pool of insurance contracts or a specified type of insurance contract;</li> <li>(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or</li> <li>(iii) the profit or loss of the company, fund or other entity that issues the contract,</li> </ul> </li> </ul> <p>provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.</p>
<b>financial risk</b>	<p>The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.</p>
<b>guaranteed benefits</b>	<p>Payments or other benefits to which a particular <b>policyholder</b> or investor has an unconditional right that is not subject to the contractual discretion of the issuer.</p>
<b>incremental acquisition costs</b>	<p>The costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.</p>

<b>insurance contract</b>	A contract under which one party (the <b>insurer</b> ) accepts significant <b>insurance risk</b> from another party (the <b>policyholder</b> ) by agreeing to compensate the policyholder if a specified uncertain future event (the <b>insured event</b> ) adversely affects the policyholder. (See Appendix B for guidance on this definition.)
<b>insurance contract asset</b>	An <b>insurer's</b> net remaining contractual rights less obligations under an <b>insurance contract</b> , if the rights exceed the obligations.
<b>insurance contract liability</b>	An <b>insurer's</b> net remaining contractual obligations less rights under an <b>insurance contract</b> , if the obligations exceed the rights.
<b>insurance risk</b>	Risk, other than <b>financial risk</b> , transferred from the holder of a contract to the issuer.
<b>insured event</b>	An uncertain future event that is covered by an <b>insurance contract</b> and creates <b>insurance risk</b> .
<b>insurer</b>	The party that has an obligation under an <b>insurance contract</b> to compensate a <b>policyholder</b> if an <b>insured event</b> occurs.
<b>policyholder</b>	A party that has a right to compensation under an <b>insurance contract</b> if an <b>insured event</b> occurs.
<b>portfolio of insurance contracts</b>	<b>Insurance contracts</b> that are subject to broadly similar risks and managed together as a single pool.
<b>pre-claims liability</b>	An <b>insurer's</b> stand-ready obligation to pay valid claims for future <b>insured events</b> arising under existing contracts (ie the obligation relating to the unexpired portion of risk coverage).
<b>present value of the fulfilment cash flows</b>	The expected present value of the future cash outflows less future cash inflows that will arise as the <b>insurer</b> fulfils the <b>insurance contract</b> , adjusted for the effects of uncertainty about the amount and timing of those future cash flows.
<b>reinsurance assets</b>	A <b>cedant's</b> net contractual rights under a <b>reinsurance contract</b> .
<b>reinsurance contract</b>	An <b>insurance contract</b> issued by one insurer (the <b>reinsurer</b> ) to compensate another insurer (the <b>cedant</b> ) for losses on one or more contracts issued by the cedant.

<b>reinsurer</b>	The party that has an obligation under a <b>reinsurance contract</b> to compensate a cedant if an <b>insured event</b> occurs.
<b>risk adjustment</b>	An adjustment to the expected present value of future cash flows, to capture the effect of uncertainty about the amount and timing of those cash flows.
<b>unbundle</b>	Account for the components of a contract as if they were separate contracts, according to their nature.
<b>unit-linked contract</b>	A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the <b>insurer</b> or a third party and operated in a manner similar to a mutual fund). In some jurisdictions referred to as a variable contract.



## Appendix B

### Application guidance

*This appendix is an integral part of the [draft] IFRS.*

- B1 This appendix provides guidance on the following issues:
- (a) definition of an insurance contract (paragraphs B2–B33).
  - (b) measurement of an insurance contract (paragraphs B35–B110).

### Definition of an insurance contract (paragraph 7 and Appendix A)

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- B2 This section provides guidance on the definition of an insurance contract as specified in Appendix A. It addresses the following:
- (a) the term ‘uncertain future event’ (paragraphs B3–B5).
  - (b) payments in kind (paragraphs B6 and B7).
  - (c) insurance risk and other risks (paragraphs B8–B17).
  - (d) examples of insurance contracts (paragraphs B18–B22).
  - (e) significant insurance risk (paragraphs B23–B31).
  - (f) changes in the level of insurance risk (paragraphs B32 and B33).

### Uncertain future event

- B3 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
- (a) whether an *insured event* will occur;
  - (b) when it will occur; or
  - (c) how much the insurer will need to pay if it occurs.
- B4 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

- B5 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

### **Payments in kind**

- B6 Some insurance contracts require or permit payments to be made in kind, in which case the insurer provides goods or services to the policyholder to settle its obligation to compensate the policyholder for insured events. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder for the amount of its loss. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the insurance contract.
- B7 For some fixed-fee service contracts, the level of service depends on an uncertain event. Although such contracts meet the definition of an insurance contract if the uncertain event would cause significant additional payments by the insurer, they are outside the scope of this [draft] IFRS if the primary purpose of the contract is the provision of services. Examples of such contracts are:
- (a) a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction.
  - (b) a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage.

### **Distinction between insurance risk and other risks**

- B8 The definition of an insurance contract refers to insurance risk, which this [draft] IFRS defines as risk, other than financial risk, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.
- B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of

changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (ie a financial variable), but also the condition of a specific non-financial asset held by a party to a contract (ie a non-financial variable). For example, if a guarantor of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

- B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.
- B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment that is contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract (see paragraph 12).
- B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.
- B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial effect of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a used and damaged asset with a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.

- B14 Some contracts require a payment if a specified uncertain event occurs, but do not require there to be an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses that contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. That contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but it does permit the insurer to deny payment if it is not satisfied that the event caused an adverse effect.
- B15 Lapse or persistency risk (ie the risk that the counterparty will cancel the contract earlier or later than the issuer had expected when pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (ie the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.
- B16 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless that contract also exposes the issuer to significant insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.
- B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual entity has accepted the risk that is the essence of insurance contracts.

### **Examples of insurance contracts**

- B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

- (a) insurance against theft or damage to property.
- (b) insurance against product liability, professional liability, civil liability or legal expenses.
- (c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).
- (d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).
- (e) insurance against disability and medical cost.
- (f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that compensate the holder if another party fails to perform a contractual obligation, for example an obligation to construct a building).
- (g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.
- (h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this [draft] IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are within the scope of IAS 18 and IAS 37 because they either:
  - (i) do not meet the definition of an insurance contract (warranties intended to provide a customer with coverage for latent defects in the product); or
  - (ii) meet the definition of an insurance contract but are outside the scope of this [draft] IFRS (warranties intended to provide a customer with coverage for faults that arise after the product is transferred to the customer).
- (i) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

- (j) travel insurance (ie compensation in cash or in kind to policyholders for losses suffered during travel).
- (k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).
- (l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.
- (m) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

- (a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk. For example, life insurance contracts in which the insurer bears no significant mortality risk are not insurance contracts (such contracts are non-insurance financial instruments or service contracts—see paragraphs B20 and B21).
- (b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts pass all significant insurance risk back to the policyholder (such contracts are normally non-insurance financial instruments or service contracts—see paragraphs B20 and B21).
- (c) self-insurance (ie retaining a risk that could have been covered by insurance). In such situations, there is no insurance contract because there is no agreement with another party.
- (d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see paragraph B13).

- (e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment solely on the basis of changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (such contracts are accounted for in accordance with IFRS 9 or IAS 39).
  - (f) credit-related guarantees (or letters of credit, credit derivative default contracts or credit insurance contracts) that require payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (such contracts are accounted for in accordance with IFRS 9 or IAS 39).
  - (g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).
  - (h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.
- B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9 or IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:
- (a) one party recognises the consideration received as a financial liability, rather than as revenue; and
  - (b) the other party recognises the consideration paid as a financial asset, rather than as an expense.
- B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, IAS 18 applies. In accordance with IAS 18, revenue associated with a transaction involving the rendering of services is recognised as an entity satisfies its performance obligation by providing the services to the customer.
- B22 The credit insurance discussed in paragraph B18(g) and the credit-related guarantees discussed in paragraph B19(f) can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. If those contracts require the issuer to make specified payments to reimburse the holder for a loss the holder incurs because a specified debtor fails to make payment when due in

accordance with the original or modified terms of a debt instrument, they are insurance contracts and are within the scope of this [draft] IFRS. However, IFRS 9 or IAS 39 apply to contracts described in paragraph B19(f), such as contracts that require payment:

- (a) regardless of whether the counterparty holds the underlying debt instrument; or
- (b) on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due.

## Significant insurance risk

- B23 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8–B22 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.
- B24 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely or even if the expected (ie probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining cash flows from the insurance contract.
- B25 In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.
- B26 In determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into account the effect of the time value of money. As a result, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. Consider the following reinsurance example. A cedant enters into a contract covering a book of one-year contracts. The contract provides that the reinsurer's payment will be ten years after the start of the contract. At the beginning of the contract, the reinsurer expects that claims will range from CU1,000 to CU1,200.<sup>7</sup> In assessing whether the reinsurance

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\* In this [draft] IFRS, monetary amounts are denominated in 'currency units (CU)'.



contract transfers significant insurance risk, the reinsurer considers the present value of the future payments in each scenario, ie not their nominal amounts. Assuming a discount rate of 5 per cent, the relevant benefit payments range from CU614 to CU737 (ie the nominal payments discounted at a rate of 5 per cent over 10 years).

- B27 The additional benefits described in paragraph B24 refer to the present value of amounts that exceed the present value of amounts that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:
- (a) the loss of the ability to charge the policyholder for future services. For example, in an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Therefore, the potential loss of future investment management fees is not relevant in assessing how much insurance risk is transferred by a contract.
  - (b) waiver on death of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, the waiver of these charges does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in assessing how much insurance risk is transferred by a contract.
  - (c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million if an asset suffers physical damage causing an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing CU1. At the same time, the contract creates non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.
  - (d) possible reinsurance recoveries. The insurer accounts for these separately.

- B28 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements (for that purpose, contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract). Thus, insurance risk can be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.
- B29 It follows from paragraphs B24–B28 that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). As noted in paragraph B27(b), the waiver on death of cancellation or surrender charges is not included in this assessment if that waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.
- B30 Paragraph B24 refers to additional benefits. Those additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (ie insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.
- B31 If an insurance contract is unbundled in accordance with paragraph 8 into an insurance component and one or more other components (eg an investment component), the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

## Changes in the level of insurance risk

- B32 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the annuity rates charged by the insurer to other new annuitants at the time the policyholder exercises the option. Such a contract transfers no insurance risk to the issuer until the option is exercised because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.
- B33 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (ie discharged, or cancelled or expires).

## Measurement of insurance contracts

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- B34 This section provides guidance on the measurement of insurance contracts. It addresses the following:
- (a) initial measurement (paragraph B35).
  - (b) initial measurement of reinsurance contracts (paragraph B36).
  - (c) estimates of future cash flows (paragraphs B37–B66).
  - (d) risk adjustments (paragraphs B67–B103).
  - (e) insurance contracts acquired in portfolio transfers (paragraphs B104–B107).
  - (f) insurance contracts acquired in a business combination (paragraphs B108 and B109).
  - (g) measurement of insurance contracts on transition (paragraph B110).

## Initial measurement (paragraphs 17–46)

B35 Paragraph 17 requires an insurer to measure an insurance contract initially at the present value of the fulfilment cash flows plus a residual margin that eliminates any gain at inception of the contract. A residual margin arises if the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows. However, if the present value of the fulfilment cash flows is greater than zero (ie the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), paragraph 18 requires that an expense shall be recognised immediately. Furthermore, paragraph 39(a) requires an insurer to include in the present value of fulfilment cash flows those acquisition costs that are incremental at the level of an individual contract. The following example illustrates how an insurer applies these principles.

### Example 1 – Initial measurement of insurance contracts

An insurer issues an insurance contract, receives CU50 as the first premium payment and incurs acquisition costs of CU70, of which incremental acquisition costs are CU40. The insurer estimates an expected present value (EPV) of subsequent premiums of CU950 and a risk adjustment of CU50. In example 1A, the insurer estimates that the EPV of future claims is CU900. In Example 1B, the insurer estimates that the EPV of claims is CU920. The present value of the fulfilment cash flows is the difference between the EPV of cash inflows (CU1,000) and the EPV of fulfilment cash outflows (CU940 in Example 1A and CU960 in Example 1B), less the risk adjustment (CU50). At initial recognition, the insurer would measure the insurance contract as follows:

	Example 1A	Example 1B
	CU	CU
EPV of cash outflows	940	960
Risk adjustment	50	50
EPV of cash inflows	<u>(1,000)</u>	<u>(1,000)</u>
Present value of the fulfilment cash flows	(10)	10
Residual margin	<u>10</u>	<u>0</u>
<b>Liability at initial recognition</b>	<b><u>0</u></b>	<b><u>10</u></b>

*continued...*

<i>...continued</i>		
The effect on profit or loss will be the following:		
Loss at initial recognition	0	10
Non-incremental acquisition costs (CU70–CU40)	<u>30</u>	<u>30</u>
Loss	<u><u>30</u></u>	<u><u>40</u></u>
Immediately after initial recognition, the carrying amount of the insurance contract liability changes as follows because of the cash flows (first premium and incremental acquisition costs) arising on the day of initial recognition (see paragraph 24):		
EPV of cash outflows	900	920
Risk adjustment	50	50
Residual margin	10	0
EPV of cash inflows	<u>(950)</u>	<u>(950)</u>
<b>Liability immediately after initial recognition</b>	<u><u>10</u></u>	<u><u>20</u></u>

### **Initial measurement of reinsurance contracts (paragraphs 43–46)**

- B36 Paragraph 43 requires a cedant to measure a reinsurance contract initially at the present value of the fulfilment cash flows plus a residual margin. A residual margin arises for a reinsurance contract if the expected present value of the future cash inflows (eg recoveries) plus the risk adjustment is less than the expected present value of future cash outflows (eg premium ceded to the reinsurer). However, if the present value of the fulfilment cash flows is greater than zero (ie the expected present value of the future cash inflows plus the risk adjustment exceeds the expected present value of the future cash outflows), paragraph 45(b) of this [draft] IFRS requires that a gain shall be recognised. The following example illustrates how a cedant applies these principles.

**Example 2 – Initial measurement of reinsurance contracts**

A cedant enters into a 30 per cent proportional reinsurance contract. At initial recognition of the reinsurance contract, the cedant measures the corresponding underlying insurance contract, which it issued at the same moment, as follows:

	<b>CU</b>
Single premium	(1,000)
Expected present value (EPV) of claims	870
Incremental acquisition costs	30
Risk adjustment	<u>60</u>
<b>Present value of fulfilment cash flows</b>	<b>(40)</b>
<b>Residual margin</b>	<u><b>40</b></u>
<b>Liability at initial recognition</b>	<u><u><b>0</b></u></u>

From the characteristics of the underlying insurance contract, the cedant estimates the following:

- expected present value (EPV) of cash inflows of CU261 (recovery of 30 per cent of the EPV of claims payable to the policyholder of CU870 for the underlying insurance liability);
- risk adjustment of CU18 (30 per cent of the risk adjustment of CU60 for the underlying insurance liability); and
- EPV of cash outflows (the single reinsurance premium paid to the reinsurer, less ceding commissions received from the reinsurer) of
  - in example 2A, CU285;
  - in example 2B, CU275.

Assuming that the risk of non-performance by the reinsurer is negligible, the measurement of the asset arising from the reinsurance contract would be:

*continued...*

<i>...continued</i>	<b>Example 2A</b>	<b>Example 2B</b>
	<b>CU</b>	<b>CU</b>
EPV of cash inflows (recoveries)	261	261
Risk adjustment	18	18
EPV of cash outflows (premium ceded)	<u>(285)</u>	<u>(275)</u>
Present value of the fulfilment cash flows	(6)	4
Residual margin	<u>6</u>	<u>0</u>
<b>Asset at initial recognition</b>	<b><u>0</u></b>	<b><u>4</u></b>
The effect on profit or loss will be the following:		
<b>Gain at initial recognition</b>	<b><u>0</u></b>	<b><u>4</u></b>

## Estimates of future cash flows (paragraphs 23–25)

B37 This section addresses:

- (a) uncertainty and the expected present value approach (paragraphs B38–B41).
- (b) market variables and non-market variables (paragraphs B42–B52).
- (c) source of estimates (paragraph B53).
- (d) using current estimates (paragraphs B54–B56).
- (e) future events (paragraphs B57–B60).
- (f) which cash flows (paragraphs B61–B64).
- (g) level of measurement (paragraphs B65 and B66).

## Uncertainty and the expected present value approach

B38 The starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome in order to derive an expected present value. Thus, the aim is

not to develop a single 'best' estimate of future cash flows, but, in principle, to identify all possible scenarios and make unbiased estimates of the probability of each scenario. In some cases, an insurer has access to considerable data and may be able to develop those cash flow scenarios easily. But in other cases, the insurer may not be able to develop more than general statements about the variability of cash flows without incurring considerable cost. In those cases, the insurer shall use those general statements in estimating the future cash flows.

- B39 When considering all possible scenarios, the objective is not necessarily to identify every possible scenario but rather to incorporate all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios. For example, if an insurer estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will suffice to estimate those parameters. Similarly, in some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions (eg if the cash flows reflect a series of interrelated implicit or explicit options). In such cases, more sophisticated stochastic modelling is likely to be needed, including the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes.
- B40 The probability assigned to each scenario shall reflect conditions at the end of the reporting period. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period and before the financial statements are authorised for issue, a storm strikes. The present value of the fulfilment cash flows under that contract shall not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement are multiplied by the 20 per cent probability that was apparent at the end of the reporting period (with appropriate disclosure that a non-adjusting event occurred after the end of the reporting period in accordance with IAS 10 *Events after the Reporting Period*).



- B41 The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. However, the scenarios exclude possible claims under possible future contracts. For example, suppose there is a 5 per cent probability that an earthquake during the remaining coverage period of an existing contract will cause losses with a present value of CU1,000,000. In that case, the expected present value of the cash outflows includes CU50,000 (ie CU1,000,000 × 5 per cent) for those catastrophe losses. But the expected value of the cash outflows for that contract does not include the possible catastrophe losses from an earthquake that could happen after the end of the coverage period.

### **Market variables and non-market variables**

- B42 The cash flows shall reflect the manner in which the insurer expects to fulfil the contract. A search for market inputs is not required, except for market variables such as interest rates. Therefore, this application guidance distinguishes between two types of variables:
- (a) market variables—variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates).
  - (b) non-market variables—all other variables (eg the frequency and severity of insurance claims and mortality).

#### *Market variables*

- B43 Estimates of market variables shall be consistent with observable market prices at the end of the reporting period. An insurer shall not substitute its own estimates for observed market prices.
- B44 Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Therefore, they are not a single point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was ‘wrong’.
- B45 An important application of market variables is the notion of a replicating asset, or a replicating portfolio of assets. A replicating asset is one whose cash flows exactly match those contractual cash flows in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows arising from an insurance contract. The fair value of that asset reflects the expected present value of the cash flows from the asset, and it also reflects the risk associated with those

cash flows. If a replicating portfolio of assets exists for some or all of the cash flows arising from an insurance contract liability, the insurer can for those contractual cash flows simply include the fair value of those assets in the present value of the fulfilment cash flows, instead of explicitly estimating the expected present value of those particular cash flows and the associated risk adjustment. For cash flows not measured by a replicating portfolio of assets, an insurer estimates explicitly the expected present value of those particular cash flows and the associated risk adjustment.

- B46 This [draft] IFRS does not require an insurer to use a replicating portfolio technique. However, if a replicating asset exists and an insurer uses a different technique, the insurer shall satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different answer. One way to assess whether that is the case is to verify that applying the other technique to the cash flows generated by the replicating portfolio produces a measurement that is not materially different from the fair value of the replicating portfolio.
- B47 As an example of a replicating portfolio technique, suppose an insurance contract contains a feature that generates cash flows equal to the cash flows from a put option on a basket of traded assets. The replicating portfolio for those cash flows would be a put option with the same features. The insurer would observe or estimate the fair value of that option and include that amount in the measurement of the entire insurance contract. However, the insurer could use a technique other than a replicating portfolio if that technique, in principle, is expected to achieve the same measurement of the contract as a whole. For example, other techniques may be more robust or easier to implement if there are significant interdependencies between the embedded option and other features of the contract. Judgement is required to determine which approach best meets the objective in practice in particular circumstances.

### *Non-market variables*

- B48 Estimates of non-market variables shall reflect all available evidence, both external and internal.
- B49 Non-market external data (eg national mortality statistics) may have more or less relevance than internal data (eg internal mortality statistics), depending on the circumstances. For example, a life insurer shall not rely solely on national mortality statistics, but shall consider all other

available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an insurer shall consider all evidence available, giving more weight to evidence that is more persuasive. For example:

- (a) internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population and the national statistics are out of date; in that case, an insurer would place more weight on the internal data and less weight on the national statistics.
- (b) conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population, and the national statistics are current, an insurer would place more weight on the national statistics.

B50 Estimated probabilities for non-market variables shall not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios shall be as consistent as possible with probabilities implied by market interest rates. Paragraphs B51 and B52 discuss this further.

B51 In some cases, an insurer concludes that market variables vary independently of non-market variables. If so, the insurer shall prepare scenarios that reflect the range of outcomes for the non-market variables and each scenario shall use the same observed value of the market variable.

B52 In other cases, market variables and non-market variables may be correlated. For example, there may sometimes be evidence that lapse rates are correlated with interest rates. Similarly, there may sometimes be evidence that claim levels for house or car insurance are correlated with economic cycles and hence with interest rates and expense amounts. In such cases, an insurer shall develop scenarios for different outcomes of the variables. The insurer shall calibrate the probabilities for the scenarios, and risk adjustments relating to the market variables, so that they are consistent with observed market prices that depend on those market variables.

### **Source of estimates**

B53 An insurer estimates the probabilities associated with future payments under existing contracts on the basis of:

- (a) information about claims already reported by policyholders.
- (b) other information about the known or estimated characteristics of the portfolio of insurance contracts.
- (c) historical data about the insurer's own experience, supplemented when necessary with historical data from other sources. Historical data are adjusted if, for example:
  - (i) the characteristics of the portfolio differ (or will differ, because of adverse selection) from that of the population used as a basis for the historical data.
  - (ii) there is evidence that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows arising from the existing insurance contracts.
  - (iii) there have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the portfolio of insurance contracts.
- (d) current price information, if available, for reinsurance contracts and other instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of portfolios of insurance contracts. This information is adjusted for differences between the cash flows arising from those reinsurance contracts or other instruments, and the cash flows that would arise as the insurer fulfils the underlying contracts with the policyholder.

### **Using current estimates**

- B54 In estimating the probability of each cash flow scenario relating to non-market variables, an insurer shall use all available current information at the end of the reporting period. An insurer shall review the estimates of probabilities it made at the end of the previous reporting period and update them if evidence indicates that the previous estimates are no longer valid. In doing so, an insurer shall consider both:
- (a) whether the updated estimates represent faithfully conditions at the end of the reporting period, and
  - (b) whether changes in estimates represent faithfully changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the

period. If conditions have not changed, changing the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an insurer's most recent estimates are, initially, different from its previous estimates, but conditions have not changed, the insurer shall assess whether the new probabilities assigned to each scenario can be justified. In updating its estimates of those probabilities, the insurer shall consider both the evidence that supported its previous estimates and all available new evidence, giving more weight to evidence that is more persuasive.

B55 Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience last year was 20 per cent worse than previous experience and previous expectations. Several factors could have caused the sudden change in experience, including:

- (a) lasting changes in mortality.
- (b) changes in the characteristics of the insured population (eg changes in underwriting or distribution, or selective lapses by policyholders in unusually good or bad health).
- (c) flaws in the estimation model, or mis-calibration of parameters, such as mortality and lapse rates, used in the model.
- (d) random fluctuations.
- (e) identifiable non-recurring causes.

B56 An insurer shall investigate the reasons for the change in experience and develop new probability estimates for the possible outcomes, in the light of the most recent experience, earlier experience and other information. Typically, the result for this example would be that the expected present value of death benefits increases, but not by as much as 20 per cent. Actuaries have developed various 'credibility' techniques that an insurer could use in assessing how new evidence affects the probability of different outcomes. In this example, if mortality continues to be significantly higher than previous estimates, the estimated probability assigned to high-mortality scenarios will increase as new evidence becomes available.

**Future events**

- B57 Estimates of non-market variables shall consider not just current information about the current level of insured events, but also information about trends. For example, mortality rates have declined consistently over long periods in many countries. In developing cash flow scenarios, an insurer shall assign probabilities to each possible trend scenario in the light of all available evidence.
- B58 Similarly, if cash flows from the insurance contract are sensitive to inflation, cash flow scenarios shall reflect possible future inflation rates (see also paragraph B52). Because inflation rates are likely to be correlated with interest rates, an insurer shall calibrate the probabilities for each inflation scenario so that they are consistent with probabilities implied by market interest rates (eg those used in estimating the discount rate specified in paragraphs 30–34).
- B59 In estimating the cash flows from an insurance contract, an insurer shall take into account future events that might affect the cash flows without changing the nature of the obligation. The insurer shall develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability weights for each scenario.
- B60 However, an insurer shall not take into account future events, such as a change in legislation, that would change or discharge the present obligation or create new obligations under the existing insurance contract.

**Which cash flows?**

- B61 Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract that are incremental at the level of a portfolio of insurance contracts, and no others. Cash outflows that are incremental to a portfolio of insurance contracts include direct costs and systematic allocations of costs that relate directly to the insurance contracts or contract activities. Accordingly, the relevant cash flows include:
- (a) premiums (including premium adjustments and instalment premiums) from policyholders and any additional cash flows that result from those premiums.
  - (b) payments to (or on behalf of) policyholders, including claims that have already been reported but have not yet been paid (ie reported claims), claims that have already been incurred but have not yet

been reported (IBNR) and all future claims and other benefits under the existing contract.

- (c) claim handling costs (ie the costs that the insurer will incur in processing and resolving claims under existing insurance contracts, including legal and adjuster's fees and internal costs of processing claim payments).
- (d) the costs that the insurer will incur in providing contractual benefits that are paid in kind.
- (e) cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not unbundled (see paragraph 12). When insurance contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios.
- (f) the incremental costs of selling, underwriting and initiating an insurance contract for those contracts that have been issued and that the insurer has incurred because it has issued that particular contract (ie the incremental acquisition costs). Thus, these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.
- (g) policy administration and maintenance costs, such as costs of premium billing and costs of handling policy changes (eg conversions and reinstatements). Such costs also include recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.
- (h) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis.
- (i) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims.
- (j) payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides

policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.

- B62 The following cash flows shall not be considered in estimating the cash flows that will arise as the insurer fulfils an existing insurance contract:
- (a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of a participating insurance liability is affected by the cash flows, if any, that depend on the investment returns.
  - (b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.
  - (c) cash flows that may arise from future insurance contracts, ie cash flows that are outside the boundary of existing contracts (see paragraphs 26 and 27), or from options, forwards and guarantees that do not relate to the existing insurance contract. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate changes in the cash flows from existing contracts that could take place if the insurer stopped issuing new contracts, unless the insurer actually stops issuing new contracts.
  - (d) acquisition costs other than incremental acquisition costs.
  - (e) cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract.
  - (f) costs that do not relate directly to the contract or contract activities, such as general overheads.
  - (g) income tax payments and receipts. Such payments and receipts are recognised, measured and presented separately in accordance with IAS 12 *Income Taxes*.
  - (h) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds.
  - (i) cash flows arising from components that are unbundled from the insurance contract (eg interest that the insurer expects to credit to policyholder account balances). See paragraphs 8 and 9.
- B63 Some costs relate directly to insurance contracts or contract activities but are the result of activities that cover more than one portfolio (eg salaries of staff of a claims handling department working on more than one portfolio). An insurer shall allocate those costs, other than acquisition costs (see paragraph B61(f)), on a rational and consistent basis to



individual portfolios of insurance contracts. Even though such costs are allocations, they are still incremental at the portfolio level. Costs that are not incremental at the portfolio (or lower) level because they do not relate directly to the insurance contract or contract activities, such as general overheads, are not allocated to portfolios and therefore are not included in the measurement of insurance contracts.

- B64 In some cases an insurer incurs costs that in substance are the equivalent of cash outflows. For example, an insurer may own a workshop to repair cars for damages covered under an insurance contract. The cash flows include the depreciation of that workshop because it is a resource required to satisfy the insurer's obligation from its insurance contract.

### **Level of measurement**

- B65 In principle, the expected (probability-weighted) cash flows from a portfolio of insurance contracts equal the sum of the expected cash flows of the individual contracts. Therefore, the level of aggregation for measurement does not affect the expected present values of future cash flows.
- B66 However, from a practical point of view, it may be easier to perform some types of estimate in aggregate for a portfolio, rather than for individual insurance contracts. For example, IBNR estimates are typically made in aggregate. Similarly, if expenses are incremental at the portfolio level but not at an individual insurance contract level, it may be easier, and perhaps even necessary, to estimate them at an aggregate level. However, in principle, this is no different from making expected value estimates for individual insurance contracts and then aggregating the results for the portfolio of those contracts.

### **Risk adjustments (paragraphs 35–37)**

- B67 This section addresses:
- (a) objective and characteristics (paragraphs B68–B72).
  - (b) techniques for estimating risk adjustments (paragraphs B73 and B74).
  - (c) features of permitted risk adjustment techniques (paragraphs B75–B90).
  - (d) application of risk adjustment techniques (paragraphs B91–B102).

- (e) risk adjustments and the use of a replicating portfolio (paragraph B103).

### **Objective and characteristics**

- B68 The risk adjustment conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract. To achieve this, paragraph 35 requires that the risk adjustment shall be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.
- B69 Because the purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows arising from the insurance contract only, the risk adjustment shall reflect all risks associated with that contract. It shall not reflect risks that do not arise from the insurance contract, such as investment risk (except when investment risk affects the amount of payments to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.
- B70 The risk adjustment shall be included in the measurement in an explicit way. Thus, the risk adjustment is separate from estimates of future cash flows and the discount rate that adjusts those cash flows for the time value of money; it cannot be included implicitly in those two other building blocks. However, that requirement is not intended to preclude ‘replicating portfolio’ approaches (see paragraph B103).
- B71 Care is needed to avoid duplicating adjustments for risk (see also paragraphs B45 and B103).
- B72 To meet the objective in paragraph B68, the risk adjustment shall, to the extent practicable, have the following characteristics:
- (a) risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity.
  - (b) for similar risks, contracts with a longer duration will result in higher risk adjustments than those of a shorter duration.
  - (c) risks with a wide probability distribution will result in higher risk adjustments than those risks with a narrower distribution.
  - (d) the less that is known about the current estimate and its trend, the higher the risk adjustment shall be.
  - (e) to the extent that emerging experience reduces uncertainty, risk adjustments will decrease and vice versa.

## Techniques for estimating risk adjustments

- B73 An insurer shall use only the following techniques for estimating risk adjustments:
- (a) confidence level (paragraphs B75–B79).
  - (b) conditional tail expectation (paragraphs B80–B83).
  - (c) cost of capital (paragraphs B84–B90).
- B74 Paragraphs B75–B90 provide an overview of the main features of those permitted techniques. Paragraphs B91–B102 discuss how the permitted techniques could meet the characteristics in paragraph B72 and indicate when they are applicable.

## Features of permitted risk adjustment techniques

### *Confidence level*

- B75 The confidence level technique expresses the likelihood that the actual outcome will be within a specified interval. The confidence level technique is sometimes referred to as Value at Risk (VaR). The International Actuarial Association's paper *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins* describes the use of confidence levels in estimating a risk adjustment as follows:

[Risk adjustment techniques] based on confidence levels express uncertainty in terms of the extra amount that must be added to the expected value so that the probability that the actual outcome will be less than the amount of the liability (including the risk [adjustment]) over the selected time period equals the target level of confidence.

- B76 The use of confidence levels for estimating a risk adjustment has the benefits of being relatively easy to communicate to users and relatively easy to calculate. However, the usefulness of confidence level diminishes when the probability distribution is not statistically normal (which is often the case for insurance contracts). When the probability distribution is not normal (in which case, the probability distribution may be skewed and the mean may not equal the median), the selection of the confidence level must take into account additional factors, such as the skewness of the probability distribution. In addition, this technique ignores outliers (ie extreme losses in the tail of the distribution beyond the specified confidence level).
- B77 For example, suppose a confidence level of 95 per cent is used and the following estimates are made for two insurance contracts:

- (a) for contract A, the 95 per cent confidence level is at CU1,000 and the remaining 5 per cent of the distribution is evenly spread from CU1,001 to CU1,010.
- (b) for contract B, the 95 per cent confidence level is at CU1,000 and the remaining 5 per cent of the distribution is evenly spread from CU1,001 to CU2,000.

B78 At the 95 per cent confidence level, those two contracts would have the same risk adjustment. However, at, for example, the 97 per cent confidence level, contract A would be measured at CU1,004 and contract B at CU1,400.

B79 Judgement is required to determine the confidence level (ie what percentage) to set for particular portfolios of insurance contracts in particular circumstances. In setting the confidence level, an insurer needs to consider factors, such as the shape of the distribution, which may differ by portfolio. Because the distribution can change over time, the insurer may need to change the confidence level accordingly in future periods.

#### *Conditional tail expectation*

B80 A conditional tail expectation (CTE) (also referred to as a tail conditional expectation or a tail value at risk) technique is an enhancement of VaR. A CTE technique provides a better reflection of the potentially extreme losses than VaR by incorporating the expected value of those extreme losses into the measurement of the risk adjustment (although a confidence level technique may meet the objective of the risk adjustment if the distribution is not particularly skewed). The Society of Actuaries' paper *Analysis of Methods for Determining Margins for Uncertainty under a Principle-Based Framework for Life Insurance and Annuity Products* describes a CTE technique as follows:

The CTE technique is a modified percentile approach that combines the percentile and mean values of different cases. It basically calculates the mean of losses within a certain band (or tail) of pre-defined percentiles. With the CTE method, the margin is calculated as the probability weighted average of all scenarios in the chosen tail of the distribution less the mean estimate (which may or may not be the median, i.e. the 50<sup>th</sup> percentile).

B81 The CTE over, for example, the 75 per cent confidence level (referred to as CTE(75)) is the expected value of all outcomes that are in the highest 25 per cent of the claim distribution (ie in the tail). The risk adjustment in this case would be the expected value of claims at CTE(75) less the expected value (ie mean) of claims for the entire probability distribution.

- B82 The focus of a CTE technique on the tail of the probability distribution reflects a fundamental aspect of an insurance contract—the fact that the tail is the riskiest part of the distribution. Tail risk is an important factor in contracts with skewed payments, such as insurance contracts that contain embedded options (eg the interest guarantees and other financial guarantees embedded in many life insurance products) or that cover low-frequency high-severity risks (such as an earthquake), or portfolios that contain significant concentrations of risk. For example, if a large portfolio of insurance contracts is subject to significant earthquake risk but the insurer estimates that the probability of an earthquake occurring is only 1 per cent, the measurement of the insurance contract should not ignore that risk. As part of the estimation of the amount an insurer would rationally pay to be relieved of the risk, significant consideration needs to be given to the tail of the loss distribution. Consequently, CTE techniques would meet the objective for a risk adjustment described in paragraph B68. However, a confidence interval technique may meet the objective if distributions are not particularly skewed.
- B83 Judgement is required to determine the CTE band set for particular portfolios of insurance contracts in particular circumstances. In setting the CTE band, an insurer will consider the shape of the distribution. Because the distribution can change over time, the CTE band may need to change accordingly in future periods.

### *Cost of capital*

- B84 Cost of capital techniques are applied for a number of purposes, for example pricing insurance contracts, valuations in business combinations, regulatory reporting, internal capital management and supplementary reporting. For general purpose financial reporting, a cost of capital technique can be used to estimate a risk adjustment that reflects the uncertainty about the amount and timing of the future cash flows that will arise as an insurer fulfils its existing insurance contracts.
- B85 In order to fulfil an insurance contract, an insurer needs to hold and maintain a sufficient amount of capital. If an insurer does not have sufficient capital, it might be unable to fulfil its obligations and the policyholders would be likely to surrender their insurance contracts.
- B86 An insurer applies a cost of capital technique as follows:
- (a) first, the insurer derives an estimated probability distribution for the cash flows.

- (b) secondly, the insurer sets a confidence level from that distribution. That confidence level is intended to provide a high degree of certainty that the insurer will be able to fulfil its obligations under existing insurance contracts. The difference between the amount at that confidence level and the expected value (ie mean) of claims for the entire probability distribution indicates a capital amount that corresponds to the high degree of certainty that the insurer will be able to fulfil its obligations under the portfolio of existing insurance contracts, ignoring any risk factors not related to those contracts.
- (c) lastly, the insurer estimates the risk adjustment by:
  - (i) applying a factor, in the form of an appropriate annual rate, to that capital over the lifetime of the contract, and
  - (ii) making a further adjustment for the time value of money because the capital will be held in future periods.

B87 For example, suppose an insurer sets the capital amount as the amount necessary to provide for a confidence level of 99.5 per cent, and estimates that the corresponding capital amount is CU100. Suppose also that the insurer estimates that the appropriate capital rate is 8 per cent per year, and that it will need to hold the capital amount for one year. Therefore, the risk adjustment will be CU8 (ie the capital amount of CU100 at 8 per cent for one year). For simplicity, this example assumes that the time value of money is not material. However, the computation of the risk adjustment using the capital amount and the annual rate needs to reflect the time value of money, which is particularly relevant if a capital amount is held for a longer period.

B88 To meet the objective for a risk adjustment (ie to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfilment cash flows will exceed those expected), both the amount of capital and the capital rate need to be derived in an appropriate way, as follows:

- (a) the amount of capital shall be set at a sufficiently high level that it captures almost the entire tail of the distribution. To do this, an insurer will need to identify how much uncertainty exists in the tail of the distribution.
- (b) the capital rate shall reflect the risks that are relevant to the liability (ie those risks that the owners of the insurer would require for exposure to the risk in the liability), but not reflect risks that are not relevant to the liability (eg asset risk for non-participating

insurance contracts and avoidable mismatch risk) or those risks that are already captured elsewhere in the model. For example, suppose investors require an 18 per cent return for investing in an insurer, including:

- (i) 4 per cent relating to the time value of money (ie the risk-free rate, which is not related to the insurance liability; the insurer can generate that return by investing the capital amount in risk-free assets and so does not need to generate that return from the insurance liabilities);
- (ii) 2 per cent relating to asset risks borne by the insurer;
- (iii) 1 per cent relating to avoidable asset/liability mismatch risk taken by the insurer; and
- (iv) 3 per cent relating to uncertainty about future business (including operational risk related to future business).

This results in a capital rate of 8 per cent relating to the capital return (ie the residual, which is calculated as 18 per cent – 4 per cent – 2 per cent – 1 per cent – 3 per cent).

- B89 The cost of capital technique reflects almost the entire distribution, and only a relatively small band on the far end of the distribution, beyond the selected confidence level for the capital amount, would not be considered. This is because the confidence level for determining the capital amount is set at a level that is intended to provide a high degree of certainty that the insurer will be able to fulfil its obligations under existing insurance contracts. Therefore, in setting the confidence level in the cost of capital technique, an insurer takes into account the possibility of low-frequency high-severity losses in all but the extreme tail of the probability distribution. Because the cost of capital technique takes into account the release of the capital amount over the life of the contract, this technique also reflects how the risk associated with the insurance contract changes over time.
- B90 The confidence level for the capital amount, and the annual rate applied to that capital amount to calculate the risk adjustment, shall be set in a way that reflects the characteristics of the liability at each point in time. Conceptually, it would be possible to apply different confidence levels and different capital rates to different types of contracts. However, it may be possible to apply a consistent confidence level and capital rate to different portfolios (and over time) because the capital amount needs to be set so that it captures almost the entire distribution.

## Application of risk adjustment techniques

- B91 Paragraph B72 sets out the characteristics that a risk adjustment must have in order to satisfy the objective (ie to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfilment cash flows may exceed those expected). All three techniques permitted by this [draft] IFRS meet those characteristics in at least some, but not necessarily all, situations and will do so in varying degrees depending on the circumstances.
- B92 The selection of the most appropriate risk adjustment technique depends on the nature of an insurance contract. An insurer shall apply judgement in determining the most appropriate technique to use for each type of insurance contract. In applying that judgement, an insurer shall also consider the following:
- (a) the technique must be implementable at a reasonable cost and in a reasonable time, and be auditable;
  - (b) the technique must provide concise and informative disclosure so that users of financial statements can benchmark the insurer's performance against the performance of other insurers. Paragraph 90(b)(i) requires disclosure of the confidence levels used for the three permitted techniques.
- B93 The following paragraphs describe when each technique is more likely to be appropriate.

### *Shape of the probability distribution*

- B94 Paragraph B72(a) states that risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity. In other words, risk adjustments will be larger for probability distributions that are more skewed.
- B95 Because a confidence level technique focuses on one point in the probability distribution, it satisfies this characteristic only if the distribution is not particularly skewed. Consequently, a confidence level technique is not appropriate for distributions that are highly skewed.
- B96 A CTE technique can satisfy this characteristic, even for skewed distributions, because it considers all outcomes above the confidence level.



- B97 Similarly, cost of capital techniques can satisfy this characteristic, even for skewed distributions, if the required capital is set at a sufficiently high level to capture almost the entire tail of the distribution.

#### *Contract duration*

- B98 Paragraph B72(b) states that, for similar risks, contracts with a longer duration will result in higher risk adjustments than those of shorter duration. The confidence level and CTE techniques achieve this to the extent that the insurer's estimate of the distribution of outcomes takes account of this factor. Cost of capital techniques achieve this in a way that explicitly reflects the changing shape of the distribution over time by applying a capital factor (rate) to the capital required during each period during the life of the contract.

#### *Width of probability distribution*

- B99 Paragraph B72(c) states that risks with a wide probability distribution will result in a higher risk adjustment than risks with a narrower distribution. A confidence level technique achieves this if the additional width of the distribution is below the selected confidence level. A CTE technique achieves this because it takes into account the entire tail. A cost of capital technique takes into account the width of the distribution when the widening of the distribution does not occur further out in the tail of the distribution than the confidence level used to estimate the required capital.

#### *Uncertainty of estimates*

- B100 Paragraph B72(d) states that the less that is known about the current estimate and its trend, the higher the risk adjustment shall be. A confidence level technique and a CTE technique could take into account this characteristic by, for example, setting a higher confidence level. A cost of capital technique could take it into account by, for example, increasing the confidence level used to estimate the required capital.

#### *Emerging experience*

- B101 Paragraph B72(e) states that to the extent that emerging experience reduces uncertainty, risk adjustments will decrease (and vice versa). All three of the techniques meet this characteristic because emerging experience will affect the loss distribution and, therefore, the amount of the risk adjustment.

B102 Thus, in summary, when the probability distribution is not skewed and does not vary significantly over time, a confidence level technique can typically provide a risk adjustment that possesses the characteristics described in paragraph B72. However, when the probability distribution is skewed or varies significantly over time, a CTE technique or cost of capital technique is more appropriate, because those approaches result in a risk adjustment that is likely to be more sensitive to the shape of the distribution of possible outcomes around the mean (and, thus, the risk) and to changes in its shape over time.

### **Risk adjustments and the use of a replicating portfolio**

B103 The requirement that a risk adjustment is included in the measurement in an explicit way (ie separately from the expected cash flows and discount rate building blocks), does not preclude a ‘replicating portfolio’ approach as described in paragraphs B45–B47. To avoid double-counting, the risk adjustment does not include any risk that is captured in the fair value of the replicating portfolio.

### **Insurance contracts acquired in portfolio transfers (paragraph 40)**

B104 Paragraph 40 requires an entity to measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of the consideration received and the present value of the fulfilment cash flows.

B105 If the consideration received is higher than the present value of the fulfilment cash flows, the excess (ie the consideration received less the present value of the fulfilment cash flows) establishes the residual margin at initial recognition (which will be recognised in profit or loss over the coverage period in accordance with paragraph 50).

B106 If the present value of fulfilment cash flows is higher than the consideration received, the excess (ie the present value of the fulfilment cash flows less the consideration received) is immediately recognised in profit or loss as an expense in accordance with paragraph 18.

B107 The following example illustrates how an entity applies this principle.

**Example 3 – Measurement of a portfolio of insurance contracts acquired in a portfolio transfer**

An insurer acquires a portfolio of insurance contracts in a portfolio transfer. The consideration received is CU30. In Example 3A, the insurer estimates that the present value of the fulfilment cash flows is CU20, which is lower than the consideration received. In Example 3B, the insurer estimates that the present value of the fulfilment cash flows is CU45, which is higher than the consideration received. At initial recognition, the insurer measures the insurance contract liability as follows:

	<b>Example 3A</b>	<b>Example 3B</b>
	<b>CU</b>	<b>CU</b>
Present value of the fulfilment cash flows	20	45
Residual margin	<u>10</u>	<u>0</u>
<b>Liability at initial recognition</b>	<b><u>30</u></b>	<b><u>45</u></b>

In Example 3A, the insurer measures the portfolio at the consideration received of CU30. As a result, the difference of CU10 between the consideration received and the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

In Example 3B, the insurer measures the portfolio at the expected present value of CU45. As a result, the difference of CU15 between the consideration received and the present value of the fulfilment cash flows is recognised as an expense at initial recognition.

**Insurance contracts acquired in a business combination (paragraph 42)**

- B108 Paragraph 42 requires an insurer to measure a portfolio of insurance contracts acquired in a business combination at the higher of the fair value of the portfolio and the present value of the fulfilment cash flows. If the present value of the fulfilment cash flows is higher than the fair value, the excess (ie the present value of the fulfilment cash flows less the fair value) would increase the initial carrying amount of goodwill recognised in the business combination.

B109 The following example illustrates how an entity applies this principle.

**Example 4 – Measurement of a portfolio of insurance contracts acquired in a business combination**

An insurer acquires a portfolio of insurance contracts in a business combination. The fair value of the portfolio is CU30. In Example 4A, the insurer estimates that the present value of fulfilment cash flows is CU20, which is lower than the fair value. In Example 4B, the insurer estimates that the present value of the fulfilment cash flows amounts to CU45, which is higher than the fair value. At initial recognition, the insurer measures the insurance contract liability as follows:

	<b>Example 4A</b>	<b>Example 4B</b>
	<b>CU</b>	<b>CU</b>
Present value of the fulfilment cash flows	20	45
Residual margin	10	0
<b>Liability at initial recognition</b>	<b>30</b>	<b>45</b>

In Example 4A, the insurer measures the portfolio at its fair value of CU30. As a result, the difference of CU10 between the fair value and the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

In Example 4B, the insurer measures the portfolio at the present value of the fulfilment cash flows of CU45. As a result, goodwill initially recognised in the business combination is CU15 higher than it would have been if the insurer had measured the portfolio at its fair value of CU30.

**Measurement of insurance contracts on transition (paragraph 100)**

B110 The transition requirements in paragraph 100 require an insurer to measure an insurance contract at the present value of the fulfilment cash flows, and to recognise any resulting adjustment in retained earnings. In addition, an insurer shall derecognise any existing balances of deferred acquisition costs and any intangible assets relating to existing insurance contracts assumed in previous business combinations with a corresponding adjustment to retained earnings. The following example illustrates how an entity applies this principle.

**Example 5 – Measurement of insurance contracts on transition**

An entity presented the following amounts in its financial statements in accordance with its previous accounting policies:

	<b>CU</b>
Deferred acquisition costs (DAC)	150
Intangible assets relating to existing contracts	125
Intangible assets relating to possible future contracts	75
Insurance contract liabilities	(900)

On the date of transition, the entity estimates that the present value of the fulfilment cash flows of its insurance liabilities is CU630. The entity also concludes that the intangible assets relating to possible future contracts are appropriately recognised and measured in accordance with IFRSs.

As a result, the entity recognises the following adjustments on the date of initial recognition:

- a decrease in insurance liabilities of CU270 (CU900 – CU630);
- a total decrease in assets of CU275 to derecognise the DAC of CU150 and the intangible assets relating to existing insurance contracts of CU125; and
- a net reduction of CU5 in retained earnings (CU275 – CU270).

## Appendix C

### Amendments to other IFRSs

The Board expects to make the amendments described below when it finalises the new standard on insurance contracts.

Standard	Description of amendment
<ul style="list-style-type: none"> <li>IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i></li> </ul>	<ul style="list-style-type: none"> <li>Delete second sentence of D4. This refers to material in IFRS 4 that is no longer relevant.</li> <li>Delete reference in IG58A to financial guarantee contracts. See draft amendment to IAS 39.</li> </ul>
<ul style="list-style-type: none"> <li>IFRS 3 <i>Business Combinations</i></li> </ul>	<ul style="list-style-type: none"> <li>Introduce a measurement exception for insurance contracts, consistent with paragraph 42 of the exposure draft.</li> </ul>
<ul style="list-style-type: none"> <li>IFRS 7 <i>Financial Instruments: Disclosures</i> and IAS 32 <i>Financial Instruments: Presentation</i></li> </ul>	<ul style="list-style-type: none"> <li>Delete the definition of financial guarantee contracts.</li> <li>Amend the scope exclusion for insurance contracts, to treat financial guarantee contracts in the same way as all other insurance contracts. At present, some requirements of IFRS 7 and IAS 32 apply to such contracts, but the proposed requirements for insurance contracts would remove the need for this.</li> <li>Introduce a scope exclusion for investment contracts with a discretionary participation feature. As a result, paragraph 29(c) of IFRS 7, which exempts entities from disclosing the fair value of these contracts, would become redundant.</li> <li>Amend example in paragraph AG8 of IAS 32 (a financial guarantee contract) so that the example provided is a financial instrument, not an insurance contract. An example could be a guarantee that requires a payment in response to changes in specified credit ratings (IAS 39, paragraph AG4(b)).</li> </ul>

<ul style="list-style-type: none"> <li>• IFRS 9 <i>Financial Instruments</i> and IAS 32 <i>Financial Instruments: Presentation</i></li> </ul>	<ul style="list-style-type: none"> <li>• Introduce a requirement to recognise and measure at fair value through profit or loss shares issued by an insurer and held as part of a pool of assets underlying unit-linked contracts.</li> </ul>
<ul style="list-style-type: none"> <li>• IAS 16 <i>Property, Plant and Equipment</i></li> </ul>	<ul style="list-style-type: none"> <li>• Introduce a requirement to measure at fair value through profit or loss property owned and occupied by the insurer that is part of a pool of assets underlying unit-linked contracts.</li> </ul>
<ul style="list-style-type: none"> <li>• IAS 36 <i>Impairment of Assets</i> and IAS 38 <i>Intangible Assets</i></li> </ul>	<ul style="list-style-type: none"> <li>• Delete the scope exclusion for deferred acquisition costs arising from insurance contracts, as such items will no longer exist.</li> </ul>
<ul style="list-style-type: none"> <li>• IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i></li> </ul>	<ul style="list-style-type: none"> <li>• Delete Example 9, which illustrates existing requirements for financial guarantee contracts, and replace it with an example illustrating the IAS 37 requirements for other guarantee obligations (such as statutory guarantees) that would continue to be within the scope of IAS 37.</li> </ul>
<ul style="list-style-type: none"> <li>• IAS 39 <i>Financial Instruments: Recognition and Measurement</i></li> </ul>	<ul style="list-style-type: none"> <li>• Delete the definition of a financial guarantee contract ('a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument').</li> <li>• Amend the scope exclusion for insurance contracts, to treat financial guarantee contracts in the same way as all other insurance contracts. Delete paragraph 47(c) on subsequent measurement of financial guarantee contracts. Update discussion of financial guarantee contracts in paragraph AG4 to reflect these changes.</li> <li>• Update paragraph AG4E(b) to reflect the use of current information in the proposed measurement model for insurance contracts.</li> </ul>

