A PUBLIC POLICY PRACTICE NOTE

Actuarial Practices Relating to Accounting for Insurance Pursuant to International Financial Reporting Standards

March 2011

American Academy of Actuaries
Members of the Life Financial Reporting Committee

American Academy of Actuaries

A PUBLIC POLICY PRACTICE NOTE

Actuarial Practices Relating to Accounting for Insurance Pursuant to International Financial Reporting Standards

March 2011

Developed by Members of the Life Financial Reporting Committee
of the American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

Practice Note on Actuarial Practices Relating to Accounting for Insurance Pursuant to International Financial Reporting Standards

This practice note is not intended to give accounting advice. Any accounting questions should be directed to those qualified to give accounting advice.

This practice note was prepared by Life Financial Reporting Committee within the Life Practice Council of the American Academy of Actuaries. The practices described here represent observations of actuaries working in the life insurance industry. Accordingly, while property-casualty and health practitioners may find portions of this practice note to be of interest they should recognize that by design, this practice note does not present observations that may be unique to property-casualty and health coverages.

This practice note is not a promulgation of the Actuarial Standards Board, is not an actuarial standard of practice, is not binding upon any actuary and is not a definitive statement as to what constitutes generally accepted practice in the area under discussion.
Events occurring subsequent to this publication of the practice note may make the practices described in this practice note irrelevant or obsolete.

This practice note primarily discusses the current accounting under the International Financial Reporting Standards (IFRS) for policyholder liabilities typically found in insurance companies operating in the United States to which IFRS applies (as described in the answer to question 2 below). As described in the "Background" section, accounting for insurance contracts under IFRS is likely to change in the future. Various proposals have been put forth for a new accounting model for insurance contracts, but both the form of such a model and the timeline for adopting it remain unresolved. This practice note, therefore, only covers current accounting (often called "Phase I" for insurance contracts) under IFRS to the extent that IFRS applies to an insurance company, and does not address the various future proposals ("Phase II"). Because IFRS continues to evolve with the addition of new pronouncements and the evolution of interpretations, practitioners are encouraged to continually review recent developments to determine whether the practices described herein remain relevant. Please address all communications to LifeAnalyst@actuary.org.

The members of the work group responsible for this practice note are:

Robert Frasca, FSA, MAAA (Chair)

Marina Adelsky, FSA, MAAA
Rod Bubke, FSA, MAAA
Ken LaSorella, FSA, MAAA
Patricia Matson, FSA, MAAA
Leonard Reback, FSA, MAAA
Mark Alberts, FSA, MAAA
Phillip Grigg, FSA, MAAA
Steven Malerich, FSA, MAAA
Nicholas Ranson, FIA, FIAA, FSA, MAAA
Douglas Robbins, FSA, MAAA

American Academy of Actuaries

1850 M Street N.W., Suite 300
Washington, D.C. 20036-5805

TABLE OF CONTENTS

A. Background

1. What is IFRS and who defines IFRS?

a. International Financial Reporting Standards (IFRS) is an international financial reporting system with an objective of providing high quality information that is transparent to users and comparable over all entities and all periods presented. The International Accounting Standards Board (IASB) is the body responsible for developing and issuing IFRS pronouncements. To the extent that IFRS is applicable, financial statements prepared in accordance with IFRS must comply with all standards and interpretations of the IASB. The authoritative literature of IFRS consists of a series of pronouncements and interpretations, including, though not necessarily limited to, the following:

i. *Statements of International Financial Reporting Standards (IFRSs)* – Standards issued by the IASB. Currently, there are eight IFRSs, plus a Preface to IFRS.

ii. *Statements of International Accounting Standards (IASs)* – Standards issued by the International Accounting Standards Committee (IASC), the predecessor body to the IASB. Some IASs have been superseded by IFRSs, but those not superseded have been adopted (and in many cases amended) by the IASB and remain in effect.

iii. *Interpretations of IASs and IFRSs* – Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) and approved by the IASB. In addition, some interpretations developed by the predecessor to IFRIC, the Standard Interpretations Committee (SIC), are still in effect.

iv. *Framework for the Preparation of Financial Statements* – Framework describing the basic concepts by which financial statements are prepared, serving as a guide to the IASB in developing accounting standards and as a guide to resolving accounting issues that are not addressed directly in an IFRS, an IAS or an Interpretation.

2. Where is IFRS required or permitted as the basis on which financial statements are prepared?

IFRS is currently required or permitted by more than one hundred countries. It is the required reporting basis for listed companies in the European Union, Hong

Kong and Australia. In Canada it will become required starting in 2011. Japan is working on a path towards convergence over time.

Currently, domestic US SEC registrants are required to use US Generally Accepted Accounting Principles (GAAP) as their basis of accounting and are not permitted to use IFRS. However, foreign private issuers are no longer required to report under US GAAP or reconcile to US GAAP if they file with the SEC using IFRS exclusively. US companies that currently apply IFRS are generally subsidiaries of non-US firms domiciled in countries where IFRS has been adopted, and which are required to prepare financial statements under IFRS by their parent company or their parent company's domiciliary jurisdiction.

3. What is the status of IFRS with respect to US accounting standards?

In 2006 FASB and IASB issued a Memorandum of Understanding that reaffirmed the Boards' shared commitment to enhance consistency, comparability and efficiency of financial reporting by developing high quality common accounting standards for use in the world's capital markets.

Several short-term international convergence projects were established jointly by FASB and IASB to achieve convergence in certain areas of financial reporting, primarily by addressing the high-quality convergence solutions achievable in the short term (usually by selecting between US GAAP and IFRS). For example, in the area of business combinations, a joint project between FASB and IASB resulted in an updated FASB Statement 141 and a revised version of IFRS 3.

4. What is the SEC roadmap for adoption of IFRS for US issuers?

On November 14, 2008, the SEC proposed a "Roadmap" for the potential use of financial statements prepared in accordance with IFRS as issued by the IASB for US issuers. The Roadmap sets forth several milestones that, if achieved, may result in the mandatory use of IFRS in financial statements filed with the SEC by US issuers beginning in 2014, 2015 or 2016, depending on the size of the issuer.

The Roadmap calls for the SEC to make a final decision in 2011 on whether it would formally propose rules that would require reporting in accordance with IFRS as issued by the IASB for US issuers. In making this determination, the SEC would need to decide whether the milestones have been achieved and whether to expand the group of companies permitted to adopt IFRS early.

On February 24, 2010, the SEC reaffirmed its commitment to convergence and announced the development of a "Work Plan" to assist the SEC in reaching a decision regarding IFRS adoption in 2011.

5. What is the IASB's two-phased approach for development of IFRS for insurance contracts, and what is its status?

In 2001, the IASB undertook an insurance contracts project to develop an IFRS for insurance contracts. Prior to standards developed as part of this project, IFRS for insurance contracts relied on local GAAP. The insurance contracts project was split into two phases because there was not enough time to develop a full standard by the time of EU's 2005 year-end deadline for the mandatory adoption of IFRS.

- Phase I was intended to develop an interim IFRS for insurance contracts, resulting in IFRS 4 Phase I issued in March 2004. IFRS 4 Phase I defines the characteristics whereby contracts are classified as "insurance contracts" as well as the interim accounting for insurance contracts until such time as a permanent standard is adopted.

- Phase II is currently in process and is intended to produce a permanent standard to provide a basis for consistent accounting for insurance contracts, ultimately replacing IFRS 4, Phase I.

The current Phase II timeline calls for an Exposure Draft of a new IFRS in April 2010 and a final IFRS in 2011. A discussion paper (DP), "Preliminary Views on Insurance Contracts," was published by the IASB in 2007, proposing "exit value" as the fundamental measurement framework for insurance contracts. Since that time, various discussions have been held and exit value may not be the measurement objective that is included in the exposure draft.

The FASB joined the IASB's insurance contracts project in October 2008 and will participate in development of a permanent IFRS for insurance contracts. In February 2009 FASB held its first public board meeting discussing the insurance contracts project which primarily referred to the IASB discussion paper described above.

This practice note addresses Phase I reporting only. A separate practice note will address Phase II developments after that phase is completed.

6. What IFRS pronouncements are most likely to impact insurance entities?

The IFRS pronouncements, and their predecessor IAS pronouncements, appear to be far-reaching, addressing financial statement reporting, presentation, and disclosure for all types of reporting entities. Many of the IFRS and IAS pronouncements appear to be broadly applicable, and apply to insurance entities as well as other companies. The *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in April 2001,and the *Preface to International Accounting Standards*, adopted by the IASB in April 2002, provide overall guidance for all companies regarding the application of IFRS, and provide important background to all of the IFRS pronouncements. Other pronouncements

that specifically relate to contracts between insurance companies and their policyholders include, but may not be limited to: *IFRS 4 Insurance Contracts*; *IAS 39 Financial Instruments: Recognition and Measurement*; *IAS 18 Revenue*; *IAS 32 Financial Instruments: Presentation*; *IFRS 7 Disclosure*; and *IFRS 3 Business Combinations*.

7. What other resources are available to help understand IFRS as applied to insurance companies?

The International Actuarial Association (IAA) has established a set of International Actuarial Standards of Practice (IASPs) to provide non-authoritative assistance to practicing actuaries in applying IFRS. These IASPs have been published as "Practice Guidelines", meaning they are educational and non-binding in nature. They represent a statement of appropriate practices, but do not necessarily define practices that would be utilized by all actuaries. The IASPs relating to IFRS, referenced throughout this practice note, are and include the following:

IASP 2 – Actuarial Practice
IASP 3 – Classification of Contracts
IASP 4 – Measurement
IASP 5 – Current Estimates
IASP 6 – Liability Adequacy Testing
IASP 7 – Discretionary Participation Features
IASP 8 – Changes in Accounting Policies
IASP 9 – Accounting for Reinsurance Contracts
IASP 10 – Embedded Derivatives and Derivatives
IASP 11 – Business Combinations
IASP 12 – Disclosure of Information about Insurance Contracts
Glossary

B. Classification of Contracts under IFRS

8. What are the IFRS pronouncements that cover policyholder liabilities and assets?

The following pronouncements apply directly to insurance contracts typically issued by insurance entities to which IFRS is applicable. Other pronouncements may apply as well.

IFRS 4 Insurance Contracts – defines "insurance contracts", specifies Phase I accounting for insurance contracts and for contracts with discretionary participation features, and establishes rules regarding Accounting Policies and Changes in Accounting Policies for insurance contracts.

IAS 39 Financial Instruments: Recognition and Measurement – specifies accounting for financial instruments, including financial instruments issued by insurance entities which do not meet the definition of insurance contracts under IFRS 4. As of the end of 2009, IAS 39 was in the process of being replaced by IFRS 9. IFRS 9 is being adopted in stages, so portions of IAS 39 will continue to be effective until IFRS 9 is fully adopted.

IAS 18 Revenue – specifies revenue and expense recognition, including acquisition costs, for standalone service contracts and service components of financial instruments.

IAS 32 Financial Instruments: Presentation – provides guidance for determining whether a contract is a financial instrument.

IFRS 3 (R) Business Combinations – specifies accounting for acquisitions, including intangible assets, and contains requirements similar to SFAS 141(R) in US GAAP.

9. What is the process for classifying contracts under IFRS?

Under IFRS, contracts issued by insurance companies typically fall into one of three classes: (1) insurance contracts; (2) financial instruments;, and (3) service contracts. Contracts may contain multiple components that fall into different classes, and for which unbundling of the components may be allowed or required. The process and requirements for classification of contracts issued by insurance companies and their components are defined by IFRS 4.

IASP 3 provides non-authoritative information on this issue and states the following:

While there are some exceptions, the general process of classification normally includes the following steps:

a. *Obtain relevant information.*
b. *Definition of a contract for accounting purposes — Consider whether to separate or combine contracts for accounting purposes.*
c. *Classification of stand-alone service contracts — Consider whether the contract creates financial assets or liabilities for the reporting entity in which case it may be a financial instrument, rather than solely requiring the entity to provide services for a fee.*
d. *Classification as an insurance contract — Determine if the contract contains significant insurance risk. If yes, then the contract is an insurance contract and IFRS 4 applies.*
e. *Classification as an investment contract — If it is not insurance, determine if the contract is a financial instrument (e.g., it creates financial liabilities, equity instruments, or financial assets). If yes, then*

the contract is an investment contract. If no, the contract is a service contract and IAS 18 applies.

f. Discretionary Participation Features (DPF) — If the contract is an investment contract, determine if the contract contains a DPF. If yes, then IFRS 4 and IAS 32 are applicable. If no, then IAS 32 and IAS 39 apply.

g. Service Component — If IAS 39 is applicable, determine if the contract contains a service component. If yes, then acquisition and other servicing expenses related to the service component and related earnings are accounted for under IAS 18. The rest of the contract is accounted for under IAS 39.

h. Embedded derivatives — For insurance contracts, investment contracts, and service contracts, determine if the contract contains an embedded derivative. If an embedded derivative is included, determine if that component is already measured at fair value or if it is closely related to the host contract. If neither of these conditions is satisfied, separation might be required. In case of an embedded derivative special disclosure might be required under IFRS 4.

i. *Unbundling of a contract into components — For insurance contracts, determine if unbundling of a deposit component is required or permitted by the accounting guidance. If unbundled into deposit and insurance components, the deposit component is accounted for under IAS 39 and the insurance component is accounted for under IFRS* 4.

More detailed, non-authoritative information to assist actuaries regarding each of these steps is provided in IASP 3, including a decision tree that walks through the step-by-step decision process.

10. What is a "financial instrument" under IFRS?

IAS 32.11 defines a financial instrument as "any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity." Financial instruments include both financial assets and financial liabilities, but not service contracts.

Financial assets and financial liabilities are defined in IAS 32, and are summarized in the following table:

Financial Asset	**Financial Liability**
Cash	
Equity instrument of another entity	
Contractual right to receive cash or other financial asset	Contractual obligation to pay cash or other financial asset
Contractual right to exchange financial assets/liabilities under potentially advantageous conditions	Contractual obligation to exchange financial assets/liabilities under potentially disadvantageous conditions
Non-derivative contract under which	Non-derivative contract under which

the entity is or may be obliged to receive a variable number of its own equity instruments	the entity is or may be obliged to deliver a variable number of its own equity instruments
Derivative contract that will or may be settled in the entity's own equity instruments AND which will or may be settled other than by exchange of a fixed amount of cash or other financial instruments for a fixed number of the entity's equity instruments.	Derivative contract that will or may be settled in the entity's own equity instruments AND which will or may be settled other than by exchange of a fixed amount of cash or other financial instruments for a fixed number of the entity's equity instruments.

11. How is an "investment contract" defined under IFRS?

IFRS 4, paragraph BC22, footnote 12 states that "'(i)nvestment contract is an informal term referring to a contract issued by an insurer that does not expose the insurer to significant insurance risk and is therefore within the scope of IAS 39."

Furthermore, IFRS 4, paragraph BC185 defines "investment contracts" as "financial instruments that do not transfer enough insurance risk to qualify as insurance contracts."

An investment contract falls within the scope of IAS 32 and IAS 39 except if it contains a discretionary participation feature. In that case, it is subject to IFRS 4 and IAS 32. See question 20 for further discussion on discretionary participation features.

Deferred annuities, both fixed and variable, that do not provide for guaranteed annuitization options, or for which these options are not significant, and do not contain significant mortality or morbidity risk would be classified as investment contracts. Payout annuities without life contingencies are classified as investment contracts since they do not contain significant insurance risk.

12. How is an "insurance" contract defined under IFRS?

As referenced in Question 8 above, IFRS 4 defines an insurance contract as "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder…."

A policyholder is defined as a person who controls the right to the compensation. A policyholder can be either an individual person or a legal entity such as a corporation or non-profit organization.

An insurance contract must specify at least one insured event that could trigger a benefit resulting from a legal obligation. The benefit can be uncertain as to its

occurrence, amount or timing. The uncertainty must be present at the individual contract level and be the result of risks other than financial risk. Appendix B of IFRS provides additional detail around the definition of "insurance."

Uncertainty is often exhibited in traditional life insurance contracts because the timing of the event (death) is uncertain. Uncertainty may be seen in health and disability insurance contracts because the occurrence, amount and timing of claims are all uncertain. Payout annuities with life contingencies may also exhibit uncertainty because the timing of benefits is uncertain.

Deferred annuities, both fixed and variable, with guaranteed annuitization options that result in significant mortality risk may be classified as insurance, which may result in an accounting treatment different from US GAAP.

13. How are a "service contract" and a "service component" defined under IFRS?

A service contract is one in which there is an obligation to render a service(s) but does not create financial assets or liabilities and does not transfer insurance or financial risk.

Stand-alone service contracts are those in which there is no financial asset or liability, but services are performed for a fee. A service component is a component of an investment contract or insurance contract that does not create a financial asset or a financial liability. If an investment contract contains a service component, revenues and expenses associated with the service component are unbundled and accounted for under IAS 18. However, under IFRS 4, service components are not unbundled from insurance contracts.

Examples of stand-alone service contracts are those that provide for policy or claim administration or investment management services but do not create a financial asset or liability. An example of a service component would be the payment of management fees to a mutual fund for investment management services as part of a variable universal life contract.

14. What is the difference between "insurance" risk and "financial" risk?

The distinction between insurance risk and financial risk is addressed authoritatively by paragraphs B8-B17 of IFRS 4. Additional non-authoritative information to assist actuaries is available in Section 4.5 of IASP 3.

Financial risk is the risk of a future change in a price or value of an asset due to changes in financial variables (e.g., interest rates) or due to changes in non-financial variables that are NOT specific to the policyholder (e.g., oil supply).

Insurance risk, on the other hand, arises from changes in non-financial variables that ARE specific to the policyholder (e.g., the occurrence or nonoccurrence of a fire that damages or destroys an asset of that party). In addition, the risk of change to the fair value of a non-financial asset is insurance risk if the change reflects the condition of the asset held by the policyholder (a non-financial variable) in addition to the change in market values for such assets (a financial variable). A typical variable annuity guaranteed minimum death benefit transfers insurance risk because the trigger event (the policyholder's death) is a non-financial variable specific to the policyholder. Conversely, a typical equity put option transfers only financial risk because it protects against changes in financial variables with no triggering event that is non-financial and policyholder-specific.

Insurance risk is a pre-existing risk transferred from the policyholder to the insurer. A new risk created by the contract (e.g., risk arising from surrender charges) is not insurance risk.

Both insurance risk and financial risk may be transferred by an insurance contract.

An equity-indexed annuity crediting guarantee is an example of financial risk transfer, because it depends on a financial variable. A variable annuity guaranteed minimum death benefit is an example of insurance risk transfer, because it depends on a policyholder specific non-financial variable (death of the policyholder). Waiver of surrender charge at death on a deferred annuity does not transfer risk, because the surrender charge is created by the contract.

15. What is meant by "significant insurance risk?"

Under IFRS, a contract is an insurance contract only if the insurance risk transferred by the contract is "significant." Significance of insurance risk is addressed authoritatively by paragraphs B22-B28 of IFRS 4. Additional non-authoritative information to assist actuaries is available in Section 4.5.3 of IASP 3.

The significance of insurance risk is determined on a contract-by-contract basis and depends on two factors: 1) scenarios must exist under which the additional benefits provided if the insured event occurs are significant compared to the benefits provided if the insured event does not occur; and 2) such scenarios must have "commercial substance." A scenario has commercial substance if it has a discernible effect on the economics of the transaction.

This definition of significant insurance risk is generally more inclusive than insurance risk transfer concepts found in U.S. GAAP. U.S. GAAP principles are often interpreted to require that there is a reasonable possibility of a significant loss to the assuming entity, calculated at present value from the ceding entity's perspective. However, under IFRS, one need only demonstrate that the additional benefits are significant in a single, commercially substantive scenario.

16. What types of tests are used in practice to determine whether insurance risk is "significant?"

Section 4.5.3 of IASP 3 provides the following, non-authoritative information to assist actuaries. "Significance is normally determined by assessing the greatest difference between economic value of benefits payable under the contract, assuming one possible insured event, and the economic value of benefits payable under any other single scenario with commercial substance determined at outset. In cases where the additional benefit also depends on a contingency other than an insurance risk (a double trigger contract), the additional benefit qualifies the contract as insurance if the greatest additional benefit payable in a scenario of commercial substance is significant." A variable annuity GMDB is an example of such a double trigger concept, where the death benefit depends upon unfavorable investment results for the variable annuity, in addition to the death of the insured individual.

While there is no "bright line" test of significance under IFRS, practice is emerging to give some sense of where the threshold of "significance" may lie. For example, a death benefit that provides an insignificant marginal benefit (e.g., 101% of the account value otherwise available for withdrawal) to a policyholder may generally not be deemed to constitute significant insurance risk.

17. How does the definition of insurance under IFRS differ from the definition under US GAAP?

One difference is that primarily IFRS requires only a single, plausible scenario in which there is a significant loss for the policyholder compensated by the insurance company. While there is no prescriptive definition under US GAAP, the definition typically relies on there being material insurance loss under a range of plausible scenarios. For example, the definition of insurance under SOP 03-1 relies on present values of loss measured over a range of scenarios. FAS 97 and FAS 113 (for reinsurance) also provide guidance about what constitutes insurance under US GAAP.

18. What are some examples of contracts that might be classified as insurance under IFRS but not under US GAAP, and *vice versa*?

Under IFRS, fixed deferred annuities issued in the US would typically be insurance, because of the annuitization options which have commercial substance. Under US GAAP, such contracts are typically defined as "investment" contracts because the annuitization phase is deemed to be a separate contract that does not impact the classification of the underlying deferred annuity. Also, a reinsurance contract that takes on lapse risk is commonly deemed to be "insurance" for IFRS. Under US GAAP, persistency may be interpreted not to meet the definition of insurance risk under SFAS 113.

Typically, if a contract is classified as insurance under US GAAP, it will be classified as insurance under IFRS.

19. Can a contract ever be reclassified under IFRS based on changes occurring after issue?

Yes. If the level of insurance risk in a contract that had previously not qualified as an insurance contract becomes significant, the contract is reclassified as an insurance contract.

However, in IFRS 4, Appendix B, B30, "a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations extinguish or expire." This is true even if the insurance risk is eliminated. So, for example, if an annuity with payments certain for 10 years and life thereafter is deemed an insurance contract at issue, then it will remain an insurance contract even if the primary annuitant dies and the payments become certain for the remainder of the life of the contract.

20. As defined under IFRS, **what is a discretionary participation feature in an insurance contract or an investment contract?**

A Discretionary Participation Feature (DPF), as defined in Appendix A of IFRS 4, is a policyholder's contractual right to receive certain supplemental benefits in addition to the guaranteed benefits under the contract. In order to be considered a DPF, the additional benefit must satisfy three conditions. The additional benefit must be:

- Likely to be a significant portion of the total contractual benefits;
- Contractually at the discretion of the issuer, in timing or amount; and
- Contractually based on: 1) the performance of a specified pool of contracts or a specified type of contract; 2) the investment returns on a specified pool of assets held by the issuer; or 3) the profit or loss of the company, fund or other entity that issues the contract.

A typical example of a DPF in an insurance contract is the dividend provision of a participating contract that follows the contribution principle. The amounts of such dividends are typically at the discretion of the insurer, but are based on the performance of a specific class of policies, meeting the definition above. Note that the interest crediting provision of a fixed deferred annuity or universal life contract in the U.S. is typically not a DPF because it does not meet the third condition (i.e., the declared rate is not contractually tied to performance of a specified pool of contracts, a specified pool of assets, or the entity's profit or loss).

Investment contracts with DPFs are not common in the U.S. market.

IFRS 4, paragraphs 34 and 35 provide authoritative guidance regarding treatment of DPFs in insurance contracts and DPFs in financial instruments, respectively. Additional non-authoritative information to assist actuaries is available in IASP 7. See question 41 for discussion of the accounting treatment of DPFs.

C. Accounting for Insurance Contracts

21. What is the first step in determining the accounting under IFRS for a contract that has been classified as an insurance contract?

After determining that a contract is an insurance contract, a determination would typically be made as to whether it contains a financial component—either an embedded derivative that needs to be bifurcated or a deposit component that needs to be unbundled. Refer to section D, Accounting for Derivatives, and section E, Accounting for Investment Contracts, in this practice note, for further information on accounting for financial components.

22. What is unbundling?

IFRS 4, Appendix A defines "unbundling" as "account(ing) for the components of a contract as if they were separate contracts." The term is explicitly applied in IFRS 4 to the practice of separating a contract into an "insurance component" and a "deposit component" for the purpose of measuring each separately. However, some people apply the term more generally and use it to refer to other situations, such as when a service contract is separated from an investment contract or an embedded derivative is separated from a host contract.

By unbundling, the insurance component of a contract is accounted for under IFRS 4 and a deposit component is accounted for under IAS 39.

23. Under what circumstances must a contract be unbundled, and under what circumstances does an insurer have the option to unbundle a contract?

According to IFRS 4, paragraph 10, an insurance contract must be unbundled if it contains a deposit component that can be measured without considering the insurance component and the insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.

An insurance contract may be unbundled if it contains a deposit component that can be measured without considering the insurance component (as above) but its accounting policies already require it to recognize all obligations and rights arising from the deposit component.

Though not technically referred to as "unbundling" in the literature, a contract must also be separated into components if it contains an embedded derivative that is not itself an insurance contract, except for a cash surrender option that is not

triggered by and does not vary by a change in a financial variable. This situation is covered in IAS 39 and is addressed separately in question 45 of this practice note.

IASP No. 3, paragraph 4.10, contains additional, non-authoritative information about unbundling of contracts.

Examples of common US products that typically contain deposit components include deferred annuities and universal life contracts. However, these products are unlikely to require unbundling under IFRS 4 when the current accounting policy follows US GAAP since current US GAAP accounting requires insurers to recognize all obligations and rights arising from the deposit components within these contracts. For example, in a universal life contract with a secondary guarantee, the combination of FAS 97 and SOP 03-1 contains accounting guidance for both the basic product and its guarantees and options.

Service components of insurance contracts are not required to be unbundled under IFRS.

24. How is it determined if an insurance contract has a deposit component that can be measured without considering the insurance component of the contract?

A deposit component is defined rather broadly, including any amount available to the policyholder in a form other than an insurance benefit (e.g., a surrender value) or any amount for which a current value can be determined from an accumulation of past activity.

IASP No. 3, paragraph 4.10.1 contains non-authoritative information on unbundling a deposit component from an insurance contract and paragraph 4.10.2 contains non-authoritative information on unbundling an insurance component from a non-insurance contract.

IASP No. 9, paragraph 4.6 includes non-authoritative information on unbundling deposit components of reinsurance contracts. This information may also be useful in considering the unbundling requirements of other insurance contracts.

Two common deposit components found in US insurance contracts are traditional life cash values and universal life account values. Most US companies would not consider unbundling these components because they are already fully recognized under US GAAP (in FAS 60 for the traditional life cash values and in FAS 97 for the universal life account values).

25. What are some examples of insurance contracts that have deposit components that must be measured separately from the insurance contract?

As noted in question 24, if an insurer's current accounting policies require it to recognize all obligations and rights arising from the deposit component associated with a contract, then unbundling is not required (although it is permitted).

Whether a deposit component must be measured separately is, therefore, partly dependent upon an insurer's current accounting policies.

One example of a deposit component that might have to be measured separately is a side fund established to pay future premiums on an insurance contract or a reinsurance contract.

IFRS 4, paragraph 11 includes another example: A cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay the compensation in future years. In this case, the contract effectively establishes a deposit account with no insurance risk.

Implementation Guidance accompanying IFRS 4 (IG Example 3) illustrates the unbundling of an experience account associated with a reinsurance contract.

26. How is an embedded derivative within an insurance contract identified and what accounting rules apply?

In essence, embedded derivatives are terms of a contract or instrument that behave like a derivative. Specifically, IAS 39 states that "an embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract — with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative." IAS 39 also provides the definition of a derivative that is applicable when considering the existence of embedded derivatives (see section D of this practice note for further details).

The identification of embedded derivatives within insurance contracts therefore involves an examination of the cash flows arising under these contracts, with consideration given to whether any of these cash flows meet the definition of a derivative under IAS 39.

Embedded derivatives within insurance contracts that meet certain requirements may need to be separated from their host contracts and valued in accordance with the provisions of IAS 39. Some exceptions to this include embedded derivatives that are themselves insurance contracts, and also a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

Further discussion regarding the requirements to separate embedded derivatives from their host contracts and the approach to value them under Phase 1 is included in section D of this practice note.

27. What rules are used to measure insurance contracts or the insurance component of an unbundled contract under Phase 1?

For Phase 1, insurance contracts are valued using IFRS 4 *Insurance Contracts*, which was first issued by the IASB in March 2004. IFRS 4 is also applicable to

financial instruments that contain a discretionary participation feature (as discussed below).

Under IFRS 4, insurance contracts (and the insurance components of unbundled contracts) are accounted for using the entity's existing accounting policies, together with a liability adequacy test. If the liability adequacy test shows that the carrying amount of insurance liabilities (less related deferred acquisition costs and intangible assets) is inadequate, the deficiency must be recognized in profit or loss.

For US companies, existing accounting policies will typically default to US GAAP so that insurance contracts continue to be valued based on the relevant US GAAP guidance. In certain instances (discussed below) insurers may be permitted to change their existing accounting policies for insurance contracts so that US companies may sometimes use an approach that differs from US GAAP.

However, with a small number of possible exceptions (discussed below), there is no requirement for companies to alter their existing accounting policies for insurance contracts. For instance, where an asset for deferred acquisition costs (DAC) is currently permitted under US GAAP, this practice could continue to be allowed under IFRS 4.

For companies applying US GAAP prior to application of IFRS 4, most practices may be continued under IFRS 4, although such practices may not be newly introduced upon the application of IFRS 4. This is further discussed below in questions 38 and 39.

Even where existing accounting policy are permitted to be applied to insurance contracts upon the application of IFRS 4, it may be necessary to alter some elements because of indirect effects of other accounting standards. For example, amortization of deferred acquisition costs under FAS 97 is a function of estimated gross profits, which are dependent on asset performance. Under IFRS, accounting for assets is subject to IAS 39. Asset performance may, therefore, be different under IFRS than under US GAAP.

28. What is meant by existing accounting policies?

"Existing accounting policy" refers to the accounting policy that the company was following prior to the application of IFRS to such company. For example, if a company had been following the accounting requirements of Country A's insurance regulators ("Country A stat") for the purpose of its GAAP filings in Country B and Country B's financial regulators adopted IFRS to replace the GAAP standard in Country B, then the company's existing accounting policy for the purpose of the Country B GAAP filings under IFRS would be Country A stat.

For companies that are reporting under US GAAP for a particular purpose at the time of adoption of IFRS, US GAAP will be the existing accounting policy under IFRS for that purpose.

29. What happens if the rules for the accounting basis that a company uses to account for insurance under IFRS (i.e., the "existing" accounting basis when the company adopts IFRS) change subsequent to the company adopting IFRS?

There are at least two potential ways observed in practice of addressing changes in accounting rules associated with an accounting basis that has been adopted by a company for accounting for insurance under IFRS.

One way is to follow such changes as they are implemented for the accounting basis.

The other way is to interpret the "existing" accounting basis to be frozen at the time of IFRS adoption and not to follow subsequent modifications to such basis.

Some companies believe that it is appropriate to disclose any differences between the accounting basis as currently constituted and the accounting basis as frozen for IFRS purposes.

30. What are the modifications to existing accounting policies that are either allowed or mandated when accounting for an insurance contract?

Under IFRS 4, paragraph 22, "An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs."

Paragraphs 23-30 address specific issues relating to:

- Current market interest rates: "An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities to reflect current market interest rates and recognizes changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities."
- Continuation of existing practices: An insurer may continue certain specified practices but the introduction of any of them does not satisfy the conditions of IFRS paragraph 22 as outlined above. (See questions 38 and 39 for more on this.)
- Prudence: "An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence."
- Future investment margins: "An insurer need not change its accounting policies for insurance contracts to eliminate future investment margins. However, there is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the

measurement of insurance contracts, unless those margins affect the contractual payments."

- Shadow accounting: "An insurer is permitted, but not required, to change its accounting policies so that a recognized but unrealized gain or loss on an asset affects those measurements in the same way that a realized gain or loss does."

Paragraphs 14-20 address specific requirements (liability adequacy test; when to remove a liability; and impairment of reinsurance assets) and prohibitions (liability for possible future claims on contracts that do not yet exist; offset of reinsurance assets and income items against the related insurance liabilities and income items). These are discussed further below.

31. What is the liability adequacy test for insurance contracts?

The liability adequacy test is intended to help ensure that the liabilities calculated using existing accounting policies are not understated and that related amounts recognized as assets (such as deferred acquisition costs and intangible assets) are not overstated. The test is based on comparing the assets and liabilities determined under existing accounting policies with the value of current estimates of future cash flows.

If an insurer's accounting policies already incorporate a liability adequacy test that meets certain minimum requirements set out in IFRS 4, then insurance contract accounting simply follows existing accounting policies. The minimum requirements, as set out in paragraph 16 of IFRS 4, are:

> *"(a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.*
>
> *(b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss."*

However, if existing accounting policies do not incorporate a liability adequacy test, or they incorporate a test that does not meet these minimum requirements, then the liability adequacy test defined in paragraph 17 of IFRS 4 must be applied in addition to existing accounting policies. This test requires an insurer to compare the insurance liabilities calculated under existing accounting policies (less related deferred acquisition costs and intangible assets) with the amount that would be required if the liabilities were within the scope of IAS 37. Any deficiency must be recognized in profit or loss, and the insurer must decrease the carrying amount of the related deferred acquisition costs or intangible assets or increase the carrying amount of the insurance liabilities.

Actuaries may find section 4.1 of IASP 6 to be a useful source of non-authoritative reference information in this area.

32. How frequently should liability adequacy testing be performed?

Regardless of whether the liability adequacy test is based on existing accounting policies or IAS 37, it must be considered at the end of each reporting period under IFRS. For in force business, liability adequacy testing is typically performed annually unless significant events or changes indicate that the previous test may need to be updated.

33. What level of grouping is appropriate within a liability adequacy test?

If an insurer's accounting policies incorporate a liability adequacy test that meets the minimum requirements described above, the test may be applied at the level of aggregation specified in the existing accounting policies.

Alternatively, if an insurer is required to apply the liability adequacy test described in paragraph 17 of IFRS 4, the comparison, "shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio."

34. How should reinsurance be allowed for within a liability adequacy test?

If an insurer is required to apply the liability adequacy test described in paragraph 17 of IFRS 4, then related reinsurance assets should not be considered because the insurer must account for them separately (as stated in paragraph 17(a)(ii)).

Alternatively, if an insurer's accounting policies incorporate a liability adequacy test that meets the minimum requirements described above, the requirements of IFRS 4 are less clear. However, given that reinsurance is generally accounted for separately within IFRS 4, many practitioners assume that the liability adequacy test should also be performed on a gross of reinsurance basis. Though non-authoritative, IASP 6 paragraph 4.1.9 appears to provide additional support for this view.

35. How should an insurer deal with impairment of a reinsurance asset?

Under certain circumstances relating to the impairment of a reinsurance asset, an insurer is required to reduce the carrying amount of that asset and recognize the impairment in profit or loss. Specifically, paragraph 20 of IFRS 4 states that:

> *"20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:*
>
> *(a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and*
>
> *(b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer."*

36. How does the liability adequacy test differ from a premium deficiency test under US GAAP?

As explained above, if an insurer's accounting policies already incorporate a liability adequacy test that meets certain minimum requirements set out in IFRS 4, then insurance contract accounting simply follows existing accounting policies.

US GAAP premium deficiency (loss recognition) testing, as defined in FAS 60, generally meets the minimum requirements as it includes current estimates of all contractual cash flows.

Paragraph 16 of IFRS 4 states "if the test shows that the liability is inadequate, the entire deficiency is recognized in profit or loss." This is also the requirement for contracts classified as insurance contracts under US GAAP, whether within FAS 60 or FAS 97. However, for contracts classified as investment contracts under US GAAP and insurance contracts under IFRS (e.g., deferred annuities classified as FAS 97 investment contracts), the maximum loss to be recognized under US GAAP may be limited to unamortized DAC (i.e., base US GAAP reserves for investment contracts cannot exceed policyholder account value balances). In those circumstances where the entire deficiency, as determined by the loss recognition test, is not fully recognized due to limitations imposed by US GAAP rules, the resulting limited loss recognition may be out of compliance with IFRS requirements and an additional liability would need to be recorded for IFRS purposes.

The question of whether the US GAAP loss recognition test meets the minimum requirements of paragraph 16 of IFRS 4 needs to be decided on a case by case basis (depending on the consolidation level of loss recognition testing performed, expense allocation method, etc.). However, commonly the tests applied for insurance contracts under US GAAP would appear to satisfy the IFRS requirements.

37. What are some practices prohibited under IFRS 4?

IFRS 4 prohibits insurers from recognizing liabilities for possible future claims under contracts that are not in existence at the end of the reporting period (such as catastrophe and equalization provisions). It also prohibits companies from offsetting reinsurance assets against related insurance liabilities, or income and expenses from reinsurance contracts against the expense or income from the related insurance contracts. These practices are also typically prohibited under US GAAP.

38. What prior practices may continue under IFRS?

Under IFRS 4, an insurer may continue the following practices, but is prohibited from introducing them after adoption or application of IFRS:

a. measuring insurance liabilities on an undiscounted basis;

b. measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services; or

c. using non-uniform accounting policies for the insurance liabilities of subsidiaries.

In addition, IFRS 4 states that

- *"An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence."*
- *"An insurer need not change its accounting policies for insurance contracts to eliminate future investment margins. However, there is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts, unless those margins affect the contractual payments. … An insurer may overcome the rebuttable presumption … if, and only if, the other components of a change in accounting policies increase the relevance and reliability of its financial statements sufficiently to outweigh the decrease in relevance and reliability caused by the inclusion of future investment margins."*

39. Which of the practices in Q38 are currently used under US GAAP?

a. Measuring insurance liabilities on an undiscounted basis is the standard practice for property-casualty and short-duration health contracts;

b. Measuring contractual rights to future investment management fees at an amount that exceeds their fair value, as implied by a comparison with current fees charged by other market participants for similar services, may occur when US GAAP best estimate assumptions related to discount rates or to future investment management fees specific for a certain entity are more favorable than fair value market assumptions; and

c. Generally, under US GAAP, using non-uniform accounting policies for the insurance liabilities of subsidiaries does not occur, except for some specialized accounting for subsidiaries.

40. What if a contract is classified as "insurance" under existing accounting policies but as "investment" under IFRS, or *vice versa*?

Regardless of the classification of a contract under existing accounting policies, an insurer must determine whether the contract meets the definition of an insurance contract as set out in Appendix B of IFRS 4. If it does, it must be

accounted for as an insurance contract in accordance with the requirements of IFRS 4. Similarly, if a contract meets the definition of a financial instrument with a discretionary participation feature, it must be accounted for in accordance with IFRS 4.

Some diversity of practice may occur if a contract is classified as an insurance contract under IFRS but as an investment contract under US GAAP. If US GAAP is the existing accounting framework used by a company, then many believe that the US GAAP accounting consistent with its US GAAP classification as an investment contract would apply. This is the most common view and is supported because, as an insurance contract subject to IFRS 4, accounting for the contract would revert to the US GAAP accounting appropriate for that contract. An alternative view holds that because the contract is deemed to be an insurance contract under IFRS, accounting consistent with some form of insurance accounting under US GAAP would be appropriate.

If a contract does not meet the definition of an insurance contract under IFRS 4, it will not be accounted for as an insurance contract, regardless of its classification under existing accounting policies. In this case, if the contract did not contain any discretionary participation features, but met the definition of a financial instrument, it would be accounted for under IAS 39.

In some instances, this may result in the classification of contracts changing between existing accounting and IFRS. Where this is the case, additional work may be required to value the contracts, particularly where:

- a contract is classified as an insurance contract under existing accounting but classified as an investment contract under IFRS (this is rarely, if ever, encountered if the existing accounting basis is US GAAP); or
- a contract becomes an insurance contract under IFRS but the insurer's existing accounting policies either do not incorporate a liability adequacy test that meets the minimum requirements set out under IFRS 4 or violate the prohibitions discussed above.

41. What rules are used to measure investment contracts with discretionary participation features under IFRS?

As noted above, IFRS 4 also applies to financial instruments that contain a discretionary participation feature (DPF). As such, these contracts are also accounted for using existing accounting, together with a liability adequacy test. The tests required depend on whether the insurer classifies the DPF as a liability or a component of equity.

If an insurer classifies the entire DPF as a liability then the standard liability adequacy test described above must be applied to the whole contract (i.e., both the guaranteed element and the discretionary participation feature). This test may be based on either the insurer's existing accounting policies or IAS 37 as outlined above.

If an insurer classifies part or all of the DPF as a component of equity, then it is also required to ensure that the liability recognized for the whole contract is not less than the amount that would result from applying IAS 39 to the guaranteed element of the contract.

Further details regarding accounting for investment contracts with DPFs is provided in section E of this practice note. Note that investment contracts with DPFs are not commonly found in the US.

D. Accounting for Derivatives

42. How are derivatives defined under IFRS?

Paragraph 9 of IAS 39 defines a derivative as a financial instrument (or a contract otherwise within the scope of IAS 39) that has all three of the following characteristics:

a. Its value changes in response to an "underlying." An underlying could be a specified interest rate, the price of a financial instrument or commodity, a foreign exchange rate, a credit rating or index, or a price or rate index. An underlying can also be another variable, with the exception of a non-financial variable that is specific to a party to the contract.

b. It requires either no initial net investment or an initial investment smaller than the investment that would be required for other contracts that would be expected to respond similarly to market factors.

c. It is settled at a future date.

43. How are embedded derivatives defined under IFRS?

Paragraph 10 of IAS 39 defines an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative." For example, an embedded derivative would cause some of the cash flows in the contract to be modified based on a specified interest rate, a financial instrument price, or some other underlying.

44. How do the definitions of "embedded derivative" and "derivative" differ from the definitions under US GAAP?

The definition of "embedded derivative" under IFRS is very similar to the definition of "embedded derivative" under US GAAP, as defined by paragraph 12 of FAS 133. The only meaningful distinction in the definition of "embedded derivative" under IFRS vs. US GAAP lies in the definition of the word "derivative," as discussed further below.

Under US GAAP, paragraph 6 of FAS 133 defines "derivative" in a manner that also requires three characteristics. However, there are differences to the first and third characteristics. Under US GAAP, characteristic (a) requires both an "underlying" and a "notional amount." This typically is not considered to be a material distinction. More significantly, under US GAAP characteristic (c) does not just require settlement at a future date. To qualify as a derivative under US GAAP, an instrument must require or permit "net settlement." That is, the instrument can "readily be settled net by means outside the contract."

The requirement for "net settlement" under US GAAP precludes certain instruments that could be accounted for as derivatives under IFRS from being accounted for using derivative accounting in FAS 133 under US GAAP. One common example for insurance companies is a guaranteed minimum income benefit (GMIB). Such benefits typically fail the net settlement criteria under US GAAP, because the proceeds are invested into a new contract (an annuity) that is only settled in such a way that they cannot be directly converted to cash. Conversely, under IFRS, the settlement of the guarantee with non-life contingent annuity payments likely would satisfy the criteria for derivative accounting and render at least a portion of the guarantee subject to fair value measurement through profit and loss (but see an alternative view discussed in Question 49).

45. When do embedded derivatives need to be bifurcated under IFRS?

Per paragraph 11 of IAS 39, an embedded derivative needs to be bifurcated and reported as a derivative separately from the host contract if all three of the following conditions are met.

a. the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract;

b. a separate instrument with the terms of the embedded derivative would be defined as a derivative under the IAS 39 definition; and

c. the hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in net income (profit or loss in IFRS terminology).

These three criteria are the only items to consider in determining whether to bifurcate an embedded derivative from an investment contract. IFRS 4 requires bifurcation from an insurance contract, given those three conditions, plus two additional stipulations: (1) the embedded derivative itself is not also an insurance contract, and (2) the guarantee in question is not a standard surrender value guarantee. These criteria are similar to those given for bifurcation under US GAAP (FAS 133 paragraph 12), except that under US GAAP criterion (a) requires the embedded derivative to be "clearly and closely related" to the host,

not merely "closely related." This distinction in wording is believed by many practitioners to be inconsequential.

Although an embedded derivative within an insurance contract does not need to be bifurcated in these two instances, according to IFRS 4 paragraph 39(e), its existence does need to be disclosed.

46. How are derivatives accounted for under IFRS?

Under IFRS, most derivatives are reported at fair value, with changes in fair value reported in net income. Different rules apply if the derivatives are used in a hedging relationship. However, derivatives that are classified as insurance follow insurance accounting as discussed in IFRS 4, which reverts to existing accounting.

Paragraph 46 of IAS 39 discusses the measurement of derivatives that are assets, and paragraph 47 of IAS 39 discusses the measurement of derivatives that are liabilities.

IAS 39, Appendix A provides the following hierarchy to be used for fair valuing financial instruments:

> Quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.
>
> If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.
>
> If there is no active market for an equity instrument and the range of reasonable fair values is significant and these estimates cannot be made reliably, then an entity must measure the equity instrument at cost less impairment.

As discussed in Question 58, the definition of "fair value" under IFRS is currently under discussion and may be replaced at some point with a standard that is similar to the US GAAP definition for FAS 157.

47. How does the accounting for derivatives under IFRS differ from the accounting for derivatives under US GAAP?

Setting the definitional differences aside, the accounting for derivatives under IFRS is very similar to the accounting treatment defined in FAS 133. Both IFRS and US GAAP define fair value measurement as the basis for derivative valuation and both provide exclusions for derivatives that are defined as insurance contracts. Some differences may arise from different definitions of "fair value" under US GAAP and IFRS. These differences are discussed in question 59.

48. Where can I find a roadmap for how to treat embedded derivatives in insurance contracts?

IASP 4 provides a detailed, non-authoritative description of valuation methods a company might use to value embedded derivatives. This is found in sections 4.4 and 4.5. IFRS 4 also contains an example – "IG Example 2: Embedded Derivatives" – which provides additional guidance on possible contract feature classifications as investment or insurance, with explanations on each.

49. What are the factors to be considered in determining how to account for typical guarantees found in variable annuity contracts accounted for under IFRS?

The primary consideration related to accounting for variable annuity guarantees under IFRS typically relates to the presence of insurance risk. If insurance risk is present within the guarantee, then the guarantee is typically deemed to be an embedded derivative that is classified as an insurance contract under IFRS 4 and consequently is not afforded derivative accounting under IAS 39. Otherwise, the guarantee may be an embedded derivative measured at fair value with the change in fair value being reflected through profit and loss.

In some cases these practices may constitute a difference from current practice under US GAAP.

50. How is a GMDB evaluated for an embedded derivative under IFRS?

Under this consideration, virtually all Guaranteed Minimum Death Benefits ("GMDBs") are considered to be insurance features and accounted for as such. This typically extends to even modest GMDBs, like return-of-premium designs, because the triggering event is an insurable event (death). Under IFRS, for an insurance element to be significant, only one plausible scenario of commercial substance needs to be identified.

51. How are living benefits evaluated for an embedded derivative under IFRS?

Other variable annuity guarantees are evaluated along the same lines. To the extent that a benefit is only settled in conjunction with life-contingent payments, the guidance in IFRS 4 (referred to above) appears to require these to be treated as insurance. Non-life contingent guarantees would appear to meet the criteria for derivative accounting at fair value (an alternative view is presented in the subsequent discussion of GMAB). Benefits (like some GMIBs) which give policyholders a choice whether to resolve their guarantee as either a life-contingent stream, or a certain-period stream only, result in potentially alternative treatments. Some believe that such guarantees should be valued in two pieces: the life contingent alternative under IFRS 4 and the non-life contingent under IAS 39 with the results probability weighted by assumed election rates. Others believe that the existence of a non-life contingent settlement option renders the entire guarantee subject to derivative accounting at fair value. Still others believe the opposite: that the ability to elect a life contingent option results in the entire guarantee meeting the insurance exclusion and reverting to IFRS 4. Furthermore, if it is determined that the period certain option cannot be valued distinctly from the rest of the benefit, the entire benefit may be deemed insurance.

The guaranteed minimum accumulation benefit (GMAB), which is similar to a European put option, is clearly an embedded derivative under US GAAP that needs to be bifurcated and accounted for at fair value. Derivatives Implementation Group (DIG) Issue B8 classifies the GMAB as an embedded derivative because it is "not clearly and closely related" to its host contract (a plain-vanilla variable annuity contract). Consequently, actuaries familiar with US GAAP might logically conclude that the GMAB would be classified and accounted for similarly under IFRS.

However, the examples in IFRS 4 referenced above (IG4 (b) 2.4 and 2.7) have led some to believe that, under IFRS, the GMAB is an insurance derivative due to the presence of a life contingent persistency requirement whereby the policyholder has to survive until the maturity date to collect the benefit. This view would eliminate most variable annuity guarantees from being embedded derivatives that would need to be bifurcated and accounted for at fair value under IAS 39. However, even if such a guarantee is deemed to be "insurance" under IFRS, it still may result in the guarantee being recorded at fair value if, for example, the existing accounting for such a guarantee is fair value, as is the case under US GAAP. See Question 40 for additional discussion on this point. Furthermore, guarantees in which the death of the policyholder does not extinguish the guarantee would likely still qualify as embedded derivatives, even under this view.

Similar arguments apply to the guaranteed minimum withdrawal benefit (GMWB), which has similar characteristics to the GMAB. An exception might apply to the special case of GMWB that involves a lifetime withdrawal benefit,

which likens the benefit to a GMIB. Under US GAAP, the derivative status of the lifetime withdrawal benefit is not universally agreed upon, and this lack of uniform agreement may translate to IFRS as well.

E. Accounting for Investment Contracts

52. What is an investment contract?

See the definition in question 11. In general, the remainder of this section is intended to refer to practices that apply to contracts typically issued by insurance companies, rather than other types of financial instruments.

53. What is the valuation method used to measure investment contracts under IAS 39?

In general, investment contracts issued by insurance companies are valued using either a fair value approach or an interest method approach.

IAS 39 states the following: "When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."

Paragraph A76 of the Appendix to IAS 39 provides additional guidance that states that the best evidence of fair value, or market price, at initial recognition is the transaction price unless there are other observable transactions for the same instrument or the fair value is based on a valuation technique using inputs only from observable data. In cases where the transaction price is used, this can potentially lead to losses at initial recognition of financial liabilities recorded at fair value if substantial acquisition costs are incurred in acquiring the liability.

Subsequent to initial recognition, IAS 39 states that "an entity shall measure all financial liabilities at amortized cost using the effective interest method" with some limited exceptions. One exception worth noting related to contracts typically issued by life insurance companies is financial liabilities measured at fair value through profit or loss. Considerations for electing to measure a financial liability at fair value through profit or loss are discussed in paragraph 7 of IAS 39 and relate primarily to improving the matching between the accounting for financial liabilities and the assets that back them. In addition, as described in section D above, embedded derivatives that do not meet the definition of insurance are measured at fair value.

54. Are there limitations on selecting the fair value or effective interest approaches?

Certain limitations exist with respect to selecting the fair value versus effective interest approaches for investment contracts. IAS 39 allows an entity to designate a financial asset or financial liability (or a group of them) on initial recognition to be measured at fair value with changes in fair value reflected through profit and loss. However, an entity is generally precluded from moving assets or liabilities in and out of this category. Though very rare, IAS 39 specifies, in paragraph 54, certain circumstances in which fair value is no longer a reliable measure and therefore the measurement method moves from fair value to effective interest.

Certain types of contracts, such as derivatives that do not meet the definition of insurance, are required to be recorded at fair value.

55. What is a service contract?

See question 13 above.

56. How does the presence of a service component impact the measurement of an investment contract?

Components that meet the definition of a service contract may be bifurcated out and valued separately.

For service components within investment contracts measured at fair value that are not bifurcated, the cost of servicing the contract should be included in the fair valuation. Such costs should be based on the costs a market participant would expect to incur, and not the level of costs specific to the entity valuing the contract. Under the effective interest method, the servicing costs are included implicitly, since the initial premium is typically the initial liability used as the basis for computing the effective interest rate, and includes a component for servicing.

For additional non-authoritative information, IASP 4, section 4.1.3, provides "the IFRSs permit transaction costs for the service element to be deferred to match the related fees. A practitioner may wish to consider a look-through approach to the service contract and to the nature of the original expenses to ascertain if they are truly incremental and eligible for deferral within the spirit of IAS 39." This can effectively result in a DAC asset being created for the contract.

57. How is a service contract measured under IFRS?

The methodology for measuring a service contract is outlined in IAS 18 and states: "When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date." IAS 18 provides specific guidance as to when the outcome can be measured reliably, including (1) whether the revenue can be measured reliably; (2) whether the economic benefits of the transaction are probable; (3) whether the stage of completion can be measured reliably; and (4) whether transaction costs can be measured reliably.

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognized in the accounting periods in which the services are rendered.

58. How are embedded derivatives that are present in investment contracts treated?

IAS 39 defines embedded derivatives and how they should be treated. In particular, IAS 39 requires that embedded derivatives be bifurcated from the host contract and fair valued. If bifurcation is not possible, IAS 39 requires fair valuation of the entire investment contract. To the extent the fair value of the embedded derivative cannot be reliably measured at fair value, the fair value of the embedded derivative equals the fair value of the entire contract less the fair value of the host instrument. Refer to Section D "Accounting for Derivatives" for more information.

59. How does the fair value determined under IAS 39 differ from the fair value determined under FAS 157?

There are several differences in how fair value is defined between IAS 39 and FAS 157.

- Under FAS 157, fair value is defined as an "exit price," whereas under IAS 39, fair value is defined as exit price, except in the absence of observable market data, in which case the transaction price is presumed to be fair value at initial recognition only.

- FAS 157 requires that fair values be based on the principal market for the transaction, unless there is no principal market in which case the most advantageous market is used. IAS 39 references use of the most advantageous market only.

- The fair value definition for a liability under FAS 157 is based on the assumption that the instrument is transferred, whereas under IAS 39 it is based on the assumption that the liability is settled.

- IAS 39 includes a provision that the fair value cannot be less than the demand feature (for example, surrender value) if one exists, whereas no such restriction exists in FAS 157.

- FAS 157 allows for the use of mid market pricing, whereas IAS 39 requires use of the bid price for assets and the ask price for liabilities.

There are also potential differences in the inputs to the calculation of fair value between FAS 157 and IAS 39.

- FAS 157 explicitly requires a risk margin, whereas the requirements under IAS 39 are not explicit,

- FAS 157 requires use of observable market inputs to the extent available. IAS 39 paragraph AG82, item (f) states "Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices." Some practitioners believe that this provides the ability to reflect historical information in valuation assumptions under IFRS to a greater extent than under US GAAP.

It appears that many of these differences will be eliminated if the IASB's exposure draft, "Fair Value Measurements," issued May 2009, which provides potential guidance on the application of fair value that is substantially similar to FAS 157, is adopted by the IASB. However, some differences will likely persist. For example, it is currently unclear whether the fair value floor of cash value (zero) would continue to apply under IFRS for financial liabilities.

60. Do companies reflect non-performance ("own credit") risk in fair values determined under IAS 39?

Paragraphs AG69 and AG82 of IAS 39 address credit risk with respect to fair value. AG 69 states "Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument." AG82 states "The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices or traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings."

Since there is typically a lack of available market data on the credit risk associated with the issuance of insurance contracts by life insurers, most life insurers look to other sources of data in developing an adjustment for their own credit risk. Examples of data points that might be used include credit spreads on bonds issued by comparably rated entities in the same industry, credit spreads on credit default swaps issued by a parent company, and long term insurance industry default data from historical studies. The considerations and challenges in reflecting own credit are similar to those encountered by companies in the application of FASB Statement No. 157.

As described above, the IASB has issued an exposure draft on "Fair Value Measurements" which also references requirements with respect to inclusion of nonperformance risk that are similar to those under FAS 157.

61. How is fair value calibrated to market inputs under IFRS?

As described above, at contract inception fair value is typically assumed to be calibrated to the entry price, absent evidence to the contrary. In addition, since the definition of fair value requires that the entity consider the view of a market participant, certain market transactions (such as reinsurance, acquisitions, current entry prices, etc) may have some impact on the "calibration" of the fair value.

62. What is the "effective interest method" used to measure investment contracts at amortized cost?

IAS 39 defines the effective interest method as "a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period." Under the effective interest method, the liability for an investment contract is amortized over the contract life using an interest rate that is determined at contract inception. IAS 39 further states that "when calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses." The interest rate is "solved for" such that the initial liability (computed by discounting back cash flows at that interest rate) is equal to inception fair value (commonly equal to entry price less any transaction costs).

63. How are changes in the amortized cost of an investment contract reflected in the financial statements?

According to paragraph 56 of IAS 39, "For financial assets and financial liabilities carried at amortised cost, a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognized or impaired, and through the amortization process." Note that additional rules apply for financial assets and financial liabilities that are hedged items, but this is not generally expected to apply to financial instruments that are contracts issued by insurance companies.

Based on this guidance, the periodic amortization of an investment contract is expected to be reported directly in the profit and loss statement.

F. Disclosures

64. Why is disclosure an important aspect of IFRS?

- As insurers continue to use existing GAAP accounting policies, the diversity of GAAP would result in difficulty in comparing the financial performance of insurers without extensive disclosure.

- The guidance provided in IFRS 4 (and elsewhere in the IFRS framework) is not intended to be exhaustive; rather, it is principle-based and focuses on the needs of users of the financial statements.

65. What are the main sources of information in IFRS related to disclosure of relevance to actuaries?

IFRS 4 contains guidance related to disclosure requirements applied to insurance contracts. IFRS 7 covers disclosure requirements for financial instruments (including investment contracts). IASP 12 provides additional non-authoritative information around the application of disclosure requirements related to insurance contracts.

66. What are the two main principles of IFRS disclosure specified in IFRS 4?

- Paragraph 36 of IFRS 4 states that "(a)n insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts."

- Paragraph 38 of IFRS 4 states that "(a)n insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts."

67. What are the minimum levels of disclosure included in IFRS guidance to support the two main principles?

Paragraph 37 of IFRS 4 states that an insurer is required to disclose:

- Its accounting policies for insurance contracts and related assets, liabilities, income and expense;
- The recognized assets, liabilities, income and expense arising from insurance contracts;
- The process used to determine the assumptions that have the greatest effect on the measurement of the recognized amounts described above and, where practicable, quantified disclosures of those assumptions;
- The effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements and;
- Reconciliation of changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs.

68. What disclosures are required with respect to "the nature and extent of risks arising from insurance contracts?"

Paragraph 39 of IFRS 4 states that an insurer should disclose:

- Its objectives, policies and process for managing risks arising from insurance contracts and the methods to manage those risks
- Those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows
- Information about insurance risk, including sensitivity to insurance risk, concentration of insurance risk and actual claims compared to previous estimates
- Information about credit risk, liquidity risk and market risk
- Information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to and does not measure the embedded derivatives at fair value

69. How does IFRS 4 recommend that these disclosure requirements be met?

- In the disclosure of accounting policies the company may need to address the treatment of premiums, fees and other charges made to policyholders, acquisition costs, claims incurred, claims handling costs, liability adequacy tests, discounting of cash flows and insurance liabilities etc.
- The company may also address the following items in their disclosure of accounting policies
  - The nature and the models used to adjust insurance liabilities for risk and uncertainty
  - Embedded options and guarantees
  - Discretionary participation features
  - Salvage, subrogation or other recoveries from third parties
  - Reinsurance held
  - Underwriting pools, coinsurance and guarantee fund arrangements
  - Insurance contracts acquired in business combinations and portfolio transfers, and the treatment of related intangible assets
  - The judgments management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognized in the financial statements
- Disclosures of the process used to determine the assumptions may include the objectives of the assumptions (to achieve best estimate or prudence), the source of data used, whether based on observable market information or entity specific, whether past experience/future trends are used and any correlation between the assumptions
- Information on sensitivity may include analysis of how profit/loss and equity would have been affected had changes in the relevant risk variables occurred, the methods and assumptions used in sensitivity analysis, disclosure of changes from the previous period in performing sensitivity analysis
- Key financial variables in sensitivity analysis may include interest rates, credit losses, stock market prices, currency rates

- Key non-financial variables in sensitivity analysis may include mortality and morbidity, lapses and surrenders, expenses, frequency and severity of other insured events

70. What disclosure requirements apply to financial liabilities that are not classified as insurance contracts?

IFRS 7 covers disclosure requirements for financial instruments that are not classified as insurance contracts. Disclosure requirements under IFRS 7 also apply to embedded derivatives within insurance contracts that are accounted for under IAS 39.

Briefly, IFRS 7 requires that financial liabilities be identified between those that are recognized at amortized cost and those that are recognized at fair value through profit and loss.

For liabilities that are recognized at fair value through profit and loss, the net gains and losses arising from such liabilities in the reporting period must be disclosed. There is a requirement to disclose the methods used to determine fair value for such instruments as well as extensive requirements to identify the amount of credit risk embedded within the fair value of the financial liability.

For liabilities that are recorded at amortized cost, interest expense calculated using the effective interest method must be disclosed as well as other sources of fee income and expense.

Paragraph 31 of IFRS 7 also requires the disclosure of "information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments." Disclosure of both qualitative and quantitative information is required. Qualitative disclosure must address the exposures to risk, how they arise and how they are managed (paragraph 33). Quantitative disclosures must address exposures to risk, risk concentrations, credit risk, and liquidity risk. Sensitivity analysis is required for significant market risks to which the reporting entity is exposed. Detail on these requirements may be found in paragraphs 34 to 42 of IFRS 7.

In March 2009, IFRS 7 was amended to include additional disclosure requirements about items recorded at fair value. These requirements are similar to those required under FAS 157 for US GAAP. In addition, the requirements include disclosure of significant transfers between level 1 and level 2 classification as well as sensitivity tests on level 3 measurements where reasonably possible alternative assumptions could significantly change the fair values otherwise calculated. The amendments are concentrated in paragraph 27 of IFRS 7.

The disclosure requirements in IFRS 7 are extensive and are considered to be an integral part of IFRS.