Exposure Draft

ED 5 INSURANCE CONTRACTS

Comments to be received by 31 October 2003

ED 5 *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 as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklets) should be submitted in writing so as to be received by **31 October 2003**.

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

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INVITATION TO COMMENT

The International Accounting Standards Board invites comments on any aspect of this Exposure Draft of its proposed IFRS *Insurance Contracts* and the related Basis for Conclusions and draft Implementation Guidance. The Board would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **31 October 2003**.

Until an IFRS based on this Exposure Draft becomes effective, existing International Financial Reporting Standards, including International Accounting Standards, remain in effect.

Question 1 - Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

Question 2 – Definition of insurance contract

The draft IFRS 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 or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

Question 3 – Embedded derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

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

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

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

    (ii) reinsurance contracts that it holds.

    (paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

    Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

    (i) eliminate catastrophe and equalisation provisions.

    (ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

Question 5 – Changes in accounting policies

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

(b) Should unbundling be required in any other cases? If so, when and why?

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

Question 8 - Insurance contracts acquired in a business combination or portfolio transfer

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

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

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

Question 13 – Other comments

Do you have any other comments on the draft IFRS and draft Implementation Guidance?

[Draft] International Financial Reporting Standard X *Insurance Contracts* ([draft] IFRS X) is set out in paragraphs 1-35 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.* These provide a basis for selecting and applying accounting policies in the absence of explicit guidance.

INTRODUCTION

Reasons for issuing the [draft] IFRS

IN1 Until now, there has been no IFRS on insurance contracts, and insurance contracts are excluded from the scope of existing IFRSs that would otherwise be relevant (IFRSs on provisions, financial instruments, intangible assets). In addition, accounting practices for insurance contracts are very diverse, and often differ from practices in other sectors. Because it is not feasible for the International Accounting Standards Board to complete its project on insurance contracts in time for the many entities that will be required to adopt IFRSs in 2005, the Board has issued this [draft] IFRS:

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

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

IN2 The Board sees this [draft] IFRS as a stepping stone to phase II of its project on insurance contracts. The Board is committed to completing phase II without delay once it has thoroughly investigated all relevant conceptual and practical questions and completed a full and extensive due process.

Main features of the [draft] IFRS

IN3 The [draft] IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, it does not address accounting by policyholders.

IN4 The [draft] IFRS exempts an insurer temporarily (ie for accounting periods beginning before 1 January 2007) from some precedents set by other IFRSs and the *Framework*. However, the [draft] IFRS:

(a) eliminates catastrophe and equalisation provisions.

(b) requires a loss recognition test if no such test exists under an insurer's existing accounting policies.

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

IN5 The [draft] IFRS permits an insurer to change its accounting policies for insurance contracts only if that would mean that its financial statements present information that is more relevant and reliable. In particular, an insurer cannot adopt a new accounting policy that involves any of the following, although it may continue using existing accounting policies that involve them:

(a) measuring insurance liabilities on an undiscounted basis.

(b) measuring insurance liabilities with excessive prudence.

(c) reflecting future investment margins in the measurement of insurance liabilities.

(d) using measurements that implicitly measure contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services.

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

IN6 When an insurer changes its accounting policies for insurance liabilities, the [draft] IFRS permits it to reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss.

IN7 The [draft] IFRS also:

(a) exempts an insurer from accounting for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.

(b) requires an insurer to unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet.

(c) limits reporting anomalies when an insurer buys reinsurance.

(d) permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer.

(e) addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

IN8 The [draft] IFRS requires disclosure about:

(a) the amounts in the insurer's financial statements that arise from insurance contracts.

(b) the estimated amount, timing and uncertainty of future cash flows from insurance contracts.

(c) the fair value of the insurer's insurance liabilities and insurance assets.

IN9 The [draft] IFRS is effective for periods beginning on or after 1 January 2005 but earlier application is encouraged. The requirement to disclose the fair value of insurance liabilities and insurance assets applies from 31 December 2006.

[Draft] International Financial Reporting Standard IFRS X

Insurance Contracts

OBJECTIVE

1 The objective of this [draft] IFRS is:

(a) to make limited improvements to accounting practices for *insurance contracts*, without requiring major changes that may need to be reversed when the Board completes the second phase of its project on insurance contracts; and

(b) to require the issuer of an insurance contract (described in this [draft] IFRS as an *insurer*) to disclose information about insurance contracts that gives users of its financial statements insights into the key risk drivers and sensitivities, without imposing costs that exceed the benefits and at a reasonable, but not excessive, level of aggregation.

SCOPE

2 An entity shall apply this [draft] IFRS to:

(a) insurance contracts (including *reinsurance contracts*) that it issues and to reinsurance contracts that it holds.

(b) financial instruments that it issues with a *discretionary participation feature* (see paragraph 25). IAS 32 *Financial Instruments: Disclosure and Presentation* addresses disclosure about these financial instruments.

3 This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transitional provisions in paragraph 35.

4 An entity shall not apply this [draft] IFRS to:

(a) product warranties issued directly 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 [draft IFRS] ED 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) contingent consideration payable or receivable in a business combination (see [draft IFRS] ED 3 *Business Combinations*).

(d) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets*).

(e) financial guarantees that an entity incurs or retains when it transfers financial or non-financial assets or liabilities to another party, regardless of whether they are described as financial guarantees, letters of credit or insurance contracts (see IAS 39).

(f) *direct insurance contracts* that the entity holds (ie direct insurance contracts in which the entity is the *policyholder)*.

Embedded derivatives

5 IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in profit or loss. IAS 39 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract within the scope of this [draft] IFRS.

6 As an exception to the requirement in IAS 39, an insurer need not separate, and measure at fair value, 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) even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirement in IAS 39 does apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index.

Unbundling of deposit components

7 Some insurance contracts contain both an insurance component and a deposit component. In some instances, the application to the deposit component of an insurer's existing accounting policies for insurance contracts could mean that the insurer does not recognise obligations to repay amounts received under the insurance contract, or rights to recover amounts paid under the insurance contract. In that case, if the cash flows from the insurance component do not affect the cash flows from the deposit component, an insurer shall:

(a) treat the insurance component as an insurance contract.

(b) treat the deposit component as a financial liability or financial asset under IAS 39.

8 Many traditional life insurance contracts provide surrender or maturity values that could be regarded as deposit components. Nevertheless, paragraph 7 does not require an insurer to unbundle those surrender or maturity values if the insurer's existing accounting policies mean that it recognises all liabilities under those contracts to pay benefits to policyholders.

RECOGNITION AND MEASUREMENT

Temporary exemption from some other IFRSs

9 Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. For accounting periods beginning before 1 January 2007, this [draft] IFRS exempts an insurer from applying those criteria to its existing accounting policies for:

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

(b) reinsurance contracts that it holds.

10 Nevertheless, this [draft] IFRS does not exempt an insurer from some implications of the criteria in paragraphs 5 and 6 of [draft] IAS 8. Specifically, an insurer:

(a) shall not recognise as a liability any catastrophe provisions or equalisation provisions relating to possible future claims under future insurance contracts.

(b) shall carry out the loss recognition test described in paragraphs 11-13 below.

(c) shall derecognise (ie remove from its balance sheet) an insurance liability or a portion of an insurance liability when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled, or expires.

(d) shall not offset:

  (i) reinsurance assets against the related insurance liabilities; or

  (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

Loss recognition

11 An insurer shall carry out a loss recognition test at each reporting date, using current estimates of future cash flows under its insurance contracts. If those estimates show that the carrying amount of its insurance liabilities (less related deferred acquisition costs and intangible assets) is insufficient in the light of the estimated future cash flows, the insurer shall recognise the entire deficiency in profit or loss. If an insurer's existing accounting policies require a loss recognition test that meets these minimum requirements, this [draft] IFRS does not impose further requirements on the test. For example, it does not specify which cash flows should be included, whether or how the cash flows should be discounted, or whether or how the cash flows or discount rate should be adjusted for risk and uncertainty.

12 If an insurer's existing accounting policies do not require a loss recognition test that meets the minimum requirements of paragraph 11, the insurer shall:

(a) determine the carrying amount of its insurance liabilities less the carrying amount of:

  (i) any related deferred acquisition costs; and

  (ii) any related intangible assets acquired in a business combination or portfolio transfer.

(b) compare the amount described in (a) with the measurement that would be required if the insurance liabilities were subject to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. If the measurement under IAS 37 is greater than the amount described in (a), the insurer shall recognise the difference by decreasing the carrying amount of the related deferred acquisition costs or intangible assets or increasing the carrying amount of the insurance liabilities.

13 For the test described in paragraph 12, the measurement under IAS 37 shall include future investment margins (see paragraph 16(c)) if, and only if, the amount described in paragraph 12(a) also includes those margins.

Changes in accounting policies

14 An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the decision-making needs of users and reliable, judged by the criteria in [draft] IAS 8.

15 To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in [draft] IAS 8, but the change need not be sufficient to achieve full compliance with those criteria.

16 An insurer may continue using existing accounting policies that involve the following, but a new accounting policy that involves any of them does not satisfy the requirements of paragraph 14:

(a) measuring insurance liabilities on an undiscounted basis.

(b) measuring insurance liabilities with excessive prudence.

(c) reflecting future investment margins in the measurement of insurance liabilities, by either:

(i) using a discount rate that reflects the estimated return on the insurer's assets; or

(ii) projecting the returns on those assets at an assumed rate of return, discounting the projected returns at a different rate and including the result in the measurement of the liability.

(d) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services. It is likely that the fair value at inception of those contractual rights equals the origination costs paid, unless future investment management fees and related costs are out of line with those market comparables.

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

17 Paragraphs 14-16 apply both to changes made by an insurer that already applies IFRSs and to changes made by an insurer adopting IFRSs for the first time.

Accounting by a cedant for reinsurance

18 When an insurer buys reinsurance:

(a) that insurer (the *cedant*) shall not change the measurement basis for its insurance liabilities. An example of a change in measurement basis is a change from an undiscounted basis to a discounted basis.

(b) the cedant shall use the net amounts paid at inception to obtain the reinsurance to measure its rights under the reinsurance contract at that date, so that it does not recognise a gain at that date, subject to (c) below.

(c) the cedant shall recognise receipts from the *reinsurer* at inception as income to the extent that they compensate the cedant for the reinsurer's portion of acquisition costs that the cedant recognised as an expense in the current or past periods. All other receipts from the reinsurer at inception reduce the initial carrying amount of the cedant's rights under the reinsurance contract.

(d) if the net amounts paid by the cedant are less than the carrying amount of the related portion of its liability under the direct insurance contract (for example, because that liability is measured on an undiscounted basis), the cedant shall recognise that difference as income on a systematic and rational basis over the period of the underlying risk exposure.

(e) if the net amounts paid by the cedant exceed the carrying amount of the related portion of its liability under the direct insurance contract, that is evidence that the liability may be understated. The cedant shall consider that evidence in carrying out the loss recognition test under paragraphs 11-13.

19 A cedant shall apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract.

Insurance contracts acquired in a business combination or portfolio transfer

20 This [draft] IFRS does not exclude insurance liabilities and *insurance assets* (and related reinsurance) from the requirement for an acquirer to measure at fair value assets acquired and liabilities assumed in a business combination (see [draft IFRS] ED 3 *Business Combinations*). However, this [draft] IFRS permits, but does not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

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

(b) an intangible asset, representing the fair value of the contractual insurance rights and insurance obligations acquired, to the extent that the liability does not reflect that fair value.

21 An insurer acquiring a block of insurance contracts may use the expanded presentation described in paragraph 20.

22 This [draft] IFRS excludes the intangible assets described in paragraphs 20 and 21 from the scope of:

(a) IAS 36 *Impairment of Assets*, because they are covered by the loss recognition test described in paragraphs 11-13.

(b) IAS 38 *Intangible Assets.* The subsequent measurement of these assets shall be consistent with the measurement of the related insurance liability.

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

Discretionary participation features in insurance contracts

24 Some insurance contracts contain a discretionary participation feature as well as a fixed element that requires non-discretionary payments. The issuer of such a contract:

(a) may, but need not, report the fixed element separately from the discretionary participation feature.

(b) shall classify unallocated surplus arising from the discretionary participation feature as either a liability or equity. This [draft] IFRS does not specify how the issuer determines whether the unallocated surplus is a liability or equity. The issuer may split the unallocated surplus into liability and equity components, but shall not classify the unallocated surplus as an intermediate category that is neither liability nor equity.

(c) shall, if the contract contains an embedded derivative within the scope of IAS 39, apply IAS 39 to that embedded derivative.

(d) shall, in all respects not described in paragraphs 10-13 and 24(a)-(c), continue its existing accounting policies for such contracts, unless it demonstrates that a change in those accounting policies would result in more relevant and reliable financial statements, as required by paragraph 14.

Discretionary participation features in financial instruments

25 The requirements in paragraph 24 also apply to the issuer of a financial instrument that is not an insurance contract and contains both a discretionary participation feature and a fixed element that requires non-discretionary payments. In addition, the issuer shall recognise a liability measured at no less than the measurement that IAS 39 would apply to the fixed element. The issuer need not determine the IAS 39 measurement of the fixed element if the total reported liability is clearly higher.

DISCLOSURE

Explanation of reported amounts

26 An insurer shall disclose information that identifies and explains the amounts in its balance sheet and income statement that arise from insurance contracts.

27 To comply with paragraph 26, an insurer shall disclose:

(a) its accounting policies for insurance contracts and related assets, liabilities, income and expense.

(b) the material amounts of assets, liabilities, income and expense (and, if it presents its cash flow statement using the direct method, cash flows) arising from insurance contracts.

(c) the process used to determine the assumptions that have the greatest effect on the measurement of these amounts and, when practicable, give quantified disclosure of those assumptions.

(d) 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.

(e) material changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs.

Amount, timing and uncertainty of cash flows

28 **An insurer shall disclose information that enables users to understand the estimated amount, timing and uncertainty of future cash flows from insurance contracts.**

29 To comply with paragraph 28, an insurer shall disclose:

(a) its objectives in managing risks arising from insurance contracts and its policies for mitigating risk.

(b) those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows.

(c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:

  (i) the sensitivity of reported profit or loss and equity to changes in variables that have a material effect on them.

  (ii) material concentrations of insurance risk.

  (iii) actual claims compared with previous estimates (claims development). The disclosure about claims development shall go back to the period in which the earliest material incurred claim still outstanding arose, but need not go back more than ten years. It follows that an insurer need not disclose this information for claims that are typically settled within one year.

(d) the information about interest risk and credit risk that IAS 32 *Financial Instruments: Disclosure and Presentation* would require if the insurance contracts were within the scope of IAS 32.

(e) information about material exposures to interest risk or market risk under 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.

Fair value of insurance liabilities and insurance assets

30 An insurer shall disclose the fair value of its insurance liabilities and insurance assets.

EFFECTIVE DATE AND TRANSITION

31 An entity shall apply this [draft] IFRS in annual financial statements for periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this [draft] IFRS for an earlier period, it shall disclose that fact.

32 The transitional provisions in paragraphs 33-35 apply both to an entity that is already applying IFRSs when it first applies this [draft] IFRS and to an entity that applies IFRSs for the first-time (a first-time adopter).

Disclosure

33 An insurer need not disclose the fair value of its insurance assets and insurance liabilities for dates before 31 December 2006. For example, in financial statements for the year ending 31 December 2006, an insurer shall disclose fair value at that date, but need not disclose in those financial statements fair value at 31 December 2005.

34 An insurer need not disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies this [draft] IFRS.

Redesignation of financial assets

35 When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss.* This reclassification is permitted if an insurer changes accounting policies when it first applies this [draft] IFRS and if it makes a subsequent policy change permitted by paragraph 14. The insurer shall treat the reclassification as a change in accounting policy under [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

* Under the current version of IAS 39, this category is limited to financial assets held for trading. Under the amendments to IAS 39 proposed in June 2002, an entity could elect at inception to designate any financial asset for inclusion in this category.

Appendix A
Defined terms

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

cedant	The policyholder under a **reinsurance contract**.
direct insurance contract	An **insurance contract** that is not a **reinsurance contract**.
discretionary participation feature	A contractual right held by an investor or policyholder to receive, as a supplement to guaranteed minimum payments, additional payments: (a) that are likely to be a significant portion of the total contractual payments; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
financial risk	The risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a 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.
insurance asset	An insurer's net contractual rights under an **insurance contract**.

insurance contract	A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the **insured event**) adversely affects the policyholder or other beneficiary. (See Appendix B for guidance on the application of this definition.)
insurance liability	An insurer's net contractual obligations under an **insurance contract**.
insurance risk	Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.
insured event	The uncertain future event covered by an **insurance contract**.
insurer	The issuer of an **insurance contract**.
policyholder	The holder of an **insurance contract**.
reinsurance contract	An **insurance contract** issued by one insurer (the **reinsurer**) to compensate another insurer (the **cedant**) for losses on one or more contracts issued by the cedant.
reinsurer	The issuer of a **reinsurance contract**.

Appendix B
Definition of an insurance contract

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

B1 This appendix gives guidance on the application of the definition of an insurance contract in Appendix A. It addresses the following issues:

(a) the term ‘insurer’ (paragraphs B2 and B3);

(b) the term ‘uncertain future event’ (paragraphs B4-B6);

(c) payments in kind (paragraph B7);

(d) the distinction between insurance risk and *financial risk* (paragraphs B8-B16);

(e) examples of insurance contracts (paragraphs B17-B20);

(f) significant insurance risk (paragraphs B21-B24); and

(g) changes in the level of insurance risk (paragraphs B25 and B26).

Insurer

B2 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.

B3 The definition of an insurance contract requires the insurer to accept significant insurance risk from the policyholder. This is possible only if the insurer is an entity distinct from the policyholder. In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract.

Uncertain future event

B4 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.

B5 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.

B6 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

B7 Some insurance contracts require or permit payments to be made in kind. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.

Distinction between insurance risk and financial risk

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. 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 held by a party to a contract is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held (a non-financial variable). For example, if a guarantee 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 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 the payment that is contingent on the insured event is not trivial. For example, a life-contingent annuity linked to a cost-of-living index is an insurance contract because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative. However, because that embedded derivative meets the definition of an insurance contract, it need not be separated and measured at fair value (see paragraph 5 of this [draft] IFRS).

B12 The definition of insurance risk refers to risk transferred from the policyholder to the insurer, rather than to a new risk created by the contract. For example, consider a contract that requires the issuer to pay the holder one million currency units if the holder suffers an insignificant loss of one currency unit. In this contract, the holder transfers to the insurer the insignificant risk of losing one currency unit. At the same time, the contract creates non-insurance risk that the issuer will need to pay 999,999 currency units if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.

B13 The definition of an insurance contract refers to an adverse effect on the policyholder or other specified beneficiary. The definition does not limit the payment by the insurer to an amount equal to the financial impact 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 damaged old asset by a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased policyholder's dependants.

B14 Some contracts require a payment if a specific uncertain event occurs, but do not require an adverse effect on the policyholder or other specified beneficiary as a precondition for payment. These contracts are not insurance contracts even if the holder uses the 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 cash flows from an asset of the entity. The definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder or other beneficiary is a contractual precondition for payment.

B15 Lapse or persistency risk (the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in 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. Therefore, a contract that exposes the issuer to lapse risk or persistency risk is not an insurance contract unless it also exposes the issuer to insurance risk.

B16 Expense risk (the risk that servicing a contract will cost the issuer more than it had expected in pricing the contract) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty. Therefore, a contract that exposes the issuer to expense risk is not an insurance contract unless it also exposes the issuer to insurance risk.

Examples of insurance contracts

B17 The following are examples of insurance contracts:

(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 (compensation for the uncertain future event—the survival of the annuitant or pensioner—assists the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) disability and medical cover.

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (under which an entity undertakes to make a payment if another party fails to perform a contractual obligation, for example an obligation to construct a building).

(g) credit insurance that, as a precondition for payment, requires that the holder has incurred a loss on the failure of the debtor to make payments when due. These contracts could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default product or insurance contract. However, these contracts are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* if the issuer incurred or retained them when it transferred financial or non-financial assets or liabilities to another party.

(h) product warranties. Product warranties issued indirectly by another party on behalf of a manufacturer or dealer are within the scope of this [draft] IFRS. However, product warranties issued directly by a manufacturer or dealer are outside its scope, because they are covered by IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(i) title insurance (insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(j) travel assistance (compensation in cash or in kind to policyholders for losses suffered while they are travelling).

(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 climatic, geological or other physical variables that cause an adverse effect on the holder of the contract.

(m) reinsurance contracts.

B18 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 (such contracts are non-insurance financial instruments).

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or group contracts (such contracts are non-insurance financial instruments).

(c) self-insurance, in other words retaining a risk that could have been covered by insurance (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 or other beneficiary specified in the contract.

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a 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 (see IAS 39 *Financial Instruments: Recognition and Measurement*).

(f) a financial guarantee contract (or letter of credit, credit derivative default product or credit insurance contract) that requires payments regardless of whether the holder has incurred a loss on the failure of the debtor to make payments when due (see IAS 39).

(g) contracts that require a payment based on climatic, geological or other physical variables regardless of any adverse effect on the holder of the contract (commonly described as weather derivatives).

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on climatic, geological or other physical variables regardless of any adverse effect on the holder of the contract.

B19 If the contracts described in the previous paragraph create financial assets or financial liabilities, they are subject to IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting:

(a) the issuer recognises the consideration received as a financial liability, rather than as revenue.

(b) the holder recognises the consideration paid as a financial asset, rather than as an expense.

B20 If the contracts described in paragraph B16 do not create financial assets or financial liabilities, IAS 18 *Revenue* applies. Under IAS 18, 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 (IAS 18, paragraph 20).

Significant insurance risk

B21 Insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (ie probability-weighted) present value of all the contractual cash flows.

B22 Insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer's contractual cash flows in all plausible scenarios. An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements.* Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts.

B23 It follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant (ie trivial, judged by reference to the contract rather than to an entire book of contracts). 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.

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

B24 Paragraph B21 refers to the present value of cash flows. This reference addresses contracts where the amount of the loss, and the resulting payment by the insurer, are known, but their timing is unknown. If the loss occurs earlier than expected, the insurer will suffer a loss. An example is whole life insurance for a fixed amount (in other words, 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 unknown. The insurer will suffer a significant loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

Changes in the level of insurance risk

B25 A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire. If a contract did not qualify as an insurance contract at inception, the issuer shall reclassify it subsequently as an insurance contract if, and only if, a significant change in the present value of the issuer's net cash flows becomes a plausible possibility (see paragraph B21).

B26 If the issuer can foresee at inception that the probability or present value of a significant loss may increase over time, the contract is an insurance contract from inception, even if the expected (ie probability-weighted average) present value of the loss is very small at inception. In other words, if an event can occur that makes insurance risk significant, the contract is an insurance contract from inception.

Appendix C
Amendments to other IFRSs

The amendments in this [draft] appendix become effective for accounting periods beginning on or after 1 January 2005. If an entity adopts this [draft] IFRS for an earlier period, these amendments become effective for that earlier period.

Amendments to IAS 32 and IAS 39

C1 Paragraph 3 of [June 2002 Exposure Draft of improvements to] IAS 32 *Financial Instruments: Disclosure and Presentation* is deleted. Paragraph 1(d) is renumbered as 1(c). Paragraph 1(c) is renumbered as 1(d) and amended to read as follows:

(d) insurance contracts within the scope of IFRS X *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts (see IAS 39 *Financial Instruments: Recognition and Measurement*).

C2 Paragraph 1(e) of [June 2002 Exposure Draft of improvements to] IAS 39 *Financial Instruments: Recognition and Measurement* is renumbered as paragraph 1(d). Paragraph 1(d) is renumbered as 1(e) and amended to read as follows:

(e) rights and obligations under a contract that is within the scope of IFRS X *Insurance Contracts* because the contract is an insurance contract or contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in such a contract if the derivative is not itself an insurance contract within the scope of IFRS X (see paragraphs 22-26A).

C3 Paragraph 1(e) of [draft] IAS 32 and paragraphs 1(h) and 2 of [draft] IAS 39 contain scope exclusions for derivatives based on climatic, geological, or other physical variables. Those paragraphs are deleted. As a result, such derivatives are subject to IAS 32 and IAS 39, unless they meet the definition of an insurance contract and are within the scope of [draft] IFRS X *Insurance Contracts*.

C4 The following new paragraph 1(e) is inserted in [draft] IAS 32:

(e) financial instruments that are within the scope of IFRS X *Insurance Contracts* because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 18-29G of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IAS 39 *Financial Instruments: Recognition and Measurement*).

C5 Paragraph 1(f) of [draft] IAS 39 is amended to read as follows:

(f) financial guarantee contracts that provide for specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due (see [draft] IFRS X *Insurance Contracts*). In contrast, financial guarantee contracts are subject to this Standard if they require payments in response to changes in a specified interest rate, security price, commodity price, credit rating, foreign exchange rate, index of prices or rates, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract. For example, a financial guarantee contract that requires payments if a debtor's credit rating falls below a particular level is within the scope of this Standard. In addition, this Standard requires an entity to recognise all financial guarantees that it incurs or retains when it transfers financial or non-financial assets or liabilities to another party.* The contracts discussed in this paragraph could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default product or insurance contract.

C6 Paragraph 5 of [draft] IAS 39 is amended to read as follows:

This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 1(e) and (f) excludes because they arise under contracts within the scope of IFRS X *Insurance Contracts*.

C7 Paragraph A4 of [draft] IAS 39 gives examples of embedded derivatives that are regarded as not closely related to a host contract, and paragraph A7 gives examples of embedded derivatives that are regarded

* In developing this Exposure Draft, the Board has not yet considered whether it is appropriate to apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in measuring these contracts after initial recognition. The Board will consider that question when it completes a final Standard based on the improvements to IAS 39 that it proposed in June 2002.

as closely related to a host contract. Paragraphs A4(g) and A7(a), (b) and (d) are amended by the insertion of references to insurance contracts so that they read as follows:

A4(g) a call, put, or prepayment option embedded in a host debt instrument or insurance contract is not closely related to the host instrument unless the option's exercise price is approximately equal to the carrying amount of the host contract on each exercise date. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt instrument is made before separating the equity element under IAS 32.

A7(a) an embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt instrument or insurance contract is closely related to the host instrument unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recorded investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

A7(b) an embedded floor or cap on the interest rate on a debt instrument or insurance contract is closely related to the host debt instrument, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the instrument is issued, and the cap or floor is not leveraged in relation to the host instrument. Similarly, provisions included in a contract to purchase or sell an asset (for example, a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

A7(d) an embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies: (i) the functional currency of any substantial party to that contract; (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (for example, a relatively stable and liquid currency that is commonly used in local business transactions or external trade). Such a contract is not regarded as a host contract with an embedded foreign currency derivative.

Amendments to other IFRSs

C8 Paragraph 6(c) of IAS 18 *Revenue* is amended to read as follows:

(c) insurance contracts within the scope of IFRS X *Insurance Contracts*;

C9 The following new paragraph 14(a)(iii) is added to the Appendix of IAS 18:

(iii) Origination fees received by the enterprise on issuing financial liabilities measured at amortised cost.

These fees are an integral part of generating an involvement with the financial liability and, together with the related direct costs, are deferred as part of its initial carrying amount and recognised as an adjustment to the effective yield.

C10 A new paragraph 1(h) is inserted in IAS 36 *Impairment of Assets* as follows:

(h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of IFRS X *Insurance Contracts*, other than a cedant's rights under a reinsurance contract.

C11 Paragraph 1(c) of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is deleted and a new paragraph 5(e) is inserted as follows:

(e) those arising from an insurer's contractual obligations and rights under insurance contracts within the scope of IFRS X *Insurance Contracts*.

C12 Paragraph 4 of IAS 37 is amended to read as follows:

This Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS X *Insurance Contracts*.

C 13 Example 9 (a single guarantee) in Appendix C of IAS 37 is deleted. Examples 10 and 11 are renumbered as examples 9 and 10 respectively.

C14 Paragraph 1(d) of IAS 38 *Intangible Assets* is deleted and a new paragraph 2(g) is inserted as follows:

(g) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of IFRS X *Insurance Contracts*. IFRS X sets out specific disclosure requirements for those deferred acquisition costs but not for those intangible assets. Therefore, the disclosure requirements in this Standard apply to those intangible assets.

C15 Paragraph 6 of IAS 38 is amended to read as follows:

Exclusions from the scope of a Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. Therefore, this Standard does not apply to expenditure on such activities and contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurers.

Changes in terminology

C16 In the following paragraphs, 'insurance policy' is replaced by 'insurance contract' and 'insurance company' or 'insurance entity' is replaced by 'insurer':

(a) paragraphs 7, 39-42 and 104-104D of IAS 19 *Employee Benefits*

(b) paragraph 40(e) of IAS 32 *Financial Instruments: Disclosure and Presentation*

(c) paragraph 85 of IAS 39 *Financial Instruments: Recognition and Measurement*.