

Introduction

Certain terms are used in this paper with meanings specified in the Glossary (Appendix D). Each such term is set in bold type when it is first used in this paper.

1. In April 1997 the Board of the International Accounting Standards Committee (IASC) approved a proposal that IASC should start a project on Insurance Accounting. This paper is the result of the first stage in that project.
2. There is a need for an International Accounting Standard on Insurance Accounting because:
 - (a) the insurance industry is an important, and increasingly international, industry;
 - (b) there is currently great diversity in accounting practices for insurers. Also, insurance industry accounting practices in a number of countries differ significantly from accounting practices used by other enterprises in the same countries; and
 - (c) International Accounting Standards do not currently address specific insurance issues and it is not obvious how an enterprise should deal with these issues under International Accounting Standards. Also, certain existing International Accounting Standards contain specific scope exclusions in these areas, in recognition of the need for further study of these issues. Table 1 on the following page lists references to insurance in International Accounting Standards.
3. This paper:
 - (a) identifies the different forms of **insurance contract** and those specific characteristics that are relevant in determining the appropriate accounting treatment;
 - (b) identifies the accounting and disclosure issues and arguments for and against possible solutions to those issues;
 - (c) identifies the Steering Committee's tentative views on those issues; and
 - (d) is published together with an accompanying booklet that;
 - (i) contains illustrative examples (Appendix A); and
 - (ii) summarises relevant national standards and requirements (Appendix B);
 - (iii) summarises the main features of the principal contracts found in selected countries (Appendix C);

- (iv) contains a glossary of terms used in this paper (Appendix D); and
 - (v) summarises the tentative views expressed in this paper (Appendix E).
- 4. The IASC Board appointed a Steering Committee to work on this project. The Steering Committee has developed this Issues Paper. The Board has not reviewed or discussed this Issues Paper.
- 5. The Steering Committee and the Board will consider comments received on this Issues Paper. The Steering Committee views expressed in this Issues Paper are inevitably tentative at this stage and the Steering Committee may modify its views in the light of comments on this Issues Paper before developing specific proposals for inclusion in a Draft Statement of Principles (DSOP). The Steering Committee will publish the DSOP for public comment.
- 6. The Steering Committee and the Board will review the public response to the DSOP. The Steering Committee will then develop a final Statement of Principles and submit it to the IASC Board for approval. The Steering Committee will use the approved Statement of Principles to develop an Exposure Draft of a proposed International Accounting Standard. On approval by the Board, the Exposure Draft will be issued for public comment. The Steering Committee will consider responses to the Exposure Draft and then prepare an International Accounting Standard for Board approval.
- 7. This Issues Paper discusses the measurement of insurance liabilities in fairly general terms. The Steering Committee will develop more specific guidance on measurement issues as it develops the DSOP.

Table 1 References to Insurance in International Accounting Standards

- (a) IAS 1, Presentation of Financial Statements, sets out guidelines for the structure of financial statements and minimum requirements for their content. The Standard applies to all enterprises reporting in accordance with IAS. Thus, it applies to insurance enterprises. IAS 1 states that the minimum structures are designed to be sufficiently flexible that they can be adapted for use by any enterprise. Banks, for example, use a presentation which complies with IAS 1 and the more detailed requirements in IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions.
- (b) IAS 7, Cash Flow Statements, does not address insurance specifically, but it does contain (in Appendix 2) an example of a cash flow statement for a financial institution. Paragraph 14(e) of IAS 7 cites “cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits” as an example of cash flows from operating activities.
- (c) IAS 8, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies, notes that, although losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurer that insures against such risks.
- (d) IAS 14, Segment Reporting, notes that an enterprise should consider the nature of the regulatory environment (in, for example, insurance) in identifying business segments for segment reporting purposes.
- (e) IAS 18, Revenue, excludes from its scope revenue arising from insurance contracts of insurers. The appendix to IAS 18 gives guidance on recognising revenue for insurance agency commissions.
- (f) IAS 19, Employee Benefits, gives guidance on insurance premiums paid to fund a post-employment benefit plan. This guidance focuses on the distinction between defined contribution plans and defined benefit plans.
- (g) IAS 32, Financial Instruments, Presentation and Disclosure, excludes from its scope obligations arising under insurance contracts, although it encourages enterprises to consider the appropriateness of applying the provisions of the Standard in presenting and disclosing information about such obligations. However, the Standard does apply when a **financial instrument** takes the form of an insurance contract but principally involves the transfer of financial risks, for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other enterprises.

Table 1 (continued)

- (h) IAS 37, Provisions, Contingent Liabilities and Contingent Assets, excludes from its scope **provisions, contingent liabilities** and **contingent assets** arising in insurance enterprises from contracts with policyholders. However, IAS 37 does deal with one specific issue that arises where an enterprise expects reimbursement of some or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). It states that the enterprise should recognise a reimbursement when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The amount recognised for the reimbursement should not exceed the amount of the provision and the enterprise should recognise the expected reimbursement as a separate asset. In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
- (i) IAS 38, Intangible Assets, excludes from its scope intangible assets arising in insurance enterprises from contracts with policyholders.
- (j) IAS 39, Financial Instruments: Recognition and Measurement, excludes from its scope rights and obligations under insurance contracts as defined in IAS 32. However, IAS 39 does deal with **embedded derivatives** that are included in insurance contracts.

Scope

Basic issue 1 Should the Project Cover all Aspects of Accounting by Insurers (Insurance Enterprises) or should it Focus Mainly on Insurance Contracts of All Enterprises?

8. Basic Issue 1 starts by considering whether IASC's insurance project should cover all aspects of accounting by insurers or focus mainly on insurance contracts (sub-issue 1A). It then looks at a number of related questions:
- (a) how insurance contracts should be defined (sub-issues 1B-1D);
 - (b) whether any types of insurance contract should be separated into different components (sub-issues 1E and 1F);
 - (c) whether the project should exclude any specific types of insurance contract (sub-issues 1G-1J);
 - (d) whether separate requirements are needed for specific types of insurance contract or insurer (sub-issues 1K-1M); and
 - (e) whether specific guidance should be given on self-insurance (sub-issue 1N).

Sub-issue 1A Should the Project Cover all Aspects of Accounting by Insurers or should it Focus Mainly on Insurance Contracts of all Enterprises?

9. A fundamental issue is whether the project should cover all aspects of accounting by insurers (in other words, insurance enterprises) or whether it should focus mainly on insurance contracts of all enterprises. Some argue that the project should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They also point out that insurers are often subject to a prudential framework comprising licensing procedures, authorisation to extend business to other insurance classes, fit and proper criteria for the management of the company, capital requirement and funding rules, investment rules, prescriptions as regards the amount to technical provisions, supervision by competent authorities, and so on.
10. Others argue that the project should cover insurance contracts of all enterprises, because:
- (a) it would be extremely difficult, and perhaps impossible, to create a robust definition of insurance enterprise that could be applied consistently from country to country. Among other things, an increasing number of groups have major activities in both insurance and other areas;
 - (b) it would be undesirable for an insurer to account for a transaction in one way and for a non-insurance enterprise to account in a different way for the same transaction;

- (c) the project should not re-open issues addressed by other IASC standards, unless specific features of insurance justify a different treatment; and
- (d) a set of internally consistent accounting requirements for insurers will be obtained if the accounting requirements for insurance contracts are consistent with other International Accounting Standards.

Tentative Steering Committee View

11. *The Steering Committee recommends that the main focus of the project should be on insurance contracts of all enterprises. However, the project will also need to deal with some enterprise-wide issues, such as the following:*
 - (a) *identifying the reporting entity; and*
 - (b) *presentation requirements, including format of the financial statements.*
12. *Sub-issue 1A addresses a scope issue – should the project focus on particular types of enterprise (insurers) or on particular types of transaction (insurance contracts)? Sub-issue 6A addresses a separate recognition and measurement issue: should an enterprise account for groups (or “books”) of insurance contracts on a portfolio basis or should it account for individual insurance contracts? The Steering Committee’s scope decision to focus on insurance contracts is not intended to prejudge that recognition and measurement issue.*

Sub-issue 1B How should Insurance Contracts be Defined?

13. The definition of insurance contracts will be used to determine the scope of an International Accounting Standard on insurance. Most insurance contracts are **financial instruments**, as defined in International Accounting Standards, because they create contractual rights or obligations that will result in the flow of cash or other financial instruments.¹ It follows that the definition of insurance contracts will serve two functions:
 - (a) provide a demarcation from other financial instruments on the basis of some attribute that suggests the need for a separate standard; and
 - (b) distinguish insurance contracts from other items that are not financial instruments (for example, provisions covered by IAS 37² and intangible assets covered by IAS 38).

¹ IAS 32 defines a **financial instrument** as “any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.” It defines a **financial asset** as “any asset that is: (a) cash; (b) a contractual right to receive cash or another financial asset from another enterprise; (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or (d) an equity instrument of another enterprise”. It defines a **financial liability** as “any liability that is a contractual obligation: (a) to deliver cash or another financial asset to another enterprise; or (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable”.

² It should be noted that financial instruments carried at fair value are excluded from the scope of IAS 37.

14. The following definition of insurance contracts is currently used in IAS 32, Financial Instruments: Disclosure and Presentation, IAS 39, Financial Instruments: Recognition and Measurement and the March 1997 Discussion Paper, Accounting for Financial Assets and Financial Liabilities. This definition is used primarily to exclude insurance contracts from the scope of IAS 32 and IAS 39.

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

15. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, and IAS 38, Intangible Assets, exclude from their scope provisions, contingent liabilities, contingent assets and intangible assets that arise in insurance enterprises from contracts with policyholders. This wording was used to avoid referring to a definition of insurance contracts that may change as a result of the insurance project.

Tentative Steering Committee View

16. *The Steering Committee believes that the definition used in IAS 32 needs to be refined so that it focuses more specifically on the features of insurance contracts that cause accounting problems unique to insurance contracts.*
17. *The Steering Committee believes that the feature that distinguishes insurance contracts from other financial instruments is the risk that the insurer will need to make payment (in cash or in kind) to another party if a specified uncertain future event occurs.*
18. *The Steering Committee believes that a contract that transfers only **price risk** (i.e. a derivative) should not be included in the definition of an insurance contract and should fall within the scope of the financial instruments project. Therefore, the Steering Committee proposes that the definition of insurance contract should exclude contracts where the only uncertain future event that triggers payment is a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. This is consistent with IAS 39, Financial Instruments: Recognition and Measurement, which defines a derivative as “a financial instrument:*
- (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the ‘underlying’);*
 - (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and*
 - (c) that is settled at a future date.”*

19. *Under some insurance contracts, the insurer is required to make payments in kind rather than by transferring cash or other financial assets to the policyholder (or other beneficiary named in the contract). An example is where the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Such contracts may not meet the definition of financial instruments in International Accounting Standards. The Steering Committee acknowledges that payments in kind may make it more difficult to measure an insurer's obligations under such contracts. However, the Steering Committee believes that there is no conceptual reason to treat such contracts differently from other insurance contracts that are financial instruments.*
20. *An important economic feature of insurance is that a population of policyholders are pooling their risks when they take out insurance. Some believe that the pooling of risks – either between different policyholders or over time - is a factor that may need to be considered in measuring insurance liabilities. However, the Steering Committee believes that this feature is not relevant in defining insurance contracts for financial reporting purposes.*
21. *In some countries, the legal definition of insurance requires that the policyholder (or the beneficiary under the contract) should have an insurable interest in the insured event. Such requirements are often created on public policy grounds to discourage behaviour such as insuring other people's lives and then causing their death or to discourage gambling. Insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities.*
22. *Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest. Accordingly, the Steering Committee believes that there is no need to refer to insurable interest in defining an insurance contract for financial reporting purposes.*
23. *Because it does not contain a notion of an insurable interest, the proposed definition of an insurance contract captures not only transactions that are traditionally viewed as insurance but also other transactions that are sometimes regarded as gambling. There are important social, moral, legal and regulatory differences between insurance and gambling. Nevertheless, issuers of insurance contracts and issuers of gambling contracts both accept an obligation to make payments of unknown timing or amount related to uncertain future events. Accordingly, the Steering Committee has so far identified no economic reason to exclude gambling transactions from the definition of insurance contract used for financial reporting purposes and from the scope of the project.*
24. *An insurer generally receives a payment (often known as a **premium**) as consideration for undertaking the obligations set out in the insurance contract. However, the receipt of a premium is not a feature that distinguishes an insurance contract from other types of contract. Accordingly, the Steering Committee believes that there is no need to refer to the premium in defining an insurance contract for financial reporting purposes.*

25. *The Steering Committee proposes the following definition of an insurance contract, for use in all International Accounting Standards, and related guidance. The Steering Committee recognises that other definitions may sometimes be appropriate for other purposes.*

Definition

- 25.1 An insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).

Suggested Guidance to Support the Definition

- 25.2 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, it is uncertain at the inception of a contract:
- (a) whether a future event specified in the contract will occur;
 - (b) when the specified future event will occur; or
 - (c) how much the insurer will need to pay if the specified future event occurs.
- 25.3 Some insurance contracts cover events that are discovered during the term of the contract, even if they occurred before the inception of the contract; these contracts do not cover events that are discovered after the end of the contract term, even if the events occurred during the contract term. Other insurance contracts cover events that occur during the term of the contract, even if those losses are discovered after the end of the contract term.
- 25.4 Insurance contracts may require payments to be made directly to the policyholder, to their dependants or to third parties. Insurance contracts may require payments to be made in cash or in kind.
- 25.5 It is convenient to describe the risk that is present in an insurance contract as **insurance risk** and the risk that is present in a derivative financial instrument as **price risk**. Insurance risk may be analysed into a number of different types of risk, including:
- (a) **occurrence risk** (the possibility that the number of insured events will differ from those expected);
 - (b) **severity risk** (the possibility that the cost of events will differ from expected cost); and

- (c) **development risk** (a residual category. It refers generally to changes in the amount of an insurer's obligation after the end of a contract period. Such changes may result from the late identification of insured events that occurred during the contract period, the possibility that claims will settle more quickly or in amounts greater than expected, that courts may interpret the insurer's liability differently than expected, and other factors that may change the insurer's initial estimate of costs to settle incurred claims).
- 25.6 Insurance contracts often expose an insurer to further risks, in addition to insurance risk. For example, an insurer is often exposed to **financial risk** (the possible variation in amounts earned from investing premiums during the period from receipt to payment of claims. It includes the possibility of duration mismatch and liquidity risk). Similarly, many life insurance contracts guarantee a minimum rate of return to policyholders and such guarantees expose the insurer to financial risk. However, a contract that exposes the issuer to financial risk without insurance risk is not an insurance contract.
- 25.7 The amount to be paid under an insurance contract may be affected by changes in a price or a similar variable, such as an index. However, a contract does not meet the definition of an insurance contract if the only event that triggers payment is a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. Such a contract is a derivative financial instrument and falls within the scope of IAS 39, Financial Instruments: Recognition and Measurement.
- 25.8 Some insurance contracts include an **embedded derivative** with economic characteristics and risks that are not closely related to the characteristics and risks of the insurance contract. An example is a guarantee of the returns on an investment (either an absolute return or by reference to an index or interest rates). IAS 39 requires that an enterprise should separate the embedded derivative from the "host" insurance contract and account for it at fair value as if it were a separate derivative, unless the enterprise measures the combined instrument at fair value and includes the changes in fair value in net profit or loss.³
- 25.9 The following are examples of contracts that meet the definition of an insurance contract:
- (a) insurance against damage to property;
 - (b) insurance against product liability, professional liability, civil liability or legal expenses;

³ Sub-issue 1E addresses the question of separate accounting for embedded derivatives or other components of an insurance contract.

- (c) life insurance (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur at all within the period covered by the insurance);
- (d) **annuities** and pensions (for annuities, the uncertain future event is the survival of the annuitant);
- (e) disability and medical cover;
- (f) **performance bonds** and **bid bonds** (under which an enterprise undertakes to make a payment if another party fails to perform a contractual obligation, for example an obligation to construct a building);
- (g) product warranties issued either directly by a manufacturer or dealer or indirectly by an insurer;
- (h) **financial guarantees**, for example of a loan;
- (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 uncertain future 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** (bonds that provide for reduced payments of principal and/or interest if a specified event occurs);
- (l) contracts that require a payment based on climatic, geological or other physical variables (commonly referred to as **weather derivatives**); and
- (m) **reinsurance** (insurance contracts between a **direct insurer** and a **reinsurer**, or between two reinsurers, in order to limit the risk exposure of the first insurer).

25.10 The following are examples of items that do not meet the definition of an insurance contract:

- (a) investment products that have the legal form of an insurance contract but do not expose the insurer to insurance risk (such contracts are non-insurance financial instruments);⁴
- (b) **derivatives**, in other words contracts (financial instruments) that require one party to make payment based solely on changes in a

⁴ Paragraph 27 describes an example of a contract that might have the legal form of an insurance contract in some countries but does not expose the insurer to insurance risk.

specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable; and

- (c) “**self-insurance**”, in other words an enterprise’s decision to retain a risk that could have been covered by insurance. There is no insurance contract because there is no agreement with another party (unless the risk retained itself arises from an agreement with another party, for example, under a product warranty).

25.11 Under some contracts, the amount payable is linked to a price index, but the uncertain event that triggers payment is not a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. Such contracts are insurance contracts. For example, an annuity linked to a cost-of-living index is an insurance contract. That is because payment is based not solely on changes in the index but is triggered by an uncertain event – the survival of the **annuitant**.

Sub-issue 1C How much Uncertainty is Required for a Contract to Qualify as an Insurance Contract?

26. Certain investment contracts are traditionally described as insurance contracts, but do not create significant insurance risk. In practice, such contracts may be issued by both **direct insurers** (general insurers, life insurers) and **reinsurers**.

Insurance Risk in Direct Insurance

27. An example of such a contract issued by a direct insurer is a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy an annuity at the current annuity rates charged by the insurer to other new annuitants when the policyholder exercises the conversion option. Until the option is exercised, the insurer is not exposed to insurance risk, because the insurer remains free to price the annuity on a basis that reflects the risk that the insurer assumes when the policyholder exercises the conversion option.⁵
28. Some argue that contracts of the kind described in the previous paragraph are almost indistinguishable from other financial instruments that are traditionally not treated as insurance contracts but as, for example, investments. Supporters of this view point to IAS 1, Presentation of Financial Statements, which requires that financial statements should “reflect the economic substance of events and transactions and not merely their legal form”. They argue that such contracts should be treated in the same way as other financial instruments that do not create insurance risk. In other words:

⁵ If the contract did specify the annuity rates (or a basis for setting the annuity rates), the insurer would be exposed to insurance risk.

- (a) the issuer of the contract should recognise the premium received as a financial liability, rather than as revenue; and
- (b) the holder of the contract should recognise the premium paid as a financial asset, rather than as an expense.

As explained in paragraph 99 below, the IASC Board is, together with the Joint Working Group on Financial Instruments, pursuing the objective of fair valuing all financial assets and financial liabilities in the primary financial statements.

29. Others argue that all such contracts should be treated as insurance contracts, as they are traditionally described as insurance contracts and are generally subject to regulation by insurance supervisors.
30. If the accounting treatments and disclosures for insurance contracts differ from those for other financial instruments, IASC may need to give detailed guidance on the amount of insurance risk that must be present before a contract qualifies as an insurance contract. The amount of insurance risk might be defined in quantitative terms in relation to, for example:
 - (a) the probability that payments under the contract will exceed the expected level of payments (for example, if it is expected that payments will be 100 and the estimated probability of payments exceeding this level is only, say, 1%, the insurance risk might be considered insignificant. Similarly, some would say that no insurance risk is present if the policyholder will receive a lender's rate of return under all reasonably possible scenarios);
 - (b) the range between the highest and lowest level of payments. This range might be expressed in absolute monetary amounts, as a percentage of the expected level of payments or as a percentage of some other monetary amount in the financial statements; or
 - (c) the standard deviation of payments (either in absolute monetary amounts, as a percentage of the expected level of payments or as a percentage of some other monetary amount in the financial statements).
31. The amount of loss might also be defined in qualitative terms by referring to, for example, materiality. IASC's Framework for the Preparation and Presentation of financial Statements describes materiality as follows. "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."
32. Those who support quantitative guidance believe that it promotes comparability by requiring a consistent threshold. Those who oppose quantitative guidance believe that it:
 - (a) creates arbitrary dividing lines which result in different accounting treatment for similar transactions that fall marginally on either side of the line; and

- (b) creates opportunities for accounting arbitrage by encouraging enterprises to enter into transactions that fall marginally on one side or the other of the line.

Insurance Risk in Reinsurance

33. When does a contract create sufficient insurance risk to qualify as an insurance contract? The preceding paragraphs discuss this question in the context of direct insurance. This question may also be important in reinsurance, as illustrated by the following examples of contracts between a direct insurer and a reinsurer:
- (a) contract A requires the reinsurer to make a series of fixed payments beginning in 5 years;
 - (b) contract B requires the reinsurer to reimburse certain claims, but delays that reimbursement for 10 years after they are paid by the primary insurer;
 - (c) contract C requires the reinsurer to reimburse the first 1 million of claims from a particular class of policies, in which the primary insurer expects to pay 10 million of claims;
 - (d) contract D includes provisions for the reinsurer to refund a portion of the ceded amount, or to require additional premiums, based on claim experience.
34. Many would probably agree that contract A is a loan from the direct insurer to the reinsurer. However, they would probably disagree whether the remaining three contracts transfer sufficient risk to qualify for reinsurance accounting. The second contract appears to transfer risk related to the assertion and amount of claims, but significantly delays payment. The third contract provides for timely payment, but there is little likelihood of any payment other than 1 million. The last contract might transfer risk, or the refund and assessment provisions might eliminate all risk in the contract.
35. Where a reinsurance contract does not transfer risk, it is generally considered that the premiums paid should be treated as a deposit placed by the **ceding insurer** with the reinsurer. The premiums and claims are not recognised as income and expense. This method of accounting is sometimes described as deposit accounting because banks and other financial institutions use this method to account for deposits received from other parties. Under IAS 39, Financial Instruments: Recognition and Measurement, such deposits are measured at amortised cost. As explained in Basic Issue 2 below, IASC is participating in a Joint Working Group of standard setters that is pursuing the objective of measuring all financial instruments – including deposits received – at fair value.
36. There are several criteria that might be used in determining whether or not a reinsurance contract transfers risk from the ceding company to the reinsurer:
- (a) some suggest that any contract with a reasonably predictable outcome fails the test of risk transfer;

- (b) some suggest that a reinsurance contract transfers risk only if both the amount and timing of the reinsurer's payments vary directly with the amount and timing of claims incurred by the ceding company;
 - (c) others suggest that reinsurance contracts might be considered to transfer risk if either the amount or the timing, but not necessarily both, of the reinsurer's payments vary directly with the amount and timing of claims settled by the ceding company; and
 - (d) finally, some suggest that a reinsurer must face at least the reasonable possibility that a contract will result in a financial loss, that is, that the present value of claims will exceed the premium received.
37. The previous paragraph distinguishes different types of risk. One primary motivation for this distinction is to prohibit reinsurance accounting for transactions that have the legal form of reinsurance contracts but do not transfer significant amounts of insurance risk (sometimes known as **financial reinsurance**). Where reinsurance accounting is permitted, financial reinsurance may, for example:
- (a) generate immediate accounting profits in countries where general insurance liabilities are not discounted. Such profits arise because the premium paid to the reinsurer would reflect the present value of the liability and is, therefore, less than the previous carrying amount of the liability. However, these transactions create no economic profit; and
 - (b) result in a stable pattern of earnings.

Tentative Steering Committee View

38. *Contracts that do not create insurance risk are financial instruments, but not insurance contracts for financial reporting purposes. The Steering Committee intends to develop guidance to clarify that these products fall within the scope of the Financial Instruments project. This sub-issue will not be particularly significant if the recognition, measurement and disclosure requirements for insurance contracts are consistent with those for other financial instruments.*
39. *The Steering Committee has not yet developed guidance on the amount of insurance risk that should be present for a contract to qualify as an insurance contract for financial reporting purposes. The Steering Committee welcomes comments on:*
- (a) *whether detailed guidance is needed on the amount of insurance risk that should be present for a contract to qualify as an insurance contract;*
 - (b) *the amount of insurance risk that should be present for a contract to qualify as an insurance contract; and*
 - (c) *whether any contracts that do transfer insurance risk should be excluded from the definition of insurance contracts.*

40. *The Steering Committee believes that insurance risk is present if either the amount or timing (or both) of the insurer's payments vary directly with the amount or timing (or both) of losses incurred by the policyholder.*
41. *The Steering Committee proposes that reinsurance contracts should be defined simply as insurance contracts between two insurers. To determine whether a contract transfers insurance risk, the same principles should be used for both a reinsurance contract and a (direct) insurance contract.*
42. *Some argue that the definition of a reinsurance contract should exclude contracts where the timing of payments by the reinsurer does not vary directly with the timing of losses incurred by the direct insurer. They believe that this restriction is necessary to avoid the abuse of reinsurance accounting where the direct insurance liability is measured on an undiscounted basis. However, as explained in sub-issue 7I, the Steering Committee proposes that all insurance liabilities should be discounted. Accordingly, there is no need to consider such a restriction.*

Sub-issue 1D Should an Enterprise Assess whether a Contract Creates Insurance Risk Only at Inception of the Contract or Throughout the Life of the Contract?

43. Some argue that an enterprise should review contracts at each balance sheet date to determine whether they meet the definition of an insurance contract. They argue that this is necessary so that contracts receive the same accounting treatment if they present the same level of insurance risk. On this view, an enterprise might account for a contract in one year as, for example, a financial instrument, and in the following year as an insurance contract – or vice versa.
44. Others argue it would be an unnecessary burden for an enterprise to review its contracts for this purpose at each balance sheet date. They propose that an enterprise should determine at the beginning of a contract whether the future event specified in the contract is uncertain and:
 - (a) if a contract qualifies as an insurance contract at inception, it remains an insurance contract until all rights and obligations are extinguished or expire; and
 - (b) if a contract does not qualify as an insurance contract at inception, it should not be reclassified subsequently as an insurance contract, even if an uncertainty that was previously considered insignificant becomes significant.
45. Others argue that:
 - (a) a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire (even if an uncertainty that was previously significant becomes insignificant). They argue that a requirement to reclassify in this case would be of no benefit to users of financial statements and would impose unnecessary burdens on enterprises; but

- (b) if a contract does not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if an uncertainty that was previously considered insignificant becomes significant. They argue that this would ensure consistent treatment of all contracts that create insurance risk.

Tentative Steering Committee View

46. *For the reasons described in the previous paragraph, the Steering Committee believes that:*

- (a) *a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire; and*
- (b) *if a contract does not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if an uncertainty that was previously considered insignificant becomes significant.*

47. *Paragraph 27 describes an investment contract that does not create insurance risk at inception, but includes an option for the policyholder to buy an annuity at market rates that are current when the investor buys the annuity. Until the policyholder exercises the option, the contract is not an insurance contract for financial reporting purposes. If the policyholder decides to buy the annuity, the insurer will account for the annuity as an insurance contract from that date.*

Sub-issue 1E Should an Enterprise Account Separately for the Components of Insurance Contracts that Bundle Together an Insurance Element and Other Elements, such as an Investment Element or an Embedded Derivative?

Investment element

48. The proposed definition of insurance contracts includes some products that bundle together both an insurance element (for example, death benefits) and an investment element (for example, returns linked to particular types of investment). Two possible approaches to such contracts are:

- (a) unbundle the contract for accounting purposes and account for the insurance element as an insurance contract and for the investment element as a financial instrument; or
- (b) account for the entire contract as an insurance contract.

49. Approach (a) has the advantages that:

- (a) an enterprise will account in the same way for the investment element of an insurance contract as for an otherwise identical financial instrument that does not contain an insurance risk element; and

- (b) unbundling reduces the need for detailed guidance on the level of insurance risk that must be present before a contract qualifies as an insurance contract.
50. Some would argue that the need to unbundle such contracts for accounting purposes is particularly relevant for life insurance products that contain a significant investment element. They contend that the income statement should make a clear distinction between premium income derived from risk transfer products and premium income derived from investment products. Moreover, the tendency in some countries for banks to own insurance companies (and vice-versa) and the similarity of products offered by the insurance and the fund management industry suggest that insurers, banks and fund managers should account for the investment element in a similar manner.
 51. Others maintain that it is not practical to unbundle complex insurance products into their constituent parts without making significant systems changes. They regard contracts of this kind as a single product that is regulated as insurance business by insurance supervisors and should be treated in a similar way for accounting purposes.
 52. Some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they consider information about gross premium inflows to be important.

Embedded Derivatives

53. IAS 39, Financial Instruments: Recognition and Measurement, requires that an enterprise should account separately for derivatives that are embedded in a financial instrument (the “host” contract) and have economic characteristics and risks that are not closely related to the characteristics and risks of the host contract, unless the enterprise measures the combined instrument at fair value and includes the changes in fair value in net profit or loss.
54. This requirement applies to derivatives embedded in an insurance contract, even though insurance contracts are scoped out of other aspects of IAS 39. Those who support this approach argue that it promotes comparability by requiring enterprises to account for such embedded derivatives in the same way as for a free-standing derivative with the same terms. Others argue that it may not always be practicable to separate the embedded derivative in this way.
55. IAS 39 gives the following examples of embedded derivatives with economic characteristics and risks that are not closely related to the characteristics and risks of the host contract:
 - (a) a put option on an equity instrument held by an enterprise is not closely related to the host equity instrument;
 - (b) a call option embedded in an equity instrument held by an enterprise is not closely related to the host equity instrument from the perspective of the holder (from the issuer’s perspective, the call option is an equity instrument of the

issuer if the issuer is required to or has the right to require settlement in shares, in which case it is excluded from the scope of IAS 39);

- (c) an option or automatic provision to extend the term (maturity date) of debt is not closely related to the host debt contract held by an enterprise unless there is a concurrent adjustment to the market rate of interest at the time of the extension;
- (d) equity-indexed interest or principal payments – by which the amount of interest or principal is indexed to the value of equity shares – are not closely related to the host debt instrument or insurance contract because the risks inherent in the host and the embedded derivative are dissimilar;
- (e) commodity-indexed interest or principal payments – by which the amount of interest or principal is indexed to the price of a commodity – are not closely related to the host debt instrument or insurance contract because the risks inherent in the host and the embedded derivative are dissimilar;
- (f) an equity conversion feature embedded in a debt instrument is not closely related to the host debt instrument;
- (g) a call or put option on debt that is issued at a significant discount or premium is not closely related to the debt except for debt (such as a zero coupon bond) that is callable or puttable at its accreted amount; and
- (h) arrangements known as credit derivatives that are embedded in a host debt instrument and that allow one party (the ‘beneficiary’) to transfer the credit risk of an asset, which it may or may not actually own, to another party (the ‘guarantor’) are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with a reference asset without directly purchasing it.

56. IAS 39 gives the following examples of embedded derivatives with economic characteristics and risks that are closely related to the characteristics and risks of the host contract:

- (a) the embedded derivative is linked to an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on the host debt contract (that is, IAS 39 does not permit floating rate debt to be treated as fixed rate debt with an embedded derivative);
- (b) an embedded floor or cap on interest rates is considered to be closely related to the interest rate on a debt instrument if the cap is at or above the market rate of interest or if 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;
- (c) the embedded derivative is a stream of principal or interest payments that are denominated in a foreign currency. Such a derivative is not separated from the

host contract because IAS 21, The Effects of Changes in Foreign Exchange Rates, requires that foreign currency translation gains and losses on the entire host monetary item be recognised in net profit or loss;

- (d) the host contract is not a financial instrument and it requires payments denominated in (i) the currency of the primary economic environment in which any substantial party to that contract operates or (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions). That is, such contract is not regarded as a host contract with an embedded foreign currency derivative;
- (e) the embedded derivative is a prepayment option with an exercise price that would not result in a significant gain or loss;
- (f) the embedded derivative is a prepayment option that is embedded in an interest-only or principal-only strip that (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative and that (ii) does not contain any terms not present in the original host debt contract;
- (g) with regard to a host contract that is a lease, the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the enterprise's own economic environment), (ii) contingent rentals based on related sales, and (iii) contingent rentals based on variable interest rates; or
- (h) the embedded derivative is an interest rate or interest rate index that does not alter the net interest payments that otherwise would be paid on the host contract in such a way that the holder would not recover substantially all of its recorded investment or (in the case of a derivative that is a liability) the issuer would pay a rate more than twice the market rate at inception.

Tentative Steering Committee View

57. *The Steering Committee believes that unbundling as described in paragraph 48(a) is conceptually preferable but that it relies on distinctions that may be difficult to make in practice. The Steering Committee proposes that contracts should be unbundled when the separate components are either:*

- (a) disclosed explicitly to the policyholder; or*
- (b) clearly identifiable from the terms of the contract.*

58. *The Steering Committee believes that a derivative embedded in a host insurance contract is clearly identifiable from the terms of the policy, and should be separated from the host insurance contract, where all of the following conditions are met:*

- (a) the embedded derivative does not create insurance risk;*

- (b) *the embedded derivative has characteristics and risks that are not closely related to the characteristics and risks of the host insurance contract; and*
 - (c) *a stand-alone instrument with similar terms would meet the definition of a derivative.*
59. *The Steering Committee would welcome comments on whether unbundling should be used for other contracts.*
60. *If all financial instruments, including insurance contracts, are measured at fair value, it may be less important to account separately for the components of insurance contracts that bundle together an insurance element and other elements. This is because there would be no scope for accounting arbitrage between contracts treated as insurance and contracts treated as other financial instruments. On the other hand, there may still be a need for some unbundling to the extent that there are differences in presentation or disclosure requirements – for example, if all cash inflows for insurance contracts are treated as premium revenue and cash inflows for some other financial instruments are treated as deposits.*

Sub-issue 1F Should Catastrophe Bonds be Treated as Insurance Contracts?

61. *Insurers have started to issue catastrophe bonds in the last few years as an alternative to conventional reinsurance. Catastrophe bonds are bonds that provide for reduced payments of principal and/or interest if a specified event occurs. In return for bearing the risk of losing some or all of the principal or interest, the bondholder receives a higher interest rate than on a conventional bond of the same amount and maturity. For many catastrophe bonds, the specified event is a rare event that causes severe losses, for example aggregate losses of \$X billion from an earthquake. The specified level of losses may be determined in monetary terms or by reference to an index.*

Tentative Steering Committee View

62. *In substance, the holder of a catastrophe bond has issued an insurance contract that is embedded in a conventional bond. The premium for that contract is the additional interest that the bondholder will receive if the specified event does not occur. Consistent with the Steering Committee's view on sub-issue 1E, both an issuer and a bondholder should account separately for (unbundle) the host bond and the embedded insurance contract:*
- (a) *the host bond should be treated as an asset of the bondholder and a liability of the issuer; and*
 - (b) *the embedded insurance contract should be treated as an insurance contract issued by the bondholder (in substance, an insurer) to the issuer of the bond (in substance, a policyholder).*
63. *Separate accounting will be particularly important if there are any differences between the measurement bases for insurance contracts and financial instruments. However, where a catastrophe bond is quoted in a deep and liquid market, the fair*

value of the bond will be readily obtainable and this may reduce the need for separate accounting for the components.

Sub-issue 1G Should Financial Guarantees be Treated as Insurance Contracts or as (Other) Financial Instruments?

64. Financial guarantees, for example of a loan, meet the proposed definition of an insurance contract. Some argue that because financial guarantees create credit risk rather than other forms of insurance risk, they should be covered in a standard on financial instruments. It should be noted that financial guarantees that are not measured at fair value fall within the scope of IAS 37, Provisions, Contingent Liabilities and Contingent Assets (the scope of IAS 37 excludes financial instruments that are carried at fair value).

Tentative Steering Committee View

65. *The Steering Committee has identified three types of financial guarantee:*
- (a) financial guarantees that require payments in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. Such financial guarantees meet the definition of derivatives in IAS 39 and IAS 39 establishes accounting requirements for them. In the Steering Committee's view, these financial guarantees should remain within the scope of the financial instruments project;*
 - (b) financial guarantees that require payments to be made if the debtor fails to make payment when due. In the Steering Committee's view, the credit risk resulting from these contracts is a form of insurance risk. Therefore, the Steering Committee believes that they should be covered by a standard on insurance rather than by IAS 37 (as at present) or a standard on financial instruments; and*
 - (c) financial guarantees that require payments to be made (either to the debtor or to the creditor) if the debtor's income is reduced by specified adverse events such as unemployment or illness, even if the debtor continues to pay off the loan when due. The Steering Committee believes that the insurance project should cover these contracts.*

Sub-issue 1H Should Product Warranties be Included in the Scope of the Project?

66. Product warranties create obligations and risks that are similar in some ways to those arising under financial guarantees. A product warranty clearly meets the proposed definition of an insurance contract if it is issued by an insurer on behalf of another party (such as a retailer or manufacturer).
67. A product warranty issued directly by a retailer or manufacturer also meets the proposed definition of an insurance contract; although some might think of this as "self-insurance", the risk retained itself arises from an agreement with another party –

the customer. Some would argue that product warranties issued directly by a retailer or manufacturer are so closely related to the underlying sale of goods that they should not be covered by the standard on insurance. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, already addresses product warranties. The revenue received for product warranties is covered in IAS 18, Revenue.

Tentative Steering Committee View

68. *The Steering Committee believes that the insurance standard should address product warranties issued by insurers on behalf of other parties (such as a retailer or manufacturer) because such product warranties are excluded from the scope of IAS 37 and IAS 39. However, the Steering Committee believes that the insurance standard should not address product warranties issued directly by a retailer or manufacturer, as these are already covered by IAS 37.*

Sub-issue 1I Should the Project Deal with Accounting by Insured Enterprises?

69. From the perspective of an insured enterprise, the main sub-issues would seem to be:
- (a) how should an enterprise account for amounts paid in advance for future coverage? It is uncontroversial that these should be treated as prepayments;
 - (b) when should an enterprise recognise receivables as an asset? To an extent, this is covered by IAS 37, Provisions, Contingent Liabilities and Contingent Assets, which deals, among other things, with reimbursements from insurers for expenditure required to settle a provision; and
 - (c) should reimbursements under insurance contracts be offset against the related losses in the income statement? To an extent, this topic is also covered by IAS 37 for reimbursements that relate to a provision.
70. Some argue that accounting by insured enterprises for insurance contracts does not appear to cause any particular problems in practice and should not, therefore, be included in the scope of the project.
71. Others argue that if the project deals with insurance contracts, then it would be logical to deal with the accounting consequences for both parties to the transaction. Also, the project will certainly need to deal with an insurer's rights under reinsurance contracts, so it seems logical to deal with the rights that enterprises of all kinds have under insurance contracts of all kinds.

Tentative Steering Committee View

72. *The Steering Committee's view is that accounting by insured enterprises for insurance contracts should not be excluded from the project at this stage. The Steering Committee will consider such an exclusion later in the project. The Steering Committee has not considered whether recognition and measurement requirements for insured enterprises should be the same as the recognition and measurement requirements for insurers.*

Sub-issue 1J Should the Project Deal with Employee Benefit Plans?

73. Defined benefit pensions and other defined-benefit-type post-employment benefits meet the proposed definition of insurance contracts. Accounting by employers for such benefits is covered by IAS 19, Employee Benefits. Accounting by retirement benefit plans is covered by IAS 26.
74. Some enterprises operate funded defined benefit pension plans that enter into insurance contracts. If the contracts are with an external insurer, the contracts generally qualify as plan assets under IAS 19, Employee Benefits, and the enterprise offsets them against the reported pension liability. However, if the contracts are issued by the enterprise itself (if it is an insurer) or by a consolidated subsidiary that is an insurer, the contract will generally be eliminated from the financial statements. The result is that the enterprise will report:
- (a) the full amount of its pension obligation without any deduction for the plan's rights under the contract;
 - (b) no liability to policyholders under the contract; and
 - (c) the assets backing the contract.

Tentative Steering Committee View

75. *The Steering Committee proposes to exclude employee benefits from the scope of the project, as IAS 19 and IAS 26 already deal with this issue.*

Sub-issue 1K Is the Distinction between General Insurance and Life Insurance Important? If So, How should the Distinction be made?

76. In many countries, it is mandatory for prudential reasons to make a distinction between **general insurance** (sometimes known as **property and casualty insurance** or **short-term insurance**) and **life insurance** (sometimes known as **long-term insurance**).
77. General insurance contracts typically provide insurance protection for a fixed period of short duration and enable the insurer to cancel the contract or to adjust the terms of the contract at the end of any contract period, such as adjusting the amount of premiums charged and cover provided. General insurance contracts are sometimes classified as **long-tail** (where claims may not be settled for many years) or **short-tail**. General insurance contracts cover risks such as:
- (a) losses from damage to, or destruction of, property (for example, through fire, storm, earthquake or theft);
 - (b) losses arising from accidents involving motor vehicles, ships or aircraft; or

- (c) indemnity against losses from product liability, professional liability, business interruption, civil liability or legal expenses.
78. Life insurance contracts are often of long duration and the insurer often has little or no ability to adjust the level of premiums during the term of the contract. Examples of life insurance are:
- (a) term life insurance, where the insurer is required to make a payment if the policyholder dies during the term of the contract. If the policyholder survives to the end of the period specified in the contract, no payment is made;
 - (b) whole-life contracts, where the insurer is required to make a payment when the policyholder dies, regardless of when the policyholder dies. For such contracts, it is certain that the insurer will need to make a payment (provided that the policyholder continues to pay premiums) but it is uncertain when the payment will be required;
 - (c) investment-linked contracts, where the insurer is required to make a payment if the policyholder dies during the term of the contract. If the policyholder survives to the end of the period specified in the contract, a payment is made based on premiums paid by the policyholder and actual or notional investment earnings on those premiums. Investment-linked contracts are, in effect, a combination of an investment and a term life contract. In some cases, the investment element may be predominant and the term contract element may be relatively insignificant;
 - (d) annuities, which are a periodic payment (usually monthly) made from a stated or contingent date and continued for a fixed period, or for as long as the annuitant or annuitants live;
 - (e) insurance against sickness, disability or accident (sometimes classified as general insurance or as a separate category, depending on the regulatory regime);
 - (f) long-term care, for example in old age; and
 - (g) contracts that are predominantly investment products, where the policyholder normally bears most of the investment risk.
79. Some people argue that it is important to develop separate requirements for general insurance and for life insurance because, although both categories expose an insurer to risk, the nature of the risks is very different. They also feel that users, preparers and regulators are familiar with such a distinction and would be surprised if it were removed.
80. Others argue that it is not helpful to distinguish between general insurance and life insurance, on the grounds that:

- (a) the differences between general insurance and life insurance are more a matter of degree than of principle. Some general insurance contracts have characteristics that are more often associated with life insurance contracts. For example, some general insurance contracts require the insurer to provide coverage for ten years at rates specified at inception. Similarly, a one-year non-renewable term insurance contract may resemble a typical general insurance contract rather than a typical life insurance contract;
 - (b) it is important that the same principles should be used for both general insurance and life insurance; and
 - (c) it is not always clear whether a particular type of contract should be classified as life insurance or general insurance. Indeed, different jurisdictions draw the boundary between general insurance and life insurance in different places. This may make it difficult to make the distinction in a consistent way.
81. Some argue that a distinction between general insurance and life insurance is less relevant than a distinction between short-term contracts and long-term contracts, perhaps using a twelve-month cut-off.

Tentative Steering Committee View

82. *The Steering Committee intends to develop accounting models for general insurance and life insurance that are separate, but based on the same underlying principles.*
83. *The Steering Committee believes that the main economic feature that distinguishes most general insurance contracts from most life insurance contracts is the length of the contract. For most general insurance contracts, the contract is for a short term and the insurer is free to change premiums after the end of the period covered by the current premium, or even to decline to renew the contract. For many life insurance contracts, the contract is for a long term and the insurer has limited or no ability to reset premiums and is required to continue to provide cover if the policyholder continues to pay premiums. This requirement to continue providing cover is a source of additional liabilities (and, perhaps, assets) that do not arise in contracts that do not have this feature.*
84. *Accordingly, the Steering Committee proposes to make the distinction for financial reporting purposes as follows:*
- (a) *insurance should be treated as general insurance for financial reporting purposes if the insurer is committed to a pricing structure for not more than twelve months; and*
 - (b) *insurance should be treated as life insurance for financial reporting purposes if the insurer is committed to a pricing structure for more than twelve months.*

Sub-issue 1L Are there any Specific Issues that are Unique to Health and Medical Insurance?

85. The nature of health and medical insurance varies from country to country. For example, in some countries, insurers are permitted to change the level of premiums during the contract. In other countries, this is not permitted. Health and medical insurance is sometimes considered to be a form of general insurance and sometimes it is considered to be a form of life insurance. Some consider it be a category separate from both general insurance and life insurance.

Tentative Steering Committee View

86. *The Steering Committee has not identified any characteristics of health and medical insurance that are not already addressed elsewhere in this Issues Paper. The Steering Committee welcomes comments on any aspects of health and medical insurance that need to be considered separately.*
87. *The Steering Committee believes that health and medical insurance will sometimes be best classified for accounting purposes as general insurance and sometimes as life insurance, depending on the specific characteristic of each contract.*

Sub-issue 1M Should Different Accounting Requirements be Set for Different Types of Insurer or for Insurers with Different Legal Forms?

88. There are a number of different types of insurer. Some insurers (stock companies or proprietary companies) take the legal form of a corporation owned by stockholders or shareholders. Other insurers are mutuals owned by their policyholders. In some countries, insurers are owned by government.
89. Some insurers reinsure risks ceded to them by other insurers. This may be a part of their business or it may be their only business.
90. Some insurers insure only risks of a single enterprise or group. These insurers are known as captives or captive insurers. Under some definitions, captives also include insurers that insure only risks of a limited number of unrelated enterprises or groups, and insurers that started as captives but now also write a limited amount of business for other enterprises or groups.
91. Insurers or reinsurers sometimes form **underwriting pools** or enter into **co-insurance** arrangements as vehicles for jointly insuring particular risks or types of risks. Premiums, claims and expenses are usually shared in agreed ratios by insurers or reinsurers involved in such arrangements. An example of such arrangements are the syndicates through which members of Lloyd's of London issue contracts. Lloyd's Syndicates are joint ventures formed for one year. Every syndicate is managed by a managing agent. Each member of the syndicate is liable for its share of the claims under the contract, but has no liability if another member of the syndicate defaults on its share of the claims.

Tentative Steering Committee View

92. *The Steering Committee sees no reason to set different accounting requirements for different types of insurer. As the project progresses, the Steering Committee will consider whether there is a need for additional requirements for certain types of insurer to supplement the requirements that it will develop for all enterprises that are parties to insurance contracts.*

Sub-issue 1N Should Specific Guidance be Given on Self-insurance?

93. The term “self-insurance” refers to an enterprise’s decision not to transfer risk to another party (i.e. an insurer). “Self-insurance” does not meet the proposed definition of an insurance contract. Appendix 2 to E59, Provisions, Contingent Liabilities and Contingent Assets gave the following guidance on “self-insurance”. This guidance is not included in the final standard (IAS 37).

An enterprise that operates a chain of retail outlets has reviewed its insurance arrangements for its liability in respect of accidents sustained by its customers. It establishes that, based on its past experience, the cost of these accidents is 100,000 a year. Instead of continuing its policy with an insurance enterprise, it decides to “self insure”: that is, to bear the risk of these losses itself. Is provision made for the amount expected to arise in a normal year?

As there is no obligation to another party until an accident occurs, provision of a larger amount than the cost of the actual accidents is not permitted by paragraph 14. It is for this reason that paragraph 20 notes that provision is not made for general business risks. As provision is not made the expenses of different periods vary, depending upon the incidence of accidents, which may contrast with the more constant expense that would be likely if the enterprise's policy were to insure for these risks. However, this variability in expense is a consequence of the enterprise's exposure to risk, and is not obscured by making a provision, since to do so would not represent faithfully the enterprise's position.

Because an obligation arises on the occurrence of an accident, it is necessary to provide for the expected cost of all such accidents that occurred prior to the balance sheet date, including those for which the customer has yet to make a claim.

Tentative Steering Committee View

94. *The Steering Committee believes that the example that was contained in E59 is consistent with the principles set out in IAS 37: where there is no obligation at the reporting date to another party, no liability should be recognised. The Steering Committee does not intend to develop guidance on self-insurance, other than perhaps a brief reference to explain how self-insurance differs from insurance.*

Basic issue 2 Should the Project Deal with Financial Instruments (Other than Insurance Contracts) held by Insurers?

95. Some argue that the project should deal with investments and other financial instruments (other than insurance contracts) held by insurers, to ensure that the financial reporting for insurers is internally consistent.
96. Others argue that the project should not deal with financial instruments (other than insurance policies) because:
- (a) it would be undesirable for an insurance enterprise to account for a transaction in one way and for a non-insurance enterprise to account in a different way for the same transaction;
 - (b) the project should not re-open issues addressed by other IASC standards, unless there are specific features of insurance that justify a different treatment; and
 - (c) a set of internally consistent accounting requirements for insurers will be obtained if the accounting requirements for insurance contracts are consistent with the International Accounting Standard on the recognition and measurement of financial instruments. Paragraphs 97-101 explain the current status of IASC's work on financial instruments.

IASC's Project on Financial Instruments

97. In March 1997, IASC's Steering Committee on Financial Instruments published a Discussion Paper, Accounting for Financial Assets and Financial Liabilities. The Discussion Paper proposed that financial instruments should be measured at fair value and (with exceptions for certain hedging instruments) changes in fair value should be recognised as income immediately when they arise.
98. In relation to insurance contracts, chapter 2 of the Discussion Paper included the following discussion in paragraphs 2.5-2.7 and 6.23-6.26.

- 2.5 Some advocate exempting insurance companies, defined benefit pension plans and similar enterprises from this project, because of the unique characteristics of their obligations, which some believe affect accounting for both their assets and obligations. Measurement of insurance and pension-type obligations present difficult estimation problems to take account of mortality, morbidity and similar risks.
- 2.6 Some argue that if these obligations of insurance companies and pension plans are exempt from the project, then the assets of these enterprises should also be exempt. They argue that this would permit the assets to be recognised and measured on a basis consistent with the methods used for determining the obligations, thus enabling internal consistency within an enterprise. The considerable disadvantage of this approach is that insurance and pension organisations own large amounts of financial assets, and the result would be

non-comparability with similar assets, and reported income therefrom, of other enterprises. IAS 32 exempts only obligations under insurance contracts, pension and similar plans, not other financial instruments (but, of course, it only deals with presentation and disclosure issues).

- 2.7 The [Financial Instruments] Steering Committee has concluded that the general principles proposed in this Discussion Paper are relevant to insurance, pension and similar enterprises, and that their financial assets and financial liabilities should be recognised and measured on the same basis as those of other enterprises. At the same time, the Steering Committee accepts that obligations of defined benefit pension plans, and insurance obligations, reinsurance receivables and similar items, have unique attributes that require special consideration in order to appropriately apply the proposed principles. A proposal to exempt these items, pending further study, is discussed in paragraphs 6.23 to 6.26 of this chapter.
- 6.23 These items include the obligation of an enterprise to provide benefits to its present and past employees, the obligations and reinsurance receivables of an insurance company arising under insurance contracts and the obligations of a pension plan to make future payments to members. An insurance contract is defined to be “a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death, (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption” (see IAS 32, paragraph 3).
- 6.24 Such items are financial instruments because they are contractual rights or obligations that will result in the flow of cash or other financial instruments. Nevertheless, IAS 32 excludes pension type obligations and obligations arising under insurance contracts from its scope, although it encourages enterprises that have obligations under insurance contracts “to consider the appropriateness” of applying its presentation and disclosure provisions to insurance contract obligations (paragraph 3). The similar Canadian Standard on the presentation and disclosure of financial instruments (CICA Handbook, Section 3860) does not provide this exemption, but does defer application of the Standard to life insurers to allow them time to develop bases for applying the requirements.
- 6.25 These items present unique estimation problems, and are exposed to mis-estimation risk (i.e. the risk that the amounts ultimately payable may be higher than expected). The problem has been that actuarial methodologies developed for making these estimates have not been consistent with accounting framework concepts and measurement principles. The insurance industry and the accounting and actuarial professions have not yet reached a common understanding about how to estimate the fair value of these obligations.
- 6.26 On the one hand the [Financial Instruments] Steering Committee has concluded that the objective should be to recognise and measure all financial instruments in accordance with the principles proposed in this Discussion

Paper, and that these principles are relevant to pension and insurance obligations, reinsurance receivables and similar items. On the other hand, it is beyond the scope of this Discussion Paper to address the issues involved in recognising and measuring these items. [footnote omitted] The [Financial Instruments] Steering Committee thus accepts that additional study and consultation will be necessary to resolve the application issues associated with pension and insurance obligations, reinsurance receivables and similar items before the principles proposed in this Discussion Paper can be applied to these items.

99. After reviewing the comment letters on the Discussion Paper, the Board decided in November 1997 that IASC should participate with national standard setters in a Joint Working Group (JWG) to pursue the objective of measuring all financial instruments at fair value. The JWG aims to produce an Exposure Draft by the year 2000. The intention is that the standard setters (including IASC) participating in the JWG will publish that Exposure Draft. In the light of the comments on the Exposure Draft, the JWG will then develop recommendations for a final standard and submit them to the participating standard setters.
100. To meet the urgent need for a standard on financial instruments, the IASC Board approved IAS 39, Financial Instruments: Recognition and Measurement, in December 1998. The intention is that IAS 39 will ultimately be superseded by a final standard based on the JWG's final recommendations, if those recommendations are acceptable to the IASC Board.
101. Under IAS 39:
 - (a) all financial assets and financial liabilities held for trading purposes and all derivatives are measured at fair value. Changes in their fair value are recognised in the income statement;
 - (b) all available-for-sale investments are measured at fair value. Changes in their fair value are recognised either in the income statement or directly in equity, through the statement of changes in equity. When the financial asset is sold, collected, or otherwise disposed of or impaired, the cumulative gain or loss previously recognised in equity is included in the income statement; and
 - (c) the amortised cost basis is used to measure:
 - (i) all loans and receivables originated by the enterprise and not held for trading;
 - (ii) all held-to-maturity investments;
 - (iii) any financial asset that does not have a quoted market price in an active market and whose fair value cannot be reliably measured; and
 - (iv) all financial liabilities, other than derivatives and financial liabilities held for trading purposes.

Responses to the Financial Instruments Discussion Paper

102. The responses to the March 1997 Discussion Paper on Accounting for Financial Assets and Financial Liabilities include a number of comments on insurance contracts and insurers. These comments are summarised below.
103. The Discussion Paper argued that further study would be needed before insurance obligations could be included within the scope of a Standard embodying the principles set out in the Discussion Paper. Most respondents who commented on this question agreed with this view. A number argued further that assets held by insurers or to satisfy insurance obligations should be excluded, at least temporarily, from the scope of the proposals until issues associated with accounting for insurance obligations have been resolved.
104. Some respondents argued that the financial instruments project should deal with instruments that have the form of an insurance contract but transfer financial risks or have characteristics similar to derivatives. Examples cited were credit risk insurance, financial guarantees and “time and distance” insurance contracts (i.e. contracts that are essentially financing transactions and do not transfer insurance risk) and interest rate products that are investment vehicles rather than mortality products.
105. Some respondents asked for more guidance on the treatment of derivatives that are embedded in insurance contracts, for example products that hedge foreign currency risk combined with traditional insurance coverage of, for example, worker’s compensation claims. One respondent asked for a more operational definition of an insurance obligation. Another respondent suggested that the principles to be developed for insurance obligations should also apply to warranty obligations (such as product warranties).
106. Several respondents argued that accounting for insurance liabilities should be consistent with accounting for financial instruments. A few respondents argued that the fair value of insurance obligations may be difficult to determine, or not relevant, because:
 - (a) insurance liabilities are often long term in nature;
 - (b) insurance liabilities often have option-like characteristics embedded in them;
 - (c) the duration of many insurance liabilities is uncertain and liability values can vary depending on whether interest rates rise or fall. Also, a cash value exists for some life insurance or annuity obligations, but that cash value may not be an appropriate measure of their fair value. Some respondents saw analogies with the issues of core deposit intangibles;
 - (d) many insurance liabilities have a significant discretionary component, for example, the sizes of future bonuses that might be declared on participating contracts;

- (e) many valuation assumptions are needed to measure life insurance liabilities and these are often company specific. As a result, a significant element of actuarial judgement is needed to measure many life insurance liabilities; and
- (f) sometimes assets are “ring-fenced” for the benefit of policyholders so that the policyholders bear most of the risk from fluctuations in these assets and liabilities, while the shareholders have only an indirect interest in a proportion of these assets.

107. Other points made by some respondents were that:

- (a) a switch towards a fair/market value approach may have adverse tax consequences;
- (b) the EU Insurance Accounts Directive permits life assurance companies writing with-profits (participating) business to set up a “fund for future appropriations”. This is classified as neither a liability to policyholders nor a shareholders' asset;
- (c) valuation of insurance liabilities and related assets should be prudent, as over-distribution may increase the risk of insolvency;
- (d) some insurers hold private loans and mortgage loans that are priced on an unofficial market with less transparent pricing than on the official market.
- (e) real estate held by insurers should be measured in the same way as their other assets;
- (f) in some cases, there is an obligation to return a portion of changes in fair value to policyholders (either directly via participation, as in some life insurance, or by the balancing out of underwriting results, as in some property-casualty insurance);
- (g) the discount rate for liabilities should reflect the expected investment earnings; and
- (h) insurers must comply with regulatory requirements (governing the holding of assets matched to liabilities). This means that an “intent-based model” of hedging should be considered.

Tentative Steering Committee View

108. *The Steering Committee believes that the project should deal with financial instruments that are insurance contracts, but not with other financial instruments. The Steering Committee will monitor progress by the Joint Working Group on financial instruments.*
109. *In developing proposals for the treatment of insurance contracts, the Steering Committee will work for consistency with the treatment of assets held by insurers.*

For this purpose, the Steering Committee has assumed that IAS 39 will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities, including all non-insurance financial assets and non-insurance financial liabilities held by insurers.

Project Timetable

Basic issue 3 Should IASC Issue Provisional Guidance on Certain Aspects of Insurance Accounting or Disclosure?

110. As explained in paragraphs 5 and 6, the rest of IASC's insurance project will involve several stages, including the development of a Draft Statement of Principles (DSOP), a final Statement of Principles, an Exposure Draft and a final International Accounting Standard. Even on the most optimistic assumptions, this process cannot realistically be completed before 2003 and any final Standard could not be in force before 2004.
111. As this Issues Paper demonstrates, there are many, very difficult, conceptual and practical issues in insurance accounting. As a result, it is almost inevitable that there will be delays in resolving some of these issues and such delays are likely to hold back the completion of the project. In addition, the Steering Committee's work is closely intertwined with the work of the Joint Working Group on Financial Instruments (JWG). If the JWG experiences difficulties in completing its own complex and difficult work, this may delay the completion of the Insurance project.
112. Some believe that it would be unacceptable for IASC to delay completion of its insurance project until 2003, or even longer. They stress that there is an urgent need for an international standard for insurance, because there is not yet an internationally recognised accounting standard on this subject and national standards are quite different throughout the world. They propose that IASC should develop a provisional Standard on Recognition and Measurement issues, building on the best features of current practice. They believe that IASC should be able to develop a provisional Standard of this kind on a timely basis, while still working towards a more lasting solution working from the Steering Committee's tentative views as expressed in this Issues Paper. Supporters of this approach point to IASC's approach to financial instruments. IASC issued IAS 39 to meet the urgent need for a Standard on financial instruments, while still working (with the Joint Working Group) towards a more lasting solution).
113. Others believe that it would not be worthwhile trying to develop an interim solution, for the following reasons:
- (a) given the diversity of current national practices, it may not be easy to reach a quick agreement on what the interim solution would be;
 - (b) an interim solution would inevitably involve a number of compromises that could create recognition and measurement mismatches. Efforts to minimise those mismatches may lead to considerable complexity;

- (c) if the Joint Working Group achieves its current timetable, a final standard on financial instruments may be in place before IASC could finalise an interim insurance standard and so an interim standard would be immediately out of date (of course, if the JWG is seriously delayed, the Steering Committee will need to reconsider its approach and there may then be a more compelling case for trying to develop an interim standard); and
 - (d) even for an interim standard, IASC would need to follow a full due process. Even on the most optimistic assumptions, this could not take less than three years from now. It should be noted that IAS 39 was not issued suddenly without preparation – it took over ten years of intensive work and discussion for IASC to reach this point and IAS 39 was preceded by three exposure drafts. IASC has never previously discussed insurance issues and this Issues Paper is IASC’s first publication on the subject.
114. One other possibility would be for IASC to develop a Standard dealing solely with disclosure issues, leaving recognition and measurement issues until a later date. IASC followed this path with financial instruments, approving a disclosure and presentation Standard in 1995 (IAS 32) and a recognition and measurement standard (IAS 39) in 1999. However IASC did not begin its financial instruments with this intention and some argue that IASC should not start this project with that intention.

Tentative Steering Committee View

115. *For the reasons discussed in paragraph 113, the Steering Committee considers that it is not worthwhile trying to develop an interim standard on recognition and measurement of insurance contracts. When it reviews the comment letters on this Issues Paper, the Steering Committee will consider whether there is case for trying to develop a separate Standard on disclosure issues at an earlier date.*