Compiled Accounting Standard **AASB 4**

Insurance Contracts

This compilation was prepared on 23 September 2005 taking into account amendments made up to and including 15 September.

Prepared by the staff of the Australian Accounting Standards Board.

Australian Government

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AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.com.au
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Other enquiries

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail: standard@aasb.com.au

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BASIS FOR CONCLUSIONS ON IFRS 4

(available to AASB online subscribers or through the IASB)

Australian Accounting Standard AASB 4 *Insurance Contracts* is set out in paragraphs 1 – 45 and in Appendices A – B. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in this Standard are in *italics* the first time they appear in the Standard. AASB 4 is to be read in the context of other Australian Accounting Standards, including AASB 1048 *Interpretation and Application of Standards*, which identifies the Australian Accounting Interpretations. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

COMPILATION DETAILS

Accounting Standard AASB 4 *Insurance Contracts* as amended

This compilation takes into account amendments up to and including 15 September 2005 and was prepared on 30 September 2005 by the staff of the Australian Accounting Standards Board (AASB).

This compilation is not a separate Accounting Standard made by the AASB. Instead, it is a representation of AASB 4 (July 2004) as amended by other Accounting Standards, which are listed in the Tables below.

Table of Standards

Standard	**Date made**	**Date of notification in *Gazette* or FRLI registration**	**Application date (*annual reporting periods)***	**Application, saving or transitional provisions**
AASB 4	15 Jul 2004	22 Jul 2004	*(beginning)* 1 Jan 2005	
AASB 2005-9	6 Sept 2005	19 Sept 2005	*(beginning)* 1 Jan 2006 (a)	
AASB 2005-10	5 Sept 2005	19 Sept 2005	*(beginning)* 1 Jan 2007 (a)	

(a) Entities may choose to early adopt this Standard for annual reporting periods beginning on or after 1 January 2005.

Table of Amendments

Paragraph affected	**How affected**	**By … [paragraph]**
2(b)	amended	AASB 2005-10 [36]
3	amended	AASB 2005-10 [37]
4(d)	amended	AASB 2005-9 [7]
35(d)	added	AASB 2005-10 [38]
38 & 39	amended	AASB 2005-10 [39]
39A	added	AASB 2005-10 [40]
41A	added	AASB 2005-9 [8]
Appendix A	added	AASB 2005-9 [9]
B18(g)	amended	AASB 2005-9 [10]
B19(f)	amended	AASB 2005-9 [11]

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

AASB 4 and IFRS 4

AASB 4 as amended is equivalent to IFRS 4 *Insurance Contracts* as issued by the IASB. Paragraphs that have been added to this Standard (and do not appear in the text of the equivalent IASB Standard) are identified with the prefix “Aus”, followed by the number of the relevant IASB paragraph and decimal numbering.

Compliance with IFRS 4

Entities that comply with AASB 4 as amended will simultaneously be in compliance with IFRS 4.

AASB 4 and IPSASs

International Public Sector Accounting Standards (IPSASs) are issued by the International Public Sector Accounting Standards Board of the International Federation of Accountants.

There is no specific IPSAS dealing with insurance contracts at present.

ACCOUNTING STANDARD AASB 4

The Australian Accounting Standards Board made Accounting Standard AASB 4 *Insurance Contracts* under section 334 of the *Corporations Act 2001* on 15 July 2004.

The compiled version of AASB 4 incorporates subsequent amendments contained in other AASB Standards made by the AASB up to and including 15 September 2005 (see Compilation Details).

ACCOUNTING STANDARD AASB 4

INSURANCE CONTRACTS

Objective

1 The objective of this Standard, in conjunction with AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*, is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this Standard as an insurer) until the AASB and IASB complete the second phase of the insurance project. In particular, this Standard requires:

(a) limited improvements to accounting by insurers for insurance contracts; and

(b) disclosure that identifies and explains the amounts in an insurer's financial report arising from insurance contracts and helps users of those financial reports understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Application

Aus1.1 This Standard applies to:

(a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;

(b) **general purpose financial reports of each other reporting entity; and**

(c) **financial reports that are, or are held out to be, general purpose financial reports.**

Aus1.2 **This Standard applies to annual reporting periods beginning on or after 1 January 2005.**

Aus1.3 **This Standard shall not be applied to annual reporting periods beginning before 1 January 2005.**

Aus1.4 **The requirements specified in this Standard apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**

Aus1.5 Notice of this Standard was published in the *Commonwealth of Australia Gazette* No S 294, 22 July 2004.

Scope

2 An entity shall apply this Standard to:

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

(b) financial instruments that it issues with a *discretionary participation feature* (see paragraph 35). AASB 7 *Financial Instruments: Disclosures* requires disclosure about financial instruments, including financial instruments that contain such features.

3 This Standard 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 AASB 132 *Financial Instruments: Presentation* and AASB 139 *Financial Instruments: Recognition and Measurement*), except in the transitional provisions in paragraph 45.

4 An entity shall not apply this Standard to:

Aus4.1 *general insurance contracts* (see AASB 1023 *General Insurance Contracts*), except for fixed-fee service contracts that meet the definition of an insurance contract under this Standard;

Aus4.2 *life insurance contracts* (see AASB 1038 *Life Insurance Contracts*);

(a) product warranties issued directly by a manufacturer, dealer or retailer (see AASB 118 *Revenue* and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*);

(b) employers' assets and liabilities under employee benefit plans (see AASB 119 *Employee Benefits* and AASB 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see AAS 25 *Financial Reporting by Superannuation Plans*);

(c) 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 AASB 117 *Leases*, AASB 118 *Revenue* and AASB 138 *Intangible Assets*);

(d) *financial guarantee contracts* unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either AASB 139 and AASB 132 or AASB 1023 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable;

(e) contingent consideration payable or receivable in a business combination (see AASB 3 *Business Combinations*); and

(f) direct insurance contracts that the entity holds (i.e. direct insurance contracts in which the entity is the policyholder). However, a cedant shall apply this Standard to reinsurance contracts that it holds.

5 For ease of reference, this Standard describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this Standard to insurance contracts also apply to reinsurance contracts.

Aus6.1 This Standard applies to fixed-fee service contracts, described in paragraphs B6 and B7, which meet the definition of an insurance contract under this Standard.

Embedded derivatives

7 AASB 139 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. AASB 139 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.

8 As an exception to the requirement in AASB 139, 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 AASB 139 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 a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, that requirement also applies if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

9 Paragraph 8 applies equally to options to surrender a financial instrument containing a discretionary participation feature.

Unbundling of deposit components

10 Some insurance contracts contain both an insurance component and a *deposit component*. In some cases, an insurer is required or permitted to *unbundle* those components:

(a) unbundling is required if both the following conditions are met:

  (i) the insurer can measure the deposit component (including any embedded surrender options) separately (i.e. without considering the insurance component); and

  (ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component;

(b) unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations; and

(c) unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).

11 The following is an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. A cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant's accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required.

12 To unbundle a contract, an insurer shall:

(a) apply this Standard to the insurance component; and

(b) apply AASB 139 to the deposit component.

Recognition and Measurement

Temporary exemption from some other Australian Accounting Standards

13 Paragraphs 10-12 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy if no Standard applies specifically to an item. However, this Standard exempts an insurer from applying those criteria to its accounting policies for:

(a) insurance contracts that it issues (including related acquisition costs and related intangible assets, such as those described in paragraphs 31 and 32); and

(b) reinsurance contracts that it holds.

14 Nevertheless, this Standard does not exempt an insurer from some implications of the criteria in paragraphs 10-12 of AASB 108. Specifically, an insurer:

(a) shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions);

(b) shall carry out the *liability adequacy* test described in paragraphs 15-19;

(c) shall remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished – that is, 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; and

(e) shall consider whether its reinsurance assets are impaired (see paragraph 20).

Liability adequacy test

15 An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

16 If an insurer applies a liability adequacy test that meets specified minimum requirements, this Standard imposes no further requirements. The minimum requirements are the following:

(a) the test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees; and

(b) if the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

17 If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall:

(a) determine the carrying amount of the relevant insurance liabilities[1] less the carrying amount of:

   (i) any related deferred acquisition costs; and

   (ii) any related intangible assets, such as those acquired in a business combination or portfolio transfer (see paragraphs 31 and 32). However, related reinsurance assets are not considered because an insurer accounts for them separately (see paragraph 20).

(b) determine whether the amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*. If it is less, the insurer shall recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

18 If an insurer's liability adequacy test meets the minimum requirements of paragraph 16, the test is applied at the level of aggregation specified in that test. If its liability adequacy test does not meet those minimum requirements, the comparison described in paragraph 17 shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio.

19 The amount described in paragraph 17(b) (i.e. the result of applying AASB 137) shall reflect future investment margins (see paragraphs 27-29) if, and only if, the amount described in paragraph 17(a) also reflects those margins.

Impairment of reinsurance assets

20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:

(a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

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1 The relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16.

(b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Changes in accounting policies

21 Paragraphs 22-30 apply both to changes made by an insurer that already applies IFRSs and to changes made by an insurer adopting Australian equivalents to IFRSs for the first time.

22 An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial report more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in AASB 108.

23 To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial report closer to meeting the criteria in AASB 108, but the change need not achieve full compliance with those criteria. The following specific issues are discussed below:

(a) current interest rates (paragraph 24);

(b) continuation of existing practices (paragraph 25);

(c) prudence (paragraph 26);

(d) future investment margins (paragraphs 27-29); and

(e) shadow accounting (paragraph 30).

Current market interest rates

24 An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities[2] to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as AASB 108 would otherwise require. If an insurer designates liabilities for this election, it

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2 In this paragraph, insurance liabilities include related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32.

shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all these liabilities until they are extinguished.

Continuation of existing practices

25 An insurer may continue the following practices, but the introduction of any of them does not satisfy paragraph 22:

(a) measuring insurance liabilities on an undiscounted basis;

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

(c) using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries, except as permitted by paragraph 24. If those accounting policies are not uniform, an insurer may change them if the change does not make the accounting policies more diverse and also satisfies the other requirements in this Standard.

Prudence

26 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.

Future investment margins

27 An insurer need not change its accounting policies for insurance contracts to eliminate future investment margins. However, there is a rebuttable presumption that an insurer's financial report will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts, unless those margins affect the contractual payments. Two examples of accounting policies that reflect those margins are:

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

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

28 An insurer may overcome the rebuttable presumption described in paragraph 27 if, and only if, the other components of a change in accounting policies increase the relevance and reliability of its financial report sufficiently to outweigh the decrease in relevance and reliability caused by the inclusion of future investment margins. For example, suppose that an insurer's existing accounting policies for insurance contracts involve excessively prudent assumptions set at inception and a discount rate prescribed by a regulator without direct reference to market conditions, and ignore some embedded options and guarantees. The insurer might make its financial report more relevant and no less reliable by switching to a comprehensive investor-oriented basis of accounting that is widely used and involves:

(a) current estimates and assumptions;

(b) a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty;

(c) measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and

(d) a current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets.

29 In some measurement approaches, the discount rate is used to determine the present value of a future profit margin. That profit margin is then attributed to different periods using a formula. In those approaches, the discount rate affects the measurement of the liability only indirectly. In particular, the use of a less appropriate discount rate has a limited or no effect on the measurement of the liability at inception. However, in other approaches, the discount rate determines the measurement of the liability directly. In the latter case, because the introduction of an asset-based discount rate has a more significant effect, it is highly unlikely that an insurer could overcome the rebuttable presumption described in paragraph 27.

Shadow accounting

30 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32. An insurer is permitted, but not required, to change its

accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity. This practice is sometimes described as 'shadow accounting'.

Insurance contracts acquired in a business combination or portfolio transfer

31 To comply with AASB 3 *Business Combinations*, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance* assets acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

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

(b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

32 An insurer acquiring a portfolio of insurance contracts may use the expanded presentation described in paragraph 31.

33 The intangible assets described in paragraphs 31 and 32 are excluded from the scope of AASB 136 *Impairment of Assets* and from the scope of AASB 138 *Intangible Assets* in respect of recognition and measurement. However, AASB 136 and AASB 138 apply to customer lists and customer relationships reflecting the expectation of future contracts 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

Discretionary participation features in insurance contracts

34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:

(a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. If the issuer classifies them separately, it shall classify the guaranteed element as a liability;

(b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This Standard does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity;

(c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests). The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see AASB 101 *Presentation of Financial Statements*);

(d) shall, if the contract contains an embedded derivative within the scope of AASB 139, apply AASB 139 to that embedded derivative; and

(e) shall, in all respects not described in paragraphs 14-20 and 34(a)(d), continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with paragraphs 21-30.

Discretionary participation features in financial instruments

35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:

(a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15-19 to the whole contract (i.e. both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying AASB 139 to the guaranteed element;

(b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying AASB 139 to the guaranteed element. That amount shall include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying AASB 139 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher; and

(c) although these contracts are financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability; and

(d) although these contracts are financial instruments, an issuer applying paragraph 19(b) of AASB 7 to contracts with a discretionary participation feature shall disclose the total interest expense recognised in profit or loss, but need not calculate such interest expense using the effective interest method.

Disclosure

Explanation of recognised amounts

36 An insurer shall disclose information that identifies and explains the amounts in its financial report arising from insurance contracts.

37 To comply with paragraph 36, an insurer shall disclose:

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

(b) the recognised assets, liabilities, income and expense (and, if it presents its cash flow statement using the direct method, cash flows) arising from insurance contracts. Furthermore, if the insurer is a cedant, it shall disclose:

(i) gains and losses recognised in profit or loss on buying reinsurance; and

(ii) if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period;

(c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b). When practicable, an insurer shall also 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 report; and

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

Nature and extent of risks arising from insurance contracts

38 An insurer shall disclose information that enables users of its financial report to evaluate the nature and extent of risks arising from insurance contracts.

39 To comply with paragraph 38, an insurer shall disclose:

(a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks;

(b) [deleted by the IASB];

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

(i) sensitivity to insurance risk (see paragraph 39A);

(ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristics that identifies each concentration (e.g. type of insured event, geographical area, or currency); and

(iii) actual claims compared with previous estimates (i.e. claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year;

(d) information about credit risk, liquidity risk and market risk that paragraphs 31-42 of AASB 7 would require if the insurance contracts were within the scope of AASB 7. However:

(i) an issuer need not provide the maturity analysis required by paragraph 39(a) of AASB 7 if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead. This may take the form of an analysis, by estimated timing, of the amounts recognised in the balance sheet; and

(ii) if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may use that sensitivity analysis to meet the requirement in paragraph 40(a) of AASB 7. Such an insurer shall also provide the disclosures required by paragraph 41 of AASB 7; and

(e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

39A To comply with paragraph 39(c)(i), an insurer shall disclose either (a) or (b) as follows:

(a) a sensitivity analysis that shows how profit or loss and equity would have been affected had changes in the relevant risk variable that were reasonably possible at the reporting date occurred; the methods and assumptions used in preparing the sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by paragraph 41 of AASB 7; and

(b) qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows.

Effective Date and Transition

40 The transitional provisions in paragraphs 42-45 apply both to an entity that is already applying IFRSs when it first applies this Standard and to an entity that applies Australian equivalents to IFRSs for the first-time (a first-time adopter).

41 [deleted by the AASB]

41A [deleted by the AASB]

Disclosure

42 An entity need not apply the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005, except for the disclosures required by paragraph 37(a) and (b) about accounting policies, and recognised assets, liabilities, income and expense and cash flows.

43 Where an entity applies the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005, if it is impracticable to apply a particular requirement of paragraphs 10-35 to comparative information that relates to annual periods beginning before 1 January 2005, an entity shall disclose that fact. Applying the liability adequacy test (paragraphs 15-19) to such comparative information might sometimes be impracticable, but it is highly unlikely to be impracticable to apply other requirements of paragraphs 10-35 to such comparative information. AASB 108 explains the term 'impracticable'.

44 In applying paragraph 39(c)(iii), an entity need not disclose information about claims development that occurred earlier than five years before the end of the first annual reporting period in which it applies this Standard. Furthermore, if it is impracticable, when an entity first applies this Standard, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with this Standard, the entity shall disclose that fact.

Redesignation of financial assets

45 When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of

its financial assets as 'at fair value through profit or loss'. This reclassification is permitted if an insurer changes accounting policies when it first applies this Standard and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and AASB 108 applies.

APPENDIX A

This appendix is an integral part of AASB 4

Defined terms

cedant

The **policyholder** under a **reinsurance contract**.

deposit component

A contractual component that is not accounted for as a derivative under AASB 139 and would be within the scope of AASB 139 if it were a separate instrument.

direct insurance contract

An **insurance contract** that is not a **reinsurance contract**

discretionary participation feature

A contractual right to receive, as a supplement to **guaranteed benefits**, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(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 guarantee contract

A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
guaranteed benefits	Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.
guaranteed element	An obligation to pay **guaranteed benefits**, included in a contract that contains a **discretionary participation feature.**
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** if a specified uncertain future event (the **insured event**) adversely affects the **policyholder**. (See Appendix B for guidance on 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	An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.
insurer	The party that has an obligation under an **insurance contract** to compensate a **policyholder** if an **insured event** occurs.
liability adequacy	An assessment of whether the carrying amount of an

test	**insurance liability** needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.
policyholder	A party that has a right to compensation under an **insurance contract** if an **insured event** occurs.
reinsurance assets	A **cedant's** net contractual rights under a **reinsurance 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 party that has an obligation under a **reinsurance contract** to compensate a **cedant** if an **insured event** occurs.
unbundle	Account for the components of a contract as if they were separate contracts.

Additional Australian Defined Terms

general insurance contract	An **insurance contract** that is not a **life insurance contract**.
life insurance contract	An **insurance contract**, or a financial instrument with a **discretionary participation feature**, regulated under the *Life Insurance Act 1995*, and similar contracts issued by entities operating outside Australia.

APPENDIX B

DEFINITION OF AN INSURANCE CONTRACT

This appendix is an integral part of AASB 4

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

(a) the term ‘uncertain future event’ (paragraphs B2-B4);

(b) payments in kind (paragraphs B5-B7);

(c) insurance risk and other risks (paragraphs B8-B17);

(d) examples of insurance contracts (paragraphs B18-B21);

(e) significant insurance risk (paragraphs B22-B28); and

(f) changes in the level of insurance risk (paragraphs B29 and B30).

Uncertain future event

B2 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.

B3 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.

B4 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

B5 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.

B6 Some fixed-fee service contracts in which the level of service depends on an uncertain event meet the definition of an insurance contract in this Standard but are not regulated as insurance contracts in some countries. One example is a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash). Another example is a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage. The latter contract could meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts.

B7 Applying the Standard to the contracts described in paragraph B6 is likely to be no more burdensome than applying the Standard that would be applicable if such contracts were outside the scope of this Standard.

(a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.

(b) If AASB 118 *Revenue* applied, the service provider would recognise revenue by reference to the stage of completion (and subject to other specified criteria). That approach is also acceptable under this Standard, which permits the service provider (i) to continue it's existing accounting policies for these contracts unless they involve practices prohibited by paragraph 14 and (ii) to improve its accounting policies if so permitted by paragraphs 22-30.

(c) The service provider considers whether the cost of meeting its contractual obligation to provide services exceeds the revenue received in advance. To do this, it applies the liability adequacy test described in paragraphs 15-19 of this Standard. If this Standard did not apply to these contracts, the service provider would apply AASB 137 *Provisions, Contingent Liabilities and*

Contingent Assets to determine whether the contracts are onerous.

(d) For these contracts, the disclosure requirements in this Standard are unlikely to add significantly to disclosures required by other Australian Accounting Standards.

Distinction between insurance risk and other risks

B8 The definition of an insurance contract refers to insurance risk, which this Standard defines as risk, other than financial risk, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (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 insurance risk, not financial risk.

B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.

B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided the payment that is contingent on the insured event can be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event - the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it need not be separated and measured at fair value (see paragraph 7 of this Standard).

B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.

B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial 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's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.

B14 Some contracts require a payment if a specified uncertain event occurs, but do not require an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract 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 derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

B15 Lapse or persistency risk (i.e. 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. Similarly, expense risk (i.e. the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

B16 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the issuer to insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.

B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual 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.

Examples of insurance contracts

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

(a) insurance against theft or damage to property;

(b) insurance against product liability, professional liability, civil liability or legal expenses;

(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance);

(d) life-contingent annuities and pensions (i.e. contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival);

(e) disability and medical cover;

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (i.e. contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building);

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in AASB 139 and are within the scope of AASB 132 and AASB 139, not this Standard (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either AASB 139 and AASB 132 or AASB 1023 to such financial guarantee contracts;

(h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this Standard. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of AASB 118 *Revenue* and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*;

(i) title insurance (i.e. 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 (i.e. compensation in cash or in kind to policyholders for losses suffered while they are travelling). Paragraphs B6 and B7 discuss some contracts of this kind;

(k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate);

(l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract; and

(m) reinsurance contracts.

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

(a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, for example life insurance contracts in which the insurer bears no significant mortality risk (such contracts are non-insurance financial instruments or service contracts, see paragraphs B20 and B21);

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts (such contracts are normally noninsurance financial instruments or service contracts, see paragraphs B20 and B21);

(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. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see also paragraph B13);

(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, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see AASB 139);

(f) a credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see AASB 139);

(g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives); and

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of AASB 139. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue; and

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

B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, AASB 118 applies. Under AASB 118, revenue associated with a transaction involving the rendering of services is recognised by reference to the stage of completion of the transaction if the outcome of the transaction can be estimated reliably.

Significant insurance risk

B22 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8-B21 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.

B23 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (i.e. probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

B24 The additional benefits described in paragraph B23 refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:

(a) the loss of the ability to charge the policyholder for future services. For example, in an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of the client. Therefore, the potential loss of future investment management fees is not relevant in assessing how much insurance risk is transferred by a contract;

(b) waiver on death of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, the waiver of these charges does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in assessing how much insurance risk is transferred by a contract;

(c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay one million currency units if an asset suffers physical damage causing an insignificant economic loss of one currency unit to the holder. 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; and

(d) possible reinsurance recoveries. The insurer accounts for these separately.

B25 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial report.[3] Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.

B26 It follows from paragraphs B23-B25 that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of

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

contracts). As noted in paragraph B24(b), the waiver on death of cancellation or surrender charges is not included in this assessment if this waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

B27 Paragraph B23 refers to additional benefits. These additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (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 uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

B28 If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

Changes in the level of insurance risk

B29 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the current annuity rates charged by the insurer to other new annuitants when the policyholder exercises the option. The contract transfers no insurance risk to the issuer until the option is exercised, because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.

B30 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.

GUIDANCE ON IMPLEMENTING

AASB 4 *INSURANCE CONTRACTS*

This guidance accompanies, but is not part of, AASB 4.

Introduction

IG1 This implementation guidance:

(a) illustrates which contracts and embedded derivatives are within the scope of the Standard (see paragraphs IG2-IG4).

(b) includes an example of an insurance contract containing a deposit component that needs to be unbundled (paragraph IG5).

(c) illustrates shadow accounting (paragraphs IG6-IG10).

(d) discusses how an insurer might satisfy the disclosure requirements in the Standard (paragraphs IG11-IG71).

Definition of Insurance Contract

IG2 IG Example 1 illustrates the application of the definition of an insurance contract. The example does not illustrate all possible circumstances.

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
1.1	Insurance contract (see definition in Appendix A of the Standard and guidance in Appendix B).	Within the scope of the Standard, unless covered by scope exclusions in paragraph 4 of the Standard. Some embedded derivatives and deposit components must be separated (see IG Examples 2 and 3 and paragraphs 7-12 of the Standard).
1.2	Death benefit that could exceed amounts payable on surrender or maturity.	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
		significant loss on an individual contract if the policyholder dies early. See IG Examples 1.23-27 for further discussion of surrender penalties.
1.3	A unit-linked contract that pays benefits linked to the fair value of a pool of assets. The benefit is 100 per cent of the unit value on surrender or maturity and 101 per cent of the unit value on death.	This contract contains a deposit component (100 per cent of unit value) and an insurance component (additional death benefit of 1 per cent). Paragraph 10 of the Standard permits unbundling (but requires it only if the insurance component is material and the issuer would not otherwise recognise all obligations and rights arising under the deposit component). If the insurance component is not unbundled, the whole contract is an investment contract because the insurance component is insignificant in relation to the whole contract.
1.4	Life-contingent annuity	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
1.5	Pure endowment. The insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then.	Insurance contract (unless the transfer of insurance risk is insignificant). If a relatively homogeneous book of pure endowments is known to consist of contracts that all transfer insurance risk, the insurer may classify the entire book as insurance contracts without examining each contract to identify a few non-derivative pure endowments that transfer insignificant insurance risk (see paragraph B25).
1.6	Deferred annuity: policyholder will receive, or can elect to receive, a life contingent annuity at rates guaranteed at inception.	Insurance contract (unless the transfer of insurance risk is insignificant). The contract transfers mortality risk to the insurer at inception, because the insurer might have to pay significant additional benefits for an individual contract if the annuitant elects to take the life-contingent annuity and survives longer than expected (unless the contingent amount is insignificant in all scenarios that have commercial substance).
1.7	Deferred annuity: policyholder will receive, or can elect to receive, a life contingent annuity at rates prevailing when the annuity begins	Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Within the scope of AASB 139 *Financial Instruments: Recognition and Measurement* unless the contract contains a discretionary participation feature. Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all scenarios that have commercial substance).

IG Example 1: Application of the definition of an insurance contract

Contract type		*Treatment in phase I*
1.8	Investment contract[4] that does not contain a discretionary participation feature.	Within the scope of AASB 139.
1.9	Investment contract containing a discretionary participation feature.	Paragraph 35 of the Standard sets out requirements for these contracts, which are excluded from the scope of AASB 139.
1.10	Investment contract in which payments are contractually linked (with no discretion) to returns on a specified pool of assets held by the issuer.	Within the scope of AASB 139. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph AG33(g) of Appendix A of AASB 139).
1.11	Contract that requires specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. The contract may have various legal forms (e.g. insurance contract, financial guarantee or letter of credit).	Insurance contract. Within the scope of the Standard, unless the contract was entered into or retained on the transfer of financial assets or financial liabilities within the scope of AASB 139. If the issuer's accounting policies do not require it to recognise a liability at inception, the liability adequacy test in paragraphs 15-19 of the Standard may be particularly relevant. The legal form of the contract does not affect its recognition and measurement.
1.12	A financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the	Not an insurance contract. Within the scope of AASB 139.

4 The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract.

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
	failure of the debtor to make payments on the guaranteed asset when due. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index.	
1.13	Guarantee fund established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, for example, insurance, banking or travel.	The contract that establishes the guarantee fund is an insurance contract (see IG Example 1.11).
1.14	Guarantee fund established by law.	The commitment of participants to contribute to the fund is not established by a contract, so there is no insurance contract. Within the scope of AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
1.15	Residual value insurance or residual value guarantee. Guarantee by one party of the fair value at a future date of a non-financial asset held by a beneficiary of the insurance or guarantee.	Insurance contract within the scope of the Standard (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable). However, if the contract compensates the beneficiary only for

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
		changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and within the scope of AASB 139. Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 Leases.
1.16	Product warranties issued directly by a manufacturer, dealer or retailer.	Insurance contracts, but excluded from the scope of the Standard (see AASB 118 *Revenue* and AASB 137).
1.17	Product warranties issued by a third party.	Insurance contracts, no scope exclusion. Same treatment as other insurance contracts.
1.18	Group insurance contract that gives the insurer an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money	Insurance risk is insignificant. Therefore, the contract is a financial instrument within the scope of AASB 139. Servicing fees are within the scope of AASB 118 (recognise as services are provided, subject to various conditions).
1.19	Catastrophe bond: bond in which principal, interest payments or both are reduced if a specified triggering event occurs and the triggering event does not include a condition that the issuer of the bond suffered a loss.	Financial instrument with embedded derivative. Both the holder and the issuer measure the embedded derivative at fair value.

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
1.20	Catastrophe bond: bond in which principal, interest payments or both are reduced significantly if a specified triggering event occurs and the triggering event includes a condition that the issuer of the bond suffered a loss.	The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component. (a) If specified conditions are met, paragraph 10 of the Standard requires the holder to unbundle the deposit component and apply AASB 139 to it. (b) The issuer accounts for the insurance component as reinsurance if it uses the bond for that purpose. If the issuer does not use the insurance component as reinsurance, it is not within the scope of the Standard, which does not address accounting by policyholders for direct insurance contracts. (c) Under paragraph 13 of the Standard, the holder could continue its existing accounting for the insurance component, unless that involves the practices prohibited by paragraph 14.
1.21	An insurance contract issued by an insurer to a defined benefit pension plan covering the employees of the insurer, or of another entity consolidated within the same financial statements as the insurer.	The contract will generally be eliminated from the financial report, which will include: (a) the full amount of the pension obligation under AASB 119 *Employee Benefits*, with no deduction for the plan's rights under the contract. (b) no liability to policyholders under the contract. (c) the assets backing the

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
		contract.
1.22	An insurance contract issued to employees as a result of a defined contribution pension plan. The contractual benefits for employee service in the current and prior periods are not contingent on future service. The insurer also issues similar contracts on the same terms to third parties.	Insurance contract within the scope of the Standard. If the employer pays part or all of the employee's premiums, the payment by the employer is an employee benefit within the scope of AASB 119. See also AASB 119, paragraphs 39-42 and 104-104D. Furthermore, a 'qualifying insurance policy' as defined in AASB 119 need not meet the definition of an insurance contract in this Standard.
1.23	Loan contract containing a prepayment fee that is waived if prepayment results from the borrower's death.	Not an insurance contract. Before entering into the contract, the borrower faced no risk corresponding to the prepayment fee. Hence, although the loan contract exposes the lender to mortality risk, it does not transfer a pre-existing risk from the borrower. Thus, the risk associated with the possible waiver on death of the prepayment fee is not insurance risk (paragraphs B12 and B24(b) of Appendix B of the Standard).
1.24	Loan contract that waives repayment of the entire loan balance if the borrower dies.	This contract contains a deposit component (the loan) and an insurance component (waiver of the loan balance on death, equivalent to a cash death benefit). If specified conditions are met, paragraph 10 of the Standard requires or permits unbundling. If the insurance component is not unbundled, the contract is an insurance contract if the insurance component is significant in relation to the whole

IG Example 1: Application of the definition of an insurance contract	
Contract type	*Treatment in phase I*
	contract.
1.25 A contract permits the issuer to deduct a market value adjustment (MVA) from surrender values or death benefits to reflect current market prices for the underlying assets. The contract does not permit an MVA for maturity benefits.	The policyholder obtains an additional survival benefit because no MVA is applied at maturity. That benefit is a pure endowment (see IG Example 1.5). If the risk transferred by that benefit is significant, the contract is an insurance contract.
1.26 A contract permits the issuer to deduct an MVA from surrender values or maturity payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death benefits.	The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that benefit is significant, the contract is an insurance contract.
1.27 A contract permits the issuer to deduct an MVA from surrender payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.	The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money (see paragraph B27 of the Standard). The contract is an investment contract. This contract combines the two features discussed in IG Examples 1.25 and 1.26. When considered separately, those two features transfer insurance risk. However, when combined, they do not transfer

IG Example 1: Application of the definition of an insurance contract		
Contract type		*Treatment in phase I*
		insurance risk. Therefore, it is not appropriate to separate this contract into two 'insurance' components. If the amount payable on death were not adjusted in full for the time value of money, or were adjusted in some other way, the contract might transfer insurance risk. If that insurance risk is significant, the contract is an insurance contract.
1.28	A contract meets the definition of an insurance contract. It was issued by one entity in a group (for example a captive insurer) to another entity in the same group	If the entities present individual or separate financial statements, they treat the contract as an insurance contract in those individual or separate financial statements (see AASB 127 *Consolidated and Separate Financial Statements*). The transaction is eliminated from the group's consolidated financial statements. If the intra-group contract is reinsured with a third party that is not part of the group, the reinsurance contract is treated as a direct insurance contract in the consolidated financial statements because the intra-group contract is eliminated on consolidation.
1.29	An agreement that entity A will compensate entity B for losses on one or more contracts issued by entity B that do not transfer significant insurance risk.	The contract is an insurance contract if it transfers significant insurance risk from entity B to entity A, even if some or all of the individual contracts do not transfer significant insurance risk to entity B. The contract is a reinsurance contract if any of the contracts issued by entity B are insurance contracts. Otherwise, the contract is a direct insurance contract.

Embedded Derivatives

IG3 AASB 139 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the Standard). Nevertheless, separation and fair value measurement of such an embedded derivative are not prohibited if the insurer's existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the Standard.

IG4 IG Example 2 illustrates the treatment of embedded derivatives contained in insurance contracts and investment contracts. The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract. The example does not illustrate all possible circumstances. Throughout the example, the phrase 'fair value measurement is required' indicates that the issuer of the contract is required:

(a) to measure the embedded derivative at fair value and include changes in its fair value in profit or loss; and

(b) to separate the embedded derivative from the host contract, unless it measures the entire contract at fair value and includes changes in that fair value in profit or loss.

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.1 Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.	The equity-index feature is an insurance contract (unless the life contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).
2.2 Death benefit that is the greater of: (a) unit value of an investment fund (equal to the amount payable on surrender or maturity); and (b) guaranteed minimum.	Excess of guaranteed minimum over unit value is a death benefit (similar to the payout on a dual trigger contract, see IG Example 2.19). This meets the definition of an insurance contract (unless the life-contingent payments are insignificant) and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.3 Option to take a life contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).	The embedded option is an insurance contract (unless the life contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).
2.4 Embedded guarantee of minimum interest rates in determining surrender or maturity values that is at or out of the money on issue, and not leveraged.	The embedded guarantee is not an insurance contract (unless significant payments are life contingent[5]). However, it is closely related to the host contract (paragraph AG33(b) of Appendix A of AASB 139). Fair value measurement is not required (but not prohibited). If significant payments are life contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the deposit component (paragraph 10 of the Standard).	Fair value measurement is not permitted (paragraph AG33(b) of AASB 139).

5 Payments are life-contingent if they are contingent on death or contingent on survival.

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
	If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be interdependent; if the option to cancel the deposit component cannot be measured separately (i.e. without considering the other option), both options are regarded as part of the insurance component (paragraph AG33(h) of AASB 139).	
2.5 Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue, or leveraged.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life contingent to a significant extent). Fair value measurement is required (paragraph AG33(b) of AASB 139).	Fair value measurement is required (paragraph AG33(b) of AASB 139).
2.6 Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices:		

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
(a) guarantee relates only to payments that are life contingent.	The embedded guarantee is an insurance contract (unless the life contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).
(b) guarantee relates only to payments that are not life contingent.	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph AG33(b) of AASB 139).	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph AG33(b) of AASB 139).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
(c) policyholder can elect to receive life contingent payments or payments that are not life contingent, and the guarantee relates to both. When the policyholder makes its election, the issuer cannot adjust the pricing of the life contingent payments to reflect the risk that the insurer assumes at that time (see paragraph B29 of the Standard for discussion of contracts with separate accumulation and payout phases).	The embedded option to benefit from a guarantee of life-contingent payments is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited). The embedded option to receive payments that are not life-contingent ('the second option') is not an insurance contract. However, because the second option and the life contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (i.e. without considering the life-contingent option), the second option is closely related to the insurance contract. In that case, fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.7 Embedded guarantee of minimum equity returns on surrender or maturity.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.8 Equity-linked return available on surrender or maturity.	The embedded derivative is not an insurance contract (unless the equity linked return is life contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.9 Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life contingent annuity.	The embedded guarantee is an insurance contract (unless the life contingent payments are insignificant), because the policyholder can benefit from the guarantee only by taking the annuity option (whether annuity rates are set at inception or at the date of annuitisation). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.10 Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment, (b) a period-certain annuity or (c) a life contingent annuity, at annuity rates prevailing at the date of annuitisation.	If the guaranteed payments are not contingent to a significant extent on survival, the option to take the life contingent annuity does not transfer insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract and is not closely related to the host insurance contract. Fair value measurement is required. If the guaranteed payments are contingent to a significant extent on survival, the guarantee is an insurance contract (similar to a pure endowment). Fair value measurement is not required (but not prohibited).	Fair value measurement is required.

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.11 Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment (b) a period certain annuity or (c) a life contingent annuity, at annuity rates set at inception.	The whole contract is an insurance contract from inception (unless the life contingent payments are insignificant). The option to take the life contingent annuity is an embedded insurance contract, so fair value measurement is not required (but not prohibited). The option to take the cash payment or the period certain annuity ('the second option') is not an insurance contract (unless the option is contingent to a significant extent on survival), so it must be separated. However, because the second option and the life contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (i.e. without considering the life-contingent option), the second option is closely related to the host insurance contract. In that case, fair value measurement is not required (but not prohibited).	Not applicable.

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.12 Policyholder option to surrender a contract for a cash surrender value specified in a schedule (i.e. not indexed and not accumulating interest).	Fair value measurement is not required (but not prohibited: paragraph 8 of the Standard). The surrender value may be viewed as a deposit component, but the Standard does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph AG30(g) of AASB 139). Otherwise, the surrender option is measured at fair value.
2.13 Policyholder option to surrender a contract for account value based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest-bearing securities), possibly after deducting a surrender charge.	Same as for a cash surrender value (IG Example 2.12).	Same as for a cash surrender value (IG Example 2.12).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.14 Policyholder option to surrender a contract for a surrender value based on an equity or commodity price or index.	The option is not closely related to the host contract (unless the option is life contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the Standard and AG30(d) and (e) of AASB 139).	Fair value measurement is required (paragraph AG30(d) and (e) of AASB 39).
2.15 Policyholder option to surrender a contract for account value equal to the fair value of a pool of equity investments, possibly after deducting a surrender charge.	If the insurer measures that portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender value differs significantly from account value) (see paragraph AG33(g) of AASB 139). Otherwise, fair value measurement is required.	If the insurer regards the account value as the amortised cost or fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from account value). Otherwise, fair value measurement is required.
2.16 Contractual feature that provides a return contractually linked (with no discretion) to the return on specified assets.	The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph AG30(h) of AASB 139). Fair value measurement is required.	Fair value measurement is required.

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.17 Persistency bonus paid at maturity in cash (or as a period certain annuity).	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the Standard). Fair value measurement is required.	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph AG30(c) of AASB 139). If the option or provision is not closely related to the host instrument, fair value measurement is required.
2.18 Persistency bonus paid at maturity as an enhanced life contingent annuity.	The embedded derivative is an insurance contract (unless the life contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.19 Dual trigger contract, for example, a contract requiring a payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events occur.	The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance). 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 (paragraph B30 of the Standard). Therefore, although the remaining exposure is similar to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the first trigger lacks commercial substance).

IG Example 2: Embedded derivatives		
Type of embedded derivative	*Treatment if embedded in a host insurance contract*	*Treatment if embedded in a host investment contract*
2.20 Non-guaranteed participating dividend contained in a life insurance contract. The amount is contractually at the discretion of the insurer but is contractually based on the insurer's actual experience on the related block of insurance contracts.	The contract contains a discretionary participation feature, rather than an embedded derivative (paragraph 34 of the Standard).	Not applicable. The entire contract is an insurance contract (unless the life contingent payments are insignificant).

Unbundling a Deposit Component

IG5 Paragraph 10 of the Standard requires an insurer to unbundle some insurance contracts that contain a deposit component. IG Example 3 illustrates this requirement. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, unbundling is not required if the insurer recognises all obligations or rights arising from the deposit component.

IG Example 3: Unbundling a deposit component of a reinsurance contract

Background

A reinsurance contract has the following features:

(a) The cedant pays premiums of CU10[6] every year for five years.

(b) An experience account is established, equal to 90 per cent of cumulative premiums (including the additional premiums discussed in (c) below) less 90 per cent of cumulative claims.

(c) If the balance in the experience account is negative (i.e. cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.

(d) At the end of the contract, if the experience account balance is positive (i.e. cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.

(e) Neither party can cancel the contract before maturity.

(f) The maximum loss that the reinsurer is required to pay in any period is CU200.

This contract is an insurance contract because it transfers significant insurance risk to the reinsurer. For example, in case 2 discussed below, the reinsurer is required to pay additional benefits with a present value, in year 1, of CU35, which is clearly significant in relation to the contract.

The following discussion addresses the accounting by the reinsurer. Similar principles apply to the accounting by the cedant.

6 In this Implementation Guidance monetary amounts are denominated in ‘currency units’ (CU).

Application of requirements: case 1—no claims

If there are no claims, the cedant will receive CU45 in year 5 (90 per cent of the cumulative premiums of CU50). In substance, the cedant has made a loan, which the reinsurer will repay in one instalment of CU45 in year 5.

If the reinsurer's accounting policies require it to recognise its contractual liability to repay the loan to the cedant, unbundling is permitted but not required. However, if the reinsurer's accounting policies would not require it to recognise the liability to repay the loan, the reinsurer is required to unbundle the contract (paragraph 10 of the Standard).

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows. Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying AASB 139 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component. Assume that an appropriate discount rate is 10 per cent and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of CU10 by the cedant is then made up of a loan advance of CU6.7 and an insurance premium of CU3.3.

The reinsurer accounts for the insurance component in the same way that it accounts for a separate insurance contract with an annual premium of CU3.3.

The movements in the loan are shown below.

Year	Opening balance	Interest at 10 per cent	Advance (repayment)	Closing balance
	CU	CU	CU	CU
0	0.00	0.00	6.70	6.70
1	6.70	0.67	6.70	14.07
2	14.07	1.41	6.70	22.18
3	22.18	2.22	6.70	31.09
4	31.09	3.11	6.70	40.90
5	40.90	4.10	(45.00)	0.00
Total		11.50	(11.50)	

Application of requirements: case 2—claim of CU150 in year 1

Consider now what happens if the reinsurer pays a claim of CU150 in year 1. The changes in the experience account, and resulting additional premiums, are as follows.

Year	Premium	Additional premium	Total premium	Cumulative premium	Claims	Cumulative claims	Cumulative premiums less claims	Experience account
	CU	CU	CU	CU	CU	CU	CU	CU
0	10	0	10	10	0	0	10	9
1	10	0	10	20	(150)	(150)	(130)	(117)
2	10	39	49	69	0	(150)	(81)	(73)
3	10	36	46	115	0	(150)	(35)	(31)
4	10	31	41	156	0	(150)	6	6
		106	156		(150)			

Incremental cash flows because of the claim in year 1

The claim in year 1 leads to the following incremental cash flows, compared with case 1:

Year	Additional premium	Claims	Refund in case 2	Refund in case 1	Net incremental cash flow	Present value at 10 per cent
	CU	CU	CU	CU	CU	CU
0	0	0			0	0
1	0	(150)			(150)	(150)
2	39	0			39	35
3	36	0			36	30
4	31	0			31	23
5	0	0	(6)	(45)	39	27
Total	106	(150)	(6)	(45)	(5)	(35)

The incremental cash flows have a present value, in year 1, of CU35 (assuming a discount rate of 10 per cent is appropriate). Applying paragraphs 10-12 of the Standard, the cedant unbundles the contract and applies AASB 139 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the CU150 received in year 1 as income, and the incremental payments in years 2-5 as expenses. However, in substance, the reinsurer has paid a claim of CU35 and made a loan of CU115 (CU150 less CU35) that will be repaid in instalments.

The following table shows the changes in the loan balance. The table assumes that the original loan shown in case 1 and the new loan in case 2 met the criteria for offsetting in AASB 132. Amounts shown in the table are rounded.

Loan to (from) the reinsurer

Year	Opening balance	Interest at 10 per cent	Payments per original schedule	Additional payments in case 2	Closing balance
	CU	CU	CU	CU	CU
0	-	-	6	-	6
1	6	1	7	(115)	(101)
2	(101)	(10)	7	39	(65)
3	(65)	(7)	7	36	(29)
4	(29)	(3)	6	31	5
5	5	1	(45)	39	0
Total		(18)	(12)	(30)	

Shadow Accounting

IG6 Paragraph 30 of the Standard permits, but does not require, a practice sometimes described as ‘shadow accounting’. IG Example 4 illustrates shadow accounting.

IG7 Shadow accounting is not the same as fair value hedge accounting under AASB 139 and will not usually have the same effect. Under AASB 139, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of foreign currency risk.

IG8 Shadow accounting is not applicable for liabilities arising from investment contracts (i.e. contracts within the scope of AASB 139) because the underlying measurement of those liabilities (including the treatment of related transaction costs) does not depend on asset values or asset returns. However, shadow accounting may be applicable for a discretionary participation feature within an investment contract if the measurement of that feature depends on asset values or asset returns.

IG9 Shadow accounting is not applicable if the measurement of an insurance liability is not driven directly by realised gains and losses on assets held. For example, assume that financial assets are measured at fair value and insurance liabilities are measured using a discount rate that reflects current market rates but does not depend directly on the actual assets held. The measurements of the assets and the liability both reflect changes in interest rates, but the measurement of the liability does not depend directly on the carrying amount of the assets held. Therefore, shadow accounting is not applicable and changes in the carrying amount of the liability are recognised in profit or loss because AASB 101 *Presentation of Financial Statements* requires all items of income or expense to be recognised in profit or loss unless a Standard or Interpretation requires otherwise.

IG10 Shadow accounting may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an entity uses the revaluation model in AASB 116 *Property, Plant and Equipment*, it recognises changes in the carrying amount of the owner-occupied property in revaluation surplus. If it also elects to use shadow accounting, the changes in the measurement of the insurance liability resulting from revaluations of the property are also recognised in revaluation surplus.

IG Example 4: Shadow accounting

Background

Under some national requirements for some insurance contracts, deferred acquisition costs (DAC) are amortised over the life of the contract as a constant proportion of estimated gross profits (EGP). EGP includes investment returns, including realised (but not unrealised) gains and losses. Interest is applied to both DAC and EGP, to preserve present value relationships. For simplicity, this example ignores interest and ignores re-estimation of EGP.

At the inception of a contract, insurer A has DAC of CU20 relating to that contract and the present value, at inception, of EGP is CU100. In other words, DAC is 20 per cent of EGP at inception. Thus, for each CU1 of realised gross profits, insurer A amortises DAC by CU0.20. For example, if insurer A sells assets and recognises a gain of CU10, insurer A amortises DAC by CU2 (20 per cent of CU10).

Before adopting Australian equivalents to IFRSs for the first time in 2005, insurer A measured financial assets on a cost basis. (Therefore, EGP under those national requirements considers only realised gains and losses.) However, under Australian equivalents to IFRSs, it classifies its financial assets as available for sale. Thus, insurer A measures the assets at fair value and recognises changes in their fair value directly in equity, through the statement of changes in equity. In 2005, insurer A recognises unrealised gains of CU10 on the assets backing the contract.

In 2006, insurer A sells the assets for an amount equal to their fair value at the end of 2005 and, to comply with AASB 139, transfers the now-realised gain of CU10 from equity to profit or loss.

Application of paragraph 30 of the Standard

Paragraph 30 of the Standard permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 2005 by an additional CU2 (20 per cent of CU10) as a result of the change in the fair value of the assets. Because insurer A recognised the change in their fair value in equity, it recognises the additional amortisation of CU2 directly in equity, through the statement of changes in equity. When insurer A sells the assets in 2006, it makes no further adjustment to DAC, but transfers DAC amortisation of CU2 relating to the now-realised gain from equity to profit or loss.

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain, except that the unrealised gain and resulting DAC amortisation are (a) recognised in equity rather than in profit or loss and (b) transferred to profit or loss when the gain on the asset becomes realised.

If insurer A does not adopt shadow accounting, unrealised gains on assets do not affect the amortisation of DAC.

Disclosure

Purpose of this guidance

IG11 The guidance in paragraphs IG12-IG71 suggests possible ways to apply the disclosure requirements in paragraphs 36-39 of the Standard. As explained in paragraph 1(b) of the Standard, the objective of the disclosures is to identify and explain the amounts in an insurer's financial report arising from insurance contracts and help users of the financial report understand the amount, timing and uncertainty of future cash flows from insurance contracts.

IG12 An insurer decides in the light of its circumstances how much detail it gives to satisfy those requirements, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information that has materially different characteristics. To satisfy the requirements, an insurer would not typically need to disclose all the information suggested in the guidance. This guidance does not create additional requirements.

IG13 AASB 101 *Presentation of Financial Statements* requires an entity to 'provide additional disclosures when compliance with the specific requirements in Australian Accounting Standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance'.

IG14 For convenience, this Implementation Guidance discusses each disclosure requirement in the Standard separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures may satisfy more than one requirement. For example, information about the terms and conditions of insurance contracts may help to convey information about insurance risk and interest rate risk.

Materiality

IG15 AASB 101 notes that a specific disclosure requirement in a Standard or an Interpretation need not be satisfied if the information is not material. AASB 101 defines materiality as follows:

> Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial report. Materiality depends on the size and nature of the omission or

misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

IG16 AASB 101 also explains the following:

> Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25 that "users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence." Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Explanation of recognised amounts (paragraphs 36 and 37 of the Standard)

Accounting policies

IG17 AASB 101 requires disclosure of accounting policies and paragraph 37(a) of the Standard highlights this requirement. In developing disclosures about accounting policies for insurance contracts, insurers might need to address the treatment of, for example, some or all of the following, if applicable:

(a) premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums);

(b) fees or other charges made to policyholders;

(c) acquisition costs (including a description of their nature);

(d) claims incurred (both reported and not reported), claims handling costs (including a description of their nature) and liability adequacy tests (including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in those tests, see paragraphs 15-19 of the Standard). An insurer might disclose whether insurance liabilities are discounted and, if they are discounted, explain the methodology used;

(e) the objective of methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency) the nature of those models, and the source of information used in the models;

(f) embedded options and guarantees (including a description of whether (i) the measurement of insurance liabilities reflects the intrinsic value and time value of these items and (ii) their measurement is consistent with observed current market prices);

(g) discretionary participation features (including a clear statement of how the insurer applies paragraphs 34 and 35 of the Standard in classifying that feature as a liability or as a component of equity) and other features that permit policyholders to share in investment performance;

(h) salvage, subrogation or other recoveries from third parties;

(i) reinsurance held;

(j) underwriting pools, coinsurance and guarantee fund arrangements;

(k) insurance contracts acquired in business combinations and portfolio transfers, and the treatment of related intangible assets; and

(l) as required by AASB 101, the judgements, apart from those involving estimations, management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial report. The classification of discretionary participation features is an example of an accounting policy that might have a significant effect.

IG18 If the financial report discloses supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial report, it might be appropriate to explain the basis. Disclosures about embedded value methodology might include information similar to that described in paragraph IG17, as well as disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.

Assets, liabilities, income and expense

IG19 Paragraph 37(b) of the Standard requires an insurer to disclose the assets, liabilities, income and expenses that arise from insurance contracts. If an insurer presents its cash flow statement using the direct method, paragraph 37(b) requires it also to disclose the cash flows that arise from insurance contracts. The Standard does not require disclosure of specific items. The following paragraphs discuss how an insurer might satisfy those general requirements.

IG20 AASB 101 requires minimum disclosures on the face of the balance sheet. To satisfy those requirements, an insurer might need to present separately on the face of its balance sheet the following amounts arising from insurance contracts:

(a) liabilities under insurance contracts and reinsurance contracts issued.

(b) assets under insurance contracts and reinsurance contracts issued.

(c) assets under reinsurance ceded. Under paragraph 14(d)(i) of the Standard, these assets are not offset against the related insurance liabilities.

IG21 Neither AASB 101 nor the Standard prescribes the descriptions and ordering of the line items presented on the face of the balance sheet. An insurer could amend the descriptions and ordering to suit the nature of its transactions.

IG22 AASB 101 requires disclosure, either on the face of the balance sheet or in the notes, of sub-classifications of the line items presented, classified in a manner appropriate to the entity's operations. The sub-classifications of insurance liabilities that require separate disclosure will depend on the circumstances, but might include items such as:

(a) unearned premiums;

(b) claims reported by policyholders;

(c) claims incurred but not reported (IBNR);

(d) provisions arising from liability adequacy tests;

(e) provisions for future non-participating benefits;

(f) liabilities or components of equity relating to discretionary participation features (see paragraphs 34 and 35 of the Standard). If an insurer classifies these features as a component of equity, disclosure is needed to comply with AASB 101, which requires an entity to disclose 'a description of the nature and purpose of each reserve within equity';

(g) receivables and payables related to insurance contracts (amounts currently due to and from agents, brokers and policyholders related to insurance contracts); and

(h) non-insurance assets acquired by exercising rights to recoveries.

IG23 Similar sub-classifications may also be appropriate for reinsurance assets, depending on their materiality and other relevant circumstances. For assets under insurance contracts and reinsurance contracts issued, an insurer might need to distinguish:

(a) deferred acquisition costs; and

(b) intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.

IG24 AASB 101 lists minimum line items that an entity should present on the face of its income statement. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. To satisfy these requirements, an insurer might need to disclose the following amounts on the face of its income statement:

(a) revenue from insurance contracts issued (without any reduction for reinsurance held);

(b) income from contracts with reinsurers;

(c) expense for policyholder claims and benefits (without any reduction for reinsurance held); and

(d) expenses arising from reinsurance held.

IG25 AASB 118 requires an entity to disclose the amount of each significant category of revenue recognised during the period, and specifically requires disclosure of revenue arising from the rendering of services. Although revenue from insurance contracts is outside the scope of AASB 118, similar disclosures may be appropriate for insurance contracts. The Standard does not prescribe a particular method for recognising revenue and various models exist.

(a) Under some models, an insurer recognises premiums earned during the period as revenue and recognises claims arising during the period (including estimates of claims incurred but not reported) as an expense.

(b) Under some other models, an insurer recognises premiums received as revenue and at the same time recognises an expense representing the resulting increase in the insurance liability.

(c) Under yet other models, an insurer reports premiums received as deposit receipts. Its reported revenue comprises charges for items such as mortality, whilst its reported policyholder claims and benefits comprise the claims and benefits related to those charges.

IG26 AASB 101 requires additional disclosure of various items of income and expense. To satisfy these requirements, an insurer might need to disclose the following additional items, either on the face of its income statement or in the notes:

(a) acquisition costs (distinguishing those recognised as an expense immediately from the amortisation of deferred acquisition costs);

(b) the effect of changes in estimates and assumptions;

(c) losses recognised as a result of applying liability adequacy tests;

(d) for insurance liabilities measured on a discounted basis:

    (i) accretion of interest to reflect the passage of time; and

    (ii) the effect of changes in discount rates; and

(e) distributions or allocations to holders of contracts that contain discretionary participation features. The portion of profit or loss that relates to any equity component of those contracts is an allocation of profit or loss, not expense or income (paragraph 34(c) of the Standard).

IG27 Some insurers present a detailed analysis of the sources of their earnings from insurance activities either in the income statement, or as a complement to an income statement presented in a more traditional format. Such an analysis may provide useful information about both the income and expense of the current period and the risk exposures faced during the period.

IG28 The items described in paragraph IG26 are not offset against income or expense arising from reinsurance held (paragraph 14(d)(ii) of the Standard).

IG29 Paragraph 37(b) also requires specific disclosure about gains or losses recognised on buying reinsurance. This disclosure informs users about gains or losses that may, using some measurement models, arise from imperfect measurements of the underlying direct insurance liability. Furthermore, some measurement models require a cedant to defer some of those gains and losses and amortise them over the period of the related risk exposures, or some other period. Paragraph 37(b) also requires a cedant to disclose information about such deferred gains and losses.

IG30 If an insurer does not adopt uniform accounting policies for the insurance liabilities of its subsidiaries, it might need to disaggregate the disclosures about amounts reported in its financial report to give meaningful information about amounts determined using different accounting policies.

Significant assumptions and other sources of estimation uncertainty

IG31 Paragraph 37(c) of the Standard requires an insurer to describe the process used to determine the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts and, when practicable, give quantified disclosure of those assumptions. For some disclosures, such as discount rates or assumptions about future trends or general inflation, it may be relatively easy to disclose the assumptions used (aggregated at a reasonable but not excessive level, where necessary). For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, in which case it is more important to describe the process used to generate the assumptions.

IG32 The description of the process used to determine assumptions might include a summary of the most significant of the following:

(a) the objective of the assumptions. For example, an insurer might disclose whether the assumptions are intended to be neutral estimates of the most likely or expected outcome ('best estimates') or to provide a given level of assurance or level of sufficiency. If they are intended to provide a quantitative or qualitative level of assurance, an insurer might disclose that level;

(b) the source of data used as inputs for the assumptions that have the greatest effect. For example, an insurer might disclose whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, an insurer might disclose the criteria used to determine when the studies are updated and the date of the latest update;

(c) the extent to which the assumptions are consistent with observable market prices or other published information;

(d) a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions. If a relationship would normally be expected between experience and future results, an insurer might explain the reasons for using assumptions that differ from past experience and indicate the extent of the difference;

(e) a description of how the insurer developed assumptions about future trends, such as changes in mortality, healthcare costs or litigation awards;

(f) an explanation of how the insurer identifies correlations between different assumptions;

(g) the insurer's policy in making allocations or distributions for contracts with discretionary participation features, the related assumptions that are reflected in the financial report, the nature and extent of any significant uncertainty about the relative interests of policyholders and shareholders in the unallocated surplus associated with those contracts, and the effect on the financial report of any changes during the period in that policy or those assumptions; and

(h) the nature and extent of uncertainties affecting specific assumptions. In addition, to comply with paragraphs 116-122 of AASB 101, an insurer may need to disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next annual reporting period that are different from assumptions could require a material adjustment to the carrying amount of insurance liabilities and insurance assets. Paragraph 120 of AASB 101 gives further guidance on this disclosure.

IG33 The Standard does not prescribe specific assumptions that would be disclosed, because different assumptions will be more significant for different types of contract.

Changes in assumptions

IG34 Paragraph 37(d) of the Standard requires an insurer to disclose the effect of changes in assumptions used to measure insurance assets and insurance liabilities. This is consistent with AASB 108, which requires disclosure of the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods.

IG35 Assumptions are often interdependent. When this is the case, analysis of changes by assumption may depend on the order in which the analysis is performed and may be arbitrary to some extent. Therefore, the Standard does not specify a rigid format or content for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for their particular circumstances. If practicable, an insurer might disclose separately the impact of changes in different assumptions, particularly if changes in some assumptions have an adverse effect and others have a beneficial effect. An insurer might also describe the impact of interdependencies between assumptions and the resulting limitations of any analysis of the effect of changes in assumption.

IG36 An insurer might disclose the effects of changes in assumptions both before and after the impact of reinsurance held, especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.

Changes in insurance liabilities and related items

IG37 Paragraph 37(e) of the Standard requires an insurer to disclose reconciliations of changes in insurance liabilities. It also requires disclosure of movements in reinsurance assets. An insurer need not disaggregate those movements into broad classes, but might do that if different forms of analysis are more relevant for different types of liability. The movements might include:

(a) the carrying amount at the beginning and end of the period;

(b) additional insurance liabilities arising during the period;

(c) cash paid;

(d) income and expense included in profit or loss;

(e) liabilities acquired from, or transferred to, other insurers; and

(f) net exchange differences arising on the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity.

IG38 An insurer discloses the movements in insurance liabilities and reinsurance assets in all prior periods for which it reports full comparative information.

IG39 Paragraph 37(e) of the Standard also requires an insurer to disclose movements in deferred acquisition costs, if applicable. The reconciliation might disclose:

(a) the carrying amount at the beginning and end of the period;

(b) the amounts incurred during the period;

(c) the amortisation for the period;

(d) impairment losses recognised during the period; and

(e) other movements categorised by cause and type.

IG40 An insurer may have recognised intangible assets related to insurance contracts acquired in a business combination or portfolio transfer. AASB 138 *Intangible Assets* contains disclosure requirements for intangible assets, including a requirement to give a reconciliation of movements in intangible assets. The Standard does not require additional disclosures about these assets.

Amount, timing and uncertainty of future cash flows (paragraphs 38 and 39 of the Standard)

IG41 The disclosures about the risk, timing and uncertainty of future cash flows are based on two foundations.

(a) There should be a balance between quantitative and qualitative disclosures, enabling users to understand the nature of risk exposures and their potential impact.

(b) Disclosures should be consistent with how management perceives its activities and risks, and the methods that management uses to manage those risks. This approach is likely:

(i) to generate information that has more predictive value than information based on assumptions and methods that management does not use, for instance, in considering the insurer's ability to react to adverse situations; and

(ii) to be more effective in adapting to the continuing change in risk measurement and management techniques and developments in the external environment over time.

IG42 In developing disclosures to satisfy paragraphs 38 and 39 of the Standard, an insurer would decide in the light of its circumstances how it would aggregate information to display the overall picture without combining information that has materially different characteristics, so that the information is useful. An insurer might group insurance contracts into broad classes in ways that are appropriate for the nature of the information to be disclosed, taking into account matters such as the risks covered, the characteristics of the contracts and the measurement basis applied. The broad classes may correspond to classes established for legal or regulatory purposes, but the Standard does not require this.

IG43 Under AASB 114 *Segment Reporting*, the identification of reportable segments reflects differences in the risks and returns of an entity's products and services. AASB 114 takes the position that the segments identified in an organisational and management structure and internal financial reporting system normally provide an appropriate segmentation for financial reporting. An insurer might adopt a similar approach to identify broad classes of insurance contracts for disclosure purposes, although it might be appropriate to disaggregate disclosures down to the next level. For example, if an insurer identifies life insurance as a reportable segment for AASB 114, it might be appropriate to report separate information about, say, life insurance, annuities in the accumulation phase and annuities in the payout phase.

IG44 AASB 132 *Financial Instruments: Disclosure and Presentation* gives the following guidance on the level of detail to be disclosed about financial instruments, which is also appropriate for insurance contracts.

> Determining the level of detail to be disclosed about particular financial instruments requires the exercise of judgement taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial reports with excessive detail that may not assist users of financial reports and obscuring important information as a result of too much aggregation. For example, when an entity is party to a large number of financial instruments with similar characteristics and no single contract is individually material, a summary by classes of instruments is appropriate. On the other hand, information about an individual instrument may be important when it is, for example, a material component of an entity's capital structure.

IG45 In identifying broad classes for separate disclosure, an insurer might consider the need to indicate the level of uncertainty associated with the risks underwritten, to inform users whether outcomes are likely to be within a wider or a narrower range. For example, an insurer might disclose information about exposures where there are significant amounts of provisions for claims incurred but not reported (IBNR) or where outcomes and risks are unusually difficult to assess (e.g. asbestos).

IG46 It may be useful to disclose sufficient information about the broad classes identified to permit a reconciliation to relevant line items on the balance sheet.

IG47 Information about the extent and nature of insurance contracts is more useful if it highlights any relationship between insurance contracts (and between insurance contracts and other items, such as financial instruments) that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by the relationship among the assets and liabilities might be apparent to users from information about the terms and conditions of insurance contracts (see paragraph IG49), but in some cases further disclosure might be useful.

Risk management objectives and policies for mitigating insurance risk

IG48 Paragraph 39(a) of the Standard requires an insurer to disclose its objectives in managing risks arising from insurance contracts and its policies for mitigating those risks. Such discussion provides a valuable additional perspective that is independent of the specific contracts outstanding at a particular time. An insurer might disclose, for example:

(a) its policies for accepting insurance risks, including selection and approval of risks to be insured, use of limits and use of options and avoiding undue concentrations of risk; the underwriting strategy to ensure that there are appropriate risk classification and premium levels. These disclosures might include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the insurance contracts and their relative significance to the insurer;

(b) the methods it uses to assess and monitor insurance risk exposures both for individual types of risks insured and overall, such as internal risk measurement models, sensitivity analyses, scenario analyses, and stress testing, and how it integrates them into its operating activities. Useful disclosure might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach;

(c) methods it employs to limit or transfer insurance risk exposures, such as retention limits and the use of reinsurance;

(d) the extent to which insurance risks are assessed and managed on an entity-wide basis;

(e) asset and liability management (ALM) techniques; and

(f) commitments received (or given) to issue (contribute) additional debt or equity capital when specified events occur.

Terms and conditions of insurance contracts

IG49 Paragraph 39(b) of the Standard requires an insurer to disclose those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows arising from insurance contracts. To achieve this, an insurer might disclose the more significant of the following for each broad class of insurance liabilities, and reinsurance assets held:

(a) the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability);

(b) concentrations of insurance risk, interest rate risk, credit risk or foreign exchange risk and the extent to which reinsurance or policyholder participation features mitigate those risks (see paragraphs IG55-IG58 for further discussion);

(c) a summary of significant guarantees, and of the levels at which guarantees of market prices or interest rates are likely to alter the insurer's cash flows materially;

(d) claims development information (see paragraphs IG59-IG61 for further discussion);

(e) the basis for determining investment returns credited to policyholders, such as whether the returns are fixed, based contractually on the return of specified assets or partly or wholly subject to the insurer's discretion; and

(f) the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts, pools of contracts or entities, including the general nature of any formula for the participation and the extent of any discretion held by the insurer.

IG50 An insurer might also disclose the following information, which need not be disaggregated by broad classes:

(a) information about the estimated timing of the net cash inflows and outflows resulting from recognised insurance liabilities, and reinsurance assets. To comply with AASB 101, the information would need to distinguish items falling due within one year from items falling due later. In addition, an insurer might disclose summary information about items falling due after one year (such as the estimated weighted average maturity of those items) or a more detailed analysis by time periods. The Standard does not require an insurer to disclose the amounts of the estimated cash flows: an analysis, by estimated timing, of the amounts recognised in the balance sheet is sufficient;

(b) a summary narrative description of how the amounts in (a) could change if policyholders exercised lapse or surrender options in different ways;

(c) if applicable, the average discount rate or interest rate implicit in the measurement of insurance liabilities for each period described in (a);

(e) the sensitivity of profit or loss and equity to changes in key variables (see paragraphs IG52-IG54 for further discussion);

(f) the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds (see also AASB 137); and

(g) segregation requirements that are intended to protect policyholders by restricting the use of some of the insurer's assets.

Insurance risk

IG51 Paragraph 39(c) of the Standard requires disclosures about insurance risk. Disclosures to satisfy this requirement might build on the following foundations.

(a) Information about insurance risk is consistent with (though naturally less detailed than) the information provided internally to the board of directors and chief executive officer, so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management'.

(b) Information about risk exposures might report exposures both gross and net of reinsurance (or other risk mitigating elements, such as catastrophe bonds issued or policyholder participation features), especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.

(c) In reporting quantitative information about insurance risk, an insurer might disclose the methods used, the strengths and limitations of those methods, the assumptions made, and the effect of reinsurance, policyholder participation and other mitigating elements.

(d) Insurers might classify risk along more than one dimension. For example, life insurers might classify contracts by both the level of mortality risk and the level of investment risk. It may sometimes be convenient to display this information in a matrix format.

(e) If an insurer's risk exposures at the reporting date are unrepresentative of its exposures during the period, it might be useful to disclose that fact.

(f) The following disclosures required by paragraph 39 of the Standard might also be relevant:

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

  (ii) concentrations of insurance risk; and

  (iii) the development of prior year insurance liabilities.

Sensitivity analysis

IG52 Paragraph 39(c)(i) of the Standard requires disclosure about the sensitivity of profit or loss and equity to changes in variables that have a material effect on them. Sensitivity analysis might be qualitative, and preferably also quantitative. An insurer might, if feasible without undue cost or effort, explain the impact of correlations between key variables. Although sensitivity tests can provide useful information, such tests have limitations. An insurer might disclose the strengths and limitations of sensitivity analyses performed.

IG53 Informative disclosure might avoid giving a misleading sensitivity analysis if there are significant non-linearities in sensitivities to variables that have a material effect. For example, if a change of 1 per cent in a variable has a negligible effect, but a change of 1.1 per cent has a material effect, it might be misleading to disclose the effect of a 1 per cent change without further explanation.

IG54 Sensitivity analysis helps to meet the requirement to disclose information about the amount, timing and uncertainty of cash flows. However, to permit meaningful aggregation, the required sensitivity disclosure does not refer directly to the cash flows but instead focuses on summary indicators, namely profit or loss and equity.

Concentrations of insurance risk

IG55 Paragraph 39(c)(ii) of the Standard refers to the need to disclose concentrations of insurance risk. Such concentration could arise from, for example:

(a) a single insurance contract, or a small number of related contracts, for instance, when an insurance contract covers low-frequency, high-severity risks such as earthquakes;

(b) single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability;

(c) exposure to unexpected changes in trends, for example, unexpected changes in human mortality or in policyholder behaviour;

(d) exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses;

(e) significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts;

(f) correlations and interdependencies between different risks;

(g) significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows; and

(h) geographical and sectoral concentrations. The guidance in AASB 114 *Segment Reporting* may help an insurer to identify these.

IG56 Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic.

IG57 Disclosure about an insurer's historical performance on low-frequency, high-severity risks might be one way to help users to assess cash flow uncertainty associated with those risks. Consider an insurance contract that covers an earthquake that is expected to happen every 50 years, on average. If the insured event occurs during the current contract period, the insurer will report a large loss. If the insured event does not occur during the current period, the insurer will report a profit. Without adequate disclosure of the source of historical profits, it could be misleading for the insurer to report 49 years of reasonable profits, followed by one large loss; users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, it might be useful to describe the extent of the exposure to risks of this kind and the estimated frequency of losses. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies.

IG58 For regulatory or other reasons, some entities produce special purpose financial reports that report catastrophe or equalisation reserves as liabilities. Those reserves are a component of equity under Australian Accounting Standards. AASB 101 requires an entity to disclose 'a description of the nature and purpose of each reserve within equity'.

Claims development

IG59 Paragraph 39(c)(iii) of the Standard requires disclosure of claims development information (subject to transitional relief in paragraph 44). Informative disclosure reconciles this information to amounts reported in the balance sheet. An insurer might disclose unusual claims expenses or developments separately, allowing users to identify the underlying trends in performance.

IG60 As explained in paragraph 39(c)(iii) of the Standard, disclosures about claims development are not required for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year. Therefore, these disclosures are not normally required for most life insurance contracts. Furthermore, claims development disclosure is not normally needed for annuity contracts because each periodic payment arises, in effect, from a separate claim about which there is no uncertainty.

IG61 IG Example 5 shows one possible format for presenting claims development information. Other possible formats might, for example, present information by accident year rather than underwriting year. Although the example illustrates a format that might be useful if insurance liabilities are discounted, the Standard does not require discounting (paragraph 25(a) of the Standard).

IG Example 5: Disclosure of claims development

This example illustrates a possible format for a claims development table for a general insurer. The top half of the table shows how the insurer's estimates of total claims for each underwriting year develop over time. For example, at the end of 20X1, the insurer estimated that it would pay claims of 680 for insured events relating to insurance contracts underwritten in 20X1. By the end of 20X2, the insurer had revised the estimate of cumulative claims (both those paid and those still to be paid) to 673.

The lower half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, if the claims liabilities are discounted, the effect of discounting is deducted to give the carrying amount in the balance sheet.

Underwriting year	*20X1*	*20X2*	*20X3*	*20X4*	*20X5*	*Total*
	CU	CU	CU	CU	CU	CU
Estimate of cumulative claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	(702)	(689)	(570)	(350)	(217)	
	-	82	275	553	751	1,713
Effect of discounting	-	(14)	(68)	(175)	(285)	(547)
Present value recognised in the balance sheet	-	68	207	378	466	1,166

Interest rate risk and credit risk

IG62 Paragraph 39(d) of the Standard requires an insurer to disclose information about interest rate risk and credit risk. The information required is the same as that required by AASB 132 (to the extent not already covered by the disclosures discussed above).

IG63 If an insurer considers that lapse behaviour is likely to be sensitive to interest rates, the insurer might disclose that fact and state whether the disclosures about interest rate risk reflect that interdependence.

IG64 Informative disclosure includes information about the extent to which policyholder participation features mitigate or compound interest rate risk.

IG65 For an insurer, disclosure about credit risk might be particularly important for reinsurance contracts held and for credit risk assumed under credit insurance contracts and financial guarantees. Balances due from agents or brokers may also be subject to credit risk.

Exposures to interest rate risk or market risk under embedded derivatives

IG66 Paragraph 39(e) of the Standard requires an insurer to disclose information about exposures to interest rate 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 derivative at fair value (for example, guaranteed annuity options and guaranteed minimum death benefits).

IG67 An example of a contract containing a guaranteed annuity option is one in which the policyholder pays a fixed monthly premium for thirty years. At maturity, the policyholder can elect to take either (a) a lump sum equal to the accumulated investment value or (b) a lifetime annuity at a rate guaranteed at inception (i.e. when the contract started). For policyholders electing to receive the annuity, the insurer could suffer a significant loss if interest rates decline substantially or if the policyholder lives much longer than the average. The insurer is exposed to both interest rate risk and significant insurance risk (mortality risk) and a transfer of insurance risk occurs at inception, because the insurer fixed the price for mortality risk at that date. Therefore, the contract is an insurance contract from inception. Moreover, the embedded guaranteed annuity option itself meets the definition of an insurance contract, and so separation is not required.

IG68 An example of a contract containing minimum guaranteed death benefits is one in which the policyholder pays a monthly premium for 30 years. Most of the premiums are invested in a mutual fund. The rest is used to buy life cover and to cover expenses. On maturity or surrender, the insurer pays the value of the mutual fund units at that date. On death before final maturity, the insurer pays the greater of (a) the current unit value and (b) a fixed amount. This contract could be viewed as a hybrid contract comprising (a) a mutual fund investment and (b) an embedded life insurance contract that pays a death benefit equal to the fixed amount less the current unit value (but zero if the current unit value is more than the fixed amount).

IG69 Both these embedded derivatives meet the definition of an insurance contract if the insurance risk is significant. However, in both cases interest rate risk or market risk may be much more significant than the mortality risk. If interest rates or equity markets fall substantially, these guarantees would be well in the money. Given the long-term nature of the guarantees and the size of the exposures, an insurer might face extremely large losses. Therefore, an insurer might place particular emphasis on disclosures about such exposures.

IG70 Useful disclosures about such exposures might include:

(a) the sensitivity analysis discussed above;

(b) information about the levels when these exposures start to have a material effect (paragraph IG49(c)); and

(c) the fair value of the embedded derivative, although neither the Standard nor AASB 132 requires disclosure of that fair value.

Key performance indicators

IG71 Some insurers present disclosures about what they regard as key performance indicators, such as lapse and renewal rates, total sum insured, average cost per claim, average number of claims per contract, new business volumes, claims ratio, expense ratio and combined ratio. The Standard does not require such disclosures. However, such disclosures might be a useful way for an insurer to explain its financial performance during the period and to give an insight into the amount, timing and uncertainty of its future cash flows.