INFORMATION FOR OBSERVERS

Board Meeting: 13 September 2001, London
Project: Insurance Contracts

Purpose of Discussion

1. At the September 2001 meeting, the staff will ask the Board to:

(a) participate in an educational session, based on the illustrative examples on pages A1–A97 of volume 2 of the November 1999 IASC Issues Paper on Insurance; and

(b) agree the scope of the project, the definition of an insurance contract and related issues.

Background

2. IASC started a project on Insurance Accounting in 1997. In December 1999, IASC’s Steering Committee for this project published an Issues Paper. IASC received 138 comment letters in response to the Issues Paper. These are available on the IASB’s web site www.iasb.org.uk. The Steering Committee met four times to discuss the comment letters and is finalising a report to the Board in the form of a Draft Statement of Principles (DSOP). The Board does not intend to publish the DSOP, but will use it in developing an Exposure Draft.

3. The Board’s discussion of the scope, definition and related issues will be based on a late draft of the relevant sections of the DSOP. The following is a brief summary of the relevant proposals.

Scope

4. A future International Financial Reporting Standard on Insurance Contracts (the Standard) should prescribe the accounting and disclosure in general purpose financial statements by insurers and policyholders for insurance contracts. With limited exceptions, the Standard should not address other aspects of accounting by insurers or policyholders.
5. The proposals in the DSOP apply to insurance contracts issued by all enterprises, regardless of their legal form and regardless of whether the enterprise qualifies as an insurer for legal or other purposes.

**Definition of an Insurance Contract**

6. An *insurance contract* is a contract under which one party (the *insurer*) accepts an insurance risk by agreeing with another party (the *policyholder*) to compensate the policyholder or other beneficiary if a specified uncertain future event (the *insured event*) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).

7. A significant proportion of contracts that have the legal form of insurance contracts will not meet the definition of an insurance contract. Examples are many life insurance contracts in which the insurer bears little or no mortality risk, some group life or group motor contracts in which the policyholder bears all the insurance risk through experience rating mechanisms, and many financial reinsurance contracts. These contracts will fall within the scope of a current or future standard on financial instruments.

8. A contract creates insurance risk if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer’s net cash flows arising from that contract. In considering whether there is a reasonable possibility of such significant change, it is necessary to consider both the probability of the event and the magnitude of its effect.

9. A contract that qualifies as an insurance contract at inception, or later, remains an insurance contract until all rights and obligations are extinguished or expire. If a contract did not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if, and only if, a significant change in the present value of the insurer’s net cash flows from the contract becomes a reasonable possibility.

**Scope Exclusions**

10. Although the following items arise under contracts that may meet the definition of insurance contracts, they should be excluded from the scope of the Standard:

    (a) financial guarantees (including credit insurance) measured at fair value;

    (b) product warranties issued directly by a manufacturer, dealer or retailer;

    (c) employers’ assets and liabilities under employee benefit plans (including equity compensation plans);

    (d) retirement benefit obligations reported by defined benefit retirement benefit plans;

    (e) contingent consideration payable or receivable in a business combination; and
(f) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, certain licence fees, royalties, lease payments and similar items).

**Bundled Contracts**

11. An insurer or policyholder should not account separately for the components of an insurance contract that bundles together an insurance element and a non-derivative investment element.

**Embedded Derivatives**

12. An insurer or policyholder should account separately for a derivative that is embedded in an insurance contract if, and only if, all of the following conditions are met:

(a) the embedded derivative:

   (i) does not create insurance risk; and

   (ii) has characteristics and risks that are not closely related to the characteristics and risks of the host insurance contract;

(b) a stand-alone instrument with similar terms would meet the definition of a derivative in IAS 39, Financial Instruments: Recognition and Measurement; and

(c) the enterprise does not measure the combined instrument at fair value or does not include the changes in fair value in net profit or loss.