Chapter 1
Scope

Introduction

1.1 The International Accounting Standards Committee (IASC) started a project on Insurance Accounting in 1997. In December 1999, IASC's Steering Committee for this project published an Issues Paper on Insurance (the Issues Paper). IASC received 138 comment letters in response to the Issues Paper. These are available on IASB's web site www.iasb.org.uk.

1.2 The Steering Committee greatly appreciates the number and high quality of responses to the Issues Paper. The Steering Committee considered the comment letters carefully at two meetings, spanning six days, and paid careful attention to the detailed, high quality and very well reasoned explanations that commentators provided for their positions.

1.3 In considering the arguments presented by commentators, the Steering Committee paid most attention to the need for insurers to provide relevant and reliable information that users of their financial statements can use as a basis for economic decisions. The information disclosed by insurers should enable users to compare the financial position and financial performance of insurers in different countries; that information should also be comparable with information disclosed about similar transactions by enterprises that are not insurers. In reassessing whether its tentative views achieve these objectives, the Steering Committee used IASC's Framework for the Preparation and Presentation of Financial Statements.

1.4 In evaluating the comment letters, the Steering Committee also considered the level of support for the tentative views expressed in the Issues Paper. However, the Steering Committee placed less weight on the absolute levels of support than on the arguments presented. Thus, the Steering Committee is extremely grateful to commentators for providing such detailed and helpful comments.

1.5 The Steering Committee reviewed the comment letters and developed this report to IASC's successor organisation, the International Accounting Standards Board (the Board). The report is presented in the format of an IASC Draft Statement of Principles (DSOP). The Board has not yet discussed the contents of this DSOP.

Need for a Standard on Insurance Contracts

1.6 There is a need for an International Financial Reporting Standard on Insurance Contracts because:

(a) the insurance industry is an important, and increasingly international, industry;

(b) there is currently great diversity in accounting practices for insurers. Also, insurance industry accounting practices in a number of countries differ significantly from accounting practices used by other enterprises in the same countries;

(c) International Accounting Standards[1] do not currently address specific insurance issues and it is not obvious how an enterprise should deal with these issues under International Accounting Standards. Also, certain existing International Accounting Standards contain specific scope exclusions in these areas, in recognition of the need for further study of these issues (see Table 1 on page 3 of the Issues Paper). Although these gaps cause difficulty for all insurers applying IAS, they cause a particularly urgent problem in the European Union (EU), where it is proposed that International Accounting Standards will become mandatory for all listed enterprises (including listed insurers) by 2005; and

(d) the existence of such a standard may help insurance supervisors in their efforts to approach certain aspects of insurance regulation in ways that are consistent both between countries and with regulation of the banking and securities sectors.

1.7 This DSOP refers frequently to the Draft Standard and Basis for Conclusions, Financial Instruments and Similar Items (the JWG Draft), published in December 2000 by the Joint Working Group of Standard Setters (JWG). The JWG Draft has important implications for several aspects of the project on insurance contracts. However, the Steering Committee has assumed, in developing the DSOP, that IAS 39, Financial Instruments: Recognition and Measurement, may still be in place when IASB finalises a standard on insurance contracts. The Steering Committee makes no particular assumptions about the nature of a possible successor standard to IAS 39.

1.8 In developing this DSOP, the Insurance Steering Committee has drawn on a draft Issues Paper developed by IASC's Present Value Steering Committee and originally intended for publication as a Steering Committee document. This discusses many issues that are relevant for the project on insurance contracts. The Insurance Steering Committee understands that the Board does not intend to publish the Present Values Issues Paper in its current form.

[1] Standards issued by IASC are known as International Accounting Standards. The Board's standards will be known as International Financial Reporting Standards.

Scope

Principle 1.1

1.9 A future International Financial Reporting Standard on Insurance Contracts (the Standard) should prescribe the accounting and disclosure in general purpose financial statements by insurers[2] and policyholders for all insurance contracts, other than those excluded by principle 1.5. The Standard should not address other aspects of accounting by insurers or policyholders (except as specified in principles 4.9, 7.4, 10.1, 10.2, and 11.2[3]).

General Purpose Financial Statements

1.10 International Financial Reporting Standards are intended to be used in general purpose financial statements directed toward the common information needs of a wide range of users. These users include present and potential investors, employees, lenders, suppliers and other trade creditors, customers (for example, the policyholders of an insurer), governments and their agencies (for example, supervisors and regulators) and the public. Special purpose financial reports, for example, computations prepared for regulatory or taxation purposes, are outside the scope of IASC's Framework for the Preparation and Presentation of Financial Statements (the Framework).

Focus on Insurance Contracts

1.11 Some argue that the Standard should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They note that regulatory requirements often cover all aspects of an insurer's business.

1.12 For the following reasons, this DSOP proposes that the Standard should cover insurance contracts of all enterprises and, with limited exceptions (principles 4.9, 7.4, 10.1, 10.2, and 11.2), should not address other aspects of accounting by insurers:

(a) it would be extremely difficult, and perhaps impossible, to create a robust definition of insurance enterprise that could be applied consistently from country to country. Among other things, an increasing number of groups have major activities in both insurance and other areas;

(b) it would be undesirable for an insurer to account for a transaction in one way and for a non-insurance enterprise to account in a different way for the same transaction;

[2] As noted in principle 1.2, this DSOP 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.

[3] Principle 4.9 deals with recoveries related to claims, principle 7.4 deals with performance-linked contracts that are not insurance contracts, principle 10.1 deals with property held by insurers, principle 10.2 deals with deferred tax and principle 11.2 deals with accounting by the transferee of a block of insurance contracts.

(c) the project should not re-open issues addressed by other IASC standards, unless specific features of insurance contracts justify a different treatment; and

(d) a set of internally consistent accounting requirements for insurers will be obtained if the accounting requirements for insurance contracts are consistent with other International Financial Reporting Standards that employ consistent accounting requirements.

1.13 In particular, the DSOP does not, with certain limited exceptions (see principles 4.9, 10.1, 10.2, and 11.2), deal with the treatment of assets held by insurers, other than assets arising under insurance contracts. Principle 3.2 discusses the interaction between the valuation of assets held by insurers and the related insurance liabilities.

1.14 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.

Accounting by Policyholders

1.15 International Accounting Standards address only limited aspects of accounting by policyholders for insurance contracts. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, addresses accounting for reimbursements from insurers for expenditure required to settled a provision. SIC-14, Property, Plant and Equipment - Compensation for the Impairment or Loss of Items, addresses some aspects of reimbursement by insurance companies for impairment or loss of items of property, plant and equipment.

1.16 The Standard will clearly need to deal with an insurer's rights under reinsurance contracts. However, some argue that accounting by policyholders for direct insurance contracts does not appear to cause any particular problems in practice and should not, therefore, be included in the scope of the Standard. They note that policyholders generally recognise amounts paid in advance for future coverage as prepayments.

1.17 For both reinsurance and direct insurance, this DSOP deals with accounting by both parties to an insurance contract, as there is no conceptual reason to exclude accounting by policyholders. Principles 8.2-3 address accounting by a policyholder for a reinsurance contract. Principle 9.1 addresses accounting by a policyholder for a direct insurance contract.

Definition of Insurance Contract

Principle 1.2

1.18 Insurance contracts should be defined as follows in all International Financial Reporting Standards and International Accounting Standards.

1.19 An <u>insurance contract</u> is a contract under which one party (the <u>insurer</u>) accepts an insurance risk by agreeing with another party (the <u>policyholder</u>) to compensate the

policyholder or other beneficiary if a specified uncertain future event (the <u>insured event</u>) 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).

1.20 For ease of reference, this DSOP 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.

1.21 The definition of insurance contracts will be used to determine the scope of an International Financial Reporting Standard on insurance contracts, by distinguishing insurance contracts from:

(a) financial instruments covered by IAS 39 (or a successor standard resulting from the JWG Draft) on the basis of some attribute that suggests the need for a separate standard; and

(b) other items that are not financial instruments (for example, provisions covered by IAS 37 and intangible assets covered by IAS 38).

1.22 The following definition of insurance contracts is currently used to exclude insurance contracts from the scope of IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement.

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

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

1.24 This DSOP proposes to refine the definition used in IAS 32 and IAS 39 so that it focuses more specifically on the features that cause accounting problems unique to insurance contracts. Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of a contract:

(a) whether a future event specified in the contract will occur;

(b) when the specified future event will occur; or

(c) how much the insurer will need to pay if the specified future event occurs.

1.25 Some insurance contracts cover events that are discovered during the term of the contract, even if they occurred before the inception of the contract; these contracts do not cover events that are discovered after the end of the contract term, even if the events occurred during the contract term. Other insurance contracts cover events that occur during the term of the contract, even if those losses are discovered after the end of the contract term.

1.26 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.

1.27 Most insurance contracts may be regarded as financial instruments,[4] because they create contractual rights or obligations that will result in the flow of cash or other financial instruments. However, some insurance contracts require or permit payments to be made in kind. An example is where the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Another example is where an insurer uses its own hospitals and medical staff to provide medical coverage. Such contracts may not meet the definition of financial instruments in International Accounting Standards. Payments in kind may make it more difficult to measure an insurer's obligations under such contracts. However, there is no conceptual reason to treat such contracts differently from other insurance contracts that are financial instruments.

Distinction between Insurance Risk and Financial Risk

1.28 The proposed definition of an insurance contract refers to insurance risk arising from an uncertain event that adversely affects the policyholder or other specified beneficiary. In this DSOP **insurance risk** is risk other than **financial risk**. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. A contract that exposes the issuer to financial risk without insurance risk is not an insurance contract.

1.29 Some contracts expose the issuer to financial risks, in addition to 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 significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.

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[4] IAS 32 defines a **financial instrument** as "any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise." It defines a **financial asset** as "any asset that is: (a) cash; (b) a contractual right to receive cash or another financial asset from another enterprise; (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or (d) an equity instrument of another enterprise". It defines a **financial liability** as "any liability that is a contractual obligation: (a) to deliver cash or another financial asset to another enterprise; or (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable". The Joint Working Group has proposed a slightly different definition intended to clarify certain aspects without making fundamental changes of meaning.

1.30 Under some contracts, the amount payable is linked to a price index, but the uncertain event that triggers payment is not a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable. Such contracts are insurance contracts. For example, an annuity linked to a cost-of-living index is an insurance contract. That is because payment is based not solely on changes in the index but is triggered by an uncertain event – the survival of the annuitant. Principle 1.6 addresses derivatives that are embedded in an insurance contract.

1.31 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. Some argue that all such contracts should be treated as insurance contracts, as they are traditionally described as insurance contracts and are generally subject to regulation by insurance supervisors.

1.32 IAS 1, Presentation of Financial Statements, requires that financial statements should "reflect the economic substance of events and transactions and not merely their legal form". Therefore, this DSOP proposes that the contracts described in the previous paragraph should not be treated as if they were insurance contracts. If the contracts create financial assets or financial liabilities, these should be treated in the same way as other financial instruments that do not create insurance risk, using what is sometimes described as deposit accounting (which would be covered by IAS 39 or a successor standard):

(a) the issuer of the contract should recognise the premium received as a financial liability, rather than as revenue; and

(b) the holder of the contract should recognise the premium paid as a financial asset, rather than as an expense.

1.33 If the contracts do not create financial assets or financial liabilities IAS 18, Revenue would apply. Under IAS 18, when the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date.[5]

1.34 In developing a successor standard to IAS 39, IASB should review the treatment of contracts that have the legal form of insurance contracts but do not meet the definition of an insurance contract. In particular, the IASB should :

[5] IAS 18, paragraph 20

(a) consider any specific features of such contracts (for example performance-linking features as discussed in chapter 7) that are not present in other financial instruments; and

(b) highlight to constituents that such contracts are to be covered by a financial instruments standard rather than a standard on insurance contracts.

Insurable Interest

1.35 This DSOP proposes a definition that is largely consistent with the definition proposed in the Issues Paper. The one significant change relates to insurable interest. In some countries, the legal definition of insurance requires that the policyholder (or the beneficiary under the contract) should have an insurable interest in the insured event. For the following reasons, the definition proposed in the Issues Paper did not refer to insurable interest:

(a) insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities;

(b) contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest; and

(c) the insurer may not always be able to determine whether the policyholder has an insurable interest.

1.36 Several commentators on the Issues Paper stressed the important social, moral, legal and regulatory differences between insurance and gambling. They noted that policyholders buy insurance to reduce risk, whereas gamblers take on risk. In the light of these suggestions, this DSOP proposes that the definition of an insurance contract should refer to insurable interest, by referring to an uncertain event that adversely affects the policyholder (or other specified beneficiary). This reference to an adverse effect is open to the objections set out in the previous paragraph. However, without this reference, the definition of an insurance contract might capture any prepaid contract to provide services whose cost is uncertain. This would be beyond the reasonable scope of this project and would extend the meaning of the term "insurance contract" too far beyond its traditional meaning.

1.37 The definition of an insurance contract refers to an adverse effect on the policyholder or other specified beneficiary. The definition does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. For example, the definition does not preclude "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 amount of the financial loss suffered by the deceased policyholder's dependants.

Examples of Insurance Contracts

1.38 The following are examples of insurance contracts:

(a) insurance against theft or damage to property;

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

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

(d) **annuities** and pensions (compensation for the uncertain future event - the survival of the annuitant or pensioner - assists the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by their survival);

(e) disability and medical cover;

(f) **performance bonds** and **bid bonds** (under which an enterprise undertakes to make a payment if another party fails to perform a contractual obligation, for example an obligation to construct a building);

(g) product warranties;[6]

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

(i) **travel assistance** (compensation in cash or in kind to policyholders for losses suffered while they are travelling);

(j) some **catastrophe bonds** (catastrophe bonds provide for reduced payments of principal and/or interest if a specified event occurs, see principle 1.6);

(k) contracts that require a payment based on climatic, geological or other physical variables that cause an adverse effect on the holder of the contract; and

(l) **reinsurance** (insurance contracts between a **direct insurer** and a **reinsurer**, or between two reinsurers, that compensate the first insurer for payments to its own policyholders).

[6] Product warranties issued indirectly by another party on behalf of a manufacturer or dealer are within the scope of this DSOP. Principle 1.5 excludes product warranties issued directly by a manufacturer or dealer from the scope of this DSOP.

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

(a) investment products that have the legal form of an insurance contract but do not expose the insurer to insurance risk (such contracts are non-insurance financial instruments);[7]

(b) contracts that have the legal form of insurance, but that pass all significant insurance risk back to the policyholder through mechanisms such as performance-linking (see paragraph 1.40(m) or experience rating (see paragraph 1.40(n)) (such contracts are non-insurance financial instruments);

(c) **self-insurance**, in other words an enterprise's decision to retain a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party);

(d) **gambling**, in other words, a contract that requires a payment if a specified uncertain future event occurs, but that does not require that the event adversely affects the policyholder or other beneficiary specified in the contract;

(e) **derivatives**, in other words contracts (financial instruments) that require one party to make payment based solely on financial risk, that is, changes in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable;[8] and

(f) contracts that require a payment based on climatic, geological or other physical variables regardless of any adverse effect on the holder of the contract (commonly described as **weather derivatives**).[9]

Other Common Features of Insurance Contracts

1.40 The following features are found in many, but not all, insurance contracts. The Steering Committee considered these common features in developing recognition, measurement and disclosure proposals. However, this DSOP takes the view that none of these features are essential components of the definition of an insurance contract.

(a) In many other industries, the costs of a product or service are known before the associated revenue. However, in insurance, the revenue (premiums) is generally known (and received) in advance and the costs (claims) are not

[7] Principle 1.3 discusses how much insurance risk should be present before a contract qualifies as an insurance contract.

[8] The description of a derivative closely parallels the definition of a derivative in IAS 39.

[9] The JWG proposes that weather derivatives should be covered by the financial instruments standard "if that payment is made payment is made regardless of any effect of the event on the contract holder". The current scope of IAS 39 excludes weather derivatives. It may be appropriate to extend the scope of IAS 39 (or a successor standard) or the standard on insurance contracts to address weather derivatives.

known until later. Some insurance contracts expose insurers to risks that will not be fully resolved for many years.

(b) By pooling the risks arising from a large number of similar contracts, an insurer acquires a reasonable statistical basis for making a credible estimate of the nature and parameters of the stochastic process that determines the aggregate outcomes of those contracts. Pooling of risks also reduces the risk of random statistical fluctuations, if the outcome of one contract is independent of the outcome on other contracts.

(c) An insurance contract may expose the insurer to moral hazard. This is the risk that the existence of the insurance contract will increase the level of losses. For example, a policyholder may behave more recklessly than someone who is not protected by insurance. Similarly, the existence of insurance against civil liability may encourage law suits against the policyholder. Some contracts contain features, such as deductibles, to limit moral hazard. For similar reasons, insurance contracts generally cover only those adverse events that are beyond the direct control of the policyholder or other beneficiary (although their behaviour may have an indirect effect on the possibility of adverse events).

(d) The policyholder generally pays a premium (single or recurring) in return for the promise of policy benefits. In other cases, premiums are paid at regular intervals and the policy lapses or becomes paid up if regular premiums cease. In some cases, for example, in some credit card contracts, no explicit premium is charged and the insurance cover is bundled with other aspects of a composite product.

(e) Longer-term insurance contracts often contain an implicit or explicit investment component - an accumulation of a portion of early premiums to supplement the expected inadequacies of later premiums.

(f) Longer-term contracts often grant the policyholder potentially valuable options to renew the contract at favourable prices even if the risk has changed, (or even if the policyholder would not be insurable at all in the current market) or to terminate the policy. Some insurance contracts contain other embedded options, such as conversion features and guarantees of investment returns. The contract may also grant the insurer certain options to limit cover or change premiums. These options may be complex and difficult to value.

(g) Policyholders are more likely to exercise an option if exercise is more favourable to them. For example, if a health insurance contract guarantees continued insurability over a long period, policyholders in poor health are more likely to continue to pay premiums. This tendency, known as anti-selection, means that the characteristics of a portfolio of insurance contracts are likely to deteriorate over time.

(h) In some cases, although neither the policyholder nor the insurer has a right to require renewal of the contract, a high (and sometimes predictable) percentage of contracts are renewed.

(i) For some insurance contracts, the insurer will incur significant administrative expenses over the life of the contract and may also provide significant services over the life of the contract in addition to collecting premiums and paying claims. The ongoing administrative costs and servicing elements are often more significant than for many exchange-traded financial instruments, although these may also be significant for such financial instruments as retail deposits and some loans.

(j) In some instances, an insurer's established pattern of past practice, published policies or specific current statement may create a valid expectation on the part of policyholders that it will accept certain responsibilities beyond those laid down explicitly in an insurance contract. The resulting constructive obligations[10] may have accounting implications.

(k) There is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts. Indeed, in many cases, an insurer cannot transfer its rights and obligations under an insurance contract to another party without the consent of the policyholder, insurance supervisors or both. Market prices that are available may serve only as a crude guide to market value. Such prices often reflect other factors, such as control of a company or the value of a distribution system or potential new business.

(l) Some insurance contracts provide a surrender value for policyholders who terminate the policy before its maturity. To discourage termination, this surrender value may not always reflect the value of a continuing contract from the perspective of the policyholder. Also, the surrender value may not reflect the value that might be attributed to the contract in a transfer to another insurer.

(m) Some insurance contracts (described in this DSOP as performance-linked contracts, also often known as participating or with profits contracts) give policyholders the right to share in the profits of a portfolio of insurance contracts. Chapter 7 discusses the specific issues that arise from such participation features.

(n) For some insurance contracts, the amount of premium payable by the policyholder is not determined finally until the actual level of claims is known. This practice is known as **experience rating**. Experience rating reduces, and

[10] IAS 37 defines a constructive obligation as "an obligation that derives from an enterprise's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

in extreme cases eliminates, insurance risk. Experience rating is a form of performance linking.

(o) Experience under a contract affects the insurer's perception of risk when that contract is renewed and this may affect the premium for the renewal. In some cases, it may be difficult to distinguish the resulting changes in premium from experience rating.

(p) Policyholders may suffer a significant loss if an insurer is unable to pay valid claims. Consequently, insurance is highly regulated in many countries.

1.41 Some believe that the main feature distinguishing insurance risk from financial risk is that insurance contracts are not routinely traded in the capital markets. In their view, any contract of a type that is routinely traded in the capital markets should be covered by a financial instruments standard, not by a standard on insurance contracts. They would treat instruments, such as weather derivatives and catastrophe bonds, that are capable of being traded in the capital markets as financial instruments, even if the instruments transfer a risk that is traditionally regarded as an insurance risk.

1.42 Some propose that the definition of an insurance contract should exclude all contracts that are capable of being trading in the capital markets. In their view, the main distinguishing feature of insurance contracts for accounting purposes is the absence of deep and liquid markets and the consequent difficulty in making reliable measurements. When, this feature is not present, supporters of this view would treat the contract as a financial instrument.

1.43 Because insurance risk is not routinely traded in the capital markets, most (indeed, virtually all) insurance contracts are not currently capable of being trading in the capital markets. Nevertheless, this DSOP defines insurance contracts by reference to the type of risk, rather than by reference to the tradeability of the instrument. In the Steering Committee's view, this is a more useful distinction. In practice, the two criteria would often lead to similar results in most cases.

Amount of Insurance Risk Required for a Contract to Qualify as an Insurance Contract

Principle 1.3

1.44 A contract creates sufficient insurance risk to qualify as an insurance contract 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.

1.45 Some propose that the amount of insurance risk should be defined in quantitative terms in relation to, for example:

(a) the probability that payments under the contract will exceed the expected level of payments (for example, if it is expected that payments will be 100 and the estimated probability of payments exceeding this level is only, say, 1%, the insurance risk might be considered insignificant. Similarly, some would say that no insurance risk is present if the policyholder will receive a lender's rate of return under all reasonably possible scenarios);

(b) the range between the highest and lowest level of payments. This range might be expressed in absolute monetary amounts, as a percentage of the expected level of payments or as a percentage of some other monetary amount in the financial statements; or

(c) the standard deviation of payments (either in absolute monetary amounts, as a percentage of the expected level of payments or as a percentage of some other monetary amount in the financial statements).

1.46 Those who support quantitative guidance believe that it promotes comparability by requiring a consistent threshold. However, this DSOP does not propose quantitative guidance, because quantitative guidance creates:

(a) arbitrary dividing lines which result in different accounting treatment for similar transactions that fall marginally on either side of the line; and

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

1.47 Principle 1.3 states that it is necessary to consider both the probability of an event and the magnitude of its effect, in order to assess whether sufficient insurance risk is present for a contract to qualify as an insurance contract. For example, insurance risk is:

(a) present if the specified event has a reasonably high probability, but its potential cost is only a small multiple of the premium (for example, insurance covering loss of contact lenses);

(b) present if the specified event is extremely costly and feasible in a plausible, but highly unlikely, scenario (for example, earthquake insurance in a geologically stable area that has not suffered earthquakes for many years and where there is no indication of geological deterioration); and

(c) not present if the specified event is not feasible in any plausible scenario (for example, a contractual requirement that will be triggered only if all the many living - and geographically well dispersed - descendants of Queen Victoria die in the same calendar month).

1.48 Some propose that the magnitude of an event should be defined in qualitative terms by referring to, for example, materiality. IASC's Framework for the Preparation and

Presentation of Financial Statements describes materiality as follows. "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." However, a single contract, or even a single book of similar contracts, would rarely be capable of generating a loss that is material in relation to the financial statements as a whole. Therefore, this DSOP defines the magnitude of an insured event by its significance in relation to the individual contract.

1.49 The Issues Paper suggested that insurance risk is present if either the amount or timing (or both) of the insurer's payments vary directly with the amount or timing (or both) of losses incurred by the policyholder. However, some propose that insurance risk is present only if *both* the amount and timing of the insurer's payments may vary directly with the amount or timing (or both) of losses incurred by the policyholder. They believe that this restriction is necessary in order to prohibit reinsurance accounting for transactions that have the legal form of reinsurance contracts but do not transfer significant insurance risk (sometimes known as **financial reinsurance**). Where reinsurance accounting is permitted, financial reinsurance may, for example:

(a) generate immediate accounting profits in countries where general insurance liabilities are not discounted. Such profits arise because the premium paid to the reinsurer would reflect the present value of the liability and is, therefore, less than the previous carrying amount of the liability. However, these transactions create no economic profit; and

(b) result in a stable pattern of earnings.

1.50 Such outcomes may be undesirable, particularly if the accounting treatments and disclosures for insurance contracts differ from those required by a standard on financial instruments. To avoid such outcomes, this DSOP proposes that a contract creates insurance risk if, and only if, an event affecting the policyholder or other beneficiary may cause a significant change in the present value of the insurer's net cash flows from the contract. Principle 1.3 applies equally to direct insurers and reinsurers.

1.51 The test for insurance risk is performed on a contract-by-contract basis.[11] On this basis, insurance risk may be present even in those cases when, for a book of contracts as a whole, there is minimal risk of significant changes in the present value of payments.

1.52 The test for insurance risk refers to the insurer's net cash flows arising from a contract. For some contracts, the sole cause of a possible significant variation in the present value of those cash flows is a variation in the return on specific assets held by the issuer of the contract. In such cases, insurance risk is not present, as the only uncertain future event is a future change in a specified interest rate, security price,

[11] For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) are considered to form a single contract.

commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.

Changes in the Level of Insurance Risk

Principle 1.4

1.53 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 becomes a reasonable possibility (see principle 1.3).

1.54 If a contract was not previously classified as an insurance contract, some argue that an enterprise should assess at each balance sheet date whether the contract now meets the definition of an insurance contract. They argue that this is necessary so that contracts receive the same accounting treatment if they present the same level of insurance risk. On this view, an enterprise might account for a contract in one year as, for example, a (non-insurance) financial instrument, and in the following year as an insurance contract – or vice versa.

1.55 Others argue it would be an unnecessary burden for an enterprise to review its contracts for this purpose at each balance sheet date. They propose that an enterprise should determine at the beginning of a contract whether the future event specified in the contract is uncertain and:

(a) if a contract qualifies as an insurance contract at inception, it remains an insurance contract until all rights and obligations are extinguished or expire; and

(b) if a contract does not qualify as an insurance contract at inception, it should not be reclassified subsequently as an insurance contract, even if a significant change in the present value of the insurer's net cash flows from the contract becomes a reasonable possibility.

1.56 Paragaraph 2.29 of the JWG Draft states that:

> Certain items resulting from insurance contracts, such as premium receivables and payables, meet part (c) of the definition of a financial instrument (see Draft Standard, paragraph 7). These items are not subject to insurance risk and are not economically different from other receivables and payables. The JWG, therefore, specifies that only those rights and obligations arising from insurance contracts that are subject to insurance risk qualify for the exemption in paragraph 1(d).

1.57 This DSOP proposes that:

(a) a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire (even if a significant change in the present value of the insurer's net cash flows is no longer a reasonable possibility). Among other things, this avoids a requirement to unbundle elements, such as some premium receivables and payables, that may not be subject to insurance risk. A requirement to reclassify a contract once it no longer generates insurance risk, or to unbundle components with no insurance risk, would be of no benefit to users of financial statements and would impose unnecessary burdens on insurers; and

(b) if a contract does 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 becomes a reasonable possibility. This would benefit users by ensuring consistent treatment of all contracts that create insurance risk. Changes in the present value of the insurer's net cash flows may arise from changes in estimates and assumptions or changes to the terms of the contract.

Scope Exclusions

Principle 1.5

1.58 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;[12]

(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[13] and similar items).

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[12] (a) Under IAS 26, Accounting and Reporting by Retirement Benefit Plans, the actuarial present value of promised retirement benefits may be either recognised in a statement of net assets, or reported in the notes to the financial statements or in an accompanying actuarial report. (b) IAS 26 does not cover employee benefit plans other than retirement benefit plans. This DSOP does not consider whether it is appropriate to exclude such plans.

[13] The JWG Draft refers to the following examples: "certain licence fees, royalties and similar items", without referring to leases.

1.59 The proposed scope exclusions relate to items covered by current International Accounting Standards or other possible future International Financial Reporting Standards.

Financial Guarantees (including Credit Insurance)

1.60 Under current International Accounting Standards, some financial guarantees are measured at fair value (under IAS 39, Financial Instruments: Recognition and Measurement) and others are measured on a different basis (under IAS 37, Provisions, Contingent Liabilities and Contingent Assets). This DSOP proposes that the Standard should cover financial guarantees that are not measured at fair value. IAS 39 deals with the following types of financial guarantees and requires them to be measured at fair value:

(a) financial guarantees that provide for payments to be made in response to changes in a specified interest rate, security price, commodity price, credit rating, foreign exchange rate, index of prices or rates, or other variable;[14] and

(b) financial guarantees incurred, or retained, on derecognition of a financial asset or financial liability.

1.61 All other financial guarantees fall within the current scope of IAS 37. Under IAS 37:

(a) no liability is recognised for such guarantees unless an outflow of resources embodying economic benefit is probable. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether the outflow of resources is probable. For a large enough portfolio, this will generally lead to the recognition of a provision, because the outflow of resources is probable. If an enterprise has issued a single guarantee or a small number of guarantees, such an outflow is generally not probable and in many cases, no liability would be recognised (other than a deferral of any guarantee fee received that does not qualify for revenue recognition under IAS 18, Revenue);[15] and

(b) if they satisfy the recognition criteria described in (a), such financial guarantees are measured at "the best estimate of the expenditure required to settle the present obligation at the balance sheet date". This is described as "the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time".[16]

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[14] Question 1-5-a, issued by the IASB's IAS 39 Implementation Guidance Committee discusses paragraph 1(f) of IAS 39, which excludes certain financial guarantee contracts from the scope of IAS 39. It states that "[a] financial guarantee contract qualifies for the scope exclusion in IAS 39.1(f) if, and only if, the contract, as a precondition for the payment, requires that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due."

[15] IAS 37, Appendix C, Example 9

[16] IAS 37, paragraphs 36 and 37

Although IAS 37 does not refer explicitly to fair value, some see this as equivalent to fair value.

1.62 Under the JWG Draft, all financial guarantees should be measured at fair value. The JWG Draft defines a financial guarantee as "a contract that requires payments to be made to a creditor if a debtor fails to make payment when due". If this JWG proposal is implemented, no financial guarantees would fall within the scope of the Standard on Insurance Contracts. If IASC's current accounting for financial instruments is maintained, the proposals in this DSOP would bring those financial instruments currently covered by IAS 37 within the scope of the Standard on Insurance Contracts.

1.63 Credit insurance would generally satisfy the JWG's definition of a financial guarantee. Some argue that credit insurance should fall within the scope of the Standard on Insurance Contracts, on the following grounds:

(a) credit insurance is generally arranged by the seller of goods and protects the seller against default by the buyer. The fact that default is generally outside the control of the seller, and so is fortuitous, allows the use of stochastic methods to estimate future cash-flows arising from the contract, since they are random and not subject to moral hazard. By contrast, some financial guarantees, such as some letters of credit, are arranged at the request of the party whose obligation is being guaranteed. Default on such guarantees is partly under the control of that party; and

(b) credit insurance is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities.

1.64 This DSOP takes the view that credit insurance is simply another way of describing a financial guarantee. Although credit insurers manage credit risk by pooling individual risk within a portfolio, this is no different from the way that banks manage credit risk in a portfolio of financial guarantees. There is no reason to require different accounting for credit insurance and for other financial guarantees that create the same exposure to credit risk. This DSOP proposes that credit insurance, and all other forms of financial guarantee, are most appropriately covered by a standard on financial instruments, as credit risk is a risk commonly traded in capital markets.

1.65 Some contracts require payments to be made (either to the debtor or to the creditor) if the debtor's income is reduced by specified adverse events such as unemployment or illness, regardless of whether the debtor continues to pay off the loan when due. Such contracts do not meet the JWG's proposed definition of a financial guarantee, but do meet the definition of an insurance contract proposed in this DSOP. Accordingly, these contracts fall within the proposed scope of the Standard on Insurance Contracts. The Steering Committee considers this result to be appropriate, as the Steering Committee views the risk in such contracts as not being primarily a financial risk.

Product Warranties

1.66 A product warranty clearly meets the proposed definition of an insurance contract if it is issued by an insurer on behalf of another party (such as a retailer or manufacturer). The proposed scope of the Standard includes such warranties.

1.67 A product warranty issued directly by a retailer or manufacturer also meets the proposed definition of an insurance contract. Although some might think of this as a form of "self-insurance", the risk retained itself arises from an agreement with another party – the customer. Some argue that such warranties create similar economic exposures to those issued by an insurer on behalf of the retailer or manufacturer. In their view, the scope of the Standard should include all product warranties. However, this DSOP proposes that the Standard should exclude product warranties issued directly by a retailer or manufacturer, because:

(a) these warranties are closely related to the underlying sale of goods; and

(b) IAS 37, Provisions, Contingent Liabilities and Contingent Assets, already addresses product warranties (except in the financial statements of "insurance enterprises" if the warranties are considered to be "contracts with policyholders"). IAS 18, Revenue, covers the revenue received for such warranties (unless the warranties are "insurance contracts of insurance enterprises").

Employee Benefit Plans

1.68 Many defined benefit pensions and other defined-benefit-type post-employment benefits meet the proposed definition of insurance contracts, because the payments to pensioners are contingent on uncertain future events such as the continuing survival of current or retired employees. IAS 19, Employee Benefits, covers accounting by employers for such benefits. IAS 26 addresses accounting by retirement benefit plans. Accordingly, this DSOP proposes that the Standard should not cover these items.

1.69 Some enterprises operate funded defined benefit pension plans that enter into insurance contracts. If the contracts are with an external insurer, the contracts generally qualify as plan assets under IAS 19, Employee Benefits, and the enterprise offsets them against the reported pension liability. However, if the contracts are issued by the enterprise itself (if it is an insurer) or by a consolidated subsidiary that is an insurer, the contract will generally be eliminated from the financial statements. The result is that the enterprise will report:

(a) the full amount of its pension obligation without any deduction for the plan's rights under the contract;

(b) no liability to policyholders under the contract; and

(c) the assets backing the contract.

State and Quasi-state Pensions and Social Security Benefits

1.70 Some respondents to the Issues Paper proposed that the scope of the Standard should exclude public sector or not-for-profit bodies that provide state or quasi-state pensions or social security benefits. As International Financial Reporting Standards are intended primarily for profit-oriented entities, the Steering Committee has not considered whether contracts issued by such entities are insurance contracts, nor whether the scope of the Standrd should exclude any such entities. Staff have referred these issues to the staff of the Public Sector Committee of IFAC (International Federation of Accountants), which is developing International Public Sector Accounting Standards, based largely on International Accounting Standards.

Other Items Covered by Existing International Accounting Standards.

1.71 A contract for the acquisition or disposal of a subsidiary may include consideration that is contingent on an uncertain future event. IAS 22, Business Combinations, addresses contingent consideration in a business combination. This DSOP does not propose any changes to those requirements. This DSOP also does not propose changes to current accounting for royalties (see IAS 18, Revenue), other payments arising from Leases (see IAS 17, Leases) or intangible assets (see IAS 38, Intangible Assets), even if these payments are wholly or partly contingent on an uncertain future event.

Bundled Contracts

Principle 1.6

1.72 An insurer or policyholder should not account separately for the components of an insurance contract that bundles together:

(a) an insurance element and a non-derivative investment element; or

(b) an embedded derivative and a host insurance contract.

Investment Element

1.73 Some insurance contracts include both an insurance element (for example, death benefits) and a non-derivative investment element (for example, returns linked to particular types of investment held by the insurer). Two possible approaches to such contracts are:

(a) unbundle (split) the contract for accounting purposes and account for the insurance element as an insurance contract and for the investment element as a financial instrument (under IAS 39 or a successor standard resulting from work by the JWG); or

(b) account for the entire contract as an insurance contract.

1.74 Unbundling would have the following implications under the proposals in later chapters of this DSOP:

(a) the insurance element would be measured on a prospective basis, reflecting the present value of future cash flows;

(b) the investment element would be measured:

(i) on an amortised cost basis under IAS 39; and

(ii) at fair value (in effect, a prospective basis) under the JWG proposals;

(c) the insurance liability would not be reduced by the present value of future investment management fees to be charged by the insurer to the policyholder. Instead, these investment management charges would be recognised as revenue in future periods on a time proportion basis, consistent with the reporting generally practised today by fund managers; and

(d) premium receipts for the investment element would be recognised not as revenue, but rather as movements in the insurance liability reported in the balance sheet. Premium receipts for the insurance element would be recognised (at their present value) at inception. The overall effect on net profit or loss would be similar, but the analysis in the individual lines of the income statement would be different.

1.75 Supporters of the approach in paragraph 1.73(a) (unbundling) argue that:

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

(b) the income statement should make a clear distinction between premium income derived from risk transfer products and premium income derived from investment products. Moreover, the tendency in some countries for banks to own insurance companies (and vice-versa) and the similarity of products offered by the insurance and the fund management industry suggest that insurers, banks and fund managers should account for the investment element in a similar manner.[17] At present:

(i) insurers generally treat the entire cash inflow as revenue, and treat the corresponding increase in policy liabilities as an expense;

(ii) banks generally treat the cash inflow as a deposit received and record the inflow as a balance sheet movement; and

[17] It is beyond this scope of this project to consider whether the existing accounting by banks and fund managers is appropriate and whether it would be more appropriate to require banks and fund managers to adopt prospective measurements of the kind that this DSOP proposes for insurance contracts.

(iii) fund managers often do not recognise the cash inflow at all, and report the funds under management, if they report these funds at all, as an off-balance-sheet item;

(iv) banks and fund managers generally recognise management fees on an accruals basis, typically on a time-apportionment basis. However, under the proposals in this DSOP, insurers would recognise the present value of future management fees arising under the closed book of existing contracts as a reduction in their insurance liabilities (see principle 4.1);

(c) unbundling reduces the need for detailed guidance on the level of insurance risk that must be present before a contract qualifies as an insurance contract; and

(d) it is consistent with the JWG Draft, which proposes unbundling for "hybrid contracts" – contracts "with one or more sets of rights and obligations that, if they were separated from the contract, would be accounted for as financial instruments that fall within the scope of the JWG Draft and one or more sets of rights and obligations that do not fall within the scope of the JWG Draft".

1.76 Others, including many respondents to the Issues Paper, maintain that:

(a) it is not practical to unbundle complex insurance products into their constituent parts without making significant systems changes;

(b) contracts of this kind are a single product that is regulated as insurance business by insurance supervisors and should be treated in a similar way for accounting purposes;

(c) the various components are closely inter-related and the value of the bundled product is not necessarily equal to the sum of the individual values of the components. This is particularly true for performance-linked contracts, but may also be true for other types of contract;

(d) some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they consider information about gross premium inflows to be important;

(e) if the recognition and measurement requirements for insurance contracts are the same as for (non-insurance) financial instruments, there would be no scope for accounting arbitrage between contracts treated as insurance and contracts treated as other financial instruments. This would eliminate the perceived need for unbundling, although there may still be some presentation or disclosure requirements to address – for example, if all cash inflows for

insurance contracts are treated as premium revenue and cash inflows for some other financial instruments are treated as deposits;

(f) a robust definition of an insurance contract reduces the scope for accounting arbitrage; and

(g) unbundling would result in retrospective measurement of the investment element (under IAS 39) and prospective measurement of the insurance element. A consistent use of prospective measurement would be more useful as an aid to economic decisions than a confusing mixture of different measurement bases.

1.77 The Issues Paper proposed that contracts should be unbundled when the separate components are either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. However, for the reasons given in the previous paragraph, this DSOP does not permit unbundling of the investment component.

1.78 Certain items resulting from insurance contracts, such as some premium receivables and payables, are not subject to insurance risk and are not economically different from other receivables and payables. The JWG Draft includes such items in its scope.[18] However, this DSOP deals with all assets and liabilities arising under insurance contracts, regardless of whether those assets and liabilities are subject to insurance risk. This follows from the conclusions that an enterprise should not unbundle the investment component of an insurance contract (principle 1.6) and that an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire (principle 1.4).

Catastrophe Bonds

1.79 One particular case of a contract that bundles together an insurance component and a non-derivative investment component is certain types of catastrophe bond. Insurers have started to issue catastrophe bonds in the last few years as an alternative to conventional reinsurance. Catastrophe bonds are bonds that provide for reduced payments of principal and/or interest if a specified event occurs, for example, aggregate losses of $X billion from an earthquake. The specified level of losses may be determined in monetary terms or by reference to an index.

1.80 In substance, a catastrophe bond is a conventional bond that is bundled with:

(a) an insurance contract issued by the bond holder to the issuer (if payment is contingent on whether the specified event affects the issuer of the bond); or

(b) a weather derivative, (if payment is not contingent on whether the specified event affects the issuer of the bond).

[18] JWG Draft, paragraph 2.29

1.81 In return for bearing the risk of losing some or all of the principal or interest, the bondholder receives a higher interest rate – in substance, an insurance premium (if payment is contingent on the effect on the issuer). The Issues Paper proposed that both an issuer and a bondholder should account separately for (unbundle) the host bond and the embedded insurance contract:

(a) the host bond should be treated as an asset of the bondholder and a liability of the issuer; and

(b) the embedded insurance contract should be treated as an insurance contract issued by the bondholder (in substance, an insurer) to the issuer of the bond (in substance, a policyholder).

1.82 Unbundling of catastrophe bonds would be consistent with the JWG's proposals on hybrid contracts (see paragraph 1.75(d) above). However, this DSOP does not permit unbundling of catastrophe bonds. The same arguments apply as for investment components.

1.83 Without unbundling, both the bondholder and the issuer will treat the entire contract as an insurance contract (assuming sufficient insurance risk is present). As a result they will measure the host bond propectively (at entity-specific value, or fair value, as discussed in principle 3.1), rather than on the basis required by IAS 39 or a successor standard. Under IAS 39, the issuer would measure the host bond at amortised cost; the treatment by the bondholder would depend on its classification for IAS 39.

Embedded Derivatives

1.84 IAS 39, Financial Instruments: Recognition and Measurement, requires that an enterprise should account separately for derivatives that are embedded in a financial instrument (the "host" contract) and have economic characteristics and risks that are not closely related to the characteristics and risks of the host contract, unless the enterprise measures the combined instrument at fair value and includes the changes in fair value in net profit or loss. Broadly similar results would arise under the JWG's proposals on hybrid contracts (see paragraph 1.75(d) above).

1.85 This requirement applies to derivatives embedded in an insurance contract (for example, a guarantee of the returns on an investment by reference to an index or interest rates), even though insurance contracts are scoped out of other aspects of IAS 39. Some argue that it may not always be practicable to separate the embedded derivative in this way. However, others argue that this approach promotes comparability by requiring enterprises to account for such embedded derivatives in the same way as for a free-standing derivative with the same terms. This DSOP reflects the latter view.

1.86 If separate accounting is required for certain derivatives embedded in insurance contracts, the Steering Committee believes that it would be useful to give guidance on identifying derivatives embedded in insurance contracts, and examples. The Steering Committee has not attempted to develop such guidance or examples. The Steering

Committee notes that the FASB's Derivatives Implementation Group has given guidance on several types of insurance contract that contain embedded derivatives.

1.87 Chapter 3 of this DSOP proposes that insurance liabilities and insurance assets should be measured at entity-specific value if IAS 39, Financial Instruments: Recognition and Measurement is still in place, and at fair value if a successor standard to IAS 39 introduces full fair value accounting for the substantial majority of financial assets and financial liabilities. The entity-specific value of a derivative would, in general, be the same as its fair value. Chapter 13 proposes that all resulting changes in entity-specific value or fair value should be recognised in the income statement. Given these proposals, there is no compelling reason to account for embedded derivatives separately from a host insurance contract.