IFRS 4 — Insurance Contracts

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Overview

IFRS 4 *Insurance Contracts* applies, with limited exceptions, to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. In light of the IASB's comprehensive project on insurance contracts, the standard provides a temporary exemption from the requirements of some other IFRSs, including the requirement to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting accounting policies for insurance contracts.

IFRS 4 was issued in March 2004 and applies to annual periods beginning on or after 1 January 2005.

History of IFRS 4

Date	Development	Comments
1 April 2001	Comprehensive insurance contracts project carried over from IASC to new IASB	History of the comprehensive project
May 2002	Short-term insurance contracts project split off from comprehensive project	History of the short-term project
31 July 2003	Exposure Draft ED 5 *Insurance Contracts* published	Comment deadline 31 October 2003
31 March 2004	IFRS 4 *Insurance Contracts* issued	Effective for annual periods beginning on or after 1 January 2005

18 August 2005	Amended by *Financial Guarantee Contracts (Amendments to IAS 39 and IFRS 4)*	Effective for annual periods beginning on or after 1 January 2006

Related Interpretations

- None

Amendments under consideration by IASB

- Insurance contracts — Comprehensive project

Summary of IFRS 4

Background

IFRS 4 is the first guidance from the IASB on accounting for insurance contracts – but not the last. A comprehensive project on insurance contracts is under way. The Board issued IFRS 4 because it saw an urgent need for improved disclosures for insurance contracts, and some improvements to recognition and measurement practices, in time for the adoption of IFRS by listed companies throughout Europe and elsewhere in 2005.

Scope

IFRS 4 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. [IFRS 4.2] It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. [IFRS 4.3] Furthermore, it does not address accounting by policyholders. [IFRS 4.4(f)]

In 2005, the IASB amended the scope of IAS 39 to include financial guarantee contracts issued. However, 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 IAS 39 or IFRS 4 to such financial guarantee contracts. [IFRS 4.4(d)]

Definition of insurance contract

An insurance contract is 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." [IFRS 4.Appendix A]

Accounting policies

The IFRS exempts an insurer temporarily (until completion of Phase II of the Insurance Project) from some requirements of other IFRSs, including the requirement to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in selecting accounting policies for insurance contracts. However, the standard: [IFRS 4.14]

- prohibits provisions for possible claims under contracts that are not in existence at

the reporting date (such as catastrophe and equalisation provisions)

- requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets
- requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and prohibits offsetting insurance liabilities against related reinsurance assets and income or expense from reinsurance contracts against the expense or income from the related insurance contract.

Changes in accounting policies

IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. [IFRS 4.22] In particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them: [IFRS 4.25]

- measuring insurance liabilities on an undiscounted basis
- measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services
- using non-uniform accounting policies for the insurance liabilities of subsidiaries.

Remeasuring insurance liabilities

The IFRS permits the introduction of an accounting policy that involves remeasuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities. [IFRS 4.24]

Prudence

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 should not introduce additional prudence. [IFRS 4.26]

Future investment margins

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts. [IFRS 4.27]

Asset classifications

When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'. [IFRS

4.45]

Other issues

The standard:

- clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract [IFRS 4.7-8]
- requires an insurer to unbundle (that is, to account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet [IFRS 4.10]
- clarifies the applicability of the practice sometimes known as 'shadow accounting' [IFRS 4.30]
- permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer [IFRS 4.31-33]
- addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments. [IFRS 4.34-35]

Disclosures

The standard requires disclosure of:

- information that helps users understand the amounts in the insurer's financial statements that arise from insurance contracts: [IFRS 4.36-37]
  - accounting policies for insurance contracts and related assets, liabilities, income, and expense
  - the recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts
  - if the insurer is a cedant, certain additional disclosures are required
  - information about the assumptions that have the greatest effect on the measurement of assets, liabilities, income, and expense including, if practicable, quantified disclosure of those assumptions
  - the effect of changes in assumptions
  - reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs
- Information that helps users to evaluate the nature and extent of risks arising from insurance contracts: [IFRS 4.38-39]
  - risk management objectives and policies
  - 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
  - information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
    - the sensitivity to insurance risk
    - concentrations of insurance risk
    - actual claims compared with previous estimates

- the information about credit risk, liquidity risk and market risk that IFRS 7 would require if the insurance contracts were within the scope of IFRS 7
- 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.

Rating agency analysis of IFRS 4

Fitch Ratings – a leading global fixed income rating agency – has analysed the implications of IFRS 4 *Insurance Contracts* and has concluded that Fitch "does not expect any rating actions as a direct result of the move to IFRS. However, Fitch cannot rule out the possibility that the additional disclosure and information contained in the accounts could lead to rating changes due to an improved perception of risk based on the enhanced information available." The special report *Mind the GAAP: Fitch's View on Insurance IFRS* provides an overview of IFRS 4 and the issues being addressed in Phase II of the IASB's insurance project; assesses the implications including increased volatility, greater use of discounting and fair values, changes to income recognition, and enhanced disclosures; and discusses how the changes affect ratings analysis. An excerpt:

> Fitch welcomes the progress made by the IASB towards standards that will be more transparent and comparable across regions. The agency recognises the significant limitations of phase 1 but believes that the enhanced disclosure and greater consistency at phase 1 of the insurance accounting project (set out in IFRS 4) will aid in the analysis of insurers and is a useful stepping stone to the more valuable phase 2.

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