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(Acts whose publication is obligatory)

COMMISSION REGULATION (EC) No 2236/2004

of 29 December 2004

amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standards (IFRSs) Nos 1, 3 to 5, International Accounting Standards (IASs) Nos 1, 10, 12, 14, 16 to 19, 22, 27, 28, 31 to 41 and the interpretations by the Standard Interpretation Committee (SIC) Nos 9, 22, 28 and 32

(Text with EEA relevance)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards ⁽¹⁾, and in particular Article 3(1) thereof,

Whereas:

(1) By Commission Regulation (EC) No 1725/2003 ⁽²⁾, certain international standards and interpretations that were extant at 1 September 2002 were adopted.

(2) On 31 March 2004, the International Accounting Standard Board (IASB) published among others three new standards, International Financial Reporting Standards (IFRSs) Nos 3 to 5, and two revised standards, IASs Nos 36 and 38, containing consequential changes. Those new standards further complete the 'stable platform', that is the set of standards which listed Community companies will have to apply in their consolidated accounts from 1 January 2005 onwards. The general objective is to improve the quality of International Accounting Standards (IASs) as well as to increase convergence of accounting standards around the world.

(3) The consultation with technical experts in the field confirms that the new IFRSs and the revised IASs meet the technical criteria for adoption set out in Article 3 of Regulation (EC) No 1606/2002, and in particular the requirement of being conducive to the European public good.

(4) The adoption of IAS 36 implies, by way of consequence, amendments to IAS 16, which was adopted by Regulation (EC) No 1725/2003, in order to ensure consistency between the accounting standards concerned.

(5) The adoption of IFRS 3, 4 and 5 implies, by way of consequence, amendments to other international accounting standards and interpretations in order to ensure consistency between international accounting standards. Those consequential amendments are affecting International Financial Reporting Standard (IFRS) No 1, International Accounting Standards (IASs) Nos 1, 10, 12, 14, 16 to 19, 27, 28, 31 to 34, 36 to 41 and interpretation issued by the Standard Interpretation Committee (SIC) No 32. In addition, the adoption of IFRS 3 makes redundant the International Accounting Standard (IAS) 22 and the interpretations issued by the Standard Interpretation Committee (SIC) Nos 9, 22 and 28; they should accordingly be replaced. Furthermore, adoption of IFRS 5 should lead to a replacement of IAS 35.

(6) Regulation (EC) No 1725/2003 should therefore be amended accordingly.

(7) The measures provided for in this Regulation are in accordance with the opinion of the Accounting Regulatory Committee,

HAS ADOPTED THIS REGULATION:

Article 1

The Annex to Regulation (EC) No 1725/2003 is amended as follows:

(1) The International Accounting Standard (IAS) 22 and the interpretations by the Standard Interpretation Committee (SIC) Nos 9, 22 and 28 are replaced by International Financial Reporting Standard (IFRS) 3 [*Business combinations*] as set out in the Annex to this Regulation;

⁽¹⁾ OJ L 243, 11.9.2002, p. 1.

⁽²⁾ OJ L 261, 13.10.2003, p. 1. Regulation as last amended by Regulation (EC) No 2086/2004 (OJ L 363, 9.12.2004, p. 1).

- (2) The (IFRS) Nos 4 [*Insurance contracts*] is inserted as set out in the Annex to this Regulation;
- (3) IAS 35 is replaced by IFRS 5 [*Non-current assets held for sale and discontinued operations*] as set out in the Annex to this Regulation;
- (4) IASs Nos 36 and 38 are replaced by IASs Nos 36 and 38 as set out in the Annex to this Regulation;
- (5) The adoption of IFRS 3 implies, by way of consequence, amendments to IFRS 1, to IASs 12, 14, 16, 19, 27, 28, 31, 32, 33, 34, 37, 39 and to SIC 32 in order to ensure consistency between accounting standards;
- (6) The adoption of IFRS 4 implies, by way of consequence, amendments to IFRS 1 and to IASs 18, 19, 32, 37, 39, 40 in order to ensure consistency between international accounting standards;
- (7) The adoption of IFRS 5 implies, by way of consequence, amendments to IFRS 1, IFRS 3 and to IASs 1, 10, 16, 17, 27, 28, 31, 36, 37, 38, 40, 41 in order to ensure consistency between international accounting standards;

Article 2

This Regulation shall enter into force on the third day following that of its publication in the *Official Journal of the European Union*.

It shall apply from 1 January 2005 at the latest.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 29 December 2004.

For the Commission
Charlie McCREEVY
Member of the Commission

ANNEX

INTERNATIONAL FINANCIAL REPORTING STANDARDS

No	Title
IFRS 3	Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations
IAS 36	Impairment of assets
IAS 38	Intangible assets

INTERNATIONAL FINANCIAL REPORTING STANDARD 4

IFRS 4

Insurance contracts

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OBJECTIVE

1. The objective of this IFRS is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this IFRS as an *insurer*) until the Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires:
 - (a) limited improvements to accounting by insurers for insurance contracts.

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

SCOPE

2. An entity shall apply this IFRS to:
 - (a) insurance contracts (including *reinsurance contracts*) that it issues and reinsurance contracts that it holds.
 - (b) financial instruments that it issues with a *discretionary participation feature* (see paragraph 35). IAS 32 *Financial Instruments: Disclosure and Presentation* requires disclosure about financial instruments, including financial instruments that contain such features.
3. This IFRS 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 IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transitional provisions in paragraph 45.
4. An entity shall not apply this IFRS to:
 - (a) product warranties issued directly by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
 - (b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 *Accounting and Reporting by Retirement Benefit 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 IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets*).
 - (d) financial guarantees that an entity enters into or retains on transferring to another party financial assets or financial liabilities within the scope of IAS 39, regardless of whether the financial guarantees are described as financial guarantees, letters of credit or insurance contracts (see IAS 39).
 - (e) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).
 - (f) *direct insurance contracts* that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply this IFRS to reinsurance contracts that it holds.
5. For ease of reference, this IFRS 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 IFRS to insurance contracts also apply to reinsurance contracts.

Embedded derivatives

7. IAS 39 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. IAS 39 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 IAS 39, 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 IAS 39 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 nonfinancial 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 (ie without considering the insurance component).
 - (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.
 - (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 IFRS to the insurance component.
 - (b) apply IAS 39 to the deposit component.

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RECOGNITION AND MEASUREMENT

Temporary exemption from some other IFRSs

13. Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. However, this IFRS 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 IFRS does not exempt an insurer from some implications of the criteria in paragraphs 10-12 of IAS 8. 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 — ie 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.
 - (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 IFRS 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.
 - (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 (*) 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 IAS 37 *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) (ie the result of applying IAS 37) 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
 - (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 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 statements 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 IAS 8.**

(*) 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.

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23. To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in IAS 8, 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 (*) 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 IAS 8 would otherwise require. If an insurer designates liabilities for this election, it 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.
 - (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 IFRS.

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.

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

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 statements 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 statements 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 statements 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'.

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Insurance contracts acquired in a business combination or portfolio transfer

31. To comply with IFRS 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 IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. However, IAS 36 and IAS 38 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 IFRS 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 IAS 1 *Presentation of Financial Statements*).
 - (d) shall, if the contract contains an embedded derivative within the scope of IAS 39, apply IAS 39 to that embedded derivative.
 - (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

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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 (ie both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying IAS 39 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 IAS 39 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 IAS 39 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.
 - (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.

DISCLOSURE

Explanation of recognised amounts

36. **An insurer shall disclose information that identifies and explains the amounts in its financial statements 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 statements.
 - (e) reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

IFRS 4*Amount, timing and uncertainty of cash flows*

38. **An insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts.**
39. To comply with paragraph 38, an insurer shall disclose:
- (a) its objectives in managing risks arising from insurance contracts and its policies for mitigating those risks.
 - (b) 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.
 - (c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:
 - (i) the sensitivity of profit or loss and equity to changes in variables that have a material effect on them.
 - (ii) concentrations of insurance risk.
 - (iii) actual claims compared with previous estimates (ie 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) the information about interest rate risk and credit risk that IAS 32 would require if the insurance contracts were within the scope of IAS 32.
 - (e) 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 derivatives at fair value.

EFFECTIVE DATE AND TRANSITION

40. The transitional provisions in paragraphs 41-45 apply both to an entity that is already applying IFRSs when it first applies this IFRS and to an entity that applies IFRSs for the first-time (a first-time adopter).
41. An entity shall apply this IFRS for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this IFRS for an earlier period, it shall disclose that fact.

Disclosure

42. An entity need not apply the disclosure requirements in this IFRS 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 if the direct method is used).
43. 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. IAS 8 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 financial year in which it applies this IFRS. Furthermore, if it is impracticable, when an entity first applies this IFRS, 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 IFRS, 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 IFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and IAS 8 applies.
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APPENDIX A

Defined terms

This appendix is an integral part of the IFRS.

cedant	The policyholder under a reinsurance contract .
deposit component	A contractual component that is not accounted for as a derivative under IAS 39 and would be within the scope of IAS 39 if it were a separate instrument.
direct insurance contract	An insurance contract that is not a reinsurance contract .
discretionary participation feature	<p>A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:</p> <ul style="list-style-type: none"> (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; <p style="text-align: center;">and</p> <ul style="list-style-type: none"> (c) that are contractually based on: <ul style="list-style-type: none"> (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; <p style="text-align: center;">or</p> <ul style="list-style-type: none"> (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 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.	IFRS 4
liability adequacy test	An assessment of whether the carrying amount of an 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.	

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APPENDIX B

Definition of an insurance contract

This appendix is an integral part of the IFRS.

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 IFRS 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 IFRS to the contracts described in paragraph B6 is likely to be no more burdensome than applying the IFRSs that would be applicable if such contracts were outside the scope of this IFRS:
- (a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.
 - (b) If IAS 18 *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 IFRS, which permits the service provider (i) to continue its 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 IFRS. If this IFRS did not apply to these contracts, the service provider would apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether the contracts are onerous.
 - (d) For these contracts, the disclosure requirements in this IFRS are unlikely to add significantly to disclosures required by other IFRSs.

Distinction between insurance risk and other risks

- B8 The definition of an insurance contract refers to insurance risk, which this IFRS 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 nonfinancial variables that are specific to a party to the contract, such as the occurrence or nonoccurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a nonfinancial 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 nonfinancial 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.

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- 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 IFRS).
- 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 nonfinancial 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 (ie 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 (ie 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 (ie 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 (ie 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 financial guarantee, letter of credit, credit derivative default product or insurance contract. However, these contracts are outside the scope of this IFRS if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of IAS 39 (see paragraph 4(d)).
- (h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- (i) title insurance (ie 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 (ie 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.
- (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 noncancellable 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).

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- (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 IAS 39).
 - (f) a financial guarantee contract (or letter of credit, credit derivative default product 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 IAS 39).
 - (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).
 - (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 IAS 39. 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.
 - (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, IAS 18 applies. Under IAS 18, 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 (ie 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 (ie 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.
 - (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 statements. (*) 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 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 lifecontingent 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.

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

IFRS 4**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.
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APPENDIX C

IFRS 4

Amendments to other IFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity adopts this IFRS for an earlier period, these amendments shall be applied for that earlier period.

Amendments to IAS 32 and IAS 39

- C1 In IAS 32 *Financial Instruments: Disclosure and Presentation* (as revised in 2003), paragraph 4(d) is renumbered as 4(c). Paragraph 4(c) is renumbered as 4(d) and amended as set out in paragraph C4.

Paragraph 6 is deleted.

The following sentence is added to the end of paragraph AG8:

Some of these contingent rights and obligations may be insurance contracts within the scope of IFRS 4.

- C2 In IAS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003), paragraph 2(e) is renumbered as paragraph 2(d). Paragraph 2(d) is renumbered as 2(e) and amended as set out in paragraph C5. Paragraph AG4 is amended to read as follows:

AG4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of IFRS 4.

- C3 Paragraphs 4(e) of IAS 32 and 2(h) of IAS 39 contain scope exclusions for derivatives based on climatic, geological, or other physical variables. Those paragraphs are deleted. As a result, such derivatives are within the scope of IAS 32 and IAS 39, unless they meet the definition of an insurance contract and are within the scope of IFRS 4. Furthermore, paragraph AG1 of IAS 39 is amended to read as follows:

AG1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of IFRS 4 *Insurance Contracts*, they are within the scope of this Standard.

- C4 In IAS 32, a new paragraph 4(e) is inserted. Following this change and changes made by paragraphs C1 and C3, and by IFRS 3 *Business Combinations*, paragraph 4(c)-(e) reads as follows:

(c) **contracts for contingent consideration in a business combination (see IFRS 3 Business Combinations). This exemption applies only to the acquirer.**

(d) **insurance contracts as defined in IFRS 4 Insurance Contracts. However, this Standard applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately.**

(e) **financial instruments that are within the scope of IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15-32 and AG25-AG35 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IAS 39).**

Paragraph 4(f), inserted by IFRS 2 *Share-based Payment*, remains unchanged.

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C5 In IAS 39, paragraph 2(f) is deleted. Following this change and changes made by paragraphs C2 and C3, and by IFRS 3 *Business Combinations*, paragraph 2(d)-(g) reads as follows:

- (d) *financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.*
- (e) *rights and obligations under an insurance contract as defined in IFRS 4 Insurance Contracts or under a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in such a contract if the derivative is not itself a contract within the scope of IFRS 4 (see paragraphs 10-13 and Appendix A paragraphs AG23-AG33). Furthermore, if an insurance contract is a financial guarantee contract entered into, or retained, on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer shall apply this Standard to the contract (see paragraph 3 and Appendix A paragraph AG4A).*
- (f) *contracts for contingent consideration in a business combination (see IFRS 3 Business Combinations). This exemption applies only to the acquirer.*
- (g) *contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.*

Paragraph 2(i) and (j) is renumbered as 2(h) and (i). Paragraph 2(i) was inserted by IFRS 2 *Share-based Payment*.

Paragraph 3 is deleted and replaced by a new paragraph 3 and paragraph AG4A is added, as follows:

3. Some financial guarantee contracts require 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 under the original or modified terms of a debt instrument. If that requirement transfers significant risk to the issuer, the contract is an insurance contract as defined in IFRS 4 (see paragraphs 2(e) and AG4A). Other financial guarantee contracts require payments to be made in response to changes in 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. Such contracts are within the scope of this Standard.

AG4A. Financial guarantee contracts may have various legal forms, such as a financial guarantee, letter of credit, credit default contract or insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraphs 2(e) and 3):

- (a) If the contract is not an insurance contract, as defined in IFRS 4, the issuer applies this Standard. Thus, a financial guarantee contract that requires payments if the credit rating of a debtor falls below a particular level is within the scope of this Standard.
- (b) If the issuer incurred or retained the financial guarantee on transferring to another party financial assets or financial liabilities within the scope of this Standard, the issuer applies this Standard.
- (c) If the contract is an insurance contract, as defined in IFRS 4, the issuer applies IFRS 4 unless (b) applies.
- (d) If the issuer gave a financial guarantee in connection with the sale of goods, the issuer applies IAS 18 in determining when it recognises the resulting revenue.

- C6 In IAS 39, paragraph 9, the phrase 'other variable' in the definition of a derivative is replaced by the phrase 'other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract'. The same change is made in paragraph 10 of IAS 39. The following new paragraph AG12A is added to IAS 39:

AG12A. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a nonfinancial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific nonfinancial asset held (a nonfinancial 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, the change in that residual value is specific to the owner of the car.

- C7 In IAS 32, the following new paragraph 91A is inserted, and in paragraph 86 the cross-reference to paragraph 90 is extended to include paragraph 91A:

91A. ***Some financial assets and financial liabilities contain a discretionary participation feature as described in IFRS 4 Insurance Contracts. If an entity cannot measure reliably the fair value of that feature, the entity shall disclose that fact together with a description of the contract, its carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie.***

In paragraph 49(e), 'insurance policy' is replaced by 'insurance contract'.

- C8 In IAS 39, paragraph AG30 gives examples of embedded derivatives that are regarded as not closely related to a host contract, and paragraph AG33 gives examples of embedded derivatives that are regarded as closely related to a host contract. Paragraphs AG30(g) and AG33 (a), (b) and (d) are amended by the insertion of references to insurance contracts as follows and in paragraph AG33, (g) and (h) are added:

AG30 (g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under IAS 32.

AG33 (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

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- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
- (i) the functional currency of any substantial party to that contract;
 - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions);
- or
- (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
- (h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

Amendments to other IFRSs

C9 IAS 18 *Revenue* is amended as described below.

Paragraph 6(c) is amended to read as follows:

- (c) insurance contracts within the scope of IFRS 4 *Insurance Contracts*;

C10 In IAS 19 *Employee Benefits*, the following footnote is added to the definition in paragraph 7 of a qualifying insurance policy, after the first occurrence of the word 'policy':

- (¹) A qualifying insurance policy is not necessarily an insurance contract, as defined in IFRS 4 *Insurance Contracts*.

C11 In IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, paragraphs 1(b) and 4 are deleted and a new paragraph 5(e) is inserted as follows:

- (e) insurance contracts (see IFRS 4 *Insurance Contracts*). However, this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of IFRS 4.

In paragraph 2 (as amended in 2003 by IAS 39), the last sentence is deleted.

C12 In IAS 40 *Investment Property* (as revised in 2003), paragraphs 32A-32C and 75(f)(iv) are added and a cross-reference to paragraph 32A is included in paragraph 30 as follows:

- 30. **With the exceptions noted in paragraphs 32A and 34, an entity shall choose as its accounting policy either the fair value model in paragraphs 33-55 or the cost model in paragraph 56 and shall apply that policy to all of its investment property.**

Investment property linked to liabilities

IFRS 4

32A. *An entity may:*

(a) *choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property;*

and

(b) *choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).*

32B. Some insurers and other entities operate an internal property fund that issues notional units, with some units held by investors in linked contracts and others held by the entity. Paragraph 32A does not permit an entity to measure the property held by the fund partly at cost and partly at fair value.

32C. If an entity chooses different models for the two categories described in paragraph 32A, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in profit or loss. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

75(f)(iv) *the cumulative change in fair value recognised in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used (see paragraph 32C).*

C13 IFRS 1 *First-time Adoption of International Financial Reporting Standards* is amended as described below.

In paragraph 12, the reference to paragraphs 13-25C is amended to refer to paragraphs 13-25D.

Paragraph 13(g) and (h) is amended and a new subparagraph (i) is inserted, as follows:

(g) designation of previously recognised financial instruments (paragraph 25A);

(h) share-based payment transactions (paragraphs 25B and 25C);

and

(i) insurance contracts (paragraph 25D).

After paragraph 25C, a new heading and paragraph 25D are added, as follows:

Insurance contracts

25D A first-time adopter may apply the transitional provisions in IFRS 4 *Insurance Contracts*. IFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter.

IFRS 4

Paragraph 36A and the preceding heading are amended by inserting references to IFRS 4, to read as follows:

Exemption from the requirement to restate comparative information for IAS 39 and IFRS 4

36A In its first IFRS financial statements, an entity that adopts IFRSs before 1 January 2006 shall present at least one year of comparative information, but this comparative information need not comply with IAS 32, IAS 39 and IFRS 4. An entity that chooses to present comparative information that does not comply with IAS 32, IAS 39 and IFRS 4 in its first year of transition shall:

- (a) apply its previous GAAP in the comparative information to financial instruments within the scope of IAS 32 and IAS 39 and to insurance contracts within the scope of IFRS 4;
- (b) disclose this fact, together with the basis used to prepare this information;

and

- (c) disclose the nature of the main adjustments that would make the information comply with IAS 32, IAS 39 and IFRS 4. The entity need not quantify those adjustments. However, the entity shall treat any adjustment between the balance sheet at the comparative period's reporting date (ie the balance sheet that includes comparative information under previous GAAP) and the balance sheet at the start of the first IFRS reporting period (ie the first period that includes information that complies with IAS 32, IAS 39 and IFRS 4) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)-(e) and (f)(i) of IAS 8.

Paragraph 28(f)(i) applies only to amounts presented in the balance sheet at the comparative period's reporting date.

In the case of an entity that chooses to present comparative information that does not comply with IAS 32, IAS 39 and IFRS 4, references to the 'date of transition to IFRSs' shall mean, in the case of those Standards only, the beginning of the first IFRS reporting period.

C14 SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (as amended by IAS 39) is amended as described below.

Paragraph 7 is amended as follows:

7. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, should be accounted for under IAS 37, or IAS 39 or IFRS 4, depending on the terms.
