

Educational Note

Classification of Contracts under International Financial Reporting Standards

Practice Council

June 2009

Document 209066

Ce document est disponible en français
© 2009 Canadian Institute of Actuaries

Members should be familiar with educational notes. Educational notes describe but do not recommend practice in illustrative situations. They do not constitute Standards of Practice and are, therefore, not binding. They are, however, intended to illustrate the application (but not necessarily the only application) of the Standards of Practice, so there should be no conflict between them. They are intended to assist actuaries in applying Standards of Practice in respect of specific matters. Responsibility for the manner of application of Standards of Practice in specific circumstances remains that of the members in the Life and Property and Casualty Insurance practice areas.

Memorandum

To: Members in the Life Insurance and Property and Casualty Insurance Practice Areas
From: Jacques Tremblay, Chairperson
CIA Practice Council
Date: June 25, 2009
Subject: **Educational Note: Classification of Contracts under International Financial Reporting Standards**

Document 209066

International Financial Reporting Standards (IFRS) will be effective in Canada for interim and financial statements relating to fiscal years starting on or after January 1, 2011.

In preparation for this conversion, the Practice Council has examined the International Actuarial Standards of Practice (IASPs) that have been issued by the International Actuarial Association (IAA), and has decided to release selected IASPs, as either Educational Notes or Research Papers, to assist CIA members in the application of IFRS. Since the IASPs were originally published by the IAA, they are presented in a different format and may use somewhat different terminology than that used in the Standards of Practice and Educational Notes developed by the CIA. Nevertheless, the Practice Council has decided to release the documents without modification.

This Educational Note addresses professional services related to the classification of contracts as insurance contracts, investment contracts, service contracts, or other financial instruments for purposes of preparation or review of financial statements in accordance with IFRS. It was originally published by the IAA as IASP 3.

In accordance with the CIA's Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice, this Educational Note has received final approval for distribution by the Practice Council on June 4, 2009.

As outlined in subsection 1220 of the Standards of Practice, "*The actuary should be familiar with relevant Educational Notes and other designated educational material.*" That subsection explains further that a "practice which the Educational Notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation." As well, "Educational Notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them."

If you have any questions or comments regarding this Educational Note, please contact Jacques Tremblay, Practice Council Chair, at his CIA Online Directory address, jacques.tremblay@oliverwyman.com.

JT

This Practice Guideline applies to an actuary only under one or more of the following circumstances:

- If the Practice Guideline has been endorsed by one or more IAA Full Member associations of which the actuary is a member for use in connection with relevant International Financial Reporting Standards (IFRSs);
- If the Practice Guideline has been formally adopted by one or more IAA Full Member associations of which the actuary is a member for use in connection with local accounting standards or other financial reporting requirements;
- If the actuary is required by statute, regulation or other binding legal authority to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements;
- If the actuary represents to a principal or other interested party that the actuary will consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements; or
- If the actuary's principal or other relevant party requires the actuary to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements.

Table of Contents

1. Scope.....	3
2. Publication Date.....	3
3. Background.....	3
4. Practice Guideline.....	4
4.1 Classification of contracts - general process.....	4
4.2 Step 1 - Obtain relevant information.....	5
4.3 Step 2 - Definition of a contract for accounting purposes.....	5
4.3.1 Separation of a contract for accounting purposes.....	5
4.3.2 Combination of contracts for accounting purposes.....	6
4.4 Step 3 - Classification of stand-alone service contracts.....	6
4.5 Step 3 - Classification as an insurance contract.....	6
4.5.1 Insured event.....	7
4.5.2 Adverse impact from insured event.....	7
4.5.3 Significant insurance risk.....	8
4.5.4 Determination of commercial substance.....	10
4.5.5 Decision basis.....	10
4.5.6 Changes in the level of insurance risk.....	10
4.6 Step 5 - Classification as an investment contract.....	11
4.7 Step 6 - Discretionary participation features.....	12
4.8 Step 7 - Service components.....	12
4.9 Step 8 - Embedded derivatives.....	13
4.10 Step 9 - Unbundling of a contract into components.....	13
4.10.1 Unbundling a deposit component.....	14
4.10.2 Unbundling of an insurance component.....	15
4.10.3 Unbundling of service components.....	15
4.10.4 Separation of embedded derivatives.....	15
4.10.5 Separation of guaranteed elements of contracts with discretionary participation features.....	15
4.10.6 Contracts with optional features.....	16
Appendix A – Decision tree for contracts.....	17
Appendix B – Relevant IFRSs.....	18
Appendix C – List of terms defined in the IAA Glossary.....	19

1. Scope

The purpose of this PRACTICE GUIDELINE (PG) is to give advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing PROFESSIONAL SERVICES in accordance with INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) concerning the classification of INSURANCE CONTRACTS, INVESTMENT CONTRACTS, or SERVICE CONTRACTS issued by REPORTING ENTITIES.

This PG addresses professional services related to the classification of insurance contracts, investment contracts, service contracts, and other FINANCIAL INSTRUMENTS for purposes of preparation or review of FINANCIAL STATEMENTS in accordance with IFRSs. This PG applies where the reporting entity is an ISSUER of insurance contracts, investment contracts, or service contracts. It is limited to the practices that relate to the classification of CONTRACTS within the scope of various IFRSs so that the proper INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) accounting guidance can be properly applied. This guideline does not provide guidance for the classification of FINANCIAL ASSETS within the scope of INTERNATIONAL ACCOUNTING STANDARD (IAS) 39, *Financial Instruments: Recognition and Measurement*. It is a class 4 INTERNATIONAL ACTUARIAL STANDARD OF PRACTICE (IASP).

Reliance on information in this PG is not a substitute for meeting the requirements of the relevant IFRSs. Practitioners are therefore directed to the relevant IFRSs (see Appendix B) for authoritative requirements. The PG refers to IFRSs that are effective as of 16 June 2005, as well as to amended IFRSs not yet effective as of 16 June 2005 but for which earlier application is made. If IFRSs are amended after that date, actuaries should refer to the most recent version of the IFRS.

2. Publication Date

This PG was published on 16 June 2005, the date approved by the Council of the INTERNATIONAL ASSOCIATION OF ACTUARIES (IAA).

3. Background

In order to determine the appropriate IFRS to apply to a contract, the nature of the contract needs to be analysed. This PG provides further guidance regarding the classification of contracts.

The PG sets forth a process for the determination and classification of contracts and contract COMPONENTS and sets out considerations that can be taken into account for each step in that process.

In performing this analysis, the practitioner would usually consult several IFRSs including, but not limited to, the following:

1. IFRS 4, *Insurance Contracts* – provides guidance for determining if a contract is an insurance (or reinsurance) contract. Some contracts, although complying with the definition of an insurance contract under the IFRS definition, are exempted from the scope of IFRS 4 (IFRS 4.4). It also provides guidance regarding the application of IFRS to financial instruments with a DISCRETIONARY PARTICIPATION FEATURE (DPF).
2. IAS 32, *Financial Instruments: Disclosure and Presentation* – provides guidance for determining whether a contract is a financial instrument.
3. IAS 39, *Financial Instruments: Recognition and Measurement* – provides guidance for determining whether a financial instrument is a DERIVATIVE or an EMBEDDED DERIVATIVE and for the measurement of the value of a financial instrument.

4. IAS 18, *Revenue* – provides FINANCIAL REPORTING requirements for revenue from rendering services.

The vast majority of contracts entered into by a reporting entity for which actuaries perform work fall within the scope of one or more of these four standards.

4. Practice Guideline

4.1 Classification of contracts - general process

This section outlines the general process for classifying contracts and contract components for the application of INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) accounting guidance. Later sections will present considerations regarding each step of the process.

While there are some exceptions, the general process of classification normally includes the following steps:

1. Obtain relevant information.
2. Definition of a contract for accounting purposes — Consider whether to separate or combine contracts for accounting purposes.
3. Classification of stand-alone service contracts — Consider whether the contract creates financial assets or liabilities for the reporting entity in which case it may be a financial instrument, rather than solely requiring the entity to provide services for a fee.
4. Classification as an insurance contract — Determine if the contract contains significant INSURANCE RISK. If yes, then the contract is an insurance contract and IFRS 4 applies.
5. Classification as an investment contract — If it is not insurance, determine if the contract is a financial instrument (e.g., it creates FINANCIAL LIABILITIES, equity instruments, or financial assets). If yes, then the contract is an investment contract. If no, the contract is a service contract and IAS 18 applies.
6. DPFs — If the contract is an investment contract, determine if the contract contains a DPF. If yes, then IFRS 4 and IAS 32 are applicable. If no, then IAS 32 and IAS 39 apply.
7. SERVICE COMPONENT— If IAS 39 is applicable, determine if the contract contains a service component. If yes, then acquisition and other servicing expenses related to the service component and related earnings are accounted for under IAS 18. The rest of the contract is accounted for under IAS 39.
8. Embedded derivatives — For insurance contracts, investment contracts, and service contracts, determine if the contract contains an embedded derivative. If an embedded derivative is included, determine if that component is already measured at FAIR VALUE or if it is closely related to the host contract. If neither of these conditions is satisfied, separation might be required. In case of an embedded derivative special disclosure might be required under IFRS 4.
9. UNBUNDLING of a contract into components — For insurance contracts, determine if unbundling of a DEPOSIT COMPONENT is required or permitted by the accounting guidance. If unbundled into deposit and INSURANCE COMPONENTS, the deposit component is accounted for under IAS 39 and the insurance component is accounted for under IFRS 4.

4.2 Step 1 - Obtain relevant information

Relevant information includes information regarding the reporting entity's products and services, their associated characteristics, and other relevant information. The latter might include such information as product design documentation, cash flow models, sales strategies or sales material used in distributing products, associated contracts, the entity's policies regarding bonus distributions, and determination and re-determination of elements that are not guaranteed.

4.3 Step 2 - Definition of a contract for accounting purposes

This section presents considerations for determining what is a contract for IFRS accounting purposes.

IAS 32.13 defines a contract as "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law."

In general, IFRS guidance determines a contract based on the economic substance of an agreement between parties, and not necessarily based on a strict legal construction of what constitutes a contract. For example, the legal understanding of the relationships between the parties may be different than that defined in IAS 32. A contract meeting the IFRS definition may contain several elements that could represent separate legal contracts and a legal contract for this purpose may constitute just one part of an agreement in the legal form of a contract. In order to determine the appropriate IFRS to apply to an agreement, its economic character would be assessed.

4.3.1 Separation of a contract for accounting purposes

The practitioner may wish to consider whether some parts of an agreement, disregarding its legal construction, must or may receive separate accounting treatment from the rest of the agreement's parts.

Within a single legal agreement certain rights and obligations may receive accounting treatment that differs from that of other rights and obligations contained in the same agreement. In some cases, components of contracts must be treated separately, as in the case of certain embedded derivatives and in the case of deposit components as described in IFRS 4.10(a). See section 4.9.1 for further information.

Indications that parts of a legal agreement may be considered as an individual contract for accounting purposes include the following:

1. The parts are managed separately, especially for risk management purposes;
2. The parts are held in different pools for risk equalisation;
3. The parts are treated in different groups under participation or premium adjustment clauses;
4. The parts can be transferred or cancelled separately (IAS 39.10);
5. The parts have different counter-parties (IAS 39.10); or
6. The parts are sold on a stand-alone basis, even though they may sometimes have been sold together in a systematic manner.

A legal agreement within the scope of IFRS 4 does not need to be unbundled into parts, even if such parts would form separate contracts, except if required by IFRS 4 (see 4.9.1) or by IAS 39.11.

4.3.2 Combination of contracts for accounting purposes

One economic relationship established by two or more legal agreements may be considered one contract for accounting purposes. IFRS 4, Appendix B, B25, states, “An INSURER shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements. For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.”

An indication that legal agreements may be considered together is if the intent of the reporting entities is to create a combined effect, the effect is expected to be material, and the effect would not be recognised otherwise. Indications of such intent may include:

1. Fully negatively correlated cash flows;
2. A formal sales program to sell such agreements together, e.g., incorporated in sales leaflets; or
3. Joint consideration of these types of legal agreements in internal procedures.

4.4 Step 3 – Classification of stand-alone service contracts

This section presents considerations for determining when a contract qualifies as a service contract.

If a contract that includes the obligation to render a service(s) does not create financial assets or financial liabilities and does not transfer insurance risk, the contract can be within the scope of IAS 18. For convenience, this PG describes such a contract as a service contract. This would often be the situation for a stand-alone service contract, a contract for which the reporting entity does not assume any financial or insurance risk, but instead provides services for a fee. IAS 18 describes the rendering of services as follows: “The rendering of services typically involves the performance by the enterprise of a contractually agreed task over an agreed period of time” (IAS 18.4).

4.5 Step 4 - Classification as an insurance contract

This section presents considerations for determining if a contract qualifies as an insurance contract for IFRS accounting purposes.

Insurance contracts are normally subject to the accounting requirements in IFRS 4. However, there are specific exclusions from its scope (see IFRS 4.4).

Derivatives embedded in insurance contracts are subject to the accounting requirements of IAS 32 and IAS 39. A contract or component of a contract that meets the definition of an insurance contract is subject to the requirements of IFRS 4 rather than IAS 39 (see PG on “Embedded Derivatives” for guidance).

IFRS 4 defines an insurance contract as “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). IFRS 4 applies a different definition to policyholder than an insurance contract might use. IFRS 4 defines policyholder as “a party that has a right to compensation under an insurance contract if an insured event occurs.” For life insurance this may not be the insured or the beneficiary. It is the person who controls the right to the compensation. For property and casualty insurance it can also refer to the injured party or the party who was affected by the loss. A policyholder can be either a natural person or a legal entity, such as a corporation or a non-profit organisation.

The practitioner may be asked to assess whether an insured event is covered by the contract, whether the occurrence of the insured event would have an adverse affect on the policyholder, or whether the insurance risk contained in the contract is significant.

4.5.1 Insured event

To be an insurance contract, a contract must specify at least one insured event that could trigger a BENEFIT based on a LEGAL OBLIGATION. Additional insured events could be specified, resulting from a legal or a CONSTRUCTIVE OBLIGATION as a consequence of the contract.

To qualify a contract as an insurance contract, the benefit can be uncertain as to its occurrence, its amount, or its timing as a result of the insurance risk (created by the insured event) that is transferred by the contract from the policyholder to the insurer. For example:

1. A typical term life insurance contract has a fixed benefit amount, but the occurrence and timing of the benefit may be uncertain;
2. A typical whole life or endowment contract has fixed benefit amounts and is certain to pay the benefit if the contract remains in-force but is uncertain as to when the benefit will be paid;
3. A pure endowment contract has a fixed benefit amount to be paid at a fixed point, but it is uncertain whether the payment will occur as it depends on the survival of the insured;
4. A retroactive REINSURANCE CONTRACT is one where the relevant event(s) has already occurred, but the net amount to be paid is uncertain; and
5. The occurrence, amount, and timing of the benefit may be uncertain in most property and casualty insurance contracts.

For a contract to qualify as an insurance contract, IFRS 4 requires the uncertainty to be present on the level of the individual contract (see 4.3) and to arise as a result of risks other than FINANCIAL RISK.

Insurance risk is defined based on a transfer of risk (there needs to exist a pre-existing risk). Only such non-financial risk, which is transferred by the policyholder to the insurer, is relevant for the assessment of whether the insurance risk is significant. The policyholder needs to be exposed to the relevant risk regardless of whether the contract exists or not. A risk created by the contract itself is not insurance risk (e.g., waiver of surrender penalties).

4.5.2 Adverse impact from insured event

As a qualitative requirement for classification as an insurance contract, IFRS 4 provides that the insured event must adversely affect the policyholder and a benefit be triggered as compensation for its effect. Nevertheless, it is not necessary for the insurer to investigate whether there is any adverse affect.

Some contracts are written in a way that the policyholder does not have to prove he, she, or it has suffered an adverse effect in order to receive the benefit payments, either because investigating the adverse effect would be generally seen as inappropriate or the type of risk makes it reasonable to assume that the policyholder is adversely affected. As an example, this is often the case for risks connected with life/death or health/illness/disability of people. Many life insurance contracts do not require policyholders to demonstrate that they have been adversely affected by the death of the insured before contract benefits are paid, although in some cases the insurer may require, usually based on a legal duty, at the original issue date that the legal counterparty will be adversely affected by the death of the insured. The adverse effect is presumed to occur. In the case of a contract that

provides income payments in part based on survivorship, the adverse impact could be deemed to be the economic COST of the annuitant's continued survivorship.

For contracts that do not require proof of adverse effect, the practitioner normally considers whether it can be assumed that an adverse effect could reasonably be expected to occur. The practitioner may take into account, among other things:

1. The legal and cultural environment in which the contract was issued;
2. Normal industry business practices; and
3. A constructive obligation created by the contract (although this may not be enough in and of itself).

In some jurisdictions, the right to receive benefits under an insurance contract can be ceded to a third party. This is known in some jurisdictions as a viatical settlement.¹ This right to cede the benefit does not impact the classification of a contract by the issuing entity under IFRS accounting.

4.5.3 Significant insurance risk

For a contract to qualify as an insurance contract, the insurance risk created by the insured events specified in the contract, i.e., the risk borne by the policyholder and transferred to the insurer, is significant. IFRS 4, Appendix B, B23, states that "Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows."

The significance of insurance risk will depend on the circumstances of the contract. The risk can be significant even when the insured event is extremely unlikely (such as with certain catastrophes). The risk can also be significant even when the expected present value of the contingent cash flows is small in proportion to the present value of all contractual cash flows (such as may be the case with a death benefit on a deferred annuity contract). This implies that the determination of significance is performed on a basis where the scenarios are not probability-weighted, using instead the range of possible benefits.

It may be assumed in each scenario that the parties execute unilateral OPTIONS in a manner that maximises the present value of those future net cash outflows not contingent on the insured events.

Significance is normally determined by assessing the greatest difference between economic value of benefits payable under the contract, assuming one possible insured event, and the economic value of benefits payable under any other single scenario with commercial substance determined at outset. In cases where the additional benefit also depends on a contingency other than an insurance risk (a double trigger contract), the additional benefit qualifies the contract as insurance if the greatest additional benefit payable in a scenario of commercial substance is significant.

Additional benefits are defined as "amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance)" (IFRS 4, B24).

¹ Viatical settlement is a term used in some countries, including the U.S., for selling the rights to certain benefits from life insurance policies.

Benefits may be interpreted as net cash flows arising from the contract that exclude future revenue lost by the issuer because the insured event occurred. Those additional benefits include claims handling and claims assessment costs.

When assessing the additional benefits, IFRS 4, B24, requires the exclusion of (1) “the loss of the ability to charge the policyholder for future services” and (2) “waiver on death of charges that would be made on cancellation or surrender.”

When comparing a benefit payable because of the occurrence of an insured event with the benefits payable on surrender, IFRS 4 requires that the nature of the differences in benefits payable be considered. Market value adjustments to surrender values to reflect market prices for underlying assets can create additional benefits if the adjustments do not apply to the benefits payable in case of occurrence of the insured event. However, the waiver of surrender or cancellation charges if an insured event occurs is not normally considered as an additional benefit.

Some interpret the reference in IFRS 4, B.24 to scenarios where “no insured event occurred” in cases where in all scenarios insured events occur as referring to those scenarios where the benefit payable is minimal. They believe that if the minimal benefit occurs only in scenarios that lack commercial substance, the practitioner would determine the minimal benefit from only those scenarios that have commercial substance. In other words, they believe scenarios that lack commercial substance would be ignored.

IFRS 4, B24(c), contains a clause designed to prevent accounting abuses through the structuring of insurance contracts that do not transfer significant insurance risk. It states additional benefits exclude “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.”

Some believe the paragraph implies that the term “additional benefits” may be understood as a surrogate for the potential loss of the policyholder. Thus, they believe that in situations where the amount of the benefit provided does not explicitly depend on the quantifiable loss suffered, the practitioner may consider whether the potential loss of the policyholder is significant, and if there is an obvious and demonstrable difference between the additional benefits and the true loss to the policyholder, but the loss is not significant, this could be used in the determination of significance, i.e., it would point to the conclusion that the insurance risk is not “significant.”

A policyholder might value the usefulness of an old item similar to that of a new one, although the market value of the old one is lower. Consequently, the loss from the policyholder’s viewpoint in extinguishing an old item is the same as the value of the new item because the value of the new item represents the cost to replace the old, extinguished item. Therefore, in the case of “new-for-old” coverage, the insured amount is usually equal to the market price of the new item that replaces the item lost to the policyholder.

In forms of insurance where pre-determined benefits are customary (such as life, accident, and disability insurance), it may be sufficient that the agreed sum insured is within a reasonable range of potential adverse effects, as is usually required in the risk examination process.

4.5.4 Determination of commercial substance

A scenario has commercial substance if it has a discernable effect on the economics of the transaction. Such an effect may be evidenced by the following, among other things:

1. A requirement to pay contributions for the resulting coverage; or
2. A specific assessment of the risk (i.e., underwriting) that is not performed when the insurance coverage is not included in the contract. Risk assessment is not required for a scenario to have commercial substance; however, it may be an indicator of it.

Upon first-time adoption, existing business will need to be evaluated for scenarios of commercial substance based on the circumstances at the time of adoption, not based on the circumstances at the original issue date of the contracts. For example, a guaranteed annuity option may have been originally issued with guaranteed rates that were set very far out of the money and not priced for in the original contract, but the rates have moved close to or in the money over time as mortality rates or interest rates have changed. It is possible that no scenarios of commercial substance would have existed if the contract had been evaluated at issue, but that scenarios of commercial substance currently exist.

4.5.5 Decision basis

The determination of significance is performed on an individual contract basis. The impact of pooling, group pricing, a portfolio premium adjustment clause, or a participation feature that depends in part on the performance of other contracts is usually ignored. Rather than evaluating every individual contract as written, a representative contract chosen from a group of similarly constructed contracts, containing insurance risk of the same type, may usually be considered instead. Effects of risk reduction, which are effective only on the level of a portfolio of contracts, would not be considered.

4.5.6 Changes in the level of insurance risk

If the level of insurance risk inherent in a contract that previously did not qualify as an insurance contract subsequently becomes significant for whatever reason, the contract is reclassified as an insurance contract. While there is no requirement to review a portfolio in this regard, because the assessment at inception would have included all scenarios that have commercial substance, the accounting policy of the reporting entity may require reviewing contracts on a periodic basis.

Insurance risk can be considered to be significant at outset if (1) the level of insurance risk inherent in a contract does not qualify it as an insurance contract at the outset based upon the application of accepted practice, but is expected to become significant later in the ordinary course of events rather than as a result of unexpected discretionary execution of rights by one party (as discussed in the following paragraph) or a contract change; and (2) the scenario giving rise to the insurance risk at that subsequent time has commercial substance.

For the purpose of making this determination, insurance risk would not be created after outset by the execution of unilateral rights present in the contract. For example, a contract may include the right to purchase additional insurance contracts with an unconstrained reassessment of the insured's risk profile. This right would not affect the assessment of insurance risk inherent in the original contract. However, in the case of a GUARANTEED INSURABILITY option, i.e., the right to purchase additional insurance without a reassessment of the insured's risk profile, the inherent risk is present at outset. If such a risk is present, the practitioner typically would evaluate the significance of the risk.

As stated in IFRS 4, Appendix B, B30, “a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.” For example, a life contingent annuity with a certain period would not change classification upon the annuitant’s death within the certain period even though the contract then becomes a stream of certain payments for the remainder of the term certain period. Nevertheless, it is still classified as insurance for IFRS accounting purposes until the payments have been completed.

The right to choose an annuity at a future date using the amounts due under the contract does not add to the insurance risk of the contract if the annuity rates included in that annuity are to be negotiated by both parties without constraints (IFRS 4, IG1.7). If the right to determine the annuity factor is limited by a contractual requirement to use those terms applicable to new business of immediate annuities at execution date of that right, that right does not add to the insurance risk of the contract since it is in the power of the insurer to avoid any annuity coverage by setting a price that covers any possible outcome arising from the risk. Therefore the potential survival risk that would have resulted from the choice of an annuity would not be considered in determining the insurance risk in the contract (second sentence of IFRS 4, Appendix B, B29).

Where the repricing is contractually required to be at a market level at the execution date, some believe that such an option may be seen to add to the insurance risk. This depends in part on one’s view of what is a market price. Some see market pricing as being able to charge a price that covers the expected value of the risk, hence there is insurance risk accepted by agreeing to accept in future risks on that market basis. Others believe that market pricing means charging a rate equal to that currently charged in the market, but typically that price would not cover the maximum reasonable outcome of the risk hence the insurer cannot avoid the risk of adverse deviation after inception of the contract. This latter interpretation of market pricing can be seen to add to the insurance risk.

A constraint on repricing may refer not only to where the annuity factor is determined in absolute terms at outset, but also to any other significant constraint in determining the annuity factor, such as a requirement to use a specific pricing survival table or interest rate outside of the control of the insurer.

4.6 Step 5 - Classification as an investment contract

This section presents considerations for determining if a contract is an investment contract.

Investment contract is an informal term used by the IFRS 4 Implementation Guidance to describe non-insurance financial instruments. IAS 32.11 defines a financial instrument as “any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.” This definition implies that investment contracts can contain a large variety of contracts, including loans, saving instruments, or liquid accounts reflecting the net rights or obligations between two parties.

While this definition describes many contracts issued by reporting entities that issue insurance contracts, insurance contracts are specifically exempted from IAS 32 and instead are subject to IFRS 4 accounting guidance. Such a contract that does not contain significant insurance risk is classified as an investment contract and is within the scope of IAS 32 and IAS 39 to the extent that it gives rise to a financial asset or financial liability, except if the investment contract contains a DPF. In that case, the contract is subject to IFRS 4 and IAS 32.

Some financial services contracts involve both the transfer of one or more financial instruments and the provision of management services. IAS 18, Appendix, 14(b)(iii), cites as an example “a long-term monthly saving contract linked to the management of a pool of equity securities. The

provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.” Revenues and expenses associated with service elements of such contracts are accounted for according to IAS 18. To the extent that any origination fees relate to a financial liability rather than the provision of services, IAS 39 applies.

4.7 Step 6 - Discretionary participation features

This section presents considerations for the determination and classification of DPFs in insurance and investment contracts.

Insurance and investment contracts may contain DPFs.

With respect to contracts with DPFs, IFRS 4.34(a) states: “The issuer of such a contract: (a) may, but need not, recognise the GUARANTEED ELEMENT separately from the discretionary participation feature. ...” This permits two approaches, i.e., (1) recognising the DPF as a separate liability or separate component of equity (IFRS 4.34(b)); or (2) recognising the DPF together with the guaranteed element commonly with all other obligations classifying “the whole contract as a liability” (IFRS 4.34(a)).

The purpose of splitting an investment contract into its guaranteed element and the DPF is, among others, so that the adequacy of the overall liability, having regard to the guarantees that exist under the contract, can be appropriately assessed. When using paragraph 35(b), the guaranteed element would be identified and would constitute a separate part to be used as a suitable basis for applying IAS 39.

IFRS 4, BC162, states that the “definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a ‘crediting rate’ that is used to credit interest or other returns to policyholders (as found in some contracts described in some countries as ‘universal life’ contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer’s resources. The Board will revisit the treatment of these features in phase II.”

Some contracts do not satisfy the definition of DPFs because the discretion to set crediting rates is not bound contractually to the performance of a specified pool of assets or the profit or loss of the reporting entity, fund, or other entity that issued the contract.

Further guidance with regard to the identification and treatment of DPFs is provided in a separate PG, *Recognition and Measurement of Contracts with Discretionary Participation Features*.

4.8 Step 7 - Service components

This section presents considerations for determining when a contract component qualifies as a service contract.

If a contract (or a component of a contract) that includes the obligation to render a service(s) does not create financial assets or financial liabilities and does not transfer significant insurance risk, the contract (or component) can be within the scope of IAS 18. For convenience, this PG describes such a contract as a service contract. IAS 18 describes the rendering of services as follows: “The rendering of services typically involves the performance by the enterprise of a contractually agreed task over an agreed period of time” (IAS 18.4).

Like insurance contracts and some financial instruments, service contracts are agreements that oblige the reporting entity to perform certain tasks. The financial reporting for such contracts can involve

the recognition of assets or liabilities. However, unlike insurance contracts or financial instruments, service contracts within the scope of IAS 18 do not create an insurance or financial obligation for the reporting entity through the transfer of insurance or financial risk. Instead, service contracts require the reporting entity to provide some sort of service in return for a fee. No significant insurance or financial risk is transferred through a service contract.

Some insurance contracts provide for payments in kind (e.g., a motor insurance contract where the reporting entity promises to repair the insured vehicle in the event it is damaged in an accident). These contracts are insurance contracts as they transfer risk to the reporting entity (e.g., an accident may or may not occur, the amount of damage to be repaired is unknown at outset).

Examples of such contracts or contract components include agreements to provide investment management services and administrative services.

Service components inherent in insurance contracts are not normally separated out. However, service components inherent in financial instruments that are not insurance contracts are separated (IAS 18, Appendix, paragraph 14(b)(iii)).

Some financial service contracts involve both the origination of one or more financial instruments or insurance components and the provision of services. The service components of contracts, such as provision of investment management services, are accounted for using IAS 18.

4.9 Step 8 - Embedded derivatives

Specified embedded derivatives are required to be separated from the host contract and measured at fair value. Furthermore, some embedded derivatives are subject to specific disclosure requirements under IFRS 4.

According to IFRS 4.7 and IAS 39.2(e), IAS 39 applies to embedded derivatives in insurance contracts unless the embedded derivative is itself an insurance contract. The PG on “Embedded Derivatives” describes a procedure to identify derivatives and embedded derivatives and discusses the separation requirement.

4.10 Step 9 - Unbundling of a contract into components

This section provides considerations for determining components of contracts for purposes of unbundling and whether they could be unbundled and given separate accounting guidance.

A component of a contract is the smallest part of a contract containing a specific identifiable and separable feature that also contains all the economic features needed to form the equivalent of a stand-alone contract. The remaining portion of the contract must also be able to form a stand-alone contract. Several components may exist in a single contract. There is a difference between splitting one legal agreement into several economic contracts to comply with the essence of IAS 32.13 (see 4.3.1), and unbundling of a contract into several components. In the first case, the split reflects the directly identifiable economic reality of the relationship; in the second case, a split is made to comply with accounting requirements, although each component must be capable of being measured separately.

For accounting purposes, all cash flows of the contract that result from the rights and obligations of the contract are split and allocated to each component of the contract.

IAS 39.11, IFRS 4.10, and IAS 18, Appendix, paragraph 14(a)(iii) and (b)(iii), require specified features of a contract to be separated once the component containing that feature has been identified.

A component includes both the contract feature to be accounted for separately and all elements of the contract that are not economically separable from the feature. These elements could include an appropriate portion of the initial cost or premiums paid for the contract and the change in any cash flow affected by the feature.

While features requiring separation are usually identifiable and separable, other required features of the component to be separated are often identifiable and separable only by applying judgment. The component may be identified based on the premise that both parties to the contract would also have accepted both the contract without the component and the component itself as a separate contract with a separate independent counter-party. For this premise to be satisfied, the pricing and design of both parts of the contract would be consistent and equivalent and would have, on a stand-alone basis, the same economic justification as the parts together.

The practitioner normally would consider all prices charged, all benefits provided, and all costs incurred in acquiring, performing, and settling the feature as part of the component.

The allocation of prices to components would typically be performed in a manner that is consistent with the relative price or value of the components had each component been priced individually. A full-blown pricing of the individual components would not normally be necessary. If the components are in fact sold separately, allocation of the total price based on the relative prices of the individually sold prices would be reasonable.

Contractual features that cause portions of prices charged to be refunded based on the insurer's actual net expenses in providing the contractual obligations acquired with that price would not usually be separated from the price charged since they are an economic unity.

If an insurer formally specifies in the contract a portion of the total price charged for a special service, right, or cash flow, that specification usually would be relevant only if that portion of the price would realistically be charged if the related service, right, or cash flow were provided separately and priced on an equivalent basis to the overall pricing of the contract.

4.10.1 Unbundling a deposit component

IFRS 4.10 states that unbundling an insurance contract into a deposit component and an insurance component is required in certain circumstances and permitted in others. If unbundled, the deposit component is within the scope of IAS 32 and IAS 39, while the insurance component is within the scope of IFRS 4.

Unbundling is permitted if the deposit component (including any embedded surrender options) can be measured without considering any other component. For example, a universal life insurance contract with a fixed death benefit may be unbundled. Such a universal life insurance contract has an explicit account value that increases with premium payments and interest credited and decreases as charges are removed periodically for the cost of providing insurance (for the difference between the face amount and the account value) and expenses of administering the policy. The deposit component of the contract, the account value, could be measured without regard to the insurance component, while the insurance component, which depends on the amount of account value, could not be measured without regard to the deposit component.

IFRS 4 requires unbundling if two criteria are met: (1) some rights and obligations of the deposit component would otherwise remain unrecognised; and (2) the deposit component can be measured without regard to the insurance component. For example, if the recognition method used in conjunction with IFRS 4 permitted the reporting entity to measure a liability for a contract without

taking into account any surrender benefits offered by the contract, and these surrender benefits could be measured without regard to the insurance component, the surrender rights could theoretically remain unrecognised. In such a situation, unbundling the contract into deposit and insurance components may be required by the accounting guidance.

4.10.2 Unbundling of an insurance component

IFRS 410 implies that a deposit component and an insurance component would be unbundled only from an insurance contract. However, IFRS 4, IG2, example 1.3, suggests that it is permitted to unbundle an insurance component from a non-insurance contract. A non-insurance contract could contain only insignificant insurance risk. Some believe that under IFRS 4 if a contract is not an insurance contract in total, it could never be unbundled into a deposit component and an insurance component since there is no provision in IAS 39 to unbundle such components.

IFRS 4 requires that, if unbundled, the insurance component is subject to IFRS 4. The significance of insurance risk would typically be measured solely based on the component (IFRS 4, Appendix B, B28).

4.10.3 Unbundling of service components

According to IAS 18, Appendix, paragraph 14(a)(iii) and (b)(iii), service components in investment contracts, but not in insurance contracts, shall be unbundled. Service components are within the scope of IAS 18. For details, refer to 4.8.

4.10.4 Separation of embedded derivatives

According to IAS 39.11, some derivatives embedded in insurance contracts and financial instruments shall be separated. They are within the scope of IAS 39. The practitioner is referred to the PG on “Embedded Derivatives” for further guidance. Some embedded derivatives are subject to specific disclosure requirements under IFRS 4.

4.10.5 Separation of guaranteed elements of contracts with discretionary participation features

The guaranteed element of a contract with a DPF may be not a component since the DPF usually need not contain all the features required to qualify it as a stand-alone contract. If it requires the contributions of the guaranteed element it may, therefore, be economically dependent on the guaranteed element. However, some believe the guaranteed element would have to include the features required for it to qualify as a stand-alone contract.

4.10.6 Contracts with optional features

Some forms of contracts contain options to switch between types of coverage and types of funds that make the contracts look alternatively like insurance contracts, investment contracts, or investment contracts with DPFs, sometimes referred to as a “switching feature.” As an example, certain unitised contracts issued in the U.K. and Ireland have the following features:

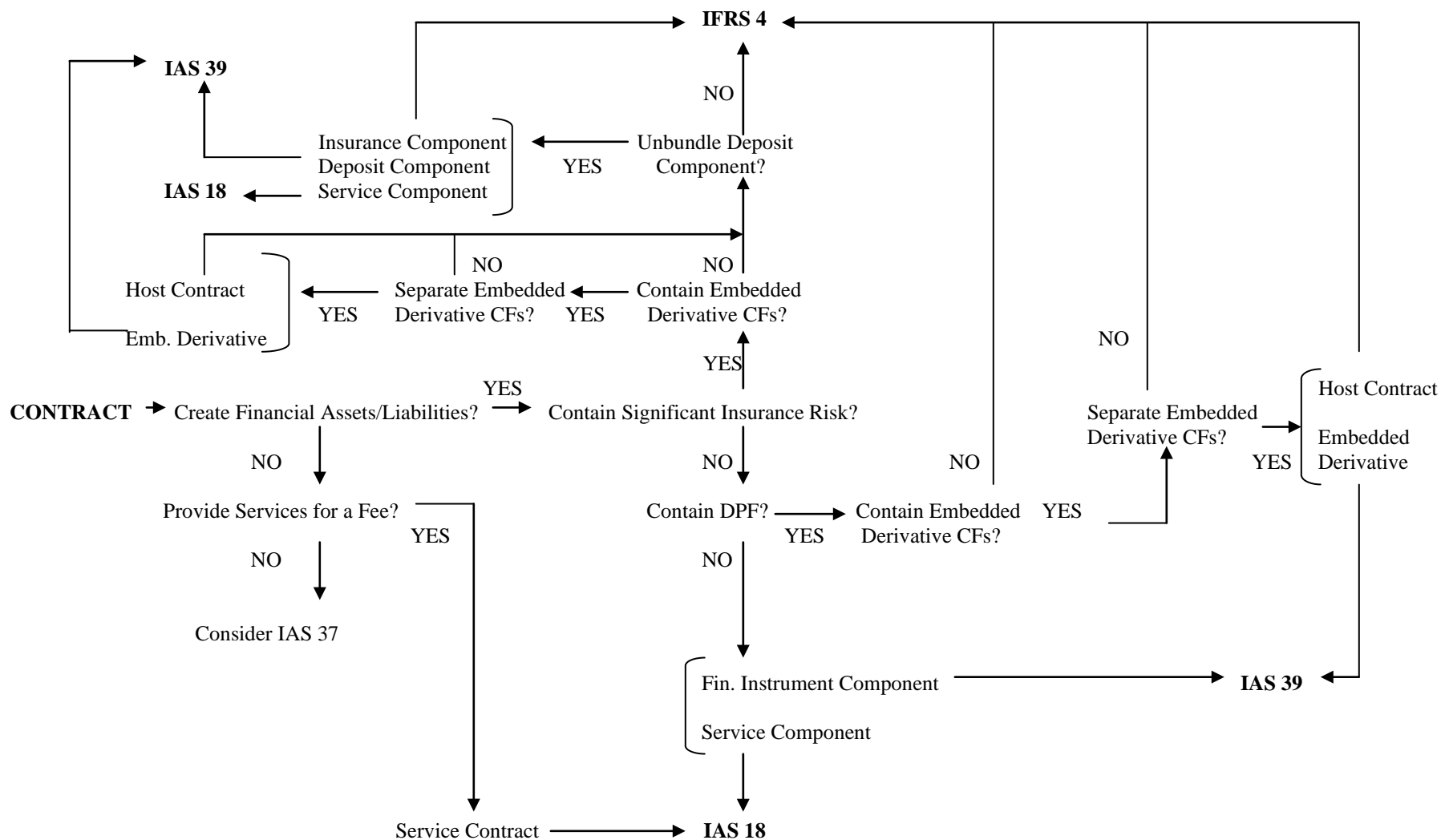
1. It is possible to include insurance coverage such as life cover or a waiver of premium benefit at inception or during the term of the contract;
2. The contract offers an option to switch investments between funds; and
3. Some investment options may include a DPF and some may not.

Depending on which option was chosen at outset, whether significant insurance risk was transferred and whether there exists a DPF, the contract can be classified as an insurance contract, investment contract without DPF, or investment contract with DPF. The difficulty for classification is when the contract is currently invested 100% in investment-linked funds without a DPF.

The mere presence of an option to add insurance coverage or to change the investment option to one with a DPF may not be sufficient for a contract to be classified as something other than an investment contract. Some believe there has to exist a scenario of commercial substance that the policyholder will be provided with significant insurance risk under the contract or a reasonable likelihood that the policyholder will change the investment options and that after the change the DPF will cause a significant additional benefit to be paid compared with the entire contract. Evidence for this can be derived from such sources as observed transfers and sales material, among others.

Some believe that the classification of contracts with DPFs should be based on the current terms and switch the classification if and when the policyholder exercises the option to change the contract.

Appendix A – Decision tree for contracts



CF = Cash flows
 DPF = Discretionary participation feature

Appendix B – Relevant IFRSs

The most relevant International Financial Reporting Standards and International Accounting Standards for this practice guideline are listed below.

- IAS 1 (2001 April) Presentation of Financial Statements
- IAS 18 (2004 March) Revenue
- IAS 32 (2003 December) Financial Instruments: Disclosure and Presentation
- IAS 39 (2004 March) Financial Instruments: Recognition and Measurement
- IFRS 4 (2004 March) Insurance Contracts

In addition, the IASB *Framework* is relevant.

Appendix C – List of terms defined in the IAA Glossary

The first time that these terms are used in this IASP, they are shown in small capital letters. The definitions of these terms are included in the IAA Glossary.

Actuary
Benefit
Component
Constructive obligation
Contract
Cost
Deposit component
Derivative
Discretionary participation feature
Embedded derivative
Fair value
Financial asset
Financial instrument
Financial liability
Financial reporting
Financial risk
Financial statements
Guaranteed element
Guaranteed insurability
Insurance component
Insurance contract
Insurance risk
Insured event
Insurer
International Actuarial Association (IAA)
International Accounting Standard (IAS)
International Accounting Standards Board (IASB)
International Actuarial Standard of Practice (IASP)
International Financial Reporting Standard (IFRS)
International Financial Reporting Standards (IFRSs)
Investment contract
Issuer
Legal obligation
Option
Policyholder
Practice Guideline (PG)
Practitioner
Professional services
Reinsurance contract
Reporting entity
Service contract
Service component
Unbundle