

Nepal Financial Reporting Standard 4 Insurance Contracts

Objective

- 1 The objective of this NFRS is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this NFRS as an *insurer*) until the Board completes the second phase of its project on insurance contracts. In particular, this NFRS requires:
- (a) limited improvements to accounting by insurers for insurance contracts.
 - (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 NFRS 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). NFRS 7 *Financial Instruments: Disclosures* requires disclosure about financial instruments, including financial instruments that contain such features.
- 3 This NFRS 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 NAS 32 *Financial Instruments: Presentation*, NFRS 7 and NFRS 9 *Financial Instruments*), except:
- (a) paragraph 20A permits insurers that meet specified criteria to apply a temporary exemption from NFRS 9;
 - (b) paragraph 35B permits insurers to apply the overlay approach to designated financial assets; and
 - (c) paragraph 45 permits insurers to reclassify in specified circumstances some or all of their financial assets so that the assets are measured at fair value through profit or loss.
- 4 An entity shall not apply this NFRS to:
- (a) product warranties issued directly by a manufacturer, dealer or retailer (see NFRS 15 *Revenue from Contracts with Customers* and NAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
 - (b) employers' assets and liabilities under employee benefit plans (see NAS 19 *Employee Benefits* and NFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see NAS 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, variable lease payments and similar items), as well as a lessee's residual value guarantee embedded in a lease (see NFRS 16 *Leases*, NFRS 15 *Revenue from Contracts with Customers* and NAS 38 *Intangible Assets*).
 - (d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either NAS 32, NFRS 7 and NFRS 9 or this NFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.
 - (e) contingent consideration payable or receivable in a business combination (see NFRS 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 NFRS to reinsurance contracts that it holds.

- 5 For ease of reference, this NFRS 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. All references in paragraphs 3(a)–3(b), 20A–20Q, 35B–35N, 39B–39M and 46–49 to an insurer shall be read as also referring to an issuer of a financial instrument that contains a discretionary participation feature.
- 6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this NFRS to insurance contracts also apply to reinsurance contracts.

Embedded derivatives

- 7 NFRS 9 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. NFRS 9 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.
- 8 As an exception to the requirements in NFRS 9, 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 requirements in NFRS 9 do 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 non-financial variable that is not specific to a party to the contract. Furthermore, those requirements also apply 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 NFRS to the insurance component.
 - (b) apply NFRS 9 to the deposit component.

Recognition and measurement

Temporary exemption from some other NFRSs

- 13 Paragraphs 10–12 of NAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy if no NFRS applies specifically to an item. However, this NFRS 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 NFRS does not exempt an insurer from some implications of the criteria in paragraphs 10–12 of NAS 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 end of the reporting period (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 statement of financial position 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 the end of each reporting period 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 NFRS 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 liabilities¹ 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 NAS 37. If it is less, the insurer shall recognise the entire difference in profit or loss and decrease the carrying amount of

¹ 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.

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 NAS 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.

Temporary exemption from NFRS 9

- 20A **NFRS 9 addresses the accounting for financial instruments and is effective for annual periods beginning on or after 16 July 2020. However, for an insurer that meets the criteria in paragraph 20B, this NFRS provides a temporary exemption that permits, but does not require, the insurer to apply NAS 39 *Financial Instruments: Recognition and Measurement* rather than NFRS 9 for annual periods beginning before 17 July 2022. An insurer that applies the temporary exemption from NFRS 9 shall:**
- (a) use the requirements in NFRS 9 that are necessary to provide the disclosures required in paragraphs 39B–39J of this NFRS; and
 - (b) apply all other applicable NFRSs to its financial instruments, except as described in paragraphs 20A–20Q, 39B–39J and 46–47 of this NFRS.
- 20B **An insurer may apply the temporary exemption from NFRS 9 if, and only if:**
- (a) it has not previously applied NFRS 9 (2013), other than only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of NFRS 9; and
 - (b) its activities are predominantly connected with insurance, as described in paragraph 20D, at its annual reporting date.
- 20C An insurer applying the temporary exemption from NFRS 9 is permitted to elect to apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of NFRS 9. If an insurer elects to apply those requirements, it shall apply the relevant transition provisions in NFRS 9, disclose the fact that it has applied those requirements and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of **NFRS 7 (as amended by NFRS 9 (2013))**.
- 20D An insurer's activities are predominantly connected with insurance if, and only if:
- (a) the carrying amount of its liabilities arising from contracts within the scope of this NFRS, which includes any deposit components or embedded derivatives unbundled from insurance contracts applying paragraphs 7–12 of this NFRS, is significant compared to the total carrying amount of all its liabilities; and
 - (b) the percentage of the total carrying amount of its liabilities connected with insurance (see paragraph 20E) relative to the total carrying amount of all its liabilities is:
 - (i) greater than 90 per cent; or
 - (ii) less than or equal to 90 per cent but greater than 80 per cent, and the insurer does not engage in a significant activity unconnected with insurance (see paragraph 20F).
- 20E For the purposes of applying paragraph 20D(b), liabilities connected with insurance comprise:

- (a) liabilities arising from contracts within the scope of this NFRS, as described in paragraph 20D(a);
- (b) non-derivative investment contract liabilities measured at fair value through profit or loss applying NAS 39 (including those designated as at fair value through profit or loss to which the insurer has applied the requirements in NFRS 9 for the presentation of gains and losses (see paragraphs 20B(a) and 20C)); and
- (c) liabilities that arise because the insurer issues, or fulfils obligations arising from, the contracts in (a) and (b). Examples of such liabilities include derivatives used to mitigate risks arising from those contracts and from the assets backing those contracts, relevant tax liabilities such as the deferred tax liabilities for taxable temporary differences on liabilities arising from those contracts, and debt instruments issued that are included in the insurer's regulatory capital.
- 20F In assessing whether it engages in a significant activity unconnected with insurance for the purposes of applying paragraph 20D(b)(ii), an insurer shall consider:
- (a) only those activities from which it may earn income and incur expenses; and
- (b) quantitative or qualitative factors (or both), including publicly available information such as the industry classification that users of financial statements apply to the insurer.
- 20G Paragraph 20B(b) requires an entity to assess whether it qualifies for the temporary exemption from NFRS 9 at its annual reporting date. After that date:
- (a) an entity that previously qualified for the temporary exemption from NFRS 9 shall reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date if, and only if, there was a change in the entity's activities, as described in paragraphs 20H–20I, during the annual period that ended on that date.
- (b) an entity that previously did not qualify for the temporary exemption from NFRS 9 is permitted to reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date if, and only if, there was a change in the entity's activities, as described in paragraphs 20H–20I, during the annual period that ended on that date.
- 20H For the purposes of applying paragraph 20G, a change in an entity's activities is a change that:
- (a) is determined by the entity's senior management as a result of external or internal changes;
- (b) is significant to the entity's operations; and
- (c) is demonstrable to external parties.
- Accordingly, such a change occurs only when the entity begins or ceases to perform an activity that is significant to its operations or significantly changes the magnitude of one of its activities; for example, when the entity has acquired, disposed of or terminated a business line.
- 20I A change in an entity's activities, as described in paragraph 20H, is expected to be very infrequent. The following are not changes in an entity's activities for the purposes of applying paragraph 20G:
- (a) a change in the entity's funding structure that in itself does not affect the activities from which the entity earns income and incurs expenses.
- (b) the entity's plan to sell a business line, even if the assets and liabilities are classified as held for sale applying NFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. A plan to sell a business line could change the entity's activities and give rise to a reassessment in the future but has yet to affect the liabilities recognised on its statement of financial position.
- 20J If an entity no longer qualifies for the temporary exemption from NFRS 9 as a result of a reassessment (see paragraph 20G(a)), then the entity is permitted to continue to apply the temporary exemption from NFRS 9 only until the end of the annual period that began immediately after that reassessment. Nevertheless, the entity must apply NFRS 9 for annual periods **beginning on or after 17 July 2022**.
- 20K An insurer that previously elected to apply the temporary exemption from NFRS 9 may at the beginning of any subsequent annual period irrevocably elect to apply NFRS 9.

First-time adopter

- 20L A first-time adopter, as defined in NFRS 1 *First-time Adoption of Nepal Financial Reporting Standards*, may apply the temporary exemption from NFRS 9 described in paragraph 20A if, and only if, it meets the criteria described in paragraph 20B. In applying paragraph 20B(b), the first-time adopter shall use the carrying amounts determined applying NFRSs at the date specified in that paragraph.

- 20M NFRS 1 contains requirements and exemptions applicable to a first-time adopter. Those requirements and exemptions (for example, paragraphs D16–D17 of NFRS 1) do not override the requirements in paragraphs 20A–20Q and 39B–39J of this NFRS. For example, the requirements and exemptions in NFRS 1 do not override the requirement that a first-time adopter must meet the criteria specified in paragraph 20L to apply the temporary exemption from NFRS 9.
- 20N A first-time adopter that discloses the information required by paragraphs 39B–39J shall use the requirements and exemptions in NFRS 1 that are relevant to making the assessments required for those disclosures.

Temporary exemption from specific requirements in NAS 28

- 20O Paragraphs 35–36 of NAS 28 *Investments in Associates and Joint Ventures* require an entity to apply uniform accounting policies when using the equity method. Nevertheless, for annual periods beginning before 17 July 2022, an entity is permitted, but not required, to retain the relevant accounting policies applied by the associate or joint venture as follows:
- (a) the entity applies NFRS 9 but the associate or joint venture applies the temporary exemption from NFRS 9; or
 - (b) the entity applies the temporary exemption from NFRS 9 but the associate or joint venture applies NFRS 9.
- 20P When an entity uses the equity method to account for its investment in an associate or joint venture:
- (a) if NFRS 9 was previously applied in the financial statements used to apply the equity method to that associate or joint venture (after reflecting any adjustments made by the entity), then NFRS 9 shall continue to be applied.
 - (b) if the temporary exemption from NFRS 9 was previously applied in the financial statements used to apply the equity method to that associate or joint venture (after reflecting any adjustments made by the entity), then NFRS 9 may be subsequently applied.
- 20Q An entity may apply paragraphs 20O and 20P(b) separately for each associate or joint venture.

Changes in accounting policies

- 21 Paragraphs 22–30 apply both to changes made by an insurer that already applies NFRSs and to changes made by an insurer adopting NFRSs 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 NAS 8.**
- 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 NAS 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 liabilities² 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

² In this paragraph, insurance liabilities include related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32.

liabilities as NAS 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 NFRS.

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.

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 other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income. This practice is sometimes described as 'shadow accounting'.

Insurance contracts acquired in a business combination or portfolio transfer

- 31 To comply with NFRS 3, 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 NAS 36 *Impairment of Assets* and NAS 38. However, NAS 36 and NAS 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 NFRS 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 non-

controlling 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 NAS 1 *Presentation of Financial Statements*).

- (d) shall, if the contract contains an embedded derivative within the scope of NFRS 9, apply NFRS 9 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

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 NFRS 9 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 NFRS 9 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 NFRS 9 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.
- (d) although these contracts are financial instruments, an issuer applying paragraph 20(b) of NFRS 7 to contracts with a discretionary participation feature shall disclose the total interest expense recognised in profit or loss, but need not calculate such interest expense using the effective interest method.

35A The temporary exemptions in paragraphs 20A, 20L and 20O and the overlay approach in paragraph 35B are also available to an issuer of a financial instrument that contains a discretionary participation feature. Accordingly, all references in paragraphs 3(a)–3(b), 20A–20Q, 35B–35N, 39B–39M and 46–49 to an insurer shall be read as also referring to an issuer of a financial instrument that contains a discretionary participation feature.

Presentation

The overlay approach

35B **An insurer is permitted, but not required, to apply the overlay approach to designated financial assets. An insurer that applies the overlay approach shall:**

- (a) **reclassify between profit or loss and other comprehensive income an amount that results in the profit or loss at the end of the reporting period for the designated financial assets being the same as if the insurer had applied NAS 39 to the designated financial assets. Accordingly, the amount reclassified is equal to the difference between:**
 - (i) **the amount reported in profit or loss for the designated financial assets applying NFRS 9; and**
 - (ii) **the amount that would have been reported in profit or loss for the designated financial assets if the insurer had applied NAS 39.**
- (b) **apply all other applicable NFRSs to its financial instruments, except as described in paragraphs 35B–35N, 39K–39M and 48–49 of this NFRS.**

- 35C** An insurer may elect to apply the overlay approach described in paragraph 35B only when it first applies NFRS 9, including when it first applies NFRS 9 after previously applying:
- (a) the temporary exemption from NFRS 9 described in paragraph 20A; or
 - (b) only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of NFRS 9.
- 35D** An insurer shall present the amount reclassified between profit or loss and other comprehensive income applying the overlay approach:
- (a) in profit or loss as a separate line item; and
 - (b) in other comprehensive income as a separate component of other comprehensive income.
- 35E** A financial asset is eligible for designation for the overlay approach if, and only if, the following criteria are met:
- (a) it is measured at fair value through profit or loss applying NFRS 9 but would not have been measured at fair value through profit or loss in its entirety applying NAS 39; and
 - (b) it is not held in respect of an activity that is unconnected with contracts within the scope of this NFRS. Examples of financial assets that would not be eligible for the overlay approach are those assets held in respect of banking activities or financial assets held in funds relating to investment contracts that are outside the scope of this NFRS.
- 35F** An insurer may designate an eligible financial asset for the overlay approach when it elects to apply the overlay approach (see paragraph 35C). Subsequently, it may designate an eligible financial asset for the overlay approach when, and only when:
- (a) that asset is initially recognised; or
 - (b) that asset newly meets the criterion in paragraph 35E(b) having previously not met that criterion.
- 35G** An insurer is permitted to designate eligible financial assets for the overlay approach applying paragraph 35F on an instrument-by-instrument basis.
- 35H** When relevant, for the purposes of applying the overlay approach to a newly designated financial asset applying paragraph 35F(b):
- (a) its fair value at the date of designation shall be its new amortised cost carrying amount; and
 - (b) the effective interest rate shall be determined based on its fair value at the date of designation.
- 35I** An entity shall continue to apply the overlay approach to a designated financial asset until that financial asset is derecognised. However, an entity:
- (a) shall de-designate a financial asset when the financial asset no longer meets the criterion in paragraph 35E(b). For example, a financial asset will no longer meet that criterion when an entity transfers that asset so that it is held in respect of its banking activities or when an entity ceases to be an insurer.
 - (b) may, at the beginning of any annual period, stop applying the overlay approach to all designated financial assets. An entity that elects to stop applying the overlay approach shall apply NAS 8 to account for the change in accounting policy.
- 35J** When an entity de-designates a financial asset applying paragraph 35I(a), it shall reclassify from accumulated other comprehensive income to profit or loss as a reclassification adjustment (see NAS 1) any balance relating to that financial asset.
- 35K** If an entity stops using the overlay approach applying the election in paragraph 35I(b) or because it is no longer an insurer, it shall not subsequently apply the overlay approach. An insurer that has elected to apply the overlay approach (see paragraph 35C) but has no eligible financial assets (see paragraph 35E) may subsequently apply the overlay approach when it has eligible financial assets.

Interaction with other requirements

- 35L** Paragraph 30 of this NFRS permits a practice that is sometimes described as 'shadow accounting'. If an insurer applies the overlay approach, shadow accounting may be applicable.
- 35M** Reclassifying an amount between profit or loss and other comprehensive income applying paragraph 35B may have consequential effects for including other amounts in other comprehensive income, such as income

taxes. An insurer shall apply the relevant NFRS, such as NAS 12 *Income Taxes*, to determine any such consequential effects.

First-time adopter

- 35N If a first-time adopter elects to apply the overlay approach, it shall restate comparative information to reflect the overlay approach if, and only if, it restates comparative information to comply with NFRS 9 (see paragraphs E1–E2 of NFRS 1).

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 statement of cash flows 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.

Nature and extent of risks arising from insurance contracts

- 38 **An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.**

39 To comply with paragraph 38, an insurer shall disclose:

- (a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
- (b) [deleted]
- (c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:
 - (i) sensitivity to insurance risk (see paragraph 39A).
 - (ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (eg type of insured event, geographical area, or currency).
 - (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) information about credit risk, liquidity risk and market risk that paragraphs 31–42 of NFRS 7 would require if the insurance contracts were within the scope of NFRS 7. However:
- (i) an insurer need not provide the maturity analyses required by paragraph 39(a) and (b) of NFRS 7 if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead. This may take the form of an analysis, by estimated timing, of the amounts recognised in the statement of financial position.
 - (ii) if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may use that sensitivity analysis to meet the requirement in paragraph 40(a) of NFRS 7. Such an insurer shall also provide the disclosures required by paragraph 41 of NFRS 7.
- (e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.
- 39A To comply with paragraph 39(c)(i), an insurer shall disclose either (a) or (b) as follows:
- (a) a sensitivity analysis that shows how profit or loss and equity would have been affected if changes in the relevant risk variable that were reasonably possible at the end of the reporting period had occurred; the methods and assumptions used in preparing the sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by paragraph 41 of NFRS 7.
 - (b) qualitative information about sensitivity, and information about 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.

Disclosures about the temporary exemption from NFRS 9

- 39B **An insurer that elects to apply the temporary exemption from NFRS 9 shall disclose information to enable users of financial statements:**
- (a) **to understand how the insurer qualified for the temporary exemption; and**
 - (b) **to compare insurers applying the temporary exemption with entities applying NFRS 9.**
- 39C To comply with paragraph 39B(a), an insurer shall disclose the fact that it is applying the temporary exemption from NFRS 9 and how the insurer concluded on the date specified in paragraph 20B(b) that it qualifies for the temporary exemption from NFRS 9, including:
- (a) if the carrying amount of its liabilities arising from contracts within the scope of this NFRS (ie those liabilities described in paragraph 20E(a)) was less than or equal to 90 per cent of the total carrying amount of all its liabilities, the nature and carrying amounts of the liabilities connected with insurance that are not liabilities arising from contracts within the scope of this NFRS (ie those liabilities described in paragraphs 20E(b) and 20E(c));
 - (b) if the percentage of the total carrying amount of its liabilities connected with insurance relative to the total carrying amount of all its liabilities was less than or equal to 90 per cent but greater than 80 per cent, how the insurer determined that it did not engage in a significant activity unconnected with insurance, including what information it considered; and
 - (c) if the insurer qualified for the temporary exemption from NFRS 9 on the basis of a reassessment applying paragraph 20G(b):
 - (i) the reason for the reassessment;
 - (ii) the date on which the relevant change in its activities occurred; and
 - (iii) a detailed explanation of the change in its activities and a qualitative description of the effect of that change on the insurer's financial statements.
- 39D If, applying paragraph 20G(a), an entity concludes that its activities are no longer predominantly connected with insurance, it shall disclose the following information in each reporting period before it begins to apply NFRS 9:
- (a) the fact that it no longer qualifies for the temporary exemption from NFRS 9;

- (b) the date on which the relevant change in its activities occurred; and
- (c) a detailed explanation of the change in its activities and a qualitative description of the effect of that change on the entity's financial statements.
- 39E To comply with paragraph 39B(b), an insurer shall disclose the fair value at the end of the reporting period and the amount of change in the fair value during that period for the following two groups of financial assets separately:
- (a) financial assets with contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (ie financial assets that meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of NFRS 9), excluding any financial asset that meets the definition of held for trading in NFRS 9, or that is managed and whose performance is evaluated on a fair value basis (see paragraph B4.1.6 of NFRS 9).
- (b) all financial assets other than those specified in paragraph 39E(a); that is, any financial asset:
- (i) with contractual terms that do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;
- (ii) that meets the definition of held for trading in NFRS 9; or
- (iii) that is managed and whose performance is evaluated on a fair value basis.
- 39F When disclosing the information in paragraph 39E, the insurer:
- (a) may deem the carrying amount of the financial asset measured applying NAS 39 to be a reasonable approximation of its fair value if the insurer is not required to disclose its fair value applying paragraph 29(a) of NFRS 7 (eg short-term trade receivables); and
- (b) shall consider the level of detail necessary to enable users of financial statements to understand the characteristics of the financial assets.
- 39G To comply with paragraph 39B(b), an insurer shall disclose information about the credit risk exposure, including significant credit risk concentrations, inherent in the financial assets described in paragraph 39E(a). At a minimum, an insurer shall disclose the following information for those financial assets at the end of the reporting period:
- (a) by credit risk rating grades as defined in NFRS 7, the carrying amounts applying NAS 39 (in the case of financial assets measured at amortised cost, before adjusting for any impairment allowances).
- (b) for the financial assets described in paragraph 39E(a) that do not have low credit risk at the end of the reporting period, the fair value and the carrying amount applying NAS 39 (in the case of financial assets measured at amortised cost, before adjusting for any impairment allowances). For the purposes of this disclosure, paragraph B5.5.22 of NFRS 9 provides the relevant requirements for assessing whether the credit risk on a financial instrument is considered low.
- 39H To comply with paragraph 39B(b), an insurer shall disclose information about where a user of financial statements can obtain any publicly available NFRS 9 information that relates to an entity within the group that is not provided in the group's consolidated financial statements for the relevant reporting period. For example, such NFRS 9 information could be obtained from the publicly available individual or separate financial statements of an entity within the group that has applied NFRS 9.
- 39I If an entity elected to apply the exemption in paragraph 20O from particular requirements in NAS 28, it shall disclose that fact.
- 39J If an entity applied the temporary exemption from NFRS 9 when accounting for its investment in an associate or joint venture using the equity method (for example, see paragraph 20O(a)), the entity shall disclose the following, in addition to the information required by NFRS 12 *Disclosure of Interests in Other Entities*:
- (a) the information described by paragraphs 39B–39H for each associate or joint venture that is material to the entity. The amounts disclosed shall be those included in the NFRS financial statements of the associate or joint venture after reflecting any adjustments made by the entity when using the equity method (see paragraph B14(a) of NFRS 12), rather than the entity's share of those amounts.
- (b) the quantitative information described by paragraphs 39B–39H in aggregate for all individually immaterial associates or joint ventures. The aggregate amounts:
- (i) disclosed shall be the entity's share of those amounts; and

- (ii) for associates shall be disclosed separately from the aggregate amounts disclosed for joint ventures.

Disclosures about the overlay approach

39K An insurer that applies the overlay approach shall disclose information to enable users of financial statements to understand:

- (a) how the total amount reclassified between profit or loss and other comprehensive income in the reporting period is calculated; and**
- (b) the effect of that reclassification on the financial statements.**

39L To comply with paragraph 39K, an insurer shall disclose:

- (a) the fact that it is applying the overlay approach;
- (b) the carrying amount at the end of the reporting period of financial assets to which the insurer applies the overlay approach by class of financial asset;
- (c) the basis for designating financial assets for the overlay approach, including an explanation of any designated financial assets that are held outside the legal entity that issues contracts within the scope of this NFRS;
- (d) an explanation of the total amount reclassified between profit or loss and other comprehensive income in the reporting period in a way that enables users of financial statements to understand how that amount is derived, including:
 - (i) the amount reported in profit or loss for the designated financial assets applying NFRS 9; and
 - (ii) the amount that would have been reported in profit or loss for the designated financial assets if the insurer had applied NAS 39.
- (e) the effect of the reclassification described in paragraphs 35B and 35M on each affected line item in profit or loss; and
- (f) if during the reporting period the insurer has changed the designation of financial assets:
 - (i) the amount reclassified between profit or loss and other comprehensive income in the reporting period relating to newly designated financial assets applying the overlay approach (see paragraph 35F(b));
 - (ii) the amount that would have been reclassified between profit or loss and other comprehensive income in the reporting period if the financial assets had not been de-designated (see paragraph 35I(a)); and
 - (iii) the amount reclassified in the reporting period to profit or loss from accumulated other comprehensive income for financial assets that have been de-designated (see paragraph 35J).

39M If an entity applied the overlay approach when accounting for its investment in an associate or joint venture using the equity method, the entity shall disclose the following, in addition to the information required by NFRS 12:

- (a) the information described by paragraphs 39K–39L for each associate or joint venture that is material to the entity. The amounts disclosed shall be those included in the NFRS financial statements of the associate or joint venture after reflecting any adjustments made by the entity when using the equity method (see paragraph B14(a) of NFRS 12), rather than the entity's share of those amounts.
- (b) the quantitative information described by paragraphs 39K–39L(d) and 39L(f), and the effect of the reclassification described in paragraph 35B on profit or loss and other comprehensive income in aggregate for all individually immaterial associates or joint ventures. The aggregate amounts:
 - (i) disclosed shall be the entity's share of those amounts; and
 - (ii) for associates shall be disclosed separately from the aggregate amounts disclosed for joint ventures.

Effective date and transition

40 The transitional provisions in paragraphs 41–45 apply both to an entity that is already applying NFRSs when it first applies this NFRS and to an entity that applies NFRSs for the first time (a first-time adopter).

41 This Standard supersedes NFRS 4 (2013). An entity shall apply this NFRS for annual periods beginning on or after 17 July 2019. Earlier application is encouraged. If an entity applies this NFRS for an earlier period, it shall disclose that fact.

Any consequential effect arising from the application of other related Standards becoming effective on the later date, shall be applied only when those Standards come into effect.

41A [Deleted]

41B [Deleted]

41C [Deleted]

41D [Deleted]

41E [Deleted]

41F [Deleted]

41G [Deleted]

41H [Deleted]

41I [Deleted]

Disclosure

42 An entity need not apply the disclosure requirements in this NFRS to comparative information that relates to annual periods beginning before September 13, 2013, 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 September 13, 2013, 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. NAS 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 NFRS. Furthermore, if it is impracticable, when an entity first applies this NFRS, 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 NFRS, the entity shall disclose that fact.

Redesignation of financial assets

45 Notwithstanding paragraph 4.4.1 of NFRS 9, 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 so that they are measured at fair value through profit or loss. This reclassification is permitted if an insurer changes accounting policies when it first applies this NFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and NAS 8 applies.

Applying NFRS 4 with NFRS 9

Temporary exemption from NFRS 9

46 [Deleted]

47 [Deleted]

The overlay approach

48 [Deleted]

49 [Deleted]

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Appendix A

Defined terms

This appendix is an integral part of the NFRS.

cedant	The policyholder under a reinsurance contract .
deposit component	A contractual component that is not accounted for as a derivative under NFRS 9 and would be within the scope of NFRS 9 if it were a separate instrument.
direct insurance contract	An insurance contract that is not a reinsurance contract .
discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits , additional benefits: <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; and (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; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
fair value	<i>Fair value</i> is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See NFRS 13.)
financial guarantee contract	A contract that requires 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 in accordance with the original or modified terms of a debt instrument.
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.

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.

Exposure Draft of NFRS 2018

Appendix B

Definition of an insurance contract

This appendix is an integral part of the NFRS.

- 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 NFRS 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 NFRS to the contracts described in paragraph B6 is likely to be no more burdensome than applying the NFRSs that would be applicable if such contracts were outside the scope of this NFRS:
- (a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.
 - (b) If NFRS 15 applied, the service provider would recognise revenue when (or as) it transfers services to the customer (subject to other specified criteria). That approach is also acceptable under this NFRS, 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 NFRS. If this NFRS did not apply to these contracts, the service provider would apply NAS 37 to determine whether the contracts are onerous.
- (d) For these contracts, the disclosure requirements in this NFRS are unlikely to add significantly to disclosures required by other NFRSs.

Distinction between insurance risk and other risks

- B8 The definition of an insurance contract refers to insurance risk, which this NFRS 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 non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial 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 non-financial 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.
- 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 NFRS).
- 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 non-financial 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 guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in NFRS 9 and are within the scope of NAS 32³ and NFRS 9, not this NFRS (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either NAS 32⁴ and NFRS 9 or this NFRS to such financial guarantee contracts.
 - (h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this NFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of NFRS 15 and NAS 37.
 - (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.

³When an entity applies NFRS 7, the reference to NAS 32 is replaced by a reference to NFRS 7.

⁴When an entity applies NFRS 7, the reference to NAS 32 is replaced by a reference to NFRS 7.

(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 non-cancellable 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 non-insurance financial instruments or service contracts, see paragraphs B20 and B21).
- (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 NFRS 9).
- (f) a credit-related guarantee (or letter of credit, credit derivative default contract 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 NFRS 9).
- (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 NFRS 9. 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, NFRS 15 applies. Under NFRS 15, revenue is recognised when (or as) an entity satisfies a performance obligation by transferring a promised good or service to a customer in an amount that reflects the consideration to which the entity expects to be entitled.

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.⁵ 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 life-contingent 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.

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.

⁵ For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.