

Research Paper

Changes in Accounting Policies under International Financial Reporting Standards

Practice Council

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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: **Research Paper: Changes in Accounting Policies under International Financial Reporting Standards**

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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 Research Paper addresses professional services related to the considerations to be made under IFRS in determining whether a change in an accounting policy for insurance contracts would be in compliance with the requirements of IFRS 4. It was originally published by the IAA as IASP 8.

The Practice Council understands that insurance companies in Canada do not intend to implement significant changes to accounting policies for the valuation of insurance contracts on adoption of IFRS. Therefore, this paper is being released as a Research Paper rather than an Educational Note.

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

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

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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.

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1. Scope

The purpose of this PRACTICE GUIDELINE (PG) is to give advisory, non-binding educational guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing PROFESSIONAL SERVICES regarding some of the considerations to be made under INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) in determining whether a change in an ACCOUNTING POLICY for a CONTRACT within the scope of INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 4, *Insurance Contracts* (2004), is in compliance with the requirements of IFRS 4.21–30 and 4.45. This information refers only to performing PROFESSIONAL SERVICES exclusively related to IFRSs, in particular under IFRS 4, as approved by the INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB). The information focuses on cases where the REPORTING ENTITY is an ISSUER of INSURANCE CONTRACTS, INVESTMENT CONTRACTS, or SERVICE CONTRACTS. 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, practitioners 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 ACTUARIAL ASSOCIATION (IAA).

3. Background

IASB *Framework*, paragraph 11, states the following regarding responsibility for preparation of the FINANCIAL STATEMENT: “The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity.” That responsibility includes determining and modifying accounting policies. However, in the case of accounting policies for insurance contracts, formulating accounting policies and assessing the appropriateness of a change to an accounting policy may require actuarial skills. Further, since IFRSs are in general principle-based, their application to specific facts and circumstances often requires both understanding of the principles and understanding of the specific practical issue involved, e.g., a measurement approach or a product feature. In such cases, actuaries need to be familiar with the underlying principles involved and their meaning. Management might especially require actuarial guidance and support to determine the consequences of a change in an accounting policy for insurance contracts in order to assess, for example, whether the intended change in the accounting policy complies with the provisions of IFRS 4. Further, IAS 8 distinguishes between changes in accounting estimates, a principal area of actuarial work in the case of insurance contracts, and changes in accounting policies. As a result, there can be a distinct role for actuaries to be involved in the assessment of changes in accounting policies.

This PG provides non-binding educational material to assist actuaries in adequately understanding the authoritative guidance in IFRS 4 and other applicable IFRSs in supporting the process of modifying accounting policies relative to technical issues, without diminishing the responsibility of the preparer of the financial statement with respect to choosing accounting policies that are in compliance with IFRSs. Changes in accounting policies occur frequently, especially in large international corporations, and supporting the modification of accounting policies is a permanent

task of many actuaries. In addition, if actuarial support cannot be achieved directly, an actuarial description of the effect of certain technical issues with respect to the accounting requirements for changes of accounting policies could be helpful for practitioners other than actuaries.

4. Practice Guideline

4.1 Introduction

This section includes a discussion on what constitutes an accounting policy and what may constitute a change in accounting policies, referring to the guidance given in the various IFRSs. Appendix A includes a more detailed discussion, as well as discussions about distinguishing between changes of accounting policies, changes of accounting estimates, and introduction of accounting policies for substantially new issues.

INTERNATIONAL ACCOUNTING STANDARD (IAS) 8.5 defines accounting policies: “Accounting policies are the specific principles, bases, conventions, rules and practices applied by a reporting entity in preparing and presenting its financial statements.” IFRSs do not provide a term for the entire set of such accounting policies applied in preparing and presenting the financial statement.

IASB *Framework*, paragraph 11, states the following regarding responsibility for preparation of the financial statement: “The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity.” That responsibility of the preparer of the financial statement, the management, includes determining and modifying accounting policies.

Comparability is a qualitative characteristic of financial statements and IASB *Framework*, paragraph 39, states the following in that regard: “Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.”

The IASB *Framework* states that users must be able to compare the financial statements. IAS 8.15 outlines the specific consequences: “...Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policies meets one of the criteria in paragraph 14.” IFRSs do not further define the term “change in accounting policies,” but as a consequence it can be assumed that a change in accounting policies is at least the application of an accounting policy for an issue in a financial statement deviating from the accounting policy applied for the same issue in the prior financial statement.

In addition, the revision of existing accounting policies based on first-time application of an IFRS in its entirety or first-time application of a single requirement of an IFRS is considered to be a change in accounting policies, since IAS 8.14 states that “an entity shall change an accounting policy only if the change: (a) is required by a Standard or an Interpretation,” and IFRS 4.21 adds that paragraphs providing guidance for changes in accounting policies “apply both to changes made by an INSURER that already applies IFRSs and to changes made by an insurer adopting IFRSs for the first time.” As a consequence, the continuation of existing accounting policies is not a change in accounting policies.

Choosing parameters and methods within a permissible range described by the accounting policies, and applying practices to determine the parameters and methods described in the accounting policies, are not changes in accounting policies but are an application of the practices that are part of the accounting policies. However, the execution of any judgment within those approaches is the responsibility of the preparers of the financial statement. Any deviation in approaches as specified in accounting policies previously in use is a change in accounting policies. The specification of approaches in accounting policies might depend significantly on circumstances. For example, determining current market discount rates in liquid, deep, and active markets might be a very straightforward approach, while in undeveloped financial markets accounting policies might necessarily be restricted to more principle-based requirements to consider all currently available information.

A few examples of relevant situations follow, although the facts and circumstances of each situation will usually have to be evaluated on a case-by-case basis. The following described issues in some cases might, but need not, be changes in accounting policies.

1. Choosing the amount of a specific parameter inconsistent with the practices described in the accounting policy for determining that parameter. For example, if the entity's accounting policy is to apply locked-in parameters or parameters determined by a procedure based on entity-specific circumstances, a move to a procedure for determining parameters based on current market circumstances might be considered a change in accounting policy;
2. Using an approach for measuring liabilities deviating from the approach specified in the accounting policies, e.g., replacing a paid loss development approach embodied in the accounting policies by another one or introducing the use of an gross premium approach if constantly applying net premium approaches (ignoring both administration charges in premiums and future administration expenses);
3. Changing a confidence level if the level is prescribed in absolute terms in the accounting policy, e.g., after using constantly 90%, moving on to use another fixed percentage or introducing an approach determining the percentage as a variable determined by current experience;
4. Changing a procedure, where the accounting policy requires applying that procedure for the choice of a parameter or measurement approach at each reporting date based on such factors as the then-available information, data, or general practice. Examples include:
 - changing the procedure for determining the discount rate, e.g., from an unweighted average of the yield curve for the past five years to a weighted average of yield curves for the past ten years; and
 - changing the method to determine claims liabilities, e.g., from a specific family of methods depending on the individual current observed risk structure of each class of risk into another extended or reduced family of methods; and
5. Changing the measurement approach previously used for participation features, e.g., if previously the liability was based on amounts legally allocated to policyholders, but after the change the policyholders' expected legal share of all recognised surplus is considered as liability. However, in some cases the legal allocation was based on the entire statutory surplus. The introduction of IFRSs, deviating from prior statutory accounting, causes that first-time surplus is recognised, which is not considered in the legal allocation. Developing

an accounting policy for such a substantially new issue might not be seen as change in accounting policy.

4.2 Principles for changing accounting policies

IAS 8.14 states that “an entity shall change an accounting policy only if the change: (a) is required by a Standard or an Interpretation; or (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.”

Regarding developments of accounting policies in the absence of applicable IFRSs, IAS 8.21 states that “in the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management may, in accordance with paragraph 12, apply an accounting policy from the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards. If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy.”

IFRS 4.22 permits an entity to change its existing accounting policies for contracts subject to IFRS 4 “if and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8.” It is necessary to demonstrate “that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria” (IFRS 4.23). IFRS 4 goes on to describe specific issues relevant to this demonstration.

IFRS 4 provides guidance in paragraphs 25–29 regarding specific features of accounting policies that may not be introduced, although their use can be continued if already in use. In addition, IFRS 4.24 and 4.30 provide guidance as to possible introduction of specific features of accounting policies, which are not in compliance with existing IFRSs but where an exemption is generally available. IFRS 4 refers to both individual features and overall effect of changes to an accounting policy, with the determination of the acceptability of such changes to be made with respect to the requirements of IFRS 4.22, based on the effects of the overall resulting accounting policies.

Further guidance to relevance, reliability, and their sub-characteristics is provided in the IASB *Framework*. It is further discussed in Appendix A as specifically applied to IFRS 4.28.

IAS 8.19 specifies the consequences to be considered in proceeding a change in an accounting policy: “Subject to paragraph 23: (a) an entity shall account for a change in accounting policy resulting from the initial application of a Standard or an Interpretation in accordance with the specific transitional provisions, if any, in that Standard or Interpretation; and (b) when an entity changes an accounting policy upon initial application of a Standard or an Interpretation that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.”

It can be assumed that preparers of financial reports might often require changes in accounting policies to be applied based on IFRS 4.21–33 retrospectively.

The consequences of retrospective application of changes in accounting policies are discussed further in Appendix A.

4.3 Undiscounted insurance assets and insurance liabilities

IFRS 4 refers in several paragraphs to changes of discounting requirements of the existing accounting policies.

IFRS 4.24 states that “an insurer is permitted, but not required, to change its accounting policies so that it remeasures designated INSURANCE LIABILITIES 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.”

IFRS 4.25 states that “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...”

IFRS 4.27 states that “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.”

If the terms “undiscounted” and respectively the term “discounted” are used in regard to INSURANCE ASSETS and insurance liabilities, they refer to values “not reflecting time value of money” and respectively “reflecting time value of money.” It is deemed that reflecting the time value of money represents an improvement in accounting practice. However, some existing accounting policies use non-discounting or reduced discount rates as a substitute for achieving an adequate level of prudence overall, for example in cases where the cash flows are inadequate compared with a cash flow adequately adjusted for risk and uncertainty or even with the current estimate.

Where some of the current prudence is as a result of low discount rates or no discounting at all, if after making the change the overall prudence level is lower and potentially insufficient, such a change in accounting policies might not comply with the requirements of IFRS 4.22. Further adjustments to the measurement approach will then be needed to maintain at least the same level of prudence that was present before the change or at least a sufficient prudence otherwise.

When introducing discounting in the case of a prior undiscounted measurement, IFRS 4 does not support embedding an unjustified amount of MARGIN FOR RISK AND UNCERTAINTY to offset the impact of reflecting the time value of money in order to increase the level of prudence compared to the prudence under the prior measurement basis. If discounting causes the LIABILITY ADEQUACY TEST to require regular strengthening of liabilities, the adequacy of both the prudence level after discounting and the prudence level of the liability adequacy test might be reconsidered in order to identify an adequate prudence level.

4.4 Current market interest rates

IFRS 4.24 permits a change in an entity's accounting policies regarding a move to current market interest rates:

An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as IAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all these liabilities until they are extinguished.

Regarding "current market interest rates," see the PG, *Current Estimates*, for further information about the reporting date in measuring those insurance liabilities, although the PG is not specific as to what set of such interest rates that "current market interest rates" would be. Also, IFRS 4 does not provide specific requirements; paragraph 28(d) refers to "a current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets."

Such a permitted change in an accounting policy need not be applied to all similar liabilities or contracts, despite the uniformity requirement in IAS 8.13, as well as IFRS 4.25(c), would otherwise require. In other words, IFRS 4.24 grants an exemption for this change from the uniformity requirement. A potential change in accounting policies can also be applied to all or only a part of the other assumptions for the "designated" insurance liabilities. However, regarding changing accounting policies for other estimates and assumptions, IFRS 4.24 grants an exemption from complying with the uniformity requirement only if there is at the same time a change in accounting policies to move to current market interest rates for the affected contracts. If current market interest rates are already applied or not introduced for those contracts, IFRS 4.24 is not applicable when moving on to other current estimates or assumptions.

The permission to change the accounting policy without uniformity refers only to changing the procedure to assess parameters. It does not cover general changes in the measurement approach, e.g., the formula, used. An exemption applies if the accounting policies determine a procedure to choose in each period the measurement approach as current estimate. However, some changes of parameters might require modifications of the formula for application, e.g., if instead of a constant discount rate for all durations a discount rate is used that depends on the duration of the discounted cash flow. If current assumptions about future administration cost are introduced together with current market interest rates, a net premium approach ignoring administration charges in premiums as well as in expenses will change to a gross premium approach.

In some cases, preparers of financial statements may also require application of IFRS 4.24 to insurance assets arising from insurance contracts or from reinsurance ceded and to liabilities and assets arising from FINANCIAL INSTRUMENTS with DPFs, although IFRS 4 does not explicitly mention this.

Such re-measurement of current market interest rates could be made through the discount rates used to determine the present value of future cash flows or, if the measurement approach considers future investment margins, in both the discount rates used and the future investment earnings assumption. Current market-based interest rates are reflected theoretically by the complete yield curve and would normally be applied to the corresponding expected durations of the cash flows. However, IFRS 4 does not prohibit the use of a single current discount rate applied to mean duration.

The main purpose of IFRS 4.24 is to grant exemption from the requirement of consistency in IAS 8.13 if an entity wishes to introduce discounting with current market interest rates. IFRS 4.24 also clarifies that the introduction of discounting with current market interest rates is a generally permissible change in accounting policies. However, the measurement of insurance assets and liabilities in many entities' existing accounting policies involves a comprehensive and sophisticated approach with significant interdependencies between assumptions, as outlined in 4.3. Changing just one measurement feature, the discount rate, could affect the overall relevance and reliability if all other measurement features remain unchanged. The combined effect of introducing discounting with current market interest rates and other measurement features might be viewed on a combined basis. In some cases, further adjustments are applied considering the effect of introduced features to achieve compliance with the requirements of IFRS 4.22. It should be noted that the second sentence of IFRS 4.24 explicitly allows a simultaneous change in other measurement features. Following the principles for the measurement of the time value of money, as outlined in IAS 39, AG69–A82, would comply with IAS 8.

A consideration in evaluating a change in measurement approach is a review of the overall level of prudence as outlined in 4.3, but the application of IFRS 4.24 can also be in conflict with IFRS 4.26 by increasing the prudence level in excess of a sufficient level of prudence. For example, a change made in accounting policies of replacing an existing discount rate with a (lower) current market interest rate could increase the prudence inherent in the measurement in excess of that permitted by IFRS 4.26 for any change of accounting policies. To comply with IFRS 4.26, and if the measurement approach already incorporates sufficient prudence, such a reduction in the discount rates requires adequate reduction of conservatism in other aspects of the measurement approach.

In addition, further consequences from such changes in measurement approach, e.g., regarding deferral and amortisation of ACQUISITION COST, may be considered to accomplish an overall change in accounting policies that is in compliance with IFRS 4.22.

A typical example of a change is the introduction of the discounting of claims liabilities not previously discounted. Such a change is generally allowed, but certain issues may be considered as outlined before and in 4.3. Depending on the current accounting policies, the undiscounted claims liability could be less than adequate, even though undiscounted, for example, if the effect of future inflation on compensations is ignored. In such cases, the introduction of discounting could make the situation worse, with a reassessment of expected cash flow needed to avoid being less relevant or reliable. Moreover, even if the undiscounted claim liability is deemed to be adequate, the discounted liability may not be, e.g., as a consequence of ignoring adequate margins for risk and uncertainty, resulting in the change not complying with IFRS 4.22.

IFRS 4.24 permits the introduction of discounting of designated insurance liabilities but does not address the case in which it is introduced only for a part of an insurance liability, e.g., if only the claims liability is discounted while liabilities for future coverage for the same contracts are undiscounted, e.g., as unearned premiums. According to the definition of an insurance liability in

IFRS 4, Appendix A, the insurance liability reflects the net contractual obligations under an insurance contract. In some cases, insurance liabilities might be related to contracts that no longer have a stand-ready obligation (e.g., unearned premiums) or to contracts that have only a stand-ready obligation but not yet a claims liability. In other cases, contracts might have both a stand-ready obligation and a claims liability. In the latter case, the combination of the obligations forms the insurance liability of that contract. However, in some cases, in particular in the case of IBNR-liabilities, it may be difficult to determine the insurance liability on an individual contract basis. Preparers of financial statements might require that the change in discount rates, if not applied to the entire insurance liability of the insurance contract, be applied either to claims liabilities or stand-ready obligations that have significantly different measurement approaches.

If the measurement of applicable assets or liabilities in the existing accounting policies does not currently reflect future investment margins (see 4.8), IFRS 4.27–29 address their re-measurement using current market interest rates that introduce such future investment margins in either discount rates or the interest earnings assumption.

If an entity uses out-of-date asset-based discount rates and switches to a current asset-based rate, this does not mean an introduction of future investment margins. However, if an entity is using old earned rates that are not asset-based and wishes to switch to current asset-based earned rates, this is subject to the rebuttable presumption in IFRS 4.27 that the introduction of such asset-based discount rates, i.e., future investment margins, is less relevant and less reliable. See 4.8 for a discussion of future investment margins.

IFRS 4 permits parts of a portfolio to be excluded from the changes in accounting policies that use significantly different measurement approaches, which are administered in other systems, or where a potential change could result in excessive cost to implement the change of accounting policies. In making a change for a specified segment of business, the preparer of the financial statement might require objective criteria to be used to distinguish that segment. For example, business could be categorised by type of product, relation with investments based on asset-liability matching strategies, certain durations at which it is easier to match with available investments, or for other practical reasons, such as all contracts administered on a specified computer valuation system that is relatively easy to change. The use of objective criteria avoids concerns regarding the possibility of “managing” results, i.e., implementing such a change at a time when profits “need” boosting.

4.5 Non-uniform accounting policies

IFRS 4.25 states that “an insurer may continue the following practices, but the introduction of any of them does not satisfy paragraph 22...(c) using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries, except as permitted by paragraph 24. If those accounting policies are not uniform, an insurer may change them if the change does not make the accounting policies more diverse and also satisfies the other requirements in this IFRS.”

However, distinguishing between changes in accounting policies and introduction of accounting policies for substantially new issues is of particular importance here. The implementation of a new accounting policy may be acceptable if the current policy in another subsidiary is used. If those new products are offered only by one subsidiary, this does not constitute an increase in diversity according to IFRS 4.25(c).

4.6 Prudence

IFRS 4.26 states that “an insurer need not change its accounting policies for insurance contracts to eliminate excess prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.” IFRS 4 neither defines “sufficient prudence” nor provides guidance as to its interpretation.

Prudence is defined in the IASB *Framework*, paragraph 37: “The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.” It is a general accounting quality, which can be difficult to quantify, i.e., it is difficult to objectively determine a specific level that first becomes “sufficient.”

Even though “sufficient prudence” is used without specific quantitative guidance, it can be expected that the level of prudence required by the preparer of the financial statement is based on a set of objective criteria, such as that currently observed in the market, or on a systematic, objective, and rigorous basis reflecting a reporting entity’s existing accounting policies that have been applied systematically to all measurements based on a consistent approach applied over a long period of time. In the case where positive evidence exists that observable market-based margins for risk and uncertainty in relevant markets for assets or liabilities determined according to IFRS 4 are materially higher than those resulting from the prudence indicated in the entity’s accounting policies, the preparer might require review of the accounting policies regarding prudence level (see PG, *Measurement of Investment Contracts and Service Contracts*, for further information; although that PG does not refer to insurance contracts, the considerations given there are applicable here as well).

The practitioner might expect that the preparer of the financial statement requires observable, reliable, and relevant experience or market data that indicate a reduced level of prudence to adopt a change in an accounting policy that results in the recognition of profits at issue where they did not exist before (see IAS 39, AG67).

IAS 8.13 requires: “An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. ...” As a consequence, accounting policies regarding prudence level are applicable to all business, including new business. Note that many accounting policies currently require a different level of prudence for different cohorts of business, e.g., where locked-in assumptions are used. Such accounting policies can be continued under IFRS 4. A change of that accounting policy only for designated insurance liabilities, e.g., new business, is not in compliance with IFRS 4. However, as stated in IAS 39, a concept of initial measurement at the net consideration given or received is in compliance with

IASB Framework. Nevertheless, prudence should not be reduced too low so as to jeopardise the results of liability adequacy testing.

4.7 Shadow accounting

IFRS 4.30 refers to shadow accounting: “In some accounting models, realised gains or losses on an insurer’s assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in equity if, and only if, the unrealised gains or losses are recognised directly in equity. This practice is sometimes described as ‘shadow accounting’.” IFRS 4, BC183(b), reasons that “shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (i) the gains and losses are realised or unrealised and (ii) unrealised gains and losses are recognised in profit or loss or directly in equity. This is a logical application of a feature of some existing models.” In some cases, preparers of financial statements might require that insurance assets are also subject to shadow accounting.

IFRS 4.35 states that “the requirements in paragraph 34 also apply to a financial instrument that contains a DISCRETIONARY PARTICIPATION FEATURE.” IFRS 4.34(c) states that “some insurance contracts contain a discretionary participation feature as well as a GUARANTEED ELEMENT. The issuer of such a contract ... (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.” Hence, shadow accounting is also applicable for entire financial instruments with DPFs, for both the guaranteed element as well as the DPF-element.

Consistency of asset and liability measurement is paramount, and as a result, shadow accounting is relevant if it addresses the inconsistencies in the measurement of financial assets and measurement of contracts in the scope of IFRS 4, if that measurement reflects realised gains or losses but not unrealised gains or losses as recognised to some extent in financial statements prepared in accordance with IFRS. The existing accounting policies for insurance contract continued according to IFRS 4 might stem from an accounting basis, which does not allow the recognition of unrealised gains or losses, neither in profit or loss nor in balance sheet. Hence, the concept of measurement of insurance liabilities might not provide any guidance for considering unrealised gains or losses, although realised gains or losses are required to affect the measurement. At first-time application of IFRSs, the introduction of recognition of unrealised gains or losses might cause an inconsistency between measurement of financial assets and insurance contracts, which can be overcome by introducing shadow accounting.

However, the change in measurement of financial assets by first-time application of IAS 39 is not a pre-condition for introducing shadow accounting; it can always be introduced if the pre-conditions are met. Shadow accounting simply means 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” (IFRS 4.30). Clearly, if realised gains or losses do not affect measurement of insurance contracts according to existing accounting policies, the introduction of shadow accounting would not cause any affect by unrealised gains or losses as well. Hence, IFRS 4.30 requires as pre-condition for introducing

shadow accounting that “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.”

Primarily, IFRS 4.30 permits an exemption from IAS 1.78: “All items of income and expense recognised in a period shall be included in profit or loss unless a Standard or an Interpretation requires otherwise.” As a consequence, shadow accounting allows the reporting of the effects of unrealised gains or losses on the measurement of the contracts in the scope of IFRS 4 directly “in equity if, and only if, the unrealised gains or losses are recognised directly in equity.” That eliminates the inconsistency in income that might arise if the movements of the insurance liability were reported entirely in profit or loss while the associated unrealised gains or losses on assets are not recognised in profit or loss. “Examples include revaluation surpluses (see IAS 16), particular gains and losses arising on translating the financial statements of a foreign operation (see IAS 21) and gains or losses on remeasuring available-for-sale (AFS) financial assets (see IAS 39)” (IAS 1.80). Available-for-sale financial assets (IAS 39.9), where changes in FAIR VALUE are not recognised in profit or loss (IAS 39.55(b)), have a special relevance in the case of insurers; hence, the extension of the exemptions from IAS 1.78 to insurance contracts is of special relevance if the measurement of their liabilities depends on the measurement of financial assets. The income statement would not be affected by such unrealised gains or losses or by the consequential effect on measurement of the liabilities for insurance contracts.

The following examples refer to four typical measurement issues, where shadow accounting might be used to improve the relevance of the financial statement: deferred acquisition cost amortised in proportion to recognised net earnings in periods, insurance liabilities discounted with the expected future yield from investments held and expected reinvestment yields, a liability adequacy test that considers such expected future yields, and performance-linked contracts where the obligation to policyholders is triggered directly by any recognised earnings and the liability is measured on that basis.

When amortisation of deferred acquisition expenses is based on expected gross profits (recognised net earnings of a period) including realised gains or losses, shadow accounting would extend this treatment so that the amortisation process of deferred acquisition costs would also consider unrealised gains or losses recognised in a period, as well as a proportion of those amortizations of deferred acquisition costs in that period. In a second calculation, the amortisation amount to be recognised in profit or loss is determined excluding from consideration any unrealised gains or losses recognised directly in equity.

When, under the accounting policies applied prior to introduction of IFRS, assets are measured at amortised cost, any unrealised gains on assets are amortised over the remaining life of the asset. The use of the unamortized portion could affect the adequacy of the liabilities. The move to AFS could result in reduced adequacy or even inadequate insurance liabilities.

This is particularly relevant for accounting policies where the insurance liability is discounted directly using the expected future yield from investments held and expected reinvestment yields and based on amortised cost values and realised gains or losses. In those cases, under shadow accounting the discount rate is replaced by that resulting from the expected future yield as determined under the new IFRSs’ basis of investments held, including unrealised gains or losses already recognised. Only those parts of movements of the insurance liability that are recognised in profit and loss that result from a discount rate entirely based on investment income are recognised

in profit or loss. Similarly, in a second calculation the discount rate is determined considering only unrealised gains or losses recognised in profit or loss, and the movement of the liability to be recognised in profit or loss is determined on that basis.

In particular, if discount rates are based only on earnings from investments as recognised in profit or loss but excluding unrealised gains or losses, despite being recognised under IFRSs, the liability adequacy might be significantly reduced in its relevance without shadow accounting. Unrealised gains constitute anticipated future investment earnings and under the liability assumptions might be needed in a future period to cover obligations. If they are reported under IFRS as net profit, but according to the existing accounting policies the liability is measured assuming that earnings will occur in the future to cover the obligation, the liability is potentially understated as a consequence. That might be especially relevant in the case of products with significant savings elements that are at risk of being deficient, such as certain forms of deferred annuities. As well, a second calculation determines the amount to be recognised in profit or loss on a basis excluding any unrealised gain or loss directly recognised in equity.

If realised gains or losses directly affect the measurement of a liability whose cash flows are linked to the performance of those assets, shadow accounting may be of special relevance. If, for example, the measurement of the obligations arising from DPFs considers realised gains or losses, the measurement approach can be changed to the extent that recognised unrealised gains or losses are considered as if they were realised. The movement of the liability is reported directly in equity insofar as it results from consideration of unrealised gains or losses that are recognised directly in equity. For further information regarding contracts with DPFs refer to the PG, *Recognition and Measurement of Contracts with Discretionary Participation Features*.

4.8 Future investment margins

4.8.1 Background

To be acceptable under IFRS 4, a change in accounting policies for insurance contracts introducing the effects of future investment margins expected from the assets held by the reporting entity requires special consideration. IFRS 4.27 states the following in that regard: “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. ...”

The next sentence of IFRS 4.27 states the following: “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.” IFRS 4.29 states that “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. ... However, in other approaches, the discount rate determines the measurement of the liability directly. ...” These paragraphs refer to several approaches that consider expected future investment margins in the measurement of insurance liabilities or insurance assets and provide examples for the issue referred to.

4.8.2 Exemption of performance-linked contracts

IFRS 4.27 states the following: "... 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. ..." As a consequence, IFRS 4 does not state the existence of that rebuttable presumption in case of investment margins that affect the contractual payments.

At the time IFRS 4 was adopted, the IASB had not developed standards addressing the treatment of such a linkage between obligations under insurance or investment contracts and the earnings of the ISSUER. The IASB concluded the following in IFRS 4, BC134: "In the Board's view, the cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability)." Therefore, IFRS 4 does not state that future investment margins are irrelevant in measuring these contracts. If the consideration of future expected investment margins is based on an actual contractual linkage of liabilities to assets or reflects the measurement of the corresponding assets, the introduction of consideration of future expected investment margins is not generally viewed as impairing the relevance and reliability of those financial statements. A change in accounting policies in that case is subject to compliance with IFRS 4.22, rather than IFRS 4.27–29.

4.8.3 Meaning of "introduction of consideration of future investment margins"

The first sentences of IFRS 4.27 state that "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. ..." This indicates that IFRS 4 restricts changes in accounting policies in which the consideration of future investment margins is introduced but does not limit changes in accounting policies where the consideration of future investment margins is continued or only modified. Therefore, judgment is required regarding whether the change of accounting policies incorporates (1) an introduction of consideration of future expected investment margins or (2) just their continuation or modification.

Since the discount rates or future expected cash flows from investment income under certain current accounting policies do not fully reflect future expected investment margins, judgment is required to determine whether such a policy is based on future expected investment margins or on another approach. Discount rates that are the smaller of the expected rates based on assets held by the reporting entity and that are determined on another non-current basis, e.g., based on historic averages of market interest rates, may be seen as an approach considering future investment margins if the assumptions about future investment margins normally affect the discount rate used.

4.8.4 Judgment about justification of an introduction of future investment margins

IFRS 4.27 asserts that there is a rebuttable presumption that the introduction of future expected investment margins where they were not previously recognised results in impairment of relevance and reliability of financial statements. IFRS 4.28 states the following in that regard:

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.

Therefore, the previous and the proposed modified accounting policies need to be checked as to whether their characteristics can overcome the rebuttable presumption.

As reasoning for allowing the continuation of existing accounting policies, the IASB outlined in IFRS 4, BC77, that "without changes made in the IFRS, an insurer adopting IFRSs in 2005 would have needed to assess whether its accounting policies for insurance contracts comply with these requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some insurers might have made major changes in 2005 followed by further significant changes in phase II." Further, paragraph 78 states: "To avoid unnecessary disruption for both users and preparers in phase I that would not have eased the transition to phase II, the Board decided to limit the need for insurers to change their existing accounting policies for insurance contracts." IFRS 4.23 specifies the following in that regard: "To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria. ..." Hence, if a new accounting policy regarding discounting is introduced, for example, the direct introduction of the approach intended by the IASB is acceptable if compatible with the intended accounting policy in the aggregate. In the case of use of a comprehensive or widely used accounting policy, such a partial modification might be problematic, either within the approach or considering the comparability with other entities using an unmodified approach.

IFRS 4.28 includes an example to illustrate a change in accounting policy that includes a very inappropriate initial accounting policy and an optimal target accounting policy. However, in most practical situations, neither the initial policy will be as bad as described nor the target accounting policy as good as described. Indeed, the target accounting policy chosen for demonstration purposes is rather idealistic, as most generally used accounting policies do not fully satisfy all the indicated criteria, especially the combination of being comprehensive and widely used, as well as applying current assumptions. As a result, the preference determination will likely not be as obvious as the one shown.

Hence, IFRS 4.28 allows the practitioner to establish a list that describes characteristics of preferable accounting policies. Accounting policies in compliance with the list above in IFRS 4.28 are preferable even if including consideration of future expected investment margins. The list of less preferable characteristics follows:

1. Excessively prudent assumptions;
2. Assumptions set at inception of the contract;
3. A discount rate prescribed by a regulator without direct reference to market conditions; and
4. Ignoring some embedded options and guarantees.

Since IFRS 4 refers to that list as an example, a change in accounting policies to consideration of future expected investment margins can be justified even when those four characteristics are not exactly present. For example, certain accounting policies imposed by regulation currently do not have the disadvantage indicated in (4). In addition, the revised accounting policies do not have to improve all of the listed disadvantages of the prior accounting policies.

Application of the list in IFRS 4.28(a) to (d) requires investigation and judgment. For informational purposes some thoughts are provided as to how those characteristics might appear in practice. Together with the criteria mentioned in IFRS 4.28, before (a), the list of criteria follows:

1. Comprehensive;
2. Investor-oriented;
3. Widely used basis of accounting involving current estimates and assumptions;
4. A reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty;
5. Measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and
6. A current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets.

The term "comprehensive" in (1) is also found in IAS 39.2 and 39.8, as well as in IFRS 4, BC81, which contain provisions for recognition, measurement, and disclosure, typically issued by a standard-setting body as described by IAS 8.12. Such provisions are of special relevance. The requirement of comprehensiveness would avoid "cherry-picking," as outlined in IFRS 4, BC81. If the intention is to apply a comprehensive approach, changing only a part of that comprehensive approach could cause missing the intended target. A comprehensive approach, especially if widely used, requires that all its components be introduced together. Otherwise, its comprehensive nature or comparability might be impaired. A single change made in an otherwise preferable comprehensive approach to the existing set of accounting policies might, in fact, significantly impair its overall relevance.

A non-comprehensive approach lacks the need to introduce the use of future expected investment margins. If an adopted change is not comprehensive, it is possible either to continue existing accounting policy for discount rates or to apply a market-related discount rate within the new approach.

Regarding embedded value approaches, IFRS 4, BC142, states that "IFRS permits continued use of embedded value measurements. ..." However, IFRS 4.29 states that "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.”

Further information is included in IFRS 4, BC144: “In some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. However, in other approaches (such as most applications of embedded value), the discount rate determines the measurement of the liability directly. The Board concluded that it is highly unlikely that an insurer could overcome the rebuttable presumption in the latter case (see paragraph 29 of the IFRS).” Hence, there is a specific need for judgment in case of embedded value approaches with respect to whether they affect the measurement of the liability at inception. In addition, IFRS 4 does not explicitly address the expanded presentation approach often used for embedded values. In some cases, preparers of financial statements may require the continuation of existing accounting policies regarding presentation. However, the introduction of such an expanded presentation can be seen as moving away from the principles of IAS 8 rather than moving closer.

The “widely used” requirement in (3) might be understood by preparers to refer to worldwide reference, especially if the reporting entity could expect a worldwide attention. If “widely used” refers only to a local situation, this typically refers to one set of accounting applied by the reporting entities in that area. Hence, it often might not be reasonable to interpret “widely used” other than as referring to widely used in the worldwide sense.

There is no indication that assumptions chosen in (4) need to be market assumptions or reflect market margins. However, it could hardly be seen as improvement if they are not more closely related to user needs than previously used assumptions.

With respect to (5), such revised margins need not be lower than those imposed by a business regulator. One aspect of relevance is whether the margins involved are investor-oriented (item (2)). Certain regulators might determine margins based on considerations in a manner similar to those reflected by investors, resulting in some cases in lower margins than investors would consider appropriate; in others larger.

4.9 Contracts with DPFs

Movement to a full recognition of the entire DPF as a liability that is more realistic than the current approach in applying IFRS 4.22 can be viewed as an improvement of reliability and relevance. However, this conclusion depends on an assessment of the relative reliability of the measurements involved.

A change of existing accounting policy regarding measurement of a DPF that results in the recognition of a liability less than the value of its LEGAL AND CONSTRUCTIVE OBLIGATIONS might require further considerations to be viewed as being less relevant. A change in assumptions to reflect the expectations and intent of management to pay amounts in excess of their legal and constructive obligations may not necessarily be considered preferable either.

4.10 Designation of financial assets

IFRS 4.45 states the following: “When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as ‘at fair value through profit or loss’. This reclassification is permitted if an insurer changes accounting policies when it first applies this IFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and IAS 8 applies.” That paragraph refers to changes in accounting policies affecting the insurance liabilities that preparers of financial statements might consider and liabilities of other contracts in the scope of IFRS 4, although not explicitly mentioned in IFRS 4. Such changes are subject to IFRS 4.22, which does not refer to changes in accounting estimates and introductions of accounting policies for in-substance new issues.

Subject to the reclassification are financial assets held at first-time application of the new accounting policies for insurance liabilities. At the time of changes of accounting policies regarding insurance liabilities and other liabilities under the scope of IFRS 4, such a change could result in better matching of the measurement basis of liabilities to the fair value measurement of assets. The reference to “some or all of its financial assets” grants a similar choice as in case of “designated insurance liabilities” in IFRS 4.24, and it is referred to the information provided in 4.4. The practitioner may wish to limit it to those assets directly related to the measurement of liabilities whose accounting policies were changed.

Note that paragraph 45 does not provide guidance regarding financial assets acquired later; hence, no exemption from provisions applicable otherwise is granted by that paragraph. The reference to IAS does not mean that the provisions of IAS 8 that set conditions for a change in accounting policies are applicable, since such a change is allowed by IFRS 4.45. Instead, the consequences described in IAS 8 are complied with in the case of changing accounting policies.

Appendix A – Discussion of some specific issues

The Appendix refers to some special points for detailed discussion. As is the main part of the PG, the Appendix is educational and non-binding in nature and provides detailed background information for issues discussed earlier in the PG.

1. Definition of Accounting Policies

The following is a discussion of the wording in the IAS 8 definition of *accounting policies*. IFRSs do not provide further guidance about how to define the terms; hence, any attempt for a more in-depth discussion can be seen only as an example for educational purposes.

Principles are the basic accounting principles underlying the preparation and presentation of financial statements, e.g., as described in the IASB *Framework*.

Bases are the formal bases of reporting; in the case of an IFRS-report they are IFRSs, as promulgated by the IASB (IAS 8.14). For certain IFRSs, e.g., IFRS 4, a local comprehensive basis of accounting can be adopted in developing accounting policies for certain issues. In addition, the entity can modify such a basis. However, after first adopting an IFRS, the reporting entity's ability to change its accounting policies for insurance contracts is limited by IFRS 4.

Conventions are interpretations of definitions or guidance, incorporating specific application of the principles to specific issues not generally addressed in bases.

Rules are the detailed requirements derived from principles and conventions as applied for entity's specific circumstances or issues.

Practices are procedures and parameters used by the reporting entity to assess information provided in the financial statement as far as such are intended to be regularly applied. Such procedures are used to choose the method taken in order to determine the parameters the assumptions or estimates used in a specific reporting period, based on the accumulated information of the experience period as applied to the relevant reporting period. However, the method taken in applying a practice based on the current knowledge is not part of the accounting policies, since it is not intended to be regularly applied but is specific to the current knowledge at the reporting date of one reporting period.

Regarding the documentation of and reference to accounting policies applied by an entity for preparation and presentation of financial statements, there are at least three sources. Such sources include disclosures in prior financial statements, since IAS 1.108 requires the following: "An entity shall disclose in the summary of significant accounting policies: (a) the measurement basis (or bases) used in preparing the financial statements; and (b) the other accounting policies used that are relevant to an understanding of the financial statements."

For disclosure requirements, the practitioner may refer to the PG, *Disclosures*, for further information. In addition, practitioners can refer further to internal documents if the entity documents its accounting policies in more detail than that disclosed. Further, management, responsible for preparation of the financial statement, provides guidance on accounting policies.

2. Distinguishing of changes in accounting policies, changes in accounting estimates, and introduction of accounting policies for substantially new issues

IAS 8 distinguishes among (1) changes in accounting policies, (2) introduction of accounting policies for in-substance new issues, and (3) changes in accounting estimates.

Regarding introduction of accounting policies for substantially new issues, IAS 8.16 states, “The following are not changes in accounting policies: (a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and (b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.”

Introducing accounting policies for in-substance new issues occurs mainly if new products, especially products covering new risks or including a new styling requiring deviation from measurement approaches, are accounted for the first time. Introducing accounting policies for in-substance new issues may result as well from first-time consolidation of subsidiaries with such products.

The differentiation between changes in accounting policies and changes in accounting estimates is based on IAS 8.5, which states that “a change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors. ...”

The differentiation between changes in accounting policies and changes in accounting estimates might cause particular difficulties for the measurement of insurance contracts. Those measurements are, considering the uncertainty typical for insurance risk, estimates. IAS 8.34 specifies that “an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. ...”

Regarding measurement basis, IAS 8.35 states that “a change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. ...” However, the reference to “measurement basis” does not refer to the normally rare but, in case of measurement of insurance contracts, sometimes occurring case, that the “measurement basis,” the method in the terminology of this PG, is itself the result of an estimation approach under the accounting policy. In that case, the change of a measurement method is required by the accounting policy if circumstances change and there is no change in accounting policies. The reference to “measurement basis” in IAS 8.35 focuses on the practice for measurement outlined in the accounting policy, regardless of how complex that practice is.

A change in estimate refers mainly to changes in parameters, methods, assumptions, or other estimates, which under the accounting policies are to be determined subject to current information or experience, and which may result in the measurement being affected by a change.

For cases of doubt, IAS 8.35 states that “when it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.” However, those responsible for the preparation and presentation of the financial statement make that decision.

3. Changing estimates and consequences

IAS 8.34 states that “an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. ...” That is a matter of judgment, if not further ruled by the accounting policies, for those who prepare and present the financial statement.

IAS 8.38 further describes the potential ongoing effect of the change: “Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate. A change in an accounting estimate may affect only the current period’s profit or loss, or the profit or loss of both the current period and future periods. ...”

IAS 8.36 describes the consequence of such a change in estimates on profit or loss: “The effect of a change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in: (a) the period of the change, if the change affects that period only; or (b) the period of the change and future periods, if the change affects both.”

Regarding effect on the balance sheet, IAS 8.37 states that “to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.”

It should be noted that IFRS 4 does not grant any permission to deviate from that approach, except in the case of shadow accounting.

The practitioner is referred to the PG, *Disclosure*, for further information about disclosure.

4. Introducing accounting policies for in-substance new issues

Regarding development of accounting policies, IAS 8.7 states the following: “When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance issued by the IASB for the Standard or Interpretation.”

IFRS 4 is the applicable standard in case of insurance contracts and financial instruments with DPFs. But IFRS 4 provides merely not more than some limitations of accounting policies to be chosen rather than complete guidance for choosing accounting policies.

IAS 8 states the following:

10. In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:
 - (a) relevant to the economic decision-making needs of users;
and
 - (b) reliable, in that the financial statements:

- (i) represent faithfully the financial position, financial performance and cash flows of the entity;
 - (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
 - (iii) are neutral, i.e., free from bias;
 - (iv) are prudent; and
 - (v) are complete in all material respects.
11. In making the judgment described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:
- (a) the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and
 - (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.
12. In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.

IFRS 4.13 states the following: “Paragraphs 10–12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. However, this IFRS exempts an insurer from applying those criteria to its accounting policies for: (a) insurance contracts that it issues (including related acquisition costs and related intangible assets, such as those described in paragraphs 31 and 32); and (b) reinsurance contracts that it holds.”

As a consequence, there is no further guidance in IFRSs regarding developing accounting policies for new issues in case of insurance contracts and other contracts within the scope of IFRS 4. Considering the distinguishing of accounting policies in principles, bases, conventions, rules, and practices, one possibility is that the preparer of the financial statement makes the decision, if applying pronouncements of another standard-setting body as bases for accounting policies of insurance contracts, to use as well pronouncements of that standard-setting body as the basis for developing accounting policies for the new issues if available. In other cases, especially when entities prepare and present financial statements at the first time, one possibility for the choice of accounting policies might be pronouncements of a standard-setting body used by subsidiaries of the entity or by other entities in the jurisdiction of the reporting entity. A possible criterion is to choose those accounting policies that would have been applicable if the entity had started preparing and presenting financial statements before first-time IFRSs were applicable in that jurisdiction. However, considering the guidance in IAS 8.10–12 can improve the quality of the financial statement.

5. Retrospective application of changes in accounting policies

IAS 8.22 describes special treatment of a retrospective application: “Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.”

IAS 8 provides the following guidance regarding limitations on retrospective application, especially as a consequence of impracticality:

23. When retrospective application is required by paragraph 19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period specific effects or the cumulative effect of the change.
24. When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
25. When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.
26. When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with a Standard or an Interpretation). Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.
27. When it is impracticable for an entity to apply a new accounting policy retrospectively, because it cannot determine the cumulative effect of applying the policy to all prior periods, the entity, in accordance with paragraph 25, applies the new policy prospectively from the start of the earliest period practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that

date. Changing an accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period. Paragraphs 50–53 provide guidance on when it is impracticable to apply a new accounting policy to one or more prior periods.

28. When initial application of a Standard or an Interpretation has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- (a) the title of the Standard or Interpretation;
- (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
- (c) the nature of the change in accounting policy;
- (d) when applicable, a description of the transitional provisions;
- (e) when applicable, the transitional provisions that might have an effect on future periods;
- (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
 - (i) for each financial statement line item affected; and
 - (ii) if IAS 33 Earnings per Share applies to the entity, for basic and diluted earnings per share;
- (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- (h) if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

29. When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- (a) the nature of the change in accounting policy;
- (b) the reasons why applying the new accounting policy provides reliable and more relevant information;
- (c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
 - (i) for each financial statement line item affected; and

- (ii) if IAS 33 applies to the entity, for basic and diluted earnings per share;
- (d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- (e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

IAS 8.5 defines “impracticable” as follows:

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- (a) the effects of the retrospective application or retrospective restatement are not determinable;
- (b) the retrospective application or retrospective restatement requires assumptions about what management’s intent would have been in that period; or
- (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
 - (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
 - (ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

IAS 8.50 outlines: “In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period. ...” Experience shows that the retrospective restatement provision is often a significant burden in the case of estimates of long-duration liabilities, as often found in insurance business. For contracts, the liabilities and assets have to be determined as if the accounting policy had been applied from the outset, which is often difficult in cases of accounting policies using historical assumptions for measurement.

IAS 8.51 outlines in this regard: “It is frequently necessary to make estimates in applying an accounting policy to elements of financial statements recognised or disclosed in respect of

transactions, other events or conditions. Estimation is inherently subjective, and estimates may be developed after the balance sheet date. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred. However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred.”

Sometimes, data required for such a measurement were not collected or filed in the past and are therefore not available. IAS 8.50 refers to that issue: “... For example, data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (including, for the purpose of paragraphs 51–53, its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.” If data required for retrospective restatement are actually not available and cannot be reasonably estimated, that is a typical case for impracticality of retrospective application. In some cases, the preparer of the financial statement will allow simplifications, shortcuts, or generalisations of retrospective application as a consequence of impracticality.

Further provisions are provided in IAS 8.52–53:

52. Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that

- (a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and
- (b) would have been available when the financial statements for that prior period were authorised for issue from other information. For some types of estimates (e.g. an estimate of fair value not based on an observable price or observable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

53. Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management’s intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in measuring financial assets previously classified as held-to-maturity investments in accordance with IAS 39 Financial Instruments: Recognition and Measurement, it does not change their basis of measurement for that period if management decided later not to hold them to maturity. In addition, when an entity corrects a prior period error in calculating its liability for employees’ accumulated sick leave in accordance with IAS 19 Employee

Benefits, it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

6. Application of principles of IAS 8 in the case of IFRS 4.27–29

The following is a discussion of some issues associated with possible changes in accounting policies as contemplated by IFRS 4.27–29, with respect to relevance and reliability, the two key criteria for evaluating a possible change in accounting policies.

IFRS 4.22 requires:

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8.

To explain that rule, the following example in IFRS 4.28 is given:

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.

Further, IFRS 4, BC134, states:

In the Board's view, the cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability).

The following discusses the issues referred to above for the different features mentioned.

Features before change

1. Excessively prudent assumptions:

- **Relevance:** The use of certain assumptions of an excessively prudent nature results in a financial statement that is not relevant and is potentially misleading.
- **Reliability:** Such assumptions are neither neutral (i.e., they are significantly biased), nor consistent with the IASB *Framework* requirement of prudence, resulting in an overstatement.

2. Assumptions set at inception:

- **Relevance:** The choice of assumptions set at outset cannot generally be seen as irrelevant in the sense of IAS 8, since IAS 39 also allows the use of assumptions set at outset if they are then considered to be reasonable and if the entity expects to hold the contract until completion or if the voluntary settlement of all rights and obligations occurs. In many cases, such information can be useful. However, a change to the initial assumptions when current assumptions have been used would likely to be determined to be less relevant. This would be particularly important if circumstances have changed significantly since outset.
- **Reliability:** As before, some believe that continuing to use the same assumptions as those at outset can be reliable in the sense of IAS 8.

3. Discount rate prescribed by a regulator without direct reference to market conditions:

- **Relevance:** The view of regulators can be different from other users. They might have significantly different objectives than investors, possibly focusing on the claims payment ability of the entity, considering that investors cannot be legally forced to provide more capital, and as a result requiring that capital be sufficient to cover obligations under certain adverse circumstances. In some cases regulators might allow discount rates, which do not currently appear prudent to justify low prices to the consumer, which may not be relevant to other users. Although the outcome might be relevant, the approach does not ensure that.
- **Reliability:** Such discount rates may neither be neutral nor prudent; rather they need to be judged on a facts-and-circumstance basis.

Considering the limitations to relevance and reliability that might affect the financial statement of a reporting entity, changing its accounting policy can contribute to a significant enhancement of overall value to its user. By describing the general principles under which certain changes to accounting policy would be permitted, the IASB has shown that practitioners should look to the overall effect of such changes, rather than just to the individual characteristics of the methods and assumptions that are changed.

Comprehensive basis of accounting

The use of a comprehensive basis of accounting can make it undesirable to change or omit a specific feature of that basis, particularly if it is an integral part of the basis of accounting (for example, see IFRS 4, BC116). Such a change might require further consequential changes, resulting in a piecemeal approach to change, which is inconsistent with one of the objectives of IFRS 4 and may prove difficult to determine preferability.

- **Relevance:** The use of a comprehensive basis of accounting improves the usefulness for users in relation to their decision-making needs. Their decisions are often based on comparisons between companies. A comprehensive approach generally improves both comparability (note that although comparability is not explicitly included in relevance in IFRS 4, it is a desirable characteristic) and understanding, especially based on IAS 8.12. Users are usually better able to understand well-established and rigorously developed comprehensive approaches.
- **Reliability:** Neutrality is usually improved, since cherry-picking of accounting policies is not possible within a comprehensive system. In addition, completeness is improved, since the controls inherent in having a comprehensive approach usually makes it easier to identify omissions.

Investor-oriented basis of accounting

- **Relevance:** Investor-orientation is referred to in IAS 8.12 and in the conceptual framework used as the basis of accounting. An investor orientation provides the principal intended users, investors (other users might be served as well, but for the purpose of IFRSs, the needs of investors are generally viewed as providing a benchmark for the common needs of all users), with useful information for its decision-making process.
- **Reliability:** Investor-orientation should include as a primary consideration the emphasis of substance over form that should in many cases enhance the relevance of a financial statement. Neutrality, prudence, and completeness also form the basis for improved investor-orientation.

Widely used basis of accounting

Only a few insurance measurement approaches, including U.S. GAAP and embedded value approaches, are widely used today, with the latter lacking a standardised and comprehensive basis and consistent application. Although some national approaches, such as in Canada, Australia, or South Africa, might comply with the majority of desirable characteristics, they lack widespread use. Local comparability is not a sound basis for introducing a practice that is otherwise not allowed. Local consistency in approach is not an objective of IFRSs.

- **Relevance:** A widely used, standardised, and tested basis of accounting is generally considered to be desirable, although the resulting comparability does not necessarily constitute a characteristic of relevance indicated explicitly in IFRS 4.
- **Reliability:** Not necessarily an improvement.

Use of current estimates and assumptions

IFRS 4 does not explicitly state that current estimates and assumptions as of a reporting date are preferable to those at issue.

- **Relevance:** Estimates and assumptions made as of the reporting date are more useful for the decision-making needs of users, although in many cases insurer actions (e.g., insured selection and pricing) that affect the extent of the obligation are taken at the time the contract is issued. As IAS 39 permits the use of the same discount rate at issue, it may be deemed to remain relevant to continue the use of the original discount rate, even if economic conditions have changed.

- **Reliability:** Such estimates and assumptions can increase neutrality, which cannot be biased by the use of non-current or potentially out-of-date assumptions in current decision-making and are prudent since current assumptions are used.

Adjustment to reflect risk and uncertainty

- **Relevance:** The adjustment is needed to be relevant to the decision-making needs of many users, as they tend to be risk-averse and require the inclusion of a compensation for taking on risk.
- **Reliability:** Such adjustments are necessary features of prudence and neutrality.

Reflection of intrinsic and time value of embedded options and guarantees

- **Relevance:** Such information is highly relevant, since the effect of risks arising from policyholders' behaviour or from changes in market factors or insurance risk should be considered and all significant expected cash flows should be considered. This is particularly relevant since the effect of deviations from expected value normally has an asymmetric effect. Emerging experience subsequent to issue related to policyholders' behaviour or from changes in market factors or insurance risk might result in their value becoming significant.
- **Reliability:** Faithful representation is achieved. It can reasonably be expected that all sources of expected future cash flows should be considered. Considering the impact of policyholders' behaviour, market factors or changes in insurance risk represents faithful representation of current expectations. The result is unbiased, i.e., neutral. The result is also prudent and complete, as all significant information is reflected, and usually results in an adverse effect on cash flows from the insurer's perspective.

Current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets

- **Relevance:** Discount rates determined based on current interest rates as available for recently issued instruments of similar duration, at least as current as at outset that include margins for risk and uncertainty or as current as at each reporting date based on expected yields, best serve the informational needs of investors.
- **Reliability:** Such rates are prudent and neutral.

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 8 (2004 March) Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 18 (2004 March) Revenue
- IAS 21 (2003 December) The Effects of Changes in Foreign Exchange Rates
- IAS 32 (2003 December) Financial Instruments: Disclosure and Presentation
- IAS 33 (2003 December) Earnings per Share
- IAS 36 (2004 March) Impairment of Assets
- IAS 37 (1999 July) Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 (2004 March) Intangible Assets
- IAS 39 (2004 March) Financial Instruments: Recognition and Measurement
- IFRS 1 (2003 December) First-Time Adoption of International Financial Reporting Standards
- IFRS 3 (2004 March) Business Combinations
- IFRS 4 (2004 March) Insurance Contracts

In addition, the IASB *Framework* is relevant.

Appendix C – List of terms defined in the 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.

Accounting policy
Acquisition cost
Actuary
Constructive obligation
Contract
Current estimate
Discretionary participation feature
Fair value
Financial instrument
Financial statements
Guaranteed element
Guarantees
Insurance asset
Insurance contract
Insurance liability
Insurer
International Accounting Standard (IAS)
International Accounting Standards Board (IASB)
International Actuarial Association (IAA)
International Actuarial Standard of Practice (IASP)
International Financial Reporting Standards (IFRSs)
Issuer
Investment contract
Legal obligation
Liability adequacy testing
Margin for risk and uncertainty
Option
Practice Guideline (PG)
Practitioner
Professional services
Reporting entity