UNIT 2:
INDIAN ACCOUNTING STANDARD 104 : INSURANCE CONTRACTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of insurance contract
- Understand the scenarios where insurance contract may not get covered under Ind AS 104
- Understand the distinction between insurance and investment contracts
- Understand the accounting treatment of embedded derivatives contained in insurance contracts
- Learn the presentation and disclosure requirements
Objective and Scope
- Embedded derivatives
- Unbundling of deposit components

Recognition and measurement
- Temporary exemption from some other IFRSs
- Temporary exemption from IFRS 9
- Changes in accounting policies
- Insurance contracts acquired in a business combination or portfolio transfer
- Discretionary participation features

Disclosure
- Explanation of recognised amounts
- Nature and extent of risks arising from insurance contracts
2.1 OBJECTIVE

Ind AS 104 is an interim standard until the second phase of the project on insurance contracts is completed. The objective of Ind AS 104 is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this Ind AS as an insurer).

In particular, Ind AS 104 prescribes:

(a) limited improvements to accounting by insurers for insurance contracts; and

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

(c) Ind AS 104 is not restricted to insurance companies but applies to all issuers of insurance contracts. This chapter does not deal with the specialized accounting that is required by regulatory insurance companies or other companies for their insurance contracts. This chapter deals with how Ind AS 104 may impact other entities that issue contracts which meet the definition of insurance contracts.

2.2 SCOPE

Ind AS 104 is applicable to:

(a) insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that it holds; and

(b) financial instruments that an entity issues with a discretionary participation feature.

Note: Ind AS 107 on ‘Financial Instruments: Disclosures’ requires disclosure about such financial instruments.

Ind AS 104 is not applicable to the following:

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<tr>
<th>S. No.</th>
<th>Particulars</th>
<th>Applicable Ind AS</th>
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<tr>
<td>1.</td>
<td>Accounting for financial assets held by insurers and financial liabilities issued by insurers.</td>
<td>Ind AS 32, Ind AS 109 and Ind AS 107</td>
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<td>2.</td>
<td>Product warranties issued directly by a manufacturer, dealer or retailer.</td>
<td>Ind AS 18 and Ind AS 37</td>
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<td>3.</td>
<td>Employers’ assets and liabilities under employee benefit plans.</td>
<td>Ind AS 19 and Ind AS 102</td>
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<td>4.</td>
<td>Retirement benefit obligations reported by defined benefit retirement plans.</td>
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<td>5.</td>
<td>Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (e.g., some licence fees, royalties, contingent lease payments and similar items), as well as a lessee’s residual value guarantee embedded in a finance lease.</td>
<td>Ind AS 17, Ind AS 18 and Ind AS 38</td>
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<td>6.</td>
<td>Financial guarantee contracts <em>(refer note below).</em></td>
<td>Ind AS 109, Ind AS 32 and Ind AS 107</td>
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<td>7.</td>
<td>Contingent consideration payable or receivable in a business combination</td>
<td>Ind AS 103</td>
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<tr>
<td>8.</td>
<td>Direct insurance contracts that the entity holds (i.e., where the entity is the policyholder). However, a cedant shall apply this Standard to reinsurance contracts that it holds</td>
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**Note:** Where the issuer has previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts, in that case the issuer may elect to apply to such financial guarantee contracts either:

(a) Ind AS 109, Ind AS 32 and Ind AS 107; or

(b) Ind AS 104.

The issuer may make that election contract by contract, but the election for each contract is irrevocable.

**Points to be noted:**

(a) As per Ind AS 104, any entity that issues an insurance contract is an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

(b) A reinsurance contract is a type of insurance contract. Accordingly, all references in this Ind AS 104 to insurance contracts should also apply to reinsurance contracts.
## 2.3 DEFINITIONS

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<thead>
<tr>
<th>S. No.</th>
<th>Term</th>
<th>Definition</th>
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<tr>
<td>1.</td>
<td>Cedant</td>
<td>The policyholder under a reinsurance contract.</td>
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<td>2.</td>
<td>Deposit component</td>
<td>A contractual component that is not accounted for as a derivative under Ind AS 109 and would be within the scope of Ind AS 109 if it were a separate instrument.</td>
</tr>
<tr>
<td>3.</td>
<td>Direct insurance contract</td>
<td>An insurance contract that is not a reinsurance contract.</td>
</tr>
</tbody>
</table>
| 4.    | Discretionary participation feature | A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:  

(a) that are likely to be a significant portion of the total contractual benefits;  
(b) whose amount or timing is contractually at the discretion of the issuer; and  
(c) that are contractually based on:  

(i) the performance of a specified pool of contracts or a specified type of contract;  
(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or  
(iii) the profit or loss of the company, fund or other entity that issues the contract. |
<p>| 5.    | Fair value                    | The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between knowledgeable willing parties in an arm’s length transaction. |
| 6.    | Financial guarantee contract  | A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. |
| 7.    | Financial risk                | The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit |</p>
<table>
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<tr>
<th></th>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>8</td>
<td><strong>Guaranteed benefits</strong></td>
<td>Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.</td>
</tr>
<tr>
<td>9</td>
<td><strong>Guaranteed element</strong></td>
<td>An obligation to pay guaranteed benefits, included in a contract that contains a discretionary participation feature.</td>
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<tr>
<td>10</td>
<td><strong>Insurance asset</strong></td>
<td>An insurer’s net contractual rights under an insurance contract.</td>
</tr>
<tr>
<td>11</td>
<td><strong>Insurance contract</strong></td>
<td>A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.</td>
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<td>12</td>
<td><strong>Insurance liability</strong></td>
<td>An insurer’s net contractual obligations under an insurance contract.</td>
</tr>
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<td>13</td>
<td><strong>Insurance risk</strong></td>
<td>Risk, other than financial risk, transferred from the holder of a contract to the issuer.</td>
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<tr>
<td>14</td>
<td><strong>Insured event</strong></td>
<td>An uncertain future event that is covered by an insurance contract and creates insurance risk.</td>
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<tr>
<td>15</td>
<td><strong>Insurer</strong></td>
<td>The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.</td>
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<tr>
<td>16</td>
<td><strong>Liability adequacy test</strong></td>
<td>An assessment of whether the carrying amount of an insurance liability needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased) based on a review of future cash flows.</td>
</tr>
<tr>
<td>17</td>
<td><strong>Policyholder</strong></td>
<td>A party that has a right to compensation under an insurance contract if an insured event occurs.</td>
</tr>
<tr>
<td>18</td>
<td><strong>Reinsurance assets</strong></td>
<td>A cedant’s net contractual rights under a reinsurance contract.</td>
</tr>
</tbody>
</table>
19. **Reinsurance contract**
   An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

20. **Reinsurer**
   The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.

21. **Unbundle**
   Account for the components of a contract as if they were separate contracts.

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### 2.4 DEFINITION OF AN INSURANCE CONTRACT

1. **Insurance contract** is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

2. **Uncertain Future Event**: Uncertainty (or risk) is the essence of an insurance contract. Accordingly, **at least one** of the following is uncertain at the inception of an insurance contract:
   - (a) whether an insured event will occur;
   - (b) when it will occur; or
   - (c) how much the insurer will need to pay if it occurs.

3. **Insurance contracts** may also cover the following type of insured events:
   - (a) the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract.
   - (b) the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.
   - (c) the insured events that have already occurred, but whose financial effect is still uncertain, e.g., a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders, where the insured event is the discovery of the ultimate cost of those claims.

4. **Payments in Kind**: Some insurance contracts require or permit payments to be made in kind.
Examples

(a) an insurance contract where the insurer replaces a stolen article directly, instead of reimbursing the policyholder.

(b) an insurance contract where an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.

5. Some fixed-fee service contracts in which the level of service depends on an uncertain event may meet the definition of an insurance contract under Ind AS 104.

Examples:

(a) a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash).

(b) a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage. The contract may meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts.

6. Insurance Risks

The following are insurance risks:

(a) the risk of changes in the fair value of a non-financial asset if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (a non-financial variable)

Example:

If a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car’s physical condition, that risk is an insurance risk, and not a financial risk.

(b) a pre-existing risk transferred from the policyholder to the insurer

The following are not insurance risks:

(a) A new risk created by the contract.

(b) Lapse or persistency risk (i.e., the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk.
because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty.

(c) Expense risk (i.e., the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

Exception:

If the issuer of a contract that exposes the issuer to lapse risk, persistency risk or expense risk mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.

7. Significant Insurance Risks

- A contract is an insurance contract only if it transfers significant insurance risk.
- The risk must be of insurance.
- Insurance risk is defined as any risk other than financial risk.
- Financial risk is the risk of a possible future change in one or more of a specified future interest rate, financial instrument price, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
- Some contracts expose the issuer to financial risk, in addition to significant insurance risk, e.g., many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder’s account balance (creating insurance risk in the form of mortality risk). Such contracts are also insurance contracts.
- Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided the payment that is contingent on the insured event can be significant, e.g., a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it need not be separated and measured at fair value.
- An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual insurer accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual insurer has still accepted the risk that is the essence of an insurance contract.
8. **Assessment of Whether Insurance Risk is Significant:** Ind AS 104 does not set a numerical range for the level of insurance risk to be 'significant'. Instead it describes insurance risk as significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario (even the scenario with a low probability), excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction).

The following are insurance contracts with significant insurance risk:

(a) if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant.

(b) An annuity contract that pays out regular sums for the rest of a policyholder’s life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

(c) a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money, e.g., whole life insurance for a fixed amount (in other words, insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

The additional benefits refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance).

Additional benefits include:

(a) claims handling costs; and

(b) claims assessment costs.

Additional benefits exclude:

(a) the loss of the ability to charge the policyholder for future services.

(b) waiver on death of charges that would be made on cancellation or surrender.

(c) a payment conditional on an event that does not cause a significant loss to the holder of the contract.

**Example:**

In an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk.
Example:

There is a contract that requires the issuer to pay one million rupees if an asset suffers physical damage causing an insignificant economic loss of one rupee to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing one rupee. At the same time, the contract creates non-insurance risk that the issuer will need to pay 999,999 rupees if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.

(d) possible reinsurance recoveries.

An insurer should assess the significance of insurance risk contract by contract rather than by reference to the materiality to the financial statements.

Exception:

(a) Contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

(b) If a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.

Note 1: If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component.

Note 2: The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

9. Adverse Effect on the Policy Holder: The definition of an insurance contract refers to “an adverse effect on the policyholder”. The definition does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event.

Example:

Insurance contract includes ‘new-for-old’ coverage that pays the policyholder sufficient to permit replacement of a damaged old asset by a new asset.

10. Examples of insurance contracts as per Ind AS 104

(a) Insurance against theft or damage to property.

(b) Insurance against product liability, professional liability, civil liability or legal expenses.

(c) Life insurance (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).
(d) Life-contingent annuities and pensions (i.e., contracts that provide compensation for the uncertain future event: the survival of the annuitant or pensioner to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) Disability and medical cover.

(f) Surety bonds, fidelity bonds, performance bonds and bid bonds (i.e., contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).

(g) Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer. However, product warranties issued directly by a manufacturer, dealer or retailer are outside scope of Ind AS 104.

(h) Title insurance (i.e., insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(i) Travel assistance (i.e., compensation in cash or in kind to policyholders for losses suffered while they are travelling).

(j) Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).

(k) Insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.

(l) Reinsurance contracts

11. Examples of contracts that are not insurance contracts as per Ind AS 104

(a) Investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, e.g., life insurance contracts in which the insurer bears no significant mortality risk.

(b) Contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, e.g., some financial reinsurance contracts or some group contracts.

(c) Self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party).
(d) Contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder.

(e) Derivatives that expose one party to financial risk but not insurance risk i.e. they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price etc. provided in the case of a non-financial variable that the variable in not specific to a party to the contract.

(f) A credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due.

(g) Contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).

(h) Catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

Illustration 1

Determine whether the following are insurance contracts as per Ind AS 104:

(a) A unit-linked contract that pays benefits linked to the fair value of a pool of assets. The benefit is 100% of the unit value on surrender or maturity and 101% of the unit value on death.

(b) Pure endowment, i.e., the insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then.

(c) Deferred annuity, i.e., policyholder will receive, or can elect to receive, a life-contingent annuity at rates guaranteed at inception.

(d) Deferred annuity, i.e., policyholder will receive, or can elect to receive, a life-contingent annuity at rates prevailing when the annuity begins.

(e) Guarantee fund established by contract where the contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (or even others).

(f) Guarantee fund established by law.

(g) Product warranties, issued directly by a manufacturer, dealer or retailer.

(h) Group insurance contract that gives the insurer an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money.
(i) Catastrophe bond, i.e., bond in which principal, interest payments or both are reduced significantly if a specified triggering event occurs and the triggering event includes a condition that the issuer of the bond suffered a loss.

(j) An insurance contract issued to employees as a result of a defined contribution pension plan. The contractual benefits for employee service in the current and prior periods are not contingent on future service. The insurer also issues similar contracts on the same terms to third parties.

(k) Loan contract containing a prepayment fee that is waived if prepayment results from the borrower’s death.

(l) Loan contract that waives repayment of the entire loan balance if the borrower dies.

(m) A contract permits the issuer to deduct an MVA (market value adjustment) from surrender values or maturity payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death benefits.

(n) A contract permits the issuer to deduct an MVA from surrender payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.

(o) An insurance contract is issued by one entity (i.e., a captive insurer) to another entity in the same group.

(p) An agreement that entity A will compensate entity B for losses on one or more contracts issued by entity B that do not transfer significant insurance risk.

Solution

(a) This contract contains a deposit component (100% of unit value) and an insurance component (additional death benefit of 1%).

(b) It is an insurance contract unless the transfer of insurance risk is insignificant.

(c) It is an insurance contract unless the transfer of insurance risk is insignificant. The contract transfers mortality risk to the insurer at inception, because the insurer might have to pay significant additional benefits for an individual contract if the annuitant elects to take the life contingent annuity and survives longer than expected (unless the contingent amount is insignificant in all scenarios that have commercial substance).

(d) It is not an insurance contract at inception, if the insurer can re-price the mortality risk without constraints.

(e) The contract that establishes the guarantee fund is an insurance contract.

(f) It is not an insurance contract because the commitment to contribute to the fund is not established by any contract.
(g) Although they are insurance contracts, but excluded from the scope of Ind AS 104 as they are covered under Ind AS 18 and Ind AS 37.

(h) It is not an insurance contract because the insurance risk is insignificant.

(i) The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component.

(j) It is an insurance contract. However, if the employer pays part or all of the employee’s premiums, the payment by the employer is an employee benefit.

(k) It is not an insurance contract because it does not transfer a pre-existing risk from the borrower.

(l) This contract contains a deposit component (the loan) and an insurance component (waiver of the loan balance on death, equivalent to a cash death benefit).

(m) The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that benefit is significant, the contract is an insurance contract.

(n) The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money. The contract is an investment contract.

(o) In individual or separate financial statements of entities: It is an insurance contract.

In the consolidated financial statement of the entity: The transaction gets eliminated.

(p) The contract is an insurance contract if it transfers significant insurance risk from entity B to entity A, even if some or all of the individual contracts do not transfer significant insurance risk to entity B.

2.5 EMBEDDED DERIVATIVES

Insurance contracts can contain embedded derivatives.

Ind AS 109 applies to embedded derivatives contained in insurance contracts, unless the embedded derivative is itself an insurance contract. Ind AS 109 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss.

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract, with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate,
index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

<table>
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<tr>
<th>Basis</th>
<th>Covered under Ind AS 109</th>
<th>Covered under Ind AS 104</th>
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<tr>
<td>Basic principle</td>
<td>Derivatives embedded in an insurance contract.</td>
<td>Embedded derivative is itself an insurance contract.</td>
</tr>
<tr>
<td>Accounting Treatment</td>
<td>Ind AS 109 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss.</td>
<td>There is no requirement of separation and measurement at fair value. It will be accounted for as an insurance contract only under Ind AS 104.</td>
</tr>
<tr>
<td>Examples</td>
<td>A put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract.</td>
<td>A policyholder’s option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability.</td>
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The holder’s ability to exercise a put option or cash surrender option is triggered by a change in such a variable (e.g., a put option that can be exercised if a stock market index reaches a specified level).

Illustration 2

Determine whether the following embedded derivatives are insurance contracts as per Ind AS 104:

(a) Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.
(b) Death benefit that is greater of:
   (i) Unit value of an investment fund (equal to the amount payable on surrender or maturity); and
   (ii) Guaranteed minimum.

(c) Option to take a life-contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).

(d) Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices: guarantee relates only to payments that are life-contingent.

(e) Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices: guarantee relates only to payments that are not life-contingent.

(f) Policyholder can elect to receive life-contingent payments or payments that are not life-contingent, and the guarantee relates to both. When the policyholder makes its election, the issuer cannot adjust the pricing of the life-contingent payments to reflect the risk that the insurer assumes at that time.

(g) Embedded guarantee of minimum equity returns available to the policyholder as either:
   (i) a cash payment;
   (ii) a period-certain annuity; or
   (iii) a life-contingent annuity, at annuity rates prevailing at the date of annuitisation.

(h) Embedded guarantee of minimum equity returns available to the policyholder as either:
   (i) a cash payment;
   (ii) a period-certain annuity; or
   (iii) a life-contingent annuity, at annuity rates set at inception.

(i) Contractual feature that provides a return contractually linked (with no discretion) to the return on specified assets.

(j) Persistency bonus paid at maturity in cash (or as a period-certain annuity).

(k) Persistency bonus paid at maturity as an enhanced life-contingent annuity.

(l) Dual trigger contract, e.g., contract requiring a payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events occur.
Solution

(a) The equity-index feature is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs.

(b) Excess of guaranteed minimum over unit value is a death benefit. This meets the definition of an insurance contract (unless the life-contingent payments are insignificant).

(c) The embedded option is an insurance contract (unless the life-contingent payments are insignificant).

(d) The embedded guarantee is an insurance contract.

(e) The embedded derivative is not an insurance contract.

(f) The embedded option to benefit from a guarantee of life-contingent payments is an insurance contract (unless the life-contingent payments are insignificant). The embedded option to receive payments that are not life-contingent (‘the second option’) is not an insurance contract.

(g) If the guaranteed payments are not contingent to a significant extent on survival, the option to take the life-contingent annuity does not transfer insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract. If the guaranteed payments are contingent to a significant extent on survival, the guarantee is an insurance contract.

(h) The whole contract is an insurance contract from inception (unless the life-contingent payments are insignificant). The option to take the life-contingent annuity is an embedded insurance contract.

(i) The embedded derivative is not an insurance contract.

(j) The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk.

(k) The embedded derivative is an insurance contract (unless the life-contingent payments are insignificant).

(l) The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance).

2.6 UNBUNDLING OF DEPOSIT COMPONENTS

Some insurance contracts contain both an insurance component and a deposit component. In some cases, an insurer is required or permitted to unbundle those components.
Unbundling is required if both the following conditions are met:

(a) the insurer can measure the deposit component (including any embedded surrender options) separately (i.e., without considering the insurance component).

(b) the insurer’s accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.

Unbundling is permitted, but not required, if the insurer can measure the deposit component separately but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.

Unbundling is prohibited if an insurer cannot measure the deposit component separately.

Accounting treatment after unbundling

<table>
<thead>
<tr>
<th>Condition</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance component</td>
<td>Apply Ind AS 104</td>
</tr>
<tr>
<td>Deposit component</td>
<td>Apply Ind AS 109</td>
</tr>
</tbody>
</table>

Does contract contain significant insurance risk?

- Yes
  - Does contract need to be unbundled?
    - Yes
      - Insurance component
        - Insurance contract (Ind AS 104)
    - No
      - Deposit component
        - Investment contract (Ind AS 109)

- No
  - Does contract contain any discretionary participation features?
    - Yes
      - Investment contract with discretionary participation features (Ind AS 104)
    - No
Example:
A cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant’s accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required.

Illustration 3
A reinsurance contract has the following features:

(a) The cedant pays premiums of ₹10 at the beginning of every year for five years.

(b) An experience account is established, equal to 90% of cumulative premiums (including the additional premiums discussed in (c) below) less 90% of cumulative claims.

(c) If the balance in the experience account is negative (i.e., cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.

(d) At the end of the contract, if the experience account balance is positive (i.e., cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.

(e) Neither party can cancel the contract before maturity.

(f) The maximum loss that the reinsurer is required to pay in any period is ₹200.

Assuming an appropriate discount rate @ 10%, prescribe the necessary accounting treatment in the books of reinsurer as per Ind AS 104 in the following two cases:

(i) No claims during 5 years.

(ii) Claim of ₹150 in year 1.

Also find out the following:

(a) Present value at year 1 of incremental cash flows because of claim in year 1 under case (ii) above.

(b) Changes in loan balance (assuming loan in case (i) and loan in case (ii) meets the criteria for offsetting in Ind AS 32).

Solution
(Note -All calculations done to nearest rupee)

Case I: No claims during 5 years
If there are no claims, the cedant will receive ₹45 in year 5 (90% of the cumulative premiums of ₹50). In substance, the cedant has given a loan, which the reinsurer will repay in
one instalment of ₹ 45 in year 5. If the reinsurer’s accounting policies require it to recognise its contractual liability to repay the loan to the cedant, unbundling is permitted but not required. However, if the reinsurer’s accounting policies would not require it to recognise the liability to repay the loan, the reinsurer is required to unbundle the contract.

**When the reinsurer is required, or elects, to unbundle the contract**

Each payment by the cedant has two components:

(a) a loan advance (deposit component); and

(b) a payment for insurance cover (insurance component).

Applying Ind AS 109 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component.

Assuming an appropriate discount rate is 10% and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of ₹ 10 by the cedant is then made up of a loan advance of ₹ 6.70 and an insurance premium of ₹ 3.30. The reinsurer accounts for the insurance component in the same way that it accounts for a separate insurance contract with an annual premium of ₹ 3.30.

The movements in the loan are as below:

<table>
<thead>
<tr>
<th>Year end</th>
<th>Opening Balance</th>
<th>Interest @ 10% p.a.</th>
<th>Advance (repayment)</th>
<th>Closing balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a)</td>
<td>(b) = (a) x 10%</td>
<td>(c)</td>
<td>(d) = (a) + (b) + (c)</td>
</tr>
<tr>
<td>0</td>
<td>-</td>
<td>-</td>
<td>6.70</td>
<td>6.70</td>
</tr>
<tr>
<td>1</td>
<td>6.70</td>
<td>0.67</td>
<td>6.70</td>
<td>14.07</td>
</tr>
<tr>
<td>2</td>
<td>14.07</td>
<td>1.41</td>
<td>6.70</td>
<td>22.18</td>
</tr>
<tr>
<td>3</td>
<td>22.18</td>
<td>2.22</td>
<td>6.70</td>
<td>31.10</td>
</tr>
<tr>
<td>4</td>
<td>31.09</td>
<td>3.10</td>
<td>6.70</td>
<td>40.90</td>
</tr>
<tr>
<td>5</td>
<td>40.90</td>
<td>4.10</td>
<td>(45.00)</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>114.94</td>
<td>(11.50)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Case II: Claim of ₹150 in year 1

The changes in the experience account and resulting additional premiums are as follows:

<table>
<thead>
<tr>
<th>Year end</th>
<th>Premium</th>
<th>Additional Premium</th>
<th>(c) = (a) + (b)</th>
<th>Total Premium</th>
<th>Cumulative Premium</th>
<th>Claims</th>
<th>Cumulative Claim less claims</th>
<th>Experience account</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>10</td>
<td>-</td>
<td>(a)</td>
<td>10</td>
<td>10</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>10</td>
<td>-</td>
<td>(b)</td>
<td>10</td>
<td>20</td>
<td>(150)</td>
<td>(150)</td>
<td>(130) (117)</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>39</td>
<td>49</td>
<td>69</td>
<td>69</td>
<td>-</td>
<td>(150)</td>
<td>(81) (73)</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
<td>36</td>
<td>46</td>
<td>115</td>
<td>-</td>
<td>(150)</td>
<td>(150)</td>
<td>(35) (31)</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>31</td>
<td>41</td>
<td>157</td>
<td>-</td>
<td>(150)</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>5</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>157</td>
<td>-</td>
<td>(150)</td>
<td>6</td>
</tr>
</tbody>
</table>

Present value of incremental cash flows because of the claim in year 1

<table>
<thead>
<tr>
<th>Year end</th>
<th>Additional Premium</th>
<th>Claims in Case I</th>
<th>Refund in Case II</th>
<th>Net incremental cash flow</th>
<th>Present value factor @ 10%</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>0</td>
<td>0 (150)</td>
<td>0</td>
<td>0 (150)</td>
<td>1.0000</td>
<td>(150)</td>
</tr>
<tr>
<td>2</td>
<td>39</td>
<td>0</td>
<td>0</td>
<td>39</td>
<td>0.9091</td>
<td>35</td>
</tr>
<tr>
<td>3</td>
<td>36</td>
<td>0</td>
<td>0</td>
<td>36</td>
<td>0.8264</td>
<td>30</td>
</tr>
<tr>
<td>4</td>
<td>31</td>
<td>0</td>
<td>0</td>
<td>31</td>
<td>0.7513</td>
<td>23</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
<td>0 (45)</td>
<td>6</td>
<td>39</td>
<td>0.6830</td>
<td>27</td>
</tr>
<tr>
<td>Total</td>
<td>106</td>
<td>(150)</td>
<td>(45)</td>
<td>(5)</td>
<td>(35)</td>
<td></td>
</tr>
</tbody>
</table>
This contract is an insurance contract because it transfers significant insurance risk to the reinsurer, e.g., in case (ii) discussed above, the reinsurer is required to pay additional benefits with a present value, in year 1, of ₹ 35, which is clearly significant in relation to the contract.

The incremental cash flows have a present value, in year 1, of ₹ 35. The cedant unbundles the contract and applies Ind AS 109 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer).

If this were not done, the cedant should have recognised ₹ 150 received in year 1 as income, and the incremental payments in years 2-5 as expenses. However, in substance, the reinsurer has paid a claim of ₹ 35 and made a loan of ₹ 115 (₹ 150 less ₹ 35) that will be repaid in instalments.

**Changes in the loan balance**

<table>
<thead>
<tr>
<th>Year end</th>
<th>Opening Balance</th>
<th>Interest @ 10%</th>
<th>Payments as per original schedule</th>
<th>Additional payments in case (ii)</th>
<th>Closing Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>₹ (a)</td>
<td>₹ (b) = (a) x 10%</td>
<td>₹ (c)</td>
<td>₹ (d)</td>
<td>₹ (e) = (a) + (b) + (c) + (d)</td>
</tr>
<tr>
<td>0</td>
<td>-</td>
<td>-</td>
<td>6</td>
<td>-</td>
<td>6</td>
</tr>
<tr>
<td>1</td>
<td>6</td>
<td>1</td>
<td>7</td>
<td>(115)</td>
<td>(101)</td>
</tr>
<tr>
<td>2</td>
<td>(101)</td>
<td>(10)</td>
<td>7</td>
<td>39</td>
<td>(65)</td>
</tr>
<tr>
<td>3</td>
<td>(65)</td>
<td>(7)</td>
<td>7</td>
<td>36</td>
<td>(29)</td>
</tr>
<tr>
<td>4</td>
<td>(29)</td>
<td>(3)</td>
<td>6</td>
<td>31</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>5</td>
<td>1</td>
<td>(45)</td>
<td>39</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>(18)</td>
<td>(12)</td>
<td>30</td>
<td></td>
</tr>
</tbody>
</table>

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2.7 RECOGNITION AND MEASUREMENT

2.7.1 Temporary exemptions from Ind AS 8

Paragraphs 10–12 of Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors, specify criteria for an entity to use in developing an accounting policy if no Ind AS applies specifically to an item.

However, Ind AS 104 exempts an insurer from applying those criteria to its accounting policies for:

(a) insurance contracts that it issues; and
(b) reinsurance contracts that it holds.

2.7.2 No exemption from Ind AS 8

Ind AS 104 does not exempt an insurer from implications of the following criteria in Ind AS 8:

(a) Insurer should not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period (such as catastrophe provisions and equalisation provisions).

(b) Insurer should carry out the liability adequacy test.

(c) Insurer should remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

(d) Insurer should not offset:
   (i) reinsurance assets against the related insurance liabilities; or
   (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

(e) Insurer should consider whether its reinsurance assets are impaired.

2.7.3 Liquidity Adequacy Test

An insurer should assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets) is inadequate in the light of the estimated future cash flows, the entire deficiency should be recognised in profit or loss.
2.7.3.1 Minimum requirements under Ind AS 104

(a) The test should consider current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

(b) If the test shows that the liability is inadequate, the entire deficiency should be recognised in profit or loss.

2.7.3.2 Minimum requirements are met

If an insurer applies a liability adequacy test that meets specified minimum requirements, Ind AS 104 does not impose any further requirements.

Note: If an insurer’s liability adequacy test meets the minimum requirements, the test is applied at the level of aggregation specified in that test.

2.7.3.3 Minimum requirements are not met

If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements, the insurer should follow the following steps:

Step I: Determine the carrying amount of the relevant insurance liabilities.

Note: The relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer’s accounting policies do not require a liability adequacy test that meets the minimum requirements.

Step II: Determine the carrying amount of:

(a) any related deferred acquisition costs.

(b) any related intangible assets.

Note: Related reinsurance assets are not considered because an insurer accounts for them separately.

Step III: Step I minus Step II.

Step IV: Determine whether the amount of the carrying amount that would be required if the relevant insurance liabilities were within the scope of Ind AS 37.

Step V: Compare amount in Step III and Step IV.

(a) If Step III minus Step IV is a negative amount: The insurer should recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

(b) If Step III minus Step IV is a positive amount: Ignore
Note: The above comparison should be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio.

2.7.4 Impairment of Reinsurance Assets

A reinsurance asset is impaired if, and only if:

(a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

(b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

If a cedant’s reinsurance asset is impaired, the cedant should reduce its carrying amount accordingly and recognise that impairment loss in profit or loss.

2.7.5 Changes in Accounting Policies

Change in accounting policies refers to:

(a) changes made by an insurer that already applies Ind ASs; and

(b) changes made by an insurer adopting Ind ASs for the first time.

2.7.5.1 Conditions for change in accounting policies

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements:

(a) more relevant and no less reliable; or

(b) more reliable and no less relevant.

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 Ind AS 8.

Note: An insurer should judge relevance and reliability by the criteria in Ind AS 8. To justify changing its accounting policies for insurance contracts, an insurer should show that the change brings its financial statements closer to meeting the criteria in Ind AS 8, but the change need not achieve full compliance with those criteria. The following specific issues are discussed below:

(a) current interest rates;

(b) continuation of existing practices;

(c) prudence;

(d) future investment margins; and

(e) shadow accounting.
2.7.5.2 Current market interest rates

1. **Change in existing accounting policy permitted**: An insurer is permitted, but not required, to change its accounting policies so that it re-measures designated insurance liabilities (including related deferred acquisition costs and related intangible assets) to reflect current market interest rates and recognises changes in those liabilities in profit or loss.

2. **Introduction of new accounting policy permitted**: At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities.

3. **Change in accounting policy for 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 Ind AS 8 would otherwise require.

4. **Consistent application**: If an insurer designates liabilities for this election, it should 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.

2.7.5.3 Continuation of existing practices

An insurer may **continue (not introduce)** the following practices:

(a) measuring insurance liabilities on an undiscounted basis;

(b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services; and

(c) using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries.

2.7.5.4 Prudence

1. **No elimination of excessive prudence**: An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence.

2. **No introduction of additional prudence**: If an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

2.7.5.5 Future Investment Margins

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, e.g., using a discount rate that reflects the estimated return on the insurer’s assets.
An insurer may overcome the rebuttable presumption 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.

Example:

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:

- current estimates and assumptions;
- a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty;
- measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and
- a current market discount rate, even if that discount rate reflects the estimated return on the insurer’s assets.

2.7.5.6 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.

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

Illustration 4

Under a jurisdiction, for an insurance contract, deferred acquisition costs (DAC) are amortised over the life of the contract as a constant proportion of estimated gross profits (EGP). EGP
includes investment returns, including realised (but not unrealised) gains and losses. At the inception of a contract, insurer A has DAC of ₹20 relating to that contract and the present value, at inception, of EGP is ₹100. In other words, DAC is 20% of EGP at inception. In 20X1, insurer A recognises unrealised gains of ₹10 on the assets backing the contract. In 20X2, insurer A sells the assets for an amount equal to their fair value at the end of 20X1. Prescribe the accounting under Ind AS 104.

Solution

Ind AS 104 permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 20X1 by an additional ₹2 (20% of ₹10) as a result of the change in the fair value of the assets. Since insurer A recognised the change in their fair value in other comprehensive income, it should recognise the additional amortisation of ₹2 in other comprehensive income. When insurer A sells the assets in 20X2, it should make no further adjustment to DAC, but should reclassify DAC amortization of ₹2, relating to the now-realised gain, from equity to profit or loss as a reclassification adjustment.

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain, except that the unrealised gain and resulting DAC amortisation are:

(a) recognised in other comprehensive income rather than in profit or loss; and

(b) reclassified from equity to profit or loss when the gain on the asset becomes realised. If insurer A does not adopt shadow accounting, unrealised gains on assets should not affect the amortisation of DAC.

2.7.6 Insurance Contracts Acquired in a Business Combination or Portfolio Transfer

2.7.6.1 Accounting as per Ind AS 103

To comply with Ind AS 103, an insurer should, at the acquisition date, measure at fair value the insurance liabilities assumed and insurance assets acquired in a business combination.

2.7.6.2 Alternative accounting as per Ind AS 104

However, an insurer is permitted, but not required, to use an expanded presentation to split the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer’s accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the difference between:

(i) the fair value of the contractual insurance rights acquired and insurance obligations assumed; and

(ii) the amount described in (a).
The subsequent measurement of this asset should be consistent with the measurement of the related insurance liability.

An insurer acquiring a portfolio of insurance contracts may also use the alternative accounting as per Ind AS 104 (as explained above).

The intangible assets described above are excluded from the scope of Ind AS 38 and Ind AS 36. However, Ind AS 38 and Ind AS 36 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination or portfolio transfer.

### 2.7.7 Discretionary Participation Features

#### 2.7.7.1 Discretionary participation features in insurance contracts

Some insurance contracts contain a discretionary participation feature as well as a guaranteed element.

**Options available to the issuer of such a contract under Ind AS 104**

(a) Do not recognise them separately.

**Classification**: Issuer should classify the whole contract as a liability.

(b) Recognise them separately.

**Classification**: Issuer should classify the guaranteed element as a liability and the discretionary participation feature as either a liability or a separate component of equity.

**Note**: The issuer of such a contract may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability should be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to non-controlling interests). The issuer should recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income.

Issuer should, if the contract contains an embedded derivative within the scope of Ind AS 109, apply Ind AS 109 to that embedded derivative.

Insurer should continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with the criteria discussed in paragraph 2.7.5 of this unit.
2.7.7.2 Discretionary participation features in financial instruments

Options available to the issuer of such a contract under Ind AS 104

(a) Do not recognise them separately.

Classification: Issuer should classify the whole contract as a liability.

(b) Recognise them separately.

Classification: Issuer should classify the guaranteed element as a liability and the discretionary participation feature as either a liability or a separate component of equity.

Classification of discretionary participation feature Requirements under Ind AS 104

<table>
<thead>
<tr>
<th>Liability component</th>
<th>Issuer should apply the liability adequacy test to the whole contract (i.e., both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying Ind AS 109 to the guaranteed element.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity component</td>
<td>Issuer should ensure that the liability recognised for the whole contract should not be less than the amount that would result from applying Ind AS 109 to the guaranteed element. (Refer Note below)</td>
</tr>
</tbody>
</table>

Note: The amount that would result from applying Ind AS 109 to the guaranteed element should include the intrinsic value of an option to surrender the contract, but need not include its time value if the option is exempted from measurement at fair value. The issuer need not disclose the amount that would result from applying Ind AS 109 to the guaranteed element, nor is required to present that amount separately. Furthermore, the issuer need not determine the amount if the total liability recognised is clearly higher.

Recognition of premiums received: Although these contracts are financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability.

Disclosure under Ind AS 107: Although these contracts are financial instruments an issuer applying Ind AS 107 to contracts with a discretionary participation feature should disclose the total interest expense recognised in profit or loss, but need not calculate such interest expense using the effective interest method.
2.8 DISCLOSURE REQUIREMENTS

2.8.1 Explanation of Recognised Amounts

An insurer should disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts.

To comply with above, an insurer should disclose:

(a) Its accounting policies for insurance contracts and related assets, liabilities, income and expense.

(b) The recognised assets, liabilities, income and expense (and, if it presents its statement of cash flows using the direct method, cash flows) arising from insurance contracts. Furthermore, if the insurer is a cedant, it should disclose:

   (i) gains and losses recognised in profit or loss on buying reinsurance; and
   (ii) if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.

(c) The process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b) above. When practicable, an insurer should also give quantified disclosure of those assumptions.

(d) The effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.

(e) Reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

2.8.2 Nature and Extent of Risks Arising from Insurance Contracts

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

To comply with above, an insurer should disclose:

(a) Its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.

(b) Information about insurance risk (both before and after risk mitigation by reinsurance), including information about:

   (i) Sensitivity to insurance risk (refer note below).
(ii) Concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (e.g., type of insured event, geographical area, or currency).

(iii) Actual claims compared with previous estimates (i.e., claims development).

The disclosure about claims development should go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year.

(c) Information about credit risk, liquidity risk and market risk if the insurance contracts were within the scope of Ind AS 107. However:

(i) An insurer need not provide the maturity analysis required by Ind AS 107 if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead. This may take the form of an analysis, by estimated timing, of the amounts recognised in the balance sheet.

(ii) If an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may use that sensitivity analysis to meet the requirement in Ind AS 107. Such an insurer should also provide the disclosures required by Ind AS 107.

(d) Information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

Note: An insurer should disclose either (a) or (b) as follows:

(a) A sensitivity analysis that shows how profit or loss and equity would have been affected if changes in the relevant risk variable that were reasonably possible at the end of the reporting period had occurred; the methods and assumptions used in preparing the sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by Ind AS 107.

(b) Qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer’s future cash flows.
SUMMARY

• Ind AS 104 is an interim standard until the second phase of the project on insurance contracts is completed. The objective of Ind AS 104 is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this Ind AS as an insurer).

• Ind AS 104 is not restricted to insurance companies but applies to all issuers of insurance contracts. This chapter does not deal with the specialized accounting that is required by regulatory insurance companies or other companies for their insurance contracts. This chapter deals with how Ind AS 104 may impact other entities that issue contracts which meet the definition of insurance contracts.

• Ind AS 104 is applicable to:
  (a) insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that it holds; and
  (b) financial instruments that an entity issues with a discretionary participation feature.

• Insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

• The standard clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.

• The standard requires an insurer to unbundle deposit components of some insurance contracts.

• The standard permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer.

• The standard exempts an insurer from applying those criteria to its accounting policies for:
  (a) insurance contracts that it issues; and
  (b) reinsurance contracts that it holds.

• An insurer should assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets is inadequate in the light of the estimated future cash flows, the entire deficiency should be recognised in profit or loss.
• Change in accounting policies refers to:
  (a) changes made by an insurer that already applies Ind ASs; and
  (b) changes made by an insurer adopting Ind ASs for the first time.

• An insurer should judge relevance and reliability by the criteria in Ind AS 8. To justify changing its accounting policies for insurance contracts, an insurer should show that the change brings its financial statements closer to meeting the criteria in Ind AS 8, but the change need not achieve full compliance with those criteria. The following specific issues have been discussed in the standard:
  (a) current interest rates;
  (b) continuation of existing practices;
  (c) prudence;
  (d) future investment margins; and
  (e) shadow accounting.

• The standard explains certain aspects of discretionary participation features contained in insurance contracts or financial instruments.

• An insurer should disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts.

To comply with above, an insurer should disclose:
  (a) Its accounting policies for insurance contracts and related assets, liabilities, income and expense.
  (b) The recognised assets, liabilities, income and expense (and, if it presents its statement of cash flows using the direct method, cash flows) arising from insurance contracts.
  (c) The process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b) above. When practicable, an insurer should also give quantified disclosure of those assumptions.
  (d) The effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.
  (e) Reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.
TEST YOUR KNOWLEDGE

Practical Questions

1. A Ltd. is an insurer as per Ind AS 104. Its accounting policy does not require a liability adequacy test that meets the minimum requirements specified in Ind AS 104. Following information has been provided:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of insurance liabilities</td>
<td>130</td>
</tr>
<tr>
<td>Related deferred acquisition costs</td>
<td>20</td>
</tr>
<tr>
<td>Related intangible assets</td>
<td>10</td>
</tr>
<tr>
<td>Related reinsurance assets</td>
<td>15</td>
</tr>
<tr>
<td>Carrying amount that would be required if the relevant insurance liabilities were within the scope of Ind AS 37</td>
<td>120</td>
</tr>
</tbody>
</table>

Do the necessary accounting as per Ind AS 104.

2. X Ltd is a dealer selling machines. The machines require servicing after each 50,000 units are made and break down from time to time. The machines are sold by the dealer with manufacturer’s warranty of 2 years. While selling a machine, X Ltd offers to its customers an extended warranty covering repairs and maintenance of the machine for a fixed period. Under this extended contract, X Ltd would be required to perform servicing and repairs to the machines as necessary for an annual fixed fee.

Would this get covered within the scope of Ind AS 104? If no, in which case would such type of contract get covered under Ind AS 104?

3. Determine whether the following are insurance contracts as per Ind AS 104:

   (a) Death benefit that could exceed amounts payable on surrender or maturity.

   (b) Life-contingent annuity.

   (c) Investment contract that does not contain a discretionary participation feature.

   (d) A credit-related guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.

   (e) Residual value insurance or residual value guarantee. Guarantee by one party of the fair value at a future date of a non-financial asset held by a beneficiary of the insurance or guarantee.
(f) Catastrophe bond, i.e., bond in which principal, interest payments or both are reduced if a specified triggering does not include a condition that the issuer of the bond suffered a loss.

4. ABC Ltd has ownership over a portfolio of properties. It enters into a contract with XYZ Ltd outsourcing its property maintenance and repair on all of those properties for a period of 10 years for an agreed fee which remains fixed. XYZ Ltd is a company in the business of property management. The fee includes property management as well as the cost of repair work.

XYZ Ltd has complete responsibility in respect of all the repairs and maintenance required to maintain the property to an agreed standard based on the condition at the time of inception of the contract.

The contract covers normal wear and tear and some other conditions, such as dry rot and damp should they be discovered in the course of any remedial work. Any repairs that may be required due to any external events, eg. loss due to fire or storm, would continue to be covered by ABC Ltd’s property insurance arrangements with a regulated insurance company.

Would this contract get covered within the scope of Ind AS 104?

Answers to Practical Questions

1. The insurer should follow the following steps:

   **Step I:** Determine the carrying amount of the relevant insurance liabilities.
   
   **Note:** The relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer’s accounting policies do not require a liability adequacy test that meets the minimum requirements.

   **Step II:** Determine the carrying amount of:
   
   (a) any related deferred acquisition costs.
   
   (b) any related intangible assets.
   
   **Note:** Related reinsurance assets are not considered because an insurer accounts for them separately.

   **Step III:** Step I minus Step II

   **Step IV:** Determine whether the amount the carrying amount that would be required if the relevant insurance liabilities were within the scope of Ind AS 37.

   **Step V:** Compare amount in Step III and Step IV

   (a) If Step III minus Step IV is a negative amount: The insurer should
recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

(b) If Step III minus Step IV is a positive amount: Ignore

<table>
<thead>
<tr>
<th>Steps</th>
<th>Particulars</th>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step I</td>
<td>Carrying amount of the relevant insurance liabilities</td>
<td>130</td>
</tr>
<tr>
<td>Step II</td>
<td>Carrying amount of any related deferred acquisition costs and any related intangible assets</td>
<td>30</td>
</tr>
<tr>
<td>Step III</td>
<td>Step I – Step II</td>
<td>100</td>
</tr>
<tr>
<td>Step IV</td>
<td>Carrying amount that would be required if the relevant insurance liabilities were within the scope of Ind AS 37</td>
<td>120</td>
</tr>
</tbody>
</table>

(c) If Step III minus Step IV is a negative amount (i.e., ₹ 20 lakhs)

The insurer should recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

2. The contract carries significant insurance risk in respect of the number of services to be performed over the term of the contract or the nature of those services which remain uncertain. This is because the issuer of the warranty and the extended warranty would be required to compensate the customer if the machine breaks down and those additional breakdowns will adversely affect the machine’s owner. The potential number and extent of any breakdowns are unknown so the warranty and the extended warranty meet the uncertain future event criteria of the insurance contract definition.

However, in respect of product warranties issued directly by the manufacturer, retailer or a dealer, there is a specific scope exclusion as per paragraph 4(a) of Ind AS 104. These contracts are warranty contracts issued by X Ltd, the dealer, and hence get excluded from the scope of Ind AS 104.

**Coverage under Ind AS 104**

If the repairs and maintenance as mentioned in the above contract are provided by a party other than the manufacturer, retailer or dealer, (such as a company specializing in repairs/maintenance of such types of machines or a competing dealer) then this would get covered within the scope of Ind AS 104.
3. (a) Insurance contract (unless contingent is significant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the policyholder dies early.

(b) Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance).

(c) Investment contract is not an insurance contract. It is covered under Ind AS 109.

(d) Not an insurance contract. It’s a derivative within the scope of Ind AS 109.

(e) Insurance contract (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable).

However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary’s asset, the contract is a derivative and would be scoped out.

(f) The contract is not an insurance contract. It’s a financial instrument with embedded derivative.

4. There can be a significant insurance risk when either the number of services to be performed over a period or the nature of those services is not pre-determined. In the following areas, there is uncertainty:

- Whether any particular repairs will be required;
- How much any particular repair will cost; and.
- When any particular repairs will be required.

As it is uncertain whether or when any particular repair will be required and how much it may cost, there is a specified uncertain event. The significance of the insurance risk for XYZ Ltd would be assessed contract by contract under Ind AS 104.

Insurance risk may be significant, even though there may be a minimal probability of material losses for XYZ Ltd arising from all its property management contracts, because a significant loss could arise on any one contract, such as the contract with ABC Ltd. If the insurance risk is significant, this contract will be an insurance contract and Ind AS 104 will apply.