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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**20 September 2006, London**
Project:	**Insurance Contracts Phase II**
Subject:	**Insurance contracts (phase II) (Agenda Paper 12)** **Reporting changes in insurance liabilities (other than premium presentation) (Agenda Paper 12A)** **Investment contracts: comparison of IAS 39 and IAS 18 with tentative conclusions for Phase II (Agenda Paper 12B) (Agenda Paper 12C)** **[Separate observer notes cover agenda papers 12D-F and 12G-H]**

AGENDA PAPER 12 Insurance Contracts Phase II

Purpose of this paper

1. This paper provides a timetable up to the publication of the discussion paper (preliminary views), and draft chapter headings for the discussion paper.

2. Other papers for this meeting deal with:

   (a) Reporting changes in insurance liabilities (other than premium presentation) (agenda paper 12A)

   (b) Investment contracts: comparison of IAS 39 and IAS 18 with tentative conclusions for Phase II (agenda paper 12B)

   (c) Investment contracts: tabular comparison with IAS 39 and IAS 18 (agenda paper 12C)

(d) A portfolio basis for measurement? (agenda paper 12D)

(e) Unbundling: should it be prohibited? (agenda paper 12E)

(f) Policyholder participation rights (agenda paper 12F)

(g) Universal life contracts (agenda paper 12G)

(h) Universal life contracts: examples (agenda paper 12H)

(i) Education session - presentation by the [European] CFO Forum, Group of North American Insurance Enterprises (GNAIE) and four leading Japanese life insurers (agenda papers 19 cover note, 19A comparison; and 19B slides)

3. There is an updated overview of the Board's tentative conclusions to date in the project update on the public web site at http://www.iasb.org/uploaded_files/documents/16_18_ProjectUpdateInsurance.pdf

Timetable

Topic and summary of content	**Date**
First pre-ballot draft	September 2006
Sweep issues [if needed]	October 2006
Policyholder accounting: The Board confirmed in May that the Discussion Paper will not address policyholder accounting, and directed the staff to consider whether a discussion paper is needed on policyholder accounting.	October 2006
Second pre-ballot draft	October 2006
Ballot draft	November 2006
Publication	December 2006

Appendix
Discussion paper – draft chapter headings

Chapter 1 Introduction

Chapter 2 Recognition and Derecognition

Chapter 3 Measurement – core issues

Chapter 4 Renewals, customer relationships

[including acquisition costs]

Chapter 5 Measurement – other issues

Chapter 6 Participating contracts

[including unit-linked and universal life, or put these in separate chapter[s]?]

Chapter 7 Changes in insurance liabilities

Chapter 8 Other issues

[eg Investment contracts]

Appendices

Appendix A Glossary

Appendix B Draft guidance on cash flows

Appendix C Draft guidance on risk margins

Appendix D Issues not covered in this discussion paper

Appendix E Other relevant IASB projects

Appendix F Summary of the Board's preliminary views

Appendix G Summary of questions for respondents

Appendix H summary of proposals by some insurance trade association [and comparison with the Board's preliminary views]

AGENDA PAPER 12A REPORTING CHANGES IN INSURANCE LIABILITIES (OTHER THAN PREMIUM PRESENTATION)

Purpose of this paper

1. This paper asks whether an insurer should be required to present separately any specified components of the changes in the carrying amount of insurance liabilities.

2. This issue is closely related to the issue of whether an insurer should present all premiums as revenue, all premiums as deposit receipts, or some premiums as revenue and some premiums as deposit receipts. The Board decided in July that the Discussion Paper should discuss that issue, but not express a preliminary view at this stage.

Summary of recommendations

3. Insurers should be required to present separately at least the following components of the changes in the carrying amount of insurance liabilities:

   (a) Gains or losses, if any, recognised at inception of insurance contracts

   (b) Premiums, claims and expenses (when a premiums and claims approach is adopted) or the unwinding of the discount, release from risk and release of service margins (when a margin approach is adopted).

   (c) Changes in estimates and changes in discount rates and margins

   (d) Policyholder participation

4. Staff recommend that insurers should be required to present a traditional premiums and claims analysis as well as a margin analysis which explains the sources of profit.

5. As the Discussion Paper will not propose a treatment for the presentation of premiums it is not possible to propose how the premiums and claims analysis and margin analysis are to be presented. However staff believe the following should be suggested in the Discussion Paper:

   (a) If premiums are to be presented as revenue in the income statement, it would be appropriate for the income statement to present a traditional premiums and

claims analysis. The margin analysis would be presented in the notes to the financial statements; or

(b) If premiums are to be presented as deposit receipts (and hence claims as repayments), it would be appropriate for the income statement to present a margin analysis. A traditional premiums and claims analysis would then be presented in the notes to the financial statements.

Components of changes in carrying amount of insurance liabilities

6. The carrying amount of insurance liabilities can change for various reasons, including:

(a) Gains or losses, if any, recognised at the inception of new contracts. At the July 2006 meeting the Board tentatively decided that any gain is to be presented as revenue rather than as a gain;

(b) Cash flows:

(i) The receipt of previously expected cash inflows (e.g. premiums). Premiums could be seen as constituting a risk premium component and a deposit component. For a typical non-life insurance contract the deposit component could be relatively small; for many life insurance contracts the risk premium component could be relatively small. The Board is yet to determine whether either component of premiums would be recognised as income in the profit and loss. The Board is also to determine on what basis any premium would be recognised in the income statement if this were to be the approach. Would the risk premium for example be recognised over the period of the contract as the insurer is released from risk? At the July 2006 meeting the Board tentatively decided that the discussion paper should review the alternatives but not express a preliminary view;

(ii) The payment of previously expected cash outflows (e.g. claims and benefits, claims handling costs, running expenses);

(c) Expected changes:

(i) Release of previously recognised risk margins and profit margins as the insurer is released from risk and provides the services specified in the contract;

(ii) Accretion of interest to reflect the passage of time (sometimes known as 'unwinding of the discount');

(d) Changes in circumstances:

(i) Changes in discount rates;

(ii) Differences between actual cash flows and previous estimates;

(iii) Changes in estimates of cash flows;

(iv) Changes in the impact of embedded options and guarantees;

(v) Changes in margins because of changes in the quantity of risk or changes in the market price for bearing risk or providing services;

(e) Policyholder participation:

(i) Non-discretionary;

(ii) Partly or wholly discretionary; and

(f) Income or expense arising from reinsurance held (possibly split into some or all of the same categories as the income and expense from the underlying direct insurance contracts).

What are the needs of users of financial statements?

7. The Insurance Working Group has provided useful feedback on the needs of users of financial statements. They have noted that the reporting system should track the main drivers of profitability. For life insurance these are, arguably, investment performance, expenses, mortality experience, lapse rates and new business production. For non-life insurance the main drivers of profitability are, arguably, claims and expense ratios. Given the different drivers of profitability of life insurance and non-life insurance it could be argued that the performance reporting should also be different.

8. Traditionally, users of insurers' financial statements have been presented with analyses of premiums and claims. In the life insurance industry many life insurers have supplemented traditional disclosures with supplementary embedded value and sources of earnings analyses (also referred to as a margin analysis); disclosures that they believe address their users' needs more appropriately.

Approaches to presentation

9. This paper explores three different approaches to performance reporting:

   (a) Performance reporting required in Australia for life insurance contracts. The Margin on Services Model ("MoS") is used in Australian financial reporting to measure life insurance liabilities. MoS is a type of current entry model, but there is no reason why the same presentation approach couldn't be used for a current exit value model. In addition, under Australian GAAP, deposit components that can be measured separately are required to unbundled and measured as at fair value through profit and loss under IAS 39 *Financial Instruments: Recognition and Measurement*. The key components of MoS are:

      (i) the liability is measured as the net present value of expected future receipts from and payments to policyholders, including participating benefits, allowing for the possibility of discontinuance before the end of insurance contract periods, plus planned margins of revenues over expenses relating to services yet to be provided to policyholders, on the basis of assumptions that are best estimates and using a risk-free discount rate discount rate;

      (ii) planned margins of revenues over expenses for life insurance contracts are recognised in the income statement over the reporting periods during which the services, to which those margins relate, are provided to policyholders, and the revenues, relating to those services, are received; and

      (iii) the insurance components of a life insurance contract are presented as income and expense in the profit and loss account and the deposit components of a life insurance contract are presented as changes in insurance liabilities, unless the deposit components cannot be measured

separately, in which case they are presented as income and expense in the profit and loss account.

(b) Embedded value disclosures. Embedded value ("EV") is essentially the present value of distributable earnings. EV is made up of the present value of future profits from existing policies and existing funds "belonging" to shareholders including, for example, undistributed profits. Embedded value calculations are presented as supplementary information. Many see embedded value as a proxy for the value of existing contracts in force; and

(c) Sources of earnings disclosures ("SOE"). Sources of earnings disclosures have developed in Canada and are prepared in accordance with regulatory guidelines and draft guidelines prepared by the Canadian Institute of Actuaries. The SOE are used to identify the primary sources of gains or losses in each reporting period.

10. All three models explored are life insurance models. This is because the current exit value model currently proposed by the Board is similar to some existing models used to recognise and measure life insurance contracts. Existing non-life insurance models tend to be deferral and matching models. Differences have developed between performance reporting for life and non-life insurance as a result of not only the different measurement models, but also the different profit drivers for life and non-life insurance.

Margin on Services Model ("MoS")

11. MoS is presented using a traditional premiums and claims type analysis, together with an analysis of the sources of profit related to the movement in insurance liabilities. Appendix A provides an example set of financial statements for MoS.

12. In Australia life insurers disclose the following components of life insurance liabilities:

(a) future policy benefits, including participating benefits;

(b) balance of future expenses;

(c) planned margins of revenues over expenses;

(d) future charges for acquisition costs; and

(e) balance of future revenues.

13. The following components of profit or loss are shown, separated between policyholder and shareholder interests:

    (a) profit related to movement in insurance liabilities;

    (b) investment earnings on assets in excess of insurance liabilities; and

    (c) other items, separated into material components.

14. The following components of profit related to movements in insurance liabilities are shown:

    (a) planned margins of revenues over expenses (the planned margin would constitute the risk margin and profit margin combined);

    (b) the difference between actual and assumed experience;

    (c) the effects of changes to underlying assumptions;

    (d) loss recognition on groups of related products or reversal of previously recognised losses; and

    (e) other movements, separated into material components.

15. Financial statements for life insurers in Australia also include relatively detailed information on significant assumptions such as profit carriers and mortality assumptions. Many Australian insurers supplement their financial reports with investor reports. These will often provide embedded value disclosures and information regarding the impact of new business. Analysts have reported that they also find the Australian non-life disclosures very useful, in particular:

    (a) disclosure of the central estimate and the risk margin; and

    (b) disclosure of the probability of adequacy intended to be achieved by the risk margin.

Embedded Value ("EV")

16. The presentation of embedded value information in financial reports has tended to focus on reconciliation of the movement in embedded value during the reporting period. A typical reconciliation might include:

    (a) impact of acquisitions;

    (b) impact of new business;

    (c) experience variances (i.e. differences between actual and assumed experience);

    (d) changes in actuarial assumptions; and

    (e) currency movements.

17. Appendix B illustrates an example of EV disclosures.

18. The key advantage of EV disclosure is that it is seen by many users as providing an indicator of the "value" of an entity's contracts. In addition, the analysis of new and existing business is seen as particularly useful for life insurance contracts. EV disclosures have been particularly useful in jurisdictions where the existing measurement models have not used current market-consistent parameters. Staff believe that under a current exit value model, EV disclosures add less value than they do in many existing accounting models.

Source of Earnings ("SOE")

19. SOE disclosures attempt to analyse earnings to provide information on key profit drivers such as the value of existing business, new business production and earnings on surplus funds. A SOE analysis is another type of margin analysis and is similar to the sources of profit disclosure required by Australian GAAP. A typical analysis might include:

    (a) expected profit from in-force business: this represents the release of Provisions for Adverse Deviation, in effect the release of the margins;

    (b) impact of new business: this represents the financial impact of new business written in the period, including acquisition expenses. New business creates economic value; however, in the first year an overall loss is likely to be

reported because of the treatment of acquisition expenses and the margins recognised (known as Provisions for Adverse Deviation);

(c) experience gains or losses (i.e. profit or loss attributable to differences between actual and assumed experience). These gains or losses arise from items such as claims, policy persistency, investment returns, fee income, and expenses;

(d) impact of management actions and changes in assumptions: this represents the financial impact of changes to valuation methods and assumptions for the policy liabilities;

(e) impact of segregated fund guarantees;

(f) earnings on surplus funds: this represents the actual investment returns on the assets supporting the entity's surplus or shareholder equity; and

(g) cost of taxes.

20. Appendix C illustrates an example of SOE disclosure.

21. A key advantage of the SOE disclosure is that it assists the user in understanding key profit drivers such as the impact of new business.

Staff recommendations

22. An insurer should be required to present separately specified components of the changes in the carrying amount of insurance liabilities for the following reasons:

(a) the change in the carrying amount of insurance liabilities is complex, as detailed in paragraph 6 of this paper. An analysis of the change is essential for users to understand the financial performance of an entity;

(b) many components of the changes in the carrying amount of insurance liabilities provide useful information to users, for example:

(i) presentation of changes in expected future profits provides information on the key profitability of the entity – especially if analysed further between existing and new business. New business production and performance is a key performance indicator for life insurers; and

(ii) analysis of assumption changes and variance analysis could provide useful information on any significant changes in assumptions such as mortality experience or lapse rates and exposes the robustness of the reserving process; and

(c) if insurers are not required to present separately specified components of the changes in the carrying amount of insurance liabilities, many will supplement their financial reports with additional disclosures to meet the needs of their users. The development of embedded value disclosures has shown that this can lead to a lack of comparability and variation in quality where this is not "regulated".

23. Insurers should present separately at least the following components of the changes in the carrying amount of insurance liabilities:

(a) Gains or losses, if any, recognised at inception of insurance contracts

(b) Premiums, claims and expenses (when a premiums and claims approach is adopted) or the unwinding of the discount, release from risk and release of service margins (when a margin approach is adopted).

(c) Changes in estimates and changes in discount rates and margins

(d) Policyholder participation

24. Staff believe both a traditional premiums and claims analysis and margin analysis are useful information for users for the following reasons:

(a) A traditional premiums and claims analysis is useful because:

(i) users are familiar, and therefore comfortable, with this type of disclosure. This is especially true for non-life insurance, for which many users rely on claims ratios (claims expense divided by earned premiums) and combined ratios ([claims expense plus other expenses] divided by earned premiums);

(ii) it is consistent with financial statements for other types of entity; and

(iii) even if premiums are to be presented as deposits, the level of premiums and the changes in premiums over time are useful indicators for users of

how the business is growing. Analysts have reported that they put significant weight on the level of premiums and for life insurance in particular would like an analysis of new and existing business.

(b) A margin analysis is useful because:

(i) it analyses the different sources of profit. A traditional premiums and claims analysis does not explain why the claims liabilities have changed. A margin analysis assists in explaining the changes; and

(ii) for long term contracts it assists the users in understanding whether there are long term changes in expected profitability.

APPENDIX A

DISCLOSURE OF LIFE INSURANCE CONTRACTS (UNDER MARGIN ON SERVICES MODEL) IN AUSTRALIA

Income Statement

	Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
Insurance revenue	*1*	**1,501**	1,245
Investment contract fee revenue		**196**	179
Other revenue		**9**	11
Investment income		**850**	901
Insurance expense	*2*	**(521)**	(486)
Operating expense		**(250)**	(214)
Change in life insurance liabilities	*4*	**(1,330)**	(1,232)
Change in investment contract liabilities		**(172)**	(253)
Profit before tax		**283**	51
Tax		**(45)**	(10)
Net profit after tax	*6*	**238**	141

Balance Sheet

	Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
Assets			
Cash		**1,023**	1,342
Receivables		**650**	430
Equity securities		**7,997**	6,557
Debt securities		**5,804**	4,861
Other assets		**1,100**	1,010
Total assets		**16,574**	14,200
Liabilities			
Insurance liabilities	*3*	**5,197**	3,867
Investment contract liabilities	*5*	**7,123**	6,545
Borrowings		**350**	350
Other liabilities		**1,008**	780
Total liabilities		**13,678**	11,542
Total equity		**2,896**	2,658

Notes

		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
1.	**Insurance revenue**			
	Total life insurance premiums received and receivable		**3,243**	3,154
	Less deposit component recognised as a change in liabilities	*5*	**(1,742)**	(1,909)
	Insurance revenue		**1,501**	1,245

		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
2.	**Insurance expense**			
	Total life insurance claims paid and payable		**(1,857)**	(1,654)
	Less deposit component recognised as a change in liabilities	*5*	**1,336**	1,168
	Insurance expense		**(521)**	(486)

		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
3.	**Insurance liabilities**			
	Best estimate liability			
	Value of future life insurance benefits		**5,021**	2,502
	Value of future expenses		**1,043**	870
	Value of future acquisition costs		**(430)**	(130)
	Value of future premiums		**(2,654)**	(1,097)
	Total best estimate liability		**2,980**	2,145
	Value of future profits		**2,217**	1,722
	Insurance liabilities		**5,197**	3,867

		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
4.	**Reconciliation of changes in life insurance liabilities**			
	Total life insurance liabilities at 1 Jan 02		**3,867**	2,635
	Changes in life insurance liabilities recognised in the income statement		**1,330**	1,232
	Total life insurance liabilities at 31 Dec 02		**5,197**	3,867
		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**

5.	**Reconciliation of changes in investment contract liabilities**			
	Total investment contract liabilities at 1 Jan 02		**6,545**	5,551
	Premiums recognised as a change in liabilities		**1,742**	1,909
	Claims recognised as a change in liabilities		**(1,336)**	(1,168)
	Changes in investment contract liabilities recognised in the income statement		**172**	253
	Total investment contract liabilities at 31 Dec 02		**7,123**	6,545

		Note	**30 Dec 02 CUm**	**30 Dec 01 CUm**
6.	**Sources of operating profit**			
	Life insurance contracts			
	Emergence of planned margins		**75**	60
	Experience profit/(loss)		**15**	(6)
	Changes to underlying assumptions		**5**	2
	Net profit from investment contracts		**86**	41
	Investment earnings on shareholders retained profits and capital		**56**	44
	Other earnings		**1**	0
	Profit/(loss) after tax		**238**	141

APPENDIX B

DISCLOSURE OF EMBEDDED VALUE

	30 Dec 02 CUm	**30 Dec 01 CUm**
Embedded value at beginning of period	**13,963**	5,448
Acquisitions	**0**	5,765
New business	**2,341**	1,865
Experience variances	**350**	401
Changes in actuarial assumptions	**101**	178
Interest on embedded value	**1,078**	876
Embedded value before discount rate, currency and capital movements	**17,833**	14,533
Discount rate changes	**(154)**	(100)
Currency changes	**(643)**	(120)
Shareholder dividends	**(500)**	(350)
Other capital movements	**123**	0
Embedded value at the end of the period	**16,659**	13,963

APPENDIX C

DISCLOSURE OF SOURCES OF EARNINGS

	US CUm	**Europe CUm**	**Total CUm**
Expected profit from in-force business	3,100	2,567	**5,667**
Impact of new business	(865)	(671)	**(1,536)**
Experience gains	153	69	**222**
Management actions and changes in assumptions	87	101	**188**
Earnings on surplus funds	562	762	**1,324**
Other	25	(88)	**(63)**
Income before tax	3,062	2,740	**5,802**
Tax	(895)	(760)	**(1,655)**
Net income	2,167	1,980	**4,147**

AGENDA PAPER 12B INVESTMENT CONTRACTS: COMPARISON OF IAS 39 AND IAS 18 WITH TENTATIVE CONCLUSIONS FOR PHASE II

Purpose of this paper

1. This paper highlights differences between the treatment of insurance contracts under the proposed current exit value model and the current treatment of investment contracts under IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 18 *Revenue*.

Summary of recommendations

2. Staff recommend that the Discussion Paper should document the key differences that exist between the proposed current exit value model for insurance contracts and the current treatment of investment contracts under IAS 39 and IAS 18. The Discussion Paper should seek feedback on whether the Board should consider eliminating these differences.

Nature of investment contracts

3. The term "investment contract" has been used informally to describe contracts issued by life insurers that do not meet the definition of an insurance contract and similar contracts issued by others such as fund managers. Investment contracts will include:

   (a) unit-linked contracts with minimal additional death benefits;

   (b) fixed term deposits;

   (c) investment fund managed by investment manager; and

   (d) some pension contracts.

4. Many life insurance contracts are very similar in substance to investment contracts, the difference being that life insurance contracts could be viewed as investment contracts with a significant insurance risk component. This suggests that life insurance contracts and investment contracts should be treated consistently.

5. Consistent treatment could be achieved by unbundling life insurance contracts into their investment and insurance components and treating the investment component under IAS 39. However, the Board have indicated that they do not support unbundling, partly

because it might often be arbitrary. An alternative approach could be to eliminate the differences in treatment that exist.

Differences in treatment

6. Agenda paper 12C is a table that compares the treatment of insurance contracts under the proposed current exit value model and the treatment of investment contracts under IAS 39 and IAS 18. The table considers the:

   (a) liability measurement at inception;

   (b) subsequent measurement of liability;

   (c) income and expense recognised in profit and loss at inception; and

   (d) subsequent recognition of income and expense in profit and loss.

7. The table analyses:

   (a) in the column headed 'Phase II' - the treatment of insurance contracts under the proposed current exit value model;

   (b) in the column headed 'Financial component: IAS 39 fair value' – the current treatment of the financial component of an investment contract that is measured as at fair value through profit or loss under IAS 39;

   (c) in the column headed 'Financial component: IAS 39 amortised cost' – the current treatment of the financial component of an investment contract that is measured using amortised cost under IAS 39; and

   (d) in the column headed 'Investment management component (IAS 18)' – the current treatment of any investment management component of an investment contract. IAS 18 *Revenue* applies to that component.

8. The most significant differences identified are:

   (a) *Liability measurement at inception:*

      (i) the current exit value model is based on expected values. Under IAS 39 the liability is subject to a minimum of the surrender value; and

(ii) under IAS 39 and IAS 18, non-incremental origination costs are likely to give rise to a loss at inception, even if the contract is priced to recover those costs. Under the current exit value model, this is not likely to be the case (see appendix for further discussion)

(b) *Subsequent measurement of liability:*

(i) the current exit value model is based on expected values. Under IAS 39 the liability is subject to a minimum of the surrender value; and

(ii) the current exit value model is based on current values. Under IAS 39, where an investment contract is measured at amortised cost, some assumptions are locked in: in particular, although the cash flows are based on current estimates,[1] the measurement reflects the original effective interest rate (including the original quantity and price of risk).

(c) *Income and expense recognised in profit and loss at inception:*

(i) the current exit value model recognises gains on inception (if any gain arises). Under IAS 18 gains are not likely to be recognised at inception unless it could be demonstrated that a service had been performed at that time; and

(ii) treatment of origination costs (see paragraph 8(a)(ii) above).

[1] Except for credit losses, for which an incurred loss model is used.

Appendix

Origination costs[2]

A1. At inception, what is the relationship between acquisition costs and the current exit value of an insurance liability? Insurers aim to price insurance contracts to provide an acceptable return after paying for claims and benefits, expenses and acquisition costs. If a book of insurance contracts is priced to be profitable and if experience under those contracts is in line with the pricing assumptions, the contract enables the insurer to recover the acquisition costs incurred.

A2. Consider a contract that generates policyholder benefits with a present value of CU 900 (including an acceptable risk margin). The insurer would want to charge at least CU 900 for this contract. Now suppose the insurer has to incur acquisition costs of CU 100 to originate the contract. The insurer will now want to charge at least CU 1,000 (plus some more if there is a time lag between payment of the acquisition costs and their recovery in premiums).

A3. Let's assume the contract has a single premium of CU 1,000, received at inception and the pricing of the contract provides the insurer with margins that are in line with the margins market participants require. Therefore, at inception, the insurer's obligation has a current exit value of CU 900. Put differently, the policyholder is paying CU 900 for risk protection and CU 100 for the contract origination activity.[3] Moreover, a hypothetical transferee might be willing to take over the liability for CU 900, not CU 1,000, because the transferee would not need to recover acquisition costs that it has not incurred.

A4. For investment contracts, IAS 39 and IAS 18 effectively lead to the deferral of origination costs, but only if they are incremental (ie they would have been avoided if the contract had not been issued), such as commission to intermediaries or employees. The deferrable acquisition costs exclude other costs that are not incremental, for example sales staff salaries and overheads attributable to the selling activity.

(a) In IAS 39, if a financial asset (financial liability) is measured at amortised cost, transaction costs are added to (deducted from) the fair value to determine the initial

[2] The substance of this discussion appeared originally in agenda paper 10F for the February 2006 IASB meeting.

[3] Of course, from the policyholder's perspective, the entire payment of CU 1,000 is for risk protection because the policyholder cannot access the risk protection without the origination.

measurement of that financial asset or financial liability.[4] Transaction costs are 'incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability'.[5] They include 'fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs'.[6]

(d) Under IAS 18 *Revenue*, incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered.[7]

A5. Arguably, when IAS 39 refers to incremental transaction costs, it contemplates the costs of transferring existing contracts, rather than the costs of originating new contracts. Unlike transaction costs, origination costs pay for a process that adds value to the instrument. An example of transaction costs would be a broker's commission for tradeable securities. If I buy securities, I incur commission, but nobody else will pay me for that commission if I sell the securities. In other words, the commission gives me a benefit (control of the securities), but adds no value to the securities. The costs incurred in originating a new instrument are different. For example, as already noted above, an insurer will try to price a product to recover its origination costs. Thus, if all else is equal, the origination costs pay for a process that adds value to the instrument. (Of course, it is still necessary to test whether the pricing actually allows those costs to be recovered.)

A6. It may be worth clarifying the interaction between the pricing of a contract, the underlying contractual performance obligation and origination costs.

[4] See IAS 39 paragraph 43.
[5] IAS 39, paragraph 9.
[6] IAS 39, paragraph AG13 of appendix A
[7] Paragraph A14(b)(iii) of the appendix to IAS 18

AGENDA PAPER 12C INVESTMENT CONTRACTS: TABULAR COMPARISON WITH IAS 39 AND IAS 18

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
LIABILITY MEASUREMENT AT INCEPTION				
Measurement attribute	Current exit value	Fair value	Fair value plus incremental transaction costs	Cost (if recoverable)
Cash flows	Unbiased current estimate (at inception) of expected present value of cash flows	Unbiased current estimate (at inception) of expected present value of cash flows	Unbiased current estimate (at inception) of expected present value of cash flows	Not estimated explicitly
Discount rate	Market risk-free rate at inception	Market risk-free rate at inception	Effective interest rate at inception[8]	Not specified (and not specified whether the cash flows are discounted)
Risk margin	Explicit – estimate of margin market participants would require	Implicit, calibrated to premium and transaction costs	Implicit (and included in effective interest rate)	Not specified
Service margin[9]	Explicit - estimate of margin market participants would require	Not applicable	Not applicable	Implicit in original measurement
Surrender value floor?	No	Yes	Yes	No
Do cash flows include (probability-weighted) future premiums that are not contractually enforceable?	Yes, if either: ○ needed to maintain guaranteed insurability, or ○ would increase liability	Surrender value floor applies	Surrender value floor applies	Yes (‘may assess recoverability on a portfolio basis’)

[8] Could be viewed as market-risk free rate at inception, adjusted for implicit risk margin
[9] Previously described as profit margin

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
Origination costs[10]:				
○ financial component	No direct impact on liability Recognised as an expense Might be part of the evidence supporting the initial measurement	No impact on measurement of the liability Recognised as an expense	Incremental costs relating to the financial component are deducted from fair value of liability	Not applicable
○ investment management component	No direct impact on liability Recognised as an expense Might be part of the evidence supporting the initial measurement	Not applicable	Not applicable	Incremental origination costs are recognised as an asset (right to benefit from management fees)
Liability adequacy test	No (not needed)	No (not needed). However, there is a surrender value floor	No (not needed). However, there is a surrender value floor	Yes - recoverability test
Credit risk inherent in insurance liability	Explicit at inception	Implicit at inception	Implicit at inception	Not specified
Embedded derivatives to be separated if not closely related?	No	No	Yes, if not at fair value through P&L	Yes, if not at fair value through P&L
Related investments	Existing IFRSs	Existing IFRSs	Existing IFRSs	Existing IFRSs

[10] Previously described as acquisition costs

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
SUBSEQUENT MEASUREMENT OF LIABILITY				
Measurement attribute	Current exit value	Fair value	Amortised cost	Cost, less amortisation (if recoverable)
Cash flows	Unbiased current estimate of expected present value of cash flows	Unbiased current estimate of expected present value of cash flows	Current estimate of cash flows[11]. However, excludes future credit losses that have not been incurred)	Not specified
Discount rate	Current market risk-free rate	Current market risk-free rate	Original effective interest rate	Not specified (and not specified whether the cash flows are discounted)
Risk margin	Explicit, reflects current quantity of risk and current price of risk	Explicit, reflects current quantity of risk and current price of risk	Explicit, reflects original quantity of risk and original price of risk, less amortisation	Not specified
Liability adequacy test	No (not needed)	No (not needed). However, there is a surrender value floor	No. Not needed to the extent that cash flows are current, however risk margin and discount rate are not current[12]	Yes - recoverability test
Credit risk inherent in insurance liability	Explicit	Explicit	Implicit at inception, not adjusted for subsequent changes	Not specified
Service margin	Explicit, reflects margin required by market participants	Not applicable	Not applicable	Implicit in original measurement

[11] IAS 39 AG8 and IAS 39 BC36

[12] Estimated cash flows do not reflect expected credit losses that have not been incurred (typically not an issue for investment contracts).

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
How is earned portion of risk margin determined?	To reflect release from risk	To reflect release from risk – implicitly part of the movement in fair value	Included in interest reported under the effective interest method, based on original effective rate, passage of time and carrying amount of the liability.	Not specified
How is earned portion of service margin determined?	To reflect provision of contractual services	Not applicable	Not applicable	As service is provided
Surrender value floor?	No	Yes	No	No

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
INCOME AND EXPENSE RECOGNISED IN P&L AT INCEPTION (if applicable)				
Gross gain[13] at inception (if applicable)	Yes	Conceptually, yes. In practice, generally no.	Conceptually, yes. In practice, generally no.	No, unless services were provided at inception.
Gross loss at inception (if applicable)	Yes	Conceptually, yes. In practice, generally no.	Conceptually, yes. In practice, generally no.	Yes
Non-incremental origination costs	Yes	Yes	Yes	Yes
Incremental origination costs	Yes	Yes	No Incremental costs relating to the financial component are deducted from fair value of liability.	No Incremental origination costs related to the investment component are recognised as an asset (if recoverable)
Initial premium and corresponding increase in the liability	To be determined after discussion paper stage	No – deposit accounting	No – deposit accounting	No – recognised as service is provided
Front end fees (if not an integral part of the effective interest rate)	To be discussed?	Not applicable	Not applicable	No (unless the related service is provided at or prior to inception)
Fees integral to the effective interest rate	Not discussed	Yes[14]	No Included in the initial carrying amount of the financial liability, resulting in an adjustment to the effective interest rate	Not applicable

[13] Gross gain means gain before origination costs
[14] IAS 18, Appendix, paragraph 14(a)

	Phase II	*Financial component: IAS 39 fair value*	*Financial component: IAS 39 amortised cost*	*Investment management component (IAS 18)*
INCOME AND EXPENSE RECOGNISED IN P&L SUBSEQUENTLY				
Portion of premium that covers:				
○ expected benefits to policyholders	To be determined	No – deposit accounting	No – deposit accounting	Not applicable
○ risk margin	Yes	Yes (part of change in fair value)	Yes (part of effective interest rate)	Not specified
○ service margin	Yes	Not applicable	Not applicable	Yes
Interest on liability (unwind of discount)	Yes	Yes	Yes (at original rate)	Not specified
Change in discount rate	Yes	Yes (part of change in fair value)	Not applicable	Not specified
Benefits to policyholders:				
○ expected benefits	To be determined	No	No	Yes (expense incurred in providing the services)
○ difference between expected and actual	Yes	Yes	Yes	Yes
○ change in estimates	Yes	Yes	Yes	No (unless recoverability is affected)
Amortisation of right to benefit from providing services	Not applicable	Not applicable	Not applicable	Yes (amortised as related revenue is recognised)
Change in quantity of risk	Yes	Yes	No	Not specified
Change in price of risk	Yes	Yes	No	No