30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 7A**

Appendix B Comparison with IAS 39

(extract from late draft of discussion paper on insurance contracts)

Many insurers issue some contracts that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* because they do not transfer significant insurance risk. The following table gives a high level summary of differences between the Board's preliminary views on insurance contracts and existing requirements in IAS 39 and IAS 18 *Revenue*. In principle, the Board would prefer to eliminate those differences. However, the Board has not yet assessed whether that will be appropriate. Thus, this paper includes no specific proposals for such contracts. The table includes references to relevant paragraphs of this paper.

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views for insurance contracts*	*Para*
1	**Initial measurement, and acquisition costs** At initial recognition, a financial liability is measured at its fair value: • less directly attributable transaction costs, if the liability will be measured subsequently at amortised cost. • without deducting transaction costs, if the liability will be classified subsequently as 'at fair value through profit or loss' (ie if it will be measured at fair value, and all changes in its fair value will be recognised in profit or loss).	Insurance contracts would be measured initially at current exit value. An insurer would recognise transaction costs (acquisition costs) as an expense when it incurs them.	31-119 161-166
2	**Gain or loss at inception** The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. Thus, no gain or loss arises at inception if the fair value of the instrument at that date equals the transaction price.	A profit or loss could arise at inception if the pricing is out of line with what market participants require. If an insurer identifies an apparently significant gain or loss at inception it would need to check for errors or omissions.	83-86

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views for insurance contracts*	*Para*
3	**Subsequent measurement** The following are classified as 'at fair value through profit or loss': o Derivative financial liabilities o Other financial liabilities if the fair value option is available and used. All other financial liabilities are measured at amortised cost. Embedded derivatives are separated and classified as 'at fair value through profit or loss', unless they are closely related to the host contract.	Insurance contracts would be measured at current exit value. The Board is not yet in a position to determine whether fair value and current exit value are the same. However, the Board has not identified significant differences between them.	31-119 104
4	**Surrender value floor and policyholder behaviour** The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This surrender value floor applies contract by contract, not on a portfolio basis.	In general, the surrender value of an insurance contract does not establish a lower limit for the current exit value. However, the current exit value cannot be negative (ie an asset), unless that asset is recoverable from future premiums that the policyholder must pay to retain guaranteed insurability. The measurement of an insurance liability includes the risk-adjusted expected present value of future premiums that pass the guaranteed insurability test.[1]	121-160

[1] As described in chapter 4, the Board views these premiums as arising from a customer relationship, not as part of its contractual rights. However, an insurer would measure that part of the customer relationship in the same way as the insurance liability and present them together.

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views for insurance contracts*	*Para*
5	**Unit of account** The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. The recoverability of origination costs relating to investment management services may be assessed on a portfolio basis.	Risk margins: • would be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. • would not reflect benefits, if any, of diversification between portfolios and negative correlation between portfolios.	183-202
6	**Presentation of premiums** Proceeds received from the customer are deposits. Therefore, they are not recognised as revenue, and repayments to customer are not recognised as an expense.	The Board has not yet formed a preliminary view on whether premiums would be treated as deposits or as revenue.	297-324

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views for insurance contracts*	*Para*
7	**Separation of investment management component** Some contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of financial assets. The provider distinguishes the financial liability from the right to provide investment management services. This affects the treatment of origination costs and service fee revenue.	If an insurance contract contains both an insurance component and a deposit component, the insurer should treat it as follows: • if the components are so interdependent that the components can be measured only on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract. • if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component. • if the components are not interdependent, the phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component.	220-228

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views for insurance contracts*	*Para*
7(a)	**Investment management component – origination costs** Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if: o they can be identified separately and measured reliably and o it is probable that they will be recovered (on a portfolio basis). An incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services. The entity amortises that asset as the entity recognises the related revenue.	The measurement of the liability would include all future premiums that pass the guaranteed insurability test, including the part of those premiums from which the insurer expects to recover acquisition costs (both incremental and non-incremental). An insurer would recognise acquisition costs as an expense when it incurs them. If the insurer expects to recover acquisition costs from future premiums that policyholders must pay to retain guaranteed insurability, those premiums reduce the measurement of the liability because the insurer includes them in the recognised part of the customer relationship. If the insurer recovers acquisition costs from premiums already received, receiving that part of those premiums does not increase the measurement of the liability.	121-160 161-166

7(b)	**Service fee revenue** Fees charged for managing investments are recognised as revenue as the services are provided. Fees received in advance are treated as unearned revenue.	Current exit value would include an explicit and unbiased estimate of the margin that market participants require for providing services. Subsequently, as the insurer provides services, the service margin reduces and the insurer recognises income. That income would be the same as the implicit or explicit fee provided by the contract, unless market participants would require a higher or lower service margin for the same services. The Board has not yet decided whether an insurer should split premium receipts into a revenue part and a deposit part for presentation in the income statement.	87-89 88(e) 297-324