AUSTRALIAN ACCOUNTING STANDARDS BOARD

Institute of Actuaries of Australia

21 November 2003

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6HX

Dear David

APPLICATION OF IAS 39 TO INVESTMENT CONTRACTS

At our meeting with you and Warren McGregor on 7 August 2003 we discussed some of our concerns in relation to current IASB proposals on investment contracts under IAS 39 *Financial Instruments: Recognition and Measurement*. It was agreed that we would come back to you with a potential solution for the treatment of acquisition costs and demand features.

In this letter we have addressed acquisition costs and demand features as we see these two issues as being closely related. It is our view that:

1. A surrender value floor should not apply to investment contracts but rather that expected surrenders should be allowed for within the liability measurement on a probability-weighted basis; and

2. Acquisition costs should include all legitimate external and internal costs attributable to the acquisition of business (based on substance rather than form).

Our focus, in this letter, is on the treatment of investment contracts written by insurers that, under Phase I of the Insurance Project, cease to be subject to local GAAP and instead are subject to other standards, notably IAS 39. Local GAAP will continue to apply to insurance contracts and hence an issue does not arise with insurance contracts for Phase I.

IAS 39 Proposals – Acquisition Costs

At its July 2003 meeting, the IASB tentatively agreed to define transaction costs as: "incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability". The precise interpretation of this definition is, at this stage, not clear, however, it would appear to significantly restrict the recognition of transaction costs to directly variable costs incurred in acquiring investment contracts (for example distribution commissions). This would exclude a large component of legitimately incurred acquisition costs that are fixed or even semi-variable (for example salaried sale support teams, application processing division costs, application form and disclosure statement production costs).

We believe that the potential consequences of the application of this definition to investment contracts subject to IAS 39 include the following:

1. Investment contracts, which are priced to recover all acquisition costs and are expected to be profitable, may report significant losses on inception. We do not believe that financial statements prepared on this basis are reliable, as they will not represent faithfully the economic substance of the contracts or operation of the business.

2. Entities with different distribution channels will account for the same business differently. Those who use external channels, such as brokers, will incur acquisition costs that are essentially incremental, and so can be treated as transaction costs. However, those with internal sales forces will directly incur the fixed costs and overheads associated with the distribution function and may not be able to treat these costs as transaction costs.

3. Under current Australian GAAP, AASB 1038 *Life Insurance Business*, acquisition costs are defined as all "fixed and variable costs of acquiring new business, including commissions and similar distribution costs, and costs of accepting, issuing and initially recording policies." This definition will continue to apply to insurance contracts written by insurers. From an Australian perspective, the proposals will, therefore, introduce an inconsistency in the way in which acquisition costs are treated, depending upon whether a contract meets the definition of an insurance contract. This difference could encourage accounting arbitrage.

4. Similar investment arrangements involving, for example, mutual funds and fund managers, which have a different legal form but essentially the same economic substance, may be reported differently. Under such arrangements the fees and charges payable to the fund manager from the mutual fund would appear to be treated under IAS 18 *Revenue*, as a service contract, with the treatment of the acquisition costs incurred in respect of those contracts also treated under IAS 18. To the extent IAS 18 does not apply such restrictive rules to acquisition cost amortisation, a very different (and we would argue more appropriate) reported result will emerge.

IAS 39 Proposals – Demand Features

Paragraph BC117(e) of the *Basis for Conclusions on ED 5* states that: "The fair value of a financial liability with a demand feature (for example an investment contract that the investor can cancel at any time) is not less than the amount payable on demand."

Paragraph BC117(c) of the *Basis for Conclusions on ED 5* states that: "If the amortised cost of the contractual liability differs from its surrender value, the issuer measures at fair value the investor's option to surrender, unless the surrender value is approximately the same as the carrying amount at each date."

These two paragraphs appear to effectively apply a "surrender value floor" to the overall net liability for both the fair value and amortised cost measurement bases in IAS 39. We believe that the surrender value floor is not consistent with a fair value model and is overly conservative, thereby potentially breaching the IASB Framework, which does not allow excessive provisions.

The "surrender value floor" implies that at the point at which it "bites" all other features of the contract, apart from the demand feature, cease to have effect and, therefore, contribute nothing to the value of the contract and the associated liability. It implies that the intent and purpose of the contract derives not from the totality of its terms and conditions, but from a subset of those terms, in combination with events external to the contract, such as actual investment experience.

Such a perspective is inconsistent with the concept of fair value, which is concerned with the value of the contract as a whole.

The potential consequences of the demand features proposals are as follows:

1. The economic substance of the contracts will be misrepresented. Investment contracts, which are expected to be profitable, may report significant losses on inception. Conversely, destruction of value through the loss of profitable business will have no discernible profit impact. We do not believe that financial statements prepared on this basis are meaningful.

2. The proposals in relation to demand features could potentially lead to spurious volatility in reported results for certain participating contracts, even though participating contracts generally remain subject to local GAAP. Under ED 5, paragraph 25, the issuer of a financial instrument with a discretionary participation feature must measure the liability at "no less than the measurement that IAS 39 would apply to the fixed element".

   For contracts where the account balance is effectively fully guaranteed, it is conceivable that the liability under local GAAP (which reflects the inherent concept of participation: that a given tranche of participating business may share, over time, in both the profits and losses arising in respect of that tranche) will be less than the surrender value when investment markets are depressed. Large losses would be reported, followed by large profits when the markets recover. For such contracts we would expect to see some losses reported when investment markets are depressed. However, the surrender value floor exaggerates the losses and subsequent profits. The surrender value floor therefore overrides the inherent concept of participation and creates <u>additional</u> volatility in the reported results.

3. Under current Australian GAAP, life insurance liabilities are measured allowing for expected surrenders on a probability-weighted basis. This approach will continue to apply to insurance contracts written by insurers. From an Australian perspective, the proposals will, therefore, introduce an inconsistency in the way in which surrender values are treated, depending upon whether a contract meets the definition of an insurance contract. Similarly, the constraint in relation to participation features does not apply to insurance contracts with the same features. It therefore imposes an inconsistency in the treatment of participation features, prior to the issue of participation features being fully considered under Phase II. These differences could encourage accounting arbitrage.

Our Solutions

Our view is that the definition of transaction costs in IAS 39 should be broadened and the proposals in relation to demand features should be deleted. However, we recognise the IASB's resistance to such an approach and hence recommend the following alternative solutions:

1. We believe that one of the IASB's chief concerns driving these proposals is the desire to avoid recognition of profits on inception of an investment contract. The IASB is already considering proposals that directly address this issue (see *Basis for Conclusions on ED 5* paragraphs BC6(b)(ii) and BC117(f)). We believe that such requirements, together with similar requirements under other standards such as IAS18, would provide a sufficient solution without the disadvantages of the surrender value and transaction costs proposals.

2. IAS 39 applies to financial instruments that arise under investment contracts. Investment contracts could be viewed as service contracts with an embedded financial instrument, in the same way that investing in a mutual fund (or a unit trust) is, in substance, simply purchasing the services of the funds manager to manage the funds. The units, in the unit trust, are separate financial instruments. As noted above, investment contracts are, in substance, the same type of arrangement.

   Our solution would, therefore, be to permit investment contracts to be unbundled, at least notionally, such that the pure financial instrument (or wholesale component) is accounted for under IAS 39 and the servicing (or retail) component (both revenue and expenses) is accounted for under IAS 18. In this model, the transaction costs associated with the pure financial instrument would be treated under IAS 39 (these costs would typically be expected to be minimal) whereas the transaction costs associated with the service element would be treated under IAS 18 (these costs would be expected to constitute the majority of the acquisition costs incurred).

The financial liability under IAS 39 would effectively be the face amount of the pure financial instrument, plus the value of any option or guarantee. Where there is a demand feature, the amount payable on demand is unlikely to be more than this value.

The costs and revenues treated under IAS 18 would be accounted for to ensure that the net profit was recognised by reference to the rendering of service under the contract. An asset, representing deferred costs recoverable from expected future revenue, would therefore be recognised. This asset could recognise all the genuine acquisition costs incurred in creating the service contract relationship (for example variable, semi-variable and fixed costs to the extent they genuinely relate to the issue of identifiable new investment contracts).

We believe that such a model is permitted within current IASB standards and seek an acknowledgement from the IASB that this is the case.

We would be pleased to discuss these solutions with you further, if this would be helpful.

Yours sincerely

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