SECTION 1
EXECUTIVE SUMMARY

This submission has been structured as follows:

1. Executive summary;
2. Issues arising from ED 5;
3. Issues arising from IAS 39;
4. Issues relating to Phase II of the Insurance Project; and
5. Other issues.

Within each section we have presented each issue in order of the perceived importance from an Australian perspective. We also include, as an Appendix, the AASB's proposed approach in implementing ED 5.

Our most significant concern is the application of IAS 39 *Financial Instruments: Recognition and Measurement*, as it is currently drafted, to investment contracts and to financial assets that back investment contract liabilities or insurance contract liabilities.

We do not support the proposals in relation to:

1. Demand features (outlined in paragraph BC117(e)); or
2. Acquisition costs (referred to as transaction costs in IAS 39); and
3. The inconsistency in the measurement of assets that support investment contract liabilities or insurance contract liabilities, and the underlying investment contract liabilities or insurance contract liabilities, that is allowed under IAS 39.

We believe that the potential consequences of the demand features (or "surrender value floor") and acquisition costs proposals include:

1. 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 relevant or reliable; they will not represent faithfully the substance of the contracts. These proposals are inconsistent with a fair value model;
2. We believe that the proposals in relation to demand features could potentially lead to spurious volatility in reported results for certain participating contracts. 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 when investment markets are depressed that the value of the supporting assets will be less than the surrender value. Large losses would be reported, followed by large profits when the markets recover. For such contracts we would expect to see losses reported when investment markets are depressed, however, the surrender value floor exaggerates the losses and subsequent profits. The surrender value floor therefore creates additional volatility in the reported results; and
3. There will be inconsistency in the treatment of acquisition costs and surrender options under IAS 39 and under Australian GAAP for insurance contracts; this could encourage accounting arbitrage. Australia is not the only jurisdiction that would face this issue.

The AASB staff believe that there are two ways of dealing with these issues under Phase I of the Insurance Project:

1. Delete the proposals in relation to demand features, and extend the definition of acquisition costs to include all external and internal costs relating to the acquisition of contracts, including the reasonable allocation of overheads. We believe that one of the IASB's chief concerns driving these proposals is the recognition of profits on inception of an investment contract. We believe that replacing these requirements with one that does not allow the recognition of profits at inception would provide a solution without the disadvantages of the demand features and transaction costs proposals; or
2. Unbundle investment contracts, at least notionally, such that the pure financial instrument (or wholesale component) is accounted for under IAS 39 and the servicing (or retail) component is accounted for under IAS 18 *Revenue*. The financial liability under IAS 39 would effectively be the face amount of the pure financial instrument, however, there would be the recognition of an asset representing deferred costs, which would relate to the retail revenue recognised under IAS 18. The AASB staff are currently working with their Australian constituents to develop this model further.

The AASB believes that assets that support investment contract or insurance contract liabilities should be measured consistently with the measurement of the investment contract or insurance contract liabilities. There is widespread actuarial support for the notion that measuring assets that support investment contract or insurance contract liabilities inconsistently from the underlying investment contract or insurance contract liabilities leads to spurious volatility in the income statement. The AASB staff believe that IAS 39 should be amended to require consistent measurement of assets and liabilities. In Appendix 1 of this submission we outline the AASB's proposed implementation of ED 5; this explains that the AASB proposes that insurers be required to apply IAS 39 to the financial assets supporting investment contract or insurance contract liabilities, and to investment contract liabilities, by electing the fair value through profit or loss designation.

SECTION 2
ISSUES ARISING FROM ED 5

2.1 Inconsistent Measurement of Insurance Contracts and Investment Contracts
Under current Australian GAAP, life insurance contracts and investment contracts written by registered life insurers are both measured using the Margin on Services model (MoS). The Appendix to this report illustrates the characteristics of this model. Phase I of the Insurance Project introduces an inconsistency in the measurement of insurance liabilities and investment contract liabilities that does not currently exist under Australian GAAP; insurance liabilities will continue to be measured using MoS, whereas investment contracts will be treated under IAS 39. We believe that this could encourage accounting arbitrage. The AASB staff believe that the IASB should be seeking to eliminate such inconsistencies as part of Phase II of its Insurance Project.

2.2 Loss Recognition Proposals
The AASB supports the loss recognition proposals in principle and agrees that such requirements are essential, especially where insurers are using a deferral and matching model. However, we make the following comments in relation to the details of the proposals:

1. We believe that a loss recognition test should be carried out at a class of business level rather than for insurance liabilities as a whole. The current proposals could result in expected losses in one class of business being netted off against expected profits in another. The AASB believes that the deferred acquisition cost (DAC) asset, and any intangible asset, is not a single asset but the sum of the DAC for all classes of insurance and that the loss recognition test proposed could result in DAC, or intangible assets, being carried forward that are impaired;
2. The AASB have interpreted ED 5 as requiring that, where an insurer has to apply IAS 37, and a write-down is required, that the insurer, as an alternative to writing down the DAC or the intangible asset, could increase the amount of the insurance liability. The AASB believes that the DAC, and any intangible asset, should always be written down first, and any further liability should then be reflected as a separate liability. If this is not the case an insurer could be carrying an impaired asset on its balance sheet. This would be in contravention of IAS 36 *Impairment of Assets*;
3. The wording used in paragraph 12(b) is unclear. It states “the insurer shall recognise the difference by decreasing the carrying amount of the related DAC or intangible assets or increasing the carrying amount of the insurance liabilities.” This does not make it clear that if the loss recognition test identifies a loss greater than the DAC, or intangible asset, that the insurer would need to write down the DAC, or intangible asset, and then provide for a further liability. This is however, in our opinion, the intention of the ED; and
4. The reference to “intangible assets” in paragraphs 11 and 12 is unclear and we believe there should be an appropriate cross-reference to paragraph 20 of ED 5.

2.3 Definition of Insurance
The AASB supports the principles based definition of insurance proposed and in particular the lack of any quantitative thresholds to define significant insurance risk. However, the AASB staff would like to make the following comments in relation to the details of the proposals:

1. Clearly the disadvantage of such a model is that it creates "grey areas" where there is the possibility of different interpretations. The AASB believes that reference should be made to considering the substance of a contract when determining whether a contract is an insurance contract. Whilst this is a requirement of the IASB Framework, we believe it would be usefully repeated in Appendix B of ED 5;
2. Paragraphs B21 to B24 of Appendix B provide examples to illustrate the interpretation of significant insurance risk. Given the pivotal nature of these paragraphs, we believe that Appendix B would benefit from a broader range of examples; and
3. The current definition of insurance appears to imply a contractual condition that the insured event adversely affects the policyholder or other beneficiary. This would exclude, for example, third party life insurance policies, since the test of insurable interest is applied at the time the policy is written and is not recited in the contract. The AASB staff believe that, in keeping with the principle of substance over legal form, there should not be the requirement of a contractual condition that the insured event adversely affects the policyholder or other beneficiary. We discuss insurable interest further below in our discussion of weather derivatives;
4. The current definition of an insurance contract does not make it clear whether or not contracts with discretionary indemnification meet the definition of an insurance contract. We believe that the deterministic approach of the current IASB standards and Framework confuse this issue. Refer to section 4.3 of this submission. For each individual contract issued on a discretionary indemnification basis it may be difficult to determine, based on previous experience, to what extent there is a transfer of significant insurance risk. However, if a portfolio as a whole is reviewed, it may become apparent, for example, that historically an insurer accepts 95% of all claims. In this example:

   1. are 95% of contracts accounted for as insurance contracts? or
   2. are all contracts accounted for as insurance contracts? or
   3. are none of the contracts accounted for as insurance?

   Theoretically we believe that all of the contracts should be accounted for as insurance contracts. In Australia the contracts issued on this basis are issued by mutual-type organisations. The members as a whole can be seen to be transferring significant insurance risk to the organisation. Determining whether or not contracts meet the definition of insurance at an individual contract level may not be appropriate.

   The AASB believe that the IASB should address this issue in the Basis for Conclusions to ED 5. This should address the issue of whether discretionary indemnification contracts can meet the definition of an insurance contract. The IASB should also refer to our recommendations made in section 4.3 of this submission.

2.4 Basis for Conclusions and Implementation Guidance

The AASB staff strongly support principles based standards and support the use of Basis for Conclusions and Implementation Guidance documents to assist users in understanding the rationale behind standards and in implementing standards. However the AASB staff believe that in many instances, with ED 5, information is not presented in the correct document, for example, some text in the Basis for Conclusions should be located in the Standard. We note the following:

1. Paragraph BC 31 on unbundling explains, "transaction costs incurred at inception would be allocated between the two components if the treatment of such costs for

insurance contracts differs from their treatment under IAS 39." We do not believe that this information is appropriate in the Basis for Conclusions, but belongs in the text of the standard; the treatment of acquisition costs is a material aspect of accounting for a transaction. It would also be useful if there was greater guidance as to how this allocation should be performed;

2. BC 93(b) on intangible assets explains the nature of the asset by way of example. It states: "this intangible asset is often known by names such as the present value of in force business, present value of future profits or value of business acquired". Many constituents have been confused by the nature of this asset and we believe that this guidance should be included in the standard;

~~3.IG Example 4 gives an illustration of a claims development table. It states that the table is a "possible format". The table shows claims development by underwriting year. We believe that the standard should state whether the claims development table should be by accident year or underwriting year. The current wording appears to allow a choice and this would make comparisons between entities difficult. The AASB staff believe that presentation by accident year is most appropriate for disclosure of the development of claims incurred;~~

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~~4.~~3. The AASB staff support the principles based disclosure requirements provided in ED 5. However, the Implementation Guidance provides very detailed guidance that some insurers could interpret as requiring large volumes of disclosure. The AASB staff believe that the IASB should consider the development of implementation principles, the current implementation guidance would be subordinate to this or could perhaps be dispensed with entirely. Alternatively, specific implementation guidance, consistent with the IASB's principles, could be left to the prerogative of local standard setters who could then have due regard to local business and regulations;

~~5.~~4. ED 5 states that the process of making assumptions must be disclosed and that the effect of changes in assumptions must be disclosed. This would suggest that the sensitivity of all assumptions must be disclosed. However, BC 129 states: "Some argue that it is difficult to disclose meaningful information about changes in assumptions, because assumptions are often interdependent. As a result, an analysis by sources of change depends on the order in which the analysis is performed. To acknowledge this difficulty, the draft IFRS does not specify a rigid format or content for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for their particular circumstance." We believe that the principle embodied in the text of BC 129 should be included in the standard;

~~6.~~5. BC 140 provides some guidance on what is meant by fair value. We believe that this concept is fundamental and that such guidance belongs in the text of he standard;

~~7.~~6. Appendix B to ED 5 provides guidance on the application of the definition of an insurance contract. The Basis for Conclusions discusses the concept of insurable interest. This concept is fundamental to most constituents' understanding of what insurance represents and we believe that it should be addressed in Appendix B.

2.5 Disclosure of Fair Value from 31 December 2006

ED 5 requires disclosure of the fair value of insurance assets and liabilities from 31 December 2006. The AASB staff consider it inappropriate to require fair value to be disclosed, when the definition of fair value has not been provided. Constituents are unable to consider the appropriateness of the disclosure if they are unable to understand the measurement basis.

The AASB staff believe that it will take time to develop the fair value model for insurance assets and liabilities, that this process will require extensive consultation with the insurance industry in many jurisdictions, and it is unlikely that the IASB will have completed this process in time for 31 December 2006 disclosures. The disclosures will therefore be based upon a definition that is likely to change once Phase II has been duly completed. The AASB staff also note that, whilst there is strong support for a fair value model for insurance contracts in Australia, some aspects of the current model, expressed by the IASB in their pronouncements, face significant opposition in the insurance industry in Australia.

The AASB staff believe this requirement should be deleted until a definition of the fair value of insurance assets and liabilities is provided as part of Phase II of the Insurance Project.

2.6 Discretionary Participation Features

ED 5 permits financial instruments with discretionary participation features to be accounted for as insurance contracts using current GAAP. Paragraph 25 of ED 5, however, states that an insurer must "recognise a liability measured at no less than the measurement that IAS 39 would apply to the fixed element". The measurement of the fixed element therefore appears to become a minimum for the liability as a whole.

It is appropriate for the fixed element to be treated under IAS 39, however we believe that the surrender value floor should not be imposed as a minimum for the liability as a whole, as this applies a surrender value floor to these insurance contracts. Section 3.1 of this report discusses our concerns with surrender value floors further. ~~We believe that the requirement relating to the fixed element should be deleted from paragraph ED 5.~~

There is a further matter of principle: paragraph 25 overrides local GAAP treatment of participation features and pre-empts Phase II of the insurance project. As noted in the *Basis for Conclusions on ED 5* paragraph BC 104: "Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board may decide on a different treatment in phase II." We believe paragraph 25 of ED 5 does exactly that. Furthermore, the proposal in ED 5 creates an inconsistency in the treatment of participation features in insurance contracts and investment contracts which increases the risk of accounting arbitrage.

We believe that the requirement relating to the fixed element should be deleted from paragraph 25 of ED 5.

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2.7 Weather Derivatives

The current proposals are that a weather derivative is to be treated as an insurance contract only if the contract holder is adversely affected by the climatic variable. This treatment stems from the definition of an insurance contract that requires the insured to be adversely affected by the insured event. It has been suggested to the AASB, by some of its Australian constituents, that weather derivatives (and other contracts where the categorisation may be uncertain) should be excluded from ED 5 on the basis that they are tradable instruments that behave like derivatives and have observable market prices, not on the basis of insurable interest.

The AASB staff believe that this debate highlights the following:

1. In ~~any~~ applying the definition of an insurance contract it is essential to consider the substance of the contract. This reiterates our comments made in relation to the definition of insurance above. Is the contract in substance a derivative or an insurance contract, the accounting should follow the substance. In considering this the cost of the premium could be considered;
2. The current definition of an insurance contract requires a specified uncertain future event to adversely affect the policyholder. There are contracts, which are in substance insurance contracts, where the policyholder can make a claim for a fixed sum if the rainfall is below a certain level at the nearest Bureau of Meteorology location. The contract is structured in such a way because of the difficulties in measuring actual loss suffered and because of the moral hazard of having a rainfall gauge on the policyholder's property. The policyholder can reasonably be expected to be affected by the rainfall at the nearest Bureau of Meteorology location at the time the policy is written, however it may be that this is not the case. The contract was purchased to provide insurance against low rainfall and should be accounted for as such.

2.8 Transitional Provisions

Paragraph 32 of ED 5 provides for exemptions, for first-time adopters, from full retrospective application. However, paragraph 9 of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, states that the requirements of IFRS 1 (which provide for full retrospective application) override all transitional provisions in other standards, except where specified in IFRS 1. The AASB staff recommend that IFRS 1 be amended to ensure that the relief proposed in ED 5 is effective.

2.9 Unbundling

We believe that the wording of paragraph 7 of ED 5 is unclear. Paragraph 7 states:

> "Some insurance contracts contain both an insurance component and a deposit component. In some instances, the application to the deposit component of an insurer's existing accounting policies for insurance contracts could mean that the insurer does not recognise obligations to repay amounts received under the insurance contract, or rights to recover amounts paid under the insurance contract. In that case, if the cash flows from the insurance component do not affect the cash flows from the deposit component, an insurer shall:
> (a) Treat the insurance component as an insurance contract.
> (b) Treat the deposit component as a financial liability or financial asset under IAS 39."

It is not clear whether "in that case" in the third sentence applies to the first or the second sentence. It is also not immediately clear that there are three conditions that need to be met before a contract must be unbundled:

1. Must be a deposit and an insurance component;
2. Accounting policies could mean that rights or obligations are understated; and
3. Cash flows from insurance component do not affect cash flows from deposit component.

We believe that the IASB should consider revising the wording of paragraph 7 of ED 5.

2.10 Claims Development Tables

Paragraph 29(c)(iii) states that an insurer shall disclose information about "actual claims compared with previous estimates". The Implementation Guidance Example 4 provides an

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example of how this might be presented. We believe that ED 5 should be more prescriptive to aid comparability and to ensure that the claims development tables disclosed are useful to users. We believe that claims development tables should be presented on an undiscounted basis, by class of business on a gross and net basis. There should also be a requirement that the table can be reconciled to the balance sheet total.

If claims development were shown for the business as a whole this would be of limited value for a complex group and could hide huge unders and overs. The table should indicate as clearly as possible, the insurer's ability to predict the cost of settling claims, discounting and reinsurance will confuse the picture. To aid comparability, an accident year basis or an underwriting year basis should be prescribed. We believe an accident year basis to be more appropriate.

2.11 Deferred Acquisition Costs Assets

A fundamental aspect of a deferral and matching model, used in Australia and in many jurisdictions, is the deferral of acquisition costs to match the recognition of premium revenue over the period of insurance risk.

ED 5, paragraph 9 states that the ED exempts an insurer from applying the criteria in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to its existing accounting policies for insurance and reinsurance contracts. Whilst it is not explicit in the ED, we understand that insurers will be able to continue to recognise a deferred acquisition costs asset ("DAC") in relation to insurance contracts, as not allowing such a treatment would make the models, involving the deferral and matching of premiums, unworkable. We believe that ED 5 should state explicitly that the recognition of DAC will be allowed under ED 5.

2.12 Accounting by a Cedant for Reinsurance

We support the proposals in relation to the accounting by a cedant for reinsurance in principle, as we believe that many deferral and matching models do not deal adequately with reinsurance contracts. However, we believe that there are inconsistencies in the requirements. Paragraph 18(d) requires gains arising from reinsurance contracts to be recognised over the period of risk, whereas paragraph 18(b) does not allow gains on inception of a reinsurance contract. Where a reinsurance contract provides cover for business that has already expired at the balance sheet date any gains could not be recognised under 18(b), which would mean that gains were not recognised over the period of risk in accordance with 18(d).

We believe that paragraph 18(b) should be amended to allow the recognition of gains where the period of risk has expired or to allow the recognition of a proportion of the gains to reflect the proportion of risk that has expired.

2.13 Accounting Policies

There is very strong support for international harmonisation of accounting standards in Australia. In light of this, some Australian constituents believe that the IASB should extend the prohibition on methods of measuring insurance liabilities contained in paragraph 16 of ED 5 to all entities, not just those entities that do not currently adopt those accounting policies at the time the standard is made.

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As a minimum, we believe that where insurer's accounting models do involve any of the accounting policies outlined in paragraph 16, ED 5 should require explicit disclosure of this in the financial statements.

We also note that we believe the drafting of paragraph 16, if it is retained in its current form, could be improved. Currently it states that "a new accounting policy that involves any of them" whereas we believe your intention is "a new accounting policy that introduces any of them". A new accounting policy may involve insurance liabilities being undiscounted and this may already be a requirement of existing accounting policies.

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2.14 Catastrophe and Equalisation Reserves

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We support the proposals to eliminate catastrophe and equalisation reserves, as these do not meet the IASB Framework's definition of an insurance liability. However we believe that the expressions "catastrophe and equalisation" reserves do not convey the principle of the requirements. These expressions could be interpreted differently in different jurisdictions.

We believe that the principle of the requirement is that insurers should not be able to provide for liabilities in relation to future claims that may arise under future contracts given that insurers do not have a present obligation for such liabilities. ED 5 could note that catastrophe and equalisation reserves for example, recognised in many jurisdictions, would not be permitted.

SECTION 3
ISSUES ARISING FROM IAS 39

3.1 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 (eg 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 effectively apply a "surrender value floor" to both the fair value and amortised cost measurement bases in IAS 39. The surrender value floor is not consistent with a fair value model and is overly conservative in our opinion, thereby potentially breaching the IASB Framework, which does not allow excessive provisions. The AASB staff note that the surrender value floor has been widely criticised by Australian constituents.

We believe that the potential consequences of the demand features proposals include:

1. Investment contracts, which are expected to be profitable, may report significant losses on inception, we do not believe that financial statements prepared on this basis are reliable; they will not represent faithfully the substance of the contracts. We believe that these proposals are inconsistent with a fair value model; and
2. We believe that the proposals in relation to demand features could potentially lead to spurious volatility in reported results for certain participating contracts. 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 when investment markets are depressed that the value of the supporting assets will be less than the surrender value. Large losses would be reported, followed by large profits when the markets recover. For such contracts we would expect to see losses reported when investment markets are depressed, however, the surrender value floor exaggerates the losses and subsequent profits. The surrender value floor therefore creates <u>additional</u> volatility in the reported results; and
3. From an Australian perspective, the proposals will introduce an inconsistency in the way in which surrender values are treated, depending upon whether a contract meets the definition of an insurance contract or not. Under current Australian GAAP, life insurance liabilities are measured allowing for expected surrenders on a probability-weighted basis. This difference could encourage accounting arbitrage.

The AASB staff believe that there are two ways of dealing with these issues under Phase I of the Insurance Project:

1. Delete the proposals in relation to demand features and extend the definition of acquisition costs to include all external and internal costs relating to the acquisition of contracts, including the reasonable allocation of overheads. We believe that one of the IASB's chief concerns driving these proposals is the recognition of profits on inception of an investment contract. We believe that replacing these requirements with one that

does not allow the recognition of profits at inception would provide a solution without the disadvantages of the demand features and transaction costs proposals; or

2. Unbundle investment contracts, 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. The financial liability under IAS 39 would effectively be the face value of the pure financial instrument, however, there would be the recognition of an asset representing deferred costs, which would relate to the retail revenue recognised under IAS 18. Investment contracts could be viewed as service contracts with an embedded financial instrument, in the same way that when investing in a unit trust an investor is in substance simply purchasing the services of the investment manager to manage the funds. The units in the unit trust are separate financial instruments. Investment contracts issued by life insurers in Australia are in substance the same type of arrangement. The AASB staff are currently working with their Australian constituents to develop this model further.

3.2 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". Under current Australian GAAP, AASB 1038 *Life Insurance Business* defines acquisition costs 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."

We believe that the potential consequences of the acquisition cost proposals include:

1. Investment contracts, which are priced to recover all acquisition costs and which are expected to be profitable, may report significant losses on inception, we do not believe that financial statements prepared on this basis are reliable, they will not represent faithfully the substance of the contracts;
2. Entities with different distribution channels will account for the same business differently. Those who use external channels such as brokers will be able to treat those brokerage or commission costs as transaction costs, whereas those with internal sales forces may not be able to treat these costs as transaction costs; ~~and~~
3. From an Australian perspective, the proposals will 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; and
4. Similar investment arrangements involving, for example, mutual funds and fund managers, which have 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 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 would emerge. In Australian life insurers and mutual funds compete directly for business and differential reporting would be unhelpful.

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The AASB staff believe that this issue can be dealt with in the same way as the demand features issue: either the acquisition costs definition is extended along the lines of the definition in AASB 1038 or an alternative model, as described above is implemented for Phase I.

3.3 Consistency in the Measurement of Assets and Liabilities

The AASB believes that assets that back investment contract or insurance contract liabilities should be measured consistently with the measurement of the underlying investment contract or insurance contract liabilities. There is widespread actuarial support for the notion that measuring assets that support investment contract or insurance contract liabilities inconsistently from the underlying investment contract or insurance contract liabilities leads to spurious volatility in the income statement. The AASB staff believe that IAS 39 should be amended to require consistent measurement of assets and related liabilities. In Appendix 1 of this submission we outline the AASB's proposed implementation of ED 5; this explains that the AASB proposes that insurers will be required to apply IAS 39 to the financial assets supporting investment contract or insurance contract liabilities, and to investment contract liabilities, and be required to elect the fair value through profit or loss designation. The AASB proposal is a response to the net present value models currently used for insurance liabilities.

SECTION 4
ISSUES RELATING TO PHASE II OF THE INSURANCE PROJECT

4.1 IASB's Tentative Conclusions for Phase II of the Insurance Project

The AASB support the development of a fair value model and recognise the difficulties in developing such a model for insurance. The AASB staff have concerns with some of the views taken by the IASB in relation to the fair value model that is being developed under Phase II of the Insurance Project.

BC6 of the *Basis for Conclusions on ED 5* discusses tentative conclusions for Phase II.

1. BC6(a) proposes an asset and liability model. The AASB supports such an approach;
2. BC6(b) proposes that assets and liabilities arising from insurance contracts should be measured at fair value. The AASB supports such an approach in theory; clearly this will depend upon the definition of fair value that evolves;
3. BC6(b)(i) proposes a caveat to the fair value model such that entities may use entity specific assumptions and information when market-based information is not available without undue cost and effort. We agree with this proposal, however, we would prefer that market-based assumptions and information should only be applied to particular parameters where this is appropriate. For example we do not believe that it would be appropriate to assume that the claims handling costs will be equivalent to the claims handling costs of an external claims handling specialist, if the entity has no intention of outsourcing claims handling and if its strategy is to control this aspect of the business for strategic reasons. The HIH Royal Commission, which investigated the collapse of HIH in Australia, identified an example of assumptions being set in this way, which led to insurance liabilities being understated;
4. BC6(b)(ii) proposes a caveat to the fair value model such that in the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less than the entity would charge to accept new contracts; an insurer would not therefore recognise a net gain at inception. The AASB staff believe that where an insurer is demonstrably able to charge premiums that are above the market rate, whether it is because of brand or customer service, that this should be reflected in the income statement. Whilst the AASB do not support the full recognition of profit at inception, it supports recognising profit margins, in excess of the risk margin, over the period of insurance service. This is consistent with current Australian GAAP for life insurance and our proposed amendments for general insurance. The AASB staff also notes that, in the general insurance market in particular, there is a pronounced market cycle. During a "soft market" premiums for some classes can be more than 25% below the level that will actually be required to cover insurance expenses. In such a market it is not appropriate to base insurance liabilities upon current premium levels;
5. BC6(c)(i) proposes that insurance liabilities are to be discounted. The AASB supports this proposal and indeed current Australian GAAP already requires discounting;
6. BC6(c)(ii) proposes that the measurement of liabilities should be independent of the performance of supporting assets. The AASB supports such a proposal and in the proposed amendments to Australian GAAP have incorporated this concept. We note, however, that where the value of the liabilities is dependent upon the performance of the assets that this should be reflected in the discount rate;
7. BC6(c)(iii) proposes that insurance liabilities should include a risk margin. The AASB supports this approach, and is proposing to introduce a margin for uncertainty for general insurance contracts, but recognises the difficulties in defining market value

margins. The actuarial community in Australia has recommended that in the absence of industry agreement over the measurement of market value margins a proxy for fair value should be adopted. This is the approach taken by the Australian regulator, the Australian Prudential and Regulatory Authority, for general insurance. General insurers are required, for regulatory purposes, to adopt a sufficiency margin at the greater of 75% sufficiency and half the coefficient of variation. The AASB staff believe that such an approach could be adopted, as an interim measure only, whilst there continues to be debate over the measurement of market value margins. This could prevent significant delays with the implementation of Phase II of the Insurance Project;

8. BC6(c)(iv) proposes that the fair value measurement of an insurance contract should reflect the credit characteristics of that contract. We note that this issue is highly contentious within the insurance industry and we believe that further debate is required before we are able to take a position on this issue;
9. BC6(d) proposes that renewals should only be recognised where the policyholder holds uncancellable continuation or renewal rights that significantly constrain the insurer's ability to reprice the contracts and where those rights will lapse if the policy is not renewed. We believe that this approach is overly conservative and inconsistent with the IASB Framework. Current Australian GAAP for life insurance contracts is based upon expected renewals and we believe that Phase II should provide for expected renewals;
10. BC6(e) proposes that acquisition costs should be recognised as expenses when incurred. The AASB supports such a proposal as an inherent aspect of an asset and liability model but notes that an element of acquisition costs would implicitly be carried forward if profits on inception in excess of the risk margin are carried forward and recognised in accordance with the period of insurance service, as recommended by the AASB;
11. BC6(f)(i) states that the IASB is to consider unbundling as part of Phase II of the Insurance Project. The AASB staff supports unbundling at a theoretical level. Where the contract as a whole meets the definition of an insurance contract, but where there are both deposit and insurance components to the contract, the deposit component should be unbundled. The AASB supports the interim approach in ED 5 as a reasonable compromise. If the IASB is to apply the conclusions in the Issues Paper published in 1999, that deposit components are to be unbundled, this will require further consultation to define the unbundling process and to allow sufficient time for the systems changes that would be required; and
12. BC6(f)(ii) states that the IASB is to consider how an insurer measures its liability under participating contracts as part of Phase II of the Insurance Project. The AASB staff believe that such contracts should be measured using expected values. The nature of the contracts is such that they tend to generate predictable returns to their policyholders. Appropriate disclosure of assumptions and guarantees should enable users of the financial statements to understand the nature of the insurers' liabilities. The AASB supports the ED 5 requirement that unallocated surpluses arising on participating contracts cannot be classified as an intermediate category that is neither liability nor equity. Under Australian GAAP unallocated surpluses are treated as a policyholder liability, this is consistent with legislative requirements. We believe that the IASB will need to maintain these high level principles in Phase II of the Insurance Project as legislation in the different jurisdictions is likely to cause inconsistencies if a more detailed approach is adopted.

4.2 Fair Value Hierarchy

Paragraphs 99 to 100A of IAS 39 establish a hierarchy for the subsequent measurement of fair value:

1. Quoted market price in an active market;
2. Recent market transactions between knowledgeable, willing parties in an arm's length transaction; and
3. Valuation techniques.

The AASB staff note that there is no active market for insurance liabilities. The AASB staff also note that there are very few market transactions in insurance liabilities. The remaining valuation method is valuation techniques. The AASB staff believe that ~~stochastic~~ probability weighted valuation techniques are the only appropriate method of measuring the fair value of an insurance contract. ~~Stochastic~~ Such valuation techniques cope well with the inherent uncertainty that exists in insurance contracts. The AASB staff believe, however, that quoted market prices and recent transactions, if available, are appropriate benchmarks for testing the validity of the liability that is generated by the valuation technique. If ~~a stochastic~~such a valuation approach is to be required as part of Phase II, insurers will require significant amounts of time to implement the required systems changes and the IASB must provide sufficient notice of the requirements.

4.3 Recognition of Insurance Liabilities

ED 5 defines an insurance liability as: "an insurer's net contractual obligations under an insurance contract". The IASB Framework states that an element of the financial statements should be recognised if it is:

1. Probable that any future benefit associated with the item will flow to or from the enterprise; and
2. The item has a value that can be measured with reliability.

For any individual insurance contract is unlikely to be probable that a loss will arise. Phase II of the Insurance Project needs to address this issue and recognise that whilst the insurance contract level ~~is~~ may be appropriate for determining whether or not a contract is an insurance contract it is not appropriate for recognising or determining the liability. Insurance liabilities only exist at a class of business level.

Similarly the liability that arises on a single contract is unlikely to be able to be calculated reliably. However, using actuarial techniques, the calculation of the liability for a group of contracts can be performed reliably.

The AASB staff believe that the IASB's deterministic framework is inappropriate for insurance contracts. A more appropriate framework for insurance is a ~~stochastic~~ probability weighted one that deals with inherent uncertainty. However, it can also be said that a probability weighted~~stochastic~~ framework is more appropriate for a fair value model, which is the future direction of all IASB standards.

SECTION 5
OTHER ISSUES

5.1 Deferred Tax

Under current Australian GAAP, life insurers' deferred tax balances are required to be discounted. This ensures consistency of measurement, given that insurance liabilities for life insurance and investment contracts are discounted under Australian GAAP. The most significant deferred tax balances that arise for insurers relate to capital gains on financial assets supporting insurance and investment contracts. IAS 12 *Income Tax* does not allow tax balances to be discounted.

For discretionary or unit-linked insurance contract or investment contract business, insurers discount deferred tax balances when calculating policyholder benefits, as a matter of policyholder equity, as capital gains are passed from one generation of policyholders to another. If the deferred tax balances are not able to be discounted then this creates an inconsistency in the measurement of ~~policyholder~~ liabilities and associated assets in the balance sheet as well as between the value of tax liabilities for ~~between~~ financial reporting purposes and regulatory and investment fund/policyholder profit allocation purposes. In addition, if policies specifically require accounting balances to be used in the calculation, then, to maintain policyholder equity, costly policy or rule changes would be required.

~~We also believe that, as a matter of principle, there should be consistency of measurement of assets and liabilities.~~

5.2 Measurement of Other Assets Backing Participating or Investment-Linked Business

In section 3.3 of this report we state our position that the financial assets backing financial liabilities should be measured consistently. In life insurance business and investment business, there may also be other non-financial assets that directly support financial liabilities ~~in a statutory fund required by Australian legislation~~. These assets include owner-occupied property, investment property, investments in subsidiaries, investments in associates, interests in joint venture entities and property plant and equipment. The AASB believes that all of these assets, where they support insurance or investment contract liabilities, should be measured at fair value with changes in fair value recognised in the income statement. Not all applicable IFRS standards allow such treatment.

In particular, current Australian GAAP requires the excess in the net market value of an interest in a subsidiary over the net assets of the subsidiary to be reported as an asset (the EMVONA asset) in the consolidated financial report of a life insurer. This asset is unlikely to be fully allowable under IFRS standards, because IAS 27 will apply and will eliminate the EMVONA.

For participating or unit-linked insurance or investment business, the value of the liabilities will reflect the full value of the assets backing the contracts. Therefore the inability to recognise this EMVONA asset may create misalignment between the measurement of assets and the measurement of liabilities.

Similarly, an office building occupied by an insurance company is no different from any other office building that may be held as an investment asset. Insurance companies (and other financial service providers) may hold such assets in the funds supporting their insurance and investment contracts. In the interests of policyholder equity, changes in the fair value of the property will be reflected in the benefits to policyholders and hence in changes in the value of the liabilities. However, that same movement in the fair value of the property asset cannot be recognised through profit and loss, but must be taken directly to reserves (the fair value approach) or is not recognised at all (the cost approach). An inconsistency in reported profit will therefore result. ~~The AASB believes that for all insurance contract or investment contract liabilities where the value of the liabilities is dependent upon the performance of the assets, that the assets backing those liabilities should be measured at fair value.~~

We note that the IASB has recently put exclusions from the scope of IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* in respect of investment-linked insurance funds, where the relevant associates or interests in joint venture entities are designated as held for trading under IAS 39.

We are not clear what is intended by these exclusions: do they apply to associates or interests in joint venture entities supporting all investment-linked contracts or only those supporting investment-linked insurance contracts? In addition, do they relate to all associates or interests in joint venture entities held by investment-linked insurance funds (an undefined term) or only those supporting investment-linked liabilities?

The AASB staff consider that the exclusions should apply to all associates or interests in joint venture entities supporting investment-linked or participating insurance and investment contract liabilities. We consider that the same extended exclusion should apply to investments in subsidiaries.

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APPENDIX
AASB'S PROPOSED IMPLEMENTATION OF ED 5

The AASB have reviewed ED 5 and have issued:

1. ED 122 *Request for Comment on IASB ED 5 Insurance Contracts*;
2. ED 122A *Request for Comment on Amendments to AASB 1023 General Insurance Contracts*; and
3. ED 122B *Request for Comment on Amendments to AASB 1038 Life Insurance Contracts.*

These exposure drafts outline the AASB's proposed response to ED 5. AASB ED 122, ED 122A and ED 122B also reflect the recommendations of the HIH Royal Commission as well as changes designed to reduce differences between Australian regulatory and financial reporting.

The following tables illustrate the current accounting models for general and life insurance contracts and the proposed accounting models.

GENERAL INSURANCE

Current Model **AASB 1023 *Financial Reporting of General Insurance Activities***	**Proposed Model** **ED 122A *Request for Comment on Amendments to AASB 1023 General Insurance Contracts***
Deferral and matching model	Asset and liability model
Revenue recognised over the period of risk	Revenue recognised from the attachment date
Acquisition costs deferred to match revenue	Acquisition costs expensed from the attachment date
Unearned premium reserve recognised	Premium liability recognised for future claims that will arise under current policies
Outstanding claims reserves measured using net present value calculation	Outstanding claims reserves measured using net present value calculation
Outstanding claims reserves reflect expected value	Outstanding claims reserves include a margin to reflect uncertainty in the measurement model
Discount rates reflect returns on supporting assets	Discount rates reflect the fact that liabilities are typically independent of the performance of supporting assets
Assets integral to general insurance activities	Assets integral to general insurance activities

measured at net market value with changes in net market value recognised in the income statement	measured at fair value with changes in fair value recognised in the income statement – insurers apply IAS 39 but must elect the fair value through profit or loss designation, insurers also apply IAS 16, IAS 40 and IAS 27 as appropriate but must elect the fair value "options" available in these standards Embedded derivatives that are not insurance contracts to be treated under IAS 39 Certain deposit components to be unbundled and treated under IAS 39

LIFE INSURANCE

Current Model **AASB 1038** ***Life Insurance Business***	**Proposed Model** **ED 122B** ***Request for Comment on Amendments to AASB 1038 Life Insurance Contracts***
Margin on services (MoS) model MoS applied to life insurance contracts and investment contracts Policy liability for life insurance contracts and investment contracts measured as net present value of future receipts from and payments to policyholders plus planned margins of revenues over expenses relating to services not yet provided on the basis of assumptions that are best estimates Acquisition costs for life insurance contracts and investment contracts included in expenses are all direct and indirect costs related to acquiring the business including allocation of overheads Differences between actual and assumed experience for life insurance contracts and investment contracts recognised immediately in the income statement Changes in assumptions for life insurance contracts and investment contracts, other than	Margin on services (MoS) model MoS applied to life insurance contracts, other standards, notably IAS 39, applied to investment contracts Policy liability for insurance contracts measured as net present value of future receipts from and payments to policyholders plus planned margins of revenues over expenses relating to services not yet provided on the basis of assumptions that are best estimates Acquisition costs for life insurance contracts included in expenses are all direct and indirect costs related to acquiring the business including allocation of overheads Differences between actual and assumed experience for life insurance contracts recognised immediately in the income statement Changes in assumptions for life insurance

discount rates assumptions, recognised over future years during which services are to be provided	contracts, other than discount rates assumptions, recognised over future years during which services are to be provided
Changes in discount rate assumptions for life insurance contracts and investment contracts recognised in income statement immediately	Changes in discount rate assumptions for life insurance contracts recognised in income statement immediately
Losses on groups of related products for life insurance contracts and investment contracts recognised immediately in the income statement	Losses on groups of related products for life insurance contracts recognised immediately in the income statement
Discount rates for life insurance contracts and investment contracts reflect performance of supporting assets	Discount rates for life insurance contracts reflect the fact that liabilities are typically independent of the performance of supporting assets except where this is not the case, in which case discount rates reflect the performance of supporting assets
Assets of a life insurer (a life insurer is an entity that writes either insurance or investments business) measured at net market value with changes in net market value recognised in the income statement	Assets of a life insurer (a life insurer is an entity that writes either insurance or investments business) measured at fair value, insurers required to apply relevant IASB standards but to elect the fair value options available under the standards. Financial liabilities relating to investment contracts measured at fair value. Issuers apply IAS 39 but are required to elect the fair value through profit or loss designation
Deferred tax assets and liabilities for life insurance contracts and investment contracts discounted	Deferred tax assets and liabilities for life insurance contracts only discounted where the deferred tax balances are part of a life insurance contract and discounting of these balances is an explicit or implicit term of that contract