International Actuarial Standard of Practice No. 6
A Practice Guideline*

International Actuarial Association | Association Actuarielle Internationale

IASP 6

Liability Adequacy Testing, Testing for Recoverability of Deferred Transaction Costs, and Testing for Onerous Service Contracts under International Financial Reporting Standards IFRS [2005]

Prepared by the
Subcommittee on Actuarial Standards of the
Committee on Insurance Accounting

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**Practice Guidelines are educational and non-binding in nature. They represent a statement of appropriate practices, although not necessarily defining uniquely practices that would be adopted by all actuaries. They are intended to familiarise the actuary with approaches that might appropriately be taken in the area in question. They also serve to demonstrate to clients and other stakeholders and to non-actuaries who carry out similar work how the actuarial profession expects to approach the subject matter.*

This Practice Guideline applies to an actuary only under one or more of the following circumstances:

- If the Practice Guideline has been endorsed by one or more IAA Full Member associations of which the actuary is a member for use in connection with relevant International Financial Reporting Standards (IFRSs);
- If the Practice Guideline has been formally adopted by one or more IAA Full Member associations of which the actuary is a member for use in connection with local accounting standards or other financial reporting requirements;
- If the actuary is required by statute, regulation, or other binding legal authority to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements;
- If the actuary represents to a principal or other interested party that the actuary will consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements; or
- If the actuary's principal or other relevant party requires the actuary to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements.

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1. Scope

The purpose of this PRACTICE GUIDELINE (PG) is to give advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing PROFESSIONAL SERVICES in accordance with INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs), specifically relating to the following:

- INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 4, *Insurance Contracts*, and where applicable, INTERNATIONAL ACCOUNTING STANDARD (IAS) 37, *Provisions, Contingent Liabilities and Contingents Assets*, as they relate to LIABILITY ADEQUACY TESTING and to the minimum liability for FINANCIAL INSTRUMENTS that contain a DISCRETIONARY PARTICIPATION FEATURE (DPF); and
- IFRS 18, *Revenue,* IAS 36, *Impairment of Assets*, and IAS 37, as they relate to testing for recoverability of deferred transactions costs and testing for onerous SERVICE CONTRACTS.

This PG applies where the REPORTING ENTITY is an ISSUER of INSURANCE CONTRACTS, INVESTMENT CONTRACTS, or SERVICE CONTRACTS. It is a class 4 INTERNATIONAL ACTUARIAL STANDARD OF PRACTICE (IASP).

Reliance on information in this PG is not a substitute for meeting the requirements of the relevant IFRSs. Practitioners are therefore directed to the relevant IFRSs (see Appendix A) for authoritative requirements. The PG refers to IFRSs that are effective as of 16 June 2005, as well as to amended IFRSs not yet effective as of 16 June 2005 but for which earlier application is made. If IFRSs are amended after that date, practitioners should refer to the most recent version of the IFRS.

2. Publication Date

This PG was published on 16 June 2005, the date approved by the Council of the INTERNATIONAL ACTUARIAL ASSOCIATION (IAA).

3. Background

Liability adequacy testing applies to the NET CARRYING AMOUNTS of insurance contracts and to investment contracts with DPFs.

The requirement for liability adequacy testing for insurance contracts is found in IFRS 4.15–19. IFRS 4.35 also makes liability adequacy testing a requirement for investment contracts with DPFs. The basis for liability adequacy testing of these CONTRACTS depends on whether the company classifies the entire DPF as a liability or whether it classifies some portion of the feature as equity.

Investment contracts that do not contain DPFs are not subject to the requirement of liability adequacy testing in IFRS 4. Rather, they fall in the scope of IAS 39.

When a service component of a contract is separated from an investment contract, deferred TRANSACTION COSTS, if any, must be tested for recoverability (IAS 18, Appendix, paragraph 14(b)(iii)). Further, if the servicing contract is an ONEROUS CONTRACT, IAS 37 requires the reporting entity to recognise a PROVISION. These considerations may apply to standalone service contracts as well.

4. Practice Guideline

The practice guidance for insurance contracts and for investment contracts with DPFs is in section 4.1. The recoverability of deferred transactions costs and testing for onerous service contracts is discussed in section 4.2.

4.1 Liability adequacy testing and minimum liabilities for insurance contracts and for investment contracts with DPFs

4.1.1 Insurance contracts

The essential requirement for liability adequacy test is given in IFRS 4.15, which states:

> An INSURER shall assess at each reporting date whether its recognised insurance liabilities are adequate, using CURRENT ESTIMATES of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred ACQUISITION COSTS [DAC] and related INTANGIBLE ASSETS…) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

Because claims liabilities or loss reserves are part of insurance liabilities, they fall within the scope of liability adequacy testing. This can be broken down as follows:

Timing — Testing is required at each reporting date. Some further considerations regarding the extent of testing that is necessary are found in section 4.1.4.

Type of testing — The test is a comparison of the carrying amount of insurance liabilities less related DAC and related intangibles to current estimates of future cash flows under insurance contracts. The net carrying

amount is discussed in section 4.1.3. Further considerations regarding current estimates of future cash flows are given in sections 4.1.5–4.1.12.

Recognition — If the net carrying amount is deficient, the entire deficiency is recognised in profit or loss. Some further considerations regarding recognising a deficiency are given in section 4.1.13.

4.1.2 Investment contracts that contain a DPF

The requirements for investment contracts depend on whether the entity has classified the DPF entirely as a liability or whether it has classified the DPF in part or in total as a separate component of equity.

When the DPF is classified entirely as a liability — The requirements for investment contracts with a DPF that is classified entirely as a liability are found in IFRS 4.35(a), which states that "if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15–19 to the whole contract (i.e., both the GUARANTEED ELEMENT and the discretionary participation feature). The issuer need not determine the amount that would result from applying IAS 39 to the guaranteed element."

The paragraphs referred to are those that relate to liability adequacy testing for insurance contracts. Hence the requirements are the same for these investment contracts as they are for insurance contracts. Further considerations for liability adequacy testing for these contracts are given in sections 4.1.3–4.1.13.

When the DPF is classified in part or in total as a separate component of equity — The requirements for investment contracts for which the DPF is classified in part or in total as a separate component of equity come from IFRS 4.35(b), which states that "if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element."

There is a debate about whether the IAS 39 minimum liability is a requirement in addition to the requirement to perform liability adequacy testing, or in lieu of liability adequacy testing. One view is that IFRS 4.35, by reference to IFRS 4.34, makes liability adequacy testing a requirement for all investment contracts with DPFs, and that IFRS 4.35 also imposes an additional requirement that the liability for the whole contract not be less that an IAS 39 measure of the liability for the guaranteed elements. The other view is that IFRS 4.35 presents two possibilities, namely:

1. When the entire DPF is in liabilities, applying liability adequacy testing; or
2. When less than the entire DPF is in liabilities, measuring the liability at not less than the IAS 39 measure. Because the guidance here is specific, it is sufficient for the purposes and there is no requirement to perform liability adequacy testing.

Further considerations related to the IAS 39 minimum are found in section 4.1.14.

4.1.3 Net carrying amount

Net carrying amount is a term of convenience used in this PG to refer to the amount tested for adequacy. IFRS 4 describes to the amount to be tested as the insurance liability less any related DAC or related intangible assets, such as those arising from business combinations as the amount subject to liability adequacy testing.

Although IFRS 4 does not refer to the application of a liability adequacy test in cases where the contract is recognised as an insurance asset, it may be appropriate to consider some assets when calculating the net carrying amount. Examples include Zillmer assets, which are created in some existing ACCOUNTING POLICIES, when a debit balance in a reserve calculation—i.e., a negative reserve—is allowed to be recognised as an asset. Another example is the internally generated value of in-force business resulting from embedded value approaches, if this is recognised under exiting accounting policies. Further examples might arise from other approaches, regardless of how characterised, if they result in recognition of net rights under the contract as an asset.

One possibility is that such assets are in the scope of IAS 36. If so, the guidance in that standard is followed to determine if the asset is impaired. Another possibility is that such assets are analogous to DAC and forms part of the net carrying amount. The approach taken may depend on facts and circumstances, and may ultimately rest on whether the asset is viewed as part of the measurement of the net obligations under the insurance contracts or an asset apart from the measurement of the insurer's obligations.

It is not clear that the carrying value of an investment contract with a DPF that is classified as a component of equity should be reduced for DAC, purchase intangibles, or other related assets when making the test for the minimum liability. The guidance simply states that "the liability recognised for the whole contract shall not be less than the amount that would result

from applying IAS 39 to the guaranteed element." Applying IAS 39 to the guaranteed elements would not allow recognition of a DAC or purchase intangible, although this might be implicit when valuing the liability, for example, by using an effective interest rate method. The approach may depend on the type of contract. A contract for which the deferred cost is associated with a separated service contract (a unit-linked contract with a DPF feature, for example) may not require a netting down for testing purposes, but contracts that do not have a separate service contract may more appropriately be considered on a net basis.

4.1.4 Timing and the extent of testing

Liability adequacy testing is performed at each reporting date. The extent of testing should be sufficient to allow a conclusion that the liabilities are adequate. Unless a deficiency is recognised, amounts are not disclosed. Hence, the precision of the test can reflect the apparent size of the sufficiency, i.e., the test may not require as much precision when the results indicate a clear sufficiency as when a more precise calculation might result in recognising a deficiency.

Other possibilities for the extent of testing include:

1. Basing conclusions on testing performed in prior periods when it is apparent, from considerations of trends in experience, that the conclusions remain valid;
2. Basing conclusions on the fact that the net carrying amount is measured on a prudent basis, one that is demonstrably adequate at inception of the contracts, and on evidence that supports that the margins for prudence have not been eroded to the extent that liability adequacy is a concern;
3. Limiting testing to selected cells or cohorts of contracts, for which testing may be sufficient to demonstrate that the net carrying amount is sufficient for an entire class; and
4. Basing conclusions on the fact that the liability measurement in the first instance assures that the liability is not less than a measure of the cash flows that meets the minimum requirements.

4.1.5 The minimum requirements and the type of testing

The type of the test depends on whether the entity's existing liability adequacy testing meets the minimum requirements found in IFRS 4.16, which states:

> If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements. The minimum requirements are the following:
>
> (a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded OPTIONS and GUARANTEES.
>
> (b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

Current estimates — This term appears to imply that estimates are based on continuously updated assumptions. IFRS 4 does not specify if assumptions or cash flows are adjusted for risk and uncertainty. Both estimates with and estimates without adjustments for risk and uncertainty seem to be acceptable for a test to meet the minimum requirements.

Future cash flows — The reference to contractual cash flows suggests that the period of the projection of cash flows would normally extend for the life of the contracts. This can be construed to mean to the end of the contract term or to the next re-pricing date. For example, cash flows for life contracts could be projected to the maturity date or the expiry date, while cash flows for general insurance contracts would be to the final payout of incurred claims and of claims projected to be incurred in the remaining period of exposure under unexpired contracts. There is no prohibition on considering receipts as well as payments; hence inclusion of recurring or flexible premium payments within the contract terms may be acceptable. The reference to claims handling expenses implies that at least direct costs should be considered and possibly allows including administrative expenses as well as claims handling costs.

Cash flows from embedded options and guarantees — IFRS 4 does not specify how options and guarantees should be considered (IFRS 4, BC99) but clearly intends that they not be overlooked. Possibilities include:

1. Current estimates of future cash flows from options and guarantees for both in-the-money and out-of-the-money options and guarantees;
2. Cash flows from options at settlement, i.e., extending the projection period beyond the maturity or settlement date to capture cash flows from options; and
3. Stochastic measurement of the costs of options and guarantees.

Does the existing policy meet the minimum requirements — Varying practices exist for liability adequacy testing, depending on the accounting regime and entity-specific practices. For example, there are varying approaches to considering options and guarantees in cash flow estimates. Some existing practices may be more conservative in their measurement of the required liability and others less conservative than the IAS 37 measure. The minimum requirements in IFRS 4 are broadly stated and appear to be fairly inclusive of the various practices.

Nonetheless, determining that existing practices meet the minimum requirements is necessary before relying on them for IFRS purposes. Existing practices may no longer meet the requirements if circumstances have changed so that the cash flows from options and guarantees are expected to become significant, such as a result of a lower interest rate environment

4.1.6 When the existing liability adequacy testing does not meet the minimum requirements

When a reporting entity's policy for liability adequacy testing does not meet the minimum requirements of IFRS 4, then the reporting entity applies the approach to the measurement of the provision for estimated cash flows found in IAS 37. IFRS 4.17(b) states, "If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall…determine whether the [net carrying amount] is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*."

4.1.7 Applying IAS 37

The measurement principles of IAS 36 are found in paragraphs 36–60 of that standard. IAS 37.36 states, "The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date."

IFRS 37.37 defines the best estimate of the expenditure required to settle the present obligation as "the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time."

Best estimates "are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts" (IAS 37.35). When the outcome is

uncertain and involves a large population of items (as is the case with insurance contracts and with investment contracts with DPFs), then the provision is the "expected value," which is the probability-weighted average of all possible outcomes. The estimates must be before tax (IAS 37.37, 37.39, and 37.41). A cash-flow MODEL, possibly with multiple scenarios when needed to properly reflect the possible outcomes, is consistent with this guidance. Although the reference is to expenditures, it is arguable that the model may consider premium receipts because ultimately the expenditures are a function of future premiums. There is no specific prohibition from considering future premiums.

Risk and uncertainty — An IAS 37 provision is adjusted for risk and uncertainty, but not to the extent that the liability is excessive. According to IAS 37.42 and 37.43:

> The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.
>
> Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

It may be necessary to take care not to duplicate adjustments for uncertainty. For example, if uncertainty is considered by taking a weighted average of possible outcomes, then adjustments to the cash flows should not reflect uncertainty with respect to the possibility of different outcomes, although they may still be needed to reflect that the outcome in a given scenario may not be fixed, but rather may be uncertain. Similarly, adjustment for risk and uncertainty made to cash flows are not duplicated in adjustments to discount rates (discussed below).

Discounting — When material to the estimate, the time value of money is considered (IAS 37.45–47). Hence the provision is the present value of future cash flows. IAS 37 calls for pre-tax discount rates that reflect current market conditions. IFRS 4.12 offers additional guidance on this point and states that the IAS 37 provisions shall reflect interest margins if and only if the subject net liabilities reflect interest margins. If, for example, a provision is a loss reserve that is not discounted, then the IAS 37 measure would be the present value of the payout on the losses, discounted at risk-free rates. If, however, the liability had been determined initially as the present value of future benefits, discounted at a rate that is tied to yields on a portfolio of investments that expect to have a spread above risk-free rates, then the IAS 37 provisions would have a similar spread. In this case, the spread would be based on current market conditions, which may differ from the spread in the initial liability calculation.

4.1.8 Additional considerations when applying IAS 37: future events and reimbursements

IAS 37 offers additional guidance regarding the measurement of a provision that may have relevance in a liability adequacy test. These relate to future events and reimbursement.

Future events — These can be reflected in the provision only to the extent that there is objective evidence that they will occur (IAS 37.48). In a cash flow measure, future events might include expense reductions and mortality improvements, conservation programs, or other operating and environmental factors that could influence cash flows. Such considerations should be incorporated into cash flow projections in light of this guidance.

Reimbursement — When the settlement of an obligation is to be reimbursed by a third party, the IAS 37 measure of the obligation is not reduced by the anticipated reimbursement, rather an asset is recognised for the reimbursement. The expense related to the provision may be presented net of the amount recognised for reimbursement.

In the context of insurance, reinsurance could be considered to be a reimbursement. The guidance for reimbursements in IAS 37 is consistent with the IFRS 4 guidance for reinsurance for balance sheet presentation, but not in the profit and loss, as IFRS 4 does not allow benefits costs to be offset by reinsurance.

It is possible salvage and subrogation are reimbursements. The treatment of salvage and subrogation should consider if and how guidance in IAS 37 is applicable.

4.1.9 Is liability adequacy testing before or after consideration of reinsurance?

When liability testing is performed using an IAS 37 measure of the cash flows, the question is answered by IFRS 4.17(a)(ii), which states that "related reinsurance assets are not considered because an insurer accounts for them separately."

While not expressly stated, when an entity does not apply IAS 37, the answer appears to be the same; namely liability adequacy testing is performed without regard to reinsurance. The description of the net carrying amount is gross of reinsurance. Further, in general in IFRS 4 reinsurance assets are accounted for separately from the related insurance liabilities.

A liability adequacy test that is net of reinsurance presents the possibility of recognising a net deficiency, rather than recognising a deficiency on a gross basis with a corresponding adjustment, if any, to the reinsurance asset (see section 4.1.10). Recognising a net deficiency may reduce transparency in the financial statements as it may obscure the extent of credit risk to which the insurer is exposed. IFRS 4.14(d) states that an insurer "shall not offset: (i) reinsurance assets against the related insurance liabilities; or (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts." Hence, an existing accounting policy that calculates a net deficiency may need to be modified to present the deficiency in the insurance liabilities without regard to reinsurance and to reflect separately the effect on the reinsurance asset, if any, of the considerations in the liability adequacy test that gave rise to the gross deficiency.

IFRS 4.16 states, "If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements." This statement does not appear to authorise a test only net of reinsurance, (if, for example, the existing policy is to test net of reinsurance) as it refers to the nature of the test, not to the amounts that are tested. As discussed above, it may be possible to meet the requirements of IFRS 4 by modifying the presentation in the balance sheet of the results of liability adequacy testing.

A liability adequacy test that is gross of reinsurance does not consider the cost of reinsurance. Again, because the accounting for reinsurance is separate from accounting for insurance liabilities, it is appropriate that the test does not consider the cost of reinsurance.

4.1.10 Other reinsurance considerations

Although not addressed in IFRS 4, as mentioned above, there may be implications to the measurement of reinsurance assets arising from recognition of a deficiency. For example, consider an insurance liability of 100 that is 50% reinsured. Under the company's accounting policy, the reinsurance asset is 50. If, as a result of liability adequacy testing the insurance liability is increased to 110, consideration should be given to a possible adjustment to the reinsurance asset. If the measure of the asset is simply that it is 50% of the direct liability, then in this example the reinsurance asset would increase to 55.

In general the effect on reinsurance assets of a recognised deficiency in insurance liabilities depends on:

1. What gives rise to the liability deficiency and how this variable affects the measurement of the reinsurance asset; and
2. The accounting policy for reinsurance.

4.1.11 Aggregation

When applying an existing accounting policy, the aggregation practice follows that practice already established in that policy. When using an IAS 37 measure of the future cash flows, the test "shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio."

4.1.12 Change in accounting policy

Consistent with the general allowance in IFRS 4 related to changes in accounting policy, an entity may change its policy regarding liability adequacy testing to an approach that is more relevant or reliable (see the PG, *Changes in Accounting Policy while under International Financial Reporting Standards*). Examples of such changes include:

1. Making policies uniform across classes, segments, or the entity;
2. Modifying existing policies that do not meet the requirements of IFRS 4 to policies that meet the requirements, for example, by making consideration of options and guarantees, when consideration of these is not a part of the existing policy, or by recognising a deficiency in the period in which it is identified rather than over a number of periods; and
3. Introducing a discounting policy where the existing accounting policy is not to discount estimated cash flows. In this event, introducing a

discounting policy that reflects future investment margins usually has the rebuttable presumption that the policy is not more relevant.

If a reporting entity has an accounting policy that meets the minimum requirements of IFRS 4 and wishes to adopt the measurement approach in IAS 37, the reporting entity may need to determine how the approach in IAS 37 is more relevant or reliable than the existing accounting policy.

The entity considers whether the adjustment to the balance sheet as a result of first-time adoption or a change in the reporting entity's accounting policy for loss recognition testing is a change in accounting policy.

4.1.13 Accounting for a deficiency

A deficiency is usually recognised by increasing the liability by the amount of the deficiency or by a reduction in the related DAC, Zillmer asset, or intangible asset. IFRS 4 does not specify which liabilities or assets are affected (IFRS 4, BC101(d)). The initial deficiency is recorded in profit or loss in the period in which it is identified. The entire deficiency is recognised; it is not spread over future reporting periods.

When using an existing liability adequacy testing policy, IFRS 4 does not modify the accounting for future changes in the amount of the deficiency at subsequent reporting dates. It stands to reason that when the testing indicates that the deficiency has increased, the increase is reflected in profit and loss in the current period. Reductions in the amount of a deficiency, other than natural run-off as obligations mature, are recognised according to the existing accounting policy. Some policies "lock-in" a new basis and do not allow for reductions. Others allow for re-measurement and reductions as well as increases. It is sensible to conclude that the liability cannot be less than it would have been if a deficiency had not been recognised.

If net carrying amounts are adequate at the present reporting date, but consistent application of existing measurement practices will result in net carrying amounts that are deficient at a future reporting date, the practitioner usually considers modifying the methods or assumptions used so that a future deficiency does not arise, if the modification conforms to existing accounting policies. Such a practice exists in U.S. GAAP, for example.

Despite the fact that IFRS 4 states that a deficiency is recognised through profit or loss, an indicated deficiency that results from, for example, a change in discount rates for liability adequacy testing caused by recognition of an unrealised gain through equity, could likewise be recognised through equity under the principle articulated in IFRS 4.30 relating to shadow accounting.

4.1.14 IAS 39 minimum

For investment contracts with DPFs recognised partially or totally as a separate component of equity, and for which the liability for the guaranteed element is separate from the DPF, the liability cannot be less than the IAS 39 measure of the liability for the guaranteed elements. As noted above in section 4.1.3, it is not clear if the requirement relates to the liability or to the net carrying amount. It is also not clear if the liability for the "whole contract" is intended to mean that the tested amount can consider some portion of the DPF that is classified as liability.

If the liability to be tested includes consideration of the liability for the DPF, then the total liability for the whole contract or for a cohort of contracts may not be known. If it is apparent that the liability for the guaranteed element considered by itself is greater than the IAS 39 measure, there is no need for further testing.

If the liability for the guaranteed element is not greater than the IAS 39 measure, it may become necessary to allocate notionally a part of the liability for the discretionary element to the contracts being tested. The allocation between these two elements is based on a rational, systematic approach and applied on a consistent basis. This allocation is notional in the sense that it is used only for testing whether the liability is understated. For example, the reporting entity could allocate the asset share to the contracts in excess of the liability for the guaranteed element.

IFRS 4 does not specify the IAS 39 measurement basis to use, i.e., it does not indicate whether the IAS 39 liability should be expressed on an AMORTISED COST or FAIR VALUE basis. Presumably, as the fair value option in IAS 39 requires a contract-by-contract designation at inception, a similar principle would apply for this purpose. IFRS 4 does state that the IAS 39 liability "should include the intrinsic value of the option to surrender the contract, but need not include its time value if the option is excluded from a fair value measure." This last point is difficult to interpret, but is intended to draw attention to the cash surrender option when an IAS 39 measure is applied.

4.2 Service contracts

IAS 18, Appendix A, paragraph 14(b), stipulates that amounts deferred as transaction costs related to the service component of investment contracts, which has been separated for accounting purposes, must be recoverable. IAS 18 does not address how to perform recoverability testing, but general guidance for asset impairment is found in IAS 36.

Another possible source of guidance is IAS 38, *Intangible Assets*. IAS 38 is applicable if the deferred cost is regarded as the intangible asset created by the purchase of servicing rights related to the investment contracts. For impairment testing, IAS 38 uses the guidance in IAS 36, so the designation of the deferred cost as an intangible asset or otherwise is moot as regards its recoverability.

Further, IAS 37 requires a provision for onerous contracts in the amount of the unavoidable costs. The unavoidable cost is the smaller of the costs to fulfil the contract or any compensation or penalties arising from the failure to fulfil the contract. The guidance also states that asset impairment should be recognised before a separate provision is recognised (IAS 37.66 and 37.69).

The guidance that follows applies when considering recoverability of deferred costs or provisions for onerous contracts relating to either standalone service contracts or service separately focusing on financial instruments.

4.2.1 Asset impairment

IAS 36

According to IAS 36, an asset is impaired if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is the higher of fair value less costs to sell and VALUE IN USE. If the net selling price cannot be reliably determined, then the recoverable amount of the asset is its value in use.

A review is made at each reporting date and, if there is an indication that the asset may be impaired, the reporting entity estimates the recoverable amount. IAS 36 gives a non-exhaustive list of indications that must be considered, including among other things that indications of impairment can include increases in market interest rates that would adversely affect the asset's value in use. Even where there is no impairment, there may be a reason to adjust the future amortisation of the asset (IAS 36.19).

The fair value less costs to sell should be based on observed market transactions or on a model that considers MARKET FACTORS. Consideration of the net selling price is allowed only if it can be reliably estimated.

VALUE IN USE is the present value of future net cash flows (IAS 36.6). The projection of net cash flows should be based on management's best estimate, using assumptions that are relevant and supportable (IAS 36.33–53). The discount rate should be a pre-tax rate reflecting current market assessments of the time value of money, and the risk relates to the variability of the cash flow. The discount rate should not be adjusted for risk to the extent that the

risks have been considered in adjustment to projected cash flows (IAS 36.55–57).

Applying IAS 36 to deferred transaction costs

While IAS 36 refers to the recoverability of an individual asset or to the amount recoverable for a cash-generating unit to which the asset belongs, IAS 18 allows a reporting entity to consider a portfolio of contracts.

Indications that it may be appropriate to test deferred transaction costs relating service contracts for recoverability include factors such as:

1. The costs for securing the contracts exceed pricing assumptions;
2. Fees assessed to contracts are at rates less than expected;
3. Fee income is less than expected for reasons such as contract terminations or market movements;
4. Costs of servicing have increased or are greater than pricing allowances; and
5. As described below, interest rates have risen to an extent that the present value of cash flows may be less than the net carrying amount of the asset.

There is no automatic presumption that the asset is recoverable when the contract is issued.

It is doubtful that deferred transaction costs could be tested for impairment by reference to net selling costs, as generally it is not practical to make a reliable estimate of the amount that would be obtainable in a sale, and as such an estimate would likely be similar to a calculated value in use. Hence, the PG does not further discuss the application of the use of net selling price.

When determining the value in use, a reasonable application of IAS 36 is to define the cash flows to be the fee income less the costs of servicing. Fee income includes fees related to the service component to be levied in the future. Any remaining unamortised deferred fees would also be part of the consideration. The test would be whether the asset exceeds the remaining unamortised deferred fees plus the present value of future fees less the present value of the costs to provide the service. For this purpose, the value of deferred front-end fees is the recognised amount, not the discounted value of projected amortisation to be included in income. Servicing costs typically include those that can be directly attributable or allocated on a reliable and consistent basis to the activities of the entity that relate to contract servicing.

The cash flows normally would be projected on a basis consistent with management forecasts and budgets. These would be considered in light of assumptions underlying projections supporting internal management planning documents or in published information such as embedded values.

In addition, as mentioned in IAS 36, the projection should be based on a scenario that is internally consistent. Any improvements, such as cost reductions, should not be projected unless there is a plan for cost reduction to which management is committed that addresses costs that management can control. Differences between projections used in estimating value in use and for internal management purposes may be appropriate, for example, to the extent that forecasts do not represent management's best estimate or to the extent that the projected cash flows are adjusted for risk and uncertainty. There is no prohibition on reflecting the effects on fee income of recurring premiums on existing contracts.

The discount rate is a pre-tax market-based rate, adjusted for risks that are not already reflected in adjustments to the cash flows. The discount rate is normally based on as much market evidence of pricing of service contracts as is available. Absent direct market evidence, the rate can be based on risk-free rates adjusted for the risks that cash flows will differ in amounts or timing from estimates. The discount rates are consistent with the scenario underlying the cash flow projections, for example, the extent of inflation incorporated into cash flow projections may be correspondingly considered in discount rates.

4.2.2 Onerous contracts

IAS 37 requires a provision for an onerous contract. Consistent with asset impairment, it is reasonable to conclude that, for servicing rights related to investment contracts, this determination can be made for a group of contracts.

Section 4.1.7 summarises the guidance for applying IAS 37 as it relates to insurance contracts. The guidance appears to allow a discounted cash flow using the same approach as for determining value in use when testing for asset impairment. This is both sensible and practical, as it allows an entity to use the same model for the purpose of testing for asset impairment and for onerous contracts. In short, a provision would be the present value of the excess of future costs over future fees. The presumption here is that either there are no deferred costs or that they have been written off. Aggregation, estimated cash flows, and discounting are consistent with impairment testing.

It should be kept in mind that the provision for an onerous contract is not greater than the penalty that the reporting entity would incur if it failed to

fulfil its contractual obligations. Although IAS 37 does not clarify this point, penalties are those that would be incurred to exit the contract prematurely or penalties assessed for not meeting service standards. It is probably not intended that the entity consider awarded damages or legal costs associated with defaulting on a contract.

4.2.3 Recognising an asset impairment or a provision for onerous contracts

Impairment is recognised in the period in which it occurs. The impairment is re-measured at subsequent reporting dates and any changes in the recoverable amount would be reflected in income of the period, whether arising from an increase or from a decrease in the amount recoverable. A reversal of an impairment recognised in a prior period should not result in an asset that is greater than the asset that would be recognised if there had never been an impairment (IAS 36.110–121).

Similar considerations apply to recognising a provision for onerous contracts. The provision is recognised in profit and loss and re-measured at subsequent reporting dates. If re-measurement results in a negative measure of the provision, this may be an indication that a previously impaired asset has some value that should be recognised.

4.3 Transition

IFRS 4 allows companies to forego applying liability adequacy testing to liabilities as of dates before 1 January 2005 if the application is impractical, even if comparative information from before this date is presented. As required by IFRS 4, if the entity does not apply liability adequacy tests to comparative information from before 1 January 2005, it should disclose this fact (IFRS 4.43).

4.4 Disclosure

The reporting entity discloses its accounting policy regarding liability adequacy testing in its disclosure about its accounting policies (IFRS 4.36, 4.37(a), and IAS 32.51(ff), as applicable). Possible disclosures include:

1. The accounting policy for liability adequacy testing, including the frequency and nature of the testing;
2. The cash flows considered;
3. Valuation methods and assumptions;
4. The discounting policy; and
5. The aggregation practices.

If the policy for loss recognition is not uniform across the entity, the reporting entity considers disclosing the different practices and indicates to which contracts they apply.

The reporting entity's disclosures usually would include an identification of any amounts recognised as losses in the period arising from liability adequacy testing and the change in any deficiencies caused by a change in the measurement basis of the liability.

The practitioner involved in liability adequacy testing or in testing for impairment of assets or for onerous service contracts may not be responsible for the reporting entity's disclosures. Nevertheless, although it is the reporting entity's responsibility to make disclosures consistent with the requirements of the accounting guidance, the practitioner often assists in the development of many aspects of disclosure.

Appendix A – Relevant IFRSs

The most relevant International Financial Reporting Standards and International Accounting Standards are listed below.

- IAS 1 (2001 April) Presentation of Financial Statements
- IAS 8 (2004 March) Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 12 (1998 January) Income Tax
- IAS 18 (2004 March) Revenue
- IAS 32 (2003 December) Financial Instruments: Disclosure and Presentation
- IAS 36 (2004 March) Impairment of Assets
- IAS 37 (1999 July) Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 (2004 March) Intangible Assets
- IAS 39 (2004 March) Financial Instruments: Recognition and Measurement
- IFRS 1 (2003 December) First-Time Adoption of International Financial Reporting Standards
- IFRS 3 (2004 March) Business Combinations
- IFRS 4 (2004 March) Insurance Contracts

In addition, the IASB *Framework* is relevant.

Appendix B – List of terms defined in the Glossary

The first time that these terms are used in this IASP, they are shown in small capital letters. The definitions of these terms are included in the IAA Glossary.

Accounting policy
Acquisition cost
Actuary
Amortised cost
Contract
Current estimate
Discretionary participation feature
Fair value
Financial instrument
Guaranteed element
Guarantees
Insurance contract
Insurer
Intangible asset
International Accounting Standard (IAS)
International Accounting Standards Board (IASB)
International Actuarial Association (IAA)
International Actuarial Standard of Practice (IASP)
International Financial Reporting Standard (IFRS)
International Financial Reporting Standards (IFRSs)
Investment contract
Issuer
Liability adequacy test
Market factor
Model
Net carrying amount
Onerous contract
Option
Practice Guideline (PG)
Practitioner
Professional services
Provision
Reporting entity
Service contract
Transaction cost
Value in use