International Actuarial Association
Association Actuarielle Internationale

International Actuarial Note 104

Measurement of Investment Contracts and Service Contracts under International Financial Reporting Standards IFRS

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IAN 104 History

IAN 104 was initially published on 16 June 2005 as International Actuarial Standard of Practice 4 (IASP 4) related to IFRS 4 (Insurance Contracts). IFRS 4 was issued in March 2004 and applied to annual periods beginning on or after 1 January 2005. IFRS 4 was replaced by IFRS 17 (insurance Contracts) as of 1 January 2023.

IASP 4 was updated, re-positioned and published as international Actuarial Note 4 (IAN 4) on 24 January 2012 to provide educational guidance to the application of the IFRS 4 (IASB standard for insurance contracts).

This IAN 104 (approved for publication in May 2024 by the IAA Professionalism Committee) is an updated version of IAN 4, reflecting the current requirements in IFRS 17 and other IFRSs that are effective as of 1 January 2023.

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INTRODUCTION

The purpose of this INTERNATIONAL ACTUARIAL NOTE (IAN) is to give advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing ACTUARIAL SERVICES related to the measurement of INVESTMENT CONTRACTS and SERVICE CONTRACTS for purposes of FINANCIAL STATEMENTS in accordance with the INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs). This IAN applies where the REPORTING ENTITY is an ISSUER of INSURANCE CONTRACTS, investment contracts, or service contracts

This IAN excludes from its scope the measurement of insurance contracts, those CONTRACTS with a DISCRETIONARY PARTICIPATION FEATURE, and hedge accounting for investment contracts not covered by IFRS 17.

Reliance on information in this IAN 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 IAN refers to IFRSs that are effective as of 1 January 2023. If IFRSs are amended after that date, practitioners should refer to the most recent version of the IFRS.

1. Definitions

1.1 Investment Contracts

This IAN expands on the IFRSs provided by the INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) regarding the treatment and measurement of FINANCIAL ASSETS and FINANCIAL LIABILITIES related to contracts, generally known as investment contracts; and on the treatment of service contracts issued by INSURERS or similar entities.

In April 2001 the International Accounting Standards Board (Board) adopted IAS 39 *Financial Instruments: Recognition and Measurement*. The Board had always intended that IFRS 9 Financial Instruments would replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the Board divided its project to replace IAS 39 into three main phases. As the Board completed each phase, it issued chapters in IFRS 9 that replaced the corresponding requirements in IAS 39. This IAN addresses the completed version of IFRS 9, issued in July 2014, as well as the amendments as introduced by the IASB thereafter.

The IAN describes a set of principles for the financial reporting of certain financial instruments and the assessment of the amounts, timing and uncertainty of an entity's future cash flows.

The scope of the IFRS 9 standard is set out in IFRS9 section 2.1, and is summarised as applying to all types of financial instruments, with the exception of:

1. Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial statements or IAS 28 Investments in Associates and Joint Ventures, except in cases where these standards permit an entity to account for an interest with some or all of the requirements of IFRS 9.
2. Rights and obligations under leases to which IFRS 16 Leases applies.
3. Employers' rights and obligations under employee benefit plans, to which IAS 19 Employee Benefits applies.
4. Financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants).
5. Rights and obligations arising under an insurance contract as defined in IFRS 17 Insurance Contracts, or an investment contract with discretionary participation features within the scope of IFRS 17. The exceptions being:
    a. Derivatives embedded in contracts within the scope of IFRS17 that are not themselves within the scope of IFRS17
    b. Investment components that are separated from contracts in the scope of IFRS17, where IFRS17 permits separation of these components
    c. an issuer's rights and obligations under insurance contracts that meet the definition of a financial guarantee contract.
    d. an entity's rights and obligations that are financial instruments arising under credit card contracts, or similar contracts that provide credit or payment arrangements, that are excluded from the scope of IFRS 17.

6. Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of IFRS 3 Business Combinations at a future acquisition date.
7. Financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 Share-based Payment applies.
8. Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.
9. Rights and obligations within the scope of IFRS 15 Revenue from Contracts with Customers that are financial instruments.

2. What is meant by the terms "Recognition", "Derecognition" and "Classification"?

2.1 Initial Recognition

An entity shall recognise a financial instrument in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument. The method to be used in the initial measurement of a financial instrument is defined, while that for subsequent measurement is subject to some alternatives. "When a financial asset or financial liability is recognised initially, an entity shall measure it at its FAIR VALUE plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability" (IFRS 9 5.1.1). As an example, for a typical investment contract, the consideration would be the initial payment and the transaction costs would be incremental costs directly attributable to the acquisition of that contract.

The best evidence of the fair value of a financial instrument at initial recognition is usually the transaction price. However, in cases where the fair value of a financial liability at initial recognition is determined as different from the transaction price, then the standard offers the following two options for measurement:

1. If the fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets, an entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.
2. In all other cases, the fair value should be adjusted to defer the difference between the fair value at initial recognition and the transaction price. The difference should only be recognised after initial recognition as a gain or a loss if it has arisen due to a change in factor that market participants would use when pricing the liability.

2.2 Derecognition of financial liabilities

IFRS 9 mandates that an entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished - i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Where there has been a substantial modification of the terms of an existing financial liability, this shall be accounted for as an extinguishment of the original financial liability and recognition of a new financial liability.

In the event that a financial liability is repurchased after being derecognised, the previous carrying value of the liability is allocated between recognised and derecognised parts based on the relative fair values of those parts on the date of the repurchase.

The difference between the carrying value of the extinguished, transferred or derecognised liability and the consideration paid shall then be recognised in the profit and loss.

2.3 Classification of contracts

Full guidance regarding the classification of contracts, including stand-alone service contracts, where the reporting entity is the issuer is provided under a separate IAN, *Classification of Contracts*, to which the practitioner may wish to refer.

IFRS 9 defines the following approach for classification of financial liabilities upon its initial recognition:

"An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

a. financial liabilities at fair value through profit or loss.
b. financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies.
c. financial guarantee contracts.
d. commitments to provide a loan at a below-market interest rate.
e. contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies." (IFRS9 4.2.1).

Based on the IFRSs, measurement rules for service contracts also apply to service components. Measurement rules for financial instrument components are those for financial instruments.

In addition, initial transaction costs are separated between the financial instrument and service component. If there is no natural split based on observable market data (an example is the spread between bid and ask market prices, which would naturally be assigned to a financial instrument component), then the subdivision is normally based on the proportion of amounts expected to be recovered from the components. Front-end fees, if there is no natural split and they are demonstrably intended to cover such initial COST, are typically allocated in the same proportion. Based on IFRSs, this allocation applies only if the measurement of initial costs can be made reliably. Otherwise, no transaction costs are deferred.

Under IFRS 9, an entity should not reclassify any financial liability (IFRS9 4.4.2).

As stated above, an entity may at initial recognition, opt to designate a financial liability as measured at fair value through profit and loss. This is irrevocable in any subsequent measurement, and is only permitted when doing so results in more relevant information being presented within the financial statements because of one of the following reasons:

a. it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases

b. a group of financial liabilities or financial assets and financial liabilities is managed, and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the

group is provided internally on that basis to the entity's key management personnel - for example, the entity's board of directors or chief executive officer. The focus in this instance is on the way the entity manages and evaluates performance, instead of on the nature of its financial instruments.

The decision of an entity to designate a financial liability as at fair value through profit or loss is similar to an accounting policy choice, although it is not required to be applied consistently to all transactions. When an entity has such a choice, IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.

2.4 Host investment contract with embedded derivative

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

Guidance regarding the identification of an embedded derivative within an investment contract issued by a reporting entity is provided under a separate IAN 10, Embedded Derivatives and Derivatives, to which the practitioner may wish to refer.

In practice, once IFRS 17 has been adopted, the instances of bifurcation of derivatives embedded within insurance contracts has generally been rare.

2.5 How are the Contracts Measured?

2.6 Initial Measurement

As set out in 3.1.1 of this IAN, at initial recognition an entity should measure their financial liabilities at fair value plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial liability. In cases where the fair value of the financial liability differs from the transaction price, the entity applies one of the two options set out in IFRS9 5.1.2, discussed in 3.1.1. of this IAN.

2.7 Subsequent measurement

The IFRSs provide some alternatives to be selected. The measurement at subsequent dates depends on the IFRSs measurement approach selected under the reporting entity's accounting policy.

IFRS 9.5.2 provides that, financial liabilities are measured at amortised cost, using the effective interest method except for financial liabilities measured at fair value through profit and loss or other comprehensive income. If the reporting entity's policy under IFRSs does not provide direction as to the measurement to be selected or the classification of financial liabilities, then the practitioner may choose to apply an internally consistent approach and document the approach selected.

If an election has been made to use fair value, the IFRSs do not allow a subsequent change in the measurement approach for future financial statements (IFRS9 4.2.2).

Where a financial liability changes as a result of interest rate benchmark reform (i.e. a market-wide reform of an interest rate benchmark), an entity may be allowed to change its basis for determining the contractual cashflows of a financial liability:

a. by amending the contractual terms specified at the initial recognition of the financial instrument
b. in a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms
c. because of the activation of an existing contractual term.

If an investment contract is designated as a hedged item, IFRS 9, section 6, is applicable.

2.8 Gains and Losses

A gain or loss on a financial liability that is measured at fair value shall be recognised in profit or loss unless:

a. it is part of a hedging relationship
b. it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income

A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process.

A gain or loss on financial liabilities that are hedged items in a hedging relationship shall be recognised as described in section 3 below and, if applicable, paragraphs 89–94 of IFRS 9 for the fair value hedge accounting for a portfolio hedge of interest rate risk.

In case of a gain or loss on a financial liability that is designated as at fair value through profit or loss, the amount of change in the fair value of the financial liability attributable to changes in the credit risk shall be presented in other comprehensive income with the balance amount of change being presented in profit or loss, unless the treatment of the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss in which case all gains or losses on that liability shall be presented in profit or loss.

3. What is Hedge Accounting?

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.

For a fair value hedge of the interest rate exposure of a portfolio of financial liabilities, an entity may apply the hedge accounting requirements in IAS 39 instead of those in IFRS 9.

3.1 Hedging instruments & Hedged items

A non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income. For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial liability may be designated as a hedging instrument provided that it is not

an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.

IFRS 9.6.2.3 states that only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments. The standard further mandates that a qualifying instrument must be designated in its entirety as a hedging instrument with certain exceptions being listed.

A full list of qualifying hedged items and underlying requirements are included within section 6.3 of the Standard. Unlike hedging instruments, an entity is allowed to designate a qualifying hedged item either in its entirety or as a component of an item.

3.2 Accounting for qualifying hedging relationships

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

a. the hedging relationship consists only of eligible hedging instruments and eligible hedged items.

b. at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

c. the hedging relationship meets all of the hedge effectiveness requirements

There are three types of hedging relationships, each with its own approach to accounting as described in IFRS 9:

a. fair value hedge (6.5.8): a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

b. cash flow hedge (6.5.11): a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction and could affect profit or loss.

c. hedge of a net investment in a foreign operation as defined in IAS 21.

An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria. This includes instances when the hedging instrument expires or is sold, terminated, or exercised.

Appendix A – Relevant IFRSs

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

IAS 1	Presentation of Financial Statements
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 12	Income Taxes
IAS 18	Revenue
IAS 32	Financial Instruments: Disclosure and Presentation
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IFRS 1	First-Time Adoption of International Financial Reporting Standards
IFRS 3	Business Combinations
IFRS 4)	Insurance Contracts
IFRS 9	Financial Instruments
IFRS 15	Revenue from Contracts with Customers
IFRS 17	Insurance Contracts

In addition, the IASB *Conceptual Framework* is relevant.