

IASB/FASB Insurance Contracts Project

PwC Summary as of 23 June 2010

Note: The following summary was developed using the IASB staff summary of the project as well as PwC knowledge gained from attendance at IASB and FASB meetings through 23 June 2010.

Component	Tentative Decisions to Date		PwC Observations
	IASB and FASB Converged Views		
	IASB	FASB	
Measurement approach	<ul style="list-style-type: none"> Measurement approach should portray a current assessment of the contract, using the following building blocks: <ul style="list-style-type: none"> - unbiased, probability-weighted average of future cash flows expected to arise as insurer fulfils the obligation; - incorporation of time value of money; and - a margin*. These building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis. Objective for measuring an insurance contract should refer to a value rather than cost. Cash flows under the building block approach would include cash flows that arise as the insurer fulfills the contract rather than the narrower objective of including those cash flows needed to fulfill the contract. <p>* Two different margin approaches proposed are explicit risk adjustment approach and composite margin approach. Both approaches eliminate any gain at inception. The Boards are split between the two approaches with FASB narrowly favoring the composite margin approach, and with IASB favoring the explicit margin approach.</p> <p>Note: Given the Boards' split views between the two margin approaches, the Exposure Draft will present both approaches. The Boards were asked during deliberations to consider the detailed application of each model. As a result, the discussion below on measurement of margins at inception and subsequently reflects the Boards' views under each model.</p>		<ul style="list-style-type: none"> Differences in views arise because approach is neither a fair value/exit value approach, nor a cost approach. Therefore, objective of an explicit risk adjustment in this hybrid model is unclear to some. Lack of explicit risk adjustment in composite margin approach takes model further away from fair value. Composite margin has implicit risk adjustment; amortisation approach and period would therefore differ from that proposed for residual margin. FASB and IASB recently revisited the objective of the measurement approach, adopting a broader view of cash flows beyond those needed to fulfill the obligation. This would encompass costs such as incremental acquisition costs and expected benefits to be paid under participating contracts.

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Risk adjustment	<p>Explicit risk adjustment approach:</p> <ul style="list-style-type: none"> This approach includes two margins: <ul style="list-style-type: none"> 1) An explicit risk adjustment for the effects of uncertainty about the amount and timing of future cash flows from the perspective of insurer rather than from the perspective of a market participant. 2) An amount that eliminates any gain at inception of the contract (residual margin). Explicit risk adjustment is the maximum amount insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows may exceed those expected. Explicit risk adjustment would be updated (remeasured) each reporting period. Under the explicit risk adjustment approach, the guidance would limit the range of permitted techniques by specifying the available techniques, currently identified as the confidence level technique (Value at Risk), the Conditional Tail Expectation technique (Tail value at Risk), or the Cost of Capital technique (using economic rather than regulatory capital). Although the risk adjustment is included in the measurement as conceptually separate from other building blocks (cash flows and discount rate), this is not intended to preclude “replicating portfolio approaches.” To avoid double counting, the risk adjustment does not include any risk captured in the replicating portfolio. <p>Composite margin approach:</p> <ul style="list-style-type: none"> This approach includes a single margin that eliminates any gain at inception of the contract (composite margin). Under composite margin approach, no explicit risk adjustment, as objective is not sufficiently robust to promote rigorous application. 	<p>Board members supporting explicit risk adjustment believe:</p> <ul style="list-style-type: none"> Riskiness of uncertain cash flows (and subsequent changes in risk) should be captured in liability measurement. Explicit risk margin is consistent with pricing of financial instruments and written options. Explicit risk margin is consistent with IAS 37 proposal. <p>Board members opposing an explicit risk adjustment note the following concerns:</p> <ul style="list-style-type: none"> Lack of clearly defined objective of measurement Appropriateness of explicit risk adjustment in a non-fair value measure. Reliability and consistency of calculation methodologies.
Level of measurement	<ul style="list-style-type: none"> If the measurement approach includes an explicit risk adjustment, that adjustment should be determined for a portfolio of insurance contracts rather than individually. The explicit risk adjustment would not reflect the effects of diversification or negative correlation between portfolios. The current definition of a portfolio of insurance contracts in IFRS 4 will be retained (“contracts that are subject to broadly similar risks and managed together as a single portfolio”). Residual and composite margins would be determined initially and subsequently at a cohort level that groups insurance contracts (a) by portfolio, (b) within the same portfolio by date of inception of the contract, and (c) by length (life) of the contract. 	<ul style="list-style-type: none"> Staff to address whether to also permit composite margin to be calculated at contract level.
Measurement of margins at inception - explicit risk adjustment approach	<ul style="list-style-type: none"> In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit. A loss arises at inception if the expected present value of cash outflows, plus explicit risk adjustment, exceeds the expected present value of cash inflows. An entity should recognise that loss in profit or loss at inception. 	<ul style="list-style-type: none"> That is, any positive margin is deferred as residual margin; any negative margin is an immediate loss.

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Measurement of margins at inception - composite margin approach	<ul style="list-style-type: none"> In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit. Composite margin is the difference between the expected value of cash inflows and the expected cash outflows. In composite margin approach, a loss arises at inception if the expected present value of cash outflows exceeds the expected present value of cash inflows, i.e., any Day 1 loss would not include a risk adjustment. An entity should recognise that loss in profit or loss at inception. 		<ul style="list-style-type: none"> That is, any positive margin is deferred as composite margin; any negative margin is an immediate loss. Composite margin approach could result in lower loss recognition due to exclusion of an explicit risk adjustment.
Use of inputs	<ul style="list-style-type: none"> Consider all current available information that represents fulfillment of the insurance contract. This includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfillment of the contract, and Use current estimates of financial market variables that are as consistent as possible with observable market prices. Existing guidance on inventory costing and proposed guidance on revenue recognition will be used as potential principles for types of costs (e.g., direct, incremental, allocated) to be included in the building block approach. Examples of costs included in the building block approach include claims and benefit payments, claims handling costs, policy administration and maintenance costs, initial and recurring incremental contract acquisition costs such as commissions, surrender benefits, participating benefits, and certain directly allocable costs , but not general overhead. 		<ul style="list-style-type: none"> IASB discussion paper had proposed an exit value approach; constituents' concern with non-availability of market observable information for non-financial variables led to proposed approach, which would likely include some entity-specific information. Boards asked staff to include more detailed guidance on types of costs to be included on such issues as whether market price of policy administration costs should be used if available, and when changes in future legislation should be included.
Unearned premium approach for certain short-duration insurance contracts	<ul style="list-style-type: none"> An unearned premium measurement approach (simplified measurement approach) for pre-claim liabilities for certain short-duration contracts would be required rather than permitted. Building block approach for claim liabilities, including an explicit risk adjustment, but excluding a residual margin. 	<ul style="list-style-type: none"> An unearned premium approach for pre-claim liabilities for certain short-duration contracts meeting specified criteria would be required rather than permitted. Scope potentially limited to those short -duration contracts with a short-term coverage period and perhaps a relatively short "tail" (claim payout period). Claim liabilities would be discounted unless the effect is not material. No margin allocated to claim liability under the unearned premium approach. 	<ul style="list-style-type: none"> Liability adequacy test required. FASB acknowledged need to further define "short-term coverage period;" but separately, it is unclear whether longer-tail contracts would be included or excluded. FASB inclusion of longer-tail contracts in simplified approach, with no margin allocated to claim liability, could result in significant difference from building block approach. IASB did not discuss unearned premium approach in composite margin model; unclear how com-posite margin would be factored into claim liability estimatety.

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Subsequent treatment of residual margins under explicit risk adjustment approach	<ul style="list-style-type: none"> • Insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates. • Insurer should release residual margin over coverage period in a systematic way that best reflects exposure from providing insurance coverage on the basis of passage of time; but if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the expected value of benefits and claims to be incurred over the coverage period. • Residual margin would be included as part of insurance liability. 		
Subsequent treatment of composite margin under composite margin approach	<ul style="list-style-type: none"> • Composite margin is “released” or “allocated” over both the coverage and claims handling periods. • Amortise composite margin based on a combination of two drivers, the provision of insurance coverage and the uncertainty in future cash flows. • Approach specifies using a formula that calculates a ratio of current period allocated premiums plus claims and benefits cash flows to the expected value of total premiums plus claims and benefits and then applies this ratio to the composite margin. • Composite margin would not be “remeasured” (no change to initial inception amount). • Composite margin would not be adjusted for changes in cash flow estimates, i.e., not a “shock absorber”. • Allocation pattern/term could change based on cash flow changes. • Composite margin would be included as part of the insurance liability. 		
Accretion of interest on residual margin or composite margin	<ul style="list-style-type: none"> • Boards are divided on whether or not there should be accretion of interest on the residual margin (under the explicit risk adjustment approach) and on the composite margin (under the composite margin approach). • Boards also divided on whether, if accreted, the interest rate should be locked in at inception or updated each period. 		<ul style="list-style-type: none"> • Supporters believe all elements of the model should reflect the time value of money and that it is a discounted amount at inception; opponents believe the margin is merely a “plug” that requires no accretion.
Discount rates	<ul style="list-style-type: none"> • The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability. • Those characteristics are <u>not</u> best reflected using a discount rate based on expected returns on actual assets backing those liabilities (unless those asset returns affect cash flows to policyholders). • Liquidity is one of the relevant characteristics that should theoretically be reflected in the discount rate. • Exposure draft will not propose to include an adjustment for nonperformance risk (including credit spreads), but will solicit views on this from constituents. 		<ul style="list-style-type: none"> • IASB staff has suggested that the rate would be a risk-free rate, adjusted for differences in liquidity between certain insurance liabilities and risk-free rate assets. • Adjustment for nonperformance risk (including credit spreads) also viewed by some as being theoretically appropriate and would provide greater consistency with fair value asset measurement. However, hesitancy expressed with its inclusion due to past constituent concerns and potential measurement issues. • Both Boards rejected using a high grade corporate bond rate. • Concerns were expressed by members as to how a liquidity adjustment would be calculated.

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Insurance contracts denominated in a foreign currency	<ul style="list-style-type: none"> An insurance contract is a monetary item, as are each of the components of the contract (expected present value of cash flows, risk adjustment, risk margin or composite margin). Conclusion also applicable to simplified unearned premium approach to pre-claims liability (as a proxy for the building block approach). 	<ul style="list-style-type: none"> Some Board members had concerns whether margins, and in particular residual or composite margins, were monetary items; however, it was noted that such margins are the result of valuing cash inflows and outflows and hence are monetary items.
Acquisition costs	<ul style="list-style-type: none"> Acquisition costs that are “incremental at the contract level,” such as initial and recurring commissions, would be included as cash flows in the building block approach. “Incremental at the contract level” means those acquisition costs that would not have been incurred absent the contract sale. 	<ul style="list-style-type: none"> Immediate expense with no income offset or no capitalisation viewed by industry as inconsistent with economics of contract pricing and major change from current practice. FASB changed its position after reconsideration of measurement objective to include a broader notion of cash flows. Inclusion of incremental acquisition costs in the building block approach effectively results in their offset against the initial residual margin (or composite margin in the alternative measurement approach) and amortisation into income consistent with the residual margin (or composite margin) amortisation pattern. “Incremental” is more restrictive than current GAAP in many territories.
Policyholder behavior and contract boundaries	<ul style="list-style-type: none"> Policyholder options, as well as options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). Options, forwards, and guarantees that do not relate to the existing insurance contract coverage would be excluded from the measurement of that contract. Those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature. 	<ul style="list-style-type: none"> Several Board members initially expressed concern as to whether a written option could be an asset. Option pricing model suggested by one FASB Board member not known to be currently in use for measuring insurance contracts.
Definition of contract boundary	<ul style="list-style-type: none"> Contract boundary is the point at which the insurer: <ol style="list-style-type: none"> Is no longer required to provide coverage OR Has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. If insurer is constrained in the pricing to below market levels, this would be within the contract boundary. 	<ul style="list-style-type: none"> FASB staff provided examples of indexed contracts, discretionary adjustments with specified maximums, portfolio-wide adjustments that would be considered part of existing contract. FASB to further analyse application of proposed definition to new healthcare reform provisions, i.e., whether guaranteed renewable health insurance contracts may now be long duration.

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Participating features in insurance contracts	<ul style="list-style-type: none"> • Include all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis. 		<ul style="list-style-type: none"> • Potential conflict exists between the proposed insurance model (reflecting all expected cash flows, including those that are discretionary) and the definition of a liability. • But limiting liability to amounts that meet legal or constructive obligation definition seen by some as not useful for users as it represents minimum rather than expected payments. • Staff noted potential practical difficulty in determining which part of participation feature meets the definition of a legal or constructive obligation. • FASB changed its position after reconsideration of measurement objective to include a broader notion of cash flows. • Unclear how unbundling of account balance decision will impact participating insurance contracts.
Participating investment contracts	<ul style="list-style-type: none"> • Included in scope of insurance contracts standard if they participate in the same pool of assets as insurance contracts. • Other participating investment contracts included in scope of financial instruments standard. 	<ul style="list-style-type: none"> • Included in scope of financial instruments standard 	<ul style="list-style-type: none"> • IASB chair made decision to include participating investment contracts in insurance contracts exposure draft after a split vote by IASB. • Several IASB members as well as FASB members concerned with lack of conceptual basis for including financial instruments in an insurance standard and potential arbitrage, arguing that all financial instruments should be measured consistently. • Unclear how unbundling of account balance decision will impact participating investment contracts.
Recognition of rights and obligations arising under insurance contracts	<ul style="list-style-type: none"> • An insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract, which is the earlier of <ol style="list-style-type: none"> 1) The insurer being on risk to provide coverage to the policyholder for insured events; and 2) The inception of the insurance contract. 		<ul style="list-style-type: none"> • Potential issue for reinsurers' treaties covering cedants' direct contracts to be written in upcoming year.
Derecognition of insurance liabilities	<p>Insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39, Financial Instruments: Recognition and Measurement. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation</p>		<ul style="list-style-type: none"> • Both Boards agree that entering into indemnity reinsurance contract would not result in derecognition.

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Unbundling	<ul style="list-style-type: none"> • Issue is whether and how to unbundle the components of an insurance contract (e.g., insurance, deposit, service, embedded derivative components) for recognition and measurement purposes. • Staff proposal built around notion of lack of significant interdependence potentially being replaced. • Possible alternative proposal is that if the policyholder could redeem or withdraw his/her investment without the occurrence of an insurable event, or if the amount varies primarily based on a financial variable, insurer must unbundle. • Factors to consider in unbundling include whether the component exposes the insurer only to financial risk, whether there is a separate observable market for the component, whether the component alters cash flows in a manner not linked to or directionally consistent with the provision of insurance protection, or whether the component represents an account balance. • “Account balance” definition would be based on the characteristics described in existing US GAAP guidance for universal life insurance contracts. • Embedded derivatives in insurance contracts should be unbundled using the unbundling principle being developed for insurance contracts. • Where unbundling is not required it should be prohibited. 		<ul style="list-style-type: none"> • Unbundling is important issue to the extent the ultimate insurance model differs from other measurement models (e.g., financial instrument and service revenue models). • Staff had proposed that a component should be unbundled if it functions independently from other components (i.e., if it is not significantly interdependent with other components). • Boards did not agree to the staff proposed principle, viewing it as too vague and non-operational. • One Board member expressed concern that possible alternative proposal wording could require unbundling of cash surrender value component of traditional life insurance, which did not seem to be the Boards’ intent.
Presentation of performance statement	<ul style="list-style-type: none"> • Summarised margin approach now preferred over an expanded margin approach as it is most consistent with the liability measurement model. Both approaches show the following information on the face of statement: <ul style="list-style-type: none"> - release of expected margin during the period; - difference between expected and actual cash flows; - changes in estimate (remeasurement); and - results from investments (with interest income separate from interest on insurance liability). • Summarised margin approach would be supplemented by additional information including a reconciliation of changes in the liability and volume of business written. • Unclear how presentation for short-duration contracts subject to practical expedient/unearned premium measurement approach is impacted by the Boards’ latest decision to adopt summarised margin presentation. 		<ul style="list-style-type: none"> • Summarised margin treats all premiums as deposits and all claims and benefits as repayments (i.e., treated as movements in insurance liability). • Expanded margin approach reports as revenue an amount derived by adding the margin released during the period plus some or all policyholder claims and benefits and other expenses.
Other comprehensive income (OCI)	<ul style="list-style-type: none"> • No change to accounting for an insurer’s assets under the insurance contract standard. • Will not allow use of OCI for changes in insurance contracts liabilities. 		<ul style="list-style-type: none"> • Consideration of OCI approach for liability changes given at request of constituents trying to get better match in performance statement.

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Reinsurance	<p>Assuming reinsurer accounting:</p> <ul style="list-style-type: none"> A reinsurer should use the same recognition and measurement approach for reinsurance contracts that it issues as all other insurers use for the insurance contracts that they have issued. <p>Cedant accounting:</p> <ul style="list-style-type: none"> A cedant should recognise and measure its reinsurance asset (reinsurance recoverable) using the same recognition and measurement approach that it uses for the reinsured portion of the underlying insurance contracts that it has issued, but with residual margin (or composite margin) calibrated on Day 1 to the consideration paid (i.e., reinsurance premium net of any ceding commission). If consideration paid by cedant (i.e., reinsurance premium net of any ceding commission) is less than the measurement of the reinsurance asset under the building block approach, the cedant would recognise the difference as a gain in income at inception (after careful assessment of the measurement for inaccuracies). Non-performance risk by the reinsurer would be taken into account in measuring reinsurance asset. 		<ul style="list-style-type: none"> Boards acknowledged that determining risk adjustment for non-proportional coverages would be challenging.
Business combinations and non-business combination portfolio transfers	<ul style="list-style-type: none"> In non-business combinations assumption transactions (portfolio transfers), any positive difference between consideration received and insurance liability calculated using building block approach recorded as residual (or composite) margin. Any negative difference recognised as an immediate loss. In a business combination, any positive difference between fair value and insurance liability calculated using building block approach recorded as residual (or composite) margin. In a business combination, if the amount calculated under the building block approach exceeds the fair value, the building block amount rather than the fair value is used to measure the liability. Any negative difference would increase the initial carrying amount of goodwill recognised. 		
Policyholder accounting	<ul style="list-style-type: none"> Boards discussed symmetry (or lack thereof) between policyholder accounting and the accounting by the issuer of the insurance contract. The Boards tentatively decided not to carry out any further discussion on policyholder accounting or differences between policyholder and insurer accounting before issuing an exposure draft. 		<p>In terms of existing policyholder accounting guidance under IFRS, the Staff noted that:</p> <ul style="list-style-type: none"> Insurance contract definition in IFRS 4 applies to both issuer and holder. Holder is scoped out of both IFRS 4 insurance and IAS 39/IFRS 9 financial instrument measurement guidance, and currently applies IAS 8 to develop accounting policies. FASB has existing guidance for policyholder accounting.

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Variable (separate account) and unit-linked contracts - Balance sheet treatment	<ul style="list-style-type: none"> • Defined as account-driven contracts that are associated with an identified portfolio of assets held, for which all of the investment performance of that portfolio is passed on to contract holders, except that the contract may include minimum guaranteed returns and death benefits. • Assets and related liabilities associated with such contracts should be reported as the insurer's assets and liabilities in the statement of financial position. • Issues involving the consolidation of investment funds associated with unit-linked and separate account contracts should be addressed in the consolidations project, and may include variable interest entity considerations. • Boards have not discussed the accounting for asset/liability mismatches for variable/unit linked contracts. 		<ul style="list-style-type: none"> • IASB staff noted that the decision that assets and liabilities should remain on balance sheet may differ from view of IASB de-recognition project staff, hinting that resolution of difference between the two project views is needed. • Consolidation issue includes situations where insurer acts as investment manager or owns units of an investment fund in its general account. • Some Board members see on balance sheet reporting for variable/unit-linked contracts as inconsistent with off balance sheet reporting of bank trust arrangements. • Differences may relate to insurer guarantees and treatment in insolvency.
Definition of insurance contract	<ul style="list-style-type: none"> • Retain IFRS 4 definition of insurance contract. This includes: <ul style="list-style-type: none"> - IFRS 4 term "compensation" for loss rather than FASB concept of "indemnification" for loss; and - IFRS 4 significant underwriting <u>or</u> timing risk rather than the current US GAAP risk transfer requirement for significant underwriting <u>and</u> timing risk, but with additional guidance that certain timing delays might be so significant so as to disqualify a contract from risk transfer because the delays could eliminate or significantly reduce uncertainty of cash flows. 		
Scope	<ul style="list-style-type: none"> • Financial guarantee contracts meeting the definition of an insurance contract should be included in the scope of the insurance contracts standard. • Residual value contracts not offered by the manufacturer, not embedded in a lease, and not constituting a derivative should be in the scope of the insurance contracts standard. • Manufacturer, dealer, and retailer warranty contracts should not be included in the scope of insurance contracts standard. • Fixed-fee service contracts should not be included in the scope of insurance contracts standard. 		<ul style="list-style-type: none"> • Staff paper describes financial guarantee contracts as including financial guarantee insurance, mortgage guaranty insurance, trade credit insurance, and some types of letters of credit issued by banks. • Healthcare contracts not specifically discussed by Boards.
Significant insurance risk	<ul style="list-style-type: none"> • Evaluation of insurance risk should be done using present values rather than absolute amounts. • Risk transfer analysis should focus on the variability of outcomes (i.e., is the range of outcomes significant to the mean), consistent with IFRS 4, but should be amended to require that there be at least one possible outcome in which the present value of net cash flows can exceed the present value of premiums. 		<ul style="list-style-type: none"> • Some Board members uncomfortable with insurance accounting for example contract where there is no chance of loss to insurer. As a result, definition was amended.

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Transition and effective date	<ul style="list-style-type: none"> • Transition impact measured using insurance contract portfolio as unit of account. • Each portfolio measured using building block approach, including both expected (probability weighted) present value of cash flows and an explicit risk adjustment. • Difference between this amount for each portfolio and the existing net insurance liability recorded under the previous GAAP (i.e., the liability net of any unamortised deferred acquisition costs and present value of in-force intangible) for that same portfolio would be charged or credited to opening retained earnings. • If explicit risk adjustment method is ultimately adopted by the Boards, risk adjustment calculated at transition would be re-measured each period subsequent to transition. • Alternatively, if composite margin method is adopted, risk adjustment calculated at transition would be treated as if it were a composite margin in subsequent periods; amortised over remaining coverage and claim settlement periods but not re-measured. • Separate disclosure of transition adjustment run-off from other margin run-off required. • At transition, an entity is permitted, but not required, to re-designate financial assets to be measured at fair value through profit and loss if doing so would eliminate or significantly reduce a measurement inconsistency. 		<ul style="list-style-type: none"> • Boards discussed but did not conclude on whether calculation and adjustment to opening balance of retained earnings would be done in earliest year presented or in year of adoption. • Effective date will be discussed at separate meeting along with other standards to be issued in 2011.

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