

## Insurance alert

# IASB/FASB Board Meetings and Education Sessions, October 11 and 15-19, 2012

*Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.*

### PwC summary of meetings:

- *Presentation and recognition pattern of premiums*
- *Presentation and recognition pattern of acquisition costs*
- *Determination of discount rate for accretion of interest under PAA*
- *Participating contracts*
- *Transition*
- *Investment contracts with discretionary participation features (IASB only)*

### Highlights

The IASB and FASB tentatively decided to apply the earned premium approach to present premiums and claims in the statement of comprehensive income and to recognise acquisition costs in the statement of comprehensive income in a way that is consistent with the proposed allocation of the residual/single margin.

The FASB also decided that acquisition costs should be presented as part of the margin liability rather than as an asset and that, the portion of the insurance liability relating to the obligation to policyholders should be separate from the unearned margin liability on the face of the balance sheet.

Under the PAA, the IASB and FASB decided to use the discount rate at inception of the contract to measure the liability for remaining coverage as well as to determine the amount of claims and interest expense in profit or loss for the liability for incurred claims.

For participating contracts, the discussions clarified that the mirroring

decisions would take precedence over the decision to present discount rate changes in other comprehensive income (OCI). The FASB decided that for contracts where the mirroring decisions do not apply and the contractual obligation to the policyholder is directly linked to the fair value of the underlying items; changes in the insurance liability should be presented in profit or loss.

On transition, the IASB and FASB reached different conclusions on the extent to which redesignation and/or reclassification of financial assets would be permitted. The IASB decided that the effective date is expected to be three years after the issue of the final standard, restatement of comparative financial statements will be required and early adoption will be allowed.

The IASB agreed some consequential amendments are needed for financial instruments with DPF that are in the scope of the insurance contract standard.

## Presentation of premiums in the statement of comprehensive income (SCI)

### Introduction

The exposure draft recommended a summarised margin presentation but in the October 2011 meeting, the boards tentatively decided that an insurer applying the building block approach (BBA) should present premiums, claims, benefits and gross underwriting margin in the statement of comprehensive income (SCI). This was in response to feedback received that volume information in the SCI would be useful and it would make contracts under the premium allocation approach (PAA) more comparable to those under the building block approach (BBA). In addition, a revenue like premium figure in the income statement would make the insurance sector and other industries more comparable.

The staff paper provided descriptions of the earned premium method (identified in a prior board meeting as being a viable option) as well as two other measures: the premium due method (suggested more recently by some preparers as a better alternative), and the written premium method.

The earned premium method would allocate premiums to each period in proportion to the relative value of insurance coverage and other services expected to be provided in that period. The driver for this allocation would be claims/benefits and expenses *expected* to be incurred in the period, an allocation of expected acquisition costs, and the release of margin (and the risk adjustment in the IASB model). Actual claims/benefits and expenses would be presented in SCI as incurred, and acquisition costs would be allocated over time, consistent with the residual (or single) margin amortisation.

The staff paper notes that some see the earned premium method as closest to an “earned revenue concept,” and note that it is in some respects a proxy for the price an insurer would have charged for coverage in that specific period. However, it does not explicitly factor in the value of options and guarantees and future renewal rights in its premium allocation formula.

The premium due method would allocate premiums to the periods in which it is due (i.e. invoiced or receivable) and is similar to the method used by many today for recognising premium on long duration contracts. At the same time, offsetting amounts would be allocated and presented as claims/benefits expense, change in the risk adjustment (IASB only) and change

in margin, in order to reconcile down to the net margin.

The written premium method would allocate premiums and costs to the period in which the contracts are initially recognised (written). This would result in recognising as premium immediately the present value of all expected future cash inflows from premiums at contract inception, along with recognising expense immediately for all expected cash outflows for claims/benefits and expenses, and any risk adjustment and margin, all netting to zero at inception. This approach would provide information about new business written during the period.

The earned premium approach, being based on expected amounts, also would require separate presentation of changes in estimates and the unwinding of previous changes in estimates in SCI. This would not be required under the premium written or premium due approach since premiums are based on contractual terms under those approaches.

While the three models differ in how they allocate premiums between periods they do have some similarities in that the net profit recognised each period will be the same under all three approaches as there are compensating differences in the amounts presented as expenses. In addition, the insurance premiums presented over the duration of the contract will equal the total premium for insurance coverage and the costs presented over the duration the contract will equal the total amount incurred (subject to possible adjustment for time value of money) under all three approaches. Also in all methods, any investment component is first unbundled.

A separate follow on staff paper proposes that under the earned premium approach, in addition to using expected claims/benefits as a driver, premium should also be allocated to cover *expected* non-claims fulfilment costs (policyholder administration and maintenance costs and claim handling costs). Similar to claims/benefits, *actual* non-claims fulfilment costs would be expensed as incurred. Claims handling costs would be considered to be “incurred” when the underlying claim is incurred rather than when such claim handling costs are subsequently paid.

### FASB education session

One of the advantages the staff noted for the earned premium approach is that it is broadly consistent with concepts of revenue recognition for other industries. The board members cautioned the staff that this is an

allocation and may not represent a proxy for what the contract would sell for separately for that period, for example, it does not factor in renewal rights.

The board then discussed further the concept that the driver of the premium allocation under this approach is expected claims/benefits and expenses. Some believe that this is an appropriate driver, as the service can be viewed as paying a claim when it occurs. In a closed portfolio, this results in premium recognition being back ended. However, others may take a different view, believing that the insurer is standing ready to provide coverage, and if that is a level amount of coverage in each period, perhaps the premium recognition should be straight line. Others point to the fact that the net amount at risk is typically larger in earlier periods, and thus that perhaps the recognition should be front-loaded.

An advantage of the earned premium approach cited by the staff is that it provides a linkage between the statement of financial position and comprehensive income, which is consistent with the premium allocation approach. The staff views the liability as two components that naturally transition over time, a decrease in the liability for remaining coverage increases premium earned and the recognition of benefits correspond to the timing of incurred claims or increase in the liability for incurred claims.

It was noted that written premium is the least complex and provides information about new business. However, this would recognise premium and expense before the insurer performs a service or satisfies any of its performance obligations. This method also introduces more volatility into the SCI. One board member noted that if the major objective is volume information, the premium written approach is the method that best addresses that.

The board also discussed whether separate presentation of BBA and PAA in the SCI may be necessary under the premium written or premium due approach for the numbers to make sense, but not under the earned premium approach.

The board also noted that changes in estimates are presented gross in the earned premium approach but not in the premium written or premium due approaches.

The FASB staff user outreach results were mixed. Half of those surveyed accepted but were not strongly supportive of the earned premium approach. Those who strongly opposed it were concerned that it is disconnected from the cash flows, over-engineered, not

reflective of an insurance company's stand ready obligation which occurs equally over the contract period, not used in running the business, and that the costs outweigh the benefits. They instead favoured a premium due approach for some of the same reasons cited above and in addition noted that it is simpler, widely used today, and is sufficient for the purposes of providing a top line number for growth.

The staff noted that the operational complexity that some constituents have noted in the earned premium approach is in the bookkeeping that would be required and not in the complexity of the expected cash flows which will build off those already in the model.

### *IASB education session*

IASB had an education session on the same topic. Several board members sought clarity on the feedback from users on whether there was a need for information by product type and whether this information should include or exclude investment components. The staff noted that there was widespread support for excluding the investment component from the measure of premium recorded in the income statement. However, there was some desire to see volume information including the investment component by product type, which they expected in the notes to the financial statements.

Several board members questioned how the presentation approaches would differ under the PAA compared to the BBA. One member suggested that a two statement presentation in the SCI would be needed should the premium due approach be used, whereas the presentation would be aligned for the earned premium approach.

For the premium due approach, a member questioned whether such amounts aligned to the conceptual framework. He suggested that many of the numbers presented did not conform and challenged why insurers should be allowed to divert from the framework when other industries are required to follow it.

Two IASB members questioned whether the exclusion of the effects of experience adjustments in the calculation of earned premium distorts the premium number since the higher claims are not offset by increased premiums. A similar issue relating to mismatches when actual experience differs from expected exists for the residual margin. Whilst the inclusion of such adjustments may lead to additional

complexity (and might be required in all presentation approaches), he felt that an impact assessment would be worthwhile. The staff agreed that this point would need to be addressed at a later meeting.

Some members suggested including a one line metric in the income statement that depicted volume information. The staff responded that users would assume any volume information presented in the SCI would be a revenue number and as such did not favour such an approach.

The discussions moved on to the adverse feedback received from preparers. The chair noted that the board needed to overcome this resistance as the approach used currently in practice in many instances is not consistent with the revenue standard. The staff discussed that there were several issues – whether the earned premium approach was fully understood and whether it created operational complexity. The staff noted that once the earned premium approach had been properly explained and understood during outreach sessions, feedback had been supportive. On complexity, the staff noted that the earned premium approach makes use of components that in any event would need to be disclosed within the notes. When questioned, the staff did not have a clear view as to whether volume information would still be desirable if a premium due approach was not accepted by the board and suggested this could only be answered through exposing the board's proposals.

Other points raised during the meeting included how investment management fees that are associated with any unbundled investment component would be separated under the earned premium approach and whether transition would be difficult (as the approach is based upon expected claims at inception of contract).

### *IASB/FASB joint meeting*

The IASB and FASB continued the discussion in a joint voting session. Overall, many members supported the earned premium approach on the basis that it is the only approach out of the three alternatives that is in line with the proposed revenue recognition standard, thus allowing comparability across industries.

Whilst the vast majority agreed on this, a FASB member added that the earned premium approach does not address the request of respondents to the ED on the need for volume information. He added that the premiums due approach is also more in line with

current practice although many other members questioned whether current practice should continue. An IASB member emphasised that only the earned premium approach is in line with the conceptual framework in terms of expense recognition: the two other methods would recognise expenses before they occur. He added that there is no other example in the IFRS framework that would require such presentation.

FASB members raised concerns about the earned premium approach as being too prescriptive in terms of the driver being specified as incurred claims and expenses, whereas other allocation methods might be appropriate as noted in the FASB education session. They thought the standard itself should contain the principle (for example under the FASB approach the objective would be to recognise the premium as the entity is released from risk) and not one prescribed method for calculating the earned premium. The IASB staff replied that when the alternative was developed they started with articulating the same objective and they added the mechanics only to illustrate how to achieve the objective.

During the discussion and in the final vote there was much support for the earned premium approach for presenting premiums and claims for the reasons previously articulated. The IASB added that if no support is received from constituents when the new exposure draft is issued and this topic is re-exposed, the board might need to reconsider the summarised margin approach as being the only other sensible answer.

In a vote, 13 IASB members and 5 FASB members supported the earned premium approach. Under this approach, premiums would be allocated to periods in proportion to the value of coverage (and any other services) the insurer has provided in the period. Claims would be presented as incurred. The FASB asked the staff to consider in drafting whether application guidance could be included about other approaches (with respect to the driver) that may meet the earned premium principle.

For the separate follow on discussion regarding the allocation of premiums to cover expected non-claims fulfilment costs, the IASB and FASB board members mostly were of the view that allocating premium in line with the *expected* (at inception in terms of amount and timing) expenses is a consequence of how the earned premium approach technically works. An IASB

clarified that *actual* costs are to be expensed when incurred.

In a vote, IASB and FASB members supported the staff proposal, although the FASB chair again raised the point of potentially presenting this as a principle with elaboration in application guidance.

## **Presentation and recognition pattern of acquisition costs in the statement of comprehensive income**

### *Introduction*

The first question on this topic was directed at the IASB and the staff asked the board to vote on its previously stated preference to recognise acquisition costs in the SCI over the coverage period.

The first question on this topic for the FASB was whether acquisition costs should be recognised as part of the insurance contract liability rather than being presented as an asset. The IASB had previously tentatively decided that acquisition costs should be included in the insurance contract liability and should not be presented as a separate deferred acquisition cost asset, and thus no vote was required on this issue by the IASB at the current session.

If the FASB decides to recognise acquisition costs as part of the insurance liability rather than as an asset, a follow on the issue is whether any unpaid acquisition costs would be presented specifically as part of the margin rather than as part of the liability owed to policyholders. Another issue is whether, on the face of the balance sheet, the insurance liability should be presented as one amount, or separated into two line items, the obligation to policyholders and the margin (including any unpaid acquisition costs).

An issue for both boards is whether acquisition costs should be recognised in SCI in a way that is consistent with the proposed allocation of the residual/single margin.

### *FASB education session*

One board member noted that he does not believe acquisition costs should be in the policyholder liability since they are not related to costs of fulfilling the obligation to the policyholder and rather they should be an asset. Another member noted that it would have

the same net effect in the financial statements either way.

The discussion then focused on a comparison to revenue recognition and how those costs are treated as an asset under that model. Treatment as an asset would require an impairment analysis. They also noted that the IASB rejected treating it as an asset. The board members continued to express concern with considering these costs paid to obtain business as part of the contract cash flows (i.e., as costs to fulfil the contract with the policyholder). They therefore rejected presenting amounts owed relating to acquisition costs in the liability to policyholders, but they could compromise and accept presenting it in the margin.

### *IASB/FASB joint meeting*

In the joint decision making session without much debate, 14 IASB members voted for recognising acquisition costs over the coverage period in the SCI.

For the FASB only question, 5 FASB members supported the staff proposal to recognise acquisition costs as a reduction in the margin rather than as an asset. It was agreed that any unpaid costs would be added to the margin, rather than presented as part of the liability owed to policyholders. The FASB members also decided that the liability owed to policyholders should be disaggregated from the margin on the face of the balance sheet.

For the last joint question on this topic, the IASB and FASB unanimously supported the staff proposal to recognise acquisition cost in the SCI in a way that is consistent with the proposed allocation of the residual/single margin.

## **Determination of discount rate for accretion of interest under the premium allocation approach (“PAA”)**

### *Introduction*

The two issues for discussion relate to the discount rate to be used under the PAA. The first issue was whether to use the discount rate at the inception date of the contract or the current rate when discounting and accreting the liability for remaining coverage under the PAA approach. The second issue was how the boards’ decision to present changes in the liability due to changes in the discount rate in other comprehensive income (OCI) applies under the PAA approach. That

is, for purposes of determining the rate to be “locked in” and used to present interest expense in the SCI on the liability for incurred claims, should the rate be (a) the rate at the inception of the contract or (b) the rate at the date the claim is incurred.

### *FASB education session*

The staff noted that the rate at inception of the contract is reflective of the underlying pricing assumptions the insurer makes, that it is similar to concepts in revenue recognition when there is a significant financing component, and that the costs required to use the current rate for such a short period of time would outweigh the benefits. However, one argument for the use of the current rate is that it is similar to the current measure of an insurance contract under the building block approach.

The staff recommends using the discount rate at the inception of the contract for the liability for remaining coverage.

With regard to the interest rate to be used for incurred claims, some staff recommend using the rate at inception which they view as being consistent with pricing as well as consistent with the BBA model and easier to implement (avoiding tranches of incurred claims at different rates where claims within a single portfolio of contracts are incurred at different times). The staff noted that the combined ratio would be more consistent if the discount rate were constant. FASB board members seemed sympathetic to this view. Other staff recommended using the rate at the date the claim is incurred for the liability for incurred claims.

Follow on questions relate to the rate to be used for onerous contracts. The board members noted that they want to keep the calculation as simple as possible. Some noted that they do not want different rates for onerous contracts than the liability for incurred claims. Another board member suggested that the calculation for an onerous contract should be based on the current rate rather than at the inception rate. However, another responded that one of the main purposes of using OCI was so that an insurer did not need to reflect in income currently a loss due solely to interest rate changes.

### *IASB/FASB joint meeting*

With little debate, both boards voted to use the discount rate at the inception date of the contract when discounting and accreting the liability for remaining coverage under the PAA approach. This approach was

explained as being consistent with the fixed price nature of the contract, consistent with revenue recognition concepts, and consistent with the building block decision to use an at inception rate to accrete interest on the insurance liability.

The discussion then moved on to the determination of the rate to be “locked in” and used to present interest expense in the SCI for the liability for incurred claims. The FASB voted to use the rate at inception of the contract. The IASB members preferred using the rate on the date the claim is incurred. However, they agreed to use the rate at the inception of the contract for the sake of convergence.

The FASB explained the rationale for using the rate at inception. They noted that it is consistent with the building block approach, as well as with the rate decided on for the liability for remaining coverage. An IASB staff challenged this view, noting that unlike the BBA approach, the incurred date is in effect the inception date of the incurred claim liability. However, the FASB explained that under the PAA (especially under the IASB view that it is a proxy for the BBA), although the liability can be thought of as having two components, the inception date of the contract is still the start of the coverage period of the contract, not the date the claim is incurred.

The FASB did acknowledge that use of the inception rate would result in a catch up adjustment immediately in OCI at the date a claim is incurred to the extent rates had changed since contract inception. However, this is viewed as a natural consequence of the boards’ prior decision to “lock in” the measurement of the liability for remaining coverage and then switch over to a building block approach when a claim is incurred.

The FASB also noted the operational complexity of using a rate determined on the date a claim is incurred, pointing out that a different rate would exist for each claim incurred date. In addition, unwinding of the incurred claims would be operationally challenging, requiring the selection and consistent application of a policy (e.g., first in first out). The rate at inception was therefore seen to be a more practical approach. However, several IASB members expressed a view that the incurred date rate would be easier to obtain than the contract inception rate.

Other board members questioned how significant the difference would be between the two rates. The IASB staff noted that it depends on the factors affecting interest rates between the date of inception and date the claim is incurred. The FASB staff pointed out that the difference could be significant, as long tail claims

could continue to develop over a number of years after the coverage period ended, and each reserve movement would be accompanied by an updated rate, which may significantly differ from the rate at inception.

## **Participating contracts**

### *Introduction*

The purpose of the joint session was to clarify the decisions previously made with regard to the “mirroring” accounting for participating contracts and the interaction of that tentative conclusion with the subsequent decision by the boards that changes in the insurance liability relating to changes in the discount rate are presented in OCI.

The boards had previously decided that they would measure the obligation for the performance linked participation feature in a way that reflects how those underlying items are measured in the US GAAP/ IFRS financial statements (referred to as mirroring). That is, the insurer would measure and present the part of the obligation that relates to the underlying assets on the same basis as it measures and presents those underlying assets (e.g., amortised cost, fair value through OCI, or fair value through income).

The FASB has an additional provision that mirroring may not apply to some items, including situations where the contractual obligation to the policyholder is based on the fair value of the underlying item to which it is contractually linked (such as the unit value of a specified pool of assets). In those situations, no matter how the underlying assets are valued for accounting purposes in the insurer’s financial statements, the liability is required to be based on the fair value of the underlying items. The issue is whether the portion of the change in fair value relating to changes in discount rates should be recorded in income or OCI for these “non-mirror” participating features.

For insurance contracts where the mirroring criteria are met, the staff interpretation is that the mirroring accounting would take precedence over the OCI accounting, meaning that contracts would be accounted for in SCI consistent with the related underlying assets.

For insurance contracts where mirroring does not apply under the FASB criteria, and where the contractual obligation to the policyholder is directly

linked to the fair value of the underlying items, the staff propose that changes in the insurance liability would be presented in profit and loss rather than OCI.

### *FASB education session*

The FASB discussed the FASB only issue relating to contracts to which the mirroring decisions do not apply, i.e., where the obligation is based on the fair value of the underlying assets. The staff noted that US separate accounts were an example. The board noted that when the obligation is based on the fair value of referenced assets, changes in the obligation should be recorded in net income irrespective of how the assets are accounted for. This is similar to how any obligation referencing underlying values of assets would be recorded (i.e., as a derivative or embedded derivative). Mirroring should not apply in this situation, and thus the accounting model used for the assets is irrelevant.

The staff noted that for separate accounts and similar structures, the intent would be that the accounting for the related assets would also be at fair value through net income, so there likely would be no asset/liability mismatches under US GAAP. The valuation of separate account assets at fair value through income would be an expected outcome of the investment companies’ project. That project would include separate accounts as being investment companies, and that designation is expected to be retained for purposes of the insurer’s accounting as well.

### *IASB/FASB joint meeting*

Several board members raised the importance to articulate clearly the OCI override for participating contracts in the final drafting. For the FASB only question relating to contracts where mirroring decisions do not apply, all the FASB members supported the staff recommendation. For contracts where the mirroring decisions do not apply and the contractual obligation to the policyholder is directly linked to the fair value of the underlying items, changes in the insurance liability should be presented in profit or loss.

## **Transition**

### *IASB board meeting*

The IASB meeting addressed a number of topics:

- Reclassification and/or redesignation of financial assets;

- Treatment of changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented;
- Application of transition requirements for first-time adopters of IFRS;
- Potential redesignation of property, plant and equipment and investment property on transition;
- Effective date, comparative financial statements and early application.

The transition requirements that might be necessary relating to tentative decisions made previously in this week's meetings regarding the presentation of premiums, claims and expenses in the SCI will be discussed at a future meeting.

The staff began the session by summarising the reasons for discussing the redesignation and/or reclassification of financial assets. The staff expects that IFRS 9 and the proposed insurance contract standard will not be adopted at the same time. Therefore, the staff believes that the board should consider whether to permit insurers to redesignate and/or reclassify their financial assets upon first application of the proposed insurance contract standard.

The staff noted that the adoption of the proposed insurance contract standard is not in itself a change of the business model, hence would not require a reclassification. However, in the situation where an entity adopts the proposed insurance contracts standard after the adoption of IFRS 9, new accounting mismatches may arise and previous accounting mismatches may no longer exist.

The staff recommended following the reclassification guidance in IFRS 9 (i.e., no reclassification permitted unless they meet the IFRS 9 change in business model criteria), but to allow insurers to:

- a) Designate eligible financial assets under the fair value option (FVO) where new accounting mismatches are created;
- b) Require to revoke previous designations under the FVO where an accounting mismatch no longer exists; and

- c) Permit to newly elect to use OCI for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election.

One board member asked what the definition of an 'insurer' is and noted that the board should watch out for abuse of the transition requirements; hence, the exemptions should only apply when a significant mismatch arises. No further discussion was held on the definition of what is significant, but illustrative examples were requested to explain the practical application of the transition requirements.

A number of board members questioned how meaningful the prospective application of the reclassification principles (as suggested here and required by IFRS 9) would be. Some board members noted that retrospective application of the reclassification requirements would create artificial comparative figures, whereas other members commented that prospective application would provide comparative figures that are not meaningful. Retrospective application would also involve the use of hindsight, which is not consistent with IAS 8.

In a vote, the board unanimously supported the staff proposals to include the three exceptions to the IFRS 9 reclassification guidance as stated above.

Last month the IASB and FASB had tentatively decided to use a modified form of retrospective application to calculate the margin on transition. In particular, the IASB modified the general requirements in IAS 8 for retrospective application regarding when retrospective application would be impracticable.

The staff in this meeting proposed simplification for the retrospective determination of the residual margin and recommended that an insurer shall determine the residual margin on transition assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition.

The staff explained that without the current proposal an entity would be required to split experience adjustments (through P&L) and changes in expectations of future cash flows (absorbed in the residual margin). This was considered onerous and would require the use of hindsight.

The IASB unanimously supported the staff proposal. On the issue of first time adopters, the IASB members unanimously agreed that the proposed transition requirements for insurers that already apply IFRS should also apply to first-time adopters of IFRS.

The ED did not address redesignation of other types of assets that insurers may hold, specifically:

- Property, plant and equipment in the scope of IAS 16 Property, Plant and Equipment; and
- Investment property in the scope of IAS 40 Investment Property.

Currently insurers can already apply the cost model or the fair value model. Therefore, the staff recommended and the board unanimously agreed not to include explicit guidance for redesignation of property, plant and equipment and investment property.

However, one board member noted that where the fair value of the investment properties is highly dependent on changes in interest rates, a potential accounting mismatch could arise. The movements in the liability related to the discount rate will go through OCI, whereas the movement on the investment properties under the fair value model would go through the income statement. The staff responded that IAS 40 currently does not provide a solution for this mismatch and that similar mismatches exist for structured debt and some other investments.

The next topic discussed was the effective date, comparative financial statements and early application of the proposed standard for insurance contracts. In a vote agreed to by 12 members, the IASB board:

- a) Stated its intent to allow a mandatory effective date that is approximately three years after the date of issuance of the final standard;
- b) Tentatively decided to permit entities to apply the final standard before the mandatory effective date; and
- c) Tentatively decided to require entities to restate comparative financial statements upon initial application.

The staff explained that the usual effective date is approximately 18 months after the issuance of a standard. The staff proposed to address the concerns of respondents and extend this to three years.

Three board members had concerns on allowing early adoption of the proposed standard for insurance contracts, as they do not believe that this serves comparability. They are concerned that variations in the initial application date of IFRS 9 and the proposed standard for insurance contracts would create uncertainty in the financial markets. They believe it is not clear whether early adoption of a standard relates to entities with higher-quality management or entities that want to benefit by choosing a specific date for early adoption in order to present better results. Some board members asked for postponing the adoption of IFRS 9, specifically for insurers, as the cost of adopting IFRS 9 and the proposed standard for insurance contracts separately would be too high. The definition of “insurer” was not discussed.

Other board members noted that it is important to get this standard completed as soon as possible. Financial markets are waiting for this standard for over a decade and in the current environment with low market rates, allowing early adoption outweighs the reduced comparability. Staff noted that on adoption the same reclassification rules would apply for early adopters as for other companies. One staff member noted that one jurisdiction already applies the principles of the ED and wants to catch up to the new rules as soon as possible. Not allowing early adoption would slow down this process.

### *FASB education session and board meeting*

The transition topic addressed by the FASB focused on the potential re-designation of financial instruments if the insurance contracts project has a later effective date than the financial instrument standard.

Unlike the IASB staff recommendation, the FASB staff proposed that upon initial adoption of the insurance contracts standard, an insurer would be permitted to designate and classify its financial assets as if it had adopted on that date the relevant classification and measurement guidance for financial instruments in effect at that time.

The staff believe this “reset” exception is necessary to allow insurers to mitigate accounting mismatches between invested assets and insurance liabilities that

could otherwise result when they adopt the insurance contracts “current value” measurement approach.

A few board members argued that the only “reset” that should be permitted would be the revoking or institution of the fair value option on specified instruments (which is typically prohibited). These board members argued that other classification decisions (e.g., amortised cost versus fair value through OCI) are based on business strategy, and an insurer’s business strategy should not change merely upon adoption of any new insurance standard. That is, insurers manage their asset portfolios to achieve duration matching with liabilities and for liquidity purposes and these objectives should not change because of a new insurance standard being adopted. They therefore could not understand how asset reclassifications would be justified upon transition to the insurance standard.

The staff provided an example of a situation where they believe reclassification should be permitted. An insurer currently holding mortgage loans at amortised cost might want to reclassify to fair value through OCI to better align with the “current value” measurement of the insurance liability. Several board members supported the notion of a reset, pointing out that one of the board’s objectives in the project was to mitigate accounting mismatch issues, and the reset option would be consistent with this concept.

The board then voted 6 to 1 in support of the staff proposal.

The next issue addressed was how to identify the population of financial instruments that would be subject to this exception. The staff suggested that the reset should be limited to assets supporting insurance liabilities. Two possible ways to identify those assets would be based on whether they were legally linked (i.e. owned by an insurance entity) or somehow internally linked (e.g., for those situations where an “insurance contract” was not issued by an insurance company).

Issues surrounding the potential manipulation of the reset exception were raised, and thus the board attempted to narrow the population to a reasonable level. The board tentatively decided that upon initial adoption of the insurance contracts standard, the redesignation/reclassification would be permitted for financial assets that are designated to an entity’s insurance business either by legal entity or by internal

designation and relating to funding of insurance contracts that are newly determined to be insurance.

The effect would be reported as a change in accounting principle.

### **Adaptations for the measurement of financial instruments with discretionary participation features (IASB only)**

The IASB board meeting addressed the consequential amendments needed as a result of the decision to include financial instruments with discretionary participation features (DPF) when issued by insurers in the scope of the insurance contract standard.

The board had previously redefined the contract boundary for *insurance* to be the point at which the contract no longer confers substantive rights to the policyholder and provided further criteria to make that determination for insurance contracts. At this meeting, the IASB agreed to adapt the contract boundary for financial instruments with DPF. The point at which the contract no longer confers substantive rights is when:

- The contract holder no longer has a contractual right to receive benefits arising from the DPF; or
- Premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those who are not yet contract holders.

The board unanimously supported this proposal.

On the topic of initial recognition of a financial instrument with DPF, it was noted that the guidance on recognition of an insurance contract refers to “insured events” and thus is not relevant to financial instruments with DPF. Therefore, the staff recommended applying the initial recognition criterion from IFRS 9 to financial instruments with discretionary participation features, that is, when the entity becomes party to the contractual provisions of the instrument.

Further adaptations of insurance contract decisions to financial instruments with DPF were not considered necessary. For example, the boards had already tentatively decided to change the allocation of the residual margin to an approach that best reflects the pattern of services. The staff believes this principle also covers financial instruments with DPF and that specific

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guidance is not required. As a result, the ED criteria, which required an allocation based on the fair value of assets under management, if that pattern differed significantly from the passage of time, have been removed. The staff noted that they believe that in practice, the margin for financial instruments with DPF will be allocated based on the provision of asset management services. However, unlike the ED the provision of those services will not be required to be linked to the fair value of the managed assets.

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## **Additional information**

Questions on this summary and the FASB/IASB joint project can be directed to: Mary Saslow (860-241-7013) a Managing Director in the National Professional Services Group, who is part of both the U.S. and Global Accounting Consulting Services groups

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