Project: **Insurance Contracts**

Topic: **Reporting changes in circumstances – Cover note**

Introduction

1. Some are concerned that the proposed measurement model for insurance contracts results in volatility in the financial statements. The Basis for conclusions on IFRS 4 explains that such volatility may stem from:

   (i) *accounting mismatches*, which arise if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes.

   (ii) *economic mismatches*, which arise if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. Economic mismatches are not necessarily eliminated by an asset-liability management programme that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities.

   Ideally, financial statements should minimise accounting mismatches while reporting economic mismatches.

2. *Accounting* mismatches occur if an entity uses different measurement bases for assets and liabilities. The boards proposed that insurance liabilities are measured at a current value, and the assets are accounted for in accordance with other IFRSs/US GAAP. Some have expressed concerns that this may result in accounting mismatches, depending on how insurers exercise particular options available under IFRSs/US GAAP. Appendix A sets out the current accounting requirements for assets under IFRS and appendix B sets out the current accounting requirements for assets under US GAAP.

This paper has been prepared by the technical staff of the IASB and the FASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Boards, the IASB or the FASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Boards.

Official pronouncements of the IASB and FASB are published only after the Boards have completed their full due processes, including appropriate public consultation and formal voting procedures.

3. In the boards' view, volatility arising from *economic* mismatches should be reflected in financial statements because it provides useful, transparent information about the present state of the insurer's matched or unmatched position.

4. Others argue that such volatility may be costly and hard to explain to users and that some users may not be able to comprehend such volatility. Those users may then penalise insurers by requiring a higher cost of capital than is warranted.

5. Appendix C summarises the responses received on the discussion of mismatches in the discussion paper.

Overview of the papers for this session

6. The recent financial crisis has led to more debate around how volatility/stability should be presented in financial statements, especially the when current values are used for financial reporting.

7. In this session, we consider only possible refinements of the proposed measurement model for the insurance liability. The objective of this project is to address the accounting of insurance contracts. Accordingly, we do not consider any changes to other standards, such as IFRS 9 *Financial Instruments*.

8. In this context, it is useful to discuss whether the proposals in the exposure draft provides users of financial statements with relevant information that is a faithful representation of an insurer's financial position and of transactions and other events that change its assets and liabilities, and to explore whether there are ways to minimise the effects of any inappropriate accounting mismatches. We have identified some areas that might be considered, based on information received during our outreach activities. They are discussed in the following papers:

Agenda papers	Issue addressed
3A	Is the proposed discount rate appropriate for insurance?
3B	Should the discount rate be ‘locked-in’ or reflect the conditions at each reporting date?
3C	Should the residual/composite margins be ‘locked-in’ or remeasured?
3D	Where and how should changes in the liability be presented?

Appendix A: Assets backing insurance liabilities under IFRS

Financial assets

A1. IFRS 9 requires financial assets to be measured at amortised cost (if specified criteria are met) or fair value. An entity is permitted to present changes in fair value of investments in equity instruments in other comprehensive income (OCI) (and with no recycling any of those gains and losses to profit and loss). The fair value option is permitted in specified circumstances.

A2. In May 2010, the FASB's exposure draft proposed that financial assets with variable cash flows or that are regularly traded should be measured at fair value with changes in profit or loss. For financial assets that are held for collection of cash, both amortized cost and fair value information would be presented. Changes in fair values for those financial assets would be presented in OCI and recycled. The FASB plans to begin redeliberations of its proposed classification and measurement approach in December 2010.

A3. The IASB does not intend to revisit the classification and measurement requirements in IFRS 9. Once the FASB has finished its deliberations, the IASB will review any remaining differences and consider what steps, if any, should be taken to reconcile those differences.

Investments in associates and joint ventures

A4. The insurer can choose to measure investment in associates and interests in joint ventures at fair value, with changes in profit or loss. Otherwise, investments in associates are accounted for using the equity method and interests in jointly controlled entity are accounted for either using the proportionate consolidation or the equity method.

Investment properties

A5. Under IAS 40, investment properties are measured at cost or fair value. If they are measured at fair value, changes in fair values are presented in profit and loss.

Property, plant and equipment

A6. An entity can choose to measure property, plant and equipment at cost (less accumulated depreciation) or revalued using fair value.

A7. Revaluation surpluses are credited to other comprehensive income and accumulated in a reserve. A downwards revaluation is recognised in profit or loss, unless it reverses a revaluation surplus relating to the same asset. On derecognition of an asset, any related amount asset in the revaluation reserve is not recycled to profit or loss. Instead it is usually transferred to retained earnings.

Appendix B: Assets backing insurance liabilities under US GAAP

Appendix C: IASB Discussion Paper *Preliminary Views on Insurance Contracts:* summary of responses on assets backing insurance contracts

A8. In general, respondents to the discussion paper did not highlight major accounting mismatches arising from the proposals in the discussion paper, when combined with the measurement of related assets using existing IFRSs. This reflects the proposal that insurance contracts would be measured at current exit value and that insurers would be required, or could elect, to carry most assets backing those contracts at fair value through profit or loss, using IAS 39 *Financial Instruments: Recognition and Measurement*, or other applicable standards.

A9. Most respondents agreed that all changes in insurance liabilities should be reported in profit or loss. Some proposed permitting or requiring insurers to use other comprehensive income (OCI) for changes in insurance liabilities to avoid accounting mismatches if insurers use the available-for-sale (AFS) category for financial assets held to back insurance contracts. Proponents of this view argued that, if this were not done, insurers would find themselves, in effect, unable to use AFS. Some also expressed concerns about volatility. Advocates of using OCI did not generally discuss whether the gains and losses would be recycled from OCI when the liability is derecognised.

A10. Respondents generally agreed that it would be desirable to eliminate accounting mismatches that arise if the assets of a unit-linked fund are not recognised (eg treasury shares) or are not carried at fair value through profit or loss (owner occupied property and investments in subsidiaries). Most of those commenting favoured permitting or requiring the insurer to carry all assets of a unit-linked fund at fair value through profit or loss, rather than adjusting the carrying amount of the liability. Some respondents indicated that similar mismatches could arise for participating contracts. Some also referred to particular practical difficulties for contracts that permit policyholders to switch between more or less freely between participating, non-participating and unit-linked funds (sometimes called 'multi-support' funds).

A11. Some respondents suggested a broader principle that insurers should be required to carry all assets backing insurance contracts (participating and non-participating) at fair value through profit or loss. Some asked the Board to remove constraints on the use of the fair value option in IAS 39.

A12. IFRS 4 *Insurance Contracts* permits insurers to redesignate financial assets as at fair value through profit or loss when they change accounting policies for insurance liabilities. This enables insurers to avoid creating accounting mismatches if they switch to current value approaches for insurance liabilities. Many respondents urged the Board to permit a similar option on transition to the phase II standard.