Staff Paper

Project	**Insurance contracts**
Topic	**Reducing accounting mismatches in profit or loss through presentation**

Introduction

1. This paper provides an analysis of accounting mismatches that arise when insurance contract liabilities and the assets that back them are measured on different bases, together with the staff's proposals on how presentation could help address those mismatches. This paper does not ask for any decisions. We will discuss a similar paper with the Insurance Working Group on 16 May and intend to ask the Board for decisions in the meeting in the week of 16 May.

2. This paper considers the issue from an IFRS perspective only. In the staff's view, the IASB and FASB need to consider this matter separately because there are differences in their underlying financial statement presentation (in particular with respect to recycling) and in the presentation requirements for changes in the assets backing insurance contracts. We believe that the presentation of the changes in insurance contract liabilities needs to consider the presentation of changes in the related assets because both preparers and users consider the effects of the assets and liabilities at the same time[1].

[1] We do not think this contradicts our project assumption that the standard will deal with insurance contracts from the perspective of the insurer, and not for the assets backing the contracts, because we do not propose different measurement approaches depending on the backing assets or any accounting requirements for the assets. However, we believe that financial statement presentation needs to consider the whole picture of an entity's activities and that this requires that presentation considers the liabilities together with

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3. The paper develops proposals on the assumption that changes in the measurement of the assets backing insurance contracts are presented in accordance with the current requirements of IFRS 9 *Financial Instruments*, consistent with the staff recommendations in agenda paper 6A that the Board will not define 'assets backing insurance contracts' and will not specify the accounting for those assets within the insurance contracts standard.

4. Appendix A summarises the types of assets an insurer might hold and the classification and measurement of those assets applying US GAAP, IFRSs and the FASB's tentative decisions in its financial instruments project.

Proposed staff recommendations

5. The staff intends to recommend:

   (a) that an insurer should be *permitted* (but not required) to present in other comprehensive income the difference between the insurance contract liability determined using the current discount rate and the insurance contract liability determined using the original discount rate at inception, if exercising that option would eliminate or substantially reduce an accounting mismatch.

   (b) that the option should be applied on a portfolio by portfolio basis.

6. To assist the Board in assessing the costs and benefits of permitting this option:

   (a) Agenda paper 6C considers the implications of permitting this option.

   (b) Agenda paper 6D provides an example that illustrates the mechanics of implementing this option.

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the assets. This is particularly important in assessing any accounting mismatch, which can only be done by considering the assets and liabilities together.

Overview of proposals in the ED/DP and summary of comment letters

Accounting mismatches

7. The Basis for Conclusions to the exposure draft (ED) noted that an 'accounting mismatch' arises 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 because different measurement attributes are applied. We reproduce the relevant extract from the Basis for Conclusions in Appendix C.

8. IFRS 9 permits entities to measure some financial assets and many financial liabilities at amortised cost. However, many respondents state that the proposals in the ED would, by imposing a current measurement approach for the insurance contract liability, in effect, prevent insurers from applying that amortised cost approach available to other financial institutions because to do so would result in accounting mismatches. Although the ED noted that insurers could avoid accounting mismatches by electing to use fair value options for the assets backing insurance contracts (eg for financial assets or investment property), these respondents believe that the ED proposals would penalise insurers for no valid reason. Accordingly, these respondents recommend that the Board should introduce an alternative treatment that would enable insurers to make use of the amortised cost approach available to other financial institutions.

Economic mismatches and short-term market volatility

9. The Basis for Conclusions to the ED noted that an 'economic mismatch' arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions.

10. In general, the Board seeks to minimize accounting mismatches and report economic mismatches, and one of the project axioms is that an ideal measurement model would report all economic mismatches (including duration mismatches)

that exist and would not cause any accounting mismatches. However, some commentators argue that information about some types of economic mismatch may not always be relevant to users of financial statements. For example:

(a) Some believe that when insurance liabilities and the assets backing them are both measured on a current basis, swings in credit spreads[2] on the assets may not be relevant to users if:

  (i) an insurer typically holds those assets to collect principal and interest, and

  (ii) the credit losses it would suffer on those assets do not vary significantly from the estimates embedded in the measurement of those assets.

(b) Some regard changes in financial inputs or market variables as irrelevant to an insurer's long term performance and believe that such changes result in short-term market volatility. In contrast, they regard other variables, such as mortality or frequency and severity of claims as indicative of longer-term performance, and believe that information about changes in those variables is more relevant to assessing an insurer's longer term performance. Those with this view suggest that short-term market movements should be clearly distinguished so that they do not obscure that longer term performance. That longer-term performance should reflect that insurers manage their investments in such a way so as to achieve a stable investment return from their portfolio to fulfil their insurance contract liabilities. (However, feedback suggests that some users view volatility as inevitable in a current measurement approach and believe that it is unrealistic to expect investors to ignore market movements even if assets and liabilities were to be measured at cost.)

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[2] The boards' have tentatively decided that, in a top-down approach for determining the discount rate, fluctuations in the overall asset spread, other than those arising from expected credit losses and the market risk premium for bearing credit risk, would be attributed to the illiquidity component of the asset yield and hence would also be mirrored in the changes in the liability discount rate. In the staff's view, this decision removes a portion of the volatility from the changes in bond yields, compared to 'bottom-up' approach that most interpreted the ED/DP to require.

(c) Some believe that changes in current value that will reverse through the payment of cash flows in the normal course of business over time are not a relevant performance indicator and should not be presented in profit or loss. For example, if an insurer had fully matched assets and liabilities, the effect of changes in interest rates would reverse over time. (However, others note that changes in interest rates are not always self-reversing over time. For example, if an insurer has assets with a duration of 10 years and liabilities with a duration of 15 years, a fall in interest rates will ultimately cause a decrease in net cash inflows if interest rates do not recover by the time the insurer needs to reinvest. Reporting the effect of increase rate changes as they occur provides a snapshot of the insurer's exposure to current levels of interest rates. Similarly, the effects of changes in interest rates do not self-reverse automatically for contracts that contain guarantees of minimum interest rates if interest rates drop below the guarantee floor and the insurer is not able to earn a high enough return to pay rates that meet the guarantee.)

Eliminating an accounting mismatch

11. Many commentators were concerned that the proposals in the ED did not accommodate the fact that both preparers and users consider the effects of changes in the insurance contract liabilities and the related assets at the same time. In particular, they were concerned that the proposals would result in an accounting mismatch when the assets backing the insurance contracts are not measured at fair value through profit or loss. Such assets include:

    (a) *Financial assets measured at amortised cost.* IFRS 9 requires an entity to measure a financial asset at amortised cost if both of the following conditions are met (unless the entity applies the fair value option to that asset):

(i) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principle and interest on the principal amount outstanding.

(b) *Non-financial assets,* especially investment property, measured at depreciated historic cost.

(c) *Equities measured at fair value through other comprehensive income (OCI).* IFRS 9 permits an entity to elect to present gains and losses on some equity instruments measured at fair value as components of OCI. If an entity uses that option:

(i) Dividends are to be recognised in profit or loss.

(ii) Fair value gains and losses are not recycled from OCI to profit or loss on disposal of the instrument

12. The accounting mismatch would arise as follows:

(a) If the assets backing the insurance contracts are measured on a cost basis (ie amortised cost or depreciated cost), an accounting mismatch arises in equity and in comprehensive income because changes in the carrying amount of the insurance contract liability do not react in the same way as changes in the assets.

(b) If the assets backing the insurance contracts are equities measured at fair value through OCI, an accounting mismatch[3] arises in profit or loss because changes in the carrying amount of the insurance contract liability would be presented in profit and loss whereas changes in the carrying

[3] There would also be an economic mismatch because the insurance contracts and the equities would not respond in the same way to changes in economic conditions. In general we believe that the economic mismatch would have a far greater effect than the accounting mismatch. However, to be consistent with the project axiom that an ideal measurement model would report all economic mismatches and while minimizing accounting mismatches, we consider in this paper only how the accounting mismatch could be reduced.

amount of the assets would be presented in OCI (although dividends would be presented in profit or loss). There would be little accounting mismatch in equity (or in comprehensive income) because both assets and liabilities would be measured at current value. Equities held at fair value through OCI are particularly relevant to participating contracts, which we discuss in Agenda paper 5. We do not discuss the accounting mismatch for these instruments further in this paper.

13. The Basis for Conclusions to the ED discussed this accounting mismatch, and in particular, whether to reduce the mismatch by requiring or permitting insurers to present in OCI changes in insurance liabilities backed by assets that are not measured at fair value through profit or loss.

14. When assets are measured on a cost basis, the accounting mismatch (described in paragraph 12) could be eliminated from profit or loss by presenting the mismatched part in OCI. However, the mismatch would not be eliminated from equity or from comprehensive income.

15. Paragraphs BC178-BC180 noted that requiring or permitting use of OCI might eliminate part of the accounting mismatch but would add complexity to the resulting information, would be difficult to understand and would be onerous for insurers to apply. This is because the insurer would need:

    (a) To determine the part of the insurance liability deemed to be backed by such assets. Insurance contracts may not be fully backed by assets that are not measured at fair value through profit or loss. This issue is discussed in agenda paper 6A on assets backing insurance contracts.

    (b) To track 'cost' information for that part of the liability, to achieve the desired split between amounts recognised in profit or loss and amounts recognised in OCI.

    (c) To determine whether and when to recycle amounts from OCI to profit or loss.

16. Furthermore, the Basis for Conclusions noted that insurers could avoid any accounting mismatch by using the options provided in IFRSs to measure the assets at fair value.

17. Many commentators disagreed that expecting insurers to use fair value options was an adequate response to this issue, because it precludes insurers from accounting for their assets on a basis the Board considers appropriate for other entities. In the staff's view, the comment letters clearly indicate that respondents:

    (a) believe that the costs of the additional complexity of presenting in OCI at least some components of the change in the insurance contract liability would be outweighed by the benefits from the information that would be provided by doing so. Commentators believe the accounting mismatch in profit or loss would obscure information about an insurer's underlying performance, and believe that eliminating this mismatch would have the benefits of increased transparency and a more faithful representation of the insurer's underlying performance.

    (b) place greater weight on an insurer's ability to account for its financial assets consistently with other financial institutions (on a 'level playing field') than on simplicity. Many commentators believe strongly that insurers should not, in effect, be precluded from using the default measurement basis for financial assets that meet the criteria in IFRS 9 for amortised cost measurement.

18. Furthermore, most commentators placed more weight on an accounting mismatch in profit or loss than on a mismatch in equity. Thus, when assets are measured on a cost basis, many placed importance on eliminating the accounting mismatch from profit or loss, even though an accounting mismatch remains in comprehensive income and in equity. In other words, they suggested the Board should not preclude the use of OCI in these circumstances if the only reason is that a mismatch remains in comprehensive income and in equity (the reason given in paragraph BC178(a)).

19. We note that the Board considered the arguments raised by respondents when it developed the ED. However, we believe that the comment letters have provided greater insight into the relative weights that preparers and users assign to the benefits and costs and to the importance of eliminating an accounting mismatch in profit or loss, even while such a mismatch remains in equity.

20. Furthermore, we note that for financial assets, IFRS 9 requires as a default the use of amortised cost when specified criteria are met and provides an option to measure those assets at fair value in order to eliminate or reduce an accounting mismatch. In other words, IFRS 9 permits an entity to eliminate or reduce an accounting mismatch by adjusting the measurement of the assets. We believe it would be equally appropriate to eliminate or reduce the mismatch by adjusting the presentation of changes in the carrying amount of the liability. Thus, if an insurer measures financial assets at amortised cost under IFRS 9 and suffers an accounting mismatch as a result, it should have the option to eliminate that mismatch:

    (a) By electing to use the fair value option for the financial asset; or

    (b) By electing to present in OCI some changes in the measurement of the insurance contract liability.

Identifying the changes in the insurance contract liability that could be presented in OCI

21. If the Board decides to eliminate some or all of the accounting mismatch from profit or loss by presenting some changes in the insurance contract liability in OCI, the next question is how to identify those changes.

22. For financial assets measured at amortised cost, interest using the effective interest rate is recognised in profit or loss. Some believe that this interest income should be presented together with an amount representing the equivalent expense, ie the unwinding of the discount on insurance contract liabilities. One feature of amortised cost in IFRS 9 is that the effective interest rate is set at inception and not adjusted at later dates (except for variable rate instruments). Therefore, the

unwinding of the discount would be based on the discount rate determined at the inception of the insurance contract liability and would not be adjusted at later dates (unless interest credited to policyholders is variable, see agenda paper 6C). In other words, we propose that the amount presented in profit or loss is determined using a locked-in discount rate, with the effects of the difference between the current discount rate and the locked-in rate presented in OCI.[4]

23. This would permit insurers to depict the relationship between gains and losses from insurance liabilities and gains and losses from the assets backing those liabilities, as described in paragraph 73 of ED:

> "The changes in estimates of discount rates and the interest on insurance liabilities shall be presented or disclosed in a way that highlights their relationship with the investment return on the assets backing those liabilities."

24. We explain in the appendix to agenda paper 6A that the underlying performance of insurance contracts could be regarded as the amount that results from excluding the effects of changes in financial market variables, in particular discount rates. Accordingly, presenting the difference between the current discount rate and the locked-in rate in OCI would have the additional benefit of presenting in profit or loss the amount considered by some to represent underlying performance from insurance contracts.

25. We discuss the implications of these proposals in agenda paper 6C.

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[4] We note that in the amortised cost model, if there are changes in the estimated cash flows from a financial asset or liability, the asset or liability is remeasured at a current estimate of the cash flows, discounted at the original effective interest rate. Therefore, to achieve consistency with the amortised cost model, profit or loss would need to reflect current estimates of cash flows

Defining when an insurer may present changes from the discount rate in OCI

26. If the Board were to decide that changes in the insurance liability arising from changes in the discount rate should be presented in OCI, the Board would also need to decide:

    (a) Whether to require this treatment in all circumstances where there is an accounting mismatch;

    (b) Whether to restrict this treatment to cases where there is an accounting mismatch; or

    (c) Whether to permit this treatment in all circumstances.

Permit or require

27. In the staff's view, the Board should not require insurers to present in OCI some changes in the insurance contract liability for the following reasons:

    (a) an option to present changes in the insurance liability arising from changes in the discount rate would not show in profit or loss duration mismatches and the value of guarantees. Arguably, using OCI could result in less transparent and less understandable information in some circumstances.

    (b) the Board expressed concerns in the past, summarized in paragraph 13, about the complexity of presenting in OCI some or all changes in the insurance contract liability. Those concerns are still valid.

    (c) the insurer would still have the option to eliminate the mismatch using the fair value option for its assets.

    (d) permitting an option will avoid the need for the Board to identify criteria to determine the assets that back the insurance contracts. We discuss the

difficulties of identifying such criteria in agenda paper 6A on assets backing insurance contracts.

28. We expect that an option to present in OCI some changes in the liability would in practice be used mostly in portfolios where all or most of the assets are measured at amortised cost, and that in turn would be restricted by the criteria in IFRS 9 for determining when financial assets should be measured at amortised cost.

Permit only when used to eliminate or reduce an accounting mismatch

29. In IFRS 9, the option to designate a financial asset at fair value through profit or loss is restricted to circumstances in which "doing so 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 recognizing the gains and losses on them on different basis." Guidance on applying this condition is provided in paragraphs B 4.1.29 - B 4.1.30 of IFRS 9 (reproduced in Appendix B).

30. That option was carried over to IFRS 9 from IAS 39, and the Basis for Conclusions to IAS 39 (in paragraph BC75A and BC75B) explains:

> BC75A …..In developing the amendment to the fair value option, the Board considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.
>
> BC75B The Board concluded that accounting mismatches arise in a wide variety of circumstances. In the Boards' view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information.

...Hence, the Board decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option….."

31. In carrying over the fair value option to IFRS 9, the board decided that it would not remove the restriction on the use of the fair value option to those cases where an accounting mismatch is reduced or eliminated, as described in paragraph BC64 of the Basis for Conclusions to IFRS 9:

    "Almost all of the respondents to the exposure draft supported the proposal to retain the fair value option if such designation eliminates or significantly reduces an accounting mismatch. Although some respondents would prefer an unrestricted fair value option, they acknowledged that an unrestricted fair value option has been opposed by many in the past and it is not appropriate to pursue it now."

32. In the staff's view, the concerns that led the Board to limit the use of the fair value option in IFRS 9 are of lesser importance for insurance contracts because we contemplate only disaggregation of changes and not measurement. Furthermore we doubt that insurers will have any incentive to use an option to present changes in the insurance contract liability in OCI when there is no accounting mismatch because doing so would create the volatility that insurers seek to avoid.

33. However, the reason for providing an option to use OCI would be to eliminate accounting mismatches, and the most significant of these arises when the assets backing insurance contracts are financial assets measured at amortised cost. In paragraph 20, we argued that an insurer that measures financial assets at amortised cost under IFRS 9 should have the ability to eliminate the resulting accounting:

    (a) by electing to use the fair value option for the financial asset; or

    (b) by electing to present in OCI some changes in the measurement of the insurance contract liability.

34. We think that it would be logical to use the same criteria for either approach to eliminating the mismatch. Accordingly, we propose that the Board restricts the option to present in OCI changes in the insurance contract liability arising from changes in the discount rate to cases where doing so eliminates or significantly reduces an accounting mismatch.

Unit of account

35. One of the project assumptions is that, in general, the final standard will measure insurance contracts at the portfolio level. Accordingly, the staff proposes that the assessment of whether an accounting mismatch is reduced or eliminated should take place at the portfolio level, and that the option to present changes in the insurance contract liability arising from changes in the discount rate should be made on a portfolio by portfolio basis. In the staff's view, insurers are likely to consider different factors in matching assets to insurance contract liabilities for different portfolios and therefore, if the option were to be applied at entity level, there might be an increase in mismatches for some portfolios.

36. We intend to consider the unit of account more holistically in a future meeting.

Discussion questions
1. Should an insurer be **permitted** to present in other comprehensive income the difference between the insurance contract liability determined using the current discount rate and the insurance contract liability determined using the original discount rate at inception, if exercising that option would **eliminate or substantially reduce an accounting mismatch**? 2. Should this option should be applied on a portfolio by portfolio basis?

Appendix A: Classification and measurement of assets that an insurer might hold

1. The following table summarises some of the types of assets an insurer might hold and the classification and measurement of those assets applying current IFRS 9, US GAAP and the FASB's tentative decisions in the financial instruments project.

37. Applying IFRS 9, financial assets are classified and measured as follows:

    (a) Fair value with changes in profit or loss (FVTPL);

    (b) Fair value with changes in OCI (FV - OCI): equity securities that are not held for sale (non-trading) and for which OCI classification is elected; recycling of the realized gains/losses to net income upon liquidation is not permitted.

    (c) Amortized cost: debt instruments for which the business model is to hold the asset to collect the contractual cash flows and the contractual terms of the financial asset gives rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.

38. Applying current U.S. GAAP, financial assets are classified and measured as follows:

    (a) Held-for-sale (loans)—Measured at the lower of cost or fair value;

    (b) Trading—Measured at fair value with changes in net income;

    (c) Available-for-sale—Measured at fair value with changes in OCI;

    (d) Held-to-maturity (securities) or held-for-investment (loans)—Measured at amortized cost.

39. Under the FASB's tentative decisions in the financial instruments project, financial assets would be classified and measured as follows:

    (a) Equity securities: measured at fair value with changes in net income;

(b) Debt instruments depending on both the characteristics of the instrument and the entity's business strategy for managing the assets:

(i) Fair Value – Net Income—Measured at fair value with changes in net income;

(ii) Fair Value – OCI—Measured at fair value with changes in OCI;

(iii) Amortized Cost.

Asset	IFRS 9	Current U.S. GAAP	FASB tentative FI decisions
Fixed income investments	FVTPL[5] Amortised cost	FV – NI[6] FV – OCI (with recycling)[7]	FV – NI FV – OCI (with recycling)
Equity investments	FVTPL FV – OCI (no recycling)	FV – NI FV – OCI (with recycling)	FV – NI
Unsecuritized mortgage loans	FVTPL Amortised cost	Amortised cost Lower of cost/FV	FV – NI Amortised cost
Equity method investments	Equity method (IAS 28)	Equity method FV – NI	Not yet redeliberated
Derivatives	FVTPL	FV – NI	FV – NI
Real Estate	Amortised cost FVTPL (IAS 40)	Amortised cost	Not yet deliberated (as part of Investment Properties Project)

[5] Fair value with changes in profit or loss
[6] Fair Value – Net Income—Measured at fair value with changes in net income
[7] Fair Value – OCI—Measured at fair value with changes in OCI

Appendix B: Extract from IFRS 9

Designation eliminates or significantly reduces an accounting mismatch

B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a).

(a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by IFRS 4, paragraph 24), and financial assets it considers related that would otherwise be measured at amortised cost.

(b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the

instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 of IAS 39 are not met.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

Appendix C: Extracts from the Basis for Conclusions on the Exposure Draft

Accounting mismatches

BC172 The Basis for Conclusions on IFRS 4 distinguishes two types of mismatches:

(a) An 'economic mismatch' arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. For example, an economic mismatch arises if the duration of insurance liabilities is longer than the duration of fixed interest assets backing those liabilities.

(b) An 'accounting mismatch' arises 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 because different measurement attributes are applied.

BC173 Users and preparers of financial statements and other interested parties have consistently stated that it is important for insurers to account for insurance contracts and related assets in a manner that avoids accounting mismatches. They have noted that it is burdensome for insurers to explain the effects of accounting mismatches even to sophisticated users, and less sophisticated users may be less able to understand these effects. In the discussion paper, the Board expressed the preliminary view that an ideal measurement model would report all economic mismatches and would not create any accounting mismatches.

BC174 A common cause of accounting mismatches for insurers relates to measuring interest-bearing financial assets at fair value when insurance contracts are measured on a basis that does not reflect current interest rates. If interest rates change, the carrying amount of the assets changes but the carrying amount of the insurance liabilities does not, with the following consequences:

(a) For financial assets classified as 'at fair value through profit or loss', there is an accounting mismatch in both the statement of comprehensive income and the statement of financial position.

(b) For measurements of financial assets measured at fair value in the statement of financial position but not in profit or loss (such as 'available-for-sale financial assets' under IAS 39 or equity instruments measured at fair value through other comprehensive income under IFRS 9), there is no accounting mismatch in profit or loss (unless the assets are sold), but there is an accounting mismatch in other comprehensive income and, consequently, also in equity.

(c) If the insurer sells assets, an accounting mismatch occurs not only for available-for-sale financial assets, but also for assets carried at amortised cost.

BC175 In developing the draft IFRS, the Board considered the following approaches to address accounting mismatches for insurers:

(a) changing the accounting for an insurer's assets, or

(b) requiring or permitting an insurer to present some or all changes in its insurance liabilities in other comprehensive income.

BC176 In the Board's view, it would not be appropriate to change the accounting for an insurer's assets, other than assets relating to unit-linked and index-linked insurance contracts, see paragraphs BC153–BC155, because:

(c) other assets and liabilities of an insurer are outside the scope of the draft IFRS.

(c) it would be undesirable to create industry-specific requirements for the accounting for assets. To do so would reduce transparency and perpetuate the barriers that impede communication between insurers and users of their financial statements.

(d) it may not be possible to identify which of the insurer's assets are held to back insurance liabilities and which are not.

BC177 The Board considered whether to require or permit insurers to present in other comprehensive income changes in insurance liabilities backed by assets that are not measured at fair value through profit or loss in accordance with IFRS 9. Assets not measured at fair value through profit or loss include:

(a) financial instruments that are measured at amortised cost in accordance with IFRS 9 (paragraphs BC178 and BC179).

(b) some investments in equity instruments for which IFRS 9 permits gains and losses to be presented in other comprehensive income (paragraph BC180).

Amortised cost

BC178 The Board does not propose to permit or require insurers to present in other comprehensive income changes in the carrying amount of insurance liabilities backed by financial assets that are measured at amortised cost. Such presentation:

(a) might eliminate some or all of the mismatch in profit or loss, but would not eliminate the accounting mismatch from comprehensive income or equity.

(b) would be complex and difficult to understand.

(c) would be onerous for insurers because of the need:

- (i) to determine the part of the insurance liability deemed to be backed by assets measured at amortised cost.
- (ii) to track 'cost' information for that part of the liability, to achieve the desired split between amounts recognised in profit or loss and amounts recognised in other comprehensive income.

(iii) to determine whether, and when, to recycle amounts from other comprehensive income to profit or loss.

BC179 Furthermore, an insurer could avoid this accounting mismatch by using the fair value option for its assets.

Other comprehensive income presentation alternative for some equity instruments

BC180 The Board does not propose to permit or require insurers to present in other comprehensive income changes in insurance liabilities backed by equity instruments measured at fair value through other comprehensive income because:

(a) an insurer's insurance liabilities may not be fully backed by those equity instruments measured at fair value. Thus, an insurer would report part of the changes in the carrying amount of its insurance liabilities in other comprehensive income and part in profit or loss. The resulting complexity would not be clear, transparent, understandable or informative for users of financial statements.

(b) the requirement would be onerous for insurers because of the need to determine the part of the insurance liability deemed to be backed by equity instruments measured at fair value through other comprehensive income.

(c) presenting changes in fair value of equity instruments in other comprehensive income is optional. Thus, no insurer is required to suffer the mismatch discussed above.

Shadow accounting

BC181 The proposal to present all income and expense from insurance contracts in profit or loss eliminates the need for a practice known as 'shadow accounting'. Shadow accounting has two forms, as follows:

(a) In some accounting models, the measurement of some or all of an insurer's non-participating insurance liabilities depends on realised gains and losses on an insurer's assets. For example, section 944-30-358 of FASB ASC Topic Financial Services – Insurance requires some insurance liabilities to be measured on the basis of the estimated gross profit, including amounts expected to be earned from the investment of policyholder balances. To eliminate the mismatch between assets measured at fair value through other comprehensive income and unrealised gains and losses, shadow accounting adjusts the insurance liability so that unrealised gains and losses are recognised in the same way as realised gains and losses. The proposals in the draft IFRS do not measure non-participating insurance contracts on the basis of gains and losses on assets. Thus, this application of shadow accounting would no longer be relevant.

(b) When policyholders participate wholly or partly in returns on assets measured at fair value through other comprehensive income, shadow accounting adjusts other comprehensive income to reflect that participation. This form of shadow accounting could be relevant because IFRS 9 permits some equity instruments to be measured at fair value through other comprehensive income. However, IFRS 9 requires that, for such equity instruments, entities recognise only dividend income in profit or loss, with realised and unrealised gains and losses recognised in other comprehensive income. As a consequence, shadow accounting is likely to result in complexity that would not be easy for users to understand or for

[8] originally introduced by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

preparers to apply. Therefore, the Board proposes not to retain shadow accounting (currently permitted under IFRS 4).

Short-term market volatility

BC182 Some respondents to the discussion paper proposed that an insurer should recognise in other comprehensive income changes in the insurance liability arising from changes in financial inputs or market variables. Those respondents believe this approach:

(a) would represent the economics of the insurance business more faithfully than recognising all changes in the carrying amount of the insurance liability in profit or loss because it would distinguish the insurer's longer-term performance from changes they regard as short-term.

(b) permit insurers to present performance on a basis comparable to financial institutions, such as banks, that use amortised cost for some of their financial assets and many of their financial liabilities.

(c) would be consistent with the proposals in the exposure draft *Defined Benefit Plans*, which proposes the use of other comprehensive income to report remeasurements of post-employment benefit liabilities. Some respondents to the discussion paper viewed post-employment benefit liabilities and insurance liabilities, particularly some long-duration life insurance contracts, as having some common characteristics.

BC183 In the Board's view, gains and losses on insurance contracts are a core part of an insurer's performance in both the short term and long term. Therefore, presentation of those gains and losses in profit or loss is appropriate. The Board welcomes comments on how gains and losses from insurance liabilities can be presented in profit or loss in a way that best depicts their relationship with gains and losses from the assets backing those liabilities.