SOCIETY OF ACTUARIES

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F5: Accounting Considerations for Insurance Companies

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IASB and FASB Financial Instruments Project: A Closer Look

Agenda

Overview

Classification and Measurement

Impairment

Hedge Accounting

Next Steps

Learning objective

To enhance understanding pertaining to:

- The FASB/IASB project on the accounting for financial instruments
- How the classification and measurement standards for financial instruments are changing under U.S. GAAP and IFRSs
- Proposed changes to credit impairment requirements
- Proposed changes to hedge accounting requirements

Overview

Overview
Drivers of change

Accounting complexity

- Existing financial instruments accounting standards have been criticized for being overly complex (e.g., hedge accounting, classification requirements)

Global financial crisis

- The global financial crisis has focused attention on financial instruments accounting (e.g., the extent to which financial instruments should be subject to fair value accounting and how credit losses should be recognized and measured)

Overview
Drivers of change (cont.)

Convergence

- The FASB and the IASB are “redoubling [their] efforts” to improve and converge U.S. GAAP and International Financial Reporting Standards (IFRSs)

Declaration by the Leaders of the G-20 Countries, April 2009

We have agreed that accounting standard setters should take action … to reduce the complexity of accounting standards for financial instruments; strengthen accounting recognition of loan-loss provisions, … [and] make significant progress towards a single set of high quality global accounting standards”

Overview
Scope and impact

The project will radically overhaul the existing accounting literature for financial instruments

Virtually no company will be unaffected

Assets	Liabilities	Derivatives
• Cash and deposits • Accounts and notes receivable • Investments in debt and equity securities • Investments in contractually linked instruments • Private equity investments • Loan assets	• Accounts and notes payable • Bonds, mortgages, and other long-term debt • Deposit liabilities	• Options • Forwards • Swaps

Overview
Timeline

2008

2009

2010

IASB	FASB
Q4 2008 - Added project to active agenda Q3 2009 - Exposure Draft (ED) Classification & Measurement Q4 2009 - ED Impairment Q4 2009 - IFRS Classification & Measurement of Financial Assets H1 2010 - ED Hedge Accounting H1 2010 – ED Financial Liabilities (TBD) H2 2010 - Comprehensive IFRS	Q4 2008 - Added project to active agenda H1 2010 - Comprehensive ED H2 2010 – Comprehensive Standard

<u>FASB/IASB Joint Statement, November 2009</u>

Our efforts to improve IFRS and US GAAP for financial instruments and to achieve their convergence have been complicated by the differing project timetables we established to respond to our respective stakeholder groups and other factors. We are committed to issuing standards by the end of 2010 that represent a comprehensive and improved solution to this complex and contentious area and that provide international comparability.

Classification and Measurement

What is changing?

FASB's tentative decisions

Measurement and income recognition	Three measurement and income recognition categories: • Fair value through earnings • Fair value through other comprehensive income (FVTOCI) • Amortized cost
Impairment	• Impairment only for FVTOCI assets
Impact on classifications	• No available-for-sale, held-to-maturity, loans held for sale, or loans held for investment categories
Hybrids	• No embedded derivatives in financial instruments
Nonmarketable securities	• No cost exemption for nonmarketable equities
Reclassifications	• No reclassifications after initial recognition

FASB's tentative decisions
Classification and measurement

Default category:

All financial instruments	Fair value through earnings	• All equities • All derivatives • Many hybrids

Option to record:

Debt instruments: Business strategy (to hold a debt instrument for collection or payment of contractual cash flows rather than selling or settling)	Portion of the change in fair value through OCI

Option to record:

Own Debt: Business strategy + measurement attribute mismatch	Amortized cost

FASB's tentative decisions
Presentation

Category	Face of the Balance Sheet	Face of the Income Statement*
Fair value through earnings	• Fair value • Amortized cost (only for own debt measured at fair value) *Note: No requirement to separately present:* • Amortized cost (except own debt measured at fair value) • Adjustments made to amortized cost to arrive at fair value	• Realized and unrealized gains and losses (in the aggregate) *Note: No requirement to separately present:* • Interest accruals • Credit losses • Dividend income (for investments in equity instruments)

*One statement of financial performance with a total for comprehensive income, including a subtotal for net income.

FASB's tentative decisions
Presentation (cont.)

Category	Face of the Balance Sheet	Face of the Income Statement
Fair value through OCI (optional for eligible debt instruments)	• Amortized cost • Cumulative credit losses • Adjustments to arrive at fair value • Fair value	• Interest income • Interest expense • Credit losses • Realized gains and losses *Note: Foreign exchange gains or losses not separated (recognized in OCI)*

FASB's tentative decisions
Presentation (cont.)

Category	Face of the Balance Sheet	Face of the Income Statement
Amortized cost (optional for own debt only)	• Amortized cost only	• Interest expense • Realized gains and losses

Objective and scope of IFRS 9

Applicable to **all financial assets** which are within the scope of IAS 39

Establish **principles** for financial reporting for financial assets

- **Not intended as fair value measurement guidance** but for determination of which instruments should be at fair value
- Fair Value Exposure Draft (May 2009) to be finalised as a standard in 2010

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What has changed?

IFRS 9

Measurement and recognition	Three measurement and income recognition categories: • Amortized cost • Fair value through profit and loss (FVTPL) • Fair value through other comprehensive income (FVTOCI) – NEW
Impairment	• Impairment only for amortized cost assets
Impact on classifications	• No available for sale or held to maturity categories
Hybrids	• No embedded derivatives in financial assets
Nonquoted securities	• No cost exemption for unquoted equities
Reclassifications	• Limited reclassifications

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Classification and measurement
Operational issues

Broad implementation that involves multiple stakeholders

Some operational simplifications include:

- Reduction in and clearer rationale for classification and measurement categories
- Elimination of bifurcation requirements for financial instruments (still retained for financial liabilities under IFRS)
- Elimination of the "tainting rules" related to sale of held-to-maturity securities

Classification and measurement
Operational issues (cont.)

Several other implementation undertakings including:

- Accounting policies, operating processes and systems changes to identify contractual terms which give rise to solely principal and interest cash flows
- Impacts on economic hedging of risks associated with previously bifurcated embedded derivatives and application of valuation techniques to hybrid financial instruments in their entirety
- Valuation processes and controls for valuations of unquoted equities
- System, valuation and capital implications from expanded use of fair value (under FASB's proposed approach)
- Implications of new classification and measurement on capital requirements

Impairment

Impairment

The IASB is proposing to replace the existing incurred loss approach with an expected loss approach

- Exposure Draft (ED) issued in November 2009. Comments due June 30, 2010
- Applies to financial assets accounted for at amortized cost (i.e., loans, receivables, and investments in debt securities carried at amortized cost)

The FASB is still developing its impairment approach

- To be addressed in the comprehensive ED to be published in Q1 2010
- Applies to financial assets classified as fair value through OCI (i.e., loans, receivables, and investments in debt securities that meet the fair value through OCI criteria)

The FASB and the IASB have agreed to consider jointly the comments received on their respective proposals

IASB's impairment approach

High level overview

Initial recognition: Estimate future credit losses over life of asset	Net interest revenue adjusted for margin to reflect initial estimate of future credit losses	Allowance for future credit losses built up over time	Ongoing adjustments to estimates of future credit losses
• Asset by asset or groups of similar assets • Estimate expected cash flows taking into account expected future credit losses over the life of the asset or assets • Probability-weighted possible outcome approach even if most likely outcome is full repayment • No upfront loss is recognized - credit loss estimate impacts net interest revenue over time	• Margin for initially expected credit losses is deducted from gross interest revenue in each period • Determined through application of the Effective Interest Rate (EIR) method • Practical expedients permitted if they meet certain criteria	• The margin for initially expected credit losses that is deducted from gross interest revenue in each period is set aside to gradually build-up an allowance for expected future credit losses • Applies even if no actual losses have yet been incurred • Does not require objective evidence of impairment or loss events to have occurred	• In each period, the entity must reassess the asset's expected cash flows , taking into account expected future cash flows • Any changes in credit loss expectations – both favorable and unfavorable – are recognized immediately on a discounted cash flow basis as a gain or loss in earnings. • Discount revised expected future cash flows at the asset's effective interest rate

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Impairment

Comparison of IASB and FASB approaches

	IASB	FASB
Scope	Financial assets accounted for at amortized cost	Financial assets accounted for at fair value through other comprehensive income
Trigger for impairment	No trigger	No trigger
Impairment measurement	Based on expected future cash flows adjusted for future credit losses expected throughout the life of the asset or portfolio (based on probability-weighted possible outcomes)	Based on expected future cash flows; all available information relating to past events and existing conditions is considered. An entity would <u>not</u> consider possible future events

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Impairment
Comparison of IASB and FASB approaches (cont.)

	IASB	FASB
Initial recognition	Recognition of a loss on initial recognition is generally precluded	Not yet deliberated
Interest recognition	Adjusted to deduct a margin for initially expected credit losses	Not yet deliberated
Ongoing reassessment	Yes. Changes in expected cash flows result in gains or losses	Yes. Changes in expected cash flows result in gains or losses

Impairment
Operational issues

- Models and systems to compute expected future cash flows and expected credit losses
- Individual asset vs. group of asset application considerations
- Collection and tracking of historical loss data or ratings information
- Estimation uncertainty and degree of judgment
- Application issues related to variable rate instruments
- Incorporation of credit losses in initial EIR plus ability to report both gross and net interest revenue
- Establish processes and data requirements to update or validate assumptions each period
- Interplay with Basel II capital requirements

The FASB and IASB have established a joint Expert Advisory Panel to advise the two Boards on operational issues and how those issues might be resolved

Hedge Accounting

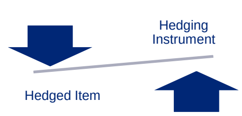
Hedge accounting

The IASB has agreed on the following proposed approach:

- Fair value hedge accounting would be replaced with a model similar to cash flow hedge accounting
- Assessment and measurement requirements would be simplified

The FASB has just commenced discussions on hedge accounting

The IASB is delaying the publication of its hedge accounting proposals until the first quarter of 2010, so as to give the two boards the opportunity to develop a common solution. The FASB plans to include hedging in the comprehensive exposure draft it expects to publish in the first quarter of 2010



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Hedge accounting
Details of the IASB's proposed approach

The effective portion of fair value hedges (not just cash flow hedges) would be recognized initially in OCI

The carrying amount of the hedged item in fair value hedges would not be adjusted

For fair value hedges, ineffectiveness resulting from both underhedges and overhedges would be recognized in profit or loss

Current approach - example	Proposed approach - example
Dr Hedged Fixed-Rate Bond $100	Dr OCI $100
Cr Earnings $100	Cr Interest Rate Swap $98
Dr Earnings $98	Cr Earnings $2
Cr Interest Rate Swap $98	

Next Steps

IASB/FASB project plan for 2010

Q1 2010

- FASB will publish a comprehensive ED on classification, measurement, impairment, and hedging (comments due end-June 2010), including a request views on the IASB's proposals
- IASB will publish:
  a) an Exposure Draft (ED) on hedge accounting (comments due end-June 2010).
  b) a revised ED, if appropriate, on the classification and measurement of financial liabilities (comments due end-June 2010).
  c) a request for views on the FASB's comprehensive ED.

Q2 2010

- IASB will conduct a post-implementation review of early adopters of its classification and measurement requirements for financial assets

Q3 2010

- FASB and IASB will consider comments jointly with "the objective of agreeing on a model that will enhance […] international comparability."

Q4 2010

- FASB and IASB will publish their final standards

Questions & Answers

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