



FASB / IASB Convergence – An emerging reality or long road ahead?

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Introduction

By now, most financial professionals are aware that the goal of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) is to converge toward a unified global Generally Accepted Accounting Principles (GAAP) standard. *Accounting for Financial Instruments* (including stocks, bonds, etc.) is one of the subjects on which FASB and IASB take decidedly different approaches. Over the next six to nine months, we believe it will become clear if true convergence on this subject will become a reality.

The FASB issued an exposure draft in May on this subject and the IASB previously addressed it in its Standard (IAS 9). These documents have prompted us to look at the competing approaches of these two standard setters. What differences exist? What are the key changes that could impact your investment portfolio?

Watching attentively is the NAIC, which inevitably will be concerned with updating Statutory Accounting Principles (as appropriate) to maintain consistency with the new U.S. and International GAAP standards.

Key Implications for Insurers

In reviewing the guidance from the FASB and IASB, it appears that they are moving closer together on the full recognition of fair market value (FMV) in the classification of financial instruments. However, they support different approaches for treating FMV as it changes over time.

As we review the current FASB draft pronouncement and compare it to the IASB Standard, we have a number of major questions:

- How do the pronouncements move closer to a universal FMV standard?
- How will the changes in FMV be recorded in financial statements and what is the significance of these differences?
- How will these changes impact operating earnings and capital & surplus?
- What do the proposed rules mean for earnings, volatility and quality?
- And, ultimately, will full FMV reporting become a consistent reality across all reporting standards anytime soon?

Critical Differences Exist

A head-on collision over the treatment of changes to FMV seems inevitable as FASB and IASB are each currently committed to their own different investment reporting philosophies on changes in FMV. Keep in mind that the IASB was out first with its pronouncement. This means the FASB has chosen to take a more forceful position in moving its standards to full FMV.

The FASB approach endorses a methodology where *all investments* would be reported at FMV. While the IASB also has endorsed a FMV approach, in certain circumstances, it supports the reporting of investments at *amortized cost*.

The Bucket Brigade

Both organizations endorse two methods for the classification and reporting of investments. We will refer to these as “Buckets.” Let’s look at how this would work under the two standards:

The Default / Trading Bucket: Both the FASB and the IASB move toward full FMV convergence in the use of the “Trading” bucket as the default classification for stocks and bonds. Securities in the Trading bucket would be reported at FMV with changes in value recorded through net income. Use of this classification would require companies to establish a policy of reporting these FMV changes either through the net income components of Realized Gain/Loss or investment income.

Since many companies are likely to want to minimize earnings volatility associated with FMV, we expect that most companies will establish a policy of reporting FMV changes through Realized Gain/Loss and not report these changes in investment income or operating earnings within net income.

The Other Bucket: Convergence can also be seen in the security qualification requirements for the new “Held For A Significant Period Of Time” bucket. This ungainly name effectively replaces the former “Held To Maturity” (HTM) and “Available For Sale” (AFS) buckets. Securities in this bucket must display certain characteristics and be used in a business strategy based on the “collection of contractual cash flows” rather than on asset turnover (as in the case for the “Trading” bucket). Helpfully, FASB includes clarifying language which further describes the meaning of Held For A Significant Period Of Time.

However, while the qualifications are similar for this bucket, the FASB and IASB reporting of FMV changes is significantly different. Under the FASB model, the changes in FMV would be reported in Capital & Surplus under Other Comprehensive Income (OCI) as an Unrealized Gain/Loss, similar to securities held in today’s AFS bucket. IASB demonstrates a lingering orientation to the former HTM bucket. Notably, the IASB model would report these securities at Amortized Cost, similar to today’s HTM securities. Both categories have pros and cons, as seen in **TABLE 1**.

TABLE 1	Advantages	Disadvantages
Trading Bucket	<ul style="list-style-type: none"> • Trade at will • Allows for more investment strategies • No impairment requirement 	<ul style="list-style-type: none"> • Income volatility • Portfolios of shorter durations to minimize income volatility
Hold for a Significant Time Bucket	<ul style="list-style-type: none"> • Report through OCI, so no earnings volatility 	<ul style="list-style-type: none"> • Loss of flexibility in managing portfolio

It is hard to know why the two organizations are espousing such different reporting models – we speculate that the banking industry in Europe has been able to impress upon the IASB the risk of mark-to-market reporting and the impact on capital.

Looking forward, FMV changes may well be reported in an enhanced “Statement of Comprehensive Income” which will consolidate all components of Realized and Unrealized Gain/Loss as well as investment income into one statement. This will make analysis more readily accessible.

An Asset/Liability Management Headache?

The adoption of these new “buckets” may impact Asset/Liability Management (ALM), Gain/Loss management and Portfolio Management styles.

ALM - a greater percentage of assets will likely be in the Trading bucket and, therefore, will be marked to market daily, meaning more volatility in values and income. Companies may choose to manage this volatility by shortening their portfolios durations (perhaps using derivatives, also recorded at FMV), but this may exacerbate the ALM mismatch.

Gain/Loss management - this may fade (for GAAP reporters) as a constraint, allowing more flexibility in investment risk and budgets.

Portfolio Management styles - the movement towards a FMV world may allow more active management of insurance portfolios as companies seek both income and return against allocated capital. Whatever the implications, a higher level of volatility is likely to be permanent. FASB recognizes this, supporting the use of new footnote disclosures to identify the components of net income, with a focus on identifying those that can be controlled (such as interest, dividends & amortization) and those that cannot (such as changes in FMV).

Equities

Another difference in the two models can be seen in the approach to equities. For FASB, all changes in the FMV of equities must be reported in net income. Although this is also the “default election” for IASB, companies also can make an election on an instrument-by-instrument basis to report changes through OCI. This election is irrevocable and any amounts reported in OCI cannot be re-classed to a Realized Gain/Loss on disposal of the security (the Unrealized Gain/Loss will remain indefinitely). **TABLE 2** below compares today’s FASB reporting classifications for stocks and bonds with the proposed standards.

TABLE 2	FASB Reporting Today	New FASB	New IASB
Held to Maturity	Bonds reported at amortized cost, no FMV, no unrealized gain/loss	Not Allowed	Allowed, however new restrictions to qualify
Available for Sale / Held for a Significant Period of Time	Bond/Stock reported at FMV, change in FMV reported in unrealized gain/loss – surplus	Allowed with new restrictions	Not allowed for bonds – restrictions for equities
Trading	Bond/Stock reported at FMV, changes in FMV reported in net income	Will become the default bucket	Will become the default bucket

Update on Impairments

On the important issue of impairments, the FASB appears to be converging with the IASB perspective. Under FASB’s exposure draft, companies can establish an impairment reserve, which can increase or decrease, based on current economic conditions. Under current FASB guidelines, impairments cannot be reversed and no reserve exists. However, there is a significant difference in the rules put forward by the two organizations as to how companies determine impairments. The FASB approach *prohibits* companies from using “future expectations” to determine impairments, while the IASB *endorses* it. Future expectations are defined as the analyzable argument about the future value of a security. Disallowing the use of future expectations is a curious decision, in light of the fact that FMV, to a significant extent, is based on future expectations. We feel that the FASB approach is likely to create more impairment volatility, with larger (potentially overstated) impairment reserves in periods of financial distress or higher interest rates, with smaller impairment reserves being established in good times.

TABLE 3	Capital & Surplus Components
Net Income Components	
<ul style="list-style-type: none"> • Interest and dividends • Credit impairment for financial assets • Equity securities – the change in fair value (currently known as unrealized gain/loss) • Realized gains/losses on the sales • Unrealized gains/losses on bonds categorized as FMV with changes reported in Net Income (Trading Bucket) 	<ul style="list-style-type: none"> • Unrealized gains/losses on bonds that are categorized as FMV with changes reported in OCI • Cumulative translation adjustment, i.e., recording the all time unrealized gain/loss on items previously not recorded at FMV

Based on the differences between the two impairment models as well as the IASB use of Amortized Cost in certain circumstances (rather than FMV), some U.S. industry professionals feel the IASB standards are more reasonable than those of the FASB. **TABLE 3** summarizes how and where these changes are likely to impact companies’ income statements or balance sheets.

Other Business Impacts to Consider

As proposed, the FASB draft may affect additional related accounting/reporting areas, perhaps requiring companies to allocate added resources to technology.

- 1. Taxes:** With more securities, including FMV changes in income, there will be more temporary book/tax differences.
- 2. Valuation Model:** More scrutiny on FMV will increase the need for more robust methods and means to determine FMV for securities (especially those that are valued using unobservable inputs or those that are not actively traded). A question remains – will the additional valuation analysis delay a company’s “closing process?”
- 3. Impairment Model:** Companies may need to develop new historical methodologies and sources to evaluate impairments.

A Brief Word on Hedging

To qualify for hedge accounting, a qualitative or quantitative assessment must be performed at inception to demonstrate that an economic relationship exists between the hedging instrument and the hedged item. Under the FASB draft, the assessment is only required to prove that the hedge will be “reasonably effective” instead of the current standard of being “highly effective.” In addition, during the life of the hedge, effectiveness testing is only required to be done in periods where circumstances suggest that the hedging relationship is no longer reasonably effective (currently, a company is required to perform on-going effectiveness testing). We feel it is likely that derivative products will be utilized more often if the FASB proposal is adopted, as more financial assets will be recorded at FMV, changes will be reported in net income, and hedging standards will be relaxed, which could ameliorate the Asset/Liability mismatch issue. The IASB has not yet issued their guidance on hedging, so any impact is still to be determined.

Current Timeline

The exposure period of the FASB’s draft pronouncement expires on September 30, 2010. A series of discussions will complete the comment period. It is expected that the FASB will issue a final Accounting Standard Update in 2011. However, because of the magnitude of the changes, it is likely that implementation date will be in 2013 or later.

As the FASB and IASB evolve toward a final conclusion, Conning expects to provide more comprehensive coverage of this topic in a late summer edition of “Conning Investment Comments.” Stay tuned! ♦

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