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Upcoming GAAP Developments

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In 2008, many valuation actuaries were faced with the challenge of implementing FAS 157 (Fair Value Measurement) for US GAAP reporting purposes. The good news is that there isn't any new US GAAP accounting standard requiring major actuarial valuation changes for existing business in 2009. However, looking over the next few years, the accounting standard-making bodies have several major projects underway that could have a significant effect on valuation actuaries. These projects include:

1. replacement of existing US GAAP with IFRS,
2. accounting for insurance contracts,
3. revenue recognition, and
4. revising the accounting for financial instruments.

In addition, there are other projects underway that may not be as significant to valuation actuaries as the projects listed above, but which may still have some effect on actuaries.

POSSIBLE REPLACEMENT OF US GAAP WITH IFRS

In the United States, the Securities and Exchange Commission (SEC) has the authority to regulate financial markets, including setting the financial reporting standards. Since the 1970s, the SEC has delegated the responsibility for promulgating financial reporting standards to the Financial Accounting Standards Board (FASB). On the other hand, many countries throughout the world, including the European Union, Australia and Hong Kong, use financial reporting standards promulgated by a different body, the International Accounting Standards Board (IASB). These financial accounting standards are generally known as International Financial Reporting Standards (IFRS). A number of other countries, including South Korea, Canada and Brazil, have announced plans to switch from their current accounting standards to IFRS over the next few years.

In November 2008, the SEC released the "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers."[1] Under this roadmap, if certain conditions are met by 2011, the SEC would then mandate the eventual replacement of US GAAP with IFRS. For the largest companies, known as large accelerated filers, this would occur in 2014. Other large companies (accelerated filers) would switch to IFRS in 2015 and all U.S. companies would switch to IFRS by 2016.

Mandating that U.S. companies switch to IFRS would enhance comparability of financial statements across companies that are domiciled in different jurisdictions around the globe. The SEC views this as an important goal, since capital markets have become increasingly global. However, the roadmap sets forth several milestones that need to be achieved by 2011 in order for the SEC to make the decision to switch.

Some of these milestones are technical, involving issues such as the funding mechanism for IASB's parent foundation and ability to report under IFRS using interactive data. Other milestones are more practical. For example, one of the milestones is to achieve certain improvements in existing accounting standards. Some of the projects currently underway by IASB and FASB, such as Revenue Recognition, are meant to achieve this goal. Another milestone is education and training about IFRS for investors, accountants, auditors, and other users and preparers of financial statements. Actuaries are explicitly noted as one of the groups that would need to be educated on IFRS.[2]

Although the potential replacement of US GAAP with IFRS in 2014 for the largest companies (and later for smaller companies) seems far off, it may not be as far as it seems. Adopting IFRS would likely be a much larger task than adopting a single new accounting standard, such as FAS 157. And companies are required to show three years of comparable audited financial statements, so a company converting in 2014 would need to show audited financial statements under IFRS for 2012 through 2014. 2012 is just three years away!

FOOTNOTES:

1 Available from the SEC's Web site at *http://www.sec.gov/rules/proposed/2008/33-8982.pdf.*

2 SEC Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, p.29.

INSURANCE CONTRACTS

In May 2007, IASB released a discussion paper proposing new guidance for accounting for insurance contracts. At the time, FASB was not involved in the project. This discussion paper has been described in detail elsewhere.[3] But as a brief reminder, the discussion paper proposes to value insurance liabilities at current exit value, or the estimated price to transfer the liability to another market participant. This value would be estimated using three building blocks:

1. explicit, unbiased, market-consistent, probability weighted, current estimates of contractual cash flows,
2. current market discount rates that adjust the estimated future cash flows for the time value of money, and
3. an explicit and unbiased estimate of the margin that market participants would require for bearing risk (risk margin) and for providing other services, if any (service margin).

The current exit value would incorporate non-performance risk (e.g., credit standing), but would not incorporate entity-specific cash flows. Beneficial policyholder behavior and, unless they caused the liability to increase, universal life premiums in excess of the minimum premium needed to maintain the contract in force would also be excluded. And certain non-guaranteed elements on universal life contracts and dividends on participating contracts might also be excluded. Under current exit value, the risk margin would not be calibrated to the premium and, therefore, a gain or loss might emerge at issue.

The IASB received many comment letters responding to these proposals, and they have begun redeliberating in light of the comments. For example, at their October 2008 meeting, the IASB discussed potential alternatives to current exit value. One of those potential alternatives was current fulfillment value, which would represent the cost to fulfill the insurer's obligation to the policyholder rather than the cost to transfer the obligation. Under a current fulfillment value model, entity-specific cash flows could be incorporated. Also, non-performance risk might be excluded from the valuation, and the risk margin might be calibrated to the premium. The other potential alternative discussed was an unearned premium liability. The Discussion Paper on Revenue Recognition (see below) notes that an unearned premium liability seems similar to the model being proposed in the revenue recognition project and, therefore, might be appropriate for short term insurance contracts.

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Another development for the insurance contracts project is that in October 2008, FASB decided to join the project. This may be beneficial in that FASB is more familiar than the IASB with the types of insurance contracts sold in the United States and, thus, can provide valuable input. Another implication of FASB joining, however, is that the project will now impact US GAAP, whereas without FASB joining, the project would have only impacted IFRS. The current schedule for the insurance contracts project is to publish an exposure draft of a standard in the 2nd half of 2009 and a final standard in 2011.

REVENUE RECOGNITION

Another joint IASB/FASB project that may be of interest to actuaries is the project on revenue recognition. In December 2008, the IASB and FASB issued a discussion paper entitled "Preliminary Views on Revenue Recognition in Contracts with Customers."[4] Despite the title, the project encompasses more than just the revenue side of the income statement; it also encompasses accounting for assets and liabilities result-

FOOTNOTES:

[3] See, for example, Freedman & Hansen, "An International Financial Reporting Standards (IFRS) Phase II Discussion Paper Primer," *The Financial Reporter*, December 2007.

[4] Available at *http://www.fasb.org/draft/DP_Revenue_Recognition.pdf*

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ing from customer contracts and expense deferral on such contracts. As a result, this project is expected to strongly influence the emergence of the insurance contracts project, even though the Boards are considering excluding some or all insurance contracts from the revenue recognition project. For example, the model being proposed in the revenue recognition project may form the basis for accounting for short duration insurance contracts. In addition, this project could directly impact the accounting for certain types of contracts issued by insurance companies, such as Administrative Services Only (ASO) contracts.

The model being proposed under the revenue recognition project is the "original transaction price approach." Under the original transaction price approach, at issue an entity would have to identify each of its "performance obligations" under the contract. Performance obligations are promises to provide goods and services to a customer. For example, the performance obligations under a term insurance contract might be the stand-ready obligations to provide insurance protection in each future reporting period for the duration of the contract. The entity would then need to estimate a standalone price for each performance obligation on a standalone basis. These prices would be prorated up or down so that the prorated value of all the performance obligations equal the transaction price (i.e., the consideration from the customer, such as the premium) under the contract.

The liability held for the contract (or asset if negative) would be equal to the prorated value of future performance obligations less the value of future premiums. This would generate a contract value of zero at issue. Revenue would be recognized as the liability declines (or the asset increases) due to fulfilling the performance obligations. Since contract acquisition costs would not be considered performance obligations, there would generally be no deferral of acquisition costs. Such costs would be recognized as expenses when incurred.

As an example, assume that a non-renewable, single premium, one-year term insurance contract was sold on January 1st. Assume a premium of 1000 and acquisition costs of 50. Assume no interest. The performance obligations would be the stand-ready obligations for each reporting period in which the contract was in force. Assume the following:

	Expected Claims	Hypothetical Standalone Price for Coverage
Jan 1 through Mar 31	100	150
Apr 1 through June 30	200	250
July 1 through Sept 30	300	350
Oct 1 through Dec 31	300	350

The value of the performance obligations totals 1100. Since this is not equal to the premium of 1000, each price needs to be prorated by 1000/1100 = 91 percent. So the prorated performance obligation values become:

	Performance Obligation Value
Jan 1 through Mar 31	150 x 91% = 136
Apr 1 through June 30	250 x 91% = 227
July 1 through Sept 30	350 x 91% = 318
Oct 1 through Dec 31	350 x 91% = 318

At issue, the contract liability would equal the prorated value of future performance obligations of 1000 (136 +

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227 + 318 + 318) less future premium of zero. So the liability would equal 1000. While the increase in liability of 1000 equals the premium collected of 1000, there would be a loss at issue due to the 50 of acquisition costs.

As of March 31, the liability would equal 864 (227 + 318 + 318 value of future performance obligations less zero of future premium). Thus, 136 of revenue would be recognized during the 1st quarter. If claims emerged as expected, e.g., 100, a gain of 36 would be recognized for the quarter (not counting the loss of 50 at issue).

Assuming claims continued to emerge as expected, income under this example over the life of the contract would be as follows:

	At issue	1st quarter	2nd quarter	3rd quarter	4th quarter	Total
Revenue	0	136	227	318	318	1000
Claims	0	-100	-200	-300	-300	-900
Expense	-50	0	0	0	0	-50
Income	-50	36	27	18	18	50

The decreasing income over the life of the contract (after the initial loss) is due to the fact that the margins in the hypothetical performance obligation prices in this example are a lower percentage of expected claims in the later periods than in the earlier periods.

Some key issues have not yet been discussed, including those of time value of money, and situations where the amount or timing of consideration from the customer is uncertain.

The Boards have taken the preliminary view that the projected contract liabilities or assets should generally be locked-in at issue and only remeasured if the contract becomes onerous. An onerous contract situation is analogous to loss recognition or a premium deficiency. However, some Board members believe that other contracts may also need to be remeasured after issue, particularly contracts with highly variable outcomes, a category many insurance contracts would fall in. One possible remeasurement basis that has been proposed is current exit value, similar to that described in the insurance contracts discussion paper. Another possible remeasurement basis is a building block approach, in which the cost of fulfilling the contract and the discount rate would be updated, but the margin would be locked-in at contract inception.

The comment period for this discussion paper runs until June 19, 2009. The remaining schedule for the project calls for an exposure draft in 2010 and a final standard in 2011.

FINANCIAL INSTRUMENTS

In March 2008, IASB and FASB jointly issued a discussion paper called "Reducing Complexity in the Reporting of Financial Instruments."[5] The discussion paper states the Boards' short-term and long-term views on accounting for financial instruments. The paper states that insurance contracts might be excluded from its scope, although it notes that the separate insurance contracts project may result in a similar accounting approach. And invested assets backing the insurance contracts and contracts defined under GAAP as investment contracts (such as GICs, annuities that don't provide death benefits, reinsurance contracts that fail the risk transfer requirements of FAS 113) appear to be in scope.

The discussion paper states that the long term view of both Boards is to report all financial instruments at fair value, with changes in fair value flowing through net income. Although the Boards recognize that this is not possible in the short term, they propose three possible shorter term steps toward expanding the use of fair value for financial instruments. These are:

1. simplify hedge accounting rules,
2. eliminate one of the categories—either held-to-maturity (HTM) or available-for sale (AFS)—currently used to classify securities. (This would expand the use of fair value because an AFS security under the current accounting rules is reported on the balance sheet at fair value, but the change in fair value does not impact net income; HTM securities are not reported at fair value at all.), and

FOOTNOTES:

[5] Available at *http://www.fasb.org/draft/ITC_Financial_Instruments.pdf*

3. require fair value for all financial instruments unless the instruments meet certain limited exceptions.

Under the third proposal, one exception would be instruments with fixed cash flows. The other exception would be instruments that have variable cash flows only to the extent of interest rate resets to avoid lasting changes to fair value resulting from changes in market interest rates. It is not clear that many of the investment contracts issued by insurance companies could meet either of these exceptions.

The discussion paper notes that certain technical issues would need to be addressed before implementing the long term goal of fair value for all financial instruments. One of these issues is how to handle options that have positive value to the entity that issues the option. The Boards have expressed some discomfort with permitting positive values for written options. But such positive values can occur. Take for example a credit card account held by a bank. The customer has an option, but not a requirement, to use the credit card. If the customer chooses to use the credit card, that generally has positive value to the bank. The resolution of this issue may have a bearing on similar issues in the insurance contract project, such as policyholder behavior or universal life premiums that benefit the insurance company. After all, these too are options given to the policyholder that, if exercised, typically benefit the insurer that issued the options.

The other technical issue to be addressed is how third party guarantees should impact the fair value of financial instruments. For contractual guarantees, the discussion paper takes the position that the guarantee is a separate contract and, thus, should be accounted for separately from the underlying financial instrument that is subject to the guarantee. For government guarantees, however, the discussion paper notes a preliminary view that the effect of the regulatory environment should be taken into account when measuring the fair value of the guarantee. This issue may also be relevant to the measurement of insurance contracts.

FASB and IASB are jointly working on a conceptual framework for accounting.

The comment period for the discussion paper ended in November 2008. In late 2008, FASB and IASB decided to add this project to their active agendas.

OTHER PROJECTS

In addition to the projects discussed above, several other FASB and IASB projects are underway that may impact actuaries. FASB and IASB are jointly working on a conceptual framework for accounting. This conceptual framework is intended to provide the foundation for future principle-based accounting guidance. While the conceptual framework will not directly result in new accounting standards, it will likely impact standards that will be developed in the future. Although the conceptual framework project will address many topics that are of more interest to accountants than actuaries, in 2009 they are scheduled to begin addressing measurement, a topic of definite interest to actuaries.

Another joint IASB/FASB project is "Financial Statement Presentation." The Boards released a discussion paper on this topic in October 2008.[6] The comment period runs until April 14, 2009. The project is not intended to change the valuation of items, but is intended to change the way the income statement, cash flow statement, and balance sheet are organized. It may also require additional details to be reported and additional reconciliations to be provided. So, actuaries may need to provide additional information to support these requirements, if this proposal gets adopted.

FOOTNOTES:

[6] Available at *http://www.fasb.org/draft/DP_Financial_Statement_Presentation.pdf*

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IASB is also in the process of developing its version of a Fair Value Measurement standard, i.e., an IASB version of FAS 157. This is scheduled for completion in 2010. Through November 2008, the tentative decisions made by IASB in this project have been generally consistent with FAS 157. In particular, IASB has tentatively decided to define fair value as an exit value. However, if differences between the IASB standard and FAS 157 emerge during the process, FASB may decide to update FAS 157 to provide consistency.

In addition, both Boards have been addressing issues related to the current credit crisis. Examples have been new guidance for calculating fair value in inactive markets and for additional disclosures for variable interest entities. While many of these issues may not impact actuarial work, there may be indirect impacts on actuaries as new issues emerge. As a result of all this activity, the next few years are likely to bring many new challenges to actuaries working in GAAP reporting. ■