SOCIETY OF ACTUARIES

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FASB and IASB Divergence

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On Feb. 19, the Financial Accounting Standards Board (FASB) made three critical decisions on its ongoing project to revise US GAAP accounting for insurance contracts. These decisions represent a step back from FASB's work in converging accounting standards with the International Accounting Standards Board (IASB), which promulgates accounting standards for many countries outside the United States. This is consistent with recent decisions in other projects in which IASB and FASB moved away from convergence.

STATUS OF THE FASB INSURANCE CONTRACTS PROJECT

On Feb. 19, FASB made the following three decisions:

1. The insurance accounting project will only address contracts sold by insurance entities. The Exposure Draft proposed applying the new standard to all contracts that meet the definition of an insurance contract, subject to specified exceptions, regardless of the nature of the entity issuing the contract. So it would have included certain guarantees sold by banks and certain warranties sold by entities which may not be financial institutions. FASB did reserve the right to reintroduce some insurance contracts sold by non-insurance entities within the scope of the project if it made sense to do so later. The proposed IASB insurance contracts standard is not restricted to insurance entities.
2. No substantive changes will be made to the measurement of short-duration contracts. However, additional disclosures will be required. It seems likely that these additional disclosures will include the loss development triangles for property and casualty (P&C) contracts. The IASB is continuing to pursue the premium allocation approach (PAA) for measuring short-duration contracts within its insurance contracts project.
3. For long-duration contracts, FASB decided to pursue "targeted improvements" to both measurement and disclosure under US GAAP, and thus will not continue working toward convergence with the model being developed by the IASB. It is not clear what improvements the board has in mind. Three of the seven board members voted to continue pursuing convergence using the building blocks approach (BBA) that FASB and IASB had been working on for the past six years. Two board members voted for targeted improvements but seemed to indicate that those improvements may ultimately come close to BBA. And two board members seemed to favor much less extensive changes to existing GAAP. Meanwhile, the IASB is moving ahead with its project to develop the BBA model and is attempting to issue a final standard in early 2015.

As far as I can tell, reactions from actuaries to FASB's decision have been mixed. P&C actuaries seem to be generally happy with the decision, as many had major concerns with the proposed PAA model. Basically, the attitude seems to be that existing accounting for short-duration contracts is not broken, so there is no need for significant changes, although many agree that additional disclosures would be useful.

Opinions of life actuaries seem to be split. Some actuaries are content with existing US GAAP, and so prefer targeted improvements to the more wholesale changes the BBA would have represented. But other actuaries believe there are significant problems with existing US GAAP that the BBA could have addressed. For example:

- Using current assumptions and discount rates to determine the balance sheet would mitigate accounting mismatches with assets and hedging instruments reported on the balance sheet at fair value, and also better reflect the economics of guarantees currently covered by SOP 03-1.
- Unlocking assumptions for FAS 60 business would also avoid issues of premium deficiencies surprising investors by recognizing losses that have built up over time all at once, and of being unable to reflect premium rate changes in the reported liability.

These actuaries are concerned that the targeted improvements FASB develops will not be able to address all the problems with existing US GAAP for long-duration contracts. Actuaries whose work involves both U.S. business and business outside the United States are also concerned about the lack of convergence between FASB and IASB.

STATUS OF FASB/IASB CONVERGENCE ON OTHER PROJECTS

In the aftermath of the 2008 financial crisis, FASB and IASB agreed to focus work on improving and converging accounting standards in four areas:

- Financial instruments
- Revenue recognition
- Leases
- Insurance contracts.

Of these four projects, only revenue recognition now appears as if it will result in a substantially converged standard. The boards intend to release their substantially converged revenue recognition standards in 2014. Although insurance contracts and financial instruments are scoped out of this project, the revised standards could have some impact on actuarial work to the extent they may impact the valuation of contracts for services other than insurance, such as administrative services only contracts.

The boards have made some significantly different decisions within their joint leasing project, although many aspects of the models are consistent. But for the two projects of most interest to actuaries—insurance contracts and financial instruments—convergence seems unlikely.

The financial instruments project has three components: classification and measurement (i.e., should instruments be measured at amortized cost or fair value, and, if the latter, should changes in fair value due to changes in interest rates be reported in net income or OCI?); impairment; and hedging. IASB recently issued its revised hedging standard. The revised standard relaxes some restrictions on eligibility for hedge accounting, although it is unclear whether these revisions themselves will be adequate to permit most hedged risks within portfolios of insurance contracts to achieve hedge accounting treatment. However, FASB has yet to begin substantial deliberations on hedge accounting since releasing an exposure draft in 2010.

On financial instrument classification and measurement, the boards had been working toward convergence. However, decisions since late 2013 have moved the boards apart. Under the IASB proposal, unless substantially all cash flows in a financial asset represent principal and interest, the asset will be reported at fair value with all changes in fair value reported in net income (FV-NI). This means that equity instruments and convertible debt will be reported at FV-NI. Any financial asset with an embedded derivative, even if the derivative has little value, will be reported in its entirety at FV-NI, since there will be no more bifurcation of embedded derivatives for financial assets and the derivative cash flows are not strictly principal and interest. And many structured securities other than the top tranche will be at FV-NI, since the compensation for protection provided to higher tranches is not considered to be strictly principal and interest. Debt instruments whose cash flows are strictly principal and interest would be eligible to be reported at amortized cost or fair value through other comprehensive income

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(FV-OCI), unless they are held for trading. IASB also decided to place some restrictions on electing a fair value option.

FASB is now looking to make targeted improvements to existing classification and measurement guidance. Bifurcation of embedded derivatives will be retained, and debt securities will continue to be classified as trading (FV-NI), available-for-sale (FV-OCI) or held-to-maturity (amortized cost). However, equity instruments will be required to be reported at FV-NI. FASB will also look to make other targeted improvements to reporting of financial instruments, so it is possible that some other instruments could be required to be reported at FV-NI. FASB has tentatively decided to retain an unrestricted fair value option provision.

The boards had been working together on a converged financial instrument impairment standard for several years, but they are now taking very different positions on this topic as well. The IASB is developing a model in which a small portion of expected future impairment losses on an asset is recognized as an allowance (and as a current loss) when a debt asset is acquired (unless that asset is reported at FV-NI). If and when there is a significant enough deterioration in the credit quality of the asset, the full present value of expected default losses over the life of the asset will be recognized in the allowance.

FASB's impairment model will recognize an allowance equal to the full present value of expected default losses as soon as the instrument is acquired, and thus a larger loss upon acquisition of an asset. However, they have decided to make a partial exception for instruments reported at FV-OCI, which represent many of the assets held by insurance contracts. For such instruments, the amount of allowance will be limited to the amount, if any, by which fair value is less than amortized cost of the instrument. So at inception, when the fair value and amortized cost would likely be equal, no impairment loss would be recognized. But if interest rates rise, and as a result the fair value falls below amortized cost, the impairment loss would be recognized to that extent.

WHAT DOES ALL THIS MEAN TO ACTUARIES?

About three years ago, it appeared that we would have largely converged accounting standards for insurance contracts and financial instruments, as well as revenue recognition and leases, between the United States and most other countries. Now it appears that most of this convergence will not be achieved, especially on the projects of most interest to actuaries—insurance contracts and financial instruments. So actuaries who work on businesses both inside and outside the United States will need to deal with different sets of accounting guidance. Also, as FASB determines its targeted improvements for insurance contracts and financial instruments, and begins to address hedging, actuaries will need to be diligent in making their voices heard to ensure that the resulting standards produce improved financial reporting information for users of financial statements. ■