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The Mini-Series Continues

By Henry Siegel

At the International Conference of Actuaries in Washington, D.C., International Accounting Standards Board (IASB) member Pat Finnegan likened the insurance contracts project to year 10 of a mini-series on TV. EY partner Jennifer Weiner agreed, although she noted that, as in "The Good Wife," the Financial Accounting Standards Board (FASB) had just killed off one of the main characters.

If you want to know more about the FASB's actions, you should read Lenny Reback's article on page 22. I'm going to continue with the main IASB plot lines.

JANUARY AND MARCH IASB MEETINGS

It's clear that both the IASB and FASB have listened carefully to the comments they received on their recent Exposure Drafts (EDs). In January, there was a joint review of those comments during which the staff went over the key comments on both, and some of those comments had considerable acceptance from both boards.

In their March 18 meeting, the IASB took the first steps to reflect the comments, agreeing to two basic changes to the ED that have broad support. These tentative decisions only apply to non-participating contracts at this point.

1) The IASB tentatively agreed to two changes to the unlocking of the contractual service margin (CSM).

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They agreed that the CSM should be unlocked for changes to assumptions about future cash flows as proposed in their ED. In recognition of a concern expressed by many, however, they also agreed that:

a) If there have been losses recognized due to unfavorable changes to assumptions about future experience that eliminate the CSM and

b) There is then a favorable change to the same set of assumptions that would create a gain,

the effect of that change can be taken into earnings until the previously recognized loss is recaptured. It appears that the assumption changes do not have to be to the same assumption (e.g., a mortality loss could be followed by an expense gain) so long as they are on the same portfolio.

Without this change, the entire effect of the second change would be absorbed into the CSM. Many in the industry urged the board to make this change and it agreed.

The IASB further agreed that changes to the risk adjustment related to future coverages and services, either an increase or decrease, should be absorbed by the CSM so long as the CSM does not become negative.

The clear intent of the board is that the entire effect of changes to assumptions about the future should not be recognized in current earnings but, as with a gain at issue, should be recognized over the lifetime of the portfolio.

2) The IASB also ratified the use of other comprehensive income (OCI) to show the effects of changes in discount rates on liabilities. It also agreed to change the ED so that the use of OCI will be optional since there are times (e.g., for variable contracts) where the use of OCI would produce an accounting mismatch. Many comment letters had urged the board to make OCI optional and, while there remain three members of the board who oppose the use of OCI at all, this change had broad support.

The board recognized that these decisions raised additional questions. At what level must the option to use OCI be decided? For instance, did the decision need to be at the portfolio level or could it be at something higher short of the entire entity? Could a reporting entity use OCI for policies issued from 2010 to 2012 and not use OCI for policies issued after that if the policies are otherwise identical?

The board also recognized that questions would arise about whether a reporting entity could change from using OCI to not using OCI (or vice versa) and if so, under what circumstances. One solution that has been suggested is that a change be allowed only upon a change of control or a significant change in investment policy. Detailed proposals on these and other issues will be worked up by staff for discussion at a future meeting.

The board also agreed that in light of the use of OCI, additional information should be provided in disclosures. They tentatively agreed to the following, according to the IASB Update on the discussion:

" i. For all portfolios of insurance contracts: an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:
   1. the amount of interest accretion determined using current discount rates;
   2. the effect on the measurement of the insurance contract of changes in discount rates in the period; and
   3. the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates.

ii. In addition, for portfolios of insurance contracts for which the effect of changes in discount rates are presented in other comprehensive income: an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:
   1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and
   2. the movement in other comprehensive income for the period."

These disclosures, while reasonable, could be quite complicated to implement, depending on the level at which they must be shown.

NEXT STEPS

The IASB intends to consider the main issues relating to insurance contracts revenue at its April meeting. It will also consider issues raised in the response to the 2013 ED, other than the five issues, on which the board did not specifically request comments.

The major outstanding issue on which the board will have to reach a consensus remains the treatment of participating contracts. Many in the industry have suggested that the board eliminate the "mirroring" proposal included in its ED. The expected timing for this discussion is not known.

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Whatever the board decides to do on participating contracts, it is likely to be quite complex, given the variety of participating contracts in existence. This makes it all the more necessary to remember.

Insurance accounting is too important to be left to the accountants!

ENDNOTES

[1] *The FASB had a locked-in CSM in its ED although it will probably change this.*