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Caesar Salad Accounting

By Henry Siegel

Many years ago a friend asked me for a simple recipe he could make for his date. Knowing he was not experienced in culinary arts, I gave him a recipe for Caesar Salad. I told him it was a very simple recipe and I was sure he could handle it.

The next day, I asked how the meal had gone. "It was a disaster," he said. "Your recipe was awful!"

"What happened? Did you follow the recipe?"

"Well, mostly. The store didn't have any romaine so I used iceberg lettuce. And they didn't have any croutons or anchovies so I used bread crumbs and sardines."

"Well, that shouldn't have been too bad. Anything else?"

"Well, the recipe called for two cloves of garlic. I looked on the shelf and found cloves so I put in two."

This is, of course, an accounting allegory. If you don't get the punch line, ask a chef.

Many years ago, the industry and the International Accounting Standards Board (IASB) agreed on a basic recipe for insurance accounting. The recipe called for a liability equal to the present value of future expected cash flows with a margin, set at inception to eliminate any gains at issue, that would run off as the business ran off. All that was left was to agree on the details.

And based on the results of the last quarter, we're still looking for the garlic. Consider the following discussions.

JANUARY

The IASB continued its discussion on insurance contracts by holding an education session to discuss:

- the eligibility criteria for applying the premium allocation approach (PAA),
- whether discounting and accretion of interest should be required for the liability for remaining coverage, and
- the treatment of acquisition costs.

The board asked the staff to prepare a short supplement to agenda paper 2A outlining a proposal for eligibility criteria that would:

- state a principle that the PAA could be used when the results would be similar to those produced by using the building block approach,
- permit contracts that have a coverage period of approximately 12 months or less to be eligible for the PAA, and
- provide application guidance on when the PAA and the building block approach would produce similar results based on the criteria being developed by the staff in agenda paper 2A.

Because this was an education session, no decisions were made.

FEBRUARY

The IASB and Financial Accounting Standards Board (FASB) continued their discussions on the insurance contracts project by considering: eligibility criteria and mechanics for the PAA; following the education sessions of the previous month; measurement of liabilities for infrequent, high-severity events; onerous contracts; unbundling goods and services components; and financial instruments with discretionary participating features.

Eligibility Criteria for the Premium Allocation Approach

The IASB tentatively decided that:

a. Contracts should be eligible for the PAA if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach.
b. A contract should be deemed to meet the condition in a. without further work if the coverage period is one year or less.
c. Application guidance would provide that contract measurements are not a reasonable approximation to the building block approach if, at the contract inception date:

    i. it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract; or
    ii. significant judgment is required to allocate the premium to the insurer's performance obligations for each reporting period. This

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may be the case if, for example, significant uncertainty exists about:

1. the premium that would reflect the exposure and risk that the insurer has for each reporting period; or
2. the length of the coverage period. The IASB noted that it would review whether it will need to update these criteria after its future discussions on the building block approach.

d. An insurer should be permitted, but not required, to apply the PAA to contracts that are eligible for that approach. This was important to the industry because some companies didn't want to use the PAA on a small piece of a large portfolio.

The FASB tentatively decided that:

a. Insurers should apply the building block approach rather than the PAA if, at the contract inception date, either of the following conditions is met:
   i. it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract; or
   ii. significant judgment is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about:
      1. the premium that would reflect the exposure and risk that the insurer has for each reporting period; or
      2. the length of the coverage period.

   On a seemingly simple issue, the boards could not reach an agreement.

b. A contract should fall within the scope of the PAA without further evaluation if the coverage period is one year or less. Four FASB members supported this decision and three opposed it despite how natural the decision might seem.
c. The PAA should be required for contracts that qualify for that approach.

Again, the boards disagreed and this time the industry and FASB were in disagreement.

Mechanics for the Premium Allocation Approach
The boards tentatively decided that discounting and interest accretion to reflect the time value of money should be required in measuring the liability for remaining coverage for contracts that have a significant financing component, as defined according to the characteristics of a significant financing component under the revenue recognition proposals. However, as a practical expedient, insurers need not apply discounting or interest accretion in measuring the liability for remaining coverage if the insurer expects at contract inception that the period of time between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's corresponding obligation to provide insurance coverage, will be one year or less.

The boards also tentatively decided that:

a. the measurement of acquisition costs should include directly attributable costs (for the FASB, limited to successful acquisition efforts only); this is consistent with the decision made for the building block approach. This difference confirmed positions the boards had previously taken despite efforts to reach consensus.
b. insurers should be permitted to recognize all acquisition costs as an expense if the contract coverage period is one year or less. This was a gift to the non-life companies.

The boards also agreed to explore an approach in which acquisition costs would be netted against the single/residual margin applying the building block approach, and netted against the liability for remaining coverage applying the PAA. That amount could be separately presented from the present value of expected cash flows (plus a risk margin for the IASB).

Measurement of Liabilities for Infrequent, High-Severity Events

The boards tentatively decided to provide application guidance to clarify that an insured event (for example, an infrequent, high-severity event such as a hurricane) that was impending at the end of the reporting period, does not constitute evidence of a condition that existed at the end of the reporting period when it occurs or does not occur after that date. Consequently, such an event is a non-adjusting event, to which IAS 10 *Events after the Reporting Period* applies, and a non-recognized event to which Topic 855-10-25 *Subsequent Events Overall Recognition* in the FASB Accounting Standards Codification® applies.

The industry and its actuaries were extremely concerned that a hurricane that had not yet hit land would have to be considered in setting the IBNR for the quarter end, and so were pleased at the eventual outcome.

Onerous Contracts

- The boards tentatively decided that the measurement of the liability for onerous contracts should be updated at the end of each reporting period.
- The IASB tentatively decided that a risk adjustment should be considered when identifying onerous contracts and that the measurement of an onerous contract liability should include a risk adjustment.
- The boards tentatively decided that if an insurer elects not to discount the liability for incurred claims that are expected to be paid within 12 months, the insurer should use an undiscounted basis in identifying whether contracts are onerous and in measuring the liability for onerous contracts.

Unbundling Goods and Services Components

The boards tentatively decided on the following criteria for unbundling goods and services:

a. An insurer shall identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the exposure draft *Revenue from Contracts with Customers.* If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or US GAAP in accounting for that performance obligation.
b. A performance obligation is a promise in a contract with a policyholder to transfer a good or service to the policyholder. Performance obligations include promises that are implied by an insurer's customary business practices, published policies, or specific statements if those promises create a valid expectation by the policyholder that the insurer will transfer a good or service. Performance obligations do not include activities that an insurer must undertake to fulfill a contract unless the insurer transfers a good or service to a policyholder as those activities occur. For example, an insurer may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the services are performed. Therefore, those promised setup activities are not a performance obligation.
c. Except as specified in the following paragraph, a good or service is distinct if either of the following criteria is met:

    i. The insurer regularly sells the good or service separately.
    ii. The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the insurer or another entity), or resources that the policyholder has already obtained (from the insurer or from other transactions or events).
d. Notwithstanding the requirements in the previous paragraph, a good or service in an insurance contract is not distinct and the insurer shall therefore account for the good or service together with the

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insurance component under the insurance contracts standard if both of the following criteria are met:

i. The good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract that the insurer has entered into with the policyholder.
ii. The good or service is significantly modified or customized in order to fulfill the contract.

Financial Instruments with Discretionary Participation Features

The IASB considered the applicable standard for financial instruments that are not insurance contracts but that have discretionary participation features similar to those found in many insurance contracts. The discussion was not held jointly with the FASB because of the different considerations for each board.

The IASB tentatively decided that the forthcoming insurance contracts standard should apply to financial instruments with discretionary participation features that are issued by insurers. It should not apply to any financial instruments issued by entities other than insurers.

MARCH

The IASB and FASB continued their discussions on insurance contracts by considering the unit of account and separation of investment components from the insurance contract.

Unit of Account

The IASB tentatively decided that:

1. A portfolio of insurance contracts should be defined as contracts that are:
   a. subject to similar risks and priced similarly relative to the risk assumed, and
   b. managed together as a single pool.
2. The unit of account used to determine the residual margin and perform the onerous test should be the portfolio.
3. The unit of account used to release the residual margin should not be prescribed. However, the release of the residual margin should be performed in a manner consistent with the objective of releasing the residual margin over the coverage period to the period(s) in which the service is provided.

The FASB tentatively decided that:

1. A portfolio of insurance contracts should be defined as contracts that are:
   a. subject to similar risks and priced similarly relative to the risk assumed, and
   b. have similar duration and similar expected patterns of release of the single margin.
2. The unit of account used to determine and release the single margin, and perform the onerous contract test should be the portfolio.

Separation of Investment Components from the Insurance Contract

The IASB and FASB tentatively decided that:

1. An investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs.

   This definition raises significant problems. For instance, does a 10-year-certain life annuity have an investment component? The insurer pays if the annuitant lives and pays the certain part if the annuitant dies. So it sounds like there is no investment component. Yet, if you look at it differently, the entire certain payments could be considered an investment component. Still another way to look at this is that only the payments in the event of death are an investment component. The boards do not agree on how to interpret this.

   In addition, this definition is intended to include cash values on traditional whole life products including participating contracts. This would result in showing less than the total premium in the income statement. Furthermore, the treatment of policyholder dividends is difficult to handle since they can be considered returns of premium.

2. In the statement of financial position (i.e., balance sheet), insurers should not be required to present investment components separately from the insurance contract. However, insurers should disclose both:
    a. the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims/benefits paid) that were excluded from the statement of comprehensive income, and
    b. the amounts payable on demand.

In addition, the IASB tentatively decided that insurers should exclude from the aggregate premium presented in the statement of comprehensive income the present value of the amounts that the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs, determined consistently with measurement of the overall insurance contract liability. The FASB did not vote on this issue.

Both boards directed the staff to consider whether any investment components (as defined) are sufficiently distinct from the insurance component that they should be recognized separately and measured applying the financial instrument standard, rather than the insurance contracts standard.

Reviewing all of the above discussions, I am struck by how detailed the discussions are. Everyone would be better off if most of these discussions were left to our profession to establish guidance to meet the general requirements. International Financial Reporting Standards are supposed to be more principle-based than US GAAP; this level of discussion is not about principle, but about the rules for applying those principles. This is another example of why …

Insurance Accounting Is Too Important To Be Left To The Accountants!