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Differences Between FASB and IASB Could Lead to Two Accounting Models for Insurance

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The Financial Accounting Standards Board (FASB), which promulgates accounting standards under US GAAP, and the International Accounting Standards Board (IASB), which promulgates accounting standards for many countries outside the United States, have been working for several years on a joint project on accounting for insurance contracts. The boards agree on many aspects of the proposed accounting model. However, as of December 2011, there are a number of key areas where they do not. This article summarizes the boards' views on the key areas where they disagree.

MARGINS

Probably the area of disagreement between IASB and FASB that has been debated the longest is the number and characterization of margins that should be included in the measurement of the liability. The IASB has consistently taken the position that there should be a risk adjustment or risk margin added to the expected present value of future cash flows to reflect the price or cost of the uncertainty present in the underlying cash flows. This risk adjustment would be calculated based on some indicator of the variability of future cash flows. The risk adjustment would be recalculated each reporting period based on the uncertainty remaining in the future cash flows. If, at inception, the expected present value of future cash flows plus the risk margin was less than the initial premium, a residual margin would be added to the initial liability as a plug to avoid a gain at issue. Thus, the IASB position is that there should be two margins on top of the expected present value of future cash flows—the risk adjustment and the remaining residual margin.

FASB has consistently taken the view that, while in theory a risk adjustment could provide useful information, in practice there is no objective way to reliably calibrate such an item. Therefore, FASB's position is of the view that there should only be one margin which eliminates any gain at issue. This margin has been called the composite margin or single margin.

One consequence of the boards' differing views on margins impacts claim liabilities on short duration contracts, particular long-tailed claims such as group disability income and long-term care, and many property and casualty contracts. Both boards agree that the residual or single margin should be amortized over the coverage period. Thus, during the claims period, the IASB view would result in a claim liability that includes a risk adjustment but no residual margin. However, the FASB view would result in a claim liability that is just the expected present value of future cash flows, with no margin at all.

During the course of 2011, an additional difference between the boards has emerged with respect to margins. That difference is in the way the residual or single margin amortizes over time. FASB's position is that the single margin is not re-measured or recalibrated and cannot increase. The margin should be amortized as it satisfies its performance obligation which they equate to the insurer being released from exposure to risk. The FASB believes that release from risk is evidenced by a reduction in the variability of the underlying cash flows. Thus the composite margin would be released in proportion to the reduction in variability of cash flows of the underlying contracts.

The IASB's position on release of the residual margin is very different. Under the IASB position, the residual margin would be unlocked to offset changes in the expected present value of future cash flows resulting from a change in cash flow assumptions, as long as the residual margin remained non-negative. As of December 2011, they were also considering whether the residual margin could be unlocked to offset changes in the expected present value of future cash flows resulting from a change in discount rates or to offset changes in the risk adjustment.

Depending on how the IASB's position on unlocking margins is implemented, it could reduce the potential volatility in the liability measurement and in resulting income. This is especially the case if applied to changes in non-financial cash flow assumptions. However, if applied to financial cash flow assumptions or to discount rates, the IASB approach may increase volatility. That is because the residual margin could only be unlocked to the extent the margin is non-negative. If a change in discount rates or financial variables caused the margin to reduce to zero, there would be no further unlocking of the margin. Basically, when the margin is positive the liability measurement would be indifferent to changes in interest rates, but when the margin is zero the liability would fluctuate with interest rates. This could increase earnings volatility, because asset values would likely be affected by the same financial forces as the liability. But the assets would either be at amortized cost (effectively a locked-in discount rate) at all times or at fair value (fluctuating with changes in interest rates) at all times. There may not be an asset measurement approach that would be consistent with the liability measurement under all scenarios.

A final difference between the boards on margins is whether the residual or single margin should accrue interest. Accruing interest on the margin would defer profits, perhaps materially and in some cases the margin with accrued interest could far exceed the present value of expected cash flows.

ACQUISITION COSTS

Another key difference between the boards' positions is the treatment of acquisition costs. Both boards agree that certain acquisition costs should be included in the liability measurement, netting those costs against the residual or single margin, avoiding a loss to the extent of such costs. Essentially, the permissible acquisition costs would be offset against the future revenue included within the liability. The boards have different views as to the extent of acquisition costs that would be permissible.

The FASB's view is that the permissible acquisition costs should be limited to costs directly attributable to successful sales efforts, similar to EITF 09-G/ASU 2010-26. The IASB has taken a more expansive view of permissible acquisition costs, on the theory that some unsuccessful sales efforts are necessary to acquire a portfolio of insurance contracts. Therefore, the IASB would include costs directly attributable to both successful and unsuccessful sales efforts in the liability measurement.

PARTICIPATION FEATURES

As of December 2011, the boards had not re-deliberated the treatment of participation features in insurance contracts for which the insurer has discretion over the amount paid. Such features are common in many U.S. life insurance contracts, such as non-variable universal life contracts, where the insurer has discretion over the credited rate and charges, and dividend-paying participating whole life contracts issued by mutual companies, where the insurer has discretion over the timing and amount of divisible surplus paid out in the form of policyholder dividends. The boards have re-deliberated the treatment of contracts with participation features where the insurer does not have discretion. Such contracts are common in many European countries, and this treatment may also be applicable to such U.S. contracts as variable life and annuities or closed block whole life contracts.

The boards believe that their views result in identical measurement of the participation feature. However, the boards disagree on the method to achieve the result. The IASB position is that to the extent that the liability cash flows depend on specific asset returns, the liability value should equal the reported asset value. That asset value may be other than a current value; for example, real estate assets and many financial assets backing such insurance contracts might be reported at amortized cost. The FASB position is that contracts with non-discretionary participation features should be measured using the building blocks, similar to any other insurance contract. However, to the extent there are timing differences between the measurement of the assets and liabilities, such as would occur if the assets are held at amortized cost, these should be adjusted for. In addition, to the extent that some changes in value of the assets backing the non-discretionary participation feature are reported in other comprehensive income rather than net income, the change in liability resulting from participation in the performance of those assets should be treated consistently.

One other difference between the boards with respect to participation features involves the treatment of investment contracts with discretionary participation features. The FASB believes that investment contracts that don't meet the definition of an insurance contract should be accounted for as financial instruments. The

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IASB has not developed an amortized cost measurement model for contracts with discretionary participation features, and thus believes that such contracts should be accounted for using the insurance contracts model, even if the contracts do not meet the definition of insurance.

PREMIUM ALLOCATION APPROACH

The boards have generally supported the use of a different measurement approach when accounting for the pre-claims period of certain contracts; ones that are typically short duration. However, the boards have a fundamentally different view of the nature of this alternative measurement model which they currently refer to as the premium allocation approach (PAA). The IASB views the PAA as a simplification of the building block approach and thus looks to the building block model for consistency and precedents. The FASB views the PAA as a completely different model and thus is less concerned about the precedents set in the building block approach.

UNBUNDLING

The final area of difference we want to highlight is the concept of unbundling explicit account balances. The boards have tentatively agreed to unbundle explicit account balances that are credited with an explicit return that is based on the account balance. The rationale is the criteria developed in the revenue recognition project for identifying separate performance obligations.

The IASB prefers to measure the entire insurance contract using the building block approach and disaggregate the account balance for presentation purposes only. The FASB has not expressed such a preference and thus may be leaning towards separate measurement of the account balance under certain conditions and measuring the rest of the insurance contract using the building block approach.

The boards plan to explore whether other types of account balances could be separated in a similar way.

CONCLUSION

As can be seen from the issues laid out in this article, there are areas of significant differences between the boards and areas where the differences are not that great. However, given the long standing nature of some of these differences it seems likely that some will persist into the final standards of each organization, a single converged standard may not be achievable. ■