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This Time is Different!

By Henry Siegel

If you've been reading my columns for a while, you have no doubt recognized that I tend to be consistently optimistic when it comes to the insurance contracts project meeting deadlines. I am constantly disappointed as the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) fail to meet their own deadlines for producing exposure drafts or other papers. But this time is different.

I really expect both boards to have new papers out by the end of June; an exposure draft for the FASB and either an exposure draft or some other type of document for the IASB. There is a real desire to get a standard adopted by the end of 2012 and the number of outstanding issues is declining.

I don't, however, expect the two releases to be same since there are some serious issues the two boards differ on, including:

- Whether to have an explicit risk margin along with a residual margin or only a single margin;
- Whether to unlock the residual (or single) margin for changes in mortality, morbidity and similar non-financial assumptions; and
- The definition and treatment of acquisition expenses.

It's my hope, however, that the boards will come together on these and any other issues so that in the end we will have a single, high quality accounting standard for insurance.

Toward this end, the boards met jointly each month this quarter and there was an Insurance Working Group meeting in October. As a result of these meetings, some progress was made.

OCTOBER MEETINGS

The IASB and FASB continued their discussions on insurance contracts, considering: fixed fee service contracts, eligibility criteria for the premium allocation approach and presentation in the statement of financial position and comprehensive income. The staff also provided an oral report on recent investor outreach activities.

Fixed Fee Service Contracts

The boards tentatively decided to exclude from the scope of the insurance contracts standard fixed-fee service contracts that provide service as their primary purpose, and that meet all of the following criteria:

- The contracts are not priced on the basis of an assessment of the risk associated with an individual customer;
- The contracts compensate customers by providing a service, rather than cash payment; and
- The type of risk transferred by the contracts is primarily related to the use (or frequency) of services relative to the overall risk transferred.

Eligibility Criteria for the Premium Allocation Approach

The boards discussed when insurers should apply the premium allocation approach. No decisions were made. This issue was brought forward to the Insurance Working Group meeting the following week.

Presentation of the Statement of Financial Position

The boards tentatively decided that:

a. An insurer should disaggregate the following components, either in the statement of financial position (balance sheet) or in the notes, in a way that reconciles to the amounts included in the statement of financial position:
   - Expected future cash flows;
   - Risk adjustment (for the IASB);
   - Residual margin (for the IASB);
   - The single margin, where relevant (for the FASB); and
   - The effect of discounting.

   Nine IASB and six FASB members agreed with this decision, subject to future consideration of whether the cash flows relating to the recovery of acquisition costs should be separately disaggregated.

   Note that by showing the effect of discounting separately on the balance sheet, the undiscounted reserve is also shown. This information would

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not be very meaningful for most life contracts but many analysts prefer undiscounted numbers for short-term P&C coverages.

b. For those contracts measured using the premium allocation approach, the liability for remaining coverage should be presented separately from the liability for incurred claims in the statement of financial position.

c. For contracts measured using the building block approach, any unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and should be accounted for in accordance with existing guidance for receivables. The remaining insurance contracts rights and obligations should be presented on a net basis in the statement of financial position.

   I suppose there might be circumstances where there is such an unconditional right, but it is certainly not the most common situation.

d. For contracts measured using the premium allocation approach, all insurance contract rights and obligations should be presented on a gross basis in the statement of financial position.

e. Liabilities (or assets) for insurance contracts should be presented separately for contracts measured using the building block approach and those measured using the premium allocation approach.

f. Portfolios that are in an asset position should not be aggregated with portfolios that are in a liability position in the statement of financial position.

This is a strange position and probably reflects the boards' misunderstanding of how common an asset position really is. Much depends, of course, on how portfolio is defined. The boards discussed this issue in December, although they didn't establish any new guidance. In general, an asset position only exists in the early years of a contract as acquisition costs are being recovered.

Presentation of the Statement of Comprehensive Income

The boards tentatively decided that an insurer should present premiums, claims, benefits, and the gross underwriting margin in the statement of comprehensive income. The boards will consider at a future meeting whether these items should be presented in the statement of comprehensive income separately for contracts measured using the building block approach and the premium allocation approach.

OCTOBER INSURANCE WORKING GROUP MEETING

The Insurance Working Group met during the week following the board meeting. The major topic at this meeting was a proposal by industry to allow changes in liabilities due to changes in discount rate to flow through Other Comprehensive Income rather than earnings. The argument is that discount rates are likely to change frequently. If the valuation basis for liabilities and assets is not the same (i.e., both at current value or both at cost), significant volatility in earnings can result.

Both the HUB Group and the CFO Forum gave presentations endorsing the proposal. Around the table there was general agreement that the proposal had merit although certain details, such as the treatment of options and guarantees needed to be worked out.

Another important issue that was discussed was proposed language for determining when a policy ended. Referred to as the contract boundary issue, the basic concern is that some contracts that are short-term on their face may require renewal of the policy, effectively becoming a long-term contract. Other contracts that appear long-term can actually have their premiums revised annually so they work more like a short-term contract.

Staff had developed working language to deal with these issues. Unfortunately, this language had the possible effect of making Universal Life contracts short term since you can change the crediting rate whenever the contract permits, thereby effectively changing the price. When this was pointed out, it was agreed that everyone would review the proposed wording and get back with possible problems and fixes.

There were also discussions about the treatment of reinsurance, eligibility for use of the premium allocation approach and presentation of financial results. Those discussions didn't lead to any new results.

NOVEMBER MEETING

The IASB and FASB continued their discussions on insurance contracts by considering the accounting for explicit account balances within insurance contracts. The boards have thankfully moved off the idea of measuring account balances separately, and are now discussing showing them separately.

The FASB tentatively decided to separate explicit account balances from the insurance contract liability for presentation. Explicit account balances are account balances within a contract that meet both of the following criteria:

- The balance is an accumulation of the monetary amount of transactions between the policyholder and an insurer.

- The balance is credited with an explicit return. A return is explicit if it is determined by applying either of the following to the balance:
  - A contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract; or
  - An allocation determined directly by the performance of specified assets.

For U.S. contracts, this would essentially apply to most fixed and variable universal life and annuity contracts. Traditional whole life, par and non-par contracts would not be subject to this disaggregation.

IASB members indicated their preference to measure explicit account balances as part of the insurance contract and to disaggregate them for presentation or disclosure. IASB members indicated that they would like to explore an approach in which some other deposit components of insurance contracts could be disaggregated in the same way. Although some indicative votes were taken, the IASB made no decisions on these subjects, asking staff to do more work on the issues.

The boards plan to consider at a future meeting:

- Whether there are additional account balances that should be presented separately from the insurance contract liability;

  - How income and expense items related to the explicit account balances should be recognized in the statement of comprehensive income; and
  - Whether to measure separated account balances:
    - Using requirements other than those being developed in the insurance contracts project; or
    - As part of the insurance contract and to disaggregate those account balances for presentation or disclosure.

The good thing about this discussion is the boards are having it before the final wording is adopted. Discussions of these issues in the past were usually brief and held at the very end of the discussions on the project, without time for industry reactions.

Insurance Contracts: Education Session on Residual Margins

The IASB discussed whether the residual margin established at contract inception should be adjusted (unlocked) to offset changes in estimates and if so, which changes in estimates should adjust the residual margin. This is a very old issue and has been discussed for many years previously. The idea is that the margin would absorb, to the extent it's large enough, changes in items such as mortality and morbidity so that you would have smaller swings in earnings when assumptions are unlocked. The effect would then be amortized into earnings as the residual (single) margin is amortized. This would help accomplish industry's goal to reduce year-to-year volatility in net earnings.

DECEMBER MEETING

Participating Contracts

This discussion dealt primarily with European-style participating contracts where there is a specific fund underlying the participating element. These can be either unit-linked contracts, which are similar to U.S. variable contracts, or contracts where the shareholders are only entitled to a percentage of earnings on the par fund, often 10 percent.

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Both the IASB and the FASB noted that their previous tentative decision meant they would measure the obligation for the performance-linked participation feature in a way that reflects how the underlying assets are measured in the US GAAP/IFRS financial statements. That could be achieved by two methods, which both lead to the same measurement:

a. Eliminating from the building block approach changes in value not reflected in the measurement of the underlying items; or
b. Adjusting the insurer's current liability (that is, the contractual obligation incurred to date) to eliminate accounting mismatches that reflect timing differences (between the current liability and the measurement of the underlying items in the US GAAP/IFRS statement of financial position) that are expected to reverse within the boundary of the insurance contract.

The bottom line is, this would result in the liability value generally being equal to the value of the underlying assets.

The boards also tentatively:

a. Confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements, should be measured within the overall insurance contract obligation, using a current, market-consistent, expected value approach; and
b. Agreed that, when an insurer measures an obligation, which was created by an insurance contract liability, that requires payment depending wholly or partly on the performance of specified assets and liabilities of the insurer, that measurement should include all such payments that result from that contract, whether paid to current or future policyholders.

The problem with b. is that it makes reference to future policyholders and some object to the concept that you can have a liability today for a policyholder who has not yet purchased a contract. However, without this, the shareholder equity would be potentially overstated on certain European contracts. In such contracts, for example, if you have earnings of 100, only 10 can be paid to shareholders. However, the 90 does not need to be paid out today or to current shareholders. It's necessary to hold the 90 as a liability or the shareholder equity will be greater than 10.

Discounting of the Liability for Claims Incurred

The boards tentatively confirmed their earlier decision to require insurers to discount the liability for incurred claims (for contracts accounted for using the premium allocation approach) when the effects of discounting would be material. All IASB and FASB members present agreed with this decision. One IASB member and one FASB member were not present.

In addition, for contracts accounted for using the premium allocation approach, the boards tentatively decided not to provide additional guidance on determining when the effect of discounting the liability for incurred claims would be material. However, the boards tentatively decided to provide a practical expedient that would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event, unless facts and circumstances indicate that payments will no longer occur within 12 months.

All IASB and FASB members present agreed with this decision. One FASB member was not present.

Onerous Contracts

The boards tentatively decided that:

a. An insurance contract is onerous if the expected present value of the future cash outflows from that contract (plus, for the IASB, the risk adjustment) exceeds:

   i. The expected present value of the future cash inflows from that contract (for the pre-coverage period); or
   ii. The carrying amount of the liability for the remaining coverage (for the premium allocation approach);

b. Insurers should perform an onerous contract test when facts and circumstances indicate that the contract might be onerous. The boards also tentatively decided that they would provide application guidance about the facts and circumstances that could indicate that a contract is onerous; and

c. Onerous contracts identified in the pre-coverage period should be measured on a basis that is consistent with the measurement of the liability recognized at the start of the coverage period. Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis that is consistent with the measurement of the liability for claims incurred.

SEC Position

The SEC was expected to announce a position on adopting IFRS by the end of 2011. However, as the year ended no position was announced. Instead, a decision on adopting IFRS will be delayed until 2012. It appears likely that the staff paper released earlier in 2011, which provides for adoption but with a review by FASB before any standard becomes effective, is likely to be the preferred course of action. However, this is far from certain.

In the meanwhile, we need to remember that …
Insurance accounting is too important to be left to the accountants!