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Stochastically Forecasting Accounting Standards

By Henry Siegel

This year I have resolved to no longer think I can predict how the insurance contracts project will turn out. It should be an easy resolution to keep; I really have no idea how it will end up. Both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) received a substantial number of comment letters critical of their most recent exposure drafts (EDs). Whether either board will agree to the changes commenters advocated in those letters is unclear. Of course, being an actuary, I can make projections.

There are only a few major decisions to be made. Let's look at them.

Q1. Will there be a change to accounting for non-life liabilities?

Probabilities: IASB: Yes 80%; FASB: Yes 60%

With the U.S. non-life industry in the lead, both boards received numerous comments essentially saying the same thing: "Our accounting isn't broken. Don't change it!" The problem with this is that there is no International Financial Reporting Standard (IFRS) on the issue so the IASB must do something. The FASB already has a standard and so, in theory, could do nothing.

Of course, the key issue is whether to discount claim reserves; both EDs call for it. In its ED, the IASB has indicated it won't be reconsidering the issue. Equally importantly, Solvency II includes discounting in its

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Henry W. Siegel, FSA, MAAA, is a semi-retired actuary most recently with New York Life Insurance Company. He can be reached at henryactuary@gmail.com.

accounting requirements so Europeans tend to be more accepting of this change. In addition, it appears likely that the International Association of Insurance Supervisors (IAIS) will include discounting in its upcoming accounting basis for Globally Significant Insurance Companies. Large multiline insurers and companies reporting in Europe would like to deal with a single accounting basis, so discounting is highly likely to be included in IFRS.

On the U.S. side, the FASB might well decide to leave well enough alone here, although many of its members believe discounting should be required. No change would make many people in the industry happy; however, it would cause a lack of convergence with the IASB and require companies reporting on both IFRS and U.S. GAAP to report different liability levels.

So my guess is there will be discounting, although I'm less certain of that for the FASB than for the IASB.

Q2. Will there be changes to life insurance accounting?

Probabilities: IASB: Yes 100%; FASB: Yes 60%

The issue here is not whether the IASB will do something. It has to. It's a question really for FASB. A new phrase arose during the round tables and comment letters advocating "targeted" changes to the insurance accounting standards. In truth, the phrase usually means "leave our accounting alone but change theirs."

Non-life companies, of course, have always been using a variation of this plea, "Our accounting isn't broken, fix the life insurers' accounting." What's new is that now some life companies are saying the same thing. In particular, the plea is to leave FAS 97 universal life (UL)-type contracts alone but make other changes such as unlocking FAS 60 assumptions. Unfortunately, simply unlocking FAS 60 is not a simple change at all. It essentially requires a rewrite of the standard for many products insurance companies write. If it's a targeted change, it's like using the side of a barn as the target.

Furthermore, leaving FAS 97 alone is a flawed proposal on its own. It doesn't address the different presentation and measurement between FAS 60 and FAS 97 products. This is one of the key weaknesses of the current accounting standard. It also doesn't eliminate the retrospective unlocking of deferred acquisition cost (DAC) inherent in FAS 97 that many analysts have difficulty understanding. Finally, the basic measurement standard itself, the account value, is a retrospective value rather than the prospective measurement to be used for other contracts. There is no assurance that such a measurement makes proper provision for future cash flow needs.

That's why I think FASB is likely to proceed with a general rewrite of the standard, but doing nothing is also a possibility. A "targeted" rewrite is not really likely since it would impact some companies far more than others and give up on the goal of having a single model for all products.

Q3. What presentation model will be used?

Probabilities: For both boards—earned premium (from current EDs): 40%; summarized margin (from the first IASB ED): 25%; building block approach (from American Council of Life Insurers (ACLI) comment letter): 20%; other 15%

This has been a very controversial topic at the round tables and in the comment letters. There is relatively little support for the boards' proposals but no common alternative solution. The arguments against the earned premium approach are that it is artificial and not really useful for analytic purposes. It does, of course, follow the revenue recognition standard to a great extent and so has appeal for the boards and for certain users.

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The summarized margin approach, on the other hand, seems to be everyone's second choice. It lacks volume information, a prime request of commenters on the first IASB exposure draft, and doesn't look anything like an income statement for most types of companies. Adopting this approach would be more of a give-up than an act of conviction.

The ACLI proposal attempts to take the summarized margin but explodes some of the items to show both actual and expected premium and benefits. This approach seems to be a viable one to me, but it's not clear whether the boards will be in a mood to consider yet another proposal. This proposal also shows actual premium on the top line, a presentation that neither board likes.

Given the lack of consensus on the best outcome, some combination of the elements of all of these proposals may turn out to be the final result.

The remainder of the issues that need resolution are more technical and largely not controversial, assuming that the boards decide to proceed with our most likely result from above.

Commenters generally agree, for instance, that the use of other comprehensive income (OCI) should be optional, depending on whether it creates an accounting mismatch or not. There's also a consensus that FASB's decision to not unlock the margin should be reversed. Otherwise, it was pointed out by many comment letters, transition and presentation are made significantly more difficult and the results are less representative of the results of the company. Both of these have about a 90 percent probability of being adopted.

Many comment letters to both the IASB and the FASB expressed concern about the guidance for calculating discount rates, particularly for the longer tenors. Companies want to be able to use long-term estimates rather than precisely what the current market might show. Some board members oppose this; others agree with the position. I think it's 60/40 that the boards will approve using long-term averages.

The most controversial technical issue revolves around what has been referred to as the mirroring approach. Many in the industry have proposed removing that requirement and just treating those contracts like every other, using a prospective present value of cash flows approach. While there is some resistance to this, the European CFO Forum has endorsed the change so it is likely to be adopted. Unfortunately, it's not clear what would replace mirroring and what has been suggested may not work well for certain U.S. contracts. There is probably an 80 percent likelihood that mirroring will be removed, but it's not certain what would replace it.

One issue that I thought had been settled was whether there would be a risk adjustment in the IASB standard. Recently, however, activity at the IAIS has indicated they will use a liability with no margin to create an International Capital Standard that would apply to many of the largest companies in the world. If this becomes the standard for regulatory accounting, then a risk adjustment might be less important. I still give it over a 95 percent chance, but there is now a non-zero probability that the IASB will change its mind.

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… Board Audit Committees should be required to have independent actuarial support.

Looking at the probabilities, it is most likely that the accounting for insurance contracts and insurance companies in general will be more dependent on actuarial calculations than ever. This raises an important concern about how management, particularly boards of directors, will be able to understand financial results without special actuarial guidance.

There is a requirement for all public companies to have someone with financial experience on their Board Audit Committee. This is no longer enough for insurance companies. Board Audit Committees should be required to have independent actuarial support, either by requiring that a qualified actuary be a member of the committee or by requiring that the audit committee get advice from an independent consulting actuary. In either event, the actuary should be qualified to review actuarial reports and reserve calculations and to ask appropriate questions concerning assumptions and other projection issues.

This is another example of why

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

Last Minute Update
At its February meeting the FASB decided not to make changes to accounting for short term contracts except for disclosures. It also decided to proceed with "targeted" changes to long-duration contracts although it made no decision as to the extent of the changes.