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GAAP/IFRS Accounting Projects—More Than Just Insurance Contracts

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Most of the focus on possible changes to US GAAP and IFRS guidance has understandably been on the insurance contracts project. However, a number of other projects are likely to impact actuaries in both the near- and long-term. Among these is a recently completed project on fair value, as well as ongoing projects on financial instruments and revenue recognition.

FAIR VALUE

In 2006, the Financial Accounting Standards Board (FASB), which promulgates US GAAP guidance, adopted FAS 157 "Fair Value Measurements."[1] In 2011, the International Accounting Standards Board (IASB) adopted its fair value measurements standard, IFRS 13. The fair value guidance in IFRS 13 is generally consistent with that of FAS 157. FASB eliminated many of the remaining differences by issuing Accounting Standards Update 2011-04 (ASU 2011-04), which revises the US GAAP fair value guidance. ASU 2011-04 takes effect in 2012, so even though the changes are probably not too onerous to adopt there is not much time to make these changes.

Most of the changes from ASU 2011-04 that will impact actuaries are increased disclosure requirements. For fair value measurements that involve unobservable inputs (i.e., level 3 measurements), a narrative will be required describing how the fair value is calculated, including controls over the process and validation of the assumptions and results. In addition, quantitative disclosures, including ranges of unobservable inputs used, will be required. Further, a narrative will be required describing the sensitivity of the measurement to changes in unobservable inputs. Since many actuarial fair value calculations involve unobservable inputs such as mortality, surrender rates and long term equity price volatility, these additional disclosures will apply to many actuarial calculations.

Finally, certain financial instruments are not measured at fair value, and current GAAP requires disclosure of their fair value. ASU 2011-04 requires these disclosures to be categorized within the "fair value hierarchy." That is, level 1 for quoted prices in active markets, level 2 for measurements that use observable inputs and level 3 for measurements that use significant unobservable inputs.

FINANCIAL INSTRUMENTS

FASB and IASB have been working for several years on a joint project covering financial instruments. Although this is technically a joint project, the boards have been working at different paces and have come to some very different tentative decisions in the project. The project will impact the accounting for many of the assets used to back insurance contracts. It will also impact the accounting for investment contracts which do not meet the definition of insurance, such as some guaranteed investment contracts. It may also impact the accounting for financial elements of insurance contracts that the boards decide to "unbundle" from the insurance contracts for accounting purposes; items that have been discussed for such unbundling include embedded derivatives, certain account balances and policy loans. Results of this project may also impact decisions in the insurance contracts project. For example, the extent to which "other comprehensive income" is permitted or required in the financial instruments project may impact the extent to which it can be used for insurance contracts. In addition, the impairment model developed for financial instruments may be required for valuing impairments of ceded reinsurance receivables.

There are four main elements to this project:

- Classification and measurement,
- Impairment,
- Hedge accounting, and
- Offsetting.

Offsetting covers the balance sheet presentation of financial instruments that meet certain criteria and will not be discussed further here. On the other three elements, the boards have not only made some different decisions, but are following different pathways to develop the financial instruments model.

FASB is attempting to develop a single comprehensive model for financial instruments to be issued all at the same time. IASB is developing the model in stages, issuing each piece when that piece is complete. Thus, IASB has already issued a standard covering classification and measurement, IFRS 9. As other elements are finalized, the new guidance will be added to IFRS 9.

Classification and measurement

IFRS 9 basically permits two possible measurement approaches for financial assets: (1) fair value with all changes in fair value flowing through net income, or (2) amortized cost. Fair value with some changes in fair value flowing through other comprehensive income—the method currently used for "available for sale" assets under current accounting—is limited to equities held for strategic purposes, and thus would rarely, if ever, be used for assets backing insurance contracts.

In order to determine which measurement model applies to a financial asset, a two pronged test is used:

- Business model—is the business model for the asset to collect contractual cash flows?
- Asset characteristics—are the contractual cash flows solely repayments of principal and payments of interest on outstanding principal?

If the answer to both of these questions is "yes," the asset qualifies for amortized cost. Otherwise, fair value through net income is required. If amortized cost would create an accounting mismatch, a fair value option is permitted for assets that would otherwise be measured at amortized cost.

Note that the business model test would likely exclude assets held in portfolios whose business model is to maximize total return from qualifying for amortized cost. Also, the asset characteristics test would exclude equities and derivatives from amortized cost. It may also exclude lower tranches of structured securities from amortized cost, since some of the cash flows are compensation for bearing the risks that would otherwise be borne by the higher tranches.

For financial liabilities, the IASB model is somewhat simpler. Derivatives and financial liabilities held for trading would be at fair value through net income. Other liabilities would be at amortized cost, except for certain embedded derivatives that would have to be bifurcated and held at fair value through net income. A fair value option is available for liabilities that meet certain criteria.

FASB's position on classification and measurement of financial instruments is different. For financial assets, only loans that meet certain criteria (i.e., having a direct relationship with the debtor) would be eligible for amortized cost. Other financial assets would be at fair value on the balance sheet. Most debt instruments would be at fair value through other comprehensive income, similar to current "available for sale" accounting. Equities and derivatives, as well as debt instruments held for trading as of when the asset was acquired, would be held at fair value through net income. In addition, for assets that are at amortized cost or at fair value through other comprehensive income, embedded derivatives would be bifurcated and held at fair value through net income (or alternatively, the entire instrument could be carried at fair value through net income).

FASB's position on financial liabilities is generally similar to IASB's. Derivatives, short sales and liabilities held for trading as of inception of the liability would be at fair value through net income. Other financial liabilities would be at amortized cost, with embedded derivatives bifurcated and held at fair value through net income (or alternatively, the entire instrument could be carried at fair value through net income).

FASB would permit a fair value option for financial assets and liabilities under some circumstances. However, FASB's criteria for permitting a fair value option are more restrictive than IASB's.

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With all the differences between the two boards on classification and measurement, it remains to be seen how these differences will be bridged. The reconciliation may be made more difficult by the fact that IASB has already issued its guidance under IFRS 9. However, the mandatory effective date for IFRS 9 is not until 2013, and in August IASB published an exposure draft proposing deferring the mandatory effective date until 2015.

Impairment

Both boards have been working together to develop a new model to determine when a financial asset held at amortized cost (or fair value through other comprehensive income) is impaired, and how to measure the impairment. The boards are attempting to address concerns raised during the financial crisis that banks were too slow in recognizing asset impairments. So the goal of the impairment phase of the financial instruments project is to recognize impairments sooner. The boards are trying to determine how to do this in a practical manner.

There have been some concerns expressed by the insurance industry about the suggested proposals. One concern has been that the proposals that may be more practical to implement involve recognizing some impairment loss upon inception of the financial asset. Another concern is that the proposals are largely geared to dealing with originated loans and less appropriate for purchased securities.

Hedge Accounting

Hedge accounting is an accounting convention by which matched accounting is provided to a hedged risk and a hedged instrument, even if those items would not normally qualify for matched accounting. Currently, the rules to qualify for hedge accounting are very restrictive, and substantial and costly documentation and testing is required. Further, due to the restrictions, it can be virtually impossible to attain hedge accounting treatment for many risks in insurance contracts.

Both IASB and FASB have proposed relaxing some of the restrictions and requirements to achieving hedge accounting. IASB is much further along in the process. IASB is planning to release a standard on general hedge accounting in 2011. The proposed standard would permit hedge accounting to be applied to risks within individual contracts or within groups of contracts with fewer restrictions than are in place today. IASB has also begun working on a standard on macro hedge accounting to deal with hedging risks within open portfolios, in which contracts containing the hedged risk can be acquired or terminated over time.

FASB has proposed some relaxation of the hedge accounting restrictions. However, as of September 2011, its proposals do not go as far as IASB's. In particular, FASB has not proposed relaxing the restrictions around attaining hedge accounting for risks within groups of contracts, which often prevent risks within certain insurance contracts such as variable annuities from attaining hedge accounting. It remains to be seen whether FASB will be persuaded to move to a position similar to IASB.

FINANCIAL INSTRUMENT DISCLOSURES

As part of its financial instrument project, FASB has also recently proposed additional disclosures for financial instruments. Many of these additional disclosures would also apply to insurance contracts. Some disclosures would be limited to financial institutions, which would include insurance companies.

The intent of the new disclosures would be to provide readers of GAAP financial statements with additional information about liquidity risk and interest rate risk. The proposals regarding liquidity risk disclosures include tables showing the expected timing of cash flows from both financial assets and financial liabilities (including insurance contracts). The interest rate risk disclosures would include tables showing when financial assets and liabilities (including insurance contracts) are subject to interest rate resets. The proposed disclosures also include impacts from specified parallel and non-parallel yield curve changes.

REVENUE RECOGNITION

IASB and FASB have been working jointly on a project for accounting for revenue recognition from contracts with customers. A final standard is expected to be issued in 2012. Insurance contracts are explicitly exempted from this project. However, the project may impact the valuation of contracts sold by insurance companies that do not qualify for accounting under the insurance contracts or financial instruments standards. An example would be administrative services only contracts. In addition, the revenue recognition may impact the valuation of features that are "unbundled" from insurance contracts that are not considered financial instruments. Items that the boards have considered for such unbundling include administrative services in contracts that combine administrative services with stop loss insurance, and investment management fees within insurance contracts.

The proposed revenue recognition model is basically an unearned premium model. There are new principles to determine how much premium or consideration is earned as goods or services are provided to the customer. Any unearned amounts would be accrued as a liability, or possibly as an asset if future required payments from the customer exceed the unearned amounts. The earnings pattern is generally locked in at inception of the contract unless the contract becomes "onerous," i.e., a loss recognition event. The earnings pattern may differ from that under current US GAAP or IFRS. There is also guidance for deferring costs associated with acquiring contracts. This guidance is generally more restrictive than the allowance for acquisition costs proposed by either board within the insurance contracts joint project.

In the case of investment management fees, it is possible that if the boards decide that such fees should be unbundled from insurance contracts, the revenue recognition model would provide a more stable earnings pattern than the proposed insurance contracts model. That is because the proposed insurance contracts model would effectively fair value the fees on variable contracts—when markets go up, the present value of future fees increases, reducing the liability and increasing income, and vice versa. Treating the fees under the revenue recognition model may reduce this volatility. But it remains to be seen what the boards will decide with respect to unbundling these fees.

As you can see, there are many changes coming in the US GAAP and IFRS accounting world besides the insurance contracts project that may impact actuarial work for years to come. And in addition to the projects discussed here, some actuaries may be impacted by changes to lease accounting, consolidation, employee benefits and other projects. The next few years are likely to be very interesting for actuaries working on GAAP or IFRS reporting. ■

END NOTES

[1] Under Accounting Standards Codification, the US GAAP fair value measurement has since been renamed "Topic 820."