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Incredible, Unbelievable

By Henry Siegel

I recently was at a session where the person speaking was encouraging the listeners to attend another session with excellent presenters. "The speakers are incredible," he said. On another occasion I was reading a newspaper review of a restaurant. "The food is unbelievably good!" the review read.

Tell me, why should I go listen to a speaker who is not credible? Why should I try food with quality that is unbelievable? Why is our use of language so sloppy? It makes conversations so much more difficult, particularly when English is not the first language of all the participants.

I have run into this problem recently at the accounting discussions where the term "participating contract" has been subject to various meanings depending on who is speaking. As used by the Financial Accounting Standards Board (FASB), participating contracts are normally those contracts traditionally offered by mutual insurers. Another subset of these policies consist of those policies that were originally issued by a mutual, but are now contained in a closed block in a demutualized company. Both of these types of contract are accounted for under the former FAS 120 since their dividends are based on the contribution principle.

At the International Accounting Standards Board (IASB), however, participating contracts can mean not only those types of contracts, but variable products, contracts where the distribution principle is other than the contribution principle and contracts where the only distribution is excess interest, such as for fixed deferred annuities. The IASB has been struggling for most of the year to find the correct accounting for this mixed group of policies types. For a variety of reasons having to do with the characteristics of the types of contract, the board has moved from the general principle of having the liability simply equal to the present value of future cash flows to using a variable fee approach for some contracts and not for others. The good news is that it appears that this quarter the IASB has finally nearly reached a conclusion on how to handle these issues.

At the same time, the IASB has had difficult conversations on how to handle the implementation of the new IFRS 9 on Financial Instruments when the Insurance Contracts standard won't be effective for a period of time afterwards. The European companies were particularly insistent that some deferral of implementation of IFRS 9 be provided so that insurers won't have to implement IFRS 9 now, which would result in a mismatch between asset and liability measurement.

IASB MEETING IN JULY

The discussion in July centered on solutions to implementation of IFRS 9 since the insurance contracts standard will not be finished by then. The alternative discussed at this meeting was to effectively allow insurers to continue to use the existing IAS 39 accounting until the insurance standard is implemented. This would be accomplished by amending the existing IFRS 4 to allow the mismatch to be shown in Other Comprehensive Income (OCI).

The details of this proposal were confirmed at the September meeting and are shown below. There were no discussions about insurance in August.

IASB MEETINGS IN SEPTEMBER

The IASB discussed insurance in four separate meetings in September. The first two were the continuation of the discussion from July regarding IFRS 9 and IFRS 4. The last two had to do with accounting for participating contracts.

Different effective dates of IFRS 9 and the new insurance contracts standard

After reviewing the results of outreach feedback that the staff had obtained following its July meeting, the Board decided to offer two alternative approaches for dealing with IFRS 9, the Overlay Approach and the Deferral Approach. The former was the alternative discussed in July allowing the effect of any change from IAS 39 to IFRS 9 to be shown in OCI. The latter would effectively allow deferring implementation of IFRS 9 until the insurance contracts standard takes effect. The details of the two alternatives follow as described in the September IASB Update.[1]

"The Overlay Approach

Financial assets eligible for the overlay adjustment (eligible financial assets)

At this meeting, the IASB continued to discuss the overlay approach which it had tentatively decided to propose at its July meeting. The overlay approach would permit an entity to adjust profit or loss and other comprehensive income (OCI) to remove from profit or loss the effect of newly measuring financial assets at fair value through profit or loss (FVPL) in accordance with IFRS 9. The IASB tentatively decided that:

a. a reporting entity should be permitted to make an overlay adjustment in respect of financial assets that meet both of the following criteria:

   i. the financial assets are designated by the entity as relating to contracts that are within the scope of IFRS 4 *Insurance Contracts*; and

   ii. the financial assets are classified as FVPL in accordance with IFRS 9 and would not have been classified as FVPL in their entirety in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.*

b. an entity may change the designation of financial assets as relating to contracts within the scope of IFRS 4 only if there is a change in the relationship between the financial assets and contracts that are within the scope of IFRS 4.

Redesignation of financial assets

The IASB tentatively decided that:

a. an entity should be permitted to apply the overlay approach prospectively to financial assets when the eligibility criteria are met;

b. an entity should be required to cease applying the overlay approach when financial assets no longer meet the eligibility criteria. Any accumulated balance of OCI relating to the overlay adjustment should be immediately reclassified to profit or loss (recycled)."

The Board also made decisions having to do with transition rules, presentation and disclosure. One key transition rule is that only entities for which insurance activities are predominant, using liabilities as a yardstick, should be allowed to use this approach. For more details on this and other rules, consult the IASB update cited previously.

The Deferral Approach

The IASB also discussed details of a new deferral approach. Under this approach, an entity would be allowed to defer the effective date of the new IFRS 9 until it implements the new insurance contracts standard. Again, only entities for which insurance is the predominant liability type would be allowed to do this. The IASB doesn't want banks with small insurance businesses to take advantage of this provision.

Seven IASB members voted to allow the deferral approach and seven IASB members voted against it. After the meeting, the chairman of the IASB decided to use his tiebreaking vote in favor of the deferral approach.

The vote on this issue was largely geographic with European members voting in favor of allowing deferral and other members voting against it. There was a serious concern that if deferral were not allowed, the Europeans would not adopt IFRS 9.

An exposure draft of these modifications to IFRS 4 should be forthcoming by the time you are reading this article. For more details on what was tentatively agreed upon, consult the IASB update.

Accounting for Participating Insurance Contracts

The IASB resolved at this meeting most of the remaining issues regarding accounting for participating contracts, particularly for variable type contracts. The IASB tentatively decided that if an entity uses the variable fee approach to measure insurance contracts and uses a derivative measured at fair value through the profit and loss statement to mitigate the financial market risk from the guarantee embedded in the insurance contract, as is often the case in the U.S. for certain variable annuities, the entity would be permitted to recognize in profit or loss the changes in the value of the guarantee embedded in an insurance contract, determined using fulfillment cash flows. This would only be allowed, however, if there's an accounting offset between the value of the guarantee and the value of the derivative. For details, consult the IASB Update for September.

Next steps

The IASB will continue to consider the remaining outstanding items on insurance contracts at future meetings, and is aiming to issue a new Standard in 2016.

For the next year, then, the IASB and staff will be drafting the final standard to be adopted probably in the fourth quarter of 2016. During this period, it's likely that many detailed questions will arise that will require actuarial assistance to answer. After all,

***Insurance Accounting is too important to be left to the accountants*!** ■

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ENDNOTES

[1] http://media.ifrs.org/2015/IASB/September/IASB-Update-September2015.pdf