Article from:

The Financial Reporter

June 2013 – Issue 93

Are You Ready for the New Accounting Rules?

By Jim Milholland

Jim Milholland, FSA, MAAA, is a retired partner from Ernst & Young, LLP. He can be contacted at actuary@milholland.com.

It looks like it's really going to happen. The International Accounting Standards Board (IASB) has completed its discussions of the new accounting standard and expects to issue an exposure draft in the second quarter of 2013. This puts the standard on track for an effective date possibly as early as 2017. A more likely date is 2018, as the boards will probably deliberate on the comments to the exposure draft until late in 2014 and then allow three years for implementation. The Financial Accounting Standards Board (FASB) has a similar timetable for the adoption of a standard for the United States. Despite the fact that the proposals of the boards have some significant differences, and notwithstanding the possibility of changes to the proposals as a result of comments made on the exposure drafts, the essential elements of the proposals are fairly well set. It's not too early to start sizing up the challenges and assessing readiness.

THE ESSENTIAL ELEMENTS

What follows is a highly summarized description of the proposals. It provides only the points most relevant to determining the resource requirements.

For life insurers, the liabilities for most contracts other than group contracts will be measured by the building blocks. The first block is a projection of expected future cash flows. "Expected cash flows" are meant to be mean values. Estimating mean values may require multi-scenario or even stochastic projections.

Building block two is the time value of money. This is the effect of discounting the expected cash flows. As the proposals stand, there will be two discount rates. One rate (more properly, yield curve) is the basis for determining the expense for the period of the interest credited to the liability. A market-based discount rate is selected at inception of the contract and fixed for the life of the contract. The unwind of this rate is the interest expense for the period. The other rate is for the current value, using a rate that is consistent with observable rates at the time of the valuation. This measurement of liabilities using current rates is the amount that is presented on the balance sheet. The difference between the measurement under the fixed basis and under the current basis will be a component of other comprehensive income. This treatment is analogous to the available for sale treatment of financial instruments and in fact is intended to provide for treatment of insurance liabilities that is consistent with that of supporting investments. There may in fact be more than two discount rates for insurers using International Financial Reporting Standards (IFRS), if the IASB persists in its thinking that cash flows for participating contracts should be separated into those that are dependent on investment results and those that are not, with different discount rates for the two sets of cash flows.

The third block, which is applicable to IASB IFRS only, is the adjustment for risk. This is the amount that the insurer requires for bearing the risk that the actual cash flows will exceed the projected cash flows. This number is remeasured at each valuation.

The final piece is the residual margin (IASB) or single margin (FASB). This is the amount that is needed to be added to the liability at inception to prevent a profit at issue. It is amortized into income according to the guidance provided by the IASB and FASB; i.e., in relation to services provided and in relation to release from risk, respectively.

In addition to measuring the liability, the insurer must disclose the movement in the liability. This required disclosure displays how the liability progresses with premium income, interest credited and amounts distributed such as claims, surrenders and expenses.

The current proposals also call for a presentation in the statement of comprehensive income that is called the earned premium approach. Under this approach, revenue is the sum of amounts released from margins, the change in the adjustment for risk (under IASB IFRS), and the release from the liability of the amounts intended to provide for claims and expenses in the current period. The presentation is intended to allow a comparison of amounts that provide for claims and expenses to the amounts actually incurred, and a comparison of investment income to the interest credited, so that the drivers of profit are apparent in the income statement.

THE CRITICAL PATH—ACTUARIAL SYSTEMS

In short, the new standards call for a dynamic valuation, possibly needing multiple-scenario projections, requiring justification for the assumptions and the discount rates at each valuation date and the reconciliation of the beginning and ending balances, all within current reporting time schedules. Companies that do not have a robust projection capacity across their enterprise will likely conclude that putting the projection capabilities into place is the top priority.

Insurers that are already conducting embedded value reporting, economic capital calculations or Solvency II may conclude that the same platform can be modified for financial reporting purposes. Getting the systems to provide the liabilities and the reconciliation in the time frame for financial reporting is nonetheless a significant challenge. An ancillary, but important, benefit of starting with systems that serve other purposes is the general consistency of assumptions for the various frameworks. While they may serve different objectives, the various systems should not harbor inconsistencies. It would be embarrassing to an insurer to have to admit that the management perspectives that underlie the report to shareholders are different from those that form the basis for budgeting, planning, risk management, insurance regulatory reporting (such as the Own Risk and Solvency Assessment (ORSA)), or information supplemental to the financial reports (such as embedded values).

Publication of financial results often begins with an earnings release that provides a quick view of earnings, earnings per share, revenue, and drivers of profit for the year. Revenue information will be taken from the actuarial models. Actuaries will therefore need to not only have completed their valuation, but to be

confident in the reconciliation of the liabilities and the related information that is used in the presentation of comprehensive income. This puts additional emphasis on the need for robust models. It is important to avoid having significant unexplained differences in the analysis of the movement of the liabilities.

Companies that are Securities and Exchange Commission (SEC) registrants must be able to demonstrate that their systems operate in a control environment that is Sarbanes-Oxley (SOX) compliant. This is yet another reason for performing the reconciliation on a timely basis. The ability to explain the movement in the liabilities is likely a key control.

POLICIES AND PROCEDURES

While systems development may be on the critical path, equally critical are the policies and procedures required to link the calculations to the pronouncements. The pronouncements will be accompanied by implementation guidance, but many points of inter-

CONTINUED ON PAGE 12

The systems should work for the actuaries, not the other way around. ...

pretation and application will be left to the insurer. The insurer's policy and procedure statements document the insurer's interpretation of the pronouncement and how it intends to apply the interpretation, in a way that assures consistent application and can be used to demonstrate compliance.

Each aspect of the new standard can lead to a policy statement. The list is too long for comprehensive treatment here, but a few examples are in order.

Take, for example, the requirement that the projected cash flows are expected values. This requirement itself leads to several considerations.

One of the biggest decisions for insurers is to what extent stochastic or multi-scenario modeling is needed. Some contracts, especially those with interest-sensitive or equity-based features, will have to be considered for stochastic modeling.

Each assumption underlying cash flows also calls for a policy statement. For example, each insurer must decide how much mortality improvement should be incorporated into the mortality rates and if and how to anticipate some periods of abnormally high claims due to epidemics or other causes.

The insurer should document its procedures for periodic review of experience and its process for approving assumptions, whether there are changes or not. The basis for valuation must be supported at each reporting date and the effects of changes in assumptions must be disclosed.

There will be data issues as well. A couple of examples here will suffice. The models must be designed to correspond with the groupings for disclosures and for analysis of differences between actual and expected benefits and expenses. There are also groupings to make for determining margins and for setting the adjustment for risk. For death benefits, the information required may be different from what is presented now. The death benefit in the presentation of comprehensive income is the amount of the claim in excess of the contract's cash value. Getting the proper amount of the death benefit is nothing new for companies offering universal-life-type products, but insurers may not have this capability already in place for other types of contracts.

RESOURCES FOR IMPLEMENTATION AND MAINTENANCE

It is obvious that the task of implementing the new accounting standard will be daunting. It is also apparent that the amount of effort to maintain the systems and procedures after implementation is much greater than what is needed for most valuation systems in the United States today.

There are clear implications to the number of actuaries needed for the conversion effort and for ongoing reporting. The fact that the systems must be sufficiently robust for SOX-compliant financial reporting suggests that insurers should elevate the status of actuarial models used for financial reporting to be on par with those for the general ledger, policyholder administration and investment. The systems should work for the actuaries, not the other way around, meaning that the number of off-system calculations and workarounds should be kept to a minimum.

THE INDUSTRY AND THE ACTUARIAL PROFESSION

A companion question to the one in the title of this article is "Are we ready?" There are many, many considerations to be made, and most affect a large number of companies. The industry and the professional bodies will no doubt collaborate to help identify the common issues and perhaps even provide some non-authoritative, but nonetheless useful, application guidance. Industry efforts should help insurers bridge the gap between the guiding principles in the pronouncements and the detailed decision making that must take place to implement the standards.

While practices almost certainly will differ among insurers in some respects, the range of practices may narrow with time. Insurers will benefit from industry efforts to facilitate information sharing that may help the industry gravitate to best practices. Certainly practice notes provided by the American Academy of Actuaries (AAA) and the International Actuarial Association (IAA) will go a long way in helping this happen.

START NOW

One can work backwards from the effective date and realize that, while there is plenty of time for the conversion, there is little time to waste in getting started. If a company intends to report in 2018 on the new basis, it should want to have this ability by sometime in 2017. An insurer needs to allow time to conduct a thorough testing of the new reporting process. It may decide to disclose the anticipated effects of the change in accounting policies in the last report that it makes on the old basis. If it takes two years for the systems conversion, then the conversion must start in 2015. So from today, mid 2013, companies have about two years to size up the challenges, to add staff, and to select or design actuarial systems. During this time, the actuaries responsible for the conversion should begin communicating with executives and directors about the implications and impact, and make the case for the cost of the conversion and of the ongoing effort.

So there's no need to panic, but there are advantages to starting now. Well planned is half done, and by the time the details are finalized, precious time will have expired. Actuaries should pick up the project now and begin to assess their capabilities and their resource gaps. ■