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Sub-Atomic Accounting

By Henry Siegel

It looks like we're finally getting there. By the time you are reading this, all the hard decisions for the next round of Exposure Drafts (ED) should have been made. I know I've said that before but this time…

As far as I can tell, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), collectively referred to as "the boards," have both come up with theoretically defensible packages of decisions based on the same basic foundation. Once they have published, I don't expect a lot of comments saying that they have gotten the theory wrong, as there were last time around on Transition, for instance.

Instead, most of the comments will be along the lines of:

a. You've been too prescriptive,
b. We don't think we can do what you ask in a timely manner each quarter, or
c. You've required technically correct calculations that don't generate benefits commensurate with their cost.

The problems in categories a) and b) can probably be solved fairly easily by simply granting more flexibility, such as they've already done by removing restrictions on how the risk margin can be calculated. The boards have already been assured that actuaries can do anything, so I don't think arguing complete impossibility will be viable.

The really hard questions are in category c). Let's look at two of the most serious problems that are likely to be cited.

For the decade plus that the IASB has been working on accounting for insurance contracts, it had never come to grips with the types of participating life insurance policies sold in the United States until this quarter. In the course of doing this, of course, they not only redefined what it means to be a participating contract (see the discussions in October and November below for more on this), but created a standard that should terrify every actuary who might have to implement it.

In the world of physics, it's accepted that as you look closer into the makeup of matter, there's a level below which things get so small that the particles you're dealing with no longer have the characteristics of the element. For instance, a single atom of gold has no color because it's smaller than the color's wavelength. Electrons by themselves are all the same; it's only when they are combined with other particles that they begin to differ from one another.

The accounting standard setters appear to not know this. They are trying to value an insurance contract liability. In doing so for participating contracts, they have decided to look at each of the cash flows in the contract separately. They then appear to have required that each cash flow be discounted individually using its own specific set of yield curves based on the extent to which that particular cash flow is dependent on investment returns. Leaving aside the question of how to decide which cash flows are or are not dependent on investment returns and how much so, you then have the disturbing situation that an individual contract can have more than one discount rate applied to it!

While this might sound OK theoretically, we need to remember that for income statement purposes you have a current rate (or rates) that you use for the balance sheet plus a locked-in rate used to separate interest rate movements into the Other Comprehensive Income (OCI). The end result is that you could end up with potentially four different discount rates for each contract. Even if you initially set discount rates for a year's worth of issues, it will get exceedingly complicated when you start adjusting the discount rates each quarter. And in the end, these are only estimates of the future anyway; does this additional complexity really aid in understanding how the company did this year?

Another place they've made things way more complicated than necessary is in presentation, most obviously on how to show premiums. In the original ED, the boards didn't propose to show premiums in the income statement at all. Instead, all they proposed to show was the release of margins and differences between actual and expected. Users objected to this, asking for premiums and claims, at least, to be shown.

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The boards then decided, however, not to just show something simple like incurred premium. Instead, they are proposing to adjust premiums twice. The first adjustment is to remove deposit components, the idea being something along the lines of what was previously done under FAS 97 but for all contracts, even those without explicit cost of insurance (COI) charges or expense loadings. Once this is done, the remaining premium is then adjusted again so that it is recognized in proportion to how coverage is provided.

This will not only require significant systems revisions to actually calculate these adjustments, but the end result will not be something that is immediately usable by analysts. Of course, these adjustments don't affect the bottom-line earnings so there will need to be an offsetting adjustment to the liabilities and/or claims as well to make everything work. How much more confused could this be?

I trust that when the boards have assembled all the comments from users and preparers, they will conclude that some of these theoretically correct decisions are not worth pursuing. They have done this on other standards, and I trust they will do it here as well.

The IASB and FASB met each month this quarter jointly and each had meetings without the other as well.

OCTOBER MEETING

IASB-FASB Joint Sessions

The IASB and FASB continued their joint discussions on the Insurance Contracts project where they discussed:

- The time value of money in the premium allocation approach;
- The presentation of changes in the liability for participating contracts; and
- How premiums and claims, non-claims fulfillment costs and acquisition costs should be presented in the statement of comprehensive income.

Time Value of Money in the Premium Allocation Approach

The boards tentatively decided unanimously that the discount rate at inception of the contract should be used to measure the liability for remaining coverage, when it is accreted or discounted.

The boards discussed how the decision to present in OCI changes in the insurance liability arising from changes in discount rates would apply to the presentation of the liability for incurred claims for contracts to which the premium allocation approach is applied. The boards tentatively decided that when the liability for incurred claims is discounted, an insurer should use the rate at the inception of the contract to determine the amount of the claims and interest expense in profit or loss. That rate is subsequently locked in.

Originally, 11 IASB members preferred using the rate on the date the claim is incurred. However, 13 IASB members agreed to use the rate at the inception of the contract, for the sake of convergence with FASB.

This decision would seem to apply to claim reserves for all contracts, not just those using the premium allocation approach. The problem with this decision, however, is that for contracts like long term care, there is a potentially long distance between the issue date and the date of the claim, as long as 20 years or more. Discounting at a rate so distant doesn't seem to make much sense. It's possible the boards will reconsider this decision before final publication.

Participating Contracts

The boards considered previous tentative decisions that apply to contracts with participating features for which the mirroring approach would apply. (Note that in this discussion, the boards use participating contract only for those contracts where there is a contractual connection between the performance of the assets and the amounts paid to policyholders. U.S.-style participating contracts and universal life (UL) contracts would not qualify under this definition. They are handled separately in a November discussion.)

In particular, they noted that the mirroring decision would take precedence over the tentative decision that insurers should present in OCI changes in the insurance contract liability arising from the effect of changes in the discount rate. As a result, for contracts with partici-

pating features where the mirroring decision applies, insurers would present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the directly linked underlying items.

The FASB tentatively decided that, for contracts to which the mirroring decisions do not apply and where the contractual obligation to the policyholder is directly linked to the fair value of the underlying items, changes in the insurance liability should be presented in profit or loss.

Presentation in the Statement of Comprehensive Income

- *Premiums and Claims*
  The boards tentatively decided that premiums and claims presented in an insurer's statement of comprehensive income should be determined by applying an earned premium presentation, whereby premiums are allocated to periods in proportion to the value of coverage (and any other services) that the insurer has provided in the period, and that claims should be presented when incurred.

  This decision also creates a nightmare to implement since for every policy you not only need to remove any deposit component but you need to reallocate the premium over the coverage period. How this will be useful to analysts is difficult to see.

- *Non-Claims Fulfillment Costs (e.g., Expenses)*
  The boards tentatively decided that in an earned premium presentation:

  a. The portion of premium allocated to cover non-claims fulfillment costs should be equal to the originally expected non-claims fulfillment costs included in the measure of the building block liability.
  b. The premium allocated to cover non-claims fulfillment costs should be included in earned premium in the periods in which the costs are expected to be released from the liability for remaining coverage, i.e., when it is expected that they will be either incurred or added to the liability for incurred claims.
  c. The amounts presented as expenses should be the actual costs incurred or be added to the liability for incurred claims in the period.

- *Acquisition Costs*

The IASB tentatively decided that the cash flows related to acquisition costs should be recognized in the statement of comprehensive income over the coverage period. (This decision is consistent with a decision previously made by the FASB.)

The FASB tentatively decided that an insurer should disaggregate in the statement of financial position the insurance contracts liability into the expected cash flows to fulfill the insurance obligation and the single margin. Acquisition costs should be reported as part of the single margin (i.e., the margin at issue includes the acquisition costs expected to be paid and is reduced when those acquisition costs are paid). The different approaches should not produce significantly different results.

The boards tentatively decided that acquisition costs should be recognized in the statement of comprehensive income in a way that is consistent with the proposed allocation of the residual/single margin. In other words:

a. For the IASB, in a way that is consistent with the pattern of transfer of services provided under the contract.
b. For the FASB, as the insurer satisfies its performance obligations to stand ready to compensate the policyholder if a specified uncertain future event adversely affects the policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. Consequently, the single margin recognized should be grossed up for the amount of acquisition costs recognized.

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IASB-Only Meeting

The IASB met to discuss financial instruments with discretionary participation features, transition requirements, effective date, comparative information and early application.

Financial Instruments with Discretionary Participation Features

The IASB tentatively decided to adapt the contract boundary criteria and recognition criteria for a financial instrument with a discretionary participation feature as follows:

a. The contract boundary for a financial instrument with a discretionary participation feature is the point at which the contract no longer confers substantive rights on the contract holder. A contract no longer confers substantive rights on the contract holder when:

    i. The contract holder no longer has a contractual right to receive benefits arising from the discretionary participation feature in that contract; or
    ii. The premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.

b. An entity shall recognize a financial instrument with a discretionary participation feature only when the entity becomes a party to the contractual provisions of the instrument, e.g., when the entity is contractually obliged to deliver cash (like for a claim or surrender).

Transition Requirements

The IASB made the following tentative decisions related to transition to the proposed new Insurance Contracts Standard:

a. An insurer shall follow the reclassification guidance in IFRS 9 Financial Instruments except that an insurer should be:

    i. Permitted to designate eligible financial assets under the fair value option where new accounting mismatches are created by the application of the proposed new Insurance Contracts Standard;
    ii. Required to revoke previous designations under the fair value option where the accounting mismatch no longer exists because of the application of the proposed new Insurance Contracts Standard;
    iii. Following earlier application of IFRS 9, permitted to newly elect to use OCI for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.

b. An insurer shall determine the residual margin on transition, assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition.

In addition, the IASB tentatively decided that:

a. The proposed transition requirements for insurers that already apply IFRS should also apply to first-time adopters of IFRS; and

b. It would not include explicit guidance on redesignation of property, plant and equipment and investment property on transition.

Effective Date, Comparative Financial Statements and Early Application

The IASB stated its intention to allow approximately three years between the date of publication of the final Insurance Contracts Standard and the mandatory effective date. In addition, the IASB tentatively decided:

a. To permit entities to apply the final Insurance Contracts Standard before the mandatory effective date; and

b. To require entities to restate comparative financial statements on first application of the final Insurance Contracts Standard.

Given the current timetable for the project, this would imply required implementation on Jan. 1, 2018 with comparables for 2016 and 2017.

NOVEMBER MEETING

IASB-FASB Joint Sessions

IASB and FASB met on Nov. 20, 2012 to continue their joint discussions of the proposed Insurance Contracts Standard.

Discount Rate for Cash Flows That Are Not Subject to Mirroring and That Are Affected by Asset Returns (e.g., UL and U.S.-Style Par Contracts)

The boards tentatively decided to clarify that, for cash flows in an insurance contract that are not subject to mirroring and that are affected by asset returns, the discount rates that reflect the characteristics of the cash flows shall reflect the extent to which the estimated cash flows are affected by the return from those assets. This would be the case regardless of whether:

1. The transfer of the expected returns of those assets are the result of the exercise of the insurer's discretion, or
2. The specified assets are not held by the insurer.

The boards also tentatively decided that when there is any change in expectations of cash flows used to measure the insurance contracts liability (i.e., any expected change in the crediting rate), an insurer should reset the locked-in discount rate that is used to present interest expense for those cash flows in the insurance contract that are not subject to mirroring and are affected by asset returns.

This would have the effect, it appears, of making OCI largely inapplicable for these contracts.

IASB-Only Meeting

Presentation Requirements

The IASB tentatively decided that:

- An entity should present all rights and obligations for all insurance contracts on a net basis in the statement of financial position.
- An entity should be required to present separate line items for insurance contracts and reinsurance contracts in the statement of financial position.
- The general requirements of IAS 1 Presentation of Financial Statements are sufficient to specify the presentation requirements for the statement of comprehensive income for insurance contracts.

Disclosure Requirements

- Disclosure Requirements for Participating Contracts

  The IASB tentatively decided that, for contracts with cash flows with a contractual link to underlying items (the only contracts for which the term participating is deemed applicable), an insurer should disclose:

  a. The carrying amounts of those insurance contracts; and

  b. If an insurer measures those contracts on a basis other than fair value, and discloses the fair value of those underlying items, the extent to which the difference between the fair value and the carrying value of the underlying assets would be passed to policyholders.

- Disclosure Requirements for the Presentation of Earned Premiums in the Statement of Comprehensive Income

  The IASB tentatively decided that, for all insurance contracts, an insurer should disclose a reconciliation from the opening to the closing balance of the aggregate carrying amount of insurance contract liabilities and insurance contract assets, showing separately:

  a. The remaining balance of liabilities for remaining coverage but excluding any amounts that are attributable to losses on initial recognition (for the premium allocation

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approach, this will be the unearned premium);

b. Liabilities for remaining coverage that are attributable to:

   i. Losses on initial recognition; and

   ii. Subsequent changes in estimates that are immediately recognized in profit or loss (for the premium allocation approach, this will be the additional liabilities for onerous contracts); and

c. Liabilities for incurred claims.

The IASB tentatively decided that, for contracts that are accounted for using the building block approach, an insurer should disaggregate insurance contract revenue into the inputs that are used to determine the measure of the revenue in the period.

For example an insurer should disclose:

a. The probability-weighted claims, benefits and expenses that are expected to be incurred in the period;

b. An allocation of expected acquisition costs;

c. The risk margin relating to that period's coverage; and

d. The residual margin allocated to that period.

The IASB tentatively decided that, for contracts that are accounted for using the building block approach, an insurer should disclose the effect of insurance contracts written in the period on the insurance contract liability, showing separately the effect on:

a. The expected present value of future cash outflows, showing separately the amount of acquisition costs;

b. The expected present value of future cash inflows;

c. The risk adjustment; and

d. The residual margin.

The IASB tentatively decided that an insurer should disclose a reconciliation from premium receipts to revenue.

- Disclosure Requirements for Transition

The IASB tentatively decided that, in the period in which the new insurance contracts standard is initially applied, disclosure of the current period and prior period line item amounts that would have been reported in accordance with previous accounting policies in IFRS 4 Insurance Contracts should not be required.

Proposed Plan for Fieldwork

The IASB considered a proposed plan for a third round of fieldwork with preparers. In addition, the IASB considered a proposed plan for fieldwork with users of financial statements. Specifically, the IASB discussed the following objectives for fieldwork that is undertaken as part of the re-exposure of the Insurance Contracts proposals:

a. To understand how the targeted proposals would be applied in practice;

b. To evaluate the costs and benefits of the targeted proposals; and

c. To assess how the proposed approach will help insurers to communicate with users of their financial statements.

The IASB staff reported that they intend to:

a. Invite the participants from previous rounds of field tests to participate and in addition to invite new participants, particularly from regions not previously represented;

b. Pursue collaboration with standard-setters and regional bodies in conducting fieldwork;

c. Develop the fieldwork questionnaire and other materials as the forthcoming Re-exposure Draft is finalized so that entities can conduct the fieldwork during the comment letter period; and

d. Present a preliminary analysis of the results at the same time as the comment letter analysis and the views received during the outreach activities. The results of the fieldwork, together with the views expressed in the comment letters, would then be taken into consideration when the IASB re-deliberates the proposals in the forthcoming Re-exposure Draft.

DECEMBER MEETINGS

The IASB met on Dec. 14, 2012 to continue its discussions of the proposed Insurance Contracts Standard.

The IASB discussed unlocking the residual margin, the residual margin for participating contracts, and impairment of reinsurance contracts. In addition, the IASB received an update on the FASB-only meetings held in November 2012.

Unlocking the Residual Margin

The IASB tentatively decided that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. This means it's not unlocked if the estimate of claim reserves changes.

The Residual Margin for Participating Contracts

The IASB tentatively decided that the residual margin for participating contracts should not be adjusted for changes in the value of the underlying items as measured using IFRS.

The IASB tentatively decided that the constraint on recognizing revenue that is proposed in the Revenue Recognition project should not be applied to the allocation of the residual margin for insurance contracts, for both participating and non-participating contracts.

Impairment of Reinsurance Contracts

The IASB tentatively decided that a cedant should account for the risk of non-performance that is associated with changes in expected credit losses as follows:

a. At inception of the contract, the cedant determines the residual margin by reflecting in the expected fulfillment cash flows all the expected effects of non-performance, including those associated with expected credit losses.

b. After inception of the contract, the cedant shall recognize in profit or loss changes in cash flows that result from changes in expected credit losses.

Accordingly, a cedant would not apply the proposals of the Impairment Project that are being developed by the IASB to reinsurance contracts.

Some of the decisions made this quarter are critical for insurance companies that issue life insurance in the United States. In addition, the requirements for disclosure are becoming ever more detailed and while the boards recognize that they are being criticized for the amount of disclosures they are requiring in general, it looks like the disclosures for most insurance companies will be many pages long, over 100 for the larger companies.

It's we actuaries who will bear the brunt of preparing most of this information. As currently proposed, the entire income statement will be made up of actuarial numbers with not a single one directly from cash transactions. It therefore is more important all the time that we remember …

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