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# New Year's Resolutions (Again)

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So it's another new year and maybe this year we'll have a final International Financial Reporting Standard (IFRS) on insurance from the International Accounting Standards Board (IASB). It seems to me that I've said this before. Fortunately, this year I think the IASB will make that one of their resolutions. So what are mine?

First, I resolve not to think poorly of the board. I will remember that just because they make decisions that I don't agree with, that doesn't make it their fault. Sometimes they just get bad advice.

I resolve to communicate more clearly with the board and staff. I dealt with that in my article in last quarter's *Financial Reporter*. Better communication might help avoid the decisions referred to above.

I resolve to try to better understand products issued in other countries; particularly their participating contracts. This is especially important since it seems that every solution that we develop to get the accounting right for U.S. contracts causes either the British or Scandinavians to object. I'm not blaming them; their contracts just seem to be very different from ours. Every time I think I understand those products, however, I find out differently. The great variety of participating contracts in the world has caused serious delays in finishing the insurance standard. In fact, the board spent the entire past quarter having education sessions on the problem of how to handle discounting on participating contracts in the income statement without actually reaching any decision. Hopefully, they will next quarter.

I must resolve to now start thinking seriously about implementation issues. One of the joys of being semi-retired is not having to worry too much about practicalities. If the board does produce a standard, however, I need to begin to do so. This will be most apparent in work going on at the International Actuarial Association (IAA) to develop International Standards of Practice and International Actuarial Notes (IANs). It's going to be a huge challenge to produce an actuarial standard when no one has actually tried to do accounting using the insurance IFRS. The IAA has plans to produce more than 20 IANs on various aspects of the IFRS. Keeping up with all of them isn't going to be easy.

Finally, I resolve to think seriously about finding a practical method for simplifying the transition to the new IFRS. The staff has made a number of suggestions, some of which are non-starters while others don't help very much. There has to be an easier way.

As I mentioned above, the board spent most of its time worrying about participating contracts. They also made some good decisions and some dubious ones on other issues.

## JULY IASB MEETINGS

The IASB met on July 22 to continue its discussions on insurance contracts. Before their decision-making session, the board held an education session on participating contracts. They discussed approaches for determining interest expense in P&L, the rate used to accrete interest and to calculate the present value of cash flows that offset the contractual service margin, and the restrictions on changes in accounting policy relating to the presentation of the effect of changes in discount rates. Of course, no decisions were made in the education session.

**IASB education session**

*OCI mechanics for participating contracts*

The staff plan to ask the IASB to consider whether an entity should be permitted or required to present the effects of changes in discount rates in other comprehensive income (OCI) for an insurance contract with participating features. After discussion, "the IASB directed the staff to consider an approach whereby:

a. the discount rate for the presentation of interest expense in profit or loss should be reset for all the cash flows in the contract whenever there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders (i.e., cash flows that vary with returns on underlying items). That approach would apply when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract. Resetting the discount rate for all cash flows would replace the proposal in the 2013 Exposure Draft Insurance Contracts (2013 ED) for the presentation of interest expense in profit or loss, which would require the entity to split the cash flows and apply applicable discount rates to those cash flows; and

b. the discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the effective interest method. This method would replace the 2013 proposal to lock in the yield curve.

The approach in (a) and (b) would be considered alongside the book yield approach. This approach could be applied to all contracts with participating features or, if there is a book yield approach, to contracts that do not meet the specified criteria to apply the book yield approach."[1]

The board's direction is a response to suggestions by the industry that the discount rate for presentation in profit and loss needs to follow the credited rate (or equivalent) in order to avoid earnings distortions. Despite this meeting, and the related meeting in September, however, the board has not settled this issue for participating contracts.

**IASB decision-making session**

*Rate used to accrete interest and calculate the present value of cash flows that is offset against the contractual service margin for non-par contracts*

"The IASB tentatively confirmed the proposal in the 2013 ED that, for contracts without participating features, an entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin."

This is the parallel issue to the board discussion on participating contracts as described above.

*Changes in accounting policy*

"The IASB tentatively decided that an entity should apply the requirements in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to changes in accounting policy relating to the presentation of the effect of changes in discount rates."

## SEPTEMBER IASB MEETINGS

Having taken August off as is their custom, the IASB met again in September. Before their formal decision-making session, the IASB held another education session to discuss participating contracts. In particular, they discussed how/whether to use OCI to absorb the effects of changes in discount rates. They reviewed the book yield and effective yield approaches that have been proposed by the industry and other parties. No decision was made at this meeting, of course.

**IASB decision-making session**

*Premium-allocation approach: revenue recognition pattern*

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Having listened to industry and actuarial objections to their previous decision that revenue had to be recognized on the basis of the passage of time, the IASB clarified that "when an entity applies the premium-allocation approach to account for an insurance contract, it should recognize insurance contract revenue in profit or loss:

> on the basis of the passage of time; but
>
> if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits."

This is particularly important for policies that don't have uniform claim patterns over time such as stop-loss coverages.

*Determination of interest expense in the premium-allocation approach (Agenda Paper 2F)*

Again responding to interested party complaint, "the IASB tentatively decided that when an entity applies the premium-allocation approach to contracts for which the entity:

- discounts the liability for incurred claims; and
- chooses to present the effect of changes in discount rates in OCI;

the interest expense in profit or loss for the liability for incurred claims should be determined using the discount rate that is locked in at the date the liability for incurred claims is recognized."

This decision is better than the previous requirement of using the rate from when the contract was issued but still doesn't deal with those liabilities where the actual claim or policy is unknown. The primary example of this is, of course, for the Incurred But Not Reported (IBNR) liability where neither is known by the very nature of the liability. The board is therefore likely to need to address this issue again.

The board hopes to complete their discussion of participating contract issues during the upcoming quarter. I hope by the time you read this they have. They then will take the early part of 2015 to deal with transition and probably presentation and disclosures. Perhaps the final standard will then come out before the end of the year.

Then comes the hard part; actually implementing the standard. This is when it will become all the clearer that

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

## ENDNOTES

[1] All quotes in this article, unless otherwise indicated, are from the IASB Update for the associated meeting.