IASB/FASB Insurance Contracts accounting update

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The International Accounting Standards Board (IASB) and U.S.-based Financial Accounting Standards Board (FASB) are working diligently to bring the insurance contracts project to a conclusion. Despite their efforts, deadlines continue to slip, with both boards indicating the next version of their respective exposure drafts will be released in the summer of 2013. Of course, just six months ago they were targeting a release by the end of 2012, so the summer 2013 deadline could easily slip as well. The differences in the views of the boards on some key issues continue to persist. Given this and the lack of movement by the SEC toward deciding what to do about adopting IFRS for domestic companies, it appears that each board will issue its own unique document.

JOINT INSURANCE CONTRACTS PROJECT STATUS

The IASB has decided that it will issue a limited exposure draft (ED) asking for input on only those items where it believes its current proposals are significantly different from what was contained in its 2010 exposure draft. FASB will likely be issuing a full exposure draft, as it has not issued any specific proposals to date, having only asked for feedback on the IASB ED proposals. The timetable for a FASB draft will likely be within a month or two of the IASB release.

The IASB has identified the topics on which it expects to ask for feedback:

- Measurement issues
  - Participating contracts
  - Remeasurement of residual margin
- Presentation issues
  - Presentation of premiums and claims
  - Use of other comprehensive income (OCI)
- Transition issues
  - Retrospective application of measurement model to in-force business

While the IASB's ED will ask for feedback on only a few topics, the ED will contain the full language of the proposed standard. The staff is already drafting language based on decisions by the board and has released some of it on its website.

At the same time it asks for comments on the ED, the IASB will be conducting what it calls "fieldwork." It plans to invite participants of previous rounds of field tests and others from regions not previously represented to participate in the field work. The IASB is looking to 1) understand how the targeted proposals would be applied in practice, 2) evaluate the costs and benefits of the targeted proposals, and 3) assess how the proposed approach will help insurers to communicate with users of their financial statements.

The IASB has further stated that it will make the effective date for the new standard at least three years after the final standard is adopted. Under its current schedule, it believes a final standard would be released in late 2014 with implementation likely in early 2018. The FASB has not indicated its preference for implementation date.

PARTICIPATING CONTRACT MEASUREMENT

The boards have developed two approaches to measuring the performance-linked components of insurance contracts. The first approach, mirroring, is to be used for contracts where there is a direct contractual link between the performance of the underlying assets and the liability cash flows. This would include products such as variable or unit-linked contracts. For these products, the measurement of the performance-linked feature will be set equal to, or mirror, the value of the underlying assets as those are measured on the IFRS or U.S. GAAP balance sheet. The normal unbundling requirements would apply to these contracts.

The second approach will be for contracts whose cash flows are affected by asset returns, but there is some discretion on the part of the insurer in transferring the expected return to the policyholder (such as with universal life insurance or "participating" contracts as issued in North America) or the assets are not actually held by the insurer (such as with certain indexed products). In both cases, the expected cash flows should reflect the insurer's best estimate of the return on those assets and the discount rate should reflect the extent to which the estimated cash flows are affected by the estimated return on those assets. In addition, when there is a change in expectations of cash flows used to measure the insurance contracts liability such as from a change in the crediting rate, the insurer should reset the locked-in discount rate used to present the interest expense for those cash flows. Contracts subject to this approach would include participating life insurance contracts issued by mutual companies, fixed annuities, and universal life insurance contracts.

Based on discussions with FASB and IASB staff, it appears that the boards' intent of this second approach is to bifurcate the cash flows

into those that are dependent on an asset return and those that are not, and to discount each set of cash flows at different discount rates. This seems to contradict their stated intention to measure insurance contracts as a single bundle of rights and obligations.

REMEASUREMENT OF RESIDUAL MARGIN

In a significant change relative to the 2010 ED, the IASB has decided that the residual margin should be unlocked for certain changes in estimates of future cash flows. The IASB views the residual margin as a measure of unearned profit the insurer expects to earn as a result of fulfilling the contract. As the estimate of future cash flows needed to fulfill the contract change, the anticipated future profitability of the contract would also change. The IASB recognizes this and has decided to require that the residual margin be unlocked so that the remaining balance of the margin represents the expected future profitability based on then-current estimates of future experience. The residual margin would be adjusted both for favorable and unfavorable changes in estimates of future cash flows. Thus, as long as the residual margin remained positive, profit and loss would be unaffected by any changes in expected future cash flows. The residual margin cannot become negative and there would be no limit on increases in the margin.

Changes in the risk adjustment would be reflected directly in profit and loss and would not affect the residual margin.

The IASB has yet to decide how, if at all, changes in the discount rate would be reflected in the remeasurement of the residual margin.

EARNED PREMIUM PRESENTATION MODEL FOR INSURANCE CONTRACTS

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 presentation approach is referred to as the earned premium approach. The earned premium approach is consistent with the decisions made in the boards' joint revenue recognition project.

While the FASB staff supported an alternative presentation, the premiums due approach, consistency with other industries was a key consideration for IASB staff in recommending the earned premium approach. Both IASB and FASB board members ended up voting in favor of the earned premium approach.

USE OF OTHER COMPREHENSIVE INCOME

The boards have tentatively decided that for presentation purposes, the effect of changes in the discount rate should be separately shown in other comprehensive income. As a result, insurers will need to maintain two calculations of the insurance contract liability, one based on the locked-in discount rate and one based on the current discount rate as of the valuation date. The profit and loss account or "regular" income would include the interest expense based on the locked-in discount rate determined as of initial measurement. The difference in liability arising from changes in the discount rate would be reflected in OCI. This will have the effect of limiting the volatility of profit and loss due to changes in the discount rate on the liability.

TRANSITION

The boards have tentatively decided that at transition, the new measurement model should be retrospectively applied to all in-force business as if it had always been in place. That would require insurers to determine the amount of residual (or single) margin that would have been calculated at inception of every contract and determine the portion of that margin that would be unamortized as of the transition date.

The new method is to be applied retrospectively as far back as is practical. If it is impractical to go back further, the insurer is supposed to estimate the margin based on objective evidence. In the absence of objective evidence, the insurer measures the initial margin in reference to any explicit margin included in the carrying value before transition. In other words, if there was an explicit margin in the reserves prior to transition, it would be the starting point. If there was no margin, then none would be included at transition.

One of the implications of these requirements is that if an insurer has any significant amount of in-force business for which it cannot develop objective evidence and there was no explicit margin included in the carrying value prior to transition, then there would be no margin and no expected future earnings on that business. Any future profits that would have been expected would be reflected in capital at the moment of transition.

Another important practical issue is the determination of the discount rate that would have been locked in at inception of the in-force contracts for determining the amount of current period income that would be reflected in profit and loss versus OCI. The boards have provided guidance on how to determine a discount rate for those periods for which it would be impractical to determine the discount rate that would reflect the characteristics of the liability. The process they outlined is as follows:

> Calculate the discount rate in accordance with the standard for a minimum of three years. If possible, determine an observable rate that approximates the calculated rates. Use the observable reference point to determine the rate (plus or minus a spread determined from the discount rate for the first three years and the credited rates) to be applied to the contracts issued beyond three years in the retrospective period. Recognize in other comprehensive income the cumulative effect of the difference between that rate and the discount rate determined at the transition date.

The IASB will allow insurers to designate eligible financial assets under the fair value option where new accounting mismatches are created by the application of the proposed new Insurance Contract Standard and to permit the election of the use of OCI for presentation of changes in fair value of some or all equity instruments that are not held for trading.

SEC REPORT ON ADOPTION OF IFRS

In July 2012, the U.S. Securities and Exchange Commission (SEC) released the final staff report, "Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers." [i] Despite widespread anticipation that the report would signal a direction in the SEC's

thinking on adopting or integrating IFRS into U.S. GAAP, the report does not include a recommendation from the staff as to whether the SEC should bring IFRS into the U.S. GAAP framework. With the departure of the SEC's chief accountant earlier this year and the announced departure of the chairperson of the SEC, no decision is likely to be made in the next year and possibly for several years. Predictably, the IASB reacted quite negatively to the lack of action on the SEC's part and likely contributed to the end of collaboration between the IASB and the U.S. FASB. The IASB published its own analysis of the SEC staff report. [ii]

CONCLUSION

The boards are continuing to move forward on insurance accounting, but have not converged their thinking. This, coupled with the SEC's lack of a decision on whether to adopt IFRS for domestic companies, will result in each board producing its own accounting proposal and in differences in the accounting for insurance contracts under U.S. GAAP and IFRS.

[i] The staff report is available at: http://www.sec.gov/news/press/2012/2012-135.htm

[ii] The IASB analysis is available at: http://www.ifrs.org/Alerts/PressRelease/Pages/IFRS-Foundation-Staff-Analysis-of-SEC-Final-Staff-Report-on-IFRS.aspx

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