Bruce Pounder, CMA, CFM, Editor

# Accounting for Insurance Contracts

**The joint FASB/IASB project on accounting for insurance contracts could impact reporting entities of all kinds.**

For the past three years, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working together to improve and converge the insurance-accounting provisions of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). In this month's column, I'll summarize the Boards' current views on the issues they're addressing. I'll also explain how the impact of the Boards' decisions could extend well beyond traditional insurance companies to all kinds of reporting entities.

## Background

U.S. GAAP currently contains specific guidance on accounting for insurance contracts (such as life insurance policies) from the insurer's perspective. The guidance is located in Topic 944, *Financial Services—Insurance*, of the FASB *Accounting Standards Codification®* (ASC). The existing provisions of ASC Topic 944 apply only to "insurance entities" as specified in ASC Section 944-10-15. In general, ASC Topic 944 requires insurance entities to employ one of several accounting models to each insurance contract issued depending on the nature and duration of the contract.

Under IFRS, guidance on accounting for insurance contracts from the insurer's perspective is currently found in IFRS 4, *Insurance Contracts*. At the time it was issued in 2004, IFRS 4 didn't do much more than formally document the variety of ways insurers then accounted for insurance contracts. But the IASB had already begun planning improvements to the standard, and the Board's improvement efforts led it to issue the Discussion Paper (DP) *Preliminary Views on Insurance Contracts* in May 2007. The DP focused on a comprehensive accounting model in which an insurer's assets and liabilities would better reflect the rights and obligations arising from its insurance activities.

The IASB's efforts to improve IFRS 4 attracted the FASB's attention. In August 2007, the FASB issued an Invitation to Comment (ITC) titled *An FASB Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*, which incorporated the IASB's DP. Based on stakeholders' comments submitted in response to the ITC, the FASB decided in October 2008 to add an insurance contracts project to its agenda and to conduct the project jointly with the IASB.

On July 30, 2010, the IASB issued an ED of its proposed replacement for IFRS 4 (editorial corrections were issued on August 2, 2010). Then on September 17, 2010, the FASB issued the DP *Preliminary Views on Insurance Contracts*, which included a comparison of the IASB's ED, the FASB's own preliminary views, and current U.S. GAAP. After the comment period for the IASB's ED ended on November 30, 2010, the Boards conducted additional outreach to their stakeholders through public roundtable meetings and e-mail inquiries.

## Current Views

The Boards' goal for their joint project is to develop a common, high-quality accounting standard that addresses recognition, measurement, presentation, and disclosure requirements for insurance contracts. There are three significant implications of the Boards' chosen goal:

1. The scope of the new standard will be based on the characteristics of the contract between the reporting entity and anoth-

er party, not on the characteristics of the reporting entity.
2. Other current or proposed standards, such as standards on revenue recognition or financial instruments, won't apply to insurance contracts.
3. The new standard will apply only to accounting for insurance contracts, not for assets that may back such contracts.

As a result of their joint efforts so far, the FASB and the IASB have tentatively defined an *insurance contract* as a contract under which one party (the insurer) accepts significant *insurance risk* from another party (the policyholder). This means that the insurer agrees to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. The Boards have also clarified that insurance risk doesn't include *financial risk*, which is the risk of a possible future change in certain kinds of variables, such as:

- Specified interest rates,
- Financial instrument prices,
- Commodity prices,
- Foreign exchange rates,
- Indexes of prices or rates, and/or
- Credit ratings or credit indexes.

Furthermore, the Boards have decided that the new insurance-contracts standard will reflect the perspective of the insurer only, not the perspective of the policyholder.

The accounting model currently contemplated by the Boards regards an insurance contract as creating a bundle of rights and obligations that work together to generate a "package" of cash inflows and outflows. Insurers would recognize assets and liabilities for expected future cash inflows and outflows, respectively, when the expected future cash flows arise from entering into and fulfilling insurance contracts. Additionally, insurers would measure such assets and liabilities on a portfolio basis, taking the time value of money into consideration. Insurers would also update those measurements periodically.

One issue on which the Boards haven't yet reached agreement is the applicability of the new insurance-contracts standard to *financial guarantee contracts*. As defined in IFRS, a financial guarantee contract is a "contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument." One example of a financial guarantee contract is a credit default swap, a type of financial instrument that remains widely used despite being linked to the global collapse of credit markets in 2008. The standard proposed in the IASB's ED would permit the issuer of a financial guarantee contract to account for the contract as an insurance contract or as a financial instrument, with different accounting standards applying depending on the issuer's choice. In contrast, the FASB hasn't yet decided whether financial guarantee contracts should be included in the scope of the new guidance.

Another key issue that the Boards haven't yet resolved is whether *self-insurance arrangements*, such as when an employer self-insures its employees' medical benefits, should be included in the scope of new guidance for insurance contracts. As proposed in the IASB's ED, the new standard wouldn't apply to employers' assets and liabilities under employee benefit plans, but the FASB is less certain that such arrangements should be out of scope.

### A Look Ahead

Based on feedback received from stakeholders on the IASB's ED and FASB's DP, the Boards are now redeliberating several significant scope, recognition, and measurement issues. But even now there are two reasons for accounting professionals to monitor this project. First, because the new standard will apply to a particular kind of contract rather than to a particular class of entities considered to be insurance companies, all reporting entities, not just insurance companies, could fall within the scope of the new standard. Second, financial guarantee contracts and self-insurance arrangements may fall within the scope of the new standard, so the many different kinds of reporting entities that are party to such contracts could be directly affected.

Although the FASB/IASB project on insurance contracts is a joint project, it isn't part of the Boards' 2006 Memorandum of Understanding, which acknowledged their commitment to developing high-quality accounting standards and to converging U.S. GAAP and IFRS at the standard level. Nevertheless, it's still a very high priority for both Boards, which continue to invest a substantial amount of effort into the project. The next

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significant developments are likely to occur in the first half of 2012 when the FASB is expected to issue an ED of a proposed Accounting Standards Update and the IASB is expected to issue a revised ED of a proposed IFRS. **SF**

*Bruce Pounder, CMA, CFM, Dip-IFR (ACCA), is vice president, Accounting Programs, for SmartPros Ltd. He is also the immediate past chair of the IMA® Small Business Financial and Regulatory Affairs Committee. You can reach him at*