

# [Fasb takes up insurance accounting flashcard](https://assignbuster.com/fasb-takes-up-insurance-accounting-flashcard/)

Financial Accounting Standards Board is a seven member independent board that comprises professionals charged with establishing and communicating financial accounting and reporting standards in the US. These standards, commonly known as Generally Accepted Accounting Principles, govern the preparation of financial reports from corporate bodies. They are viewed as authoritative by the Securities and Exchange Commission. Every efficient market needs accounting standards because information has to be transparent, credible and understandable.

This board aims at improving corporate accounting practices by enhancing guidelines that are set out for accounting reports, identifying issues and resolving them on time and also create standards that are uniform across the financial market. This paper will discuss the role of FASB in Insurance Accounting (Nikolai, Bazley, & Jones, 2009). Currently, insurers use a number of different and largely inconsistent local approaches in measuring the value of insurance contracts that fall within their statutory financial statements. It is there felt that this diversity makes it very hard for comparisons to be made between companies and also fails to truly reflect the economic value of insurance business, putting insurers at a big disadvantage when it comes to capital competition.

This is the reason why Financial Accounting Standards Board decided to work alongside the International Accounting Standards Board (IASB) to come up with a harmonized IFRS (international financial reporting standards) for insurance contracts. They jointly worked together an effort that saw FASB release a Discussion Paper (DP) on the accounting of insurance contracts where as the IASB issued its Exposure Draft (ED) on the same last July. The DP is a summary of the key aspects carried in the ED and compares its proposals to the alternative preliminary views. For example the IASB on its part proposes a model for measurement that is based on a two-margin approach, the risk adjustment and the residual margin, where as the FASB proposes a measurement model that is based on a composite margin approach (Carlino, 2010).

If the Exposure Draft is adopted, it will replace the International Financial Reporting Standard No. 4, which is the interim standard. This will bring about a single recognition and measurement standard that is consistent for international insurance contracts. Initially, contracts that are similar to insurance contracts were not subjected to the same accounting procedures if they are not issued to an insurer. This is among the things that FASB embarked on clarifying when it joined the IASB’s project. It embarked on coming up with a standard that makes sure that contracts having similar or identical economic characteristics are accounted for in a similar way regardless of where they are issued from. That’s why they first set out to define what an insurance contract is. According to their definition, an insurance contract is “ a contract in which one party, the insurer, accepts significant insurance risk from another party, the policy holder, by agreeing to compensate the policy holder if a specified uncertain event in the future affects adversely the policy holder.”

This definition therefore meant that a contract is only an insurance contract if it transfers significant risk. Insurance risk in this case refers to the risk other than financial risk that is transferred from a contract holder to the contract issuer. It is significant if and only if an insured occurrence could cause an insurer to pay additional benefits that are significant in any event, excluding those events that lack commercial substance. It also meant that an insurance contract can not transfer insurance risk if there is no event in which the prevailing value of net cash outflows exceeds the prevailing cash inflows. By doing this, the FASB eliminated the idea that only contracts issued by an insurance company should go through the insurance contracts accounting in ASC 944 (Carlino, 2010).

The scope of the DP issued by the IASB included contracts that meet the definition of insurance issued by an insurer and reinsurance contracts held by an insurer. It had proposals to exclude from its scope warranties of products issued by a manufacturer, retailer or dealer, assets and liabilities belonging to an employer that are under employee benefit plans, rights and obligations of contract contingent on the future use or right to use a non financial item, guarantees of residual value in a lease or given by a manufacturer, retailer or dealer, contracts of fixed fee service unless they are issued by an insurer, and many other issues. A notable difference between these two boards is that FASB chose to exclude from the insurance contract standard, financial instruments containing discretionary participation features. These features provide the contracts issuer flexibility on the timing and amount of supplement benefits on top of the guaranteed benefits.

From the out set, the accounting models for the two models were different; they had two main differences, an approach to initial measurement and the way to reflect uncertainty in the new accounting model. After meeting and discussing, the two boards agreed that measurement will be on the same basis for the two models, FASB also agreed to look at the IASB approach to cater for the uncertainty so that it could the US GAAP (Reback 2009). It is a requirement that acquisition costs that are incurred while securing insurance contract must be dealt with in the initial measurement. FASB and IASB had agreed to prohibit the capitalization of these costs as an asset. FASB continued to hold on its arguments for calibrating against the gross consideration that is received from the policy holder on the initial measurement of insurance contracts.

This approach was picked by FASB to go hand in hand with the initial measurements principles that will apply to all customer contracts when the general project to come up with an accounting standard that is common for revenue recognition is completed. What FASB meant here in reality was that there should be no difference between accounting treatment given to a company selling insurance contracts and one selling any other type of goods or services. With this argument, FASB managed to convince many IASB members to modify their tentative decision held previously, to calibrate the liability of the insurance contract against the customer consideration net of incremental costs of acquisition. Together with the IASB, the FASB managed to put in place mechanisms that will make sure that acquisition costs are expensed as they are incurred.

This results in both models producing an accounting loss on the first day as a result of the calibration of the insurance contract versus the gross premium. It also required that all acquisition costs should be recognized in full as an expense. In it explanation, FASB said that it could not see any major treason to concede a treatment that is special for the insurance contracts revenue accounting approach. This board felt that giving a special treatment to insurance contractors would create an industry based revenue accounting, which many see as one of the most negative features of the US GAAP. FASB was therefore making sure that it is completely eliminated (Reback, 2009). FASB also approved under the revenue recognition principles, that the payment of commission or any form of acquisition cost to any involved party, would not stand for the meeting of an obligation towards a policy holder and therefore no revenue would be accounted for. Using the principle, FASB went further to elaborate the option of considering asset recognition for acquisition disbursement.

All these are just but proposals that the FASB and the IASB have come up with to try and stream line insurance accounting. Proposals from both boards will require insurance contracts to be accounted for by use of a current model for measurement that reflects the present value for the expected cash flows so as to fulfill their obligation, whereby estimates will have to be re-measured at every reporting period. Experts however, contend that these proposals would likely bring about increased volatility and also additional demands on data and also on modeling systems. That is why found it wise to issue a discussion paper to give stakeholders a chance to provide their input on the issue. The issues that were supposed to be discussed on included: whether the proposal by IASB would be a sufficient improvement to the US GAAP to justify the cost of change; whether the goals of improvement for the project, convergence, and also simplification would be achieved more effectively by making targeted improvements to the existing US GAAP, instead of issuing comprehensive new guidelines altogether; and also look at certain accounting issues that are critical for which the preliminary views given by the FASB differ from those in the IASB’s Exposure Draft (Dollho pf ; Foroughi, 2010).

The board saw that it was important to collect as much information as it could at this particular stage of the project so that it can help it decide on the best way to better the financial reporting for the insurance contracts. The information will help a lot both Boards in their deliberations. In addition to these, FASB has planed to have a series of roundtable public meetings later on in December this year to here the views of stakeholders. These efforts are just a testimony to what FASB is doing; it has established a work plan that is very aggressive for themselves and their constituents. If FASB is able to meet its schedule, its constituents will have as many as twelve significant due-processes documents given in the first half of the year. The Board planed to follow this with an even greater number of final documents as from July 2010 through June 2011 after which implementation issued will have to be considered by the constituents.

FASB indicated that it will treat the effective date of their MoU with IASB as a package but not on an individual standard basis in order to facilitate a transition that is smooth without considering whether it represents a move to IFRS as some issuers might see it, or a continuation of the common US GAAP reporting (Dollho pf ; Foroughi, 2010). The many flaws that exist in the standards of insurance accounting have seen stakeholders raise concerns that need to be addressed. This was one of the reasons why FASB and IASB engaged in a joint project to try and come up with new and universal standards for insurance accounting.

The two boards therefore came up with different proposals on how will insurance accounting can best be handled. The current proposals made by IASB and FASB for the measurement of liabilities for insurance contracts will to a large extent, overhaul the existing standards and bring about many significant changes. For the first time these changes will provide a global standard for insurance accounting which in part, will reflect characteristics of economic and risk based measurements. However, these proposals as they are in their present form, raise very serious concerns which require further considerations just to make sure that the resulting financial statements are relevant to their users. This is why discussions are still ongoing on this issue.