



## **Board Meeting Handout**

### **Risk Transfer in Insurance and Reinsurance Contracts**

**September 14, 2005**

#### **Purpose of Meeting**

The purpose of this meeting is for the Board to consider definitions of insurance contracts, insurance risk, and related terms based on definitions and supplemental guidance provided in IFRS 4, *Insurance Contracts*.

#### **Background**

The first step in the FASB's risk transfer project is to develop definitions of insurance related terms in order to establish a framework to build on in clarifying current risk transfer guidance. The Board agreed that the staff should initially look to IFRS 4 as a starting point for those definitions. IFRS 4 is the result of the IASB's insurance contracts phase I project and includes the definitions and supplemental guidance on accounting for insurance contracts. The purpose of basing the U.S. definitions on IFRS 4 is twofold—first, to supply definitions that are substantially lacking in U.S. GAAP and second, to provide an opportunity for an early, limited convergence effort related to the IASB's insurance contracts project.

Subsequent steps in the project include: (1) analyzing possible bifurcation of insurance contracts into risk and nonrisk components, (2) extending FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, reinsurance risk transfer guidance to insurance contracts, (3) making editorial (yet not necessarily insignificant) changes to Statement 113, and (4) exploring expanded disclosures. An Exposure Draft for risk transfer is planned for late first quarter 2006 and a final standard for third quarter 2006.

#### **The IASB's Insurance Contracts Project**

Although the IASB's phase II project will address basic accounting for insurance contracts (phase I essentially grandfathered existing national GAAP for insurance

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contract accounting), the current opportunity for limited convergence on the definitions is based on the FASB staff's understanding that the IASB does not currently intend to revisit those definitions in depth in phase II. The definitions in IFRS 4 have been under development since the IASB's predecessor, the International Accounting Standards Committee, appointed a Steering Committee on Insurance in 1997 to study accounting for insurance contracts. The definitions have been exposed for public comment twice—first in the Steering Committee's Issues Paper, *Insurance*, and second in the IASB Exposure Draft that resulted in IFRS 4. The FASB continues to monitor the IASB insurance contracts project on a modified joint project approach that likely will result in a full joint project when the IASB completes its initial discussion document.

### **The Definitions**

The definitions and related supplemental guidance in Appendixes A and B of IFRS 4 provide guidance for distinguishing between insurance and noninsurance risk as well as for determining if an insurance contract transfers significant insurance risk. In contrast, U.S. GAAP has little in the way of relevant definitions and bases its notion of risk transfer (at least for reinsurance) on conditions specified in Statement 113.

The IASB's insurance contract project applies to all insurance and reinsurance contracts irrespective of the issuer's industry. Because current insurance contract accounting under U.S. GAAP is limited to insurance enterprises, the FASB's definitions would apply only to contracts written by insurance enterprises (that is, those enterprises within the scope of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*). The definitions contemplated in this project are not intended to change current practice, as the staff believes that those definitions are consistent with existing guidance for insurance contracts. The definitions are intended to clarify the boundary between insurance contracts and other financial arrangements (such as deposits, loans, and derivatives) and, therefore, certain contracts that had been accounted for as insurance based on prior judgment may no longer qualify as insurance.

The proposed working definitions include the following definition of an insurance contract from Appendix A of IFRS 4:

A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder. [Bold terms are defined terms.]

## Issues

The staff believes that the following issues need to be considered when drafting the definitions:

1. *Definition of an insurance contract*—Should the IFRS 4 definitions include the terms and/or concepts of (a) legality or enforceability, (b) payment of consideration, (c) distribution of risk, (d) insurable interest, and (e) risk transfer?

With respect to (d) above, note that the definition of policyholder in Appendix A of IFRS 4 effectively includes other beneficiaries: “A party that has the right to compensation under an **insurance contract** if an **insured event** occurs.” This mitigates the requirement for an adverse effect on the policyholder when death benefits are paid to unrelated beneficiaries or even third-party investors.

2. *Distinction between insurance and noninsurance risk*—Certain insurance contracts may include components that do not transfer risk, for which the Board may decide that bifurcation is appropriate.
3. *Distinction between insurance and derivatives*—Current U.S. GAAP includes the notions of protection and transfer of risk as primary purposes of insurance (that is, indemnification of losses incurred by a policyholder). Although derivatives may accomplish a similar result, a significant distinction is that there is no contractual requirement that the holder of a derivative contract incur a loss to receive a benefit.
4. *Types of risk*—While Statement 113 requires both underwriting and timing risk for a contract to qualify as reinsurance, IFRS 4 requires only timing risk. Some contracts currently accounted for as insurance in the United States already include only timing risk, such as certain single premium life insurance contracts. Also, although most catastrophe reinsurance includes both underwriting and timing risk, certain high-layer contracts may not technically meet the requirement in paragraph 9(b) of Statement 113 that it be “...reasonably possible that the reinsurer may realize a significant loss from the transaction.”

## Staff Recommendation

The staff recommends adopting the draft working definitions of insurance terms and related supplemental guidance included as a starting point for the Board’s risk transfer project. The staff will continue to review these working definitions as it proceeds with the remaining phases of this project as noted above.

The staff believes that the draft working definitions and supplemental guidance establish an appropriate starting point for the Board's consideration of risk transfer because they:

1. Provide a structure and guidance for determining which contracts should be accounted for as insurance, including notions of protection and risk transfer (indemnification), commercial substance, and unbundling (bifurcation).
2. Provide the opportunity to properly include certain contracts as insurance even though they currently may not meet the technical requirements of Statement 113 for significant risk transfer, for example, the single premium life insurance and high-layer catastrophe reinsurance contracts that may not meet the requirements of Statement 113, but in the staff's view are correctly accounted for as insurance contracts.
3. Would apply to insurance as well as reinsurance contracts.
4. Provide the opportunity to begin limited convergence with the IASB's insurance contracts project.

#### **Questions for the Board**

1. Does the Board agree with the approach used in developing the working definitions and supplementary guidance?
2. Does the Board agree that the IFRS 4 definition of an insurance contract can be used without explicitly including the following notions: (a) insurance contracts should be legal or enforceable, (b) payment of consideration should be required, and (c) the definitions should include a requirement that insurance include distribution of risk? Should the definition include the notions of insurable interest (adverse effect on the policyholder) and risk transfer?
3. Does the Board agree that the supplemental guidance included in IFRS 4 should be carried forward to the extent possible, with the only exception being the guidance that is inconsistent with current U.S. GAAP? If not, what should be omitted?
4. Should the definitions accommodate contracts currently considered insurance in the United States that technically may be excluded from current U.S. GAAP, such as certain life insurance contracts (timing only) and certain catastrophe contracts (expected loss can be very small in any given year)? Does the broad definition of policyholder (including beneficiary) need clarification?



**Board Meeting Handout**  
**FAIR VALUE MEASUREMENT PROJECT**  
**September 14, 2005**

The Board will discuss issues relating to a final FASB Statement, *Fair Value Measurements* (FVM Statement).

**1. RESTRICTED SECURITIES**

The Board will discuss the following with respect to restricted securities:

- a. Whether to revise the definition of restricted securities in the FVM ED to explicitly encompass securities with restrictions that both limit and prohibit sale
- b. Whether to remove the definition of restricted stock in footnote 2 of paragraph 3(a) of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which states:

*Restricted stock*, for purposes of this Statement, means equity securities for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except if that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year, such as may be the case under Rule 144 or similar rules of the SEC, is not considered restricted.

- c. Whether to retain the related implementation guidance carried forward from SEC ASR No. 113, *Statement Regarding "Restricted Securities"*

## **2. DISCLOSURES**

The Board will discuss the following with respect to fair value disclosures:

- a. Whether to re-designate the disclosure levels, segregating estimates based on quoted prices in active markets for identical assets or liabilities (Level 1), other market inputs, whether directly observable or otherwise derived (Levels 2-4), and entity inputs (Level 5) and, if so, whether to limit disclosure of unrealized gains or losses to those that relate to estimates within Level 5
- b. Alternatively, whether to require disclosure of Level 4 estimates and related unrealized gains or losses separate from Level 5 estimates and related unrealized gains or losses

## **3. TIMING**

The Board will discuss the timing of a final FVM Statement, considering the following:

- a. Whether to re-expose the FVM ED, with issuance of a final Statement in the 1<sup>st</sup> half of 2006
- b. Alternatively, whether to post the staff draft of the final FVM Statement (the standards section and the basis for conclusions) to the FASB website for a limited period (to coincide with the comment period for the FSP relating to EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities,"), with issuance of a final Statement in the 4<sup>th</sup> quarter 2005, subject to external reviewer (and other) comments.

## **4. EFFECTIVE DATE**

The Board will discuss the effective date of a final FVM Statement, in particular:

- a. Whether to require that the FVM Statement be effective for financial statements issued for fiscal years beginning after June 15, 2006 with earlier application encouraged
- b. Whether to indefinitely defer the provisions of the FVM Statement relating to credit standing and liability remeasurements, pending further Board action, with application encouraged but not required during that indefinite deferral.

## 5. TRANSITION

The Board will discuss transition of a final FVM Statement:

- a. *Changes in methods.* The substantive guidance in the FVM Statement focuses broadly on the methods used to estimate fair value. A change in the method of applying an accounting principle is considered a change in accounting principle. However, because the methods are referred to generally and likely would be subjectively determined, the effect of that change in accounting principle would be inseparable from the effect of the change in estimate. That type of change is considered a change in estimate. Therefore, the Board will discuss a prospective transition approach, with certain exceptions (as in the FVM ED).
- b. *Blocks.* In its redeliberations, the Board decided to specify the method that should be used by broker-dealers and certain investment companies to estimate the fair value of a block (PxQ). Because that method is specified and is objectively determinable, the effect of that change in accounting principle will be separable from the effect of the change in estimate. Therefore, the Board will discuss a retrospective transition approach, specifically, whether to require a full retrospective transition approach or a limited retrospective transition approach.



**Board Meeting Handout**  
**ISSUES RELATING TO EITF ISSUE 02-3**  
**September 14, 2005**

The Board will discuss issues relating to proposed FASB Staff Position, "Measuring Fair Value of Certain Derivative Contracts under Statement 133" relating to EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" ("Issue 02-3 FSP").

**1. EFFECTIVE DATE**

The Board will discuss whether the proposed FSP should be effective for financial statements issued for fiscal years beginning after June 15, 2006. Earlier application of the proposed FSP would be encouraged, but only if the enterprise applies the Fair Value Measurements Statement concurrently.

**2. TRANSITION**

The Board will discuss transition provisions of a final Issue 02-3 FSP.

- a. Specifically, the Board will discuss whether initial application of a final FSP is a change in accounting principle (method) or a change in accounting estimate.
- b. If the initial application of a final Issue 02-3 FSP is a change in accounting principle (method), the Board will discuss whether that change in method is separable from a change in estimate (requiring retrospective application) or, alternatively, inseparable from a change in accounting estimate (requiring prospective application).
- c. If the initial application of a final Issue 02-3 FSP is a change in method separable from a change in estimate, the Board will discuss whether, when applying the Fair Value Measurement Statement concurrently, the change should be reflected prospectively.

### **3. DISCLOSURE**

Issues related to disclosure will be discussed in conjunction with the discussion of the Fair Value Measurement Statement.

### **4. ISSUE 02-3 FSP VERSUS DIG ISSUE B6**

The Board will discuss an inconsistency which would result from the guidance in the Issue 02-3 FSP and Statement 133 Implementation Issue B6. Specifically, dealer profit on an Issue 02-3 derivative would be recognized differently if it is embedded into a non-derivative host than if it is issued as a freestanding instrument. To address this issue, the Board will consider:

- a. Whether to amend DIG Issue B6 to require that each component of the hybrid instrument be recorded at fair value, with the difference between the transaction price and the sum of the component fair values (representing dealer profit) separately recognized as specified under the Issue 02-3 FSP (i.e., as either a deferred credit (debit) or as revenue, depending on where within the hierarchy the fair value estimate falls). This revised method would only be applied when the market in which the transaction occurs is not the reference market for the hybrid instrument (or its components).
- b. Alternatively, whether to revise the Issue 02-3 FSP to include anti-abuse language, clarifying that embedding an Issue 02-3 derivative in a nonsubstantive host for the purposes of circumventing the guidance in the Issue 02-3 FSP is not appropriate.

### **5. INTERACTION OF ISSUE 02-3 FSP AND THE HYBRID INSTRUMENTS EXPOSURE DRAFT**

The Board will discuss the interaction between the Issue 02-3 FSP and the Hybrid Instruments Exposure Draft (which would allow entities to record hybrid instruments at fair value). Concerns have been raised regarding when to recognize dealer profit when a Level 5 Issue 02-3 derivative is embedded into a Level 3 non-derivative host. The Board will consider whether to revise the Issue 02-3 FSP to clarify how to apply the guidance in the FVM Statement for determining where within the hierarchy the estimate of fair value falls (principal value driver).

### **6. AUTHORIZATION TO PROCEED TO PREBALLOT**

The staff will seek authorization to proceed to a preballot draft of the proposed Issue 02-3 FSP. The staff will propose a comment period of 30 days.



**Board Meeting Handout**  
**Other-Than-Temporary Impairment**  
**Board Meeting**  
**September 14, 2005**

**Purpose of Meeting**

The purpose of this meeting is for the Board to consider whether to provide transition guidance in FASB Staff Position (FSP) FAS 115-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” and, if so, what type of transition should be permitted. The transition guidance would relate to the accounting for debt securities subsequent to an other-than-temporary impairment.

**Background**

At the September 7, 2005 Board Meeting, the staff recommended that the Board provide transition guidance for the accounting for debt securities subsequent to an other-than-temporary impairment. The staff cited that there may be instances where constituents would be applying the Day 2 income accretion guidance in the proposed FSP for the first time, thereby warranting transition guidance.

Some Board members noted that constituents may interpret this FSP as eliminating the ability to place securities on nonaccrual once the proposed FSP becomes effective. Those Board members further asserted that the perceived elimination of the nonaccrual approach would not be consistent with other existing GAAP and that not accreting income may be warranted under certain circumstances. The staff indicated its expectation that while the proposed FSP would not eliminate the use of a nonaccrual approach, the use of that approach should be rare. The Board directed the staff to research the issue further before deciding on the issue.

The Board deliberated several alternatives, including adding a footnote that would acknowledge that the FSP is not intended to prevent the designation of certain securities as nonaccrual. Questions were raised as to whether this would result in the need for

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guidance addressing when it is appropriate to designate an investment as nonaccrual. The Board indicated that it did not want to address the issue at this time as part of this project.

### **Alternatives**

The staff has identified two alternatives:

1. View A—Retain the paragraph pertaining to the accounting for debt securities subsequent to an other-than-temporary impairment of the proposed FSP with transition guidance, but without any mention of nonaccrual.
2. View B—Remove the paragraph pertaining to the accounting for debt securities subsequent to an other-than-temporary impairment of the proposed FSP and do not include transition guidance.

### **Staff Recommendation**

The staff recommends View A and that transition be prospective application with no grandfathering permitted.

### **Questions for the Board**

Does the Board agree with the staff's recommendation (View A) and, if so, that the transition should be prospective application with no grandfathering permitted?



## **Board Meeting Handout**

### **Proposed FASB Staff Position FAS 123(R)-b, “Practical Exception to the Application of Grant Date as Defined in Statement 123(R)”**

**September 14, 2005**

#### **OBJECTIVE**

The purpose of this Board meeting is for the Board to decide whether to add a project to its technical agenda addressing the application of grant date as defined in FASB Statement No. 123 (revised 2004), *Share-Based Payment*.

#### **BACKGROUND**

The staff has received numerous inquiries relating to the definition of grant date in Statement 123(R). Of particular concern is the meaning of the phrase: “The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award.”

Though the notion of “mutual understanding” was included in the definition of grant date in Statement 123, most constituents have assumed that the grant date is the date an award is approved in accordance with their corporate governance provisions, so long as the approved grant is communicated to employees within a reasonable period of time from the date of approval.

The reasonable period of time interpretation appears to have been created as a practical matter. Preparers often like to communicate the granting of employee awards personally with each of their employees. For many preparers, the size and span of employees receiving options limit their ability to communicate with each of their employees immediately after the awards have been approved by the Board. For example, companies with thousands of employees that span multiple foreign jurisdictions may take as long as a few weeks to communicate individual grants to each of their employees.

#### **PRACTICAL EXCEPTION RELATED TO MUTUAL UNDERSTANDING**

The Board will consider whether to expose for public comment a proposed FSP to provide a practical exception related to the application of the concept of mutual understanding.

If the Board wishes to provide a practical exception, the staff recommends that such guidance allow an entity to determine the value of share-based payment awards (using relevant valuation inputs) on the relevant approval date provided (a) the terms of the award are not changed prior to the date the key terms of the award are communicated to the grantee, (b) the employee does not have the ability to change the key terms and

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conditions of the award, and (c) the terms of the award are communicated within a reasonable period of time from the date of Board approval.

Does the Board wish to provide a practical exception related to the concept of mutual understanding and, if so, does the Board agree with the staff recommendation related to the scope of that exception?

### **TRANSITION**

The staff recommends that any practical exception be applied upon the initial adoption of Statement 123(R). An entity that adopted Statement 123(R) prior to the issuance of this FSP shall apply the guidance in this FSP in the first reporting period beginning after the date the FSP is posted to the FASB website.

Does the Board agree with the staff recommendation?

### **COMMENT PERIOD**

The staff recommends that a proposed FSP to provide a practical exception be exposed for a 15-day public comment period.