



LETTER OF COMMENT NO. 2



**Baldwin & Lyons, Inc.**

**G. Patrick Corydon  
Senior Vice President / C.F.O.**

1099 North Meridian Street  
Indianapolis, IN 46204  
(317) 636-9800

Fax: 317-715-9610  
E-mail: corydon@baldwinandlyons.com

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Technical Director  
Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7, PO Box 5116  
Norwalk, Connecticut 06856-5116

RE: File Reference No. 1325-100  
INVITATION TO COMMENT  
Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting

Dear Sir or Madam:

I'm sure you will receive numerous responses quoting chapter and verse of current authoritative pronouncements. I simply want to give you the perspective of one C.F.O. at a micro-cap insurance company regarding the practical, or rather impractical, aspects of this proposal.

First of all, as a buyer of insurance, this proposal seems inappropriate and unworkable. For example, as a buyer of group health insurance to cover our employees, bifurcation would require me to (1) make a determination of the "claims portion" of the premium and then compute the profit and overhead included in the premium charged by our insurance carrier, (2) record the "claims portion" as an asset and (3) decrement the asset into expense as the claims are actually paid by the insurance carrier.

The obvious problems with this approach are (1) there is little likelihood that our insurance carrier will share with me the portion of our premium which is composed of profit and overhead, requiring me to make a guess, (2) I would now be obliged to obtain monthly claim payment data, by policy year, from my insurance carrier in order to relieve my asset and record expense and (3) undoubtedly, the assumed asset will not ultimately match the expenditures for claims so I will have to either charge or

credit income with the difference in an accounting period different from the actual coverage period.

How could this approach be considered more understandable, relevant and reliable for users of financial statements? The insurance contract I enter into with our group insurance carrier transfers, totally and without recourse, my company's obligation to pay medical claims for its employees to the third party insurer. This is not self-insurance. Yes, of course, we expect that there will be losses but the premium paid is not refundable and what possible advantage can be gained by complicating the accounting for such a straight-forward contract? We expense our premium each month, as it is incurred. What could be simpler to understand and more reliable for a user of financial statements? I can't see how this is any different from the purchase of a maintenance contract on equipment for a fixed fee covering a fixed period. You may have all of your service calls in only one month but the expensing of the contract cost ratably over the period of coverage is accounting which everyone expects and understands. (Please note that I'm not proposing that bifurcation be extended to maintenance contracts.)

To suggest that it would make more sense to establish an asset and then record expense as the claims are paid by the third party insurer, often months after losses are incurred, is ludicrous. To take it a step further and require that I account for the loss reserving of the group insurance carrier, to avoid using cash basis accounting for this expense, is even more impractical and would, even if possible, in most cases result in roughly the same charges to expense, period-by-period, as the current method of simply expensing the premium as it is incurred. All that would be accomplished by bifurcation of such policies would be the addition of a great deal of time, expense and complication to a simple process that is currently well understood by users of financial statements and not in need of repair. When is the last time anyone complained to you about the accounting for group insurance policies by buyers of insurance? This is clearly a solution in search of a problem.

From the perspective of an insurance underwriter, this proposal would be a disaster. Not only would it add a tremendous amount of expense to the process of financial statement preparation and certification, but it would render the historical data maintained by all users of financial statements useless, as the possibility of restating prior years would be unthinkable from a cost and timing standpoint.

I've been in the property and casualty insurance business for almost 30 years and I can assure you that it's generally not too difficult for knowledgeable professionals to determine the difference between a straight financing contract and a legitimate insurance contract with substantial passage of risk. However, many legitimate insurance contracts contain some features which would unnecessarily get caught up in this widely-thrown net of bifurcation. This would spawn an entirely new set of disclosures to discuss assumptions used to bifurcate the contracts, track the status of

the assets, disclose the charges or credits to income resulting from the fact that the bifurcation assumptions will generally not work out close to reality on many of the contracts, etc.

The fact is that sufficient guidance already exists to prevent issuers from inappropriately reporting a financing contract as insurance. The risk transfer test in Statement of Financial Accounting Standards No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113), is fully adequate and, if applied diligently, will provide understandable, relevant and reliable information to users of financial statements, as it has done in the past. The recent publicity surrounding the fact that significant financing contracts had been accounted for as insurance makes it clear that these were not inadvertent mistakes or honest misinterpretations of existing GAAP, but rather the dishonest attempt on the part of a small number of individuals to purposefully mislead.

We simply need for independent accountants to make sure the current standards are appropriately applied and for the court systems to insure that those who knowingly misstate their financial statements are punished. Simply stated: We don't need more laws, rules and regulations; we simply need to enforce the ones we have. For example, our independent accountants send every new reinsurance contract we enter into to their national office for review by a risk transfer specialist. We must justify that there is substantial risk transfer to the satisfaction of this specialist. This seems like a fully workable solution using existing standards which clearly identify the criteria necessary for the substantial passage of risk in an insurance contract.

You asked that respondents comment on their definition of insurance contract. I have no problem with the definition from Appendix A of International Financial Reporting Standard (IFRS) 4, Insurance Contracts, as noted in paragraph 34 of the ITC. I do, however, find it difficult to follow the leap from this definition to the need for bifurcation of most insurance contracts. This definition used the term "significant insurance risk", not "absolute insurance risk", thus suggesting an understanding of the reality of how insurance contracts work in the real world. In addition, this definition includes the term "specified uncertain future event". This should be taken to mean that the economic loss from a future event is uncertain, not that the probability of one or more loss events actually occurring is not certain. In the real world, people tend to buy insurance more readily when the probability of loss is higher. The tricky question is: how much to pay (or charge, if you are the insurer) to cover the risk. For the FASB to suggest that the higher probability that any amount of loss will occur, as in the case of group or commercial fleet policies, renders part of the contract not insurance is neither consistent with this definition nor is it a reasonable approach to accounting for contracts of insurance which are not substantially financing arrangements, as already provided for in authoritative guidance.

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From my perspective, bifurcation is wholly unnecessary and would not only add a significant amount of time and expense to the financial reporting process but would produce financial information much more difficult for any user to follow. In fact, the resultant complication of financial disclosure would be beyond the understanding of many individual investors. Industry analysts, while perhaps sophisticated enough to follow the convoluted trail of disclosure, would find their historical data bases to be largely worthless.

I sincerely hope that you pay attention to the volume of negative response you will undoubtedly receive from this invitation to comment and not add this albatross to the neck of a financial community already struggling with significant standards overload.

Yours truly,

G. Patrick Corydon  
Senior Vice President and C.F.O.