



August 24, 2006

Mr. Lawrence W. Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: File Reference No. 1325-100, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*

Dear Mr. Smith:

The Financial Reporting Committee (the "Committee") of the Institute of Management Accountants appreciates the opportunity to provide its views to the Financial Accounting Standards Board (the "FASB" or "Board") on the FASB's Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (the "Invitation" or "ITC").

Introductory Comments

The Invitation outlines a significant change to existing accounting standards that the Committee believes would increase the amount of time and effort devoted to accounting for insurance contracts. To our surprise, the Invitation does not explain the perceived deficiencies in existing standards that lead the Board to believe that changes may be needed. The Committee believes that the Board would not have invested its time and the staff's time in drafting the Invitation without at least a preliminary conclusion that existing standards are deficient, yet we searched the Invitation in vain for a clear statement of the problem that the Board seeks to fix.

Paragraph 13 notes that existing standards place "significant pressure" on evaluating risk transfer. The Invitation expresses no opinion about whether preparers and auditors face difficulty in this area.

Paragraphs 18 through 21 discuss three forms of employee benefit arrangements and note that the earnings impact of scenarios (b) and (c) could differ if the claim processing period is long. The Committee agrees that the earnings impact for an individual policy would differ in this circumstance, but notes that in the typical situation of a company that purchases a policy every year, the annual earnings impact would be substantially the same. Moreover, the Invitation does not evaluate whether the differential earnings impact is significant to preparers or users of financial statements.

Paragraphs 29 and 30 refer to recent reporting issues with finite risk insurance and reinsurance. Paragraph 30 notes that the view that the reported misstatements arose from misapplication of existing standards rather than any deficiencies in those standards. Paragraph 30 implies, but never states, that the Board believes the existing guidance is deficient.

Therefore, we would recommend that the Board clearly identify the deficiencies in existing standards it is looking to address and undertake a project that deals only with such deficiencies. The Committee does not believe that a complete overhaul of accounting for insurance contracts is needed. Additionally, we believe bifurcation of insurance contracts would be technically challenging and judgmental, likely resulting in diversity of execution.

The Committee observes that existing standards provide appropriate information for management decision-making and does not believe that the proposed bifurcation approaches would generate more useful information for management decision-making. Therefore, we are concerned that bifurcating insurance contracts will result in less understandable, less decision-useful information for financial statement users. As a result, based on the information in the Invitation, the Committee believes that the costs of a bifurcation approach likely would exceed the benefits.

Based on what Committee members know about insurance accounting issues from the ITC and from press accounts of the rather limited number of restatements for insurance issues, the Committee believes that it would be more productive to clarify paragraph 44 of FASB Statement No. 5 about transfer of risk in insurance contracts than to start a broad project on bifurcation of insurance contracts. Further, as noted in our response to Issue 2, the Committee doesn't believe that the existing guidance in FASB Statement No. 113 is suited to assessing insurance contracts.

Responses to Issues for Respondents

Issue 1: Does the IFRS 4 definition of insurance contract identify insurance contracts and sufficiently distinguish those contracts from other financial contracts? Does the GAAP definition of insurance risk identify and separate that risk from other risks such as financial risk? Do the descriptions of finite insurance and reinsurance contracts,

including the risk-limiting features, identify those contracts? How could the definitions and descriptions be improved?

The Committee believes the existing definition could be improved by explaining the meaning of “significant.” The definition will not be helpful if that term is undefined and unexplained.

Issue 2: *Can the Statement 113 risk transfer guidance for reinsurance contracts be applied by corporate policyholders and insurers for determining whether an insurance contract transfers significant insurance risk? If not, how can the Statement 113 guidance be modified or clarified to apply to insurance contracts?*

The Committee does not believe that the Statement 113 risk transfer guidance is appropriate for determining whether an insurance contract transfers significant insurance risk. The reinsurance guidance seems to contemplate multiple risks, such that a variety of outcomes are reasonably possible. For some property contracts purchased by commercial entities, one outcome—no loss—may be highly probable, and other outcomes may be remote. For example, suppose that a commercial entity buys earthquake insurance for its facilities in California. The likelihood of a significant earthquake in a single policy year may be remote. Therefore, the expectation of both parties is that the commercial entity will pay its premium and incur no loss. If we apply the three tests in Statement 113 as summarized in paragraph 37 of the ITC, (a) the likelihood of significant variations in the amount and timing of payments is remote [fails], (b) the likelihood that the insurance company would suffer a significant loss also is remote [fails], and (c) substantially all of the risk for losses in excess of the deductible transfers to the insurance company [passes]. Passing the third test offsets failure on the second test but does not offset failure on the first test. As a result, some Committee members believe that the Statement 113 tests would lead to a conclusion that this type of property insurance doesn’t transfer significant insurance risk. The Committee believes the hypothetical earthquake policy transfers significant risk, even though the likelihood of loss is remote. Accordingly, those Committee members believe that different guidance is needed to assess risk transfer for corporate insurance policies.

Other Committee members apply the guidance in Statement 113 to the hypothetical earthquake policy in the preceding paragraph and conclude that the policy meets the conditions for transfer of significant insurance risk and insurance accounting. This difference of opinion in the Committee indicates that the guidance in Statement 113 would, at a minimum, need clarification to be applied consistently by corporate policyholders.

Issue 3: *Does classifying an entire contract as insurance or bifurcating that contract into insurance and deposit components provide more understandable and decision-useful information? Which qualitative characteristics most influence your decision? Which approach more faithfully represents the economic substance of the contract? Why?*

As noted in the introductory comments, the Committee's initial view is that in most cases classifying an entire contract as insurance or a deposit provides useful information, and bifurcating that contract would not provide superior information.

Issue 4: *The flowchart suggests a sequence for analyzing contracts that integrates current insurance accounting guidance with a hypothetical bifurcation analysis. Do you believe that the sequencing and integration are appropriate? What changes would you propose?*

The Committee does not believe the sequencing and integration are appropriate. As noted in our response to Issue 5 below, the Committee is confused by the definition of unequivocal transfer of significant insurance risk and disagrees with the treatment of group policies. As noted in our response to Issue 2 above, the Committee believes the transfer of risk guidance in Statement 113 is not well suited to assessing transfer of risk in ordinary insurance contracts. Those are two critical elements of the flowchart.

Given the Committee's overall skepticism about whether bifurcation would generate decision useful information, the Committee favors an approach under which only a small minority of insurance contracts are bifurcated.

Issue 5: *Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk? If not, why not? Should other characteristics be added? Are the examples in Appendix B representative of the discussion in paragraphs 57–59?*

The Committee finds the discussion of unequivocal transfer of significant insurance risk confusing. The list of contracts in paragraph 58 excludes one that the Committee believes is common for large companies—a commercial insurance contract that covers one class of risk for multiple locations. For example, a large retailer might purchase a general liability policy covering risks of injuries to customers at multiple retail stores. Alternatively, a large manufacturer might purchase a property policy covering risks of casualty losses (fire, wind, rain, natural disasters, etc.) for multiple manufacturing, distribution, or office facilities. This is neither a single-premise policy nor a group policy. The Committee does not understand the Board's analysis of such single-risk, multi-location policies. Further, the Committee doesn't know whether the analysis depends on the size of the deductible. For example, a retailer's general liability policy could have a high deductible such that it is remote that any customer's injury would be covered by insurance. Alternatively, the deductible may be lower, such that it is probable that some customers' injuries will be covered by insurance. The Committee does not believe that the size of deductible should affect whether a policy unequivocally transfers significant insurance risk, but we are uncertain of the Board's view. If the size of the deductible affects the classification of policies, that will place significant pressure on determining the minimum deductible that is compatible with unequivocal transfer of significant insurance risk.

The Committee does not agree with the Board that group insurance policies should be assessed differently from individual insurance policies. The Committee believes that many group policies transfer significant insurance risk and should be treated in their entirety as insurance contracts. In addition, the Committee believes that bifurcation of group policies would be difficult for many policyholders, particularly smaller entities. Because the insurance company typically processes claims, policyholders may not have records of historical claims experience. As a result, policyholders may lack a reasonable basis to estimate the deposit portion of the premium or the manner in which to reduce the deposit during the policy's term.

Issue 6: *Do you think the characteristics described in paragraph 58 for unequivocal insurance contracts are an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113 (summarized in paragraph 37(c) of this Invitation to Comment)?*

No. As discussed in the responses to Issues 2 and 5, the Committee believes that both approaches are flawed. Until paragraph 58 is better explained, the Committee does not believe that the characteristics described in paragraph 58 are an improvement.

Issue 7: *Do you prefer Approach A or Approach B for identifying contracts subject to bifurcation? Why? Do you believe that another approach would be superior? If so, how would you describe that approach? Would your preferred approach be operational? Would it make financial statements more decision useful?*

As noted in the introduction to this letter, the ITC doesn't explain very well the deficiencies in current guidance, or whether the issue is more a matter of noncompliance than of deficient guidance. To the extent that a problem with existing guidance exists, the Committee suspects that the problem is more severe with contracts that contain a significant financing element. The Committee therefore prefers Approach A, because it limits bifurcation to the contracts for which the current accounting is more problematic. Although the Committee prefers Approach A to Approach B, the Committee believes that the Board needs to do further research on what, if any, current guidance is deficient.

Issue 8: *Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why? If yes, what differences would you suggest?*

The Committee generally believes that the principles for both should be the same. The Committee is uncertain whether the application might be different because of different groupings (units of account). An individual commercial company would account for the insurance contracts that it enters. The Committee believes that insurance companies in some cases aggregate similar insurance policies with multiple insured parties for accounting purposes. Thus, even before considering reinsurance, it is possible that insurance companies might group policies differently than policyholders. The Committee believes that insurance companies often reinsure blocks of business rather than individual policies.

Issue 9: *Which of the methods identified in this Invitation to Comment for bifurcating insurance and reinsurance contracts do you believe has the most conceptual merit? Please explain. Please describe any additional bifurcation methods that you believe should be considered. Would corporate policyholders encounter unique implementation problems in applying any of the methods discussed in this Invitation to Comment?*

The Committee is uncertain whether the Board considers a deductible to be a risk-limiting feature for purposes of a bifurcation analysis. A deductible is not listed in paragraph 36, but it affects the sharing of risk between policyholder and insurer. The Committee recommends that a deductible should *not* be viewed as a risk-limiting feature for purposes of a bifurcation analysis. Of the three methods described in the Invitation, the Committee believes that it understands the expected payout method. The explanations of the other two methods are not adequate for the Committee to understand how they would be applied. Numerical examples would be helpful to understand the methods and the information that would be needed to apply them.

Although the Committee understands the expected payout method, the Committee does not believe that it would be operational. If losses in excess of the deductible occur frequently, Committee members note that the policyholder typically does not maintain data on claims organized by policy year. For those types of insurance policies, a policyholder would need to develop the data based on claims filed, which would be costly and time consuming, particularly for coverages with long tails. Alternatively, a policyholder might ask its insurance company for the information. We question how willing insurance companies will be to provide such information. Even if insurance companies are willing to provide the information, we also question whether that information would be adequate for audit purposes. AICPA Interpretations No. 1 to AU Sections 328 and 332 (issued in July 2005) state that fair value information from a trustee or an investment manager does not, in and of itself, constitute adequate audit evidence of fair value; the reporting entity needs to perform additional procedures to verify the fair value information. By extension, a corporate policyholder might need to perform additional procedures to verify claims information supplied by an insurance company.

Issue 10: *Would data availability limit the development of any of the bifurcation methods discussed in this Invitation to Comment? To what extent are the models that would form the basis for these methods used to underwrite and price products? Would data availability (or lack thereof) affect only certain insurance forms, products, or lines of business? If so, which ones and why?*

As noted in the response to Issue 9, the Committee believes that data availability would be an issue for policyholders. New or rapidly changing companies would face additional obstacles, because they would not have relevant historical information to estimate probable claims.

Issue 11: *In view of the IASB's project on insurance contracts, should the FASB be considering bifurcation of insurance contracts based on transfer of insurance risk?*

The Committee believes that the most important next step is to determine whether bifurcation of insurance contracts is an appropriate solution to a real problem. If the primary problem is compliance with existing standards, then clarification of the existing standards coupled with education efforts would be the appropriate response. The existing guidance on transfer of risk is fragmented in different places in the accounting literature and, as noted in the introductory comments, the guidance with respect to transfer of risk for insurance in Statement 5 is quite limited. If the Board concludes that existing guidance is deficient, then the next step would be to identify a logical progression for addressing accounting for insurance contracts. The Invitation discusses the IASB project on insurance. The timing of that project and any planned FASB convergence effort should be analyzed in deciding whether to proceed with a project on bifurcation. Another project that relates to insurance accounting is the FASB's recent Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties*, and its IASB counterpart. The timing of that project also should be analyzed in deciding whether to proceed with a project on bifurcation.

Again, we appreciate the opportunity to provide our views on the Proposed Statement and would be pleased to discuss any of these comments further. You may contact me at 212-484-6680.

Sincerely,

A handwritten signature in black ink, appearing to read "Pascal Desroches", written over a horizontal line.

Pascal Desroches
Chair, Financial Reporting Committee