



August 24, 2006



LETTER OF COMMENT NO. 37

Mr. Larry Smith, CPA
Technical Director-File Reference No. 1235-001
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: May 26, 2006 FASB Invitation to Comment (ITC), *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the ITC and is providing the following comments on selected issues below for your consideration.

GENERAL COMMENTS

TIC appreciates the Board's effort to issue a document for public comment in the early stages of its deliberations on these complex issues.

Although the ITC was advertised as a neutral discussion document, TIC noted a definite bias toward the bifurcation approach. TIC believes the ITC should have provided more balanced coverage of the issues by closely examining the disadvantages of a broad-scope bifurcation model.

TIC understands that this issue was added to the Board's agenda to address abusive practices that occurred within the insurance industry relating to finite risk contracts. However, TIC believes the broad scope of the ITC is an overreaction to the problems at hand. The ITC is a broad manifest that would effect sweeping accounting changes among most (if not all)





commercial policyholders. TIC suggests the Board investigate the common elements within the identified abusive practices and write a standard that will address inappropriate accounting.

TIC believes bifurcation may have merit for certain arrangements. However, TIC would oppose the pervasive adoption of bifurcation from a cost/benefit perspective for most policyholders and would strongly object to its use for short-term insurance arrangements (one year or less), including most group health insurance arrangements. Most financial statement users of small business clients will not understand deposit assets created as part of the bifurcation of standard insurance contracts. If the accounting is not transparent to users, it will not be relevant to them. Further, TIC constituents would likely have legal restrictions (such as the Health Insurance Portability and Accountability Act of 1996 [HIPAA]) in obtaining the necessary information to make the adjustments called for by the ITC.

Our specific comments are presented in issue number order below. The Other Comments section includes some editorial and definitional issues not elsewhere addressed.

SPECIFIC COMMENTS

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?

TIC agrees with the IFRS 4 definition of an insurance contract. However, the definition of insurance risk includes the following sentence with which TIC disagrees:

Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured. [ITC, paragraph 35]

In TIC's view, no insurance risk is **completely** outside the control of the insured. Entities have various programs that may be implemented to establish some control over the risk of loss, including:

- Safety programs for worker's compensation
- Training programs for drivers
- Wellness programs for employees

The definition of insurance risk and particularly significant insurance risk (paragraphs 14-17) should be expanded to provide more discussion of short-term arrangements and





recognize that certain types of contracts would be exempt from bifurcation due to low timing risk.

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?

No comment.

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?

TIC believes bifurcation may have merit for certain arrangements, such as those involving finite risk arrangements, structured finance arrangements, and captive insurance companies that, at the inception of the policy, promise to return a portion of the premiums to the insured if claims are low. However, even where bifurcation may be relevant to financial statement users, TIC is uncertain whether cost/benefit and other constraints can be overcome to achieve a representationally faithful measure in certain circumstances.

In particular, TIC opposes the bifurcation of short-term (one-year or less) insurance contracts because they do not meet certain essential qualitative characteristics of financial reporting. Bifurcation of short-term contracts (particularly health insurance arrangements) cannot be faithfully depicted in a manner that would be either logical or cost beneficial. A sound methodology does not exist to depict the bifurcation in financial terms, and there are significant constraints in gaining access to the claims data that would be needed to calculate the split between insurance and deposit accounting. Further in a typical commercial group health insurance policy, the typical lag between premium payment and payment of “expected” claims is not significant enough to warrant the accounting treatment proposed. Given the ambiguous definitions in the ITC, most entities would not have sufficient basis for calculating the pre-funding v. insurance expense components of an insurance contract. Further, bifurcation in these circumstances is largely a balance sheet gross-up exercise with limited expense differences. TIC believes strongly this is not a cost beneficial process for short-term arrangements.

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?

Yes, the sequencing and integration of the flowchart steps are appropriate. However, TIC



believes the screen for unequivocal insurance contracts is a step that requires additional consideration, as discussed in Issue 5 below.

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?

No. The stated characteristics of the unequivocal test for insurance accounting in paragraphs 58(d) – (f) and 59 are too restrictive and, in some cases, too ambiguous to identify whether significant insurance risk has been transferred.

For example, paragraph 58(f) requires that the insurance contract be “not likely to result in any claims.” TIC believes that would be a very difficult condition to judge.

TIC believes all short-term insurance arrangements (such as group health insurance) should be exempted from bifurcation. Under the proposed accounting, group health arrangements would be split between a deposit asset representing a pre-funding of anticipated claims and an insurance expense representing coverage for catastrophic occurrences (such as heart attacks and other major unexpected medical treatments).

To calculate an appropriate bifurcation between the financing and insurance elements, the insured would need access to historical claims data. TIC believes access to this information would be restricted due to the privacy provisions of HIPAA.

Furthermore, the ITC does not consider the claim turnaround cycle. The pre-funding or deposit element of the bifurcation could be very short (one month or so). In addition, most group health policies require claims to be submitted within one year of the date of service—limiting the maximum pre-funding period to 12 months. Paragraph 14 of the ITC acknowledges that insurance contracts with short claim processing periods would not be exposed to timing risk—an element of insurance risk. The insured entities would bear the burden of time and cost to calculate a pre-funding element that would only be reversed within the operating cycle. Therefore, TIC believes bifurcation would be of limited usefulness to financial statement users for group health and related policies.

Paragraph 58 also included some ambiguities that would create implementation problems. Paragraph 58(d) specifies that any deductibles in the contract must be fixed. However, the ITC is silent regarding how percentage deductibles (i.e., coinsurance) would be considered in the framework.

Paragraph 58(e) states that a contract cannot have any “risk-limiting features that adjust the profit or loss on the contract based on the claim loss experience.” The ITC was not clear





whether an experience adjustment on a contract renewal would qualify as a risk-limiting feature that would prevent insurance accounting.

The examples in Appendix B are not realistic or logical and therefore are not suitable illustrations of the unequivocal test for insurance and reinsurance accounting. The examples create an arbitrary bright line between those insurance contracts that unequivocally transfer risk and those that don't. The examples assume that individual insurance contracts always transfer significant risk to the insurer and group contracts do not. TIC believes the rationale that all group contracts have expected claim losses but individual policies do not is an erroneous assumption. An individual policy could easily have an expectation of claims, such as an auto policy for an individual with a bad driving record or for an individual race car driver.

The professional liability examples on pages 29-30 of the ITC illustrate many of the problems within the appendix. The ITC assumes that the sole practitioner malpractice insurance coverage transfers the entire risk to the insurer on the theory that it "provides protection for a single policyholder and a single risk." In contrast, professional liability coverage for a large partnership would not be exempt from further testing because it "provides protection for multiple professionals." The theory underlying these conclusions is presented in paragraph 10:

For many individual insurance contracts, such as personal auto or homeowners, neither the policyholder nor the insurer expects any claims during the contract term—the contract provides protection if an insured event occurs. On the other hand, the insurer expects claim losses on the portfolio of such contracts.

TIC disagrees with this reasoning because all insurance policies are priced based on an expectation of claims. Even an individual insurance policy will be priced based on the expectation of losses. The premiums for the professional liability insurance policy noted in Appendix B would certainly be based on the insurer's claim experience with malpractice insurance in its state and the nature of the practitioner's practice.

The other major fault with the examples in the ITC is that they are presented in a black-and-white, one-sided fashion. The policies illustrated are either single or individual policies with no risk or large group policies with significant risk. For every example, a slight change in fact pattern could yield the opposite answer from that given. No guidance is provided for the permutations between the two extremes of single v. group policies. Using the malpractice example above, it is not clear whether a large practice with a low claim history in a non-litigious practice area would be subject to bifurcation any more than a 10-person accounting firm that performs only compilation engagements.





It is impractical and meaningless to assume that all group policies of all entities should be bifurcated. The bifurcation criteria should be refined to establish more meaningful benchmarks. For malpractice insurance, the nature of the firm's practice and industry and historical claim experience (assuming it is reasonably attainable) should be determining factors.

If the FASB decides to pursue its bifurcation approach (which TIC opposes for most contracts), TIC recommends that examples be designed more realistically. Alternative scenarios should be presented to illustrate how and where judgment is necessary. One example could demonstrate a policy covering one insured with a horrible driving record; a corresponding example could explain how the answer would differ for a single policy on a good driver.

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 comment.

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?

TIC prefers Approach A, which requires contracts with significant financing components to be bifurcated. Approach A is more logical than Approach B since Approach A is risk-based rather than an automatic default to bifurcation for contracts remaining after applying the other "screens" outlined in the ITC.

However, TIC would modify Decision Box e in the flowchart on page 16 of the ITC, which precedes the bifurcation box, to include an exemption for short-term (one year or less) insurance arrangements. As discussed above, TIC believes the short-term arrangements should be exempt from bifurcation.

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

No comment.

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?

If the FASB decides to pursue the bifurcation methodology, TIC believes the expected payout method would be the easiest to apply and most conceptually applicable to TIC's constituency (assuming the relevant data were available). TIC had difficulty conceptualizing the arrangements that our clients would have with the other two methods. TIC noted in particular that the description of the proportional risk method was not easy to follow as written. The cash flow yield method would seem more appropriate for insurers rather than insureds and would be difficult to apply to an entity with an erratic claim history. TIC would agree with those who believe that more research is necessary to determine whether this method is operational.

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 discussed in Issue 5 above, TIC believes HIPAA may restrict access to patients' historical claim data for health care insurance contracts. This data would seem to be essential to implement any of the stated bifurcation methods.

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?

No comment.

OTHER COMMENTS

Paragraph 1(b)—Financing components that are accounted for as deposits

Paragraph 1(b) states that, under deposit accounting, recovery from an insured event is a reduction to the deposit asset "with no income statement benefit." This statement would not be relevant to health insurance arrangements since the deposit would be accreted to expense when claims are made for employees.

TIC is also concerned with the asset accounting related to the calculated deposit amount in a bifurcated health insurance (or similar) arrangement. In a common situation where actual claims turn out to be lower than estimated, the company would likely be carrying a non-recoverable asset on its balance sheet. Frequently, only after the contract has expired would



the information be available to conclude the deposit asset should be written down. TIC does not believe users will see this as an improvement in accounting.

Paragraph 14—Definition of timing risk

Paragraph 14 states that, “Timing risk is uncertainty in the timing of the net cash flows.” This definition implies that timing risk would include more than uncertainty about the timing of the loss event. TIC therefore questions whether timing risk would include the time spent by an insurance adjuster determining the loss claim or the time needed by a court to determine policy coverage of a particular loss event. TIC believes the definition of timing risk needs further clarification to properly evaluate the significance of insurance risk for particular contracts.

Paragraph 22—Description of flowchart on page 16

TIC noted inconsistencies between the narrative in paragraph 22 and the Risk Transfer and Bifurcation Testing Flowchart on page 16 of the ITC. There are more screens within the flowchart than are indicated in the narrative. The lack of correspondence between the steps in the narrative and the steps in the flowchart is confusing. In addition, paragraph 22 implies two possible approaches could be taken to determine which remaining contracts from the first three screens should be bifurcated. However, the flowchart implies Approach A, described in paragraph 61, would be the required approach. That is, bifurcation would be required for contracts that include a significant financing component. The flowchart should stand alone or the narrative in paragraph 22 should be clarified.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Edward J. Knauf, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees

