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Proposed FASB Staff Position No. FAS 97-a
Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97,
Accounting and Reporting by Insurance Enterprises for Certain Long-Duration
Contracts and for Realized Gains and Losses from the Sale of Investments, Permit or
Require Accrual of an Unearned Revenue Liability

We appreciate the opportunity to comment on the above-referenced proposed FASB Staff Position (FSP). Overall, we do not support finalization of this proposed FSP in its current form because, in our opinion, it does not provide the additional guidance necessary to resolve the underlying interpretative issue causing diversity in accounting. While the FSP would answer the question of whether a company can have an unearned revenue liability when assessments and costs for an insurance benefit feature result in a pattern of profits followed by lower profits, without providing the FASB Staff's insight as to when such deferral is appropriate and the manner in which deferred amounts should be determined and amortized, we do not believe it will resolve the underlying practice issue. The differing interpretations of FAS 97 that have led to practice diversity are: in situations where there are differing levels of profits from cost of insurance (COI) charges, some companies concluded that disproportionate pricing of mortality charges as compared to mortality benefits is indicative of amounts collected for services to be performed in future periods, perhaps for other insurance benefits or policy administration, and have responded by establishing uncarned revenue liabilities to cover a portion of the COI charges collected, while other companies concluded that differing levels of profitability were not a sufficient basis for establishing an unearned revenue liability.

The proposed FSP and Statement of Position 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts, (SOP 03-1), are significant steps away from the concepts of FAS 97, or, at least, the concepts as we had understood them:



Some respondents suggested that the information provided by the insurer to individual policyholders does not represent the substance of the services provided under the contract. They maintained that services are provided ratably over the life of a contract and that amounts should be deferred or anticipated to produce a pattern of reported earnings that reflects a level pattern of service. The Board rejected that view. Accounting typically presumes that the terms and conditions of a contract entered into between two parties dealing at arm's length are representative of their agreement. This presumption can be overcome if evidence indicates that the substance of the agreement is not captured in the contract – for example, if the terms of contract financing differ from performance of contract services. (FAS 97, paragraph 54, in part)

Some respondents suggested, for example, that amounts assessed for mortality protection often produce a much larger gross profit margin in early years than is produced from those same amounts assessed in later years. They maintained, therefore, that a portion of early mortality assessments represent compensation for services to be provided in future periods. The profit attributed to mortality assessments in early years, however, is usually the result of the recently completed underwriting process rather than of the collection of amounts assessed before they are earned. (FAS 97, paragraph 60, in part)

We interpreted this discussion to indicate that higher levels of profitability in the early years of the contract did not represent a sufficient basis to conclude that some portion of the assessments in the earlier years should be deferred, and believed that the hurdle for departing from the principle of recognizing charges as assessed under the terms of the contract was very high – amounts assessed only in the first year of a contract or for a period substantially shorter than the expected life of the contract. Otherwise, revenues and expenses under the contract "fall where they may", and differing levels of profitability inherent in different charges were recognized as they occurred. Some have stated that an unearned revenue liability is necessary when charges are such that higher profit margins exist in earlier years than in later years, but still result in profits in all years, to prevent "front-ending" of profits – but determining whether profits are "front ended", like beauty, is in the eye of the beholder.

The FSP appears to set a fairly low standard for departing from recognition of assessments in accordance with contract terms: undefined "facts and circumstances" that lead the financial statement preparer and/or auditor to conclude that some portion of the amounts assessed currently are really being collected for services to be provided in the future. Further, the FSP does not appear to provide insight into the facts and circumstances that should lead to a conclusion that a portion of charges assessed in one





period are for services to be provided in a subsequent period, other than a statement that it cannot be "... an attempt to inappropriately level the contract's gross profit over the life of the contract or the accrual would serve to level mortality assessments in order to produce a level gross profit from that function over the life of the contract." It would appear that some leveling of profits is always a result of establishing and amortizing an unearned revenue liability.

It is difficult to see how, without additional guidance, this FSP will result in anything other than discretionary exercises in redesigning the recognition of profit to conform to the individual preparer's view of a more appropriate profit recognition pattern than the one that results from contract terms. While we understand and applaud the Staff's reluctance to establish a set of "bright lines" or rules in the FSP, if the FASB is to retain the basic conclusion reached in the proposed FSP, it would be helpful for the FSP to articulate the Staff's views as to the principles or concepts that should be applied to determine whether certain amounts are being assessed before being earned and, therefore, should be recognized as unearned revenue.

Also, since it appears the impact of this FSP will be to expand the circumstances in which unearned revenue liabilities will be recognized, conceptual guidance should be provided on how amounts to be deferred should be determined. That is, are amounts determined purely arbitrarily? Are they the amounts that rationalize the profit recognized from specific contract functions or from the contract in total? Are they determined as the amount charged in excess of the rate available from the insurer or in the general market place for the insurance benefit offered under the policy? Does the characterization of the charge to the customer matter? That is, if the charge is characterized to the customer as an expense or administrative charge, can it be recharacterized as an insurance benefit charge? Is the opposite also true? Are there circumstances in which amounts characterized as insurance benefit charges should be consider administrative charges for purposes of SOP 03-1? If so, under what circumstances and how is the recharacterized amount determined? What facts and circumstances would lead to the conclusion that amounts should be characterized differently from their contractual characterization?

In discussing the recognition of unearned revenue, FAS 97 states:

Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. (paragraph 20, in part)





The Board recognized that amounts assessed against policyholders might compensate the insurer for services to be provided in future periods. In those cases, this Statement requires that amounts be deferred and recognized over the period that service is provided. (paragraph 54, in part)

We understand that currently companies generally amortize unearned revenue liabilities using the same assumptions and methodology used to amortize deferred acquisition costs, that is, deferred amounts are amortized into income relative to estimated gross profits (EGPs). When the deferred revenue results from an up-front expense charge or initiation fee assessed as consideration for originating the contract, the assessment could be viewed as a way for the insurer to recover some portion of the acquisition costs incurred in the issuance of the contract, and recognition relative to EGPs is consistent with the manner in which the related acquisition costs are being recognized, with both recognized relative to the profits generated by the contract. However, it is much less clear to us that recognition relative to EGPs results in recognition in the "period benefited" or "the period that service is provided" when the deferral is related to COI charges and benefits; the relative levels of overall contract profitability would not seem to be representative of the provision of insurance coverage. This recognition pattern would, however, be appropriate if the COI charges were being deferred not because they were related to future insurance benefit feature services to be provided, but were instead viewed as a charge to accelerate the recovery of acquisition costs. We believe it would be helpful for the Staff to provide insight into the issue of whether the recognition basis should ever be other than EGPs and, if so, the factors that should be considered in determining that another basis is more appropriate.

We found the language in paragraph 14 of the proposed FSP to be ambiguous and confusing. The SOP specifies that when there is an unearned revenue liability, amounts considered assessments are the amounts recognized in revenue. How should paragraph 14 be applied in the following example?

CompanyA currently reflects an unearned revenue liability of \$50 million related to COI charges. CompanyA considers the mortality charges on an earned basis and mortality benefits on an incurred basis and concludes that the mortality feature results in a pattern of profits followed by losses. CompanyA calculates that the insurance benefit liability determined in accordance with paragraph 26 of SOP 03-1 is \$400 million.

Which of the following reflects the FASB Staff's view?

 A liability determined under SOP 03-1, paragraph 26, replaces the unearned revenue liability when there are profits followed by losses. The unearned revenue liability is \$0 and the insurance benefit liability is \$400 million.



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- 2. When there is an unearned revenue liability and profits followed by losses determined as specified in SOP 03-1 (assessments considered as recognized in revenue), the financial statements reflect both the unearned revenue liability determined under FAS 97 and the SOP 03-1, paragraph 26 liability. The unearned revenue liability is \$50 and the insurance benefit liability is \$400 million.
- 3. When there is an unearned revenue liability, the liability determined under paragraph 26 of SOP 03-1 is reduced on a dollar-for-dollar basis by the balance of the uncarned revenue. The unearned revenue liability is \$50 and the insurance benefit liability is \$350 million.

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We would urge the FASB to reject the tentative conclusion reached in the proposed FSP. We believe there is little, if any, diversity as it relates to the treatment of charges that occur in the first year or first few years of the contract; in our experience, such charges consistently are accounted for as unearned revenue in accordance with paragraphs 17(b) and 20 of FAS 97. That is not the case for charges, such as COI charges, that are assessed for substantially the entire life of the contract. The FASB has the opportunity to significantly lessen diversity by concluding that, in fact, the circumstances under which unearned revenue liabilities are to be recognized are only when: (1) charges are assessed for a period of time substantially less than the entire life of the contract, in which case, the accounting specified in paragraph 20 is to be followed, (2) charges for insurance benefit features are assessed in a manner that results in profits followed by losses, in which case, the guidance in paragraph 26 of SOP 03-1 is to be followed, and (3) charges are refundable, in which case, revenue is recognized after the charges becomes non-refundable. We would be pleased to discuss out comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernet + Young LLP