

November 28, 2007

Technical Director – File Reference No. 1540-100
 Financial Accounting Standards Board
 401 Merritt 7
 P.O. Box 5116
 Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 40

The Accounting Standards Executive Committee (AcSEC) and the Insurance Expert Panel, both of the AICPA, appreciate the opportunity to comment on the FASB Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts*.

AcSEC and the Insurance Expert Panel believe the FASB should include a joint project with the IASB on its agenda. Convergence, with respect to accounting guidance, is especially important when it involves a large global industry such as insurance. In order for this guidance to represent the best thinking of all constituents, the FASB and US GAAP users should be active participants in the current IASB debates on guidance. This will only be possible as part of a joint project with the IASB. Attempting to engage in a convergence process after the IASB has completed its insurance contracts project will be much more difficult. By choosing to participate in this project, the FASB will be in a position to reinforce the importance of its other projects and highlight differences if the IASB insurance project begins to diverge from the decisions reached in those other projects.

AcSEC and the Insurance Expert Panel also believe the IASB Discussion Paper represents the most appropriate body of work to use as a starting point for the insurance project, due to the process that led to the Discussion Paper. During this process the IASB considered the input to date from worldwide users and preparers of insurance company financial information (including certain major US insurers). The views expressed in the Discussion Paper represent detailed considerations of the application of several methods for measuring insurance liabilities. It should be recognized that the application of exit value, as described in the Discussion Paper, may influence the determination of fair value measurements under US GAAP for those insurance companies that choose the fair value option for insurance liabilities.

A more complete response to the Board's specific questions is included in Appendix A. We have also attached, in Appendix B, a copy of our comment letter to the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*, to provide the FASB with our responses to the more significant questions asked by the IASB.

As noted in our response to Question 14 of the IASB Discussion Paper, AcSEC has historically had concerns with the recording of gains from the inclusion of creditworthiness in the measurement of a liability. For instance, when an entity's credit rating falls, it seems counterintuitive that a gain should be recognized when the entity is still

Technical Director
November 28, 2007
Page 2

contractually liable to the policyholder for the insurance liability. However, AcSEC recommends that the IASB and FASB be consistent in the treatment of credit characteristics in the measurement of all liabilities, and not treat the measurement of an insurance liability differently.

Representatives of AcSEC or the Insurance Expert Panel are available to discuss our comments on either the FASB Agenda Proposal or the IASB Discussion Paper with the Board members and staff.

Yours truly,

Ben Neuhausen, Chair
Accounting Standards Executive Committee

Donald Doran, Chair
Insurance Expert Panel

Appendix A

Response to Questions:

FASB Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts.*

Question 1

Is there a need for the FASB to comprehensively address accounting for insurance contracts? Why or why not?

- a. What aspects of existing U.S. GAAP accounting for insurance contracts could be improved or simplified and how pervasive are these issues?**
- b. How important is the development of a common, high-quality standard used in both the U.S. and IFRS jurisdictions?**

AcSEC and the Insurance Expert Panel believe the FASB should include a joint project with the IASB on its agenda. Convergence, with respect to accounting guidance, is especially important when it involves a large global industry such as insurance. In order for this guidance to represent the best thinking of all constituents, the FASB and US GAAP users should be active participants in the current IASB debates on guidance. This will only be possible as part of a joint project with the IASB. Attempting to engage in a convergence process after the IASB has completed its insurance contracts project will be much more difficult. By choosing to participate in this project, the FASB will be in a position to reinforce the importance of its other projects and highlight differences if the IASB project begins to diverge from the decisions reached in those other projects.

US GAAP already has comprehensive guidance for the financial reporting of insurance contracts. In contrast, IFRS accounting statements currently have no consistent application of insurance accounting and allows for the retention of local accounting standards in consolidated financial statements. This has motivated the IASB to take on this insurance contracts project.

While complex, current US GAAP models for insurance contracts, for example, multiple models for life insurance contracts, are generally well understood by users and over time practices have evolved to provide information to users that creates more transparency. However, with the clear movement toward fair value in emerging accounting guidance, these existing models may be in need of modernization. While the cost of implementing any significant change will likely be very high (it is costly to implement standards that impact an entire industry and educate users regarding the change), the implementation of uniform accounting guidance for similar transactions across all jurisdictions would greatly increase the comparability and usefulness of financial information. The real debate involves choosing the standard that should be used for convergence and determining the timeframe over which it is to be implemented.

The following projects, all currently on the FASB's and IASB's joint agenda, will bear on the conclusions reached in a comprehensive review of the accounting for insurance contracts: the conceptual framework, revenue recognition,

liabilities and equities, financial instruments and financial statement presentation. Unless the comprehensive review of insurance contracts is coordinated with the outcomes of these other projects, there is potential for US preparers and users of financial statements to experience multiple significant implementations, one addressing the final outcome of the insurance project and others to conform the insurance model to the results of the other projects.

Currently, products that provide for specified payments to reimburse a holder for a loss incurred because a specified debtor fails to perform a contractual obligation meet the definition of an insurance contract under IASB International Financial Reporting Standard (IFRS) No. 4, *Insurance Contracts*, and the definition of a financial guarantee contract under International Accounting Standard (IAS) No. 39, *Financial Instruments: Recognition and Measurement*. As the proposed standard on insurance contracts develops, this conflict will need to be resolved. Given the significant amount of effort that the FASB has already put into its proposed standard on financial guarantees, it will have valuable input regarding this issue.

From a US GAAP perspective, the quality of the converged model is more important than the speed with which it is developed. However, should the SEC go forward with a proposal to allow domestic registrants to choose between US GAAP and IFRS, global insurance companies domiciled in the United States may choose to follow IFRS to avoid the need to maintain both US GAAP and IFRS based accounting systems. Depending on the timing of that change, it could increase the importance of a converged model and the need for the FASB to be involved.

Question 2

Are the preliminary views expressed in the IASB's discussion paper a suitable starting point for a project to improve, simplify and converge US financial reporting for insurance contracts? If not, why not?

- a. Do you believe the preliminary views would be feasible to implement? If not, what aspects of the preliminary views do you believe could be difficult to apply and why?**
- b. Are there other alternatives to improve or simplify US financial reporting for insurance contracts that you would recommend? What would be the benefits of those alternatives to users of financial statements?**

AcSEC and the Insurance Expert Panel believe the IASB Discussion Paper represent an appropriate body of work to use as a starting point for the IASB insurance project, due to the process that led to the Discussion Paper. During this process the IASB considered the input to date from worldwide users and preparers of insurance company financial information (including certain major US insurers). The views expressed in the Discussion Paper represent detailed considerations of the application of several methods for measuring insurance liabilities. It should be recognized that the application of exit value, as described in the Discussion Paper, may influence the determination of fair value measurements under US GAAP for those insurance companies that choose the fair value option for insurance liabilities.

Please see our responses to the more significant questions (Appendix B of this letter) asked by the IASB in their Discussion Paper to understand our views with the proposals in the Paper and where we believe additional work needs to be performed before decisions can be reached. In particular, we believe the debate regarding performance measurement for insurance contracts needs to be resolved in order to understand the implications of unbundling and the systems needs of implementation.

It is the nature of a discussion paper to raise relevant questions and highlight those areas where debate still exists and, therefore, many more debates will occur as the proposed accounting model is refined. It will be critical that the particular aspects of US insurance products, for which specific US GAAP guidance has developed over time, be given adequate consideration by the IASB in their deliberations. FASB's participation will be crucial in this respect. FASB's involvement will also facilitate the input of smaller non-global US insurers who may not have participated sufficiently in the IASB's development process.

Finally, we would like to point out that the underlying papers, which ultimately led to IASB's Discussion Paper, represent detailed discussions of various aspects of the proposed model and represent a valuable supplement to the concepts expressed in the Discussion Paper itself.

Question 3

Is there a need to address policyholders accounting in an insurance contracts project? Why? If yes, should accounting by policyholders be addressed at the same time as the accounting by insurers? Can or should that wait until after the accounting by insurers is completed?

AcSEC and the Insurance Expert Panel believe that policyholder accounting should not be addressed at the same time as the accounting by insurers, due to the possibility for significant delays in the overall project. We would recommend that policyholder accounting be addressed in a separate project, perhaps combined with a project on indemnities and guarantees.

Question 4

How would you address the interaction between the accounting for insurance contracts and FASB's other projects on the conceptual framework, revenue recognition, liabilities and equities, financial instruments and financial statement presentation? Are certain projects precedential?

Consistent with the comments above, all these projects have significant implications on the accounting for insurance contracts. The definition of an asset affects the accounting for beneficial policyholder behavior. Revenue recognition issues are important as well. In US GAAP, for example, life insurance contracts have different definitions of revenue and different methods for its recognition over time depending of whether the contract is within the scope of FASB Statement No. 60, No. 97 or No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. A clear articulation of what revenue represents will be needed to converge these standards. The liabilities and equities project has implications on insurance contracts that contain an element of company discretion in the related benefits (interest crediting, cost of insurance charges, dividends, etc.). With respect to financial statement presentation, whether all insurance contracts are more appropriately represented as financial instruments and whether liabilities such as debt and contingent liabilities should reflect a current market approach are relevant debates for other industries besides the insurance industry.

Appendix B

Response to Questions:

IASB Discussion Paper, *Preliminary Views on Insurance Contracts*.

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

AcSEC and the Insurance Expert Panel agree with the preliminary views that the measurement of insurance liabilities should be based on market observable inputs when that information is available, but recognize that due to the lack of market observable information for the insurance industry, a significant portion of both cash flows and estimates will need to be based on entity specific assumptions.

While we agree with the principles of the three building blocks, we think that the first building block should be consistent with the exit value concepts embodied in paragraph 30 of FASB Statement No. 157, *Fair Value Measurements*, for fair value measurements using significant unobservable inputs. Specifically, we believe the guidance should clarify that a company may use its own data as a starting point in developing assumptions, using the best and most objective information available in the circumstances, incorporating market consistent data that is reasonably available without undue cost and effort. We believe this clarification is necessary, as some might otherwise view the guidance as requiring an exhaustive search for market consistent information where none is available. We note the IASB's observations in paragraph 58 of the Discussion Paper:

In principle, consistency with observed market price implies that estimates of cash flows should be consistent with the estimates that other market participants would make. Nevertheless, many variables cannot be observed in, or derived directly from, market prices (e.g., the frequency and severity of insurance claims and mortality). For such variables, there is rarely, if ever, persuasive evidence that the insurer's own estimates differ from the estimates that other market participants would make. For these variables, the distinction between entity-specific estimates and market estimates has little practical significance.

To acknowledge the need for entity-specific assumptions, we would recommend the following revisions to the proposed building blocks:

- (a) Explicit, unbiased, ~~market-consistent,~~ probability-weighted and current estimates of the contractual cash flows, market consistent where reasonably available,
- (b) Current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) An explicit and unbiased estimate of the margin ~~that market participants require~~ for bearing risk (a risk margin) and for providing other services, if any (a service margin) reflecting what market participants require where available.

We also propose explicit disclosure of the methods applied by the entity in estimating cash flows and margins to enable users to determine whether or not these methods and assumptions are consistent with those used by other financial statement preparers. We would expect that such disclosure requirements would encourage management to adopt best practices in the methods chosen to estimate cash flows and risk margins.

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

AcSEC and the Insurance Expert Panel believe more guidance is needed on risk and service margins. Specifically, we think the objective of each margin and what are the components of each margin are unclear.

Appendix F of the Discussion Paper lays out various approaches to estimate risk margins. Our understanding is that these models can result in vastly different profit emergence. This could limit comparability across reporting entities as their results will be impacted based on the method selected. For instance, the cost of capital and quantile methods as discussed in Appendix F of the Discussion Paper are examples of two models that will release risk very differently, possibly resulting in significantly different liability measurements even if the liabilities are calculated using the current exit value model described in the Discussion Paper.

There is very little guidance on how the service margin should be calculated. We are not certain what types of services should be included. The example in Appendix G of the Discussion Paper includes asset management margins, but we are not sure whether margins related to policy administration, claims adjudication, or other services should also be included.

As discussed in our response to Question 4 in the Discussion Paper, we are in favor of Alternative B that is a rebuttable presumption that the margin implied by the actual premium is consistent with the margin that market participants require. We believe that additional clarity is needed in the earnings recognition process relating to subsequent accounting for margins. Determining the appropriate process for releasing the margins is dependent on understanding the overall performance measurement objectives. Under Alternative B of Question 4 of the Discussion Paper, we also believe additional guidance is needed on how margins will be released after initial measurement.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognize a profit at the inception of an insurance contract.

(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognize a profit or loss at inception.

(d) Other (please specify).

AcSEC and the Insurance Expert Panel believe there should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. This would result in no Day 1 gain in most cases. We consider it to be imprudent to record a gain that would be effectively a “model” gain. Our concern is that many assumptions used in the measurement attribute will be based on unobservable information and this is not a reliable basis to record a gain at inception. We acknowledge that many insurers expend significant resources to build their brand, but we are unconvinced that an insurer can have a significant Day 1 gain because of an insurer’s heavy investment in name branding and distribution when they may have not yet performed under the insurance contract. We expect that the final standard would need to include additional guidance regarding the actual measurement criteria to be used for subsequent periods.

We do believe there are limited cases where a Day 1 gain may be reasonable. If the inputs are sufficiently observable in the marketplace (equivalent to Level 1 or Level 2 hierarchy in FASB Statement No. 157), this could rebut the presumption allowing for justifiable Day 1 gain recognition.

For consistent application, we believe that additional guidance is needed on what relevant costs (i.e., incremental costs only, all related deferrable acquisition costs as considered under FASB Statement No. 60, or all development and acquisition costs that are included in the pricing of the product) should be included when calibrating the margin when evaluating the Day 1 gain.

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute ‘current exit value’.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favor, and why?

AcSEC and the Insurance Expert Panel agree that the starting point for the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity, but recognizes that due to the lack of market observable information for the insurance industry that a significant portion of both cash flows and estimates will primarily be based on entity specific assumptions.

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

AcSEC and the Insurance Expert Panel strongly believe that any decisions on unbundling revenue should wait until the IASB has further developed what will be the approach taken on the broader issues of a model for accounting for insurance contracts. In particular, the objective of revenue and other key performance indicators should be clarified before a decision on unbundling is made.

Question 14

(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?

(b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

AcSEC has historically had concerns with the recording of gains from the inclusion of creditworthiness in the measurement of a liability. For instance, when an entity’s credit rating falls, it seems counterintuitive that a gain should be recognized when the entity is still contractually liable to the policyholder for the insurance liability. However, AcSEC recommends that the IASB be consistent in the treatment of credit characteristics in the measurement of all liabilities, and not treat the measurement of an insurance liability differently.

Question 18

Should an insurer present premiums as revenues or as deposits? Why?

AcSEC and the Insurance Expert Panel believe that decisions regarding separation of insurance premiums should be considered jointly with decisions regarding the unbundling of the components of insurance liabilities, consistent with our response to Question 13 of the Discussion Paper. If liabilities can only be separated in an arbitrary manner, then the same arbitrary determination would apply with respect to premiums.

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

AcSEC and the Insurance Expert Panel believe that the IASB should put forth what they believe to be the purpose of revenue and performance measurement. After that has been done, then a proper design of a performance/income statement for insurance contracts would be possible. We would like to remind the IASB that the decisions made during the revenue recognition and financial statement presentation projects could have a significant impact on the insurance contract project, and would request that they be considered in tandem

Financial statements are intended to provide meaningful information for making business and economic decisions. The information needs to be useful and comprehensible for existing and prospective capital providers and other stakeholders. Analysts, investors, creditors, regulators and other internal and external users should be interviewed to determine what are the key indicators of management's performance during a period, including what information is needed in order to understand the uncertainties of prospective cash flows. These should be matched up to information given in financial statements. Below is a list of some indicators that are currently used for analyzing performance measurement:

Non-life insurance contracts:

- Loss ratios-premiums earned and losses incurred
- Combined ratio- premiums earned and expenses incurred
- Written premiums
- Survival ratios
- Subsequent development-nominal, interest rates and timing

Life insurance contracts:

- In force
- Mortality margins-risk premium and mortality expense
- Expense margins-expense premium and expenses
- Investment margins-investment yield and interest credited

Given the complexity of the proposed model in the Discussion Paper and the need for human and technological resources to execute the transition, consideration should be given to how to provide for a transition for the user community who frequently uses financial statement information to study trends over a period of years and builds models to project estimated future cash flows.

Question 20

Should the income statement include all income and expenses arising from changes in insurance liabilities? Why or why not?

AcSEC and the Insurance Expert Panel believe presenting a single line item in the statement of income representing the change in liabilities for insurance contracts, would not be useful to users of financial statements and instead would

recommend that the IASB separately display the components of changes in insurance liabilities. We request that the IASB consider whether and how to accommodate differences between changes in the different measurement components of the liability. For example, should changes due to cash payments or receipts, the expiration of time, or changes in interest rates or risk or service margins be reported separately from changes in expected cash flows? Should changes in the margins driven by price changes and quantity of risk changes be separately reported? Should any Day 1 gain arising from differences between the cash received from the policyholder and the initial measurement of the contract be separately presented as a means to increase its prominence?

We also believe that the IASB should give their performance reporting project higher priority than it has to date. Without a more complete set of principles, it will be difficult to assess the appropriate form of reporting, and it will be quite difficult to determine whether the rest of this proposal will provide meaningful information for financial statement users.

Comments on Other Issues

Field Testing

AcSEC and the Insurance Expert Panel believe that the IASB should strongly consider the use of field testing before finalizing any new accounting model for insurance contracts. We would recommend that the IASB develop a spectrum of example products to be tested by various insurers around the world, to determine if a proposed model would be applied consistently.

Currently in the United States, insurance enterprises account for insurance contracts based on whether the contract is classified as short-duration (primarily property and casualty), long-duration (primarily life), or reinsurance. Accident & health contracts are accounted for as either long or short-duration, depending on whether they are guaranteed renewable. The current U.S. GAAP models used for these products differ fundamentally, taking into consideration their distinct characteristics, and we are concerned that there will be significant implementation issues in trying to apply one accounting standard to all insurance contracts – especially a model that is very different from the ones used today. We believe that the results of field testing would be an important indicator in determining if the principles of the proposed model are sufficient to encompass the needs of various world wide insurance products.

Field testing would highlight areas where additional guidance was needed, and allow the Board to enhance or clarify guidance *before* companies implement expensive system changes. We see many benefits of field testing this particular standard, including, but not limited to, verification of:

- the ability to utilize a highly conceptual model that differs significantly from any model used today for financial reporting purposes
- the appropriateness of one model being applied to contracts with a wide range of durations, risks and cash flow predictability
- the consistency of the application of this model to the same or similar products across different companies
- the reliability and relevance of the resulting financial statement measurement, including presentation
- the decision useful nature of these new measurements from the perspective of management, analysts and other financial statement users.

We believe it is important that the IASB provide direction to any field testing effort, but their involvement does not need to be such that it puts a burden or strain on the resources of the IASB staff. As discussed above, we would be supportive of the IASB providing product examples to be tested for consistent worldwide application.

Given the significance of this project to insurance companies on a worldwide basis, informal, company-initiated field testing has already begun and will continue through the remaining deliberations. We believe that the IASB should leverage off of this testing and harness the work that is already being done in order to minimize the consumption of staff resources, while at the same time adding a formality to the process so that testing can be performed and results can be reported and analyzed in an efficient and effective manner. We again recommend that the IASB take into consideration, when deliberating the Discussion Paper, the results of any informal field testing that already is being performed.

Definition of an Insurance Contract

Although the Discussion Paper does not address whether the definition of an insurance contract as included in the IASB International Financial Reporting Standard (IFRS) No. 4, *Insurance Contracts*, is still appropriate, AcSEC and the Insurance Expert Panel believe that the scope of the project should be set earlier rather than later. We believe the definition of an insurance contract will become more important to the extent that the accounting and performance measurement models for insurance contracts, are different than the models for noninsurance contracts.

Currently, products that provide for specified payments to reimburse a holder for a loss incurred because a specified debtor fails to perform a contractual obligation meet the definition of an insurance contract under International Financial Reporting Standard (IFRS) No. 4, *Insurance Contracts*, and the definition of a financial guarantee contract under International Accounting Standard (IAS) No. 39, *Financial Instruments: Recognition and Measurement*. As the proposed standard on insurance contracts develops, this conflict will need to be resolved.