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August 23, 2006



LETTER OF COMMENT NO. 13

Technical Director  
File Reference 1325-100  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**RE: Invitation to Comment, “Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting” (File Reference 1325-100)**

Dear Technical Director:

We appreciate the opportunity to respond to the Financial Accounting Standards Board’s Invitation to Comment, “Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting” (ITC).

We support the Board’s efforts to improve the accounting for short-duration insurance and reinsurance contracts. We also support the FASB’s proposed approach to the International Accounting Standards Board’s project on insurance accounting. Accordingly, we do not believe that a comprehensive change in the insurance accounting model, such as a broad application of a bifurcation-type approach, should be considered until the FASB considers feedback on the FASB’s anticipated Invitation to Comment on the IASB’s preliminary views on its insurance project. Nevertheless, we believe that there are certain aspects of existing practice, primarily focused on evaluation of risk transfer, that need more immediate attention from the FASB in advance of the ongoing IASB project.

The ITC identifies concerns about the accounting for insurance that has significant risk-limiting features, commonly referred to as *finite risk insurance*, and the application of the widely-used risk transfer test. For simplicity, we refer to both insurance and reinsurance as insurance in this letter. We believe that the Board should provide guidance in the near term to address the evaluation of risk transfer, including whether an insurance contract results in a reasonable possibility of a significant loss for the insurer. Such guidance could result in a more consistent application of the risk-transfer guidance and conclusions



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regarding which contracts qualify for insurance accounting. Additionally, the Board could define a limited set of arrangements for which it is unclear whether the arrangement transfers a significant amount of insurance risk and require accounting for those arrangements using a bifurcation-type approach. However, we have significant concerns regarding the application of the bifurcation approach described in the ITC.

The remainder of this letter includes our comments on potential improvements to existing guidance and on the proposed bifurcation approach.

### **Improvements to Existing Guidance**

The Board should improve existing guidance on evaluating risk transfer in determining the accounting for insurance arrangements. The ITC acknowledges that the guidance on the accounting by policyholders, including determining whether risk has transferred, is limited and that some companies apply by analogy the guidance in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.<sup>1</sup> We believe that the risk-transfer tests should not depend on whether or not an entity is an insurance company and, accordingly, we believe that both insurance and non-insurance companies generally should apply the same guidance to evaluate risk transfer.

In addition to guidance that would result in both insurance and non-insurance companies applying similar risk-transfer tests, we believe that the Board should improve the existing risk-transfer guidance. In 2003, the AICPA's Insurance Expert Panel submitted to the Board a paper, *Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts* (Expert Panel's Paper), that identified a number of risk-transfer practice issues for which they asked the Board for guidance. We believe that the Board should consider the issues that were raised in the Expert Panel's Paper as part of its efforts to improve the risk-transfer guidance.

Other areas where additional risk-transfer and other guidance is needed, particularly for non-insurance companies, include:

- Determination of what constitutes a contract for accounting purposes and how this impacts the evaluation of risk transfer. This guidance should address the

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<sup>1</sup> EITF Issue No. 03-8, "Accounting for Claims-Made Insurance and Retroactive Reinsurance Contracts by the Insured Entity," indicates that the guidance in Statement 113 may be "useful" to non-insurance companies in assessing whether an insurance arrangement transfers risk. EITF Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises," has a similar reference to the guidance in EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises."



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circumstances under which multiple contracts with the same counterparty should be combined and circumstances under which multiple risks within a contract should be accounted for separately. Additionally, the Board should clarify the application of paragraph 18 of Statement 113, Question 25 of EITF Topic D-35, "FASB Staff Views on Issue No. 93-6, 'Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises,'" and Question 13 to EITF Topic D-34, "Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113" to make clear the circumstances under which certain elements of individual contracts should be bifurcated.

- Application of the risk transfer test when the potential risk of loss is low, but the potential severity of a loss is significant (for example, catastrophe insurance or certain single exposure policies).
- Application of EITF 93-6 to interim periods within a single-year contract, including the appropriate accounting treatment for reinstatement premiums and similar provisions.
- Expanded guidance on the conditions which qualify for the exception to cash flow testing under paragraph 11 of Statement 113.

### **Bifurcation Approach**

We believe that a bifurcation-type approach applied to a limited set of arrangements that have significant risk-limiting features may improve financial reporting for those arrangements. We acknowledge that some of the tension on the risk-transfer analysis in the current "pass-fail paradigm," as described in the ITC, will continue even with improvements to that analysis. However, we do not support a comprehensive reconsideration of the accounting for insurance contracts before the Board has further considered the results of the IASB's ongoing efforts to comprehensively address the accounting for insurance contracts. Additionally, non-insurance company policyholders often have limited loss data such that a broader application of the bifurcation approach will require significant subjective judgments by those companies. Accordingly, we support the Board exploring a bifurcation-type approach that would be applied only to a limited set of arrangements.

#### *Long-duration contracts*

We believe that long-duration contracts should be excluded from the scope of any proposed guidance that would require bifurcation. The concerns about insurance accounting, including the publicized misapplications and alleged abuses, have involved



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short-duration contracts. However, if the Board includes long-duration contracts in the scope of its future deliberations and proposals, the FASB staff should consider whether the proposed bifurcation methods would be appropriate for those contracts and whether the guidance for risk transfer related to long-duration contracts in Statement 113 is sufficient and appropriate for use by policyholders.

*Application of the bifurcation approach to certain contracts*

We believe that the proposed sequencing of the analysis to identify the arrangements that would be bifurcated (that is, by identifying the arrangements that would not be bifurcated) may not be the most effective approach to a limited bifurcation requirement. The Board should consider a more direct approach to identifying arrangements for bifurcation consideration. For example, the Board could define and describe the arrangements with enough specificity so that preparers could identify the arrangements to be bifurcated. We believe that the bifurcation approach should be applied only to contracts that are commonly described as finite-risk arrangements (starting with Approach A in the ITC). The Board should develop a clear description of contracts to be bifurcated based on concepts that could be applied to existing and evolving arrangements, rather than restricting guidance to a list of terms and features that limit risk. In that regard, the Board should focus the description of contracts to be bifurcated on the level of uncertainty in the arrangement relative to the amount of related cash flows.

*Unequivocal insurance contract*

The description of an unequivocal insurance contract should be broadened. We support the proposed exemption from the cash flow test in Statement 113 and from bifurcation for certain types of contracts. Additionally, we believe that the characteristics listed in the ITC should be expanded to include contracts such as a traditional insurance contract between an insurer and a policyholder with no risk limiting features and other contracts which would be consistent with the paragraph 11 exception.

*Bifurcation methods*

We believe that more detailed descriptions and examples of the three potential methods of bifurcating an insurance arrangement are needed to assist in evaluating (i) the conceptual merits of each method, (ii) the feasibility of each method, and (iii) whether data limitations to apply the methods exist. Although the ITC did not provide enough information on the application and the financial reporting consequences to evaluate the different bifurcation methods, the Board should consider whether a single method of bifurcation should be prescribed or whether multiple methods may be acceptable. If the



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Board describes the objectives of bifurcation and how those objectives might be achieved, it may not be necessary or preferable to prescribe a single method of bifurcation. Permitting multiple approaches would be similar to the Board's conclusion in Statement No. 123 (revised 2004), *Share-Based Payment*, that permits entities to determine the best method for estimating fair value, rather than to prescribe a single method. Prescribing a single method puts pressure on the standard-setting process in selecting the single model that will provide the most meaningful bifurcation when applied to a broad spectrum of contracts. A single method would also prohibit companies from applying new, possibly better methods that may be developed in the future.

Additionally, the Board should consider whether other components in addition to the underwriting and financing components of contracts should be identified and accounted for separately. For example, an arrangement also may include servicing/maintenance charges, claims processing fees, acquisition costs, and other similar components. In considering a bifurcation model, the Board should evaluate the need to measure and separately account for each of these components.

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As the FASB continues to consider insurance risk transfer matters and potential alternatives, we believe that the Board and its staff should continue to request input from its constituents. In that regard, the Board should form a working group that includes representatives of insurance companies, policyholders, auditors, and financial statement users to help identify alternatives and evaluate the financial reporting impact and feasibility of those alternatives. Ultimately, the Board should consider field-testing any proposed guidance.

We appreciate the opportunity to respond to the Invitation to Comment. If you have any questions concerning our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419 or Darryl Briley at (212) 909-5680.

Sincerely,

KPMG LLP