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Financial Accounting Series

INVITATION TO COMMENT

Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting

Applies to Policyholders, Insurers, and Reinsurers

Comments are requested by August 24, 2006.



Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Invitation to Comment must be *received* in writing by August 24, 2006. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1325-100. Those without email may send their comments to the “Technical Director—File Reference No. 1325-100” at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

Any individual or organization may obtain one copy of this Invitation to Comment without charge until August 24, 2006, on written request only. *Please ask for our Product Code No. ITC 20.* For information on applicable prices for additional copies and copies requested after August 24, 2006, contact:

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BIFURCATION OF INSURANCE AND REINSURANCE CONTRACTS FOR FINANCIAL REPORTING

THE PURPOSE OF THIS INVITATION TO COMMENT

1. The purpose of this FASB Invitation to Comment is to gather input from the buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bifurcation of those contracts. Bifurcation would divide some or all of these contracts into the following components for financial reporting purposes:

- a. Components that transfer significant insurance risk and are accounted for as *insurance*—for policyholders, that means premiums are expensed during the contract period and the occurrence of an insured event generates an insurance recovery that is recorded as a gain in the income statement.
- b. Financing components that are accounted for as *deposits*—for policyholders, that means premiums paid are recorded as an asset by the policyholder and the recovery from an insured event is a reduction to the deposit with no income statement benefit.

The accounting by insurance companies and reinsurance companies (as policyholders) generally mirrors the accounting by noninsurance-company policyholders.

2. Accounting for insurance contracts affects not only insurance and reinsurance companies, but also noninsurance companies that buy insurance contracts (referred to herein as *corporate policyholders*). Substantially all entities buy insurance and could be affected by the issues discussed in this Invitation to Comment. This Invitation to Comment does not address the accounting for the insurance components or the deposit components, and nothing in the Invitation to Comment should be interpreted to change current insurance accounting guidance. The terms *corporate* and *company* are used for simplicity in this Invitation to Comment and are not intended to suggest that noncorporate entities, such as partnerships and not-for-profit organizations, would not be affected by the issues discussed.

3. Of particular concern to the FASB is the depiction in the policyholder's financial statements of insurance or reinsurance contracts that transfer only limited insurance risk—often referred to as finite risk contracts. These finite risk contracts likely have both insurance components and deposit components but they generally are accounted for in their entirety as insurance contracts. The threshold question is whether bifurcation would improve financial reporting by providing users of financial statements with better information about the economic substance of insurance arrangements relative to the information provided by the current accounting for these arrangements.

4. Specifically, the FASB is requesting information about:
 - a. The definition of insurance contract and insurance risk
 - b. Whether insurance and reinsurance contracts should be bifurcated into insurance and deposit components
 - c. If so, which insurance and reinsurance contracts would be bifurcated
 - d. If so, how would insurance and reinsurance contracts be bifurcated.

Questions relating to these issues are included in the Invitation to Comment after related discussions and are repeated in Appendix A.

5. The FASB is seeking information from a broad spectrum of its constituents including corporate policyholders and investors and other users of financial statements. Accordingly, the terminology used in this Invitation to Comment addresses that audience.

6. The U.S. generally accepted accounting principles (GAAP) that provide guidance for insurance accounting mainly address financial reporting by insurance and reinsurance companies. Limited guidance exists on accounting for insurance contracts by corporate policyholders. Furthermore, most of the existing risk transfer guidance is focused on reinsurance. Accordingly, the FASB also is seeking input about applying that accounting guidance to insurance contracts—for corporate policyholders and their insurers.

7. The FASB has not reached any tentative conclusions on the issues discussed in this Invitation to Comment. This Invitation to Comment is intended to be a neutral discussion document whose sole purpose is to gather information to help the FASB in its discussion of those issues. Alternatives identified in this Invitation to Comment are illustrative and presented to facilitate discussion on accounting for insurance, risk transfer, and bifurcation of insurance and reinsurance contracts. Readers are encouraged to suggest other alternatives.

CURRENT ACCOUNTING FOR INSURANCE CONTRACTS

8. Insurance is the *indemnification* of a policyholder by an insurer against a loss or liability covered by an insurance contract. The notion of indemnification—that is, reimbursement for a loss—is central to GAAP accounting for all insurance contracts. There are typically two parties to an insurance contract—a policyholder and an insurer. In some cases—such as life insurance—a beneficiary other than the policyholder receives the insurance benefits.

9. In this Invitation to Comment, policyholders (insureds) include noninsurance companies (corporate policyholders), insurance companies, and reinsurance companies. Insurers include both insurance companies and reinsurance companies. *Reinsurance* is insurance for insurance companies—indemnifying the insurance company against specified claim losses on the insurance contracts it wrote. Unless otherwise noted in this Invitation to Comment, the terms *insurance*, *insurance contract*, *insurance company*, and

insurer include reinsurance, reinsurance contract, reinsurance company, and reinsurer, respectively.

10. In purchasing insurance, a policyholder pays a premium to an insurance company and in return expects the insurance company to pay valid claims. 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. The *pooling* or *spreading* of risks is an important function of insurance—the pooling of risks and premiums from a large number of policyholders to pay the claims of the small number of those policyholders who suffer an insured loss.

11. Whether a contract is accounted for as insurance depends on whether that contract **transfers significant insurance risk** from the policyholder to the insurer. In current practice, if the contract is determined to pass that significant risk transfer threshold, the entire contract is accounted for as an insurance contract. The policyholder expenses the premium paid as insurance expense during the contract coverage period and recognizes as income recoveries for insured losses if and when those losses occur. The insurer recognizes the premium received as revenue during the contract coverage period and recognizes claims and claim settlement expenses as they occur, including an estimate for claim losses incurred but not yet reported to the insurer. Policyholder benefit liabilities for life insurance contracts are also accrued by the insurer over the expected life of the contract.

12. If a contract is determined not to transfer significant risk, the entire contract is accounted for as a deposit. The policyholder treats the insurance premium paid as a deposit asset with claim recoveries reducing that asset (like repayments of a loan). The insurer records the premium received as a deposit liability and claims payments as a reduction in that liability—a return of the premium received (like a borrowing). Deposit accounting has a minimal impact on income.

13. An alternative to accounting for an entire contract as either insurance or a deposit would be to bifurcate (separate) that contract into insurance and deposit components. Accounting for an entire contract as either insurance or a deposit—sometimes referred to as a *pass-fail paradigm* in this Invitation to Comment—places significant pressure on determining the minimum level of risk transfer that satisfies the significant risk transfer criterion.

14. GAAP defines *insurance risk* as the risk arising from uncertainties related to the amount and timing of an insurance contract's net cash flows (including premium, commission, claims, and claim settlement expenses). *Underwriting risk*—uncertainty in the amount of net cash flows—relates to the frequency and severity (amount) of claims paid. For life insurance, underwriting risk includes the uncertainty about whether or not the policy is in force at the policyholder's death—for example, whether premiums have been paid to maintain the coverage. *Timing risk* is uncertainty in the timing of the net cash flows. Timing risk can refer to uncertainty about the timing of a loss event. That uncertainty can be significant in contracts in which claims are expected to be paid in the

distant future—such as life insurance benefits or certain liability insurance claims. In those cases, investment income on the premiums received and invested can significantly affect the profitability of the insurance contract. If the loss event occurs earlier than expected, the premium plus the investment income could be less than expected, leading to a loss on the contract. Contracts with claims that are reported and paid quickly would not be exposed to this type of timing risk. Nevertheless, prompt payment of claims is a necessary condition for timing risk to exist; an insurer that is allowed to delay the payment of claims would bear reduced (or even no) timing risk. Insurance risk requires both underwriting risk and timing risk.

15. A principal factor in determining an insurance contract's price (the premium charged) is an estimate of the expected claims for that contract. If there is significant uncertainty about that estimate, including disagreement between the policyholder and insurer, the risk for each party can be mitigated by including in the contract adjustable features that, depending on the claim experience of the contract, either reduce the policyholder's cost of insurance or limit the insurer's claim losses. For example, a feature such as an experience account (includes premiums plus investment income on a notional account balance less claim costs) can be used to determine an increase or decrease in premiums based on the insurance contract's claim activity. Contracts with such features are often determined to transfer **significant insurance** risk and, therefore, qualify for insurance accounting in their entirety.

16. The accounting by a corporate policyholder for an insurance contract can materially affect its financial statements. For example, assume that the company incurs a significant insured casualty loss that will not be settled (processed and paid) for several years, that the insurance contract is determined to transfer significant insurance risk, and that the company is able to record a full (undiscounted) insurance recovery in the year of loss. Because the claim will not be settled for several years, the insurer will accumulate investment income that will mitigate its claim payment. Thus, under current GAAP, the insured records a recovery in the year of the loss while the insurer's loss is partly offset over time by investment income. However, if the insurance contract had been bifurcated, the insurance component of the contract still would provide an insurance recovery. The remainder of the contract—a deposit or financing component—would provide little income benefit to the insured. The bifurcation would effectively result in a very different depiction of the financial statement impact of the insurance recovery, relative to the accounting under current GAAP.

17. The only available measure of an insured risk of a corporate policyholder may be the premium paid for the insurance, and this amount often is not material enough to be disclosed in the policyholder's financial statements. The amount of risk not insured or partially insured by the policyholder may not be discernible by a user of its financial statements. Risk-limiting features could result in retention of risk that is greater than would be reflected by the premium paid. Bifurcation of that contract would treat only the component of the contract that transfers risk as insurance and the remainder as a deposit. That accounting treatment would depict any limitation on the risk transferred.

18. Another form of an insurance contract purchased by corporate policyholders is the group insurance contract—a contract that protects a group of employees from covered risks. Employee benefits such as health insurance and term life insurance often are provided through the purchase of group contracts.

19. Corporate policyholders can provide employee benefits through a variety of arrangements. For example, a noninsurance company considering a health plan for its employees may consider the following options:

- a. The company can hire an administrator to process employee claims under the provisions of the health plan (an administrative services only contract). The company would pay the administrator a fee for the claim processing service and provide funds to pay claims. Although this type of arrangement is often called *self insurance*, the company is buying only an administrative service.
- b. Based on the company's history of claim payments, the company can decide to:
 - (1) Hire an administrator to process the claims (an administrative services only contract)
 - (2) Pay the claims as received up to the expected level of payments
 - (3) Buy insurance for the claims exceeding the expected level of payments.
- c. The company can purchase an insurance contract with no risk-limiting features from an insurer for a premium that covers all employee claim processing and payments under the health plan.

20. Scenario (a) provides only for the administration of the health plan and is accounted for as a service contract. Scenarios (b) and (c) could be structured to provide the company equivalent insurance protection, but the GAAP accounting for the two arrangements would differ. In scenario (b), the company accounts separately for the service contract and the insurance contract. In scenario (c), the company expenses the premium paid to the insurance company over the contract coverage period. If the claim processing period is short, the impact on income for scenario (b) versus scenario (c) might be similar because the contract coverage period and claim processing period would not be significantly different; however, the expense classification could differ—for example, administrative, claims, and insurance contract expense versus only insurance contract expense. The longer the claim administration period, the more the period expense in scenarios (b) and (c) would diverge. Also, under scenario (b), changes in the estimated claim liability could affect reported income during the claim settlement period, whereas under scenario (c), the level of claim activity would have no impact on income so long as losses were within the terms of the insurance contract.

21. In scenario (c), the payment of premiums related to expected claim payments is sometimes called *dollar trading*. Bifurcation would separate the dollar-trading component of the contract and account for it as a deposit for funding expected claim payments. The remainder of the premium would be allocated to insurance for claims exceeding the expected claims and the administrative contract. This form of bifurcation is discussed

later in this Invitation to Comment and would conform the accounting for scenarios (b) and (c) when the contracts are economically equivalent.

22. If a bifurcation approach is adopted, this Invitation to Comment suggests a sequential analysis applying four suggested screens for determining which contracts should be bifurcated. The first three screens would sort identified contracts into four groups—those that:

- a. Fail to meet the definition of insurance contract
- b. Have negligible noninsurance features
- c. Fail risk-transfer guidance
- d. Are remaining contracts that could be subject to bifurcation.

The fourth screen would eliminate from bifurcation those remaining contracts with the presence or absence of specified contract terms or features. For example, the final screen might take a narrow approach and identify for bifurcation only those contracts that are determined to have significant financing components (in addition to insurance components). Alternatively, a broad approach might require bifurcation for all insurance contracts not exempted by the first three screens. The flowchart on page 16 illustrates the steps in this analysis. Two approaches to the fourth screen—a narrow approach (Approach A) and a broad approach (Approach B)—are discussed in paragraphs 62–69.

23. If a bifurcation approach is adopted and the population of contracts subject to bifurcation is identified, an appropriate bifurcation method would need to be selected. Three methods are explored in this Invitation to Comment. The *expected payout method* is based on the expected level of claims activity for the contract and would identify a probability level that would determine the amount of claims expected to be paid. This method would view a portion of the insurance premium as a **prepayment** of claim payments by the insured. That portion of the contract could be accounted for as financing those payments.

24. Two other bifurcation methods discussed in this Invitation to Comment are the *proportional method* and the *cash flow yield method*. The proportional method is based on the notion that a mathematical measure of the portion of the risk that is retained by the policyholder could be applied to a contract's cash flows to determine the financing component of the insurance contract. The remainder of the cash flows would represent the proportion of the risk transferred—that is, the proportion of the risk insured. That portion would be accounted for as insurance.

25. The cash flow yield method is based on the notion that the insurance contract's cash flows could be divided into:

- a. Cash flows that provide a return equivalent to the interest rate on a loan
- b. Cash flows that produce a yield in excess of the interest rate on a loan.

The cash flow elements related to the interest rate on a loan would be accounted for as a financing and the remainder as insurance.

CURRENT ACCOUNTING FOR REINSURANCE CONTRACTS

26. Most of the discussion in paragraphs 8–21 applies to insurers and reinsurers as either policyholders or insurers. The financial reporting benefits of **reinsurance** (see paragraph 28) accrue principally to the buyers of reinsurance (insurers) rather than the sellers (reinsurers).

27. A *reinsurance contract* is an insurance contract issued by a reinsurance company (also known as the insurer or assuming company) for consideration (premium) to compensate an insurance company (also known as the policyholder, insured, or ceding company) for all or part of the losses on insurance contracts issued by the insurance company. Premium is *ceded* (most often paid) by the insured to the reinsurer who *assumes* that premium. While many insurance contracts have standard terms, reinsurance contracts generally are tailored to protect an insurer against all or a portion of its losses as specified in the contract.

28. Reinsurance provides a current recovery for the insured's claim losses that are reinsured, thus limiting the volatility of the insurance company's results for a given period. For property and casualty companies, reinsurance also reduces the cedent's *premium leverage ratio*. Calculated as the ratio of *net premiums* (premiums received or assumed by an insurer less premiums ceded to a reinsurer) to *capital*, this ratio often is used as an indicator of capital adequacy, that is, the ability of the insurer to support its retained insurance risk. A higher ratio implies that less capital is supporting the assumed risk. This ratio is particularly significant for regulatory reporting (based on statutory accounting practices). Other commonly used property and liability company analytical ratios such as net premiums to net claim liabilities (gross claim liabilities less ceded claim liabilities) also would be affected.

RECENT REPORTING ISSUES

29. The press has reported certain alleged abuses of the accounting for certain insurance and reinsurance contracts, often referred to as *finite risk insurance and reinsurance contracts*. Several major insurance companies and at least one noninsurance company have restated their financial statements. The extent to which insurance and reinsurance contracts transfer insurance risk and qualify for insurance accounting has been a significant issue in several of the restatements. Because finite risk contracts typically contain significant risk-limiting features, those contracts often include significant deposit components.

30. Some believe that the reported misstatements were largely due to misapplication of the current accounting guidance for risk transfer rather than to any inadequacy of that guidance. They point out that current GAAP guidance for determining significant risk transfer for **reinsurance contracts** is principles-based guidance and differences in judgment made in good faith should be expected and tolerated. The existing GAAP guidance for determining risk transfer for **insurance contracts** is limited, although some believe it is appropriate to apply the reinsurance guidance by analogy.

What Is an Insurance Contract?

31. Although GAAP does not define an insurance contract, paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, describes an insurance or reinsurance contract based on the notion of indemnification of the insured by the insurer:

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for **indemnification** of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a **deposit** by the insured or the ceding company. [Emphasis added.]

32. Paragraph 44 of Statement 5 was repeated in the reinsurance guidance provided by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. Paragraph 44 of Statement 5 also was included in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, which supersedes the reinsurance guidance in Statement 60 but carries forward the notion of indemnification as a fundamental insurance accounting concept.

33. Although several descriptions of an insurance contract appear in GAAP insurance accounting guidance, some believe that the lack of a formal accounting definition for an insurance contract is a weakness in that existing guidance. Several financial contracts have features similar to insurance contracts—for example, guarantees and certain derivative instruments that function like insurance contracts by providing compensation for changes in specified conditions. The lack of a definition of an insurance contract that would properly identify these contracts could result in mischaracterization of a contract that, in turn, could affect the decision usefulness of the accounting depiction of that contract.

34. The FASB has decided to use the definition of *insurance contract* in Appendix A of International Financial Reporting Standard (IFRS) 4, *Insurance Contracts*, as a working definition for this project. That definition states:

A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. [Emphasis omitted.]

This definition is generally consistent with the ideas in paragraph 44 of Statement 5. However, some consider **indemnification** more stringent than the IFRS notion of **compensation**—because they believe indemnification limits compensation to the amount of the policyholder’s loss.

35. The IFRS 4 definition of insurance contract depends on a definition of significant *insurance risk*. Although IFRS 4 includes a definition of insurance risk, this Invitation to Comment uses the GAAP definition of insurance risk in paragraph 121 of Statement 113:

The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

Consistent with this definition, GAAP requires that an insurance or reinsurance contract transfer both underwriting risk and timing risk. Paragraph 9 of Statement 113 states that insurance risk requires a greater than remote possibility of a significant variation in either the amount or the timing of payments by the reinsurer. Paragraph 14 of this Invitation to Comment discusses timing risk.

36. Although no commonly accepted definition exists, finite risk insurance and reinsurance contracts are often described as including features that limit the amount of insurance risk (both underwriting and timing) transferred from the policyholder to the insurer:

- a. Finite insurance and reinsurance contracts transfer a restricted amount of insurance risk from the policyholder to the insurer with the policyholder retaining a significant portion of that risk. The principal issue in accounting for finite risk contracts is whether the contract amounts reported in the policyholder's financial statements faithfully represent the economic rights and obligations provided by the contract.
- b. Contract terms and features that can limit the transfer of insurance risk include the following:
 - (1) Contract terms that result in the premium paid by the policyholder plus anticipated investment income earned by the insurer on that premium approximately equaling the reimbursements (including claim recoveries and any contract adjustments) expected by the policyholder from the insurer
 - (2) Adjustable features that result in profit- and loss-sharing arrangements between the policyholder and the insurer
 - (3) A contract coverage period that extends beyond one year and premiums for subsequent periods that may depend on the loss experience of earlier years
 - (4) Limits on the amount of claims to be paid by the insurer
 - (5) Loss corridors that limit or eliminate the risk of loss for a specified percentage or dollar amount of claims within the range of contract coverage
 - (6) Favorable contract termination provisions, for example, that would result in a loss to the policyholder
 - (7) Premiums that are a substantial percentage of the maximum coverage provided.

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?

Statement 113 and the Risk Transfer Conditions

37. Additional GAAP guidance pertaining to risk transfer, beyond the indemnification notion of Statement 5, is in paragraphs 8–13 of Statement 113. That guidance applies to reinsurance and is provided for short-duration contracts (mostly property and liability contracts) and long-duration contracts (principally life and health contracts). Indemnification of the ceding company against loss or liability relating to insurance risk in **reinsurance of short-duration contracts** requires the following:

- a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts, that is, the probability of a significant variation in both the amount and timing of payments by the reinsurer must be reasonably possible.
- b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes compared with the present value of the amounts paid or deemed to be paid to the reinsurer.
- c. If substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the reinsurance contract is exempted from the cash flow testing in (b) above. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts.

In subparagraph (a), significant variation in amount and timing must be reasonably possible. The reasonably possible criterion establishes the threshold for satisfying this criterion as a probability greater than remote.

38. Indemnification of the ceding company against loss or liability relating to insurance risk in the **reinsurance of long-duration contracts** (many life and health contracts) requires the reasonable possibility that the reinsurer may realize a significant loss from assuming insurance risk. In addition, that reasonable possibility of a significant loss must come from the mortality risk or the morbidity risk contained in the underlying insurance contracts. Mortality risk is the relative incidence of death in a given place or time, and morbidity risk is the relative incidence of disability resulting from disease or physical impairment. If mortality or morbidity risk is not reinsured, the reinsurance contract does not indemnify the ceding company against insurance risk.

39. Some believe that, under Statement 113, a contract that transfers a limited, but significant, amount of the underlying insurance risk qualifies for insurance accounting, as does a contract that transfers substantially all of the underlying insurance risk. Therefore,

reinsurance contracts that are structured to limit the amount of risk transferred to minimal qualifying amounts will achieve insurance accounting. One rule of thumb, developed in practice in implementing the Statement 113 insurance risk transfer criteria, is that a reinsurance contract that has at least a 10 percent chance of resulting in at least a 10 percent loss satisfies the risk transfer condition of a reasonable possibility of a significant loss. Although this rule of thumb (also called the 10/10 rule) has no authoritative accounting support, some have used it as an informal bright-line measure of significant (but limited) risk transfer. As an alternative to this pass-fail paradigm that determines whether an entire contract is either insurance or deposit, insurance accounting could be based on the amount of insurance risk transferred—for example, the bifurcation of an insurance contract into insurance and deposit components.

40. The 10/10 rule focuses on 10 percent as a minimum measure of a reasonable possibility. Existing GAAP uses an array of probability levels in determining the appropriate accounting for a transaction or event. The sequence of increasing probability levels is **remote, reasonable possibility, probable, and highly probable**. The levels are not quantified, and varying probability ranges for each level are used in practice. For example, reasonable possibility covers a broad range of probabilities—from greater than remote to less than probable—and individual estimates of the probabilities making up reasonable possibility vary. Another measure of probability used in certain accounting guidance is *more likely than not* (which for most means a probability greater than 50 percent).

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?

CONCEPTUAL FRAMEWORK: DECISION-USEFUL INFORMATION

41. The principal issue in this Invitation to Comment is whether bifurcation of insurance contracts into insurance and deposit components would improve the understandability and decision usefulness of financial statements. Decision usefulness is judged in terms of relevance and reliability as discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

Understandability

42. Concepts Statement 2 includes the following definition of *understandability*:

The quality of information that enables users to perceive its significance.

43. To be useful, information must be understandable to the users of that information. Some believe bifurcation would reduce the understandability of financial statements. They believe questions would arise as to when and how to bifurcate contracts and, once bifurcated, to understand what the insurance and deposit components represent. Furthermore, some view insurance contracts as essentially indivisible. For them, splitting

a contract into insurance and deposit components would be arbitrary at best. They believe that readers of financial statements would not be able to evaluate what the bifurcated components imply about future cash flows.

44. Others believe that the understandability of financial statements would be improved through bifurcation of a contract into insurance and deposit components. They acknowledge that bifurcation (the when and how to bifurcate) would require judgment. However, with accompanying disclosures about a policyholder's risk management strategies, they believe a user would be able to determine better the risk that a company bears and its strategy to limit that risk. For example, they believe the users of an insurer's financial statements likely would have a better understanding of the insurance risk retained by the company as measured by net insurance premium—that is, gross premiums less ceded premiums.

45. Some believe that the understandability of financial information would be improved if bifurcation were required only for specified types of contracts—for example, contracts that are significantly affected by implicit or explicit consideration of investment income. They believe that bifurcation of those contracts should be easy to understand because it would separate a contract with obvious financing elements into insurance and deposit components. Others believe that bifurcating all insurance and reinsurance contracts would increase overall understandability of the accounting for all insurance contracts, since all the contracts would be accounted for on the same basis.

Relevance

46. The Summary of Concepts Statement 2 includes the following excerpt on relevance:

Relevant accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations.

Some believe that both feedback value and predictive value of financial statements would be enhanced by bifurcation of insurance contracts because they believe bifurcation better represents the economic substance of insurance contracts. That representation should, in turn, assist users in predicting future cash flows and evaluating those predictions. Others believe that bifurcation would make financial statements more complex (less understandable) and would not provide a better depiction, therefore not enhancing the predictive value or the feedback value of financial statements.

Reliability

47. The Summary of Concepts Statement 2 includes the following discussion of reliability:

Reliability rests upon the extent to which the accounting description or measurement is verifiable and representationally faithful.

Verifiability is a quality that may be demonstrated by securing a high degree of consensus among independent measurers using the same

measurement methods. Representational faithfulness, on the other hand, refers to the correspondence or agreement between the accounting numbers and the resources or events those numbers purport to represent.

48. Paragraph 72 of Concepts Statement 2 distinguishes reliability from precision:

Reliability does not imply certainty or precision. Indeed, any pretension to those qualities if they do not exist is a negation of reliability. . . . Reporting accounting numbers as certain and precise if they are not is a negation of reliable reporting.

49. Some believe that bifurcating insurance contracts would require arbitrary scopes, methods, and assumptions and that the resulting components would not provide reliable information. They believe that the contract is a single instrument constructed to provide a defined element of protection to the policyholder. The terms and price of the protection purchased are based on market factors and competition. To require that the price of a single contract be split into components characterizes insurance contracts as something that they are not—that is, bifurcated insurance and deposit components are neither representationally faithful nor verifiable.

50. Others believe that bifurcation of insurance contracts would faithfully represent those contracts in financial statements because the contracts always embody both insurance and deposit components. They believe that accounting for those entire contracts as either insurance or deposits does not indicate how much insurance risk is transferred and how much is retained. They also believe that the financial statements of insurers already include significant estimates and judgments and that bifurcation would not reduce the reliability of those statements. In addition, they note that verifiability of bifurcated components should improve over time as practice evolves.

Constraints

51. The Summary of Concepts Statement 2 discusses costs and benefits:

Each user of accounting information will uniquely perceive the relative value to be attached to each quality of that information. Ultimately, a standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for another; and it must also be aware constantly of the calculus of costs and benefits.

52. Some argue that the costs of bifurcating insurance contracts, such as the tracking and reporting of bifurcated contract cash flows, will exceed any benefits from that accounting.

53. Those who support bifurcation of insurance contracts believe the current practice of accounting for an entire insurance contract as either insurance or a deposit provides limited information to users of financial statements. They believe that some of the information needed for bifurcation analysis is necessary for risk management and should already be available. They acknowledge that significant changes in accounting practices

impose costs on both the preparers and the users. However, they also believe that users currently incur the cost of not having adequate information about the insurance and deposit components of insurance and reinsurance contracts.

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?

CONSIDERING POSSIBLE BIFURCATION OF INSURANCE CONTRACTS

54. Considering possible bifurcation of insurance contracts leads to questions about:
- a. Which insurance (and reinsurance) contracts would be subject to possible bifurcation
 - b. How those contracts would be divided into components.
55. The first question relates to scope—whether any contracts should be exempt from any bifurcation requirements. This Invitation to Comment discusses scope in terms of whether (and how) specified contracts are **screened out** of the bifurcation analysis. Assuming that bifurcation would be considered appropriate in some circumstances, the second question is how to perform the bifurcation—that is, how would a contract be divided to represent fairly the insurance and deposit components?

If Bifurcation Were Appropriate, Which Contracts Should Be Bifurcated—Scope

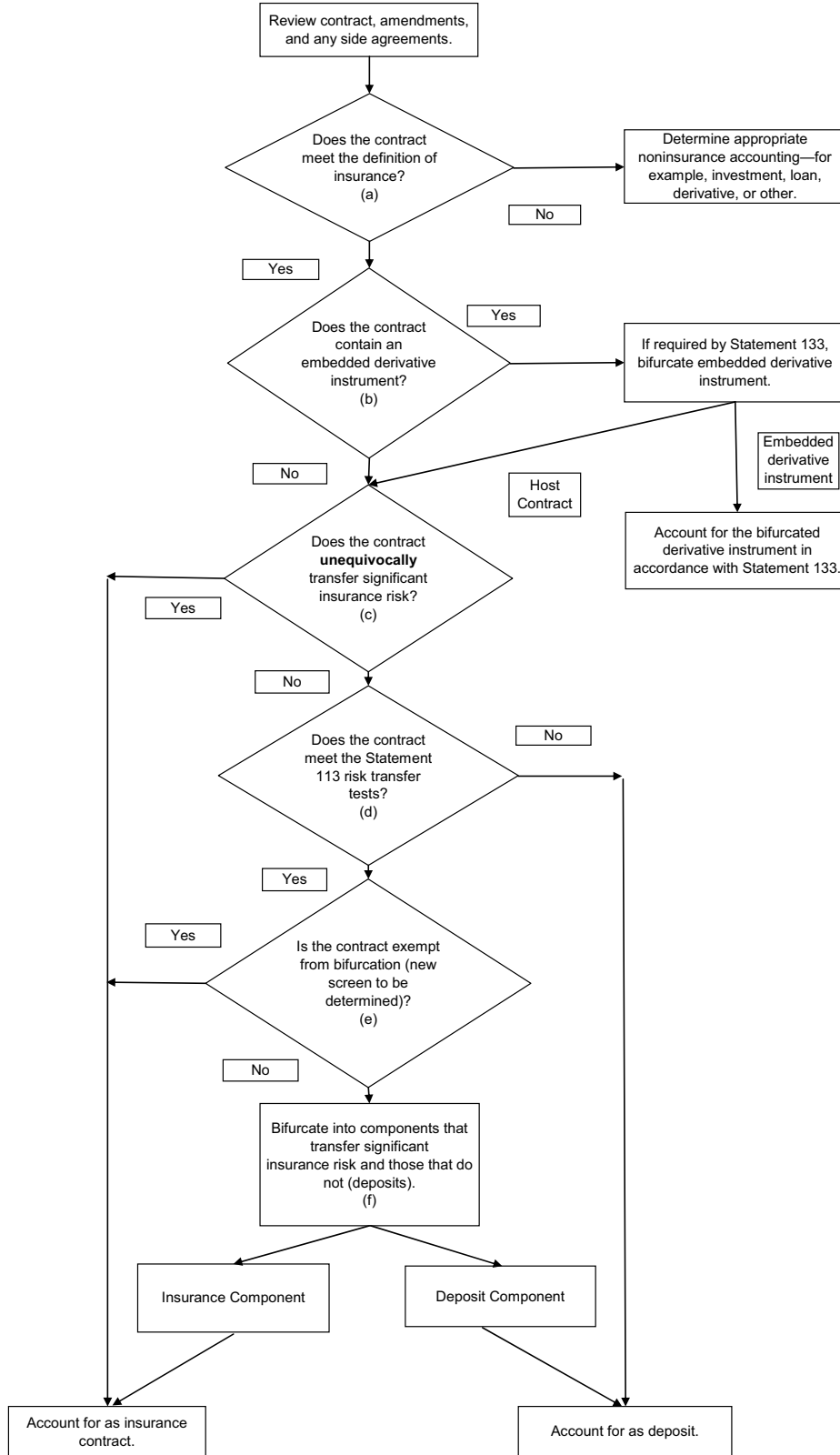
56. If the FASB were to decide that bifurcation of insurance contracts is appropriate, the initial step of the process would be determining which contracts should be bifurcated—that is, developing appropriate screens. The flowchart on page 16 is designed to illustrate a possible series of screens integrating the insurance contract definition and Statement 113’s risk transfer guidance with possible bifurcation. **This flowchart assumes that all insurance and reinsurance contracts would be subject to this analysis.** The steps in the process screen out (eliminate) from the universe of insurance contracts those contracts that would not be subject to bifurcation—basically those contracts that meet the definition of insurance contracts and are either substantially all insurance or all deposit (the steps below are referenced on the flowchart).

- a. First, contracts are reviewed to screen out from further analysis those contracts that do not meet the definition of an insurance contract. These contracts would be subject to other applicable accounting guidance.
- b. Then insurance contracts are reviewed for embedded derivatives that would require bifurcation under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- c. Next, contracts determined to *unequivocally transfer significant insurance risk* (contracts with negligible noninsurance features) are screened out of the potential bifurcation candidates (second screen) and accounted for in their

entirety as insurance contracts. This step is discussed further in paragraphs 57–59.

- d. Then, the remaining bifurcation candidates are tested (third screen) to confirm that they meet the Statement 113 risk transfer tests. Those that fail are screened out of the bifurcation candidates and accounted for as deposits.
- e. Next, contracts could be screened out or in (fourth screen) based on specified contractual terms or features. The options for this screen range from a narrow application of bifurcation—for example, finite risk contracts only—to a broad application—all insurance and reinsurance contracts not otherwise screened out of bifurcation.
- f. The remaining contracts not otherwise screened out are bifurcated.

Risk Transfer and Bifurcation Testing



Note: The letters in parentheses refer to descriptions in paragraph 56 of the Invitation to Comment.

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 Unequivocal Test for Insurance Accounting

57. As indicated on the flowchart, all insurance and reinsurance contracts must first meet the definition of an insurance contract. Contracts meeting the definition are reviewed to identify those that **unequivocally transfer significant insurance risk**. The purpose of this screen is to identify contracts that have negligible noninsurance features. This screen is intended to reduce the cost imposed on preparers in instances where further risk transfer analysis, or bifurcation, or both would provide little or no additional useful financial information to users. Paragraphs 58 and 59 discuss characteristics of contracts that would or would not be considered unequivocal insurance. (See Appendix B for examples.)

58. Judgment would be required to determine whether a contract unequivocally transfers significant insurance risk. For each type of insurance contract in subparagraphs (a)–(c) below, all of the characteristics in subparagraphs (d)–(f) would be required for that contract to be evaluated as unequivocally transferring significant insurance risk:

Type of Contract

- a. A single personal insurance contract for (1) a single risk (for example, individual whole or term life) or (2) a group of similar coverages related to a single asset, liability, or event for which the policyholder is at risk (for example, personal auto or homeowners insurance).
- b. A single commercial insurance contract for a noninsurance company that has single-risk characteristics, such as single-premise property and liability insurance.
- c. A single-risk reinsurance contract under which all the insurance risk in the reinsured portion of an underlying insurance contract is reviewed by the reinsurer who may decline coverage for that risk.

Required Characteristics

- d. The contract has a market-equivalent level of premium and the premium is not a substantial percentage of the maximum coverage provided. Any deductibles and coverage limits are fixed and also are based on standard market terms.
- e. The contract has no risk-limiting features that adjust the profit or loss on the contract based on the claim loss experience of the contract.
- f. The contract is not likely to result in any claims (for life insurance, although death is certain, the timing of the death and the existence of insurance coverage at the time of death are not).

59. Group contracts, that is, contracts with one policyholder and multiple insureds, such as group health or life insurance, would not qualify as contracts that are unequivocally insurance. As discussed in paragraphs 18–21 of this Invitation to Comment, a portion of

the premium for group and similar contracts compensates the insurer for the likely payment of expected claim losses. That arrangement is adaptable to bifurcation and deposit accounting. Similarly, portfolios of contracts that qualify individually as unequivocal insurance contracts would have expected losses. Contracts that reinsure these portfolios would not meet the unequivocal test because those contracts also would have an expected level of claim activity. Accordingly, arrangements that provide for reinsurance of any portion of business written by the reinsured would be subject to further bifurcation testing.

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?

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)?

Determination of Whether to Bifurcate an Insurance Contract

60. In the flowchart, contracts that meet the definition of insurance contracts but are not considered purely insurance remain as contracts available for bifurcation. These contracts are then subjected to the Statement 113 risk transfer tests. Contracts that fail this risk transfer reevaluation—that is, contracts that are determined not to transfer significant insurance risk—are accounted for in their entirety as deposits. Thus, contracts that meet the definition of insurance and that are either unequivocal insurance or confirmed deposits have been identified and are accounted for in their entirety as such.

61. The next step analyzes which contracts should be bifurcated. The following two approaches are presented for discussion:

- a. Approach A—Bifurcation would be required for contracts that include a significant financing component.
- b. Approach B—Bifurcation would be required for all contracts not screened out for insurance or deposit accounting in their entirety.

Approach A—Contracts with Significant Risk-Limiting Features

62. Under Approach A, insurance and reinsurance contracts subject to bifurcation include those with contract terms or features (or both) that would result in a significant financing component or an insignificant insurance component. Those risk-limiting terms or features include:

- a. Contract terms that result in the premium paid by the policyholder plus anticipated investment income earned by the insurer on that premium approximately equaling the reimbursements (including claim recoveries and any contract adjustments) expected by the policyholder from the insurer.

- b. Provisions for significant profit or loss sharing between the policyholder and the insurer—for example, adjustable premiums or commissions that are adjusted based on the insurer’s loss activity or contract experience accounts (notional accounts that accumulate a contract’s net cash flows plus interest on the account balance). These contractual terms and features typically adjust the contract’s net cash flows to limit the impact of insured events on the insurer. These contractual provisions also can allow the policyholder to share in any insurer profits on the contract.

63. Investment income and profit- or loss-sharing features affect the premium charged for an insurance contract. Those factors have a significant economic impact on the contract, and their presence is important in identifying the contracts included in Approach A.

64. Approach A is intended to identify insurance contracts that have been described as *finite risk* arrangements (unless either the insurance component or the deposit component is insignificant). As noted earlier in this Invitation to Comment, no generally accepted definition of finite risk captures the complexities of those contracts. Therefore, in developing the criteria for contracts subject to bifurcation under Approach A, the objective has been to determine common characteristics of contracts that have significant financing components or insignificant insurance components.

65. Some believe that Approach A is appealing because it attempts to target problematic contracts including those that resulted in allegations of abusive accounting.

Approach B—All Remaining Insurance and Reinsurance Contracts

66. Approach B would bifurcate all the contracts not screened out for insurance or deposit accounting in their entirety. Approach B would provide consistent accounting across all remaining insurance and reinsurance contracts regardless of the form, products, or features included in the contract.

67. Approach B could provide users of noninsurance company financial statements with an indication of the company’s insurable exposures and perhaps its less well understood exposures (for which management may want to limit the amount of risk insured and the cost of insuring that risk).

68. As discussed in the context of group insurance contracts, another component of an insurance contract that can be designed to transfer limited insurance risk is the *dollar-trading* component.

69. Many reinsurance arrangements also have dollar-trading components. One example is an unrestricted quota share reinsurance contract—that is, a contract that provides for the reinsurer to share ratably in the premiums and losses of an underlying portfolio of insurance contracts. Although many of those insurance contracts may not have any claims during the policy term, a portfolio of such contracts would be expected to have some level of claim payments. For example, although a single holder of an auto policy may not expect to have a claim during the term of a policy, it is expected that some policyholders

in a portfolio of auto policies will file claims. Accordingly, the insurer expects a certain level of claim payments from the portfolio of those policies and also expects the reinsurer to reimburse the insurer for the reinsurer's share of those claim payments. Because a portion of the premium paid (ceded) by the insurer to the reinsurer will be offset by expected claim payments from the reinsurer to the insurer, there is a dollar-trading component to the reinsurance contract—similar to group insurance policies. Under current accounting practice, the full amount of the premium transferred by the insurer to the reinsurer is reflected as ceded premium by that insurer (thus reducing the net premium by that amount) and implies that an equivalent amount of risk has been transferred. Some believe that including the dollar-trading component of the transaction in the net premium calculation overstates the amount of insurance risk transferred. They believe that the dollar-trading portion of the ceded premium should be accounted for as a deposit and that only the remaining premium should be reflected in the insurer's net premiums. They also believe that premiums paid with the expectation of repayment transfer little risk.

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?

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

Possible Bifurcation Methods

70. The process of bifurcating insurance or reinsurance contracts into insurance and deposit components would apply to the contracts remaining after the exemptions provided by the screens described in paragraphs 56–69. Three methods for bifurcating those contracts are identified in this Invitation to Comment. Additional work would be needed to test whether the methods are operational and whether the bifurcated results offer a significant improvement in financial reporting for insurance contracts.

71. The first method, the **expected payout method** (a dollar-trading method), focuses on components of contracts that are likely to produce insignificant variability in cash flows—that is, the component or components of the contract that transfer little or no insurance risk. That component consists of cash flows that are more like a deposit (an amount likely to be repaid to the insured). The second method, the **proportional method** (an effectiveness method), measures the degree of risk in cash flows of a policyholder (a) with and (b) without the effect of the insurance contract. The ratio of (a) to (b) is the percentage of risk retained by the policyholder. That ratio then is used to determine the portion of cash flows representing the deposit component. The rest of the cash flows represent the risk transferred (insurance). This approach could be described as an effectiveness method—that is, how effective is the insurance contract in reducing the insurance risk of the insured (for the portion of the risk insured). The third method would use the interest rate on a loan to isolate the financing component from the insurance component. In this **cash flow yield method**, cash flow elements yielding the interest rate

on a loan would be considered financing and cash flows producing a yield in excess of the interest rate on a loan would be considered insurance.

The Expected Payout Method

72. Statement 133 Implementation Issue No. B26, “Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts,” describes the accounting for dual-trigger insurance policies—that is, insurance policies in which claims are triggered by the occurrence of both an insurable event and changes in a separate pre-identified variable (used for determining the amount of the claim). The Implementation Issue includes a provision that any amount of claim payments that is highly probable of occurring would not be considered insurance for the Statement 133 exemption of insurance contracts. This requirement is equivalent to bifurcating an insurance contract into an insurance component and a deposit component.

73. Implementation Issue B26 includes the following guidance on expected payments:

If there is an actuarially determined minimum amount of expected claim payments (and those cash flows are indexed to or altered by changes in a variable) that are the result of insurable events that are highly probable of occurring under the contract and those minimum payment amounts are expected to be paid each policy year (or on another predictable basis), that “portion” of the contract does not qualify for the insurance exception [in Statement 133]. (For example, if an insured has received at least \$2 million in claim payments from its insurance company (or at least \$2 million in claim payments were made by the insurance company on the insured’s behalf) for each of the previous 5 years related to specific types of insured events that occur each year, that minimum level of coverage would not qualify for the insurance exclusion.)

The Proportional Method

74. This section describes one approach to a proportional bifurcation method—there may be other approaches not discussed here. This proportional bifurcation method uses a ratio to depict mathematically the insured risk that a policyholder bears before consideration of insurance compared to the portion of the insured risk retained by the policyholder after applying the terms of the insurance contract. That risk-retained ratio then would be applied to the cash flows of the insurance contract to identify the deposit component versus the remainder of the cash flows—the insurance component.

75. Under this concept of relative risk transfer, if the insurer has the same insurance risk as the insured would have had without insurance, then the insurer has assumed all of the insured’s risk and insurance accounting would be used for the entire contract. To the extent that the insurer has limited the insurance risk transferred by the contract, a portion of the transaction reflecting the effect of any risk-limiting features in the contract would be accounted for as a deposit. The relative risk positions of the insured and insurer are measured using mathematical metrics that would best achieve the financial reporting objective of separating the insurance component and deposit component.

The Cash Flow Yield Method

76. Some have observed that an insurance contract would require cash flows that generate a yield greater than the interest rate for a loan. Embedded in the interest rate for a loan is a margin for risk related to a possible default by the borrower; however, that interest rate does not contemplate the underwriting and timing risks required for an insurance contract. Therefore, the cash flows associated with an insurance contract should yield more than the interest rate on a loan. For example, if a policyholder is paying more than the interest rate on a loan (based on the policyholder's estimate of the insurance contract's cash flows), the contract could be transferring insurance risk. Similarly, if an insurer is receiving more than the interest rate on a loan, that also could be an indicator that the contract is transferring insurance risk.

77. Accordingly, some believe that applying the interest rate for a loan to the expected cash flows of an insurance contract could identify the elements of those cash flows that constitute a loan—that is, those cash flows that do not transfer insurance risk. Such cash flow elements would be accounted for as a deposit. The elements of the expected cash flows that produce the yield in excess of the interest rate for a loan would be accounted for as insurance. More research is necessary to determine the feasibility and operationality of such an approach.

Summary of Bifurcation Methods

78. The expected payout method could produce a contract deposit component that is measured in terms of an expected amount of dollar trading at a high probability level. *Dollar trading* is an example of the deposit component of the expected payout method and indicates that there is little insurance risk transferred in the dollar-trading component of the transaction. The cash flow yield method would identify cash flows equivalent to a financing. This method also identifies underlying cash flows that do not transfer insurance risk. The proportional method would involve a calculation of the expected percentage of an insured risk that would be retained by the insured after considering the effect of the insurance contract on that risk. One way to view that arrangement is in terms of the effectiveness of the contract in reducing the variability of the retained cash flows. The proportion related to the variability retained is considered the deposit component, and the proportion related to the variability transferred to the insurer is considered the insurance component of the contract.

79. Models using historical data typically would be used to bifurcate insurance and reinsurance contracts—the proportional method would seem especially dependent on such models. These models would rely on understanding the claim loss distributions. Some have expressed concern that the available data concerning insurance exposures are not sufficient to develop the necessary model parameters and that results based on those models will not be reliable.

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?

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?

CONVERGENCE

IFRS 4

80. Unbundling (bifurcation) is currently required by IFRS 4 for some insurance contracts. Appendix A of IFRS 4 includes the following definition of unbundle:

Account for the components of a contract as if they were separate contracts.

81. The focus of unbundling in IFRS 4 is on ensuring that all contractual rights and obligations are recognized (especially contract liabilities that may not be otherwise recognized). IFRS 4 requires unbundling if some of those contractual rights and obligations would not otherwise be recognized. In other cases, IFRS 4 permits unbundling unless the insurer cannot measure reliably the deposit component.

82. Similar to accounting guidance for deposits under GAAP, IFRS 4 requires contracts that do not transfer significant insurance risk to be accounted for as financial instruments under International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*.

83. Some believe that bifurcation of insurance contracts would diverge from the requirements in IFRS 4. IFRS 4 does not give detailed guidance on how to identify insurance components and deposit components, though the International Accounting Standards Board's (IASB), *Revised Guidance on Implementing IFRS 4 Insurance Contracts*, includes a simplified example of a contract involving an experience account.

IASB Insurance Contracts Phase II

84. Some believe any need for bifurcation of insurance contracts into insurance and deposit components is dependent on the insurance contract accounting that results from phase II. They believe that, if the IASB's phase II standard results in accounting for insurance contracts that is similar to the accounting for financial instruments, bifurcation of insurance contracts likely would be unnecessary.

85. Others believe that, even if the recognition and measurement of insurance and deposit components are similar, there is still an issue with respect to revenue recognition and whether premium receipts should be recognized as revenue or deposit receipts or

whether bifurcation into those components is appropriate or necessary. This Invitation to Comment is expected to provide information that may be helpful in addressing that issue.

86. Although the FASB is not currently participating in the IASB's phase II project, the IASB and the FASB have agreed to approach that project on the modified joint approach. Under that approach, the IASB will issue for public comment a Discussion Paper containing its tentative decisions on the accounting for insurance contracts. The FASB plans to seek input from its constituents on the IASB's preliminary views by issuing an Invitation to Comment containing the IASB Discussion Paper. The feedback received on that Invitation to Comment will be used by the FASB in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contracts. As of April 1, 2006, the IASB Discussion Paper is scheduled to be issued in the fourth quarter of 2006. An FASB Invitation to Comment would be issued after its release. The FASB has not yet decided on the timing of that document.

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?

Appendix A

THE ISSUES

A1. This Invitation to Comment requests your views and comments on the following issues (please refer to the issue number in your response). The issues also are included in this Invitation to Comment at the page numbers referenced following the relevant discussions.

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? (page 10)

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? (page 11)

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? (page 14)

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? (page 17)

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? (page 18)

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)? (page 18)

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? (page 20)

Issue 8: Should the criteria for bifurcation be different for **insurance contracts** and **reinsurance contracts**? Why? If yes, what differences would you suggest? (page 20)

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? (page 22)

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? (page 23)

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? (page 24)

Appendix B

EXAMPLES OF CONTRACTS THAT UNEQUIVOCALLY TRANSFER INSURANCE RISK

The Unequivocal Test for Insurance and Reinsurance Accounting

B1. The table below presents examples of contracts that would qualify as insurance contracts that **unequivocally transfer significant insurance risk** and, therefore, would be accounted for in their entirety as insurance contracts as well as a few examples that would not qualify. Those contracts that qualify would be exempt from further bifurcation analysis as described in this Invitation to Comment. This exemption assumes a reasonable (that is, market based) level of premium and no risk-limiting features in the contract that adjust its profit or loss based on the claim loss experience of the contract. Any deductibles and coverage limits are fixed and are also based on standard market terms.

B2. Insurance contracts that would be considered to unequivocally transfer significant insurance risk include those contracts for which there is a **single contract** for (a) a single risk (for example, individual whole or term life) or (b) a group of similar coverages related to a single asset, liability, or event for which the policyholder is at risk (for example, personal auto or homeowners insurance). Each of those exempt insurance contracts is not likely to incur a loss (for life insurance, although the event is certain, the coverage and timing are not and an early death can impose a loss on the insurance company). Commercial insurance contracts that have the same single risk characteristics such as single-premise property or liability insurance also would meet the unequivocal insurance standard. Another common characteristic of those types of insurance contracts is that all of the risk insured has been transferred from the policyholder to the insurer. Single risk reinsurance contracts also would meet the unequivocal standard—that is, arrangements under which insurance contracts covering single risks (that is, a single underlying contract) are reinsured.

B3. The unequivocal exempt insurance contracts typically do not include group contracts—that is, contracts with one policyholder and multiple insureds—such as group term life or health insurance. Premiums for group contracts and other similar contracts often compensate the insurer for the payment of expected claim losses—a characteristic that disqualifies those contracts from the unequivocal insurance exemption. Because pools or portfolios of unequivocal insurance contracts also would likely have expected losses, contracts reinsuring pools or portfolios would not meet the unequivocal test.

Type of Insurance	Is the Contract Exempt from Further Testing (Is It Unequivocally an Insurance Contract)?	Explanation
Individual accident and health insurance	Yes	Provides protection for one policyholder with the risk transferred to the insurance company.
Group accident and health insurance	No	Provides protection for several individuals. Premium provides compensation to the insurer for payment of expected claims. An additional test to confirm risk transfer would be required along with a bifurcation analysis.
Homeowners insurance	Yes	A single contract is issued with multiple coverages such as fire, flood, and liability. However, the coverage is issued on a single asset, and the entire risk is transferred.
Auto insurance (individual)	Yes	Provides protection for collision, comprehensive, third-party liability, etc. The contract provides an individual policyholder multiple coverages related to the same asset.
Auto insurance (for family)	Yes	A single contract is issued and covers multiple automobiles and insureds. The entire insurance risk is transferred to the insurance company, and normally the premium for each automobile and insured within the contract is individually underwritten and priced.

Type of Insurance	Is the Contract Exempt from Further Testing (Is It Unequivocally an Insurance Contract)?	Explanation
Auto insurance (fleet of automobiles)	No	While a single group contract is issued, the insurance company is compensated through premium for a certain level of expected losses. If multiple contracts are issued by the same insurance company to the same insured, a presumption would exist that the underwriting and pricing would be similar to the scenario in which a single group contract is issued. An additional test to confirm risk transfer would be required along with a bifurcation analysis.
Professional liability (sole practitioner)	Yes	Provides protection for a single policyholder and a single risk. The entire risk is transferred to the insurance company.
Professional liability (sole practitioner)—deductible of \$100,000	Yes	Provides protection for an insured loss layer of \$400,000 above \$100,000. The insured loss layer is for a single risk, and the entire risk for that loss layer is transferred to the insurance company. The premium, deductible, and coverage limit are standard market terms.

Type of Insurance	Is the Contract Exempt from Further Testing (Is It Unequivocally an Insurance Contract)?	Explanation
Professional liability (large partnership)	No	Provides protection for multiple professionals. Therefore, there is a presumption that the premium will compensate for a level of expected losses. An additional test to confirm risk transfer would be required along with a bifurcation analysis.
Umbrella coverage (general liability, fire, business interruption)	See explanation	Insurance products are often packaged to obtain price or cost efficiencies. If an umbrella contract was issued for a single location, no risk transfer analysis would be required (see homeowners for rationale). If a company with many offices obtains a single umbrella contract to cover all of the locations, a risk transfer analysis would be required. Similar to the auto coverage for a fleet of automobiles, if multiple similar policies are issued by the same insurance company, a presumption exists that the premium will compensate the insured for a level of expected losses. An additional test to confirm risk transfer would be required along with a bifurcation analysis.