new york state society of
NYSSCPA
certified public accountants
530 fifth avenue, new york, ny 10036-5101
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October 31, 2003

Mr. Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

By e-mail: CommentLetters@iasb.org.uk

Re: ED 5 Insurance Contracts and its accompanying documents

Dear Mr. Clark:

The New York State Society of Certified Public Accountants, the oldest state accounting association in the United States, which represents approximately 30,000 CPAs, thanks the IASB for the opportunity to comment on the Exposure Draft on insurance contracts and its accompanying documents.

The NYSSCPA's International Accounting and Auditing Committee deliberated the Exposure Draft and prepared the attached comments for the Board's consideration. If the IASB would like to discuss these comments with the Committee, please contact Robert N. Waxman, the Committee chairman, at (212) 468-7820, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

Jeffrey R. Hoops,

President

Attachment

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NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

INTERNATIONAL ACCOUNTING AND AUDITING COMMITTEE

COMMENTS ON IFRS EXPOSURE DRAFT

ED 5 INSURANCE CONTRACTS

And Its Accompanying Documents:
Draft Implementation Guidance **and**
Basis for Conclusions

October 31, 2003

Principal Drafter

Lewis Shayne

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New York State Society of Certified Public Accountants

COMMENTS ON PROPOSED IAASB EXPOSURE DRAFT

ED 5 INSURANCE CONTRACTS
And Its Accompanying Documents:
Draft Implementation Guidance and
Basis for Conclusions

General Comments

ED-5 contains proposals for limited improvements to accounting practices for insurance contracts and for greater disclosures by issuers of insurance contracts. The proposed split of the project into two phases, however, raises the possibility that specific rules adopted in the first phase may be reversed, changed, or clarified during the second phase. The project would be more effective if accomplished in a single phase.

The IASB should also consider the objective of convergence at the accounting principles level in order to remove individual differences between U.S. GAAP and International Financial Reporting Standards. Because U.S. GAAP is highly developed in the area of insurance, the IASB should consider working with the FASB on modifications to SFAS 60, *Accounting and Reporting by Insurance Enterprises*, as amended. The result of such a project would then be a standard adopted simultaneously by the IASB and the FASB.

Responses to the questions raised in ED 5 *Insurance Contracts* follow:

Specific Comments

Response to Question 1 - Scope

a. ED 5 correctly addresses insurance contracts rather than specific entities such as insurers. Accounting principles should reflect the substance of contracts regardless of the legal structure of the entity issuing the contract.

   Nonetheless, the scope should explicitly encompass the extensive requirements in the ED-5 for financial statement disclosures. Furthermore, the scope should be expanded to address specific assets that are held by insurers to back insurance liabilities.

b. Weather derivatives should not be specifically addressed. If warranted, broader categories should be created that would incorporate weather derivatives. Weather derivatives classification (as an insurance or non-insurance contract) should follow the classification of the category into which they fall.

Response to Question 2 – Definition of an insurance contract

The definition of an insurance contract should not be finalized until the project is completed, which would include both phase one and two. All issues should be considered before selecting the criteria for determining the circumstances under which insurance contracts should be classified as such.

Furthermore, a definition of insurance contract that does not use the word 'insurance' within the definition would be preferable. The following modification to the wording should be considered: An insurance contract is defined as a 'contract under which one party (the insurer) accepts significant risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.'

<u>Response to Question 3 – Embedded Derivatives</u>

Question 3 underscores the problems created by separating the project into two phases. IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value, and include changes in their fair value in profit or loss. If insurance contracts were like other contracts, there would be no need to address them separately. Their uniqueness, however, demands unique solutions. The distinctive characteristics of insurance contracts should be reflected in the analysis of investment-linked products. A comprehensive, rather than partial, approach would integrate the two phases of the project.

<u>Response to Question 4 – Temporary exclusion from criteria of IAS 8</u>

a. Exemptions should not be allowed from any criteria established by the IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. Furthermore, it is not advisable to introduce an exemption to criteria used in financial statements for periods beginning on or after January 1, 2005 and to reverse the exemption for periods on or after January 1, 2007, a period of merely two years.

   Paragraphs 5 and 6 of the May 2002 Exposure Draft of improvements to IAS 8 state:

   5. In the absence of a particular Standard or an Interpretation of a Standard that specifically applies to an item in the financial statements, management shall use its judgment in developing and applying an accounting policy that results in information that is:

   (a) relevant to the decision-making needs of users; and
   (b) reliable in that the financial statements;
   (i) represent faithfully the results and financial position of the entity;
   (ii) reflect the economic substance of transactions and other events, and not merely the legal form;
   (iii) are neutral, i.e., free from bias;
   (iv) are prudent; and
   (v) are complete in all material respects.

   6. In making the judgment described in paragraph 5, management shall consider the following sources in descending order:

   (a) the requirements and guidance in Standards, and Interpretations of Standards, dealing with similar and related issues, and Appendices and Implementation Guidance issued in respect of those Standards;
   (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the Framework for the Preparation and Presentation of Financial Statements; and
   (c) pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature, and accepted industry practices, to the extent, but only to the extent, that these are consistent with (a) and (b) of this paragraph.

Accounting practice would be more consistent if entities followed paragraphs 5 and 6 of IAS 8 until the insurance contract project is complete. U.S. GAAP, used broadly by many entities reporting insurance contracts, should be permitted until the entire project on insurance contracts is concluded.

b. It is not appropriate to eliminate catastrophe and equalization provisions in phase one as a piecemeal amendment to the existing approaches. Such elimination could come after an in-depth analysis in partnership with the FASB, IAIS, NAIC, other standard setting bodies, and key professional organizations. This approach could lead to a generally accepted definition of a catastrophe. Not only would this clarify the accounting for a catastrophe but also the accounting for the segregated part of the premium (the catastrophe premium).

Furthermore, introducing a loss recognition test in phase one introduces a piecemeal stopgap rule, whose appropriateness is further confounded because of the lack of a clear explanation of its implementation.

<u>Response to Question 5 – Changes ins accounting policy</u>

a and b Whereas the concept behind the proposals is valid, the specific requirements are premature because of the lack of guidance for fair value measurement.

<u>Response to Question 6 -- Unbundling</u>

a, b, and c. The unbundling concept requires additional study. Theoretically, any insurance contract or product could be unbundled into various components. For example, contracts may contain the following three components:

1. True insurance component
2. Interest/investment component
3. Inflation (deflation) adjustment component

The second and the third item together could be identified as a deposit component. Currently, in some geographical regions, interest rates or return on investment are very low. The same areas often experience very low inflation or deflation. In extreme circumstances, the rate of deflation could be higher than the interest rate, raising the question of how such components be reported. A comprehensive solution for these multidimensional problems should be sought before unbundling rules are finalized. Over time, the correctness of possible solutions could be analyzed by econometric approaches, such as two-stage least-squares regression analysis, Monte Carlo simulations, and other analyses. The best unbundling model would become apparent after appropriate research. Only then, when a theoretically sound and cost-effective solution is found and, should unbundling be required.

<u>Response to Question 7-- Reinsurance</u>

Phases one and two of the project must be combined to eliminate any short-term rules created in phase one that will be superceded by decisions in phase two. The current proposal would create the need for significant and costly data collection and analysis systems that would subsequently not be required upon the completion of phase two.

<u>Response to Question 8 – Insurance contracts acquired in a business combination</u>

a. All liabilities of every entity should be measured in accordance with the insurer's accounting policies.

b. The requirement in (b), however, has the prerequisite of meaningful guidance related to fair value measurement. Such guidance should precede final determinations about related accounting treatments.

Response to Question 9 – Discretionary participation features

We reiterate our position that phases one and two of the project be combined to eliminate any short-term rules.

Response to Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposed approach is inappropriate. New or different disclosures should not be required before the IASB determines how those disclosures should be formulated. BC139 of the Basis for Conclusions on this Exposure Draft states, *"The Board's tentative decision to adopt a fair value model will not become definitive until the due process for phase II is complete. Therefore, some argue that the Board should not require disclosure of the fair value of insurance liabilities and insurance assets until it completes phase II.*"

It is premature to require the presentation of the fair value of liabilities without a fully acceptable and agreed upon methodology of ascertaining such fair values. Such sweeping new disclosure rules should be adopted after the appropriate methodology has been formulated, presented for public comments, and published.

Furthermore, it is not advisable to introduce a change in reporting for financial statements for periods beginning on or after January 1, 2005 only to amend those changes for periods on or after January 1, 2007 (the date when phase II is expected to be completed).

Entities should be allowed to follow the guidance in paragraphs 5 and 6 of IAS 8 until both phases of the insurance contract project have been completed. U. S. GAAP, followed by many entities reporting insurance contracts, should be permitted until the entire project on insurance contracts is concluded.

Question 10 does not include the third paragraph of the exposure draft, which states:

This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 and IAS 39 Financial Instruments: Recognition and Measurement), except in the transitional provisions in paragraph 35.

Paragraphs 3, 30, and 33 should be modified to ensure clear and consistent presentation. Further, the ED should clarify those assets and liabilities covered by paragraphs 3, 30, and 33.

Response to Question 11 – Other disclosures

a. Insurers should make disclosures about amounts in their financial statements, but specific requirements concerning those disclosures should be postponed until the entire project is complete and a final statement issued. Some of the proposed disclosure requirements are inconsistent with U. S. GAAP. The final standard would be far stronger if IASB and FASB requirements were converged.

b. There should be clear guidelines describing how the requirements relate to U. S. GAAP requirements, NAIC statutory requirements, and other major GAAP and statutory requirements. Such guidelines are essential for a smooth, cost-effective transition.

c. Those entities that were previously disclosing information about claims development should not shorten the reporting period after implementation of the proposed international standards.

<u>Response to Question 12 – Financial guarantees</u>

We agree with the proposal.

<u>Response to Question 13 – Other comments</u>

The IASB should issue a document that would include sample hypothetical financial statements. In addition, there should be additional statements based on the same financial data, prepared in accordance with provisions of GAAP (such as U. S. GAAP) and statutory requirements (such as U. S. SAP). Because the insurance industry differs from other reporting entities, such a document would clarify many issues.

The issuance of the proposed IFRS in its current form might interfere with the necessary implementation of regulatory reporting in various jurisdictions. Since the nineteenth century, many jurisdictions' regulators have required that financial statements prepared by insurance entities be based on liquidation accounting principles, because the regulators wanted to assess the insurer's ability to pay claims to policyholders in worst-case circumstances (e.g., statutory accounting principles [SAP] in the United States). Usually SAP statements have been required in addition to GAAP statements. It is conceivable that, in some jurisdictions, arguments may be raised against SAP statements based on IASB pronouncements. Such a potential misuse of an IASB pronouncement would be forestalled by including, in the basis for conclusions, an acknowledgement of the usefulness of SAP for regulatory purposes. If such an approach were adopted, the basis for conclusion should then specify that GAAP financial reporting is predicated on the going concern assumption rather than a liquidation assumption.