November 17, 2003

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

Dear Mr. Clark:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants is pleased to offer comments on the IASB's Phase I exposure draft of the proposed International Financial Reporting Standard, *ED 5 Insurance Contracts* (ED).

AcSEC supports the issuance of the Phase I proposed standard on insurance contracts as interim guidance that is a start in the process of developing an international insurance standard. AcSEC recommends expeditiously addressing Phase II to eliminate inconsistencies remaining from Phase I.

AcSEC also recommends that all significant conclusions be included in the standard section of ED 5; currently there are several conclusions that are not clearly stated in the standard section but further explained in the Basis for Conclusions.

AcSEC has not commented on every issue raised in the ED, but offers the following observations and comments:

- Definition of an insurance contract – request clarification on what is meant by significant insurance risk
- Embedded derivatives – propose additional examples that would be beneficial to include in IG Example 2: Embedded Derivatives
- Temporary exclusion from criteria in IAS 8 - recommend expeditiously addressing Phase II to eliminate any inconsistency in accounting remaining from Phase I, and allowing presentation of premium and claims expense net of reinsurance when accompanied by appropriate disclosures.
- Changes in accounting policies – request clarification as to what is meant by "excessive prudence"
- Unbundling – request clarification on the application of the proposed unbundling guidance
- Reinsurance purchased – recommend that the guidance prohibiting an immediate gain at the inception of a reinsurance contract should be incorporated in paragraph 10 of ED 5, and request clarification as to what is considered the period of underlying risk exposure for income recognition for prospective and retrospective reinsurance contracts.
- Disclosure of fair value – recommend that fair value disclosures not be required until appropriate guidance has been developed on an insurance fair value model and that companies be given sufficient time to implement the new guidance.
- Other disclosures – recommend a reduction in the proposed amount of claims

development data included in the financial statements.

- Application of IAS 39 to investment contracts – request clarification on several questions relating to the application of IAS 39 to investment contracts
- Loss recognition – recommend the IASB allow entities following existing accounting policies without loss recognition tests to follow any other loss recognition test that other entities follow provided it meets the minimum requirements of the standard.
- Purchased insurance – recommend revising the scope of IAS 39 to exclude all insurance contracts

The attachment to this letter contains more comprehensive responses to the specific questions addressed by AcSEC. Representatives of AcSEC would be pleased to discuss our comments with the Board or its representatives. Please feel free to contact Jeff Swormstedt at (203) 761-3544 or Kim Kushmerick Hekker, AICPA at (212) 596-6160 or khekker@aicpa.org.

Sincerely,

Mark Bielstein, Chair	Jeff Swormstedt, Chair
Accounting Standards Executive Committee	International Insurance Task Force

ED 5 Insurance Contracts

The following attachment contains AcSEC's response to specific questions raised in the ED.

Question 2 – Definition of an Insurance Contract
The draft IFRS defines an insurance contract as a "contract under which one party (the insurer) accepts significant insurance 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" (Appendices A and B of the draft IFRS, paragraph BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

AcSEC agrees in principle with the direction of the IASB with respect to the definition of an insurance contract, but requests clarifications. Because the guidance here and elsewhere in the International Accounting Standards will be translated into many languages, AcSEC believes it is important that every effort be made to ensure the guidance is clear, unambiguous and distinct.

1) AcSEC recommends additional guidance as to what is meant by "significant insurance risk". Specifically, AcSEC believes that the use of the terms *plausible* and *extremely unlikely* in paragraph B21 of Appendix B of the ED are potentially confusing, in they could both be read as intended to describe insured events that should be incorporated in the determination of significant insurance risk.

Paragraph B21 of Appendix B of the ED, states:

> Insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (i.e., probability-weighted) present value of all the contractual cash flows.

The strict definition of plausible would imply that it should be reasonably possible that an insured event would cause a significant adverse change. Paragraph B21 could be read to note that the condition could be met if the insured event is extremely unlikely to occur implying that remote scenarios should be included.

AcSEC recommends explicitly clarifying in paragraph B21 whether or not remote scenarios, including catastrophic type events, should be included. AcSEC would like to ensure that situations where there is a fixed premium paid in the purchase of an insurance contract are not excluded in the determination of significant insurance risk. AcSEC also recommends that the IASB provide clarification as to what is meant by "plausible" or replace plausible with a word that more clearly conveys what situations should be included in that definition:

> Insurance risk is significant if, and only if, ~~it is plausible that~~ **a possible** insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small

proportion of the expected (i.e., probability-weighted) present value of all the contractual cash flows.

2) Paragraph BC28 of the Basis for Conclusions, discusses why the significance of insurance risk should be evaluated on a single contract basis and states:

…..Therefore, the draft IFRS defines the significance of insurance risk in relation to the individual contract. The Board has two reasons for this proposal:

(a) Although insurers manage contracts on a portfolio basis, and often measure them on that basis, the contractual rights and obligations arise at the level of the individual contract.

(b) An assessment contract by contract is likely to increase the proportion of contracts that qualify as insurance contracts. If a large book of contracts consists mainly of insurance contracts, the Board does not intend insurers to examine each contract within that book to identify a few non-derivative contracts that do not transfer significant insurance risk. The Board's intention is to make it easier, not harder, for a contract to meet the definition.

AcSEC has interpreted paragraph BC28 (b) as providing practical guidance for how the overall principle for determination of significance of insurance risk may be applied, that is, within a large book of homogenous contracts a few representative contracts could be evaluated and the determination for insurance risk applied to the entire book of contracts. AcSEC agrees with this implementation guidance, but believes it is important to specify that the block or grouping must consist of homogenous contracts, as it would not be appropriate to classify a non-homogenous group of contracts based on the evaluation of a limited number of contracts that may not be representative of the group.

AcSEC recommends including additional wording to clarify the intent of paragraph BC28 (b), to read:

If a large book of **homogenous** contracts mainly consist of insurance contracts, the Board does not intend insurers to examine each contract within that book to identify a few non-derivative contracts that do not transfer significant insurance risk.

Question 3 – Embedded Derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* 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. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

AcSEC agrees with the proposed exemptions from the requirements in IAS 39, but recommends including several additional examples in IG Example 2: Embedded Derivatives, specifically:

1) Contracts containing non-guaranteed participating dividends or experience refund provisions (based on actual experience of the insurance enterprise with respect to the related block of contracts)
2) Contract that provides for pass-through to the contract holder of investment return on a group of assets
3) Insurance contract containing a cash surrender option that provides for the contract holder's allocation of contract account value among various variable investment options.

These examples and the recommended treatment under the ED and IAS 39 are included in Appendix A of this letter.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

1) AcSEC notes that the temporary exemption from the criteria in paragraphs 5 and 6 of IAS 8 will allow for continued diversity within a standard that was supposed to provide uniformity. AcSEC does not prefer interim guidance but understands the practicality needs for Phase I. AcSEC recommends expeditiously addressing Phase II to eliminate inconsistencies remaining from Phase I.

2) AcSEC agrees that the proposals in paragraphs 10-13 of the draft IFRS are appropriate to be included in Phase I, other than the required gross reporting of income and expenses from reinsurance contracts. AcSEC recommends that the IASB allow companies to report premiums and losses net of reinsurance. AcSEC believes it is reasonable to allow for either presentation (gross or net) on the statement of operations during Phase I, but does agree that gross presentation should be required for the balance sheet.

Question 5 – Changes in accounting policies

The draft IFRS:

(a) Proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) Proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognized in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

1) AcSEC recommends that the IASB provide guidance as to what is meant by the term "excessive prudence" as used in paragraph 16 (b) of ED 5 or not include the term in the Phase I standard.

Paragraph BC79 states:

> Insurers sometimes measure insurance liabilities on what is intended to be a highly prudent basis that lacks the neutrality required by the Framework. However, phase I does not define excessive prudence and cannot, therefore, eliminate it. Consequently, the proposals in the draft IFRS would permit an insurer to continue using measurements of insurance liabilities that lack neutrality because of excessive prudence. Nevertheless, they would not permit an insurer to adopt a new accounting policy that creates or increases excessive prudence (see paragraph 16(b) of the draft IFRS)…

AcSEC is concerned that this guidance, as currently drafted would be difficult to consistently apply. AcSEC acknowledges that the IASB does not intend to define *excessive prudence* in ED 5, but notes that the term excessive prudence could be interpreted differently among different insurers within different countries and could lead to increased diversity. If the IASB does not feel it can provide additional guidance regarding the definition of *excessive prudence*, AcSEC recommends that the related guidance be removed from ED 5.

2) AcSEC does not object to the guidance in paragraph 16 (e) of ED 5 that insurance subsidiaries are allowed to be on different accounting basis for Phase I, but strongly recommends that subsidiaries should be on a consistent accounting basis for Phase II.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (i.e., account for separately) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

(b) Should unbundling be required in any other cases? If so, when and why?

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

AcSEC believes that it is appropriate to require unbundling, but believes the conditions that require unbundling are not clear under the guidance in ED 5, and requests clarification as to the following:

1) What types of contracts are to be included in the definition of traditional life insurance contracts. For U.S. products would "traditional" be considered life contracts accounted for under FASB Statements No. 60 and No. 97 or a subset? AcSEC believes that the current description of traditional life insurance contracts under paragraph 8 of the ED may lead to inconsistency in determining to which contracts the unbundling guidance in Phase I should be applied.

2) Paragraph IG6 of the Implementation Guidance, states:

> The unbundling requirement is intended to capture examples of this kind in which a payment by one party leads to automatic repayments by the other party in a future period. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, paragraph 8 of the draft IFRS confirms that the unbundling requirement is not intended to capture traditional surrender features in life insurance contracts.

The last sentence in paragraph 7 of ED 5 notes that if the cash flows from the insurance component do not affect the cash flows from the deposit component, an insurer shall effectively unbundle the contract into insurance and deposit components.

AcSEC requests clarification as to whether the unbundling guidance in paragraphs 7 and 8 of the ED applies to all property and casualty contracts or only those types of contracts described in paragraph IG6. AcSEC also requests that the IASB explicitly state whether all contracts that contain experience refund provisions by definition should be unbundled and subject to the guidance in paragraph 7.

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to those proposals? If so, what changes and why?

1) AcSEC agrees with the conclusion that prohibits a cedant from recognizing a gain at contract inception, except to the extent that receipts from the reinsurer compensate the cedant for the reinsurer's portion of acquisition costs that the cedant recognized as an expense in the current or past periods, as stated in paragraphs 18(d) and BC 91(c) of ED 5; but recommends that this guidance be included in paragraph 10 of ED 5 as a requirement for Phase I. AcSEC also recommends including guidance that an immediate gain may only be allowed if the reinsurance contract is a legal replacement of one insurer by another and extinguishes the ceding enterprise's liability to the policyholder (as noted in paragraph 19 of U.S. GAAP, FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*).

AcSEC proposes the following wording to be included in ED 5:

> Paragraph 10 (e): shall not recognize a gain at the inception of a reinsurance contract, except to the extent that receipts from the reinsurer compensate the cedant for the reinsurer's portion of acquisition costs that the cedant recognized as an expense in the current or past periods or if the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding enterprise's liability to the policyholder.

2) AcSEC requests clarification as to what is considered the period of underlying risk exposure for income recognition for prospective and retrospective reinsurance contracts.

Paragraph 18 (d) of the ED states:

> If the net amounts paid by the cedant are less than the carrying amount of the related portion of its liability under the direct insurance contract (for example, because that liability is measured on an undiscounted basis), the cedant shall recognize that difference as income on a systematic and rational basis over the period of the underlying risk exposure.

AcSEC recommends that the period of underlying risk exposure for retrospective reinsurance contracts should be the settlement period, as noted in paragraph 22 of U.S. GAAP, FASB Statement No. 113:

> Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period….

3) Paragraph 19 of ED 5 requires that a cedant apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract.

AcSEC believes it would be more appropriate to apply the impairment requirement in paragraph 111 of IAS 39 *Financial Instruments*, as by analogy reinsurance recoverables have similar characteristics to some financial assets. AcSEC believes that the theory for financial assets held at amortized cost in IAS 39, (if it is probable that an enterprise will not be able to collect all amounts due according to the contract, an impairment has then occurred) should also be applied to reinsurance recoverables.

The application of IAS 36 to reinsurance contracts would result in a mismatch of assets and liabilities recorded by the ceding entity in Phase I, as insurance liabilities will be recorded for undiscounted expected losses vs. reinsurance recoverables under IAS 36 on a discounted basis.

Question 8 – Insurance contract acquired in a business combination or portfolio transfer

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- **(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and**
- **(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.**
  This expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

  Are these proposals appropriate? If not, what changes would you suggest and why?

1) AcSEC agrees with the guidance in ED 5 as an interim step in Phase I, requiring that insurance assets and liabilities acquired in a business combination or portfolio transfer be recorded, in aggregate, at fair value, but allowing entities to continue to measure the insurance liabilities in accordance with that entity's accounting policies for insurance contracts, with a separate intangible asset, recorded to reflect the fair value of the contractual insurance rights and insurance obligations acquired to the extent that the liability does not reflect that fair value. However, AcSEC believes that this issue should be further considered in Phase II or a separate business combinations project.

2) AcSEC requests clarification as to when a portfolio transfer should be considered a business combination so that the proper accounting can be followed.

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

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

AcSEC believes it is premature to require fair value disclosure of the fair value of insurance assets and insurance liabilities until the fair value insurance liability model has been deliberated, subject to due process, and operational guidance has been provided. AcSEC is aware that there are a variety of implementation issues associated with fair value measurements, including the discount rate to be used, the level of aggregation or disaggregation of contracts for purposes of fair value measurements (that is, whether an insurance enterprise should value individual contracts or a block or contracts), and the treatment of renewal premiums, which, without adequate guidance, could be subject to differing interpretations. AcSEC notes that the disclosure of fair values can be valuable information to the readers of financial statements, but without appropriate guidance on such a fair value model, disclosures would not be comparable, and may be misinterpreted by readers of the financial statements.

AcSEC also strongly believes that the IASB must give companies adequate time to understand and implement any final fair value model, as it will be a significant change for most if not all companies.

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

AcSEC believes the proposed ten year reserve development disclosure requirement is an excessive amount of information that is far beyond what is normally included in financial statements [ED 5 paragraph 29 (c) (iii)].

AcSEC understands that many insurance companies outside the United States may not maintain their history of loss reserve activity on a calendar year basis, which is the basis required to provide the information proposed for reserve disclosure, to manage the operations of their company. Accordingly, the requirement to provide a ten-year reserve table disclosure could result in significant expenditures by some companies to prepare the necessary data. AcSEC believes that the IASB should reconsider the requirement to provide the ten-year reserve development and, specifically, consider whether the benefit from the disclosure of such information will significantly exceed the cost to prepare the information.

If the Board decides that the benefit of the disclosure exceeds the cost, AcSEC believes that any disclosure that relates to fiscal periods not included in the basic financial statements should be unaudited.

Question 13 – Other comments

AcSEC would like to provide additional comments on the following topics:

1. **Application of IAS 39 to investment contracts**

It is unclear to AcSEC whether the guidance in IAS 39 is being amended through certain paragraphs of ED 5. AcSEC recommends that the IASB provide clarification as to whether certain contracts should be accounted for under ED 5 or IAS 39, such as a derivative that meets the definition of an insurance contract, but strongly believes that revisions or changes to the guidance in IAS 39 should not be included in ED 5 but in a separate document. Combining these revisions could be confusing or possibly overlooked by the reader.

However, if guidance related to IAS 39 is ultimately included within the final IFRS, AcSEC has the following comments:

In paragraphs BC 115 through BC 117 of the Basis for Conclusions of ED 5, the Board noted that some investment contracts have features that are less common in other types of financial instruments, and acknowledged a number of areas in which the measurements required under IAS 39 differ from the measurements that are often used at present under national accounting requirements for investment contracts. AcSEC believes that this situation gives rise to a number of implementation issues that warrant consideration by the Board for the purpose of providing implementation guidance. Such issues include the following:

a. Limitation of the definition of transaction costs to those incurred externally is likely to result in inconsistencies in reporting among entities leading to a lack of comparability. For example, entities that outsource functions such as sales, underwriting, and policy issue will be able to defer such costs when applying the IAS 39 amortized cost method to investment contracts, while entities that manage those functions internally will not.

b. Currently, IAS 39 does not provide for an immediate recoverability test, nor loss recognition testing during the life of the contract (the Board has concluded that amortized cost should not be adjusted when interest rates change, even if the return on available assets is below the effective interest rate on the liability, unless the change in rates impacts the liability cash flows). Should some sort of recoverability or impairment test be required for investment contracts that are classified as “not for trading” under IAS 39?

c. Should cash flow estimates used to determine amortized cost and fair value for investment contracts under IAS 39 include contract maintenance/administration costs? Should cash flow estimates include renewals?

d. The IASB has concluded that future cash flows from assets cannot be taken into account in determining amortized cost unless payments to policyholders are contractually linked to the asset cash flows. However, some contracts that may fall within the scope of IAS 39 are not contractually linked to assets, but their declared interest rates at least in part are based on asset returns less a "spread" (profit assumption). It is not clear how "best estimate" cash flows on such contracts, which will need to include an assumption with respect to credited rates, should be determined in light of the prohibition against using asset-related assumptions in the determination of amortized cost.

e. How should the effective interest method be applied for contracts which provide for the policyholder's direction of allocation of contract account value among various variable investment options? Similarly, how should fair values for such contracts be calculated?

f. Should cash flow estimates be updated to reflect actual experience (similar to FASB Statements No. 97 and No. 120 retrospective unlocking approach)? Some are looking to the accounting for mortgaged back securities, CBO's, etc. for analogies that would allow "reestimation" of cash flows (to update assumptions regarding uncertain cash flows, such as crediting rates, lapses, etc.). Would this analogy be appropriate?

g. Should sales inducements be treated as an adjustment to the liability balance (consistent with transaction costs), or expensed as incurred? Note that the definition of "effective interest method" in IAS 39 indicates that that computation should include "all fees and points paid or received between parties to the contract."

h. Should the calculation of fair value of contractual liabilities be measured at the individual contract level or on a block of contracts? The guidance appears to be inconsistent as paragraph BC 117 (c) appears to discuss individual contract surrender values, and BC 117 (d) discusses the expected surrender patterns of a block of contracts.

2. Loss Recognition

AcSEC agrees with the IASB's concept that a loss recognition test should be performed to reduce the possibility that losses remain unrecognized during Phase I. However, AcSEC notes that the guidance in paragraphs 11 and 12 of ED 5 appears to create two different thresholds for evaluating potential future losses:

1) If the existing accounting policy requires a loss recognition test and that test meets the minimum requirements of the proposed guidance, the IFRS does not impose further requirements on the test.

2) If the existing accounting policy does not require a loss recognition test that meets the minimum requirements of the proposed guidance, the insurer is required to use the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, to determine if a deficiency exists.

As the guidance in IAS 37 is based on a fair value estimate of the liability, any existing accounting policy that does not have a loss recognition test will default to a measurement model that can be labeled the higher of fair value or existing accounting policy. This requirement will lead to the recognition of a loss in the current period followed by a gain in future periods, because a fair value model will result in a risk margin being included in the estimation of the fair value of the liability. As the liabilities are settled over the expected life of the contracts, the risk margin will be unwound creating a gain as the exposure to risk is reduced. However, for most loss recognition tests that are included in existing accounting policies the additional liability that is recognized is an amount that would be necessary to avoid the recognition a future loss over the remaining life of the underlying contracts without consideration of risk margins.

Accordingly, it appears that ED 5 could impose a more stringent loss recognition test on entities whose existing accounting policies do not contain a loss recognition test. AcSEC does not believe it is appropriate to have two types of loss recognition tests and therefore entities following existing accounting policies without loss recognition test should be allowed to follow the same loss recognition test that other entities follow provided those tests meet the minimum requirements of the standard.

Also as the guidance in paragraph 11 of ED 5 does not define "these minimum requirements," AcSEC requests that the minimum requirements that have to be met to continue to use an existing loss recognition test be clearly identified.

3. **Purchased Insurance**

Although, direct insurance contracts in which the entity is the policyholder [paragraph 4(f) of ED 5] are not included in the scope of ED 5, AcSEC would like to address an inconsistency in current IASB guidance.

Prior to the issuance of ED 5, the scope of IAS 39 had not included insurance contracts (whether written or purchased). Currently, the scope of IAS 39 has been revised to exclude contracts that are covered by ED 5. Insurance contracts that are purchased by an entity are not included in the scope of ED 5, per paragraph 4(f) of ED 5. Under the current wording those contracts would be included in the scope of IAS 39 and need to apply fair value.

AcSEC recommends that the current scope of IAS 39 be modified to exclude all insurance contracts, as we believe it was not the intention of the IASB for insurance contracts purchased by an entity to be accounted for at fair value during Phase I.

4. **Policy Loans**

The definition of *insurance liability* in Appendix A of ED 5 is “an insurer’s net contractual obligations under an insurance contract.” AcSEC notes that this definition may be interpreted as requiring policy loans to be netted against the related contract liability, and recommends allowing policy loans to be classified as assets during Phase I. The treatment of policy loans should be addressed in Phase II.

Appendix A – Additional Items to Include in IG Example 2: Embedded Derivatives

Type of embedded derivative	Treatment if embedded in a host insurance contract	Treatment if embedded in a host investment contract
Non-guaranteed participating dividend contained in a life insurance contract, or non-guaranteed experience refund contained in a workers compensation contract; based on actual experience of the insurance enterprise with respect to the related block of insurance contracts.	The embedded derivative is not an insurance contract. However, it does not satisfy the definition of "derivative". Payment of the dividend or experience refund is discretionary on the part of the insurance company and is based on results (investment, mortality and expense) of the block of business in which the contract is included, rather than on results related to that specific contract alone. Further, there is no requirement to "settle" the dividend or experience refund feature at a future date because it is not guaranteed. Fair value measurement is not required.	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
Contract that provides for a return through periodic crediting rates, surrender adjustments, or termination adjustments based on a specified proportion of the insurance company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of its investment securities).	The embedded derivative is not an insurance contract. It transfers the credit risk of assets to the policyholder, and is not considered closely related to the contract (paragraph A4 (h) of IAS 39). Fair value measurement is required.	Fair value measurement is required.
Cash surrender option embedded in an insurance contract, which provides for the policyholder's direction of allocation of contract account value among various variable investment options. The cash surrender value varies in response to the changes in the market value of the variable investment options in which the policyholder has invested his or her account balance, and is not subject to a minimum floor guarantee.	The embedded derivative is not an insurance contract. However, the value of the cash surrender option is closely related to the host contract, which is considered to have equity characteristics. Fair value measurement is not required.	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
Cash surrender option embedded in an insurance contract, which provides for the policyholder's direction of allocation of contract account value among various investment alternatives, including both fixed and variable options. The cash surrender value with respect to the portion of contract account value allocated to the variable investment options varies in response to the changes	The embedded derivatives (the variable and fixed cash surrender options) are not insurance contracts. However, the value of the variable cash surrender option is closely related to its host contract, which is considered to have equity characteristics. Similarly, the value of the fixed cash surrender option, and the related minimum guarantee, is closely related to its host contract, which has	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

in the market value of those variable investment options, and is not subject to a minimum floor guarantee. The cash surrender value with respect to the portion of contract account value allocated to the fixed investment options is based on the value of the deposit to the fixed alternatives with interest accrued, and is subject to a minimum floor guarantee.	debt characteristics. Fair value measurement is not required.	