



## **The Life Insurance Association of Japan**

June 11, 2002

Sir David Tweedie  
Chair  
International Accounting Standards Board  
30 Cannon Street, London EC4M 6XH,  
United Kingdom

Dear Sir David:

This letter is submitted on behalf of the American Council of Life Insurers (ACLI), the German Insurance Association (GDV) and the Life Insurance Association of Japan (LIAJ) and is a follow up to the joint letter we submitted to you on March 21, 2002. The ACLI is the principal trade association of life insurance companies in the U.S., and its 399 members represent, in the aggregate, 75 percent of the assets of all domestic life insurers in the U.S. The GDV, with its 447 members, represents about 97% of the German insurance market calculated by premiums written. The LIAJ is the industry organization composed of all life insurance companies in Japan whose purpose is to promote development and public trust in the Japanese life insurance industry.

As noted in our previous letter, we support the Board's objective of improving accounting standards worldwide. We are issuing this letter in order to provide you with additional comments on the proposals set forth in the Draft Statement of Principles on Insurance Contracts (DSOP) that we believe you should consider before reaching any final conclusions. In that regard, our comments in this letter focus on the following important issues:

- Choice of Accounting Model
- Recognition of Gain or Loss On Issue
- Participating Insurance Contracts
- Assumptions
- Market Value Margins
- Discounting of Deferred Taxes
- Inconsistencies With Other Standards
- Audit Issues
- Cost of Implementation and Time to Convert

In addition, we are also sharing with you potential alternatives to the approach set forth in the DSOP for further evaluation.



## **The Life Insurance Association of Japan**

### **Summary of Our Comments**

- We believe that deferral/matching accounting is viable, preferable and a more appropriate approach for insurance contracts. Aspects of deferral/matching that we believe are relevant are:
  - Earnings are recognized as the earnings process is completed, i.e. as risk is released;
  - Future gains/losses are not recognized at issue;
  - Income statement is based on the realization concept, which is based on the reliance on recognizing revenues and expenses in some uniform manner over the expected life of an insurance contract; and
  - Is better suited for insurance liabilities which are generally held to maturity, i.e. illiquid.
- The proposed asset/liability approach set forth in the DSOP has numerous conceptual and practical issues, including:
  - Immediate recognition of the fair value of the estimated future profitability associated with insurance contracts, especially long-term contracts, sold during the reporting period;
  - Lack of a clear definition and guidance on the calculation of market value margins,
  - Inconsistency of the IASB prohibition of discounting deferred taxes with the treatment of other expected cash flows; and
  - Results that are difficult to understand and illogical when modeling certain insurance products.
- There are inconsistencies in accounting for insurance contracts versus noninsurance contracts. For example, insurance contract acquisition costs must be expensed immediately under the DSOP proposal, but costs incurred in issuing debt or selling mutual funds are capitalized and subsequently amortized.
- Implementation of the proposals set forth in the DSOP will be costly and will require a great deal of lead-time. We do not believe that an insurance accounting standard can be implemented by 2005. As a temporary solution, we support the Board's recent decision to explore the utilization of existing recognized accounting practices for insurance contracts.
- We encourage the Board to consider alternative approaches for accounting for insurance contracts as outlined in this letter. To assist the Board, we plan to evaluate the various alternatives expressed in this letter and share our observations with you.



## **The Life Insurance Association of Japan**

### **Choice of Accounting Model**

The DSOP discusses two major approaches for accounting for insurance contracts: 1) a deferral/matching approach and 2) an asset/liability approach. The IASC Steering Committee chose the latter approach. We believe that the deferral/matching approach is appropriate and preferable for life insurance contracts for the following reasons:

- Life insurance is a long-term undertaking and temporary fluctuations of financial markets do not influence how the insurance industry recognizes its liabilities. The deferral/matching approach recognizes revenues and expenses in a systematic and rational manner over the life of the business while allowing for adjustments relating to new facts and circumstances as they arise. We encourage the Board to revisit the existing deferral/matching accounting standards issued throughout the world and address concerns with certain ‘baked in’ assumptions rather than adopt an asset/liability based accounting standard.
- Exit value is not representative of how insurers extinguish their liabilities. Insurers generally settle their liabilities by payment to the policyholder’s beneficiary rather than by transferring their obligations to third parties (i.e., held-to-maturity.)
- Under the DSOP asset/liability approach, there can be an immediate recognition of profit (or loss) on an insurance contract sold during a period. We believe that such an immediate recognition of gain or loss detracts from the usefulness of the results. We believe that it is more appropriate to recognize earnings over the service life of the policy.

Because of the unique characteristics of insurance contracts and the lack of a secondary market, we believe that the accounting guidance should be based on the principle that insurance contracts are held-to-maturity. Revenue should be recognized as the insurer is released from risk (e.g., similar to percentage-to-completion method) over the life of the contract.

Current deferral and matching accounting concepts are well understood by analysts and the industry. It has not been effectively demonstrated that a fair value accounting model will improve the usefulness of the financial statements.



## **The Life Insurance Association of Japan**

### **Recognition of Gain or Loss On Issue**

Any model for life insurance contracts must recognize that assets are purchased in support of liabilities. Under the DSOP, neither the types of assets backing the liabilities, nor the returns on those assets would be considered when valuing the liabilities (except for performance-linked products and products whose cash flows depend directly on the supporting assets, such as variable or unit-linked products). However, this guidance is contrary to how insurance companies actually value potential acquisitions and divestitures of blocks of business. In reality, an embedded value approach is utilized that links the cash flows of the asset and liabilities of the business. The DSOP also ignores how companies price their insurance contracts and this can lead to gain/loss recognition at issue.

Many products that rely upon interest margins to generate profits (e.g., an immediate annuity) will show excess losses upon issue and inflated gains thereafter. For policies where the premiums have significant margins, either because they are participating and include margins for potential dividends (e.g., participating life policies) or because of excessive statutory reserve requirements (e.g., level term policies), the asset/liability model could create the unusual situation in which the present value of future premiums significantly exceeds the present value of future benefits and expenses resulting in either a negative liability or recognition of an asset on the balance sheet and a gain at issue.

Under a deferral/match approach, such situations cannot arise. We believe that the results produced under the DSOP are an inappropriate way to measure performance. If a similar concept were applied to a manufacturing entity, it would result in that entity recording a portion of its manufacturing profit as its products were being produced rather than when sold.

### **Participating Insurance Contracts**

A significant area in the DSOP where guidance is lacking is the accounting for participating contracts. Such contracts represent a substantial portion of insurance liabilities in the U.S. and Japanese insurance markets, and the lack of resolution of the issues associated with these contracts is troublesome.

One of the unique issues affecting U.S. and Japanese mutual life insurance companies relates to their participating contracts. In a U.S. and Japanese mutual life insurance company, the Board of Directors has discretion in deciding the amount and timing of dividends paid to policyholders. Our understanding of the DSOP regarding participating business is that it assumes assets and liabilities related to a given pool of participating contracts are held in a separate fund. A significant concern is that the DSOP does not adequately address accounting for participating contracts (e.g., those issued in the U.S.



## **The Life Insurance Association of Japan**

and Japan that don't use a fund approach). However, we believe that the current version of the DSOP would conclude that a liability for such potential future dividends should not be established until declared by the Board of Directors. Therefore, without a deferral/match approach, the premium margins for potential future dividends included in participating insurance contracts creates a gain at issue.

### **Assumptions**

The most significant aspect in developing any model for life insurance contracts is choice of proper assumptions. A small change in a given assumption can have a significant effect in the statement of operations and this will result in volatility. Also, because there is no secondary market for insurance contracts, it will be difficult to measure and validate market assumptions. There is a risk that lack of specific guidance and the inability to validate assumptions may challenge the comparability of results across companies, especially when judgment is involved. Therefore, specific guidance on how to choose and report assumptions must be developed.

### **Market Value Margins**

One area of concern in the current draft proposal is the determination of market value margins (MVM). This is a critical assumption that companies must include in its cash flows. However, there is no guidance in the DSOP on how these margins should be determined. We strongly believe that actual market value margins are elusive to determine. Also, in order for some product accounting to make sense (e.g., immediate annuities), the MVM must be negative to avoid a loss at issue. Until clear guidance is issued on MVM's or alternative approaches are considered, it is impossible to fully evaluate if the model set forth in the DSOP works.

### **Discounting of Deferred Taxes**

Under the DSOP, all cash flows are to be discounted except deferred taxes. However, we believe income taxes should be taken into account in the calculation of insurance liability cash flows. If income taxes are not discounted, then present value calculations of cash flows will not capture all events, especially temporary tax differences which originate and reverse in future periods related to existing insurance contracts. This failure to capture all events related to an insurance contract strains the credibility and usefulness of an already questionably computed fair value estimate.

### **Inconsistencies With Other Standards**

IAS 39 paragraph 93 requires that after initial recognition all financial liabilities, other than liabilities held for trading, to be recorded at amortized cost. Insurance contracts



## **The Life Insurance Association of Japan**

have some characteristics that are similar to financial liabilities in that they contain a promise to pay a third party at a future date. However, unlike most financial liabilities, there is no meaningful secondary market for insurance contracts. Insurance policies are normally “held to maturity” by the issuing company and settled with the policyholder or the beneficiary at their “face amount” under the terms of the contract. We do not see any rationale for a different accounting treatment for a financial liability that will be held to maturity versus an insurance contract that will be held to maturity.

Another inconsistency is the treatment of acquisition costs between insurance contracts and noninsurance products. For example, costs incurred in issuing debt are capitalized and subsequently amortized over the life of the debt. Under U.S. GAAP, certain costs incurred in distributing mutual funds (which are supported by future 12b-1 fees) are capitalized and subsequently amortized. We do not believe debt issue costs or mutual fund distribution costs are substantially different from costs incurred in selling insurance contracts. Companies should be allowed to defer and amortize insurance contract acquisition costs over the life of the contract similar to the noninsurance products cited above.

### **Audit Issues**

It is difficult to know what audit issues may emerge as a result of a new accounting standard until a definitive document is made available. However, we believe that the extension of fair value concepts to insurance contracts would add complexity to the audit especially where material amounts of life insurance contracts are reported based on management’s estimate of fair value. It seems to us that an analogous situation exists where a material amount of a mutual fund’s investments are carried at amounts determined in good faith. In that situation, the AICPA’s *Investment Companies* Audit Guide states the following:

“The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund’s directors. Instead, the auditor should review the company’s procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed, and make certain that these methods have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities, and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose. The auditor should also become familiar with the provisions of the SEC’s financial reporting releases on this subject, especially section 404.03.





## The Life Insurance Association of Japan

Good faith security value estimates may present the auditor with unique reporting problems. As previously discussed, securities should be stated in financial statements at amounts that represent what could have been realized on a current sale. In the absence of a bona fide offer to buy, those amounts are generally not determinable for securities that do not have readily ascertainable market values. The board of directors' fair valuation procedures are designed to approximate the values that would have been established by market forces and are therefore subject to uncertainties."

The Audit Guide goes on to address the potential need for the auditor to consider expressing a qualified opinion or a disclaimer of an opinion if the auditor is unable to obtain sufficient evidential matter to support management's assertions involving an uncertainty and its presentation or disclosure in the financial statements. Before an insurance contracts accounting standard can be finalized, issues concerning the auditor's ability to express an opinion as well as management's ability to measure and understand the methods and assumptions associated with life insurance contracts need to be addressed.

### **Cost of Implementation and Time to Convert**

While it may be desirable to implement an accounting standard for insurance contracts to meet the European Union's 2005 timeline, before the standard can be finalized, the IASB must undertake comprehensive modeling exercises to understand the impact it will have on the financial statements of reporting companies.

The proposals currently set forth in the DSOP would be a significant change for the insurance industry and could be extremely costly to implement. The DSOP would require extensive disclosures that would be a significant undertaking for many entities, especially those that currently do not have the data captured in the required format, let alone the systems to project and report such financial information. In that regard, information technology systems and architecture will need to be redesigned and extensively tested. Companies will need to assess what new data is required and where to get this data. For large companies, these disclosures could be a significant book by themselves.

Multi-national companies also would need to define/refine global modeling platforms to meet the new reporting requirements. In particular, systems will be required to perform stochastic and option-pricing modeling, earnings analysis, and forecasting. Tools will need to be developed to value insurance liabilities and guarantees and options embedded in contracts, to analyze the components of earnings, and to be able to calculate insurance liabilities at future time periods. Further, forecasts must be able to show what will happen to earnings if the economic environment changes.



## **The Life Insurance Association of Japan**

For these reasons, we do not believe that implementation of an insurance contract standard by 2005 is possible.

### **Temporary Solutions and Permanent Alternatives**

We support the Board's recent decision to explore the utilization of existing recognized accounting practices for insurance contracts as a temporary solution.

We believe that there are other viable methods, as alternatives of the DSOP proposal (i.e. permanent accounting standards), for valuing insurance contracts other than fair value and that a workable model can be developed. Some of the models that we believe the IASB should explore are as follows:

- Deferral/matching approach or a deferral/matching approach modified for dynamic and unlocking assumptions of cash flows.
- Modify the current DSOP approach to incorporate the favorable attributes of a deferral/matching approach that recognizes that insurance contracts are held to maturity and that earnings emerge over the life of the contract as risk is released.

### **Final Observation**

While "mark to market" accounting might have its places, application of such an approach where there are no verifiable market prices lends to situations where entities are free to develop and use valuation models based on their own assumptions and methods which can get out of hand. For example, consider the following excerpt from an article entitled "*The Rise and Fall of Enron*" written by C. William Thomas appearing in the April 2002 edition of the Journal of Accounting.

"Enron incorporated "mark-to market accounting" for the energy trading business in the mid-1990s and used it on an unprecedented scale for its trading transactions. Under mark-to-market rules, whenever companies have outstanding energy-related or other derivative contracts (either assets or liabilities) on their balance sheets at the end of a particular quarter, they must adjust them to fair market value, booking unrealized gains or losses to the income statement of the period. A difficulty with application of these rules in accounting for long-term futures contracts in commodities such as gas is that there are often no quoted prices upon which to base valuations. Companies having these types of derivative instruments are free to develop and use discretionary valuation models based on their own assumptions and methods.





## The Life Insurance Association of Japan

The Financial Accounting Standards Board's (FASB) emerging issues task force has debated the subject of how to value and disclose energy-related contracts for several years. It has been able to conclude only that a one-size-fits-all approach will not work and that to require companies to disclose all of the assumptions and estimates underlying earnings would produce disclosures that were so voluminous they would be of little value. For a company such as Enron, under continuous pressure to beat earnings estimates, it is possible that valuation estimates might have considerably overstated earnings. Furthermore, unrealized trading gains accounted for slightly more than half of the company's \$1.41 billion reported pretax profit for 2000 and about one-third of its reported pretax profit for 1999."

There is no question about whether a theoretical model could be developed and required for insurance contracts. The real question is whether doing so would make matters better or worse. A former SEC Chief Accountant was recently quoted as saying that companies can now fiddle with their assets by reporting items that have no market value, such as goodwill, deferred income taxes and the cost of raising capital and the answer to this problem was to pass a law requiring all corporations to institute "mark to market" accounting. We believe that the situation discussed in the above excerpt is similar to requiring a fair value approach for insurance contracts which, although might be very scientific in design, is not based on verifiable values, and would just be providing additional rosin for the fiddlers' bows.

\*\*\*\*\*

The issues set forth in this letter need to be thoroughly discussed before the draft standard on accounting for insurance contracts can be released. We thank you for the opportunity to present our views on this important project. We look forward to further discussions with the IASB and its staff regarding the points raised in this letter as well as potential issues related to the outstanding DSOP chapters.

Respectfully submitted:

American Council of Life Insurers  
German Insurance Association  
Life Insurance Association of Japan