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FASB Issues Invitation to Comment on Bifurcating Insurance Contracts

Companies that purchase or sell insurance should take note — the FASB recently issued an Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (the "Invitation"), for a project that could significantly affect the accounting for certain insurance contracts. In total, the Invitation asks for comments on 11 different issues, and provides illustrations to serve as a basis for discussion. Comments on the Invitation must be submitted to the FASB by August 24, 2006.

Any business that buys or writes insurance could be affected by this project, which endeavors to have insurance and reinsurance accounting more realistically depict the economic substance of those transactions. The project was prompted in part by recent allegations of abuses in accounting for finite risk insurance and reinsurance contracts. The Invitation does not present any tentative conclusions of the FASB; rather, it is a neutral discussion document whose sole purpose is to solicit information that will help the FASB in its discussion of the issues. **Certain concepts discussed in the Invitation, if adopted, would have a dramatic impact on buyers and sellers of insurance**. Effects could include:

- Requiring the buyers (including non-insurance companies) of many types of insurance to perform extensive analyses to determine whether insurance risk has been transferred, and establish or update their systems to enable them to bifurcate the "risk" elements of the contracts from the "financing" elements.

Editor's Note: Examples of insurance contracts that could be affected include:

- Group accident and health
- Auto insurance for a fleet of automobiles
- Umbrella coverage

- Requiring the "financing" elements of insurance contracts to be accounted for as deposits, even if there are no risk-limiting features to the contract. This would significantly change the income statement results, because the financing element would be treated as if that portion of the risk had been self-insured. For example, a company buying workers' compensation insurance that provides for coverage of losses for a fixed, nonadjustable premium could be required to bifurcate and treat as a deposit the portion of the premium that relates to a level of losses likely to occur. In addition, the buyer would record losses for the expected level of losses without the benefit of insurance.
- Changing the tax treatment of insurance and reinsurance contracts.

The Board is seeking feedback from constituents about:

- How to define an insurance contract and insurance risk,
- Whether insurance and reinsurance contracts should be bifurcated into insurance and deposit/financing components,
- Which insurance and reinsurance contracts should be bifurcated, and
- How those contracts should be bifurcated.

Although a focus of the project is to assess whether bifurcation of insurance contracts into insurance and deposit components will improve the understandability and decision usefulness of financial statements, the project does not intend to change existing accounting for insurance or deposits (i.e., the project would focus solely on the identification of the insurance and financing elements of a contract; it would not affect the subsequent accounting for those elements).

The Invitation suggests a methodology that applies a series of screens to identify contracts that should be bifurcated. Those screens include determining whether the contract:

- Meets the definition of an insurance contract;
- Includes an embedded derivative that must be bifurcated under Statement 133[1];
- Unequivocally transfers significant insurance risk (as defined in the Invitation), thereby screening out contracts with negligible noninsurance features from the bifurcation analysis;
- Meets the risk transfer tests set forth in Statement 113[2] (any contract failing to do so must be accounted for as a deposit);
- Should be screened out or in based on contractual terms or features that would be specified in the final guidance. The Invitation offers two alternatives for discussion — Approach A, which would require all contracts that include a significant financing component to be bifurcated, and Approach B, which would require bifurcation for all contracts not previously screened out.

Editor's Note: As currently defined in the Invitation, group contracts would not qualify as contracts that unequivocally transfer insurance risk. These contracts would require further analysis to determine if they should be bifurcated.

The screens will require buyers and writers of insurance to exercise even more judgment than is required under existing accounting. The screens incorporate the risk transfer tests currently set forth in Statement 113, and will expand their use by having them apply to more insurance contracts. These tests require significant judgment, and have been the key criteria used in current accounting to identify those reinsurance (and, by analogy, insurance) contracts that require deposit accounting. Even more judgment will be required to apply the final screen outlined in the Invitation. Unless Approach B is adopted, the final screen would require almost all companies to determine whether the financing elements of a contract are significant enough to warrant bifurcation.

Three possible approaches for determining the amounts that should be bifurcated are discussed in the Invitation. One approach, the *expected payout method*, characterizes as a deposit those contractual components that are likely to produce insignificant variability in cash flows (i.e., those that transfer little or no insurance risk). A second approach, the *proportional method*, calculates 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 is then applied to the contract's cash flows to identify the deposit component, and the remaining cash flows will represent the insurance component. The third method, the *cash flow yield method*, characterizes cash flow elements that yield the interest rate on an assumed loan as financing cash flows (i.e., a deposit), and cash flow elements that produce a yield in excess of the interest rate on that loan as insurance.

The Invitation does not detail how these bifurcation methods might operate, and observes that additional research about their operationality will need to be performed.

Download the Invitation at http://www.fasb.org/draft/ITC_Bifurcation_Insurance.pdf.

[1] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
[2] FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

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